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Socialist central economic planning: an analysis of challenges in theory and in reality

Luís Miguel Barbosa Fernandes

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FEP FACULDADE DE ECONOMIA
UNIVERSIDADE DO PORTO

SOCIALIST CENTRAL ECONOMIC PLANNING: AN ANALYSIS OF
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Luís Miguel Barbosa Fernandes

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Diogo Lourenço

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Abstract: The discussion regarding which economic organization system is superior, socialism or capitalism, has inspired many economists and social scientists over the centuries to write extensively about the characteristics and shortcomings of either of these systems. This dissertation aims to examine the fundamental theoretical contributions to this great historical debate, focusing on the socialist system particularly. These shall be complemented by the documented experience of real life socialist economies, so that we can obtain greater insight on how socialist systems operate and what flaws hinder their functioning. To this effect, I group the challenges faced by the socialist central planning system into four categories: those related to the impossibility of economic calculation and rational decision-making; those linked to the transmission of knowledge and its essential role in coordinating economic activity; issues connected with incentives, initiative and delimitation of responsibility; and, finally, the problematic relation between socialism and authoritarianism. The analysis concludes that all of these problems are invariably connected to central aspects of the socialist economy, and that reforms aiming to solve them involve radical shifts which have a high possibility of either being rejected outright or of causing such disruptions in the system's functioning that they eventually lead to its collapse.

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1. Introduction

To the casual observer, the object of study of the science of Economics is unclear. They certainly hear and see economists, politicians and other experts discussing “the economy”. Yet, what exactly an economist does or what the economy is escapes their grasp. But even to those of us trained in the socioeconomic sciences, as we get acquainted with the various fields – microeconomics, econometrics, finance, marketing, accounting, international trade, public economics, corporate law etc. – it may become a bit elusive what exactly has one been studying all along in his path to becoming an economist.

Economics is not *just* the science that studies money. It is not *just* the science that studies the market and exchange. It is not *just* the science that studies production, distribution or consumption. It indeed may study all of these, but because it taps into something much more fundamental, at the base of all of these. Economics is the science of human action and choice, the science that studies how the individual, seeking to satisfy his numerous needs, chooses to utilize the scarce means available to him in such a way as to reap the most benefit from their utilization (Mises, 1932/1951, pp.113-114; Lourenço & Graça Moura, 2018, p.3).

Naturally, throughout the ages, economists and other social scientists have dedicated themselves to understanding how this process unfolds and to discovering the forms of socioeconomic organization promoting a use of resources that is rational, efficient and thus conducive to well-being. In this vein, great discussions have flourished, pitting capitalism against socialism, while numerous theorists have written about the functioning, merits and flaws of each system. Concurrently with theoretical discussion, there exist extensive analyses of the historical functioning of several variations of these systems. The history of socialist economies is particularly interesting. Following a Revolution leading to the creation of the USSR, the socialist framework (especially the Soviet-inspired system of socialist central planning) has been experimented with in several countries across the world. Yet, in recent years, most countries have either abandoned the socialist system altogether, as did many countries formerly in the Soviet Union, or, as China or Vietnam, they have made extensive reforms in order to energize their economies. The countries that maintained the centralized socialist system, such as North Korea or Cuba, are hardly examples of developed and flourishing economies. One must then ask what problems undermined the functioning of the socialist system, problems that might have been

overlooked or not given due importance in the works of socialist theorists; problems that hindered its ability to provide the welfare that its proponents dreamt of.

It is to this question that I intend to contribute, by compiling and analyzing the literature on the theoretical problems that a socialist system faces, conjointly with works that investigate the reality of socialist economies, past and present. In doing so, I seek to understand the degree to which theoretically anticipated issues manifest themselves in practice. I focus to what has been called, among other names, the centrally planned socialist economy. This is the variety of socialist system that has been most discussed in the literature, the one commonly opposed to the market economy, and the one which has been most frequently attempted.

A study of this nature is relevant, first and foremost, as an overview of the considerations that economists and other social scientists have expressed on themes such as “socialism”, “liberalism”, “capitalism”, “central planning”, “planned economy”, “market economy” and related topics. It fosters a better understanding of what these terms mean, of what differentiates socialist from capitalist systems, and what system-specific problems socialism faces. I believe that the major contribution of this dissertation is in the analysis and comparison of the theoretical and practical problems faced by centralized socialist societies. The theoretical reflection underpinning this dissertation draw a lot from the challenges discussed by the Austrian School of Economics. While not the first nor the only to tackle possible issues in the theoretical workings of a socialist economy, earlier investigations remained, as Hayek (1935a, pp.26-28) noted, confined to superficial inquiries into how the socialist economy could work. The economists of the Austrian School were among the first to make a systematic critique of the foundations of socialist economic theory. The crux of their criticism was that any socialist economy, properly called, lacked certain features of the decentralized market economy on which hinge its ability to allocate resources in an efficient and productive manner and to foster progress. My selection of problems is heavily based on the problems discussed in the works of these economists:

- The *problem of economic calculation* was brought forth in the debate spurred by Ludwig von Mises’ challenge, in which he argued that a socialist society, unable to rely on the price system and the information it imparted, lacked the tools to establish a working economy.
- Friedrich Hayek subsequently expanded upon Mises’ challenge, and concluded that the proposed methods of organization for a socialist society lacked the ability to

use and even discover the knowledge needed for intersubjective coordination and for the adaptation to changing circumstances that any working economy must face – this is the basis for the *problem of knowledge* that I will present.

- The *problem of incentives, responsibility and initiative* relates to how the elimination of private ownership and of the link between productivity and income prevents the delimitation of responsibility, limits initiative to innovate and lowers the incentive to engage in productive activity.
- More distant from economic matters, the *problem of tyranny* addresses the historically conspicuous penchant of socialist systems towards authoritarianism – of the many works on the topic, Hayek's *The Road to Serfdom* is especially noteworthy.

This work will be structured as follows. The section following this introduction is a reflection on the socialist and capitalist forms of economic organization, what defines and distinguishes them. The third to sixth sections each detail a different challenge that a socialist economy might face, as discussed in political-economic theory; this is accompanied throughout by a description of those issues as they arose in the real-world socialist experiments of the past and present (the Soviet Union is evidently the textbook case, but other significant examples are China, Cuba, Czechoslovakia, Romania, and many others). The concluding section finishes by looking at the economic system as an organic whole, in an attempt to establish that the problems here presented cannot be solved within the framework of socialist central planning nor through the assimilation of capitalist institutions into said framework.

2. Clarifying Concepts

If we wish to explore systems of socioeconomic organization, more specifically socialism and capitalism, then the logical place to start is by defining what these terms refer to. This is not a simple task.

2.1. Socialism Defined

Over the decades there has been ample discussion over what exactly makes a system of socioeconomic organization capitalistic or socialistic. Socialism in particular, which will be my main focus, has quite a malleable definition, as Schumpeter noted (1976, pp.167-168). Kornai (1992, pp.9-10) likewise points out that there is much disagreement over what constitutes “true socialism”, even among proponents of socialism¹. This dissertation is by no means an extensive ideological inquiry into what constitutes “true socialism”. However, working definitions are needed. I opt to take the road taken by most economists that speak on the subject: when I speak of a socialist society, I speak of a society where the means of production are collectively owned (at least predominantly) and directed according to the wishes of the administrative organ meant to represent the community; a society where private ownership and enterprise are, to a great extent, erased (Hayek, 1935a, p.15; Mises, 1920/1935, p.89; 1932/1951, p.128). In this work, I turn my focus specifically towards *centralist socialism*, where a single authority is bent on concentrating control over all means of production (and coincidentally, on erasing private ownership), and employs mechanisms of bureaucratic coordination (of which economic planning is one) in order to allocate the collectivized resources and direct the activity of people in the system (Kornai, 1992, pp.89, 97-98; Schumpeter, 1976, pp.167-168). This is the form of socioeconomic organization most often opposed to the market economy in the literature, as well as the model which has seen the widest application in the real world, so it is the one which can provide a more enriching and fruitful analysis. It is sometimes also called “centrally planned economy”, “command economy”, “state socialism”, “Soviet-type economy” or “communist economy”, among other names².

¹ This is exemplified by the political-ideological conflicts between Stalin in the USSR and Tito in Yugoslavia, or between the post-Stalin Soviet Union and both Mao’s China and Hoxha’s Albania, with these last two having their own ideological split later (Kornai, 1992, pp.9-10).

² This latter label is used much more by press and politicians and not so much in scientific discussions. Marx and Engels never really differentiated between the terms “communism” and “socialism”, only between an earlier and later stage of the socialist society. Only much later did Stalin attribute the label “socialism” to the

Kornai (1992, pp.6-7) assembled a very complete list of countries from all across the globe that can be said to correspond to the definition of “socialist countries”. Kornai (1992, pp.5, 9) also rightfully notes that the most important countries to any analysis of the socialist system are those where its existence was longer than a decade or two, allowing its institutions the opportunity to properly settle and develop. Taking into account that most socialist regimes collapsed in the late 80s to early 90s, this means that, with few exceptions, the countries whose regime’s inception is later than the early 60s are countries where, although the seeds of socialism may have been sown and flourished, the system never grew to its fully-fledged form. The USSR is the quintessential example of this, but others include European nations such as Albania, Hungary, Poland or East Germany, Cuba in America, and, in Asia, countries such as China, Vietnam, Mongolia or North Korea.

Despite inevitable differences in detail among these countries, they are united by certain characteristics that allow them to be classified as socialist economies. The first is the rule of a single party imbued with an official ideology³. One of the most important ideological principles to note is the belief in the superiority of the socialist system, both on economic and ethical terms. But more than a means to reach a more prosper and just society, the socialist system is seen as something to strive for by itself, independently of the wellbeing it is believed to bring (Kornai, 1992, pp.50-53). Another prominent aspect of the ideology is its paternalistic conception of society: the provision of work, goods and general satisfaction of needs of the population is seen as the responsibility of the ruling powers. This cultivates an elevation of the party’s authority over the people – the party’s will is seen as infallible and as something which must be enforced for the good of the people, even if they protest against it (Kornai, 1992, pp.53-57).

These countries also have in common a clear predominance of state-owned property, an evident result of the ruling party’s ideological aim of eradicating private property and capitalism (Kornai, 1992, pp.361-362). State ownership can take the form of state-owned

earlier stage after the fall of capitalism, where the state holds full control over production and pays wages to each individual according to his contributions and to economic considerations, while “communism” was said to refer to the later stage, where the state and other institutions “wither away” and the social production would be distributed to all according to their needs (Kornai, 1992, p.10; Mises, 1932/1951, pp.543, 552). For these reasons I abstain from using the term communism and opt to use socialism to denominate the society in which there is collective ownership of the means of production and the power to put them to use lies with a single authority, which for this purpose employs the tools of bureaucratic control.

³ The party is generally known as the Communist Party, but labels such as Socialist, Workers’, Labor, People’s, Revolutionary Party or combinations of these are commonly used. The ideology, often called Marxism-Leninism, is in fact built upon several layers, of which the teachings of Marx and Lenin are only a fraction (Kornai, 1992, pp.49-50, 360-361).

firms, which may be owned by either the central government or one of its regional branches, or budgetary institutions, which are directly financed by the state and do not need to make revenue to cover their expenses (*e.g.*, public hospitals, schools or museums) (Ericson, 1991, pp.12-13; Kornai, 1992, pp.71, 76). Cooperatives, while advertised as voluntary associations, are in fact intimately tied to the state: the state selects the cooperative's leadership, and closely regulates how the income it generates and the means of production at its disposal are used (Kornai, 1992, p.76-77, 79-80). Private property, still subsists, despite the constant efforts working towards its eradication, but only in a residual form: small household farms, small industrial or commercial enterprises⁴, and in all kinds of activities across all shades of legality that comprise the informal economy (private house construction, cleaning, repair work, legal advice, trading of legally imported or smuggled goods, etc.) (Ericson, 1991, p.13; Kornai, 1992, pp.85-86).

The last great unifying feature of these socialist economies is the bureaucratization of socioeconomic activity, by which superior-subordinate relations and the forms of control typical of an administrative apparatus are expanded as the party seeks to place everything under its control (Kornai, 1992, pp.108-109, 362-363). A centralized bureaucracy makes almost all decisions and oversees and coordinates almost all activity. A plethora of administrative branches and departments gather information and transmit it to higher authorities, issue orders and monitor subordinate performance. Subordinates are stripped of autonomy, except in minor details of the implementation of their assigned tasks. A system of incentives which rewards only compliance with commands is quickly formed (Ericson, 1991, pp.12-13, 19).

2.2 Capitalism Defined

Capitalism is likewise an unclear term. However, with a clearer definition of what socialism is, we can establish its meaning via a process of "reverse engineering". Since this is the system that contrasts with socialism, logic would dictate it refers to a society where private ownership of the means of production is predominant, in which no single authority holding power determined to eliminate private property exists, and where the market is the main means of coordination, through prices and contracts (Kornai, 1992, pp.89-90, 92;

⁴ Even these were only allowed in a few countries, such as Hungary, East Germany or Poland (Kornai, 1992, p.84).

Schumpeter, 1976, p.167). Schumpeter (1976, p.167) further adds that capitalism is distinguished by the existence of credit creation, which enables enterprises to be funded via credit. I see no reason to disagree with this further criterion, and find that it is quite useful to further differentiate capitalism, since institutions such as private property and markets (although certainly in different forms) predate the industrial period that is often considered to have given rise to modern capitalism. As Kornai (1992, pp.67-70) detailed, capitalism is typically dominated by three property forms:

- Family undertaking – the household and the production unit meld together, as the family consumes some of the production and sells the rest. It is differentiated from other property forms also by the fact that it does not employ outside labor (*i.e.*, people outside of the family), at least not to any significant and lasting degree;
- Owner-managed private firm with unlimited liability – similar to the family undertaking, except that outside labor is commonly employed. It differs from the company form in the fact that the owner is responsible for the firm's debt to the extent of his own personal wealth, and not just limited to the wealth tied up in the firm;
- Joint-stock company – in this form the company is owned by many proprietors, although there can certainly exist concentration of company shares in a few people. The company is a separate legal entity from the owners, so unlike the firm with unlimited liability, the proprietors are only liable for debts to the extent of their investment in the firm.

2.3. Economic System Defined

An economic system is the means by which a society decides how to allocate resources to different objectives, and how the claims to goods and services and the income that result shall be distributed among its members (Bornstein, 1993, p.4; Neuberger, 1993, p.24). While the exact delimitation of what falls within this definition sees no consensus and is necessarily arbitrary to some degree, I would contend that its flexibility serves the purposes of this work quite well. Socialism, much like liberalism, conservatism, fascism and most other competing ideologies, does not confine itself to prescribe how foreign trade will be conducted, how the financial sector will work or how firms will be structured; rather, it intends to establish the framework within which society at large shall operate. This

definition's flexibility allows for the political system, the values that the system fosters and the ones that motivate its participants, and other things which can greatly influence the manner in which resources are directed and the ends towards which they are directed, to be considered and analyzed as well. As such, while my analysis will certainly be centered on the more "purely economic" aspects of the system, I will occasionally branch out beyond them – I find that this is not only inevitable in a topic such as this, but actually makes for a more complete and productive discussion.

3. The Problem of Economic Calculation

It was in 1920 that the Austrian economist Ludwig von Mises published an article that became the opening act for an event of great importance to the economic discussion of socialism, the decades long discussion which came to be known as the *Socialist Calculation Debate*. In this paper, he formulated the problem of economic calculation. The core argument was that communal ownership of the means of production precludes their exchange and thus the formation of prices, which in turn prevents the use of calculation in order to find their most productive use. The subsequent subsection will explore this argument at great length. The subsection after that will go into how, in the socialist economies of reality, the administrative prices, wages and other criteria governing resource allocation, which the regime found suitable for the pursuit of the political and ideological goals it prioritized, were still detrimental to economic efficiency and took its toll on the workings of the system and the lives of its people.

3.1. Rational Decision-Making and Economic Calculation

In the act of deciding which needs to satisfy, the individual makes a judgement of value. These judgements of value first concern the satisfaction of the needs; subsequently they are extended to the goods directly tied with the satisfaction of said needs (consumption goods, or goods of a lower order). However, to further extend judgements of value to goods of a higher order (production goods) is a much more difficult process. Unaided valuation is possible if conditions are simple enough. When conditions are complex, production processes are long and convoluted and causal links are blurred, so some sort of unit of value and calculation is needed for accurate valuation of production goods to be possible. In an economy where competitive exchange takes place, this role is played by goods' exchange values. Exchange values take into account the varying subjective use values attributed to a good by each individual that participates in its trade, as well as their judgements of substitutability among goods. In a monetary economy, exchange values are expressed in money units. Monetary calculation is the tool which, by allowing people to properly assess the value of goods too far removed from the direct satisfaction of needs, guides them through economic decision-making pertaining to those goods of a higher order. All of this was Mises' insight (Mises, 1920/1935, pp.95-98; 1932/1951, pp.114-115).

In a socialist economy, production goods are communal property and thus do not enter the scope of exchange. This means that no exchange value can be formed. Following Mises' reasoning, we arrive at his main conclusion, being that, without exchange values for the means of production, individuals cannot engage in operations of economic calculation to discover how to reasonably use the available production goods. Mises (1920/1935, pp.107-110; 1932/1951, pp.121-122) explains that, under socialism, even if the central economic administration were able to assess which commodities are most needed, it could only rely on rough estimation and guesswork to decide between alternative goods or alternative production processes. Moreover, even after those decisions had been made, it would be difficult to ascertain if a production process was wasting materials or taking an unnecessary amount of time, or if a different process should be adopted. Therefore, in the socialist economy, economic calculation cannot be used to predict the value of economic operations beforehand nor to appraise their value afterwards. It would be a society fit only to solve problems under simple conditions, such as those found in a family household, or under static conditions, where reproducing the calculations previously made under capitalist organization would suffice, but it would only be capable to haphazardly tackle any complex productive undertaking under changing conditions. It would be a society where economizing would be impossible and, hence, where rational action would be impossible as well.

All of this is not to say that monetary calculation is flawless. Mises (1920/1935, pp.98-99; 1932/1951, pp.115-116) makes no such claim, and reminds us that even a capitalist economy, which can employ monetary calculation to its fullest extent, still must contend with its natural limitations. Firstly, there is the fact that the relation between money and goods is prone to alterations due to the fluctuations in the value of money. However, as the value of money tends to be relatively stable, especially over short periods of time, this is usually only a mild hindrance. Another issue is that, since calculations are based on objective exchange values obtained via market transactions, monetary calculation does not take into consideration those relevant elements which lie outside the scope of exchange. For Mises (1920/1935, p.99; 1932/1951, p.115), we have no difficulty in valuing elements such as beauty, health, or honor, because their significance is tied with goods of a lower order, which we can value directly without much effort or the need for any additional tools. But such sentimental and moral factors can hardly be taken into account when determining the profitability of an undertaking. However, since this system of valuation and calculation

arises, as Mises (1920/1935, p.107; 1932/1951, pp.120-121) describes it, through the participation of individuals as both consumers who define a scale of valuation for consumer goods, and as producers who decide to use producer goods as to obtain the most compensation, Mises believes that such factors might enter calculation indirectly, for example through their sway over the subjective valuations and preferences of consumers – as an example, one need only think how the flower planter might not be able to take into account the beauty of the flowers when calculating whether it is more profitable to plant roses or lilacs, but the subjective sense of beauty of flower buyers will most definitely influence the profitability of his endeavor.

Oskar Lange presented a well-known objection to Mises' arguments. Lange's proposal attempted to address the problem of valuation and calculation by trying to reintroduce some form of markets. Lange (1936; 1937) proposed that a central authority would fix prices while using the relation between demand and supply in the market as a guide to know whether prices should be raised or lowered. While not addressing Lange himself, Mises (1932/1951, pp.137-142) does discuss the socialist proposal to solve the problem of calculation by creating an artificial market. The basic idea is a system in which the means of production are socialized, but where industrial managers are ordered to act as if they owned property. Much like the managers of joint stock companies, who do not own the property they manage but work to fulfil the wishes of the shareholders, the socialist managers would do the same, but work to fulfil the wishes of society instead. This has sometimes been called *decentralized socialism*, a label that fits Lange's proposal. Mises argues that these ideas only consider an economy under stationary conditions, when in fact the problem of calculation arises from the constant alteration in economic conditions. Because there are constant alterations, and therefore constant adaptation is needed, the problem of calculation cannot be solved by simply ordering managers to buy and sell products from one another. It is essential that capital be shifted from one line of production or undertaking, which in light of changing circumstances has become less important for the community, to another, which has in turn gained importance; this is the role of the capitalist or entrepreneur, and their influence in the market is what creates the prices and data that managers will use in their operations. The market and private ownership of the means of production cannot be separated.

Finally, as Mises (1920/1935, p.109; 1932/1951, p.122) underlines, all of what has been said does not mean that the socialist community is doomed to inaction: it will still be able

to establish goals and allocate resources towards their fulfilment. What is asserted is that it cannot do so on the basis of cost-benefit value calculations or any economic criteria. It must instead find some other principles to guide its activity.

3.2. Political-Administrative Criteria for Resource Allocation

Real-life socialist economies did not lack prices, but they did not have market prices and so could not access the plethora of information these provide. This fact, while damaging to economic efficiency, was not as detrimental to administrative management of the economy, since the objective of the socialist administration was never, at least not primarily, economic efficiency, but instead an assortment of various political and ideological goals.

Usually, money was not abandoned, and so products continued to have monetary prices. But these prices were not like those in a market economy: they were not a result of the interactions of consumers and producers but were in fact administratively defined by a pricing authority. Price setting was based not on economic criteria, but on administrative and ideological criteria (Ericson, 1991, p.17). Kornai (1992, pp.150-154) highlights the most important of these:

- Socially necessary costs – prices were based on the accounting cost of production, added what the administration considered “normal” profits, as well as turnover taxes and any payments the firm made to the state budget;
- Government’s wish to influence demand – prices were used as a way to alter buyers’ behavior in a way the state deemed desirable, *e.g.*, if the government wished to incentivize the adoption of new technology, prices were intentionally kept low as to make it more affordable (this was done for some machinery and fertilizers, for example); this was used to influence the actions of both firms and consumers;
- Price stability – stable prices allowed for a stable purchasing power and made bureaucratic economic planning easier; in East Germany for example, some prices were left the same for 30 years.

While these principles applied to both producer prices (prices used when both buyer and seller are firms) and consumer prices (used for relations in which sellers are firms and buyers are households), one more applies for the case of consumer prices:

- Income redistribution – the prices of goods and services deemed essential were lowered via subsidies, while prices of luxury goods were raised through taxes.

The application of these principles led to many issues. The most significant problem is that, since these prices were arbitrarily set by the bureaucracy based on a set of (mostly) non-economic principles, they do not impart any information on the relative scarcity of products, or in fact any economically relevant information at all. And much like Mises had explained, these arbitrary and irrational prices cannot serve as a basis for calculation and rational decision-making⁵. The role of money prices and monetary calculation as a guide among the many possibilities in production is fundamentally distorted, and there is no certainty that calculation of costs and benefits will lead to the more efficient alternative being chosen (Kornai, 1992, pp.151-154).

Wages too are administratively set by the bureaucracy. In conjunction with the bureaucratic control of prices, this allows the state to effectively control real wages – in other words, the state can control the level of consumption. Consumption is restrained so that resources can be used to increase investment. Evidently, since wages (which constitute the relative price of labor as a factor of production) are bureaucratically determined in order to achieve levels of consumption and investment that the leadership deems desirable, they do not reflect the relative scarcity of labor (compared to other factors of production) or its contribution to production. Adding to this, the socialist state distributes foodstuffs, housing, education, healthcare and other products and services at a low price or completely free of charge, which allows it to lower wages below the amount which would allow people to acquire these products and services if they were sold at prices which covered costs of production. In tandem, these phenomena lead to the distortion of the relative price of labor as a production factor, and shatter its link with labor's relative marginal productivity, making it unusable for cost-benefit economic calculation and decision-making (Kornai, 1992, pp.224-225).

The administrative prices and wages, which offer no pertinent information regarding relative scarcity, productivity or use value, make the pursuit of efficiency in day-to-day management an impossible goal. But this nefarious effect also extends to longer term decisions in investment (Ericson, 1991, p.17; Kornai, 1992, p.225). In the typical socialist

⁵ Kornai (1992, p.157) gives a firsthand example of the arbitrariness of the price system by comparing the prices of many consumer items relative to the price of one kilogram of flour, in Germany on both sides of the Iron Curtain. In East Germany, one kilogram of coffee was many dozen times the price of a kilogram of flour, and appliances such as refrigerators, washing machines or color televisions were over a thousand times more expensive than that; meanwhile, public transportation tickets, the cost of rent per square meter and even, more bizarrely, one kilo of bread, which needs flour to be produced, were but a mere fraction of its price.

economy, the state plays the role of the sole entrepreneur or investor in the economy, allocating funds to projects as it sees fit. Since there is no capital market where the profitability and risk of each investment project is assessed (nor could profitability calculations based on the arbitrary administrative prices be of much use), investment funds are distributed according to shortage signals in the various economic sectors, the pressures of different interest groups and lobbies, and, most importantly, ideological and administrative criteria (priority is given to heavy industry, steelmaking and machinery especially, the arms industry, large installations, new installations etc.). This distribution of investment funds based on arbitrary principles leads to many problems: the focus on building new installations means that the maintenance of existing ones is often neglected; the focus on building large installations makes it so that factories and service institutions (schools, libraries, universities, hospitals etc.) are as large as possible, often inefficiently so; but more prominently, the economic sectors given priority grow while the others (mostly those dealing with the production of consumer goods and services, such as agriculture, transportation and housing construction) are left behind, leading to an unbalanced economic structure (Kornai, 1992, pp.171-177).

In the end, much like Mises had predicted, resources and effort cannot be allocated on the basis of economic calculation based on money prices. As such, rational economic decision-making cannot take place. Resources and effort are allocated, and decisions are made according to the arbitrary principles and desires of those in command. As Kornai (1992, pp.125-127, 340) points out, political considerations completely override economic considerations – economic relations become politicized. Although this may be, in a twisted sense, helpful, as decision-making is no longer based on economic considerations, which would be impossible under a system where economic calculation is not possible, but instead on the political objectives of the prevailing powers, it certainly does not allow for the creation of an efficient and rational economic system.

4. The Problem of Knowledge

Friedrich Hayek, also an economist of the Austrian School, presented the argument, based on Mises' earlier insights, that the efforts of the socialist administration to direct and coordinate all economic activity would prove an herculean task, since it lacked the knowledge needed to do so. This was not only the knowledge imparted by true market prices but also the knowledge of specific circumstances known by only those who experience them. This will be developed further in section 4.1. Section 4.2 details the state of disarray in which planners found themselves in the real world, and how the tools of planning and bureaucratic management, in the pursuit of total control and order, ended up creating greater chaos than the system of decentralized economic activity.

4.1. Socioeconomic Order and the Use of Dispersed Knowledge

In the previous section, I have expounded Mises' arguments regarding the impossibility of economic calculation under socialism, and the consequent impossibility of rational economic action. In order to act rationally and with intention, the individual must possess some knowledge about reality. Because they have some knowledge about social norms and structures, individuals can act intentionally, predict the results of their actions with relative certainty, and coordinate their actions with those of others (Lawson, 1997, pp.30ff; 2012, pp.357ff; Lourenço & Graça Moura, 2018, pp.12-13). This seems in line with Friedrich Hayek's conception of social reality, especially in his later works (Lourenço & Graça Moura, 2020, pp.1002-1003, 1005). It should be noted that, in Hayek's oeuvre, knowledge is not a synonym of *justified true belief*. For Hayek, knowledge is mostly synonymous with beliefs; it includes scientific knowledge and the knowledge of the particular circumstances of time and place, but also skills, opinions, expectations, customs and rules of conduct, among other things (Scheall, 2016, pp.207-208).

If all these concepts are under the label "knowledge", one can understand why Hayek considered knowledge to be divided among the many individuals in society. The fact that the knowledge relevant for socioeconomic order and cooperation is dispersed and often tacit and inarticulable explains Hayek's advocacy for the free market and competition, over a system of centralized command of the economy. This is perhaps most apparent in *The Use of Knowledge in Society*. As Hayek explains, the fundamental economic problem is not one of allocating "given" resources to "given" purposes, as if we had all this knowledge from

the beginning; it is a problem of using to the fullest possible extent the existing fragments of knowledge spread among individuals, in order to better assign resources to various uses, whose relative importance only the individuals know. Thus, to figure out which economic system is superior, one must ask whether it would be easier to communicate all the necessary knowledge divided among individuals to a central authority, so that it can devise an exhaustive plan for the entire economy, or, alternatively, to transmit to individuals enough additional knowledge which would allow them to make informed choices on their own and create mutually compatible plans (pp.519-521).

As I have mentioned, under Hayek's definition of knowledge we find the knowledge of the particular circumstances of time and place. This is the type of knowledge which is unique to each individual, and which can only be used by him or with his aid; the supervisor who, knowing his employees, can organize them as to make the most use of their skills; the manager who, knowing the capabilities of his machinery, can fully utilize their productive capacity; the arbitrageur who takes advantage of differences in prices to make a profit – all these are examples of individuals using the unique knowledge they possess of the circumstances of time and place (Hayek, 1945, p.522). This is a type of knowledge which is very specific, linked to small details, which is significant for small specific decisions; it is however, these small specific decisions which dictate whether the production system keeps flowing without halt, satisfying the demands of the population (Hayek, 1935b, pp.208-209; 1945, p.524) – for Hayek, the economic problem of society is essentially that of rapidly adapting to alterations in the circumstances of time and place (Hayek, 1945, pp.523-524; 1968, p.311). Nonetheless, the minute nature of this kind of knowledge makes it so that it cannot be translated into large statistical aggregates to be used by a central authority. If the central authority cannot gather all this specific knowledge from individuals, compute it, and develop a single comprehensive plan for the entire economy in a timely and efficient manner, then it is reasonable to conclude that decision-making and planning should be delegated to the individual (Hayek, 1945, p.524).

However, the individual's knowledge of his immediate surroundings is insufficient, since events far beyond his perception can still affect the development of his plans. A way to communicate that additional knowledge to him must exist. Hayek explains that this is the function of the price system in a competitive market – market prices represent how important a resource is for a community and how the efforts of the people should be directed. Price changes inform individuals that what they were doing or are capable of

doing has become more or less demanded, and guide them on how to correctly reallocate resources and redirect their efforts, in the face of alterations in circumstances they might not even be aware of. Price changes communicate just enough information to individuals so that they are capable of reallocating resources in a way that, although perhaps not optimal in the traditional sense of maximizing well-being, produces a satisfactory outcome in which their plans can be fulfilled and fit with the plans of others (Hayek, 1945, pp.524-527; 1968, p.311).

Hayek does not just discuss the importance of the market and price mechanism for the transmission of knowledge. He also outlines the decisive role that the market, more concretely market competition, plays in the discovery of knowledge⁶ (Hayek, 1940, p.139; 1948, p.; 1968, pp.107-108). Hayek (1948, p.108) highlights cost curves as an example of this – cost curves are often seen as objectively given facts in neoclassical economic theory, meaning that producers know the lowest cost at which they can produce from the beginning. In fact, it is exactly the process of competition that brings about the reduction of cost to a minimum, so that a product might underbid its closest substitute⁷. Likewise, it is often assumed that consumer preferences are known by producers, and that consumers possess full knowledge of what products are available. But it is also through market competition that consumers and producers alike learn of such things (Hayek, 1948, p.148). Hayek (1937) presented a concept of societal equilibrium as a state in which the individual's beliefs (his knowledge, or subjective data) correspond to the facts of the external environment (the objective data) and with the beliefs of others. Although he would later abandon the term *equilibrium*, and opt to use *order* or *catallaxy*, his earlier insights remain valid. In his early works, however, he could not explain how this order would come to be. Subsequent works, especially in the 1940s, greatly emphasize (perhaps even excessively, according to Fleetwood (1997, p.157) and Lewis (2014, pp.205-206)) the role that the price system in a free market plays in promoting the discovery and transmission of the knowledge needed to adapt to change and bring about said economic order. As Lewis (2015, pp.1170ff) points out, Hayek would later (especially after the 60s) underline the

⁶ Since competition has this discovery component and is important as a process of exploration of undiscovered opportunities, Hayek (1968, pp.312-313) argues that it is even more important for less developed nations. This is because these are usually countries who have not grown because they have not tapped into their productive potential.

⁷ This is precisely one of the criticisms that Hayek (1940, p.139) had levelled against the theories of Lange (1936; 1937), Taylor (1929) and H. D. Dickinson (1939), which suggest the socialist state should use trial and error methods and mathematical equations to approach the equilibrium prices of market competition.

importance of social rules and norms (*e.g.*, the laws of property and contracts, or informal norms such as honesty) for the proper functioning of the market and of the price system. These rules act as guidelines for how people should behave in or react to certain situations. By essentially restricting people's behavior, rules allow individuals to predict the actions of their peers with relative certainty, and therefore enable them to devise plans of action which, despite being dependent on how others will act, will likely have the desired results. In sum, Hayek conceptualizes socioeconomic order as a state in which the individual's knowledge (his beliefs, how facts are perceived by him, etc.) are in harmony with the external facts and the knowledge of others (Hayek, 1937, p.39ff; Scheall, 2016, p.208). This harmony is a product of a set of social rules that, conjointly with a price system resulting from competitive interactions in free markets regulated by those social rules, give people the inputs they need to create and adjust plans of action that are sufficiently compatible with those of others so that they are more likely to produce the desired results.

4.2. The “Anarchy of Production” in Socialist Central Planning

The use of knowledge could be seen as the greatest challenge of nations basing their socioeconomic organization model around central command, since, evidently, any loopholes in the knowledge of the directing authority may prevent it from operating, or at the very least prevent its actions from having the desired result. Hayek had explained the emergence of socioeconomic order through a spontaneous process brought by horizontal market interactions, private ownership and a set of social norms; antithetically, the socialist party in control of the state expropriates and nationalizes private property and builds up a comprehensive bureaucratic hierarchy. In essence, it attempts to turn the economy into a giant command chain, where coordination arises not out of voluntary interactions between agents, but by agents' actions being coordinated from above, in vertical superior-subordinate relations, much like those that govern the military (Kornai, 1992, p.91-92, 95) – hence why socialist countries are often referred to as *command economies*. Kornai (1992, p.117) calls this coordination mechanism *direct bureaucratic control*. Out of the many forms that it can take, the most important one (as well as the one socialist economies are most heavily associated with) is the economic plan.

Economic plans can encompass many time frames. The Five-Year plans are one of the most infamous features of the Stalin era in the USSR but plans with shorter or longer time

horizons have been developed. The annual plans are the ones that carry the most weight in terms of actual management of the economy. As they constitute the main guide governing economic activity in socialist countries, plans must be comprehensive, detailing all aspects of economic activity. Among other things, a plan stipulates what products will be produced and in what quantity, to what use will products and materials be assigned, how labor will be distributed and compensated, how investment funds will be allocated, what new products will be produced and what use will be given to new technologies, what will be imported and exported, and much more⁸ (Kornai, 1992, pp.111-113).

Evidently, the construction of such an exhaustive plan would be beyond impossible if it were to detail specific commands and targets for every individual firm and institution in regard to the myriad of products, production and distribution processes. The limits of practicality require a process of aggregation at the top and subsequent disaggregation along the bureaucratic command line – in a simplified manner, the national planning agency works with the broadest national economic aggregates, which it breaks down in subcategories for the various ministries; these in turn further break them down for the directorates (a directorate controls the firms in a specific sector) under their wings; directorates then narrow it down for the individual firms which they are responsible for (Ericson, 1991, pp.15-16; Kornai, 1992, p.113-114).

Needless to say, superiors cannot merely define planned targets “out of thin air”. These need to be grounded in real economic capabilities – the directorate needs to know the production capacity of its firms in order to assign them targets, the ministry needs the same of its directorates, and the national planning agency of the ministries. So plans are elaborated based mostly on reports from subordinates that detail their production capacity, on records of past economic performance⁹ and on some reports of supervising agencies¹⁰ (Ericson, 1991, p.15; Kornai, 1992, p.122). Here a big problem appears. Kornai (1992, p.122) calls it *vertical bargaining* – subordinates purposefully understate their capabilities, overstate hardships and even withhold performance, so as to be assigned lower output targets while being granted more inputs and resources (Ericson, 1991, p.15; Kornai, 1992,

⁸ The challenging nature of such a task is seen in the fact that, for example, in the USSR, several tens of thousands of balances detailing the source and the purpose of materials, semifinished and finished products were devised by the ministries, the State Planning Office (known as Gosplan) and the State Material Supply Agency (known as Gosplan) (Kornai, 1992, p.111-113).

⁹ This has been referred to as the previously achieved level of production having been *planned in*, meaning that this year’s targets will have to be at least the same as what was achieved last year (Kornai, 1992, pp.122-123).

¹⁰ In the Soviet Union, agencies like Gosplan, Gosbank *i.e.* the Soviet central bank, or the People’s Control engaged in independent monitoring activities (Ericson, 1991, p.15).

p.122; Murrell & Olson, 1991, pp.255-256). This problem is characteristic of bureaucratic hierarchies and superior-subordinate relations, independently of the economic system, but the distortion incentives grow exponentially with the size of the bureaucracy, so its destructive potential is clearest under the system of central command (Murrell & Olson, 1991, p.256). I will explore this behavior and the agents' incentives to engage in it at greater length in a later section. So far it should simply be emphasized how the system suffers from this deliberate distortion of the information flow to the top, which sabotages the inner consistency of the plan and the whole concept of coordination from above.

Even setting aside purposeful information distortions, the task of gathering and processing the enormous amounts of information required to construct a single cohesive plan is simply too difficult and error prone. As it was said, information for planning and assessment of performance needs to be gathered from the "frontline" of the production process. But as it gets passed through the various layers of the bureaucratic hierarchy errors are made and involuntary distortions appear. By the nature of the process, any mistake made in one hierarchical level will be passed along to all subsequent ones. Furthermore, as information gets aggregated at each level, details which could be quite important are inevitably lost (Kornai, 1992, p.127; Murrell & Olson, 1991, p.255).

I have previously noted how Hayek (1945; 1968) had conceptualized the fundamental economic problem of society as one of rapid adaptation to changing circumstances. In this regard the planning mechanism suffers from sluggishness and lack of flexibility. Despite its many inconsistencies, the plan's different elements are still intimately interconnected – thus any alteration in one part of the plan requires corresponding alterations in other parts. If faced with unforeseen circumstances (positive or negative), making the necessary adjustments is a time-consuming and tiring task, and so it is often neglected or even actively opposed by the bureaucracy. This evidently makes the plan inflexible in the face of change and further harms its coordinating role (Kornai, 1992, pp.118, 127-128, 165, 345).

All of these problems are intensified by economic development. The growing number and variety of products, services, production processes, technology and needs and desires of consumers necessitates a progressively larger bureaucracy, and with the increase in size comes an exponential increase in all the issues discussed (Ericson, 1991, p.22).

In the end, plans are often inconsistent (except perhaps at the most aggregate level) and fail to take into account all the relevant information, much like Hayek had foreseen when he spoke of the tacit knowledge of specific circumstances – Ericson (1991, p.21) specifically

mentions opportunity costs as an information loss derived from the system's reliance on information in aggregate and physical form, and its lack of mechanisms to convey relative valuations to the central authority. Moreover, with the sluggishness of the bureaucratic process of transmission of information and coordination, commands are often based on information which is by then outdated, due to changing economic circumstances (Ericson, 1991, p.15). Kornai (1992, p.127) mentions another fault in the fact that all this process of gathering all the information, duly processing it, organizing a coherent plan and issuing commands must be done in a relatively short time frame. This frequently means that the process was not timely concluded, resulting in an incomplete plan.

This incomplete, incoherent, inflexible and cumbersome plan fails at the task it is meant to accomplish, namely, to coordinate economic agents. In fact, it ends up isolating them from one another and from the information relevant to their activities. Subordinates focus only on their narrow operation area, on following the commands of superiors and accomplishing their assignments, with no regard for social objectives or the actual needs of consumers or of those down the production chain. Should they face any shortcoming or valuable opportunity, they do not have the information, resources, authority and may even lack the incentive to deal with it properly. Higher authorities are too far removed from the actual "on-the-ground" economic activity and so lack detailed knowledge of any circumstance. Despite having the resources and authority needed to solve the issue/take advantage of the opportunity, this lack of information, coupled with the fact that they are often occupied with other problems, and that, with the slowness of bureaucratic transmission, they only learn of those occurrences with significant delay, effectively paralyzes them as well. So, it is often the case that problems go unsolved, and opportunities are wasted. The bureaucratic coordination system (of which planning is a part of) opens a rift between the continually changing information, and the authority, capability and incentive to use it (Ericson, 1991, pp.17-19, 20-21; Kornai, 1992, pp.129-130).

The planning and bureaucratic coordination mechanism is convoluted, disorderly, and rife with internal contradictions. It can achieve some main central objectives it puts greater emphasis on (Ericson, 1991, p.21; Kornai, 1992, p.117), and although market competition and the price system cannot provide any guidance, the system strays from complete chaos thanks to the information imparted by non-price signals, of which shortages play a big role (Kornai, 1992, p.159; Powell, 1977, pp.56-61). It cannot, however, produce the order which Hayek spoke of at the same level of efficiency as market coordination can.

5. The Problem of Incentives, Initiative and Responsibility

Even the system of collective central command is hardly able to consummate centralization. Rather, it sets up a command hierarchy in which significant decisions are made at superior levels, while subordinates have some ability to decide on the specifics of their implementation – what may be called *administrative decentralization* (Neuberger, 1993, pp.26-27). But autonomy is incompatible with the system, and so, even with the rules and limitations imposed by superiors, it causes many problems. More concretely, autonomy within the framework of the strict hierarchical structure creates perverse incentives to act in order to make one's life easier in ways often counterintuitive to the established goals. At the same time, the pyramidal command structure allows the avoidance of responsibility for said actions, and discourages the use of autonomy in the pursuit of innovative and creative endeavors that diverge from the norm. The first subsection will compile problems related to motivating people to do what is desired, delimitating responsibility for actions and fostering the initiative to take risks and innovate, as presented by Mises and Hayek. The second will describe real-life phenomena which exemplify this, such as the soft budget constraint, vertical bargaining, the withholding of performance or the hoarding of labor and other inputs.

5.1. Motivation and Responsibility under Socialism

Closely linked with the impossibility of economic calculation in the socialist economy, there emerge issues related to incentives, initiative and responsibility. These problems are not problems of socialism itself, but are in fact inherent to hierarchical command structures; accordingly, they exist also in the state administration, corporations and other large organizations in capitalist economies. However, the socialist system merges all of these smaller individual bureaucracies into a single colossal structure meant to encompass and coordinate all of their activities, and in doing so it multiplies the incidence and severity of these problems exponentially (Kornai, 1992, p.97; Murrell & Olson, 1991, pp.255-256). These are problems which are not to be taken lightly, as they plague everything, from the low-level worker up to the top public manager or official.

Let us begin by examining the worker. As Mises (1932/1951, pp.174-175) explains, in a socialist society, since economic calculation is unfeasible, there would also be no way of ascertaining how much the different factors of production contribute to the value of the

final product. Regarding labor particularly, this means that there is no way of linking its product with its remuneration. Without that connection, the remuneration of work will have to be dependent on somewhat arbitrary criteria more or less connected with aspects of the work done. This, however, means that the worker has no incentive to work to the utmost of his capability, but only to do the bare minimum to fulfil the prescribed criteria, in order to maintain his position or avoid punishment. Mises (1932/1951, pp.175-176) also explains that the fact that the socialist worker will work for the community is not a motivational factor, as some argue, but precisely the opposite – the worker no longer works for himself, to increase his output so that he is rewarded for it, but instead to increase the output of the community, of which only a miniscule share he is entitled to. The laborer is only pushed to give his best if his effort is rewarded¹¹.

Mises (1932/1951, p.175) argues that the supervisor and employee manager faces much the same difficulties. In a capitalist system, while he must still have the insight to organize the workers under his wing as best as possible, he does not need to do much in the way of motivating them to give their best in the tasks at hand. The fact that the worker's pay is linked with the value of his work is usually enough. Under socialism, as we have seen, that link is gone, so some sort of formal criteria for the worker to fulfil must be devised. We have also seen that such criteria fail in coaxing diligence from workers. But they serve another purpose as well, according to Mises (1932/1951, p.175, 178-179). Under capitalism, the supervisor evaluates the worker on the value of his work, and can be given greater freedom in the exercise of his powers to hire and dismiss labor, for if he dismisses competent workers or treats them poorly, or retains workers for reasons unrelated to their productivity, he will harm the output of his department or section, and therefore put himself at risk of being replaced or having his income reduced, since he too is evaluated on the value of his work. Under socialism, formal criteria will serve as tools to evaluate the performance of the workers, but also to limit the supervisor's powers, since if his income is not linked with his performance, he may be tempted to arbitrarily use his powers in whatever way he sees fit.

¹¹ Appeals to conscience and moral drive will not be very effective, except perhaps for those who do their work for the pure pleasure of it and find their joy in the serving of others, which are alas but a small fraction of the population. Systems of punishment and reward, which, since economic calculation is impossible, must necessarily be connected with some formal criteria, can only induce the effort required for the fulfillment of said criteria, but cannot push individuals to perform at the best of their abilities (Mises, 1932/1951, p.180).

As for the top manager or the enterprise administrator, he, much like the workers and supervisors, faces a serious problem of incentives. As Mises (1920/1935, pp.118-119) made clear, the private manager is connected to the property which he manages differently from the public official – he either owns, or expects to own in the future, part of the capital of the enterprise; he can make gains via speculation with the company's shares; he tries to secure a legacy for his descendants. These same ties are not present in the case of the public manager, so he is much less motivated to grow the productivity and value of the property which he manages but does not own¹². Some sort of remuneration reforms might therefore be put in place, in order to make the manager interested in the profits of the enterprise, but that leaves us with the opposing issue: the manager does not share in the enterprise's losses (Mises, 1920/1935, pp.121-122; 1932/1951, p.217). The private owner and manager directs his business and takes chances on his own account, and thus faces the loss of his own property if he makes misguided decisions. The public manager can perhaps lose his position, be fined for incompetence, or face some sort of other punishment designed by his superiors, but he is never faced with the prospect of losing that which is his, and as such is more likely to be negligent or reckless in his decisions. One could imagine that some sort of system to deter irresponsible behavior would be set up. But such a system would have to thread an impossibly fine line between being too lenient, and thus ineffective, and being too punishing of risk-taking. As Hayek (1940, pp.141-142) explains, managerial initiative would be stifled, and with it any speculative and risk-bearing activities as well, of which innovation is an important part. The private manager takes risks on his own account, and reaps himself the benefits should any experience bear fruit – he might make a decision which hurts his present results, but which will reward him later, without need to justify it to anyone. In contrast, the public manager would feel little encouragement to take risks, since he would be under the watch of the central authority, which would assess if any ventures on which he embarked were justified. Any endeavor which hurts present performance might put him at odds with his superiors, and he would have a hard time justifying his decisions.

¹² This said, Schumpeter (1976, p.141) notes some of the same disconnect between management and ownership in large private corporations. He also argues that the substance and vitality of property have faded with the transition from the ownership of physical assets (such as an actual physical factory, its building, land, machines, etc.) to stock ownership. This process of "dematerialization of property" reduces, he believed, the interest and willingness of the property owner to fight for that which is his (p.142).

To add to all of this, the assessment of the administrators' performance would be a very difficult task. This is of course linked to the inability to engage in economic calculation, which results in the same difficulty for workers and supervisors (Mises, 1920/1935, p.120). But Hayek (1940) presents a different perspective. As he explains (p.141), the manager's calculations would have to be verified by the central authority, but it would not merely be a case of confirming that effective costs correspond to reported costs. The central board would have to check if the manager did everything in his power to produce at the lowest possible costs, which means the analysis must go beyond what was effectively done, to the realms of the possibilities of what could have been done instead. To conduct such an extensive examination would be a laborious and very time-consuming task, and it would require a bureaucracy of great size and complexity. It could also easily fall prey to arbitrariness.

Finally, in a system where the state directs all economic matters, issues of delimiting responsibility must inevitably arise (Mises, 1932/1951, pp.217-219). For are poor results to be blamed on a manager if he merely acts on behalf of the central authority's wishes? And who is to blame if his output is reduced because he receives materials or products in poor condition? Is it the manager himself, the manager of the supplying enterprise, or the state who directs the production and supply of those materials? Each would be keen on pushing the fault unto the others.

And what of the entrepreneur, the businessman or the speculator? Well, as Mises (1920/1935, pp.120-121; 1932/1951, p.216) explains, such a class of people would cease to be. This is of course partly due to the fact that it is the very objective of socialist ideology to get rid of those people, as it considers them oppressors of the workers. But under communal ownership of the means of production there could be no entrepreneurs or businessmen even if they were wanted. What characterizes the businessman or entrepreneur is not his personality, the knowledge he obtained in commercial school or during previous experiences in business, nor knowledge of accounting or management. All of those factors may very well be important, but it is the position he occupies in the heart of economic activity which makes man a businessman. When he is brought into the management of a public enterprise he does not make it more "business-like", as some may think, it is he who is stripped of his "business-like" qualities. He may bring all his personal attributes, all his commercial training and experience, and make use of them, but he becomes just another public official or bureaucrat, plagued by all the problems we have just

discussed. This can only mean that the socialist system intends for the state to take over entrepreneurial activity, such as the directing of capital and investment (Mises, 1932/1951, p.141). Such a scenario would bring numerous problems. Firstly, the state would have to decide whether to expand one industrial unit or another, how much to expand it, whether the machinery used in one plant is being used to its fullest potential or should be allocated to another instead, and more. These decisions necessitate the gathering of extensive information and complicated calculations, which are made even more difficult with the problems of economic calculation and knowledge that we have discussed. Additionally, if the state is the supplier of all funds and capital, issues with attributing responsibility will arise. For if a plant is performing poorly, is it incompetence on the public manager's part, or is it the fact that the state did not supply him with the right funds and capital? Here too, each would be eager to push responsibility onto the other, and the process of determining who was at fault would necessarily waste time and resources, and throw sand in the gears of the productive process (Hayek, 1935b, pp.233, 236-237).

5.2. The Distorting Effects of State Paternalism, Obedience and Shortage

The distortion of incentives and the divide between useful knowledge and the incentive to use it or transmit it is one of the great problems of the centralized socialist system, as it hinders its logic of command from above and bureaucratic coordination (Ericson, 1991, p.21; Kornai, 1992, pp.129-130). Problems of incentives, responsibility and initiative found in the literature studying the reality of socialist economies have their origin in more or less three phenomena: predominance of public property allied with state control of and intervention in the production process, the system's focus on obedience and compliance, and the system's chronic state of shortage. I will presently expose how each of these impacts the behavior of workers, firm managers, public officials and other agents.

The first cause of problems with incentives, responsibility and initiative appears to be exactly the characteristic that differentiates socialist economies from capitalist ones: the prevalence of state ownership of property and the complementing state paternalism and interventionism. The main problem here is that the socialization of property disposes of the automatic incentive provided by private property that motivates owners to try to make the best possible use of their property, since not only are they directly to gain if their

property increases in value, they are also punished with the loss of their property and may even have to pay out of their own pockets if they make bad decisions (Kornai, 1992, p.65). As Kornai (1992, p.75) explains, the state is the nominal owner, but there is no real owner – state property belongs to everyone, but simultaneously to no one, and since nobody directly benefits from increasing its value, nor does anyone directly suffer from its losses, there is no incentive to make profits or avoid losses¹³.

The damaging effects brought by the lack of automatic incentives inherent to public ownership are made worse by a manifestation of state paternalism and interventionism, which the Hungarian economist János Kornai famously named *soft budget constraint*. This is a phenomenon which is prevalent in socialist economies, but which is in fact tied with the superior-subordinate type of relation so prevalent in bureaucracies, so it need not be circumscribed to socialist countries¹⁴. It is essentially an erosion of the link between expenditure and financial resources, since the agent expects some sort of external financial aid should he overspend¹⁵. It manifests most significantly in the fact that firms cease to be restricted by their budget, since they may receive many forms of external assistance in the case of overspending: they may plead to higher authorities for subsidies, lower payments to the state budget, higher administrative prices for their products or for a grant from a state bank (Kornai, 1986, pp.4-6; 1992, pp.140, 142, 145). The *depersonalization of property* (Kornai, 1992, p.75) under state ownership, and state paternalism in the form of the soft budget

¹³ This issue of ownership appears to be quite significant, to the point that it has effects even when governmental intervention in the economy is prevalent. Temin (1991, pp.590-592), in his comparison between Nazi Germany and the Soviet Union, notes how in Nazi Germany, despite extensive state intervention and control of production, the fact that private property was not abolished was an important motivating factor for managers, as they could acquire shares in firms and thus ensure a legacy for their descendants even if their current earnings were restricted by the state.

¹⁴ The specific reasons for the existence of the soft budget constraint are varied: the state may save a firm to protect the jobs of those who work there, because the firm's activity is deemed important, or for other reasons. But all of them invariably turn on the urging for the state to provide security for its people (Kornai, 1986, p.26). This is a sentiment that is present in a great variety of nations, but it has a special ideological component in socialist countries, where the communist party often rose to power and gathered the population's support by promising to provide all that the people need and to eliminate the economic backwardness that plagued the country under the old regime. The state's paternalism is ingrained in the ideology of the ruling party and is in fact one of the things that legitimizes the regime in the eyes of the people (Kornai, 1992, p.53-54, 314).

¹⁵ As Kornai (1980, p.149) notes, financial assistance is in line with the socialist principle of rejecting the "survival of the fittest" approach of capitalist competition. However, it is made much more prevalent due to the fact that that superiors simply do not have the information required to discover the cause of a firm's poor performance, so executives can blame their failures on various external factors, unforeseen problems or even on plan incoherence and flaws. This allows them to completely avoid responsibility and further pressures authorities to come to their aid (Ericson, 1991, pp.20, 22; Lin & Tan, 1999, p.428).

constraint combine to create some of the most dysfunctional behaviors in firm management:

- Low efficiency and restraining of innovation – there are no benefits to be reaped from producing efficiently, nor do losses due to wasteful production put the firm in any real danger. The firm ceases to make an effort to employ the most cost-effective production technology, or to replace inputs with cheaper substitutes, since there is no point in making that effort (Kornai, 1986, p.10; 1992, pp.146-147). Much the same can be said for innovation: since the profits derived from innovation do not accrue to the innovating manager, while the risk persists (perhaps not in the form of loss of property, as is the case under capitalism, but certainly in the form of demotion or harsher punishment), he has no real motivation to innovate. In addition, whatever losses come due to producing outdated products, with archaic production processes or obsolete machinery will be covered by the state, so backwardness is not a threat to the firm's survival (Kornai, 1986, p.10; 1992, p.297). This behavior is exactly what Kornai (1980, pp.151-152) saw in Hungary, even after reforms whose main goal was to liberalize and decrease bureaucratic intervention.
- Unrestrained demand for inputs – the relaxing of financial discipline leads to an unbridled expansion of demand for inputs, since overspending is no longer an issue. This is especially apparent in the case of investment¹⁶ and imported goods. This is because the costs of expansion and imports are covered by the state, and are thus no worry of the socialist manager. The only way to counter this trend is to implement administrative limits and quotas and the requirement of import or investment licenses (Kornai, 1992, pp.160-163, 346-348). This unrestrained run-away demand creates the shortage economy which, as I will show shortly, worsens many of the negative effects of state ownership and paternalism.

¹⁶ In the case of investment, to make the situation worse, managers will, in their proposals, frequently purposefully underestimate the costs and completion time of investment projects, in order to make approval more likely. Moreover, the state feels an extra pressure to intervene and cover expenses, since it is often the case that it approved the project, funded it and participated in its implementation, so it shares some of the responsibility of failure (Kornai, 1992, pp.160-163, 269-270). Kornai (1980, pp.154-155) describes how in socialist Hungary, even after some liberalization reforms in the 60s which sought to decentralize and divide the undertaking of investment decisions between individual firms and central authorities, issues with delimitation of responsibility were still prevalent, and arguably even worse, as the shared participation in investment decisions further blurred the responsibility in decision-making.

All of these effects can also be thought of as secondary effects stemming from the decreasing importance of prices for decision-making that results from state interventionism and paternalism and the soft budget constraint in particular; in other words, firms develop a *weak price responsiveness*. As prices become less important for decision-making, since financial aid in case of excessive expenditure is likely, there is no reason to find the most efficient and less costly input combination, to introduce innovative and better products and production processes, to restrain the demand for inputs, investment goods and imported products (Kornai, 1986, p.9; 1992, pp.146-147).

A second source of incentive issues is the system's fostering of, and even reliance on, the moral values of discipline, compliance and obedience to superiors. Since the system is built like a giant command chain, this is inherent to its logic and design, as it aligns with its militaristic nature (Kornai, 1992, pp.57-58). As Kornai (1992, pp.118-121) explains, all the motivations of people in places of leadership (*i.e.*, anyone that is not at the very bottom of the hierarchy and thus has people subordinate to him – it may be a firm manager, the head of a directorate, a minister etc.) are inevitably linked to their superiors¹⁷. This fixation with the satisfaction of superiors creates in officials a perverse inclination to do anything in order to easily fulfil their assignments. This motivates many dysfunctional behaviors.

One of them I have briefly discussed already: since they are only incentivized to follow orders and fulfil assignments, agents often overemphasize their needs and the difficulties they face and underrate their capabilities, so that their superiors will assign them easier output assignments and more resources – agents engage in *vertical bargaining* (Ericson, 1991, p.22; Kornai, 1992, pp.121-122). In an attempt to counter this practice, superiors base assignments on past performance, or purposefully inflate output assignments while reducing input allocation. Yet these tactics cause some problems themselves (Kornai, 1992, pp.122-123). The first method produces the pernicious practice of subordinates withholding performance and only barely accomplishing goals, even if they have the capacity to exceed them, so as to avoid superiors raising their demands in the subsequent year. The second approach, while successful on the surface, often leads to impossible tasks being assigned, which either remain unfulfilled or force subordinates to make poorly

¹⁷ Motivation may have many sources: genuine belief in the ideology, the wish to be professional, the desire for power, prestige and material gain, etc. Yet, in all of these the superiors exert prominent influence: they are the ones who imbue subordinates with ideas and ideological principles, who define what constitutes a “job well done”, who establish how one moves up in the hierarchy and how he is rewarded or penalized (Kornai, 1992, pp.119-121).

informed trade-offs. Murrell and Olson (1991, pp.256-257) mention that vertical bargaining may be stifled through competition among bureaucrats, since it makes one look less capable compared to rival bureaucrats and may put one on the path to replacement. This is true only for competition under similar circumstances however, since differences in circumstances can provide a myriad of excuses for differences in performance (such as enterprise-specific or industry-specific factors, for example). But eventually, even where it can be useful, the effectiveness of bureaucratic competition subsides as bureaucrats begin to collude in order to forward their collective interest¹⁸ (Murrell & Olson, 1991, p.257).

Another deceitful practice motivated by the incentive structure based on command fulfillment is the employment of schemes to fool superiors into believing that assignments have been accomplished. More concretely, since superiors assess performance based on large aggregate categories, subordinates will produce the simplest, easiest to mass produce goods, given their material constraints, so that they will appear to have fulfilled their responsibilities in their superiors' eyes. Of course, this often means that consumers and other producers down the production chain receive not the output that they require, but useless output that was produced for the sake of aggregate plan fulfilment (Ericson, 1991, pp.17-18; Kornai, 1992, p.271).

Perhaps worst of all, the system's innate fostering of obedience and discipline extinguishes all initiative, critical thinking and originality. New and innovative ideas, and in fact change of any kind, is suppressed, as it often involves risks that individuals are not willing to take. To act out of one's own initiative, without any superior's prior endorsement, is risky and thus avoided. Individuals refrain from criticism since, no matter how well-meaning, it can be painted as defiance and lack of discipline and punished accordingly. Overall, the system fosters only the blind following of orders, without any critical thinking and without any deviation on one's own account (Ericson, 1991, p.22; Kornai, 1992, p.121).

The third and final root cause of dysfunctional incentives is the socialist economy's state of chronic shortage¹⁹. As Kornai (1992, pp.229-233) makes clear, shortage phenomena can

¹⁸ It is important to note that collusion does not stay circumscribed to any single level in the hierarchy. Rather, it rapidly spreads across all of it – it is easy to see that, for example, if the firms in an industry begin to collectively underreport their capacity and plead for more inputs, their directorate has an incentive to disregard their deception, as it can use their pleas and forged statistics to its advantage in its bargaining with its own superiors in the ministry. This same pattern then repeats itself across the hierarchy (Kornai, 1992, p.123; Murrell & Olson, 1991, pp.258-260).

¹⁹ Here I consider shortages as an unintended byproduct of the workings of the socialist economy. Yet it is still worthwhile to consider Schleifer and Vishny's (1992, pp.238-242) hypothesis that shortages of goods and services are themselves the results of an incentive problem which leads to dysfunctional behavior. They argue

take many forms, and can appear in any society, independently of its socioeconomic organization system; but the widespread, common, long-lasting and intense nature of shortage phenomena in the traditional centralized socialist economy is what leads to its characterization as a *shortage economy*. Kornai (1992, pp.245-251) explains that this state of chronic shortage increases the relative power of sellers in their interactions with buyers, and puts most effort involved in the establishing of the transaction (the gathering of relevant information, adaptation to the other side's situation, convincing the other side to participate in the transaction) in the hands of the buyer – it creates a *seller's market*. The security provided by this kind of market complements the sense of security already created by state paternalism and the soft budget constraint, thus reinforcing many of its negative effects. More specifically, it attacks efficiency, product quality and innovation of any form on two fronts. On the one hand, efficient and quality production is hindered by the fact that it may be difficult to obtain the materials and inputs one requires due to shortages, often forcing producers to make forced substitutions which increase costs and deteriorate the quality of the final product; on the other, the shortage practically ensures that production will be sold no matter what, which effectively extinguishes all incentives to lower costs and prices, improve product quality, create new and innovative products and offer a more diverse line of products (Kornai, 1992, pp.300-301).

Shortage and the seller's market regime also worsen the uninhibited expansion of demand that effectively sustains the shortage. Under the likely scenario that shortage will not allow them to obtain the inputs they need, firms begin to hoard them as precaution. Additionally, they also increase their requests for inputs from superiors, creating *vertical shortages*. Here again investment is particularly affected. Not only will the state likely cover any losses derived from a failed expansion project, but shortage makes failed expansion an unlikely reality, as any increase in production is likely to find buyers (Kornai, 1992, pp.244, 270).

In the socialist system, shortage is prevalent all across the economy – this includes the labor market. Full employment is often paraded as one of the system's great achievements. But although the eradication of unemployment may bring workers more security and bargaining power, it also effectively rewards worker negligence and idleness²⁰. The

that enterprise administrators, aiming to circumvent the fact that they cannot pocket any profits the firms might make, deliberately restrain production in order to extract bribes from desperate buyers.

²⁰ Kornai (1980, pp.152-153) notes this exact phenomenon in the Hungarian People's Republic, which, together with the soft budget constraint, he considers one of the main features of the system that impedes efficiency.

incompetent and lazy worker is less likely to be fired because employers know it will be hard to find a replacement; in fact, it is common for firms to “hoard” labor, *i.e.*, to keep employees which could be released because there may be need for them in the future and the shortage will complicate finding the necessary manpower. But even if the lazy worker is fired, the labor shortage practically ensures he will find another job without much difficulty, so the worker does not feel like his bad behavior is truly penalized. Workers know of these facts, and so are more likely to defy their superiors. The sense of indispensability incentivizes the lazy to be idle and the cunning to consciously hold back their performance in order to extort benefits from their employers. The socialist system may provide jobs for the people, but it cannot push them to work to the best of their ability (Kornai, 1992, pp.218-219, 223).

Overall, it seems that Mises, Hayek and others’ hypotheses came into being – the socialist system cannot coax the best efforts out of people. Its essential characteristics (the prevalence of public ownership, the bureaucratic coordination with an emphasis on obeying commands from above) and resulting phenomena (the shortage economy) create many distorted incentives to idle, deceive, circumvent the system and actively go against its intended purpose.

6. The Problem of Tyranny

Earlier sections were concerned with the socialist system's problems in the allocation of economic resources: the tools used for allocation (administrative prices and political-administrative criteria take the place of market prices and monetary calculation); the method by which allocation is realized and the agents engaged in it are coordinated (centralized bureaucratic coordination, particularly economic planning, substitute price signals arising from market competition engaged in by many individual agents); the incentive system motivating agents to act in a rational and socially benefiting manner (the fostering of strict obedience to a command system, together with "artificial" incentives, are used to replace the extinct incentive of property ownership and the link between productivity and income). I now wish to address a matter distinct, although by no means entirely disconnected, from these previous ones. I wish to tackle the relation between socialism, democracy and freedom. Hayek's *The Road to Serfdom* makes the argument of the incompatibility between collective management of society and individual freedom, and will be the centerpiece of the next subsection. The subsection after that explores the many limitations on freedom in socialist nations across the world, both the more well-known and some more unexplored facets.

6.1. Collectivism and Totalitarianism

Democracy is a tool, a means to achieve desired ends; freedom, the individual's freedom from the arbitrary action of his fellows (including those that form the apparatus of the State) (Mises, 1932/1951, pp.192, 194), is an ideal, an ultimate value, by many regarded as the main end which democracy serves. Additionally, democracy can be seen as an important means of preserving internal peace: elections provide a way for citizens to express their satisfaction or discontent with their rulers in a peaceful manner, while in an autocratic society disapproval may only be shown through violent upheaval, which brings the destruction of lives and wealth (Mises, 1932/1951, pp.72-73). It is not imperative, however, that these ideals necessarily follow from democracy, independently of any circumstances of particular eras or places (Hayek, 1944, p.73-74; Schumpeter, 1976, p.242). As such, when I subsequently speak of democracy, I do so on the condition that it is particularly favorable to fostering these values. As Schumpeter (1976, pp.242-243) points out, allegiance to democracy supposes allegiance to values which the method is expected to

serve, not to the method itself, lest one would be prepared to admit that any results brought about in a democratic manner by the “will of the people”, be it the persecution of religious or ethnic minorities, or the aggressive invasion of a neighboring nation, should be met with approval.

Socialism is a type of collectivism, and as such it is characterized by the aim of directing all of society’s resources and efforts towards a defined social goal. All of society’s activities must be coordinated, presumably by some sort of higher authority, to make sure that they further said social objective. What this objective is specifically is what distinguishes the distinct strands of collectivist thought – for socialism it is typically the improvement of the situation of workers and non-property-owning individuals, but the same collectivist framework may be used to raise the status of an aristocratic elite, a certain ethnic group, the members of a political party or the military etc. (Hayek, 1935a, p.15; 1944, pp.34-35, 59-60). Independently of particularities, the goal is often worded as “the common good”, “public welfare”, “general interest”, or similar (Hayek, 1944, p.60). Naturally, the subjugation of all of society’s forces towards the pursuit of definite objectives raises concerns regarding the ability of doing so in a democratic manner which preserves individual freedom. Particularly, because it elevates said “common good” as the ultimate value guiding all action, subjugates individual will to it and individuals are relegated to mere tools for its achievement (Hayek, 1944, pp.151).

To make it clear then, the problem which concerns us here is not one whether socialism (or another type of collectivist society) may be brought about in a democratic manner, but that of whether the socialist society will be able to command its people and resources in a democratic manner, preserving individual freedoms and limiting the use of coercive power. As Hayek (1944, pp.64-65) put it, it is conceivable that the people would agree on the implementation of a system of centralized direction of the economy, but the problem lies in the fact that they will have to agree on the objectives which central direction will serve.

Let us think of a country where a socialist party has amassed the support of the population and has risen to power. It must now manage the economic affairs of society and bring about the prosperity that was promised. How will it go about in doing so? In the capitalist society, every individual directs his resources and efforts according to his personal wishes and valuations, using market prices to aid in his calculations of those effects of his actions which are too complex for him to assess. In the socialist society, the authority managing the resources, unable to go about the same process (for reasons I have explored in

previous sections), would have to direct resources on the basis of some established criteria; if it is not desired that the central authority merely impose its judgements of what is most needed upon the populace, the criteria would have to account in some form for the needs, desires and preferences of everyone. As Hayek (1940, p.148; 1944, p.60) made clear, doing so would require a comprehensive social code of values containing the needs and preferences of every individual, which would then have to be ranked in order of relative importance, in a manner which all (or at least a great majority) could agree on. In a population of any meaningful size and which can be divided into at least a handful of heterogenous groups, arriving at such a social code is a hopeless effort (Hayek, 1944, p.117). Democratic institutions are not equipped for such a task, and their resulting inertia may foster in people dissatisfaction with democracy itself. In truth, it is no fault of incompetent politicians or inadequate institutions, but merely the consequence of the fact that reaching a majority agreement on the direction of all the nation's resources was beyond the capabilities of the democratic process²¹ (Hayek, 1944, pp. 65, 67).

Hayek (1944, pp.140-141) speculates that the incapability of democratic institutions and politicians to manage the nation's economic affairs and the ensuing loss of faith and support of the population opens the door for new political movements. The failures of democratic attempts at collectivism will have offered them two important insights: that freedom and democracy are obstacles to the collective management of society, which requires dictatorial power; and that it is hopeless seek a general agreement on what is to be done with society's resources, so effort should be focused on obtaining the unwavering support of an organized minority, in which individuality is erased by the indoctrination into a single worldview (Hayek, 1944, pp.11, 140-142).

A common argument made by collectivists who have learned these lessons is that autocratic rule shall be confined only to the management of economic matters, things of minor importance which are only nuisances in our day-to-day lives. The goal, they claim, is to relieve the people from the struggle to feed and clothe themselves, so that they may occupy themselves with higher pursuits (Hayek, 1944, pp.51-52). This argument displays an evident lack of awareness of the nature of the problem with which we are dealing. The

²¹ The common belief that careful discussion could bring about compromise and agreement on the collective management of society's resources is, as Schumpeter (1976, pp.250-251, 254-255) points out, an incorrect belief based on the classical utilitarian theory of democracy. In fact, the common good may mean wildly different things for different people, due to differences in base values which may not be able to be bridged by some form of compromise. Moreover, many people do not even possess a determined stance on many issues, relying on vague poorly thought-out feelings (Hayek, 1944, pp.61-62; Schumpeter, 1976, p.253).

economic management of society cannot be perceived as a mere technical problem, such as ensuring that farmers toil the land and raise the cattle so that people may be fed, that textile workers make clothing so that people may be clothed, that construction workers build houses so that people may be housed. It is one of deciding whether more farmers or more factory workers are needed, whether existing water reserves are better used for people's consumption, watering crops or in factories, whether a given plot of land should be used for housing, planting or a factory – in other words, the central economic administration must solve the economic problem of allocating the available resources among indefinite possible uses (Hayek, 1935a, pp.5-7). To do this, it must possess an immense amount of knowledge, and it must be able to make calculations, both of which it struggles with as we have seen. However, more fundamentally than that, it must wield exclusive power over the direction of said resources – the farms, the factories, the land, the water, the people themselves – single-handedly determining in the service of what ends they are to be used. It alone wields the power to determine which objectives are to be accomplished, which needs will be satisfied, what goals will be prioritized and what people will strive for (Hayek, 1944, p.95). In an individualistic society, each individual allocates his resources out of his own accord, choosing which of his needs to prioritize and which will be left unsatisfied; onerous as having to make that choice may be, it is a necessity in a world where limited resources compete for nigh unlimited uses, *i.e.*, where an economic problem exists (Hayek, 1944, pp.93-94, 101). In the planned collectivist society, the burden of solving the economic problem is lifted from the shoulders of the individual, but only at the cost that he is rid of the ability to choose which of his needs are more needing of attention and which may be left unattended. Since all resources belong to the community, all choices concerning the use of said resources must be made by the community, or in fact by its representatives, and the individual's considerations and ends must always be subordinate to these choices (Hayek, 1944, pp.93-94, 101, 104).

All of this may still not dissuade the advocate for centralized command. He may argue that it is precisely this dictatorial control of societal forces towards defined goals which is desired, as it removes the misguided efforts of individuals, who are easily led astray by selfish impulses (Hayek, 1944, p.59). While not denying the danger of the formation of a repressive tyranny, he will assert that the collectivist centrally planned system contains the same potential for good as it does for evil, and the outcome is dependent on who commands it. Thus, we must make it of utmost importance to ensure that central planning

is established and led by righteous men (Hayek, 1944, pp.138-139) – if we place the control over our lives in the hands of an Alexander, a Marcus Aurelius or a Napoleon, we may rest easy that they will lead society to greatness.

A discussion on the merits and ethics of a dictatorship led by men of benevolence and goodwill, where our action may be restrained in a paternalistic form, “for our own good”, is beyond the scope of this work. What is more deserving of attention in regard to the topic of a humanitarian autocracy is the question of whether it is possible for one to exist at all. As Hayek (1944, p.140) pointed out, it seems that the functioning of the collectivist authoritarian system will foster the rise of values and of people guided by values unrelated to the high ideals that may push for its implementation. As said a few paragraphs prior, the impossibility of democratic collective economic management would foster dissatisfaction with democracy and the ascension of anti-democracy movements. In the formation of these movements, aspiring autocrats are likely to appeal to those led by their more basic impulses, to the naïve and the compliant; they are also likely to create unity by fostering a fight against a common enemy, often another class of people and their ideals (Hayek, 1944, pp.142-144). Thus, it is unlikely that the rising dictator will surround himself with people that could be considered righteous men from the start.

However, as Hayek (1944, pp.154-155) made clear, the selection of negative traits continues after the rise to power and the establishment of the collectivist dictatorship. The average citizen in such a society may live a relatively peaceful existence by merely showing obedience to authority, a sense of duty and willingness to sacrifice his personal desires for the “common good” (as it is dictated to him by the nation’s leadership). But those who wish to rise into positions of power must go beyond this: they will have to be adamantly faithful to the leader and the cause (whatever it may be) and ready to do anything to further the good of society. Men of virtue would be unable to make the sacrifice of their personal convictions and independence that a position of leadership under such circumstances would entail. Men who are brutal by nature however, who find pleasure in submitting others to their will, and who have no moral convictions to stop them from executing whatever task with ruthless efficiency, will quickly ascend to the top of the collectivist dictatorship, since this is the kind of man that the challenges of the system demand.

And indeed, there will be no shortage of opportunities for those wicked men to prove themselves. As it was said near the beginning of this section, the collectivist creed places the “common good” as the sole guiding beacon of action. No individual volitions, moral

convictions or interests may at any time override it; it is in fact one of the advantages of the system, claimed by its supporters, that it eliminates individualistic action for selfish purposes (Hayek, 1944, p.153). But if the goals of the community cannot be impeded by any individual will, then it follows that any encroachment upon the individual in the name of the community is justified; as a matter of fact, it is not only justified, but indeed the right thing to do. Such an arrangement must lead to a distortion of morals at a basic level, and leaves ample leeway for the most horrendous acts to be committed. This is essentially a rejection of the old principle by which “the ends do not justify the means” – the common good is the ultimate and only end in the collectivist society, and no individual will must constitute a barrier to its achievement, no matter what cruel means must be used to bend it (Hayek, 1944, p.151, 153-154).

So it should become clear that a socialist organization of society (at least of the kind which Hayek had discussed and which I turn my focus to in this work) can do nothing more than deprive people of their individual freedom and to bestow terrifying power upon the state apparatus which can only attract the most vile men to command it. And that power must truly be unlike anything seen before, even in the hands of any kings or emperors of ancient times (Hayek, 1935a, p.23; 1944, p.103). Exhaustive control of society’s forces was beyond the capabilities of the time. Moreover, the progression of the division of labor, which brought the increase in productivity that raised the living standards of entire populations, has made the individual ever more dependent on the actions of his fellows for the satisfaction of his actions – most of us no longer grow our own food (sometimes we do not even cook it), we do not make our own clothing, we do not build our own houses. The central economic authority will not simply play the role of a tyrant king which pushes rules unto his subjects at will, which they must follow under threat of punishment. Such an existence can certainly be oppressive, but it still leaves the individual a more or less broad scope of freedom and choice in regard to his day-to-day activities. But the central economic authority, intent on following a regimented plan, must extend its control to the directing of individual activity – all activities must contribute to the furthering of the plan, or at the very least not go against it, so no activity can escape its grasp, no choice which may impact the implementation of the plan can be made without its approval. It is not simply the case that freedom is restrained because the economic planners are sadistic autocrats, but that freedom is antithetical to the workings of the central planning system. So, for the sake of “the greater good” freedom must be restricted.

6.2. Socialism and Socioeconomic Control

The suppression of individual freedoms in the history of socialist nations is perhaps even better known to the general public than the economic issues. But more than a fact read about in books and research on socialist nations, it is the reality described by many people who lived before those regimes collapsed, and the reality under which many still live today. Kornai (1992, pp.55-57) points out that the power of the state bureaucracy is legitimized through a paternalistic ideological perspective: those in the communist party are exclusively qualified to understand the needs of the working class, and therefore to lead it. Said ability is not derived from popular support but exists by virtue of their understanding of and dedication to the socialist ideology; popular support is no indication of whether the party is fit for leadership, and active antagonism by the people can only be motivated by either poor understanding of what is truly best for them, or by malevolent intent. Thus, democratic principle is discarded from the very beginning – the wishes of the people as demonstrated in tangible forms (*e.g.* votes, acts of protest etc.) are irrelevant, since the communist party alone is endowed with the knowledge of what is best for the people and thus has the right to lead by default, in a manner similar to a king in the Middle Ages which held his position by divine right. This paternalism produces the exact behavior that Hayek had cautioned us about: the socialist state is seen as endowed with supreme knowledge of the common good, and so any of the actions taken in pursuit of said good are justified, no matter how many protest against it. Many examples of this exist.

The socialization of property and extinction of private property is deemed to be in the interests of the people, and so it is striven for regardless of opposition to it²² (Kornai, 1992, p.88). The collectivization of agriculture provides for an instance of especially tense transformation, which had to be progressed through mostly aggressive means: owners of small family undertakings were threatened to relinquish their land and other means of production and join cooperatives, while the owners of private farms employing outside

²² Even if one discounts the coercive process of socializing property, the very fact that the state controls everything and that nothing must stand outside its reach can certainly be perceived as tyrannical. In these societies, except for sports, arts and science, there is no way to rise to prominence and obtain prestige other than to ascend in the all-encompassing bureaucracy (either the state administration, the party, or the many organizations under their influence) (Kornai, 1992, p.42). Even athletes, artists, and scientists, much like everyone else, have no other choice than to work for the bureaucracy. Thus, the possibility of private ownership can be seen as a vehicle of freedom, an opportunity for those who wish to take a different path to rise in society. Those who are independent by nature, who enjoy the freedom to answer to no one and to do as they wish, and like to take charge of their own matters, may become entrepreneurs, and reap rewards for working diligently and efficiently (Kornai, 1988, pp.243-244).

labor, being classified as capitalist enterprises, had their property forcefully expropriated and were often imprisoned, deported or killed (an infamous example of this was the persecution of the *kulaks*, the small farm owners, in the Soviet Union) (Kornai, 1992, pp.77-78).

The growth and investment strategy of socialist countries also shows some signs of paternalism. Having risen to power in mostly underdeveloped countries, the communist parties always made it one of their goals the eradication of that backwardness; in fact, the socialist system will not only allow the country to match the developed countries of the world, but to actually surpass them. Promising this achievement is one of the things that garners the support of the people during the party's climb to power (Kornai, 1992, pp.53, 160-161). The paternalistic side comes not in the statement of this goal but in how it is proposed that it be attained: people must be ready to sacrifice themselves in whatever way is needed to achieve said goal. This often means the sacrifice of their present consumption so that more resources may be used for investment and building productive capacity (Kornai, 1992, pp.166-167). The growth of productive capacity in order to increase future production is undoubtedly an intelligent strategy which any society must apply in order to progressively develop and increase the welfare of its inhabitants. However, socialist nations seem to disregard any balance between current consumption and investment, as consumer goods and service sectors are continuously neglected in funding and left to lag behind. This is especially problematic for those sectors in which deficient provision causes consequences which cannot be solved by increasing provision in the future – such is the case of foodstuffs, healthcare or sanitation, for example (Kornai, 1992, pp.170-174).

Perhaps more fundamentally than all of this, the paternalistic ideology is evident in the socialist state's provision of economic security. From the outset, the rising communist parties garnered support by not only promising to end the underdevelopment that plagued the nation, as was already stated, but also that the socialist system would go beyond and ensure everyone a life free of worry, as it would see to any of their needs being taken care of. More explicitly, it would erase unemployment by providing jobs for all, and eliminate poverty by caring for people's more basic needs. These promises are never accomplished, but there is certainly effort in doing so when the system and its institutions attain stability. Unfortunately, they are also accompanied by strict control of individual freedom of action and choice (Kornai, 1992, pp.53-54, 314-315).

Public provision of jobs, the labor shortage and their economic consequences have been discussed already. What has not been said is that accompanying them there is heavy restriction on the freedom of labor – there is not only a right to work which must be protected, but in fact a duty to work which must be enforced (Kornai, 1992, p.315). Kornai (1988, p.246) explains that the directing of labor in his native Hungary (prior to the Kádár reforms) began while the youth was still in school: applications to higher education faced bureaucratic constraints, and people were even redirected in their education path according to manpower requirements. After completing their education, people were assigned to a job post with very little possibility of choice. Ironically, the socialist system, whose ideology avowed the liberation of workers, strengthened the workers' dependence on their employers, through their role as extensions of the bureaucracy: to change employment was impossible without the approval of the current workplace, and resigning for reasons considered arbitrary was punishable by law (Kornai, 1988, p.247; 1992, p.221). In some countries such as China and the USSR, at least for some time, permission from the current workplace was required so that people were allowed to change residence, receive bank loans, or obtain a passport, among other things (Kornai, 1992, p.221-222). Even the last possible alternative of escape, the possibility to work abroad, was inaccessible, at least before liberalization reforms, as Kornai (1988, p.247) detailed.

The socialist state also sees to it that people have their basic needs satisfied, but this can only be done because it controls their consumption. Administrative pricing has been discussed already – in the absence of markets, the socialist government administratively sets the prices of all commodities. This is done specifically with the intent of influencing demand in a manner considered desirable²³ (Kornai, 1992, p.153). To this effect, and also to pursue some form of redistribution of wealth, some products are subsidized (those deemed essential), while others are taxed (usually whatever is considered a luxury good) (Kornai, 1992, pp.153, 319-320). Disregarding the difficulties in redistributing wealth as intended using consumer prices, this is nonetheless a manner of influencing demand to not align with the preferences of consumers and a clear demonstration of state paternalism. The state goes beyond this, however, and provides some products and services free of charge, via rationing, according to multiple administrative criteria: family size, number of dependents, ability to work, but also rank occupied in the bureaucracy, political merit and

²³ This is done for both households and firms, but it has little effect on the latter because the soft budget constraint reduces firms' price responsiveness. Individual consumers and households however have a hard budget constraint and thus cannot escape it (Kornai, 1992, p.153).

other achievements (Kornai, 1992, pp.273-274). The provision of these goods and services is however accompanied by the sad reality that the state controls what and how much one may get, and willingly discriminates in whatever way it desires – a common result of this is the lack of freedom of choice in the access to many good and services²⁴, as well as the existence of special privileges for the holders of political or administrative posts²⁵ (Kornai, 1992, pp.315, 322).

Until now I have presented deliberate limitations on the freedom of choice and action brought by bureaucratic control. But the restraints on these freedoms are made worse by a secondary product of the planned economy: the state of chronic shortage and excess demand. Evidently, the individual loses his freedom of choice every time that one of the options to choose from becomes unavailable to him; one might even conjecture, as does Kornai (1988, pp.238-239), that the individual benefits even from options which he would not choose regardless, if not in his effective material welfare, which would be untouched by the lack of options unappealing to him, then in his sense of possessing true freedom to choose. The effective consequences of the shortages in socialist nations do however tend to have an effect on people's welfare, because it means even less resources are expended in those sectors that cater to the consumers, which are normally low priority already: there are intense shortages of stocks in stores, forcing people to buy unideal replacements or to postpone their purchases, sometimes indefinitely; healthcare facilities are overcrowded and there are long waiting lists for many procedures; educational institutions receive far too many applications; a shortage of housing forces families to share apartments, among other problems (Kornai, 1988, pp.238, 248-253; 1992, pp.237-238).

By now the point should be clear: the people in socialist nations are robbed of their economic agency on various levels. On the one hand, by virtue of the system's central features, the state alone directs production, with very little scope for private ownership or initiative (especially before the reforms implemented in some socialist countries from the 1960s onward); because it rules over production, it also must rule over the labor needed to

²⁴ A good example is how public healthcare or education are free or extremely accessible, but people are assigned to places of treatment, doctors and schools without much choice in the matter: Housing too is extremely accessible, yet the state decides where one lives, under what conditions and can freely evacuate and transfer people from state residences (Kornai, 1988, pp.246, 250, 251; 1992, p.315).

²⁵ This phenomenon is extremely common in socialist countries. Although inequality in money income is not big, which aligns with the socialist ideology's antagonism towards it, differences in material welfare are heightened by differences in access to goods and services. There are special stores exclusively for holders of political-administrative posts which are better stocked, have higher quality service and may even have goods found nowhere else, such as goods in shortage or imported goods. Services too experience this: bureaucrats and party members have access to better hospitals, schools and housing (Kornai, 1992, pp.42-43, 322).

produce, and thus the freedom to choose one's field of work (and even of education), to choose where to work, and even to choose to quit one's job are restricted. On the other hand, it controls consumption through indirect (taxation, administrative pricing, and nominal wage) or direct (public distribution and rationing) means, restricting people even in how they choose to satisfy their needs. Thus, the authorities exercise complete economic dictatorship, whose control is exhaustive and nigh inescapable in people's lives.

But the control of the authorities extends beyond the economic sphere. According to the ideology, the communist party alone is imbued with the knowledge of how to lead the people towards prosperity, and thus it must hold power by any means necessary. Any opposition may be a threat to the maintenance of power and must be dealt with accordingly. Not only economic freedom, but indeed social and political liberty are an affront to the party and an obstacle in the way of socialist goals. Thus, the forces and institutions which maintain order and peace become an extensive network of surveillance, policing and propaganda designed to preserve the party's power (Kornai, 1992, pp.59-60, 313). In the Soviet Union, almost from their inception under Lenin, the security forces acted as a subordinate of the Party and of the central government, with their main objective being to protect the party's power and eliminate any threat to it. Even the civilian police force (the *militsiya*), was predominantly used not for stopping crime and protecting order and citizens but for political control, as it was subordinate to the Cheka (the secret police) and worked in collaboration with it in the suppression of *kulaks*, class enemies, counterrevolutionaries, saboteurs and any opposition to Bolshevik rule. Stalin continued and built upon the trend of politicization and concentration of power in the security forces (Shelley, 1990, pp.490-492, 494-495, 497, 500). Khrushchev's rule saw a departure from the explicitly violent persecution of anti-communist sentiment, and a corresponding transition to a more covert manner of societal control, one present in socialist societies since their inception but which gains prominence after its institutions have gained roots, one more reliant on education, propaganda, surveillance and social pressures. This is what Baločkaitė (2015, p.216) calls, borrowing from Hannah Arendt's prestigious works on totalitarianism, hidden or indirect violence. Nonetheless, the security forces and the apparatus at large remained at the beck and call of the Party, never becoming a separate institution bound by the rule of law (Shelley, 1990, p.506). Only under Gorbachev were there clear strides in that direction, efforts to transition security forces to an operating model akin to the one present

in democratic Western nations, where security institutions are servants of the law and not of the Communist Party (Shelley, 1990, pp.515-518).

It is thus evident that the legacy of the centralized socialist system and its institutions is one of suppression of the freedoms of the individual on a fundamental level. Economic control reduces economic freedom to a minimal degree. The freedom from coercive powers, which precedes political freedom, religious freedom, freedom of speech, freedom of movement and others, is precluded by a near omnipotent party which breaks the will of the population, either through the explicit violence and brutality of authorities, or through the veiled methods of propaganda, deception, control of information and ideological indoctrination.

7. Conclusion

In the previous sections, I presented a set of problems that the socialist centrally planned economy must confront. I attempted to expose these problems as consequences of the system's institutional framework, instead of the result of misguided policies or agents. This distinction is vital, as I now take a concluding look at the socialist command economy from a systemic analysis perspective, at its problems and their connections to the system's structure and each other, and what this means in regards to the possibility of salvaging the socialist central planning system from the problems which afflict it.

All the problems I have presented so far are connected with the institutional framework of the socialist planning system, and, by virtue of this, also connected to one another. This is plain to see if we borrow from Neuberger and Duffy's (1976) approach of conceptualizing the economic system as fundamentally composed of three structures (the DIM approach):

- There is the decision-making structure, which determines who makes what decisions and how the authority to decide is maintained. In the socialist planned economy, all of society's resources and the authority over them are concentrated in the hands of a pyramidal bureaucratic apparatus, where one's discretion and the importance of one's decisions rise along with administrative rank – from here we derive the authoritarianism problem.
- To make rational decisions it is imperative that decision-makers have information – such is the role of the information structure, which relates to all activities that pertain to the gathering, handling and transmission of such information. After the administrative command chain of the socialist system is established, information flows through the vertical channels of the bureaucratic hierarchy. This relates to both the calculation problem and the knowledge problem, since the bureaucratic coordination mechanisms which replace the market lack the ability to produce economically significant prices and to take into account all the relevant knowledge of particular circumstances and details.
- Finally, the motivation structure is needed to persuade other agents to implement the decision-maker's decisions. The apparatus employs a variety of methods to do so. Although not entirely fruitless, those methods simply fail to reproduce the fine balance between prudence and risk that private ownership and market competition imbue into the individual, and the way they hold him responsible for his decisions – this is the crux of the problem of incentives, initiative and responsibility.

The connection between the problems described and these fundamental structures makes clear that divergence from the command economy framework is inevitable if solutions to at least some of the problems are to be reached. Mises (1932/1951, pp.217-220) had argued that the deficiencies of the socialist system could be dealt with only through the fostering of autonomy and freedom, of private ownership and horizontal relations between agents. The question is whether the socialist system can make significant strides in this direction and embrace changes of this kind, or if, lacking the ability to do so, it must collapse like a house of cards and give way to an entirely different system of economic organization.

The road to salvation presents itself as the incorporation of elements of the liberal market economy into the framework of socialist central planning – what has been called market socialism, state capitalism, even sometimes mixed economy, among other names. These ideas aim at an amalgam of features of socialism and capitalism which enjoys the advantages of both without the shortcomings of either (Kornai, 1992, pp.477-478). I have already shown some objections directed to the theories of market socialism by Mises and Hayek, and do not intend to greatly expand upon its merits and problems, or those of similar forms of mixed economic system. I instead aim to argue that the process of incorporating capitalist elements into the centrally planned socialist economy is a challenging endeavor which, due to features of the inner workings of the command economy, may very well prove impossible.

If we dispense with the ideological theories and jargon as much as possible, and look at it from a panoramic perspective, the system of socialist central planning, at its basis, constitutes in the creation of an immense hierarchical organization to direct economic activity, with the goal of substituting spontaneous interaction between many agents with consciously planned and coordinated economic activity (Hayek, 1944, pp.21, 36). This is the system's logic, from which sprouts the dominant undercurrent which guides the system's development: the tendency to expand and perfect control *ad infinitum*. This trend constitutes a roadblock on the path to market socialism, as it carries over to the problem-solving rationale within the system: problems and inadequacies are seen as the results of nothing more than deficient control which affords agents too much freedom to shirk, so regulatory mechanisms must be reviewed and authorities empowered to deal with said

issues ²⁶ (Kornai, 1992, pp.366-367, 396, 398). Concurrently, there are countless reorganizations of the administrative apparatus, firms are merged, planning indicators are altered, new methods of planning involving mathematical models and computers are introduced (Ericson, 1991, p.24; Kornai, 1992, pp.398-399, 405-407). These measures often fail to combat the problem they are meant to entirely, or do so at the expense of another issue taking its place. As has been presented before, the problems which concern us are not manifestations of superficial facets of the system, such as the organization of the bureaucratic-administrative structure, the slack or tautness of the rationing, or the plan indicators used. Tinkering with these may very well influence the severity of the problems, but it will not bring about their resolution.

But a breakaway from the dogmatic pursuit of complete control is neither easy nor the only condition to allow for the fusion of capitalist elements into the socialist framework. This is because the institutions of the command economy are interdependent parts of a mechanism which requires all of them to work properly – the whole structure works synergistically. The earlier analysis along the DIM framework already highlighted this to a degree, but it may be further emphasized through a look at the evolutionary process of development of the institutional web of the central planning system. Although I have previously underlined the “conscious control” aspect as central to the conception of the socialist command economy, this should not be understood to mean that each of its institutions must be consciously forced upon a society and maintained only through the constant oppression of the ruling powers. In fact, after an institutional framework is successfully imposed initially, it grows spontaneously in line with its inner logic. After a volatile transitional period, institutions crystallize and reach a state of equilibrium, striking a balance in which they mutually support and need one another (Kornai, 1992, pp.366, 369). Like a living organism which evolves traits that aid in its survival and reproduction, so does the command economy over time develop features which reinforce each other and promote its continuity. The whole structure of the command economy is organized in such a way that deep changes diverging from the conscious control logic and the perfection tendency disturb the harmony of the whole, and are therefore likely to have undesired results. The only solution becomes to reverse the reform and reestablish bureaucratic control (Ericson, 1991, pp.24-25; Kornai, 1992, pp.571-573). In other words, under the

²⁶ This is apparent, for example, with issues such as vertical bargaining, deceitful reporting, input hoarding, or import hunger, which are usually dealt with by making plans more taut, tightening administrative rationing and implementing quotas and permits (Kornai, 1992, p.365).

logic of full conscious control, the relinquishing of control is counterproductive and the tendency for the consummation of control imposes itself. To go back to the analogy with evolutionary biology, the system displays a process of “natural selection” of institutions: some institutions, although they may never have been planned or included in the ideological foundations and blueprints of the system, arise out of practical necessity and are embraced; others, which go against the system’s logic and do not resonate with the already established framework, cause disruptions and are promptly rejected by it, like an organism that rejects a foreign body (Kornai, 1992, p.366-367).

So the path of the mixed economy is blocked by the planned economy’s logic and the symbiotic relation of its institutions. The only way to break through is to attack their catalyst. As Kornai (1992, pp.568-569, 570) argues, deep and long-lasting reforms which go against the framework of the command economy have as prerequisite alterations in the ideology of the communist party and in its monopoly on political power. This is the seed from which sprouts and grows the whole structure of the system with its dominant trends. The ideas that the communist party should hold power exclusively, so as to direct society towards the common good, and that private ownership, markets and all related evils of capitalism should be abandoned in favor of public ownership and the strict hierarchical bureaucratic order, are ideological axioms (Kornai, 1992, pp.414-415, 572). So, while these hold, no efforts at liberalization in the economic or political sphere can go very far: non-public property forms and non-bureaucratic mechanisms of coordination can exist only in an atrophied form, within strict limits and always susceptible to arbitrary intervention from state power (Kornai, 1992, pp.566-567). But shifts in the ideology make it ambivalent and incoherent, and the easing of the communists’ hold on power opens the door for new opposing ideas and allows for greater expression of dissatisfaction – all of this erodes people’s faith in the system and its ideology, and fosters dissent (Kornai, 1992, pp.417-418, 447, 479, 571-572). More than any other, this alteration endangers the system’s integrity, and pushes it towards its tipping point. The sphere of politics and ideology certainly constitutes a great barrier to reform, but it is also the support pillar of the entire system. Without it the system collapses and a different one rises in its place. This is the experience of most socialist nations after the late 80s to early 90s, save for a few exceptions.

Throughout this work I have made it my objective to cover in detail the theoretical and practical failings of the system of socialist central planning. And the problems are plentiful, complex and debilitating indeed. But despite its many shortcomings, the system manages to

build a solid institutional structure to allocate resources to desired ends, which is able to endure. In other words, despite the many frictions and problems inherent to it, the system establishes a state of stable equilibrium. This, however, has the drawback of constituting a barrier to many changes aimed at solving its problems. Its elements work in a state of symbiosis, so changes which conflict with the preestablished foundations destabilize it greatly. An option is to backpedal on the reforms and return the system to its equilibrium, but this brings it no closer to solving the problems the reforms set out to fix. Alternatively, if reforms are stubbornly clung to, then the difficult task of sustaining a system without a cohesive framework and whose components do not quite fit together has to be shouldered. It is not my intent to fall into the pitfall of fatalism or determinism; China, Vietnam, even Laos to a degree, constitute instances of countries that have managed to successfully sustain a system blending the exclusive political power of a communist party (although with some considerable ideological shifts (Kornai, 1992, pp.416-417, 445-446)) and its trademark control over many facets of civil society, with a substantial role of private ownership and markets, along with varying degrees of political and economic freedom. To these we may add the historical cases of Hungary under Kádár or Yugoslavia from the 1950s onward, and even Poland and the Soviet Union during a briefer period before the collapse of their communist regimes (Kornai, 1992, pp.428). Yet all of this does not subtract from the conclusion – the latter examples in fact add to it – that it is still an inherently precarious balance, and that the antagonism between socialist bureaucratic institutions and capitalist market institutions may easily deteriorate the performance and functioning of the system in such a way that forces it to either return to the framework of fully centralized planning or thrusts it into a transition into a true market economy.

Ultimately, my research on the problems of socialism is not meant to elevate the liberal capitalist economy as some panacea, the undeniably superior socioeconomic system to cure all of mankind's ills. No intellectually honest person could deny the imperfections and issues of said system. Rather, it is a researcher's responsibility to use the tools of logic and reflection to fight this kind of idealism, this belief in a perfect conceptualization of society which we should all strive towards in order to fix all our problems. It is what I have attempted to do here – to argue that, even if capitalism cannot solve all of our problems, it cannot be claimed that socialism is the solution either.

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