

## Episode 408: The Main Reason Socialism Can't Work

Guest: Matt Machaj

**WOODS:** I have not yet done an episode explaining the socialist calculation problem of Mises, and I thought I should do one, and I thought of you as a guest. I could have done this episode on my own, and just given my account of the socialist calculation problem, but you have an interesting development of the analysis of this, and I'm going to be linking on the show notes page today -- [TomWoods.com/408](http://TomWoods.com/408) -- to this article of yours from *The Quarterly Journal of Austrian Economics*. It's from all the way back in 2007, when you were just a lad, and it's "Market Socialism and the Property Problem: Different Perspective on the Socialist Calculation Debate." What I'd like to do right now is lay out the best I can, off the top of my head, the traditional version of the socialist calculation problem, so everybody understands it. We can comment on it, and then I want to add to it, based on your own insight. So, you ready?

**MACHAJ:** Yes, of course.

**WOODS:** Now, you tell me where I'm wrong or where I'm imprecise, okay?

**MACHAJ:** Okay.

**WOODS:** I know that won't be a problem. You don't hesitate --

**MACHAJ:** (laughing) No, no, it's going to be a big problem, you know this.

**WOODS:** (laughing) All right, here we go. The argument that Mises made in his 1920 -- and you know what, I'm also going to jot down: I should also link to Mises' article, naturally -- his article, "Economic Calculation in the Socialist Commonwealth," is basically this: The problem with socialism is fundamentally not the problem that if you have a society based on so-called equality, then people will be less likely to work, or they won't want to do the especially dirty work. It's not primarily that. The problem is that, if you have a system in which one entity owns all the means of production, then it is impossible for you to gauge in economizing behavior. And the reason for this is that when you have multiple owners of property, when those people buy and sell the various property that they own, the process of buying and selling gives rise to prices. But when one entity already controls and owns everything, there wouldn't be any buying and selling. They already own everything. And if there is no buying and selling, there is no process by which prices emerge. And without prices, it becomes impossible to evaluate different production processes. It becomes impossible to decide, "If I'm going to produce consumer good X, where should I produce it, using what factors of production, in what quantities, in what combinations?" Because there's no single unit of account, I have no non-arbitrary way of saying that this process that uses more lumber than rubber is better than this process, which uses more rubber than lumber, or whatever the process is. I can't say that, because I have no basis, no unit of account, by which to compare them. And that unit of account also helps to make sure that what I'm producing and the way I'm producing it is not coming at the expense of some other production process, where this input might be valued more urgently by the consumers. I'm simply groping in the dark, and when

you consider that an entire economy is being organized this way -- not just the production of one good, but an entire economy is being organized without the use of prices -- the result has to be massive discoordination, chaos, ludicrously uneconomic production, and so on. Is that a fair overview of the socialism calculation problem, as Mises conceived of it?

**MACHAJ:** Yes, I agree, that's a good picture of it.

**WOODS:** All right, good. So now I've done the easy part. You're going to do the hard part, which is showing what Mises and others might have also wanted to add. Because I'll just give away the punch line: You say late in your paper that socialism is actually fundamentally not a calculation problem, not a knowledge problem as Hayek would say, but rather a property problem. But before we get to that, let's look at the way the socialists responded. The socialists did not say, "Well, I guess we're all wrong, so let's forget this and become laissez-faire capitalists." Tell us who Oskar Lange was and how he tried to respond to this. And you have a lot to answer for -- he was a Pole like you, wasn't he?

**MACHAJ:** Yes, yes, he was a Pole. And his famous argument was the market socialist argument. So he basically agreed with Mises about the necessity of calculation, that in order to decide which processes are more productive or more important, we need some form of calculation. Actually, the way he starts his article is he mentions Mises; he praises Mises in a kind of satirical way -- you can feel the irony. But there is some truth to it that he praised the argument: Yes, we need calculation. We need prices to act efficiently, even under socialism. So those utopian socialists -- Karl Marx believers and so forth -- were wrong. They were wrong that we can get rid of the market institutions. We need market institutions. We need economic calculation, monetary calculation. However, agreeing with the fact that we need calculation, the question is how to organize calculation under central planning -- or actually central ownership. That is, how to get rid of private property and still have economic calculation under socialism.

**WOODS:** Let me interrupt you for a second. I didn't actually define the term economic calculation. Why don't you do that first?

**MACHAJ:** Economic calculation is done thanks to buying and selling by private owners and by the creation of the price system, of prices. So all the factors of production and all consumer goods and various intermediate goods and ordinary factors and produce factors -- all those things can be priced in a common denominator, in a generally accepted medium of exchange -- that is, in money, in monetary terms. And because we have these prices, we can calculate -- that is, we can see which processes of production are potentially giving us higher returns, monetary profits, and which are the ones that are most probably bringing us losses rather than profits. So this is economic calculation.

**WOODS:** Okay, so profits and losses. So now go ahead and continue explaining how the market socialists, so-called, tried to answer this.

**MACHAJ:** Right, so Lange says that, sure, we need prices, but who says that, in order to have prices, we need to have exact trading in exchange? We can use prices as parameters. We can have the central planners' list under socialism, and on that list we're going to have various factors of production. We will assign prices, and then we can have a free consumer market, meaning that in

public stores, the clerks will be selling chairs and food and furniture and so forth. And depending on how high the demand is or how low the demand is, we're going to adjust the prices, because we will also have the prices for consumer goods. Henceforth, we can have a formal economic calculation; it's just, all the factors will be owned by the state. But still, the state can assign various numbers that can allow us to calculate which of the processes is more demanded by the consumers, and which ones are more profitable, and which ones are not.

**WOODS:** Okay, okay, stop right there. I want to know exactly how that would work, or how they think that would work. Because I've never understood this.

**MACHAJ:** Okay, first, we start with an accidental --that's how his argument is phrased -- an accidental range of prices. Or let's just say we nationalize the resources in one day without any aggression, so everyone agrees that we just give up the property, and we accept the new socialist order. Now everything is owned by the state, but the state is using the same prices that we used the day before. All the goods that are in the stores, they are priced. So the consumers can go in and buy products and commodities. At the same time, all the factories and all the production is owned by the state. And let's say the state hires managers to manage various companies and factories, and the managers also have to perform economic calculation, just like private owners did. So all they have to do is they look at the central planners' list -- so what is the price for various factors of production -- and they can measure how much they have to spend of their budget to produce something. And at the same time, they can measure true consumer demand -- so people are coming into the stores and buying chairs, furniture, food, TV sets, etc. -- well, we wouldn't have those under socialism, but let's say we do; let's say we introduce socialism in a very developed economy. And so when we have prices and monetary revenues associated with people buying those final consumer goods, and when we compare them with the cost that we have to cover in order to produce those goods, we can also do a form of economic calculation. We can also calculate whether it's more profitable to produce the things that consumers are buying, or if it's less profitable, or maybe it will lead to losses if we produce something which is underpriced, or for which the demand is not high enough to cover the outlays necessary to produce those commodities and goods which are purchased by consumers.

Okay, well that's the essence of the argument: that on one side, we still have a free consumer market. People are spending their income on consumer goods, which are sold in the stores. And we can see what are the monetary revenues associated with it. And at the same time, because we have a central planners' list and prices -- even taken the day before by the capitalists' order before we nationalized the resources -- we can see how much it costs to, say, make furniture, which is being sold to the consumers. And if the costs are too high or maybe the consumers are not buying chairs, we will see that there is a surplus of chairs, or we will see that it's not profitable to produce chairs. Therefore the decision of the public managers should be to decrease the production of that. And we have the whole neoclassical framework for that -- supposing that the neoclassical framework was invented to describe the process of economic adjustment and economic calculation. And the way that it was being presented, you just apply this same thing to Lange's argument, and you apply the same thing to the explanation of how market socialism works. We have prices for consumer goods, which are purchased by consumers, and at the same time, we have official price lists for all the factors. So you can calculate -- you can actually do kind of a similar thing, in terms of adding and subtracting things together. So you have a budget, in terms of you can see how much you have to spend on production of the chair, and you see how much

you can earn by selling the chairs -- that is, the consumers are deciding. And they're signaling whether it's profitable or not to produce those things.

**WOODS:** All right, now that may sound to some people who don't read about this stuff all day as being fairly similar to what happens in a free market. So we want to make clear what the problems with that are. Is this what Mises refers to as the "trial and error method"?

**MACHAJ:** A little bit, and in *Human Action*, he has two chapters about market socialism, and I think the second chapter about the managerial function is more important. Because in the trial and error method, he refers to any trial and error method, not just market socialism, but any method for choosing which option is better. And his criticism looks as if he's still responding to those arguments, which are not based on market socialism, because he points to the fact that we need some form of judgment, that we need to refer to something to estimate whether we're making a mistake or not. That is, he refers back to the calculation argument in a way, because he says that we need prices and we need standards for comparison. So the trial and error method sounds fine, but then we have to move further. So how do we recognize correct choices from incorrect choices? And then his criticism is much stronger when he talks about market socialism and the managerial problem, where he points out the fact that public managers are not really entrepreneurs. And I think that's the essence of his answer, and that's one of the best answers to market socialism.

**WOODS:** Okay, yeah, so go ahead and develop Mises' answer on this, and then I want to turn to your discussion of property as being the fundamental question. But Mises on the managers not being entrepreneurs, and of course, not using their own money.

**MACHAJ:** Right, right. So in a nutshell, they're not using their own money, and they are actually existing under a political framework, under political reality. And the choices that they make are very narrow. So they are merely organizers. But what makes the whole production process work is the market outside of those enterprises. The main problem is that we don't have competition in all fields under market socialism; we just have a very, very narrowly defined competition between the managers, which are appointed by the central planner. But under capitalism or under entrepreneurialism or through free markets, this is not the way the system works. We actually have the whole capital market -- that is, the market outside of various companies -- we have ultimate owners deciding about all factors of production. Whereas, under market socialism, many decisions are being made outside of the competitive process. So once you assign the manager to a specific company producing shoes, for example, you already made many decisions for that person. You decide about the budget, you decide in general what is supposed to be produced, you decide in general how many people should be hired, and so forth. Whereas, under a full free market system, when you're the owner, you can actually just close the factory and decide to have a restaurant, or you can decide to have a farm. It's your choice. So the range of choices is much broader. And what is important is that the budget is not being decreed, is not being decided by the state. The budget is also competitively assessed, so we have various private entrepreneurs competing for resources and actually deciding about the resources. Whereas, under market socialism, this is also a political process; this is also decided just by the central planners. It's decided by the outset, so it's not subjected to any competitive process, as compared to capitalism.

**WOODS:** All right, now I want to turn to your point about socialism as being fundamentally a property problem. And then I want you to explain how that insight helps us better understand what the fundamental difficulty with socialism is. And in other words, how are you making the Misesian critique stronger, or maybe more fundamental?

**MACHAJ:** I think what makes it stronger is actually Professor Salerno's paper about the appraisal process. So this is actually an important step forward, because Mises, at times -- well he was writing for the broader public -- but at times he's making his argument simple, and it looks sometimes -- not in *Human Action*, but let's say *Liberalism*, for example -- as if it's a technical argument about the necessity to have parameters, to have those things called prices, a common denominator. So we can assign the numbers, and just because we have numbers, we can solve the problem of economic calculation. Now in general, this is true that the unit of account, that calculation, is very important, and this is, say, one of the best inventions in human history -- double entry bookkeeping, so we can actually assign prices, and calculation becomes the method of thinking. So this is true, but then, thanks to Professor Salerno and other papers, we can take this step forward. It's not just the unit of account that we have, but we have to think how this unit of account refers to various types of actions. Sure, we need calculation and we need to calculate what is better and what is worse, what are the choices. But how the calculation is being performed -- so who is doing the calculation and in what way? And this is where the property argument comes in and where the appraisal argument comes in. The main difference between market socialism and between capitalism is that the calculation is being done in a completely different manner. In the case of market socialism, the assigning numbers and the adjustment of the numbers is done by one owner. So again, by a political entity.

So it's kind of like an extension of Mises' criticism of the manager versus the entrepreneur, in the case of market socialism. In capitalism, on the other hand, prices are not being set by one owner. They are the result of the social appraisal process, the one which was described in a paper by Professor Salerno. So prices are actually constraining the actions of the entrepreneurs, because they are not the result of their choice. So when you're a private entrepreneur in a market economy, when you see a price it's a real constraint on your action exercised by other owners. So they have other ideas for competitive assessment; they have other ideas for allocation of the resources. The so-called opportunity cost associated with calculation is exactly the result of this -- that other entrepreneurs have other ideas, and they know how to allocate the resources in a different manner. So there is some form of this agreement between the entrepreneurs, which is being done under private property -- so under peaceful cooperation -- and the price is a signal to all the other entrepreneurs that some other entrepreneurs are having some other ideas. Whereas, under market socialism, a price is just a choice invented by the central planner. It's not a signal that someone else has an idea to do something. Someone else is already in prison or tortured, right? So it's not manifesting expectations or choices of other entrepreneurs. A couple of months ago, I think you invited Deirdre McCloskey to talk about the bourgeoisie, right?

**WOODS:** Yeah.

**MACHAJ:** So in a way -- to inject her argument -- the West grew rich, because we had this bourgeoisie, so we have those private owners that compete with each other in a peaceful manner. So they have various ideas of how to make things more competitive, how to produce better products, how to supply more goods and services, how to make them cheaper, and so forth. Once

you introduce socialism, aggressively -- you have to do it aggressively, because you have to expropriate people -- you actually get rid of those people; you torture them; you imprison them; you kick them out of the country. In any case, you're getting rid of all those skills that are necessary to make the calculation work, because this is actually how calculation makes sense, because they act within the boundaries of private property and mutual cooperation. Whereas, under socialism, you can't introduce the unit of account. Of course you can *do* it, but it's just a manifestation of your own will when you're the central planner. So you're not really economizing the skills and talents of the planning of other entrepreneurs; you're just imposing your own will on the society with those units. So that's why it's completely different calculation under market socialism -- that's why it's completely different from the capitalist order.

**WOODS:** That was the point I was very, very interested to read when I read your article years ago. I thought, "Okay, here's another fundamental insight that I didn't have until reading this." It definitely helped me understand things better. Now, let me ask you one other thing: Today we have basically no regimes where -- basically nobody is proposing that the state should own the means of production. They are proposing a lot of things, but they're not proposing that. Does that mean that the socialism calculation issue is no longer really relevant to us?

**MACHAJ:** No, no, it's still relevant. The question is, how much are we torturing our bourgeoisie? How much are we torturing the private owners? And the more we torture them, the more we make our economies inefficient and stagnant. So it is relevant. We do not have the same problems as the Soviet Union, because we didn't actually destroy the productive class. But the more we consume the productive class, the more burdens we put on the productive class, the closer we get to socialism. Therefore, we have less innovative economies, and potential growth is lower than it otherwise would have been.

**WOODS:** But every time the state acts, in terms of spending -- every time the state spends, allocates resources -- even though it doesn't own all the means of production, and so therefore it's not operating the way a socialist planning board would have to operate -- it's still acting, though, in the dark. It is still acting arbitrarily, because it has no profit and loss mechanism to use. So is it maybe a light version of the socialist calculation problem?

**MACHAJ:** It is, it is. Sometimes you can find the arguments are part of the state apparatus, that the state can also calculate. But that's not actually true, because the state is not raising money in the market, and it's not voluntarily financing its activities. If it did, then of course -- but then it's not a state. So the whole argument about the state leading to some other profitable result is problematic, because state action is based on unprofitable activities. When you expropriate the resources from society, you're just consuming them immediately. So there is no true calculation in there. And, as you point out, the state is still acting in the dark under the circumstances, because they just spend the money; they just budget it: another thing, which was developed in a great, small book -- a neglected book by Mises, *Bureaucracy*.

**WOODS:** I will link to that also, as one of the books mentioned on today's show. So the show notes page will be [TomWoods.com/408](http://TomWoods.com/408), where we will link to you and your site, and we'll link to *Bureaucracy*; we'll link to the article you wrote; I'll link to Joe Salerno's article. What a wonderful companion [TomWoods.com/408](http://TomWoods.com/408) will be for people listening to this episode. But if they don't -- I can't imagine, after listening to this episode, that they're not going to the show notes

page. My heart, I don't think, could take that -- but let's imagine that they didn't. Do you want to spell out for us English speakers -- who may not be able to spell out your Polish name -- spell out your website, so people can contact you?

**MACHAJ:** Sure, sure. It's [MateuszMachaj.com](http://MateuszMachaj.com).

**WOODS:** All right, very good, we'll link to that at [TomWoods.com/408](http://TomWoods.com/408). Matt, thanks for your time today. I'm glad we were able to schedule this so it wasn't three o'clock in the morning for you.

**MACHAJ:** Thank you, Tom, it was fine; it was great.

**WOODS:** Well, it was a real pleasure to talk to you. We'll have you back one of these days. Your episode, which I'll link to also on that page, talking about the transition away from communism in Poland is still a listener favorite, so it's always great to talk to you. Thanks again.

**MACHAJ:** Thank you so much.