

Public Choice and Socialism

The idea of constructing a rational economic order through state control dominated 20th century public policy. The theory of socialism swept the intellectual world by grabbing the higher moral ground, and in the policy realm, socialism exerted its influence by creating political revolutions in Russia, China, and throughout the underdeveloped world. Less obvious, but no less important, was socialism's influence on the policies of non-socialist countries. The great 'liberal' democracies all moved in the socialist direction in terms of public policy throughout the 20th century. The rise of the democratic welfare state in the UK and US and the explosion of the government's regulatory role in these economies are all manifestations of the socialist victory in the world of ideas.

The socialist experiment proved to be a failure. It proved not only an isolated failure, but also a global one --- every political and economic system influenced by socialism suffered from a severe crisis in the last decades of the 20th century. The soft socialism of the democratic welfare states suffered from fiscal crises in the 1970s and 1980s and led to dramatic policy transformations in the UK (Thatcher), and US (Reagan). Other highly regulated and egalitarian societies followed the Thatcher/Reagan path in the 1980s and 1990s --- New Zealand, Ireland, and even the Scandinavian welfare states had to adjust their fiscal houses. Of course, perhaps the most dramatic political-economic event of the 20th century was the collapse of real-existing socialist states throughout East and Central Europe in 1989 and the dissolution of the former Soviet Union in 1991 (the only other contender for most dramatic event this century is the Great Depression of the 1930s). A century that began with increasing demands for the regulation of business and economic planning by government to achieve more efficient production and a more egalitarian distribution of income, ended with a worldwide privatization revolution and a

generalized recognition of the innovative benefits that accrue from entrepreneurship. The intellectual demand for state control of economic life was replaced by a 'gains from trade' understanding of how the world works. Public choice theory played no small role in this dramatic shift in the intellectual climate of opinion. More pertinent for our purposes here, public choice theory provided the intellectual apparatus needed to pierce the Romantic veil of socialist ideology and lay bear the ugly reality of the political economy of socialism.

THE 'AUSTRIAN' CONTRIBUTION

Before detailing the public choice contribution to our understanding of real-existing socialist economies, we will discuss the economic debate over socialism that took place in the 1930s and 1940s that set the stage for the development of public choice theory in the 1950s and 1960s. The Austrian economist Ludwig von Mises (1920, 1922 and 1949) challenged advocates of socialism to provide an answer to the problem of rational economic calculation in the socialist society. Mises, building on the earlier work of Barone, Pareto and Wieser, pointed out that if socialism was to operate efficiently and rationalize the process of production as was claimed, it would have to replicate the marginalist principles that had been detailed in the neoclassical analysis of the market economy. In other words, there was a formal similarity in the efficiency propositions of capitalism and socialism. The crucial difference was that socialism promised to achieve efficiency through an alternative institutional regime. Mises asked the advocates of socialism to detail exactly how the institutions of collective ownership and centralized economic planning would replicate the functional roles played by private property, free pricing and profit and loss accounting within the coordination of economic activities (also see Hayek 1948,). Mises pointed out that no such argument could in fact be made. Without private ownership in the

means of production, there would not be a market for the means of production. Without a market in the means of production, there would not be any exchange ratios established for the means of production. Without exchange ratios reflecting relative scarcities of the means of production, economic planners would not be able to rationally calculate alternative uses of scarce capital resources in production. This constituted Mises' famous argument that rational economic calculation under socialism is impossible.

It is important for our purposes, however, to point out that Mises' analysis of socialism raised at least four objections to the economic practicality of socialism: (1) private property rights and economic incentives; (2) prices as economizers of information within a complex system of exchange and production; (3) profit and loss accounting and the problem of economic calculation; and, (4) politics and the problem of the abuse of power and tyranny (see Boettke 2000 and 2001,). Mises (and later Hayek (1948)) tended to emphasize the problems of economic calculation and knowledge precisely because during the debate over socialism questions of incentives and complexity were eliminated by hypothesis by their opponents. Lange, for example, argued that questions of incentives lie outside the bounds of economic discourse (1936-37a and 1936-37b, 127). Such questions are best left to sociology, and to introduce them would violate the maxims of value-free economic analysis, at least that is what Lange and other pro-socialist economists contended. Moreover, Lange also maintained that developments in computational technology would solve the complexity problems associated with the coordination of economic activities (1969). So it makes sense that Mises and Hayek would emphasize the issues of calculation and dispersed knowledge in the debate with the market socialists. The calculation argument was the decisive intellectual argument because it could not be answered by assumption in the way that incentives and computational complexity could. The

reason for this inability to assume away the problem was that the calculation argument was grounded in an *institutional context*. Outside of the institutional context of private property economic calculation was not just difficult; it could not take place. Of course, in the examination of real existing socialist economies, the problems of incentives and computational complexity were damaging enough from the point of view of successful economic coordination. Socialist economies were characterized by inefficient production, and pervasive shortages of poor quality consumer goods (see Boettke 1993, 12-45).

A useful way to view the Austrian “calculation” argument is that it serves the same function within the analysis of socialism that Ronald Coase’s argument that in a zero transaction cost world firms would not exist serves within the development of the theory of the firm. The Austrian argument served to establish what real-existing socialism could not be, and thus enabled scholars to look inside the ‘black-box’ of Soviet-type economy (see Boettke 1998). Unfortunately, much of the 1950s-1960s literature in comparative economic systems was diverted into two unproductive research paths --- mathematical models of optimal planning, and macroeconomic econometric examinations of comparative economic growth rates. Both of these research programs, at best, added little to our understanding of Soviet-type economies, and at worst, significantly distorted that understanding (e.g., see Besancon 1980). This distortion was most evident in the claims made by leading economists, such as Paul Samuelson, that Soviet planning techniques rationalized production, and that the Soviet economy would catch-up and outperform the market-oriented economies of the west in the near future.

On the other hand, the Austrian ‘impossibility’ theorem, interpreted as we have suggested, sets the stage for a microeconomic analysis of how economic life within the politicized environment of the Soviet-type system actually operated. It strips the ‘Romance’

from socialist ideology and instead demands 'realism' in political-economic analyses of socialism. As we have suggested by analogy to Coase's work on the firm, the Austrian argument opened the 'black box' of real-existing socialism. And once opened, a public choice analysis allowed us to look inside and understand the incentive structures in operation internal to real-existing socialist economies.

FROM ROMANCE TO REALISM IN THE ECONOMIC ANALYSIS OF SOCIALISM

The Soviet system could not operate as the socialists of the late 19th and early 20th century had promised it would. It is important to remember the outlandish promises made on behalf of socialism. The socialists claimed that their system would out-perform capitalism by abolishing private property and rationalizing production. In substituting production for direct use for production for exchange by way of a settled economic plan, the socialist system would achieve unprecedented levels of material progress and do so in a manner that ensured harmonious social relations. The exploitation of man by other men would be abolished, and our state of alienation would be transcended. Mankind would move from the Kingdom of Necessity to the Kingdom of Freedom (see Roberts 1971 and Boettke 1990). Even the more informed arguments by economists, such as Lange, retained aspects of this earlier utopianism. Lange argued that while in theory socialism merely performed as well as capitalism, in reality it would outstrip capitalism's productive capacity and ensure an egalitarian distribution of income (1936-37b, 127).

Such socialist promises for enhanced economic performance and greater social justice proved chimerical on all levels. First, socialism in practice could not abolish private property rights completely because real collective property is conceptually incoherent --- someone must

retain control rights (Bajt 1969 and Barzel 1989). The Soviet system had an attenuated private property rights system in which decision makers retained control rights, but not cash-flow rights (see Boyko, Shleifer and Vishny 1995, 33-38).

The Soviet industrial sector was characterized by the literal monopolization of production. However, these monopoly firms were inefficient and required continuous subsidization from the central government. This created the problem that economic enterprises confronted a 'soft-budget' constraint (Kornai 1986).

Furthermore, bureaucratization of economic production was pervasive. The original advocates of planning did not believe this would be a problem (e.g., Bukharin and Preobrazhensky 1919). According to socialism's advocates, in abolishing private property socialism would overcome the division of labor. This being the case, individuals would be constantly shifting in and out of the different bureaus. The organizational reality of socialism, however, revealed just the opposite. In order to operate in a non-chaotic manner, a standing bureaucracy had to be formed. Thus, behavior in the Soviet bureaucracy, just as in its counterpart in the Western democracies, could be rendered intelligible through an economic analysis of bureaucratic incentives (Tullock 1965, Gregory 1992).

Finally, the glue that held the Soviet economic system together was the 'rents' to be had both internal and external to the plan. The Soviet economy was one of pervasive shortages where administrative prices were not allowed to adjust upwards to clear the market. The shortage situation created costs to buyers, (e.g., queuing), that were not simultaneously benefits to sellers. In such a situation, sellers have a strong incentive to transform these costs to buyers into benefits for themselves – either in monetary rewards or non-monetary compensation (e.g., the exercising of a preference). Building on Tullock's (1967) basic model, several scholars have

attempted to depict the Soviet system as a rent-seeking society. David Levy (1990), for example, argued that the bias in Soviet pricing was to set prices below market clearing levels because this generated ‘rents’ to those in control of the distribution of goods. Shleifer and Vishny (1992) developed a similar model to explain the pervasive shortages under socialism. Anderson and Boettke (1997) apply the ‘rent-seeking’ model further to explain the entire mature Soviet industrial structure, and through an argument by analogy relate the Soviet system to earlier mercantilist domestic arrangements for fiscal issues. In the absence of a well-ordered tax system, both the monopolistic industrial structure and the elaborate mechanisms in place to ensure that structure are designed to raise state revenue via the means of monopoly privilege and venality.

PUBLIC CHOICE AND TRANSITION STRATEGY

James Buchanan has stressed that work in political economy, if we desire to retain some level of realism and relevance, must begin with the “here and now” and not just postulate whatever start-state of analysis might be desired to make the model tractable (see, e.g., Buchanan 1975, 78 and 1997, 93-135). Unfortunately, most models of socialist transition that have been developed fail to appreciate the *de facto* organizing principles that governed life in the Soviet-type system. Concentration has instead been focused on the *de jure* statements of what constituted the system.

The Soviet system was made up of a series of interlocking “contracts” and “vested interests,” and any attempt to change the system must begin with this institutional inheritance. *If* the Soviet system was actually a land without any ownership claims, then post-communist reforms would be immeasurably simpler than they are -- even given the cultural conditioning often invoked to explain the resistance to reform. But the social fact is that many limited --

though tacitly legitimated -- ownership claims had been established throughout the economic system. The implication of this fact for the transition is that what is required is the divesture of some interests, the legitimation of others, and the creation of conditions so that others can be determined in the new social arena of politics and law. As Boycko, Shleifer and Vishny (1995, 36) put it: "The structure of ownership under Soviet socialism was thus both different from the textbook model and highly inefficient. The politicians had almost all the control rights, and no cash flow rights either. The managers had some of the control rights, but no cash flow rights either. The objectives of the politicians who possessed the control rights were very far removed from the public interest. The virtually complete political control without countervailing cash flow rights to moderate political temptations did not constitute an inefficient ownership structure." Given the reality of this ownership structure, the reformer's primary goal is to depolitize economic life. Thus, Boycko, Shleifer and Vishny argue that "controlling managers is not nearly as important as controlling politicians, since managers' interests are generally much closer to economic efficiency than those of the politicians. Once depoliticization is accomplished, the secondary goal of establishing effective corporate governance can be addressed" (1995, 65)

The socialist regime did not abolish the market anymore than the prohibition on alcohol in the 1920s stamped out the buying and selling of liquor. We know from historical examination of the War Communism period (1918-1921) that even during the height of the campaign against all forms of capitalist relationships (and the threat of death) some individuals still found it advantageous to enter the "black market." Of course, in both the attempt to eliminate commodity production in the Soviet Union and the attempt at prohibition in the United States, the nature of the market was transformed by the *de jure* structure. But if we want to understand

how the market actually operated, the *de facto* rules must be the focus of our attention (see Hewett 1988 and Boettke 1993).

At the time of the introduction of radical market reforms in Russia (January 1992) there existed an array of ownership claims. The right of ownership constitutes a claim to (1) the right to use the asset, (2) the right to appropriate the returns from the asset, and (3) the right to change the asset's form and substance (see Furubotn and Pejovich 1974). Institutions are the formal and informal rules governing the social intercourse under discussion. In this regard, when discussing the institution of ownership we are attempting to specify those formal and informal rules that govern the use, transfer and capitalization of an asset. In a world where formal rules are absent or defined in an incoherent manner, informal rules emerge to provide a governance structure within which economic decisions will be made. How effective or ineffective this system of governance will be is an empirical matter. Both formal and informal rules can imperfectly define rights and lead to social conflict. In pre-Yeltsin Russia, private property was not abolished despite the formal rules that said this was so. As Yoram Barzel put it: "The claim that private property has been abolished in communist states and that all property there belongs to the state seems to me to be an attempt to divert attention from who the true owners of the property are. It seems that these owners also own the rights to terminology" (1989, p. 104, fn. 8).

Markets are embedded within (and operate on the basis of) a governance structure, the formal component of which has in contemporary history been the domain of the Nation-State. But the Nation-State is itself embedded within a set of underlying cultural beliefs. Governance is required for the market to operate in a manner conducive to modern industrialization, but governance is also a function of market forces. Rules of the game engender patterns of exchange and production, and the emerging pattern of exchange and production aid in the selection

between different regime rules. The political center is rarely, if ever, truly uninhibited -- even in a totalitarian system. Pockets of civil society (perhaps *sub rosa*) emerge to challenge the legitimacy and power of the center. The center is inhibited, not only by formal rules of limited government, but also by the legitimating authority of civil society. Successful political and economic transformation, however, requires the development of transparent formal rules to subordinate the center to the rule of law. The key issue for this transformation is how to work through the indigenous institutions of informal inhibition to legitimate formal rules of subordination. The contrast is not really between the state and the market. It is between the state and civil society, within which market activity and non-market voluntary association co-exist. In an ironic twist, the public space required by civil society for political voice might only be possible when the private space of market competition is guaranteed. Looking at the issue this way leads to widely different implications for the manner in which privatization (and transition policy in general) should be pursued. Constraints on actions come not only from formal rules of governance, but from the informal rules rooted in “culture” as well. Hayek (and others) has stressed the tacit presumption that undergirds the formal adoption of law (1973). In this sense, law is seen as a codification of rules of the social game that already attained a level of legitimacy through *de facto* observance, rather than as the creation of new rules. Attempts to impose rules unconnected to pre-existing social practices then are severely limited (see Boettke 1996).

The path from “here to there” in former socialist countries then requires not only an idea of the “there” intended, but also the “here” from which one is starting, *before* an appropriate strategy for the path can be determined. With regard to the question under examination (i.e., the transfer of ownership) the steps required for the divestiture of property from some owners, the legitimization of property held by others, and the establishment of conditions for the attainment,

use, transformation, capitalization, and transfer of assets for new owners should be the focus of our attention. The appropriate policy path is necessarily multidimensional and grounded in the previous historical pattern of ownership. As David Stark (1996) has pointed out, post-communist developments are following a path-dependent trajectory. Therefore, it is more appropriate to view post-communism as a process of transforming existing institutions, than it is to view post-communism as a transition to a new economic order lying outside of history.

CONCLUSION

Building upon the Austrian argument against the possibility of a rational socialist economy, public choice economics offers crucial insight into the actual workings of real-existing socialist societies. Demonstration of the perverted incentive structure necessarily confronted under central planning, and the disastrous effects such an incentive structure generates under real-existing socialism is a great credit to the theory of public choice. Furthermore, in bringing to bear much-needed emphasis on the true nature of real-existing socialist societies as societies characterized by *de facto* property rights operating against the distorting backdrop of *de jure* property prohibition, public choice offers an invaluable insight into the way successful post-communist reform in Eastern and Central Europe must be undertaken. Public choice sheds light on the fact that a realistic reform strategy must be predicated on a realistic model of political economy that recognizes that the transition from real-existing socialism to the market cannot be achieved costlessly. Entrenched bureaucrats in the central planning system face strong incentives to resist reform, and however illegitimately, these bureaucrats must be viewed as ‘property holders’ who need to be dealt with accordingly if real reform is to take place at all. Without the crucial analysis offered by public choice theory, both our understanding of the true

nature of real-existing socialism, the functioning of this system and appropriate method of dealing with the transition process would be seriously compromised.

Peter J. Boettke, Deputy Director, *James M. Buchanan Center for Political Economy*

Peter T. Leeson, Research Fellow, *James M. Buchanan Center for Political Economy*

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