Why Existing Models of the Socialist Economy are not Economically Feasible or Desirable

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I have spent many years exploring the feasibility of alternatives to capitalism, with special emphasis on worker-owned and democratically controlled firms. This short note outlines why I considered such firms the only plausible alternatives to the capitalist firm, and why I eventually decided that these too are feasible only under extremely limited circumstances.

First, there is one fact of economic life that must always be kept in mind, yet is often overlooked. *Economic information is private* information: the conditions of production in the firm are the private information of the few people who actually control and organize the firm. These individuals will turn their private information into *public information*, accessible to others generally, only when it is in their interest to do so.

Question 1: Why use markets rather than government control of the economy, in which a state planning board (SPB) sets prices and allocates investment capital to firms?

Answer: *Markets are information-revealing institutions*. Before the modern computer age, it was infeasible for an SPB to aggregate the information necessary to set prices and allocate investment capital, but this is surely no longer the case. However, where does the SPB get its information? Because this is private information, it must be elicited from those who control production. These individuals, however, have no incentive to either systematically collect or report truthfully such information. Markets are the only known way to generate such public information. When a firm posts a price for a good and agrees to sell at this price, it is revealing information about its production costs. With competition, if another firm has lower production costs, it can post a lower price and outcompete the former. The greater the intensity of competition, the more accurately will price reflect real costs.

Question 2: Why not have a market socialist economy in which the capital stock is owned by the people and controlled by the state, which allocates new investment capital to firms?

Answer: *The democratic political process does not generally produce economically rational outcomes.* The idea that an SPB could allocate investment in promising directions is implausible because the SPB does not know what directions are promising. This too is private information that agents will not truthfully reveal, and it is widely distributed over the population of economic agents. This problem could be mitigated by setting up a *pari-mutual pseudo-stock market* in which individuals bet on which investments will be successful, and the SBP allocates investment capital proportional to the stock’s value on this pseudo-stock market. This leaves no room for startup-firms operating on personal or venture capital finance. This fault could be corrected by allowing such firms to finance privately, but it is not clear where the venture capital would come from in the absence of private ownership.

The major problem with the public ownership of capital, however, is simply that it fatally exposed to corruption and political influence. The private ownership of capital promotes the process of “creative destruction” of industries and job categories that have become technologically or otherwise economically superannuated. This process is brutal but absolutely necessary to avoid bureaucratic ossification and decline. Firms in decline are powerful and their rising alternatives are small and weak. All political influence resides with the former. The logic political democracy dictates that they will defer change with impunity.

Question 3: Why not firms that are democratically owned, financed by personal capital, as well as the usual financial institutions, including investment banks, the stock market, and venture capital?

Answer: *If such firms were efficient, they would compete effectively with standard capitalist firms. But they rarely do, and if they did, they would need no special governmental or legal favoritism.* There are of course a few highly effective and competitive worker-owned enterprises. But their existence is the exception that proves the rule: in the overwhelmingly general case, worker-owned firms cannot successfully complete.

Why is this the case? First, all but the smallest capitalist firms have many owners, the stockholders, who each bears a little risk, and many of whom are very rich so they can tolerate the firm’s failure at little personal cost. Workers typically have no wealth other than their perhaps their homes, and if they mortgaged their homes and borrowed to finance their share of the firm’s capital stock, their lives would be devastated. Why do banks not lend to worker-owned firms? The answer is that the do if the firms have little capital (such as law partnerships) or they have excellent, easily liquidated fixed capital (like airlines, most of whose capital in in planes). Otherwise, lenders cannot control the degree of risk taken by their debtors. When an worker-owned firm is in trouble, it will tend to seek increasing external finance rather than declaring bankruptcy. Moreover, a worker owned firm will not change its technology if that requires changing the technical and skill qualifications of its current members.

Question 4: When can worker-owned firms compete effectively against traditional capitalist firms?

Answer: Where capital per worker is very low, firm size is small enough so that the informal mutual monitoring of worker behavior is feasible and effective, and where the variability of profits over time is small, democratic worker-owned firms are feasible. One example that I have worked on with my colleagues Pranab Bardhan and Samuel Bowles concerns individual farmers in poor countries. Such farmers have no wealth and cannot get credit to plant crops except at exorbitant rates, so they become share-croppers on the lands of rich landlords. Sharecropping is very inefficient, because most of the profit goes to the landlord, so the peasant has a reduced incentive to work hard in comparison with the independent farmer. We show that if the government offered crop insurance and up-front loans to finance plantings at the start of the growing season, individual farmers would out-compete landlords. The insurance can be squared with proper risk-management of the farmer by basing insurance payouts on average yield for the area, not the individual farmer’s yield. Of course this is not a typical case because the worker-owners are single farmers, not collectives of workers. There would be probably be no gain over sharecropping if this were extended to worker’s collectives because individual members still would have reduced incentive to work hard on behalf of the collective.