

Capital and Income in Democratic Socialism

DW MacKenzie
SUNY Plattsburgh
dmackenz_2000@yahoo.com

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Abstract: Some scholars of the Interwar Debate on Socialism argue that the trial and error method developed by Taylor (1929), Lange (1938), and Dickinson (1939) proved that socialism could match or outperform capitalism. Other scholars argue that the trial and error method of simulating markets was an illegitimate compromise between true socialism and capitalism. The market socialists failed to understand the nature of the challenge that Mises (1920) posed. This paper argues that Lange, Lerner, and Dickinson effectively *conceded* what Mises wrote about capital accumulation in socialism. Lange and Dickinson also argued that capitalism fails regarding capital accumulation. Lerner, Lange, and Dickinson believed that democracy could solve some of the problems of socialism. Mises and Hayek saw the politicization of investment as at best, inefficient and at worst, dangerous for democracy. The antagonists in this debate agreed on many of the economic issues, but disagreed on matters of social philosophy- especially where democracy is concerned. Recent scholarship on market socialism has tended to overlook the issues raised by both sides in the interwar debate. Also, the record of the twentieth century tends to support the von Mises critique of socialized accumulation.

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THE INTERWAR DEBATE OVER SOCIALISM

The debate over socialist calculation has focused on whether market forces can be imitated in, and reconciled with socialism. Mises (1920) opened the interwar debate with his claim that socialism lacks any feasible means of calculating the opportunity costs of capital. To Mises, profit and loss calculation based on market prices produces estimates of the opportunity costs of capital. Since socialism lacks markets it also lacks market prices. Thus, socialism lacks any means of calculating costs. Taylor (1929) claims that officials can simulate market pricing through trial and error, by watching inventories. Excess inventories indicate the need to lower prices and vice versa. Lange (1938) and Dickinson (1933, 1939) perfected Taylor's proposal and advanced market failure arguments against capitalism.

Critics of market socialism argue that the trial and error market simulation is illegitimate, and the static nature of market failure arguments renders them irrelevant- given that the Mises-Hayek critique concerned dynamic issues. PC Roberts (1971), Bradley (1981), Lavoie (1985), and Kirzner (1985) argue that market socialism lacks genuine entrepreneurship and rivalry. The lack of genuine entrepreneurship and rivalry in socialism makes any simulation of markets illegitimate, and the static nature of market failure arguments render them irrelevant. Lavoie also asserts that the market socialists deserted the true aims of socialism by accepting the results of market competition.

This paper argues that Mises actually objected to the absence of financial markets in socialism. Mises argued that the absence of credit markets and interest rates in socialism results in capital depletion. The trial and error 'solution' concerned pricing of *existing* commodities, given some predetermined rate of capital accumulation. Mises was concerned with planning investment in *future* stocks of commodities- including the determination of a rate of accumulation. Taylor's proposal was therefore irrelevant rather than illegitimate.

Lange and Dickinson agreed with Mises on the incompatibility of *financial* markets and socialism, and conceded serious problems with socialist accumulation. Lange and Dickinson also argued that income inequality renders capitalist accumulation arbitrary. If capitalism and socialism are equally arbitrary concerning capital there is no net loss in realizing socialist ideals. Mises and Lerner were the only ones to consider the politics of accumulation in democratic socialism. The interwar debate over income, accumulation, and democracy consisted of the following main points from Mises and his opponents-

1. Mises argued that capital accumulation requires private property and unequal incomes. Rivalry among profit seeking entrepreneurs is essential to the functioning credit and other financial markets. The speculation of competing entrepreneurs in financial markets delivers progress through accumulation, with income inequality.
 2. Mises stressed unrestricted choice and equality of opportunity as the central tenets of democracy. Capitalism is democratic because consumers determine production with their 'dollar votes'. Income inequality is democratic if it derives from voting in the consumers' democracy of the market.
 3. Socialism delivers income equality only by abolishing financial markets and true interest rates. The absence of interest rates in socialism politicizes capital accumulation. The political nature of socialism results in capital depletion.
 4. Workers benefit from private capital accumulation through increased wages.
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1. Market socialists stressed equality of outcomes as a central tenet of a democratic society. Since income equality precludes private savings and interest, socialist officials cannot simulate financial markets to determine interest rates. Without interest rates socialist officials would have to set capital accumulation rates arbitrarily or politically. Socialist officials can simulate spot markets for existing commodities only.
 2. Market socialists countered Mises by arguing that unequal distribution of property and income in capitalism results in irrational capital accumulation. Both systems determine capital accumulation arbitrarily, but socialism is superior because it is more equitable and it eliminates market failures made evident by the Great Depression.
 3. The wages of common workers are not enough for social welfare maximization.
 4. While socialism 'fails' regarding capital accumulation, it succeeds in realizing social democratic ideals concerning income equality. Democratic voting might also bring some rationality to public investment decisions in a socialist state.

This paper assembles fragmentary remarks from Mises and his opponents on capital and democracy into a coherent picture, consisting of two main arguments. First, Mises and his opponents actually agreed on the problems of socialist capital accumulation, but embraced different types of democratic ideals. Second, Lange offered a critique of private capital

accumulation, but Mises failed to address this critique. The first part of this paper argues that the trial and error proposal to simulate markets is irrelevant, and that the principle market socialists conceded defeat on the critical issue of socialist accumulation. The second part examines the counterattack that Lange and Dickinson initiated against Mises on capitalist accumulation. The Lange-Dickinson critique of capitalist accumulation was relevant to the Mises-Hayek case for capitalism. Yet the Lange-Dickinson critique is flawed and therefore illegitimate. The third part examines Abba Lerner's analysis of accumulation and democracy. The final part examines recent proposals for democratic socialism (i.e. Roemer 1994).

THE PROBLEM OF SOCIALIST ACCUMLATION

According to Lavoie (1985), Lange's trial and error simulation of markets fails due to a lack of genuine entrepreneurial rivalry. Lavoie also claims that true socialism aims at replacing market relations and the results of competition with conscious planning to promote the common good. Market socialism sought instead to reconcile planning with markets. Lavoie's first objection indicates that market socialism is an illegitimate simulation of markets. His second objection suggests that Lange lacked true socialist convictions. Examination of the issue of socialist accumulation contradicts both of these claims¹.

Mises assumed officials would set prices for existing commodities in spot markets-

“if preferences dictate an exchange ratio of one cigar to five cigarettes, and officials set the ratio at 1-3, those obtaining cigars in their ration benefit at the expense of those receiving cigarettes” (Mises 1920)

With the wrong prices “cigars or cigarettes would pile up in the distributing offices”. Mises (1922) insisted that consumers would ‘compel officials to change substitution ratios of various commodities’. It was Mises, not Taylor, who first wrote that officials could find equilibrium *spot* market prices through trial and error, but this was not the real problem.

¹ Lavoie's third claim was that Lange ignored incentive problems in socialist bureaucracy as ‘sociological’. The validity of this claim is the subject of another paper (MacKenzie 2007a).

To Mises, the real problem with socialism is that it fails to align investment with future changes in consumer demand. The micro problem concerns individual investment projects and relative consumer demands². The macro problem concerns the rate of accumulation and time preferences. Interest rates reveal marginal rates of substitution between time periods. Mises was concerned only with investment in future inventories, not with clearing existing inventories based on prior investment. Taylor's trial and error proposal solved the 'problem' of pricing existing inventories in spot markets, given some rate of accumulation. Taylor aimed at simulating the wrong markets. Even if socialist managers could clear *existing* inventories, the problem of investing in *future* inventories would remain unsolved.

Mises embraced inequality resulting from private interest income, yet also saw capitalism as democratic- "the capitalist system is an economic democracy where every penny gives a right to vote" (Mises 1944 p25). In capitalism, the private owners of capital and those who defer consumption maintain and accumulate capital (Mises 1922 [1936] p178)³. The unequal distribution of property and income in capitalism is necessary as an incentive for some to maintain and accumulate capital (ibid). Yet this inequality is relative because capital accumulation increases labor productivity and wages. Capitalists are "obliged to share what they accrue with those whose incomes are derived from work" (ibid).

According to Mises, redistribution is an anti-democratic attempt to overturn election results in the consumers' democracy of the market- "The decision of each consumer to buy or abstain from buying determines who owns capital and manages production" (1944 p24).

² Mises argued that financial speculation directs investment towards the most urgent demands-"it is above all necessary that capital be withdrawn from particular undertakings and applied in other lines of production ... [This] is essentially a matter of the capitalists who buy and sell stocks and shares, who make loans and recover them, who speculate in all kinds of commodities" Mises 1922 [1936] p121

³ Mises mentions this again- "there is no saving without purpose. A man defers consumption for the sake of improvement of latter conditions...Capital goods come into existence as the property of the individual[s] who were in a position to consumer definite things but abstained from this consumption for the sake of latter utilization. The way in which capital goods come into existence as private property determines the institutions of the capitalist system" *Capitalism versus Socialism* 1969 p556.

It is important for markets to elect capitalists and entrepreneurs because “Only a few men, endowed with exceptional and rare abilities have the gift of planning new things and of recognizing their blessings” (ibid p73). “The market daily tries the entrepreneurs anew and eliminates those who cannot stand the test. It tends to entrust the conduct of business affairs to those men who succeed in filling the most urgent wants of consumers” (Mises 1949 [1998] p701). Consumer spending in spot markets would determine which entrepreneurs had best anticipated their demands. The profits earned by the capitalists who had funded the best entrepreneurial plans would keep them in office as planners of production.

Mises embraced equality before the law rather than equality of results. Feudal differentiation of legal rights hinders the development of individuals and this leads to violent upheavals (Mises 1922 [1936] p65). Social peace therefore requires equality before the law through universal participation in democratic institutions (ibid p66). This leads to income inequality simply because entrepreneurship must be motivated and tested with real profits; and because only a few possess superior foresight regarding future market conditions.

To Mises, the lack of credit markets in socialism politicizes accumulation. In capitalism “thrifty and well to do” determine saving, but saving in a socialist society concerns everyone equally- including “the idler and the spendthrift” (Mises 1922 [1936] p179). Mises claimed that politicians maintain power with lavish spending on final goods, and that demagogues would encourage consumption over public saving for accumulation (ibid)⁴. Socialism therefore results in capital depletion, declining living standards, and even starvation⁵. Mises

⁴ Robbins (1937 p216) also mentions “under communism individual savers would be of “quite subordinate importance”, “the main function of deciding upon capital accumulation would be discharged by the central planning authority”.

⁵ To Mises (1927) a return to mercantilism would result in starvation- “it is impossible for us to return to the forms of social and economic organization characteristic of the middle ages... the medieval system was able to support only a fraction of the number of people who dwell in [Europe]... A return to the middle ages is out of the question if one is not prepared to reduce the population to a tenth or a twentieth part of its present number” (1927 p85-86). Mises likely saw starvation as a consequence of adopting socialism as well. In contrast

saw that voter time preferences range from one tail of a distribution, who favor high present consumption, to the other tail, who favor high deferred consumption. In capitalism, the minority who discount present consumption the most, save heavily and promote capital formation. In democratic socialism the median voter sets the rate of capital accumulation; the median voter prefers more current consumption would be capitalists.

Lange also saw problems with determining the rate of accumulation in socialism. After describing the trial and error solution to the static ‘problem’ Lange mentioned that two other problems “deserve special attention”. First, distributing dividends from social investment must not prevent optimum resource allocation⁶. Second, officials must determine interest rates to allocate capital efficiently. To Lange (1942a) the condition where “intertemporal marginal rates of substitution must be equal to the corresponding intertemporal marginal rates of transformation ... implicitly determines the rate of capital accumulation which maximizes total welfare over time”. Lange agreed with Mises that socialist officials must disregard consumer time preferences. High or low interest rates misallocate *existing* capital, but “in the long period the amount of capital can increase through accumulation”. Before disbursing dividends, “the rate of capital accumulation can be determined by the central planning board *arbitrarily*” (1936a p65 emphasis original). This reduces welfare-

“the *speed* at which accumulation progresses is arbitrary. The arbitrariness of the rate of capital accumulation “corporately” performed means simply that the decision regarding the rate of capital accumulation reflects how the central planning board and not consumers, evaluate the optimum time shape of the income stream. One may argue, of course, that this involves a diminution of consumer welfare. This difficulty could be overcome only by leaving all accumulation to the saving of individuals. But this is scarcely compatible with the organization of a socialist society” The loss of his power to set the rate of capital accumulation is the price the consumer has to pay for living in a socialist society. It seems to us that this price would be

Hayek (1935 p204) claimed that “there is no reason to expect that production would be permanently lower than before planning started. What we should anticipate is that output determined by a central authority would be lower than if the price mechanism of a market operated freely”

⁶ Lange recognized that the substitution of social for private dividends eliminates indispensable speculation in stock and other financial markets. This is the subject of another paper.

overcompensated for by the advantages a socialist society offers” (Lange 1936a p65-66 emphasis original)

The fact that Lange thought it necessary to claim that socialism delivers overcompensation for this diminution and that he saw this problem deserving *special* attention, indicates that he saw its importance. There are two important things to note at this point. First, Lange recognized that socialist officials could not simulate financial markets, and that this prevents rational investment. Lange erred in thinking that Mises denied the possibility of pricing goods in spot markets. Yet Lange did admit that rational accumulation is impossible without particular financial markets. Second, Lange did seek to overturn market relations in the critical area of financial markets. Lange held true socialist convictions. Accumulation was not a passing interest of Lange’s. Lange (1957) discussed how active guidance for developing a national economy involves determination of the rate of growth by dividing income between accumulation and consumption, and the determination of the direction of development by distributing investments among different branches of the economy. These two elements were his *minimum requirement* for active guidance of national development⁷.

In a 1942 speech, Lange (1987) argued that relative prices impute data relevant to capital accumulation, but admitted that in socialism the Reconstruction Finance Corporation or Federal Reserve would do saving corporately. Lange dismissed setting the net marginal productivity of capital at zero because technical progress, population growth, and resource discoveries mean that the net productivity of capital is never zero. This fits with Mises’ claim that socialism fails under dynamic conditions⁸. Changes in technology, population, and resources mean that state officials must evaluate future consumption in *dynamic* conditions,

⁷ Lange favored realizing state plans through economic incentives, but admitted that the rate of accumulation and the basic direction of investments must be done partly by administrative fiat Lange (1957) recognized that inflexibility and a lack of proper incentives in bureaucracy would cause waste, but the rise of a socialist intelligentsia would deal with these problems.

⁸ To Dobb (1969 p196) in static conditions problems in determining interest rates disappear. Savings decisions in socialism will be “*a-priori* to any costing or pricing in terms of which methods of production are chosen”.

but cannot acquire essential data. Dickinson (1939 p92) also admitted that the greatest element of uncertainty in calculating interest in socialism probably derives from “the influence of technical discovery and invention upon the future demand for capital”⁹.

Dickinson made the same claim as Lange regarding capital accumulation-

“Another arbitrary element in our socialist economy is the allocation of resources between the satisfaction of present and future needs ... the original decision as to the magnitude of [interest] rate[s] would not depend upon the time preferences of individual savers. It would represent the time preference of the ‘community’ as a collective saver; but the ‘community’ in this sense is a purely metaphysical fiction- what would actually take place would be some board or commission, taking a decision on behalf of the individuals composing the community. And this decision would be arbitrary.” (1939 p207)

Dickinson thought investment should come out of the “social fund” collected from returns on prior capital investment, loan interest, insurance premiums, and uncertainty surcharges paid by private citizens. The part of the social fund not devoted to investment could pay for either public goods or social dividends to citizens of the socialist commonwealth.

Mises and Lange differed less than one might expect. Mises saw political bias towards lavish public spending over minority preferences for saving. Lange thought politicians could exercise full discretion to set *any* rate of saving. Lange recognized that without interest rates state officials *cannot know* the efficient rate of accrual. Wages (w) and interest rates (r) reflect forgone leisure and time preference. Entrepreneurs account for leisure and time preference in their profit calculations- $\Pi = PQ - C(w, r)Q$. Mises and Lange agreed that socialist officials could establish P 's and Q 's for existing goods through trial and error. Lange and Dickinson thought officials might discern w 's with incentive pay¹⁰. They all agreed that officials could *never* discern r 's to use in determining accumulation. Mises and Lange differed because Mises saw officials as restrained by politics, while Lange saw officials as omnipotent

⁹ He cites Dobb (1933) for raising this problem.

¹⁰ This is false because efficient wages equal the *discounted* marginal product of labor. Intertemporal allocation of labor requires discounting of wages according to time preference. Dickinson (1939 p208-9) accepted arbitrary control of labor and leisure time by socialist officials, but claims that capitalists make this decision arbitrarily anyway, and that workers might influence these decisions under Socialism through democratic institutions.

planners of accumulation. Since Lange arrived at this conclusion independently he deserves credit, with Mises, for discovering the problem of socialist accumulation¹¹.

The market socialists valued consumer sovereignty as a part of their democratic ideals. Lange and Dickinson rejected the results of market competition only where it conflicts with socialist egalitarian aims, even if this meant compromising their democratic ideals. If state officials remunerated private savings, thrifty citizens would accumulate private fortunes. Lange and Dickinson thus rejected simulating credit markets because “leaving all accumulation to the saving of individuals ... is scarcely compatible with the principles of a socialist society” (Lange 1936a p65). Since socialist egalitarian principles require arbitrary capital accumulation, socialism must violate consumer sovereignty in this instance.

Mises and his opponents agreed on the issue of socialist accumulation, but disagreed concerning the nature and limits of democracy. Mises embraced equality of opportunity and free choice in his notion of democratic capitalism, and saw income inequality as a natural and inoffensive result of free consumer choice. Mises saw egalitarianism as antidemocratic. Lange and Dickinson saw equality of outcomes as the primary aim of socialist democracy, and admitted that such ideals are incompatible with full consumer sovereignty. Lange and Dickinson saw that the abolition of interest income made capital accumulation arbitrary, though socialist opinion on this issue varied¹². The market socialists thought that democratic socialism could improve upon existing social relations. Yet Mises had already critiqued

¹¹ As an expression of recognition for this service statues of Professor Lange ought to occupy honorable places in the New York Stock exchange and the Chicago Board of Trade.

¹² To Knight (1938 p248) the state “would best secure efficiency by maintaining a capital market much in the same form as under capitalism, as regards the demand side”. Knight believed that officials can act as if they are earning their own profit. He thought the supply side came automatically out of the residual of state revenue above production costs. Schumpeter saw (1942 p179-80) the problem of determining investment with equal incomes and without private saving, but thought that officials could solve this “as a part of the social budget” or that accumulation out of “profits” could be allowed to materialize¹². Durbin (1936) thought officials could instruct socialized trusts to compete with each other for capital, and this set the price of capital equal to its opportunity cost. He thought that competition between trusts set interest rates, rather than saving and borrowing. Knight, Durbin, and Schumpeter missed the time preference issue.

democratic socialism in 1922, as did Hayek in *The Road to Serfdom*¹³. The market socialists envisioned a social democratic society based on egalitarian ideals. They believed that these ideals were worth some sacrifices. Yet they also realized that the problems of socialist accumulation must be compared to the actual results of capitalist accumulation.

THE PROBLEM OF CAPITALIST ACCUMULATION

Lange countered the von Mises critique of socialist accumulation with a critique of capitalist accumulation. Critics of market socialism dismiss Lange's critique of capitalism as static and therefore irrelevant. Contrary to the claims of postwar critics, Lange examined dynamics. Lange (1937) advanced a four-part critique of Capitalism. First, he argued that "Only a socialist economy can distribute incomes so as to attain maximum social welfare". He argued for changing the *present* system because while the formal allocational principles are the same for both systems, the *actual* distribution differs (1937 p123). Distribution of productive resources determines income under private ownership, and this is highly unequal when a large part of the population owns only its labor. Capitalist distribution is a "historical datum which originates independently of the requirements of the maximization of social welfare"¹⁴. In capitalism "some starve while others indulge in luxury". Lange referred to "estates of the feudal epoch" as the source of historically determined income inequality.

¹³ Hayek (1944) argued that democratic institutions would persist for some time in a socialist society, but totalitarianism would overcome democracy gradually, "perhaps over one or two generations". Adopting socialism means choosing among a plethora of complex plans for guiding production. Also, changing economic conditions would make the need for plan revision perpetual. The task selecting and modifying these plans must overwhelm any democratic assembly. Democratic assemblies then become "ineffective talking shops", and bureaucrats will assume greater powers. Bureaucratic empowerment means that the rule of men will displace the rule of law. The concentration of power in bureaucracies is severely problematic because there "is little to induce good men to aspire to leading positions and much to deter them". Furthermore, there will be "special opportunities for the ruthless and unscrupulous". As the government becomes more dictatorial the nature of competition for power insures that 'the worst will get on top'. The ruler of a socialist state will find it advantageous to implement his plans through officials who are "unreservedly committed to the person of the leader". Such persons must be "completely unprincipled and literally capable of anything".

¹⁴ (p123)- "under such conditions demand price does not reflect the relative urgency of consumer demand". Elites might have a higher marginal utility of income, but *present* differences here are "due social barriers between classes". "A Hungarian count may be more sensitive (to income changes) than a Hungarian peasant" but "such differences disappear in the relatively homogeneous social stratification of a socialist society".

Distribution assuming uniform marginal utility of income would “strike the right average in estimating the relative urgency of need, leaving only random errors, while capitalism introduces constant error in favor of the rich” (p125). Lange’s second argument concerned externalities and failures to account for leisure, safety, and agreeableness of work in wages¹⁵. Lange’s third argument was that socialism eliminates the “wastes of monopolistic competition”. He thought this “a much more powerful argument” than “the possibility of distributing incomes so as to maximize welfare and of taking *all* alternatives into economic account”¹⁶. Lange was also more interested in concentration of capital ownership than with externalities¹⁷. Lange’s second and third arguments represent standard market failures, whose magnitude must of course be compared to corresponding government failures.

In his fourth argument Lange advanced his critique of capitalist accumulation-

“Against these advantages of a Socialist economy, one might put the disadvantage resulting from the arbitrariness of the rate of capital accumulation, if accumulation is performed “corporately”. A rate of accumulation which does not reflect the preferences of the consumers as to the time-shape of the flow of income may be regarded as a diminution of consumer welfare. But it seems that this deficiency may be regarded as overbalanced by the advantages enumerated. Besides, saving is also in the present economic order determined only partly by pure utility considerations, and *the rate of saving is affected much more by the distribution of incomes, which is irrational from the economists point of view*” (Lange 1937 p127 emphasis original)

This is crucial to Lange’s argument. To Lange our choice is between socialism, where state officials dictate capital accrual arbitrarily; and Capitalism, where arbitrary income distribution sets accumulation according to the time preferences of a few wealthy capitalists. Socialism eliminates historically determined income inequality by abolishing classes. Socialist “errors” concerning income exist due to random variations in personal character only. Lange’s

¹⁵ To Lange market prices do not reflect occupational diseases and industrial accidents. “Much of this waste might be removed by proper legislation, taxes, and bounties, within the present economic system, but a socialist economy can do it with much greater thoroughness” (1937 p126).

¹⁶ Lange’s “advantages of a Socialist economy” in eliminating market failures are often seen as neoclassical arguments, but his overriding concern with monopoly was, in fact, consistent with Marxian concerns over increasing monopolization (Persky 1991).

¹⁷ “determining the distribution of incomes so as to maximize social welfare and of taking *all* the alternatives into economic account makes a socialist economy superior to a competitive regime, but especially superior to a competitive capitalist economy where most own only their own labor” (1937 p126).

distributional critique of capitalism aimed at establishing parity on the accumulation issue so his market failure and egalitarian arguments could tip the balance in favor of socialism.

Other interwar socialists agreed with Lange¹⁸. Dickinson argued that inequality biases capitalist investment. Dickinson accepted nearly the same concept of costs and time preference as Mises, Hayek, and Robbins *in theory*¹⁹. In practice, he thought the actions of banks and company directors overshadowed individual time preferences (1939 p80).

“the liberal individualistic view of the determination of the rate of interest in a free competitive market of millions of distinct persons’ individual ‘time preferences’ is completely unreal. The economists ‘marginal saver’ is largely a mythical creature. Moreover, even if the rate of interest were determined by the interaction of individual time preferences, it would have little claim to represent *the* time preference of the community, since the distorting influence of inequality of incomes works more powerfully in the region of interest rates than in any other part of the process of price formation... under socialism, the allocation of resources between present and future use would be at least as arbitrary as it is under capitalism” (1939 p208)

By arbitrary Dickinson meant allocation “not dependant on the freely expressed preferences of individual economic agents”. He also wrote “if either the demand for or supply of capital is changing rapidly, the error involved in aggregate demand schedules will be appreciable”²⁰. This is consistent with Mises’s claim that the calculation problem exists only under dynamic changing conditions. Dickinson accepted arbitrary interest rates, imposed by officials, but asserted that a continual process of trial and error prevented them from being completely arbitrary (ibid p92). Dickinson arrived at the conclusion that

¹⁸ Samuelson (1948 p599-600) also saw problems with of investment and time preference in both capitalism and socialism. Under socialism interest would neither “convert flows of income into capitalized present value, nor determine income from bonds and other capital assets”, nor “get people to give up hoarding money and instead hold their wealth in the form of securities”. This was true “because no one would have the opportunity of buying a corner lot or other assets”. Following Lange, Samuelson lists a third purpose for interest that *does* still exist under Socialism. “Interest acts as a rationing device: all projects that yield a 6% rate of return before any that yield 5% are undertaken”. “Whatever amount of national income society has decided to invest in capital formation cannot be embodied in the best form the without such an interest rate”. Samuelson noted that “most economic writers on Socialism do not think that the interest rate should determine capital growth”, and that the state should determine saving “in light of national and social needs”. Given the dismissive attitude that so many had towards consumer sovereignty over investment, it is not surprising that the competitive solution drew more attention than Lange’s concessions on investment.

¹⁹ See Dickinson 1939 pp66-79.

²⁰ He thought that officials would have to set a provisional interest rate while the final demand schedule was worked out.

inequality distorts allocation earlier. Dobb (1924 p79) credits Dickinson for arguing that as capitalists become richer and others become poorer, bias in resource allocation increases. Dobb later claimed (1969 p197) that since there is no one unique and optimal rate of time preference to express on any market, saving decisions must be political and arbitrary rather than economic and individualistic. Of course, credit markets do generate multiple rates of interest to reflect different rates of time preference.

Mises made no conscious effort to address the Lange-Dickinson critique of capitalist accumulation. Yet Mises did discuss the source of Lange's 'historically determined income inequality- "estates of the feudal epoch". Mises insisted that "The role that income inequality plays in the market society must not be confused with the role it plays in a feudal society"²¹.

"attacked the traditional caste system because its preservation was incompatible with the operation of the market economy. It advocated the abolition of privileges because it wanted to give a free hand to those men who had the ingenuity to produce in the cheapest way the greatest quantity of products of the best quality" (1949 p837).

Mises also claimed that

"No ordered community has callously allowed the poor and incapacitated to starve. There has always been some sort of institution designed to save from destitution people unable to sustain themselves. As general well-being has increased hand in hand with the development of Capitalism, so too has the relief of the poor improved" (1922 p430)

Mises did not offer statistical evidence to support this claim concerning poverty.

Lange's reference to 'the estates of feudal epochs' is, however, irrelevant to Mises' defense of capitalism. Mises only endorsed fortunes founded within the market economy-

Fortunes invested in capital do not represent eternal sources of income ... To own capital one must earn it afresh day by day. In the long run a capital fortune is not a source of income which can be enjoyed in idleness ... to every capital investment is attached the risk of a total or partial loss of the original capital sum. This is true not only of the entrepreneur's investment, but also of the investment the capitalist makes in lending to the entrepreneur, for his investment naturally depends completely on the entrepreneur's. His risk is smaller, because the entrepreneur offers him as security that part of his own wealth which is outside the immediate undertaking, but qualitatively the two risks are the same. Mises 1922 [1936] p338-339

²¹ Similarly Hayek (1944 p23) warned against the use of laissez faire phraseology to defend antisocial privileges.

As noted previously, capital accumulation increases labor productivity and wages. Mises predicted increasing relative poverty, but decreasing absolute poverty in capitalism.

Mere landowners do not participate in entrepreneurial planning-

“When rich entrepreneurs wish to perpetuate their wealth in the family they take refuge in land. The descendants of the Fuggers and the Welsers live even today in considerable affluence, if not luxury, but they have long since ceased to be merchants and have transformed their wealth into landed property. They became members of the German nobility, differing in no way from other South German noble families. Numerous merchant families in other countries have undergone the same development; having become rich in trade and industry they have ceased to be merchants and entrepreneurs and have become landowners, not to increase their fortunes but to maintain them” Mises 1922 [1936] p340

Mises saw that capitalism had risen to displace feudalism, as did Marx and Dobb. To Dobb (1933 p591) economic and political democracy are ‘bourgeois conceptions of our heritage from the nineteenth century’. Dobb doubted the merits of ‘the consumers’ democracy of the market’. Dobb noted that ‘the virtues of democracy rest upon the sacredness of individual choice’. But ‘unless there is complete equality of reward plural voting would remain’ in the consumer’s democracy; whereas, if equality of reward prevailed, market valuations would *ipso facto* lose their alleged significance’ (ibid p591-592). Dobb downplayed the importance of individual choice because “if consumer choice was so malleable in capitalism and so seducible by the advertising agent, what right do we have to say that under socialism it will be supremely wise? ... if taste is mainly acquired, rather than innate, and shaped by culture and convention, as it seems to be, then there is no reasons why, in a socialist order, the state should entirely abrogate the right of creating taste”. Mises did, however, provide an answer to Dobb’s point about plural voting with his claim that inequality of fortunes is itself the result of democratic voting with dollars. As for consumer sovereignty, Dobb (1935 p534) noted that very few brands of socialism propose to banish a free consumer’s market. Dobb questioned whether consumers know what they need and can express their needs on markets, but he did not demand an end to consumer sovereignty.

In any case, Lange wrongly attributed the problems of feudalism to capitalism. However, Mises' remarks on feudalism do not address Dickinson's claims that bank and company directors overshadow individual time preferences. In fact, Mises might seem to concede that Dickinson is right by admitting that maintenance of the capital stock requires inequality. After all, the fact that capitalist inequality derives from dollar votes for different consumer goods has nothing to do with time preference.

There is a stronger argument against the Lange-Dickinson capitalist accumulation critique. Lange and Dickinson erred by thinking that only those who save express their time preferences. Those who refrain from saving express their preference in favor of current consumption. Those who refrain from saving make the rate of capital accumulation lower than it would be otherwise. Those who prefer immediate consumption to saving must give up potential interest income as an unavoidable consequence of free consumer choice. The accumulation of fortunes by a few capitalists means that a small number of persons can exert great influence on further investment. Yet this is due to the fact that others chose not to contribute to accumulation by saving in previous time periods. That is, those who decided not to save in the past voted to elect others as stewards of the capital stock. Financial markets elect entrepreneurs and capitalists who most accurately predict the urgency of need in different time periods to the highest positions in industry. The position of capitalists is therefore dependent upon past and expected future consumer choices. The idea that only those who save determine interest rates is therefore demonstrably false. The combined influence of those who choose not to save reduces accumulation significantly. The Lange-Dickinson capitalist accumulation critique fails on the preceding points.

Lange wrongly associated capitalism and feudalism. Lange did not see that capitalist income inequality derives from past elections in the consumers' democracy of the market.

The Lange-Dickinson capitalist accumulation critique is relevant to the interwar debate, because if private investment is arbitrary the von Mises socialist accumulation critique proves only that no system can calculate marginal rates of substitution between time periods. Lange and Dickinson ignored several important aspects of capitalism. First, private investment increases wage rates. Second, capitalist inequality is an expression of consumers' sovereignty. Third, feudal privileges are antithetical to the classical liberal ideals of capitalism. Fourth, private investment is determined both by those who save and by those who do not.

THE ECONOMICS AND POLITICS OF FUNCTIONAL FINANCE

Abba Lerner advanced a stronger, but irrelevant, version of the Lange-Dickinson capitalist accumulation critique. Lerner took market socialism in a Keynesian direction, and tried to reconcile socialism with consumer sovereignty. To Lerner (1936) it might be possible “for the consumer in a Socialist society to have much more influence on the rate of capital accumulation than in a capitalist society”, through democratic voting. Socialists might use “the even more democratic market mechanism to discover the desires of consumers”-

“Consumers can be allowed to distribute their consumption through time in the same way as they can distribute it between different consumption goods at the same time. The principle that price should correspond to cost demands that consumers postponing consumption should get interest on their postponement in accordance with the increase (if any) in product that is made possible by this postponement, while the consumers who anticipate consumption should suffer a corresponding diminution of consumption or discount (Lerner 1936 p73).

Of course, private interest payment would increase income inequality. Lerner's acceptance of private interest income is inconsistent with socialist ideals²². Lerner thought Lange's concession to Mises important enough to address up front in his note on the competitive solution. Lerner (1937 p264, 269) thought that officials could plan in light of interest rates and time preference but admitted that investment would entail “guesswork”.

²² Ironically, Lerner (1977 p238) thought that Lange accepted too many elements of Capitalism. Lange also surprised Hayek (1940 p190) by accepting “naturally small private enterprises”. This is, however, consistent with Lange (1937) and Breit and Lange (1934) who saw monopolies as a reason for adopting Socialism.

Lerner (1938) rejected the distinction that Lange (1936) made between short and long run investment. Provided that investment is continuous, efficiency requires equalization of marginal costs and benefits in any time frame. For this reason Lerner concluded that socialist managers must follow the marginal pricing rule even if some other rule would be easier to implement. Here we can see both Lerner's impeccable logic concerning static resource allocation in ideal conditions, and his naiveté regarding public choice. Lerner (1934) had already demonstrated that marginal cost pricing in markets maximizes social welfare, and now saw that this proposition applied equally to socialism. Lerner also saw that markets never equate marginal costs and benefits exactly, but overlooked the inventive problems in politics that prevent welfare maximizing public policies.

Lerner did ultimately admit that socialist investment is 'unavoidably political'. Citizens of a socialist state cannot control investment as consumers, so "public voting between high investment and high consumption parties" must determine the rate of accumulation (1944 p263). Lerner notes that in a collectivist economy 'the rate of interest is simply announced'. However, he suggested that officials should adjust public investment to consumer desires, as expressed by *some* voluntary saving. Why did Lerner, unlike Lange, come to see socialist investment as political? One possible answer is that Lerner was a student of Hayek's- during the time that Hayek wrote *The Road to Serfdom*²³.

Lerner also moved away from his and Lange's earlier position by adopting arguments from Keynes. Keynes (1936) thought people were deterred by egalitarianism mainly by the idea that "the growth of capital depends upon the strength of the motive towards individual saving and that for a large proportion of this growth we are dependent on the savings of the

²³ Of course, Lerner did not accept the central thesis of *The Road to Serfdom*. Yet Hayek might have caused Lerner to incorporate political factors in his analysis of socialism.

rich out of their superfluity”. Keynes argued that due to the paradox of thrift we could ‘considerably modify our attitude’ towards existing objections to egalitarianism-

“up to the point where full employment prevails, the growth of capital depends not at all on a low propensity to consume but is, on the contrary, held back by it; and only in conditions of full employment is a low propensity to consume conducive to the growth of capital. Moreover, experience suggests that in existing conditions saving by institutions and through sinking funds is more than adequate, and that measures for the redistribution of incomes in a way likely to raise the propensity to consume may prove positively favourable to the growth of capital ... our argument leads towards the conclusion that in contemporary conditions the growth of wealth, so far from being dependent on the abstinence of the rich, as is commonly supposed, is more likely to be impeded by it. One of the chief social justifications of great inequality of wealth is, therefore, removed” 1936 p372-373

Keynes then concluded “that a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment”.

Lerner (1944 p1) claims that socialism extends democracy by satisfying the needs of the people. Lerner seems to admit that socialism precludes full consumer sovereignty-

“In a collectivist economy there would normally be restrictions on consumer borrowing and lending because of the danger of private accumulation of property and power that are inimical to the equalitarian and democratic ideals of the society” Lerner 1944 p269

Yet Lerner characterized (1944 p521-522) the objection that his proposals interfere with free choice between saving and spending as extraordinarily empty. Lerner claimed that the choice between present consumption and saving depend more the distribution of income than on time preference. This is identical to the Lange-Dickinson claim, but Lerner offered different supporting arguments. To Lerner ‘the decision to save does not shift resources from present to future consumption’. Increased saving ‘merely sets resources free so they can be unemployed’. Freedom of consumer choice in an ‘uncontrolled economy’ is illusory because investors determine the amount that people save raising and lowering the total income of society to the point where saving will equal the amount that has been invested. Lerner then concludes that a controlled or socialist economy allows-

“the possibility of a careful consideration of people’s attitudes as between present and future by the government when it makes a democratically controlled decision as to how much of the

resources of society to devote to current consumption and how much to devote to increasing and improving societies equipment for producing goods in the future” (ibid p322).

The preceding section of this paper countered the Lange-Dickinson critique of capitalist accumulation by pointing out that people express time preference both by saving and not saving. Since Lange assumed full employment, this author’s argument from the preceding section does not apply to the Keynes-Lerner critique of capitalist accumulation. Yet there are other reasons to reject the Keynes-Lerner critique of capitalist accumulation. Standard Monetarist (and Austrian) arguments indicate that Keynes and Lerner were wrong about the paradox of thrift. While this paper cannot resolve existing differences in professional opinion regarding the Keynesian and Monetarist paradigms, there is a decisive objection to Lerner’s arguments. Lerner himself saw that Keynes’ theory implied the need for activist fiscal policy, and not ‘somewhat comprehensive socialisation’. Lerner’s arguments are therefore irrelevant to interwar debate over market socialism²⁴.

Lerner took advantage of the popularity of Keynesian economics²⁵. Lerner also admitted to the political nature of socialist investment. Yet Lerner ultimately argued for activist fiscal policy, not socialism. Lerner and his allies distanced themselves from Bolshevism by embracing *democratic* market socialism. However, Lerner never addressed problems with politicizing investment in a democratic environment. Both state planning and deficit accumulation can severely limit capital accumulation. Politicization of investment allows median voters to prevent capitalists and entrepreneurs from realizing gains from trade with their employees and the general consuming public. Modern market socialists should, unlike their predecessors, examine political biases against accumulation carefully.

²⁴ Lerner seems to have distanced himself from socialism altogether. The author of this paper has been told by a former Lerner student that by the early 1960’s Lerner claimed that his earlier work on socialism was meant only to show how a socialist economy would work, not that it should be put into practice.

²⁵ Lange is believed to have abandoned socialism, at least temporarily, in a lecture he gave in Warsaw during 1938, because Keynes had shown that capitalism can be managed to secure stability and growth.

MARKET SOCIALISM REVISED

The collapse of the Soviet Union caused many to dismiss socialism as unworkable. Some modern socialists believe that the USSR failed because it was dictatorial and centralized. A democratic and decentralized socialism might succeed. Bardhan and Roemer (1992 p102) see the main problem with 20th century socialist states as “failure to separate political from economic criteria in decision making concerning the firm”. With centralized ownership “it is difficult to keep the financial goals of firms separate from inevitable political pressures for patronage distribution, job protection, and the like” (Bardhan and Roemer 1993 p11). Roemer (1994) proposes socialism with private, but equal, stock ownership and regulated capital investment. We shall examine two problems with the Bardhan-Roemer proposal. First, the Bardhan-Roemer proposal does not address the von Mises critique of socialist accumulation. Second, Roemer’s public choice arguments are seriously flawed.

Mises claimed that the consumers’ democracy of markets elects capitalists who are most willing to defer consumption, and most able to judge entrepreneurial projects, as directors of investment. Since median voters prefer less investment than do capitalists politicization of investment reduces the rate of capital accumulation relative to private investment²⁶. Roemer (1992 p454) accepts the inequality resulting from private saving payment. While Roemer accepts private savings, the financial intermediaries in Roemer’s world will strongly influence investment demand according to political expediencies.

Some modern socialists have also admitted to problems with socialist planning of investment. For example, Putterman (1993 p159) notes that in capitalism consumers can compare interest rates at different banks, but cannot do so when government controls all

²⁶ If voters in the high savings tail of the distribution can credibly commit to abstaining on election day, they can shift policy towards investment. However, since voters on the low savings end of the distribution can do likewise, there is no reason to expect high saving voters to shift policy towards investment.

investment. Roemer recognizes the political nature of socialist investment, but does not explicitly address Mises' claim regarding politicized accumulation. Roemer does assert that positive externalities to education and research, public goods problems, and the absence of futures markets causes sub-optimal private investment on. Socialist officials can use discounts on the interest rate charged to individual firms to increase the rate of investment (1994 p103). Since Roemer claims that externalities make private investment too low and Mises claimed that median voters prefer too little saving, we have a set of opposing empirical claims to examine. The primary purpose of this paper is to sort out the theoretical issues in this debate, yet we will briefly mention some pertinent empirical examples²⁷.

Roemer (1994 p21) also claims that markets determine investment without regard to the preferences of future generations, and that political debate will 'bring forward the position' of those who care the most about future generations. There are serious deficiencies in these claims. First, Roemer himself admits that political outcomes do not reflect the actual preferences of future generation, but only the preferences of those who care about future generations. Roemer's claim that politics brings forward the position of those who care the most about future generations is a bare assertion, and probably false. If philanthropic preferences are a distributed normally, from most to least giving, then median preferences will differ from who care the most about future generations- leaving politics biased against intergenerational philanthropy. In private markets, those in the 'caring' tail of the philanthropic distribution can donate their own money to future generations, without first gaining the consent of the median voter.

Second, contrary to Roemer's claims, private interests do invest with future generations in mind. Private foundations are usually endowed and invested in financial markets. Many

²⁷ MacKenzie and Farrant (2007) carry out more detailed empirical analysis of the issues explored in this paper.

parks (i.e. Acadia and Harriman) and libraries were established by private donations. Many institutions of higher learning have received large donations from private interests (i.e. The University of Chicago). One could argue that since capitalism operates according to self-interest these examples are aberrations. Yet investment in future generations is in the interest of those who genuinely care about future generations, and there is no reason to assume that politics provides the only means of realizing these values²⁸. There are state projects that last across generations (i.e. roads, bridges, dams). However, long-term public projects are often financed through current taxes or user fees. Which approach does more to benefit future generations, the private approach, financed out of the fortunes of living or past capitalists, or the public approach, which often relies heavily on taxation of future generations? Of course governments can establish trust funds, but how often has this happened?

Third, capital accumulation has already benefited future generations immensely. Living standards in capitalist countries have trended upwards since the adoption of the free trade policies advocated by Smith and Ricardo. Capital accumulation and technological progress in capitalism has delivered unmatched increases in living standards. Why should we expect democratic socialism, with its biases against accumulation and other public choice problems, to do better? Roemer claims that private investment is sub-optimal, but it is not clear that this statement means anything. Other financial markets serve as close substitutes for absent futures markets, and externalities are often infra-marginal. Also, private firms sometimes internalize tasks that markets fail to do efficiently (Coase 1937).

Roemer (1994 p71) claims that “as influence of the rich in the elections increases, the utility of the poor falls and the utility of the rich rises”. At one level Roemer is correct wrongly discounts the possibility of reverse causation in the wealth-influence issue. Olson

²⁸ Also, some invest in future generations for egoistic reasons- those who give to future generations buy enduring fame.

(1965) argues that narrow special interest groups have undue influence over public policies. It could be the case that influence causes wealth. That is, well organized special interest groups might use their influence to gain at the expense of the general population. There already exists a large public choice literature on how ‘political entrepreneurs’ exploit public policies for private gain. This is, of course, a problem of mixed economies, and not market socialism. However, the adoption of laissez-faire policies also prevents the rich from using public policies to exploit the general population. Furthermore, the adoption of market socialism does not allow the poor to gain from the higher wages that results from capital accumulated out of the savings of the rich. Political bias against accumulation in democratic socialism can significantly affect the wages of ordinary workers.

Bardhan and Roemer (1994 p178) emphasize the need to de-link firm management from state control in market socialism, but their proposal does not meet their own criteria of separating political and economic factors. Bardhan and Roemer see their version of market socialism as incentive compatible, but the incentive compatibility issue is secondary. The primary problem of socialism is in *planning the rate and composition of capital investment*, not the problem of aligning managerial incentives to prevent deviations from a given set of investment plans. The ability of politicians to alter the rate and pattern of investment with discounts and surcharges on interest rates politicizes accumulation²⁹.

The policies of Western social welfare states have favored consumption over investment. For example, Social Security has functioned mainly as an intergenerational transfer program, rather than as a retirement savings program. During the postwar baby boom Social Security fostered the accumulation of unfunded entitlement obligations rather than capital accumulation. Feldstein (1996) estimates that social security reduces saving by 60%. Social

²⁹ Politicization of the pattern of investment is the subject of another paper. See MacKenzie 2007a.

security therefore increases current consumption at the expense of capital accumulation. Twentieth century politics clearly failed to 'bring forward the position' of those who care the most about future generations, as far as social security is concerned. Furthermore, a recent effort to convert Social Security into a government managed saving program failed due to demagoguery from the opposing party- just as Mises predicted. The postwar federal government has also accumulated trillions of dollars in debt. Debt accumulation crowds out private investment and reduces growth, unless one takes the Ricardian Equivalence Theorem seriously. American experience is hardly unique in these matters. In fact, some other Western welfare states are burdened with debts and under funded entitlements that exceed the size of US obligations as a percentage of their GDP.

Roemer's public choice arguments reveal internal inconsistencies within the Bardhan-Roemer proposal. Roemer (1993b) argues that the political influence of wealthy capitalists generate large negative externalities. Wealthy capitalists have undue power "in lobbying, in advertising, in influencing or controlling the media and therefore shaping public opinion, and in financing electoral campaigns and political parties". His main example of a capitalist produced public bad is the first Gulf War.

If wealth concentration generates large negative externalities, then Mises' point that accumulation requires inequality loses much of its force. Yet Roemer's public choice arguments concerning wealth concentration have serious problems. If capitalists can manipulate public opinion to the extent where they can impose large externalities, then Roemer's proposals are almost certainly utopian. If wealthy capitalists manipulate public opinion regarding foreign policy, then they should also be able to use this ability to block the implementation of Roemer's proposals. Roemer assumes both a level of control over the media and a general naïveté on the part of the public that is highly unrealistic. Is media so

controlled and are people so foolish as to enable capitalist interests to shape public opinion against its own interests? Given the multitude of broadcast, print, and internet sources that currently exist, and incentive within the media to discredit rivals, the idea that capitalists simply use the media to shape public opinion is unbelievable. The fact of the matter is that the media shifted public opinion against the Second Gulf War, and the Republicans lost a recent election due to public opinion concerning this war.

Mises and Roemer view politics differently. To Mises (1922, p 459-460) "everything is decided by the interpretation and explanation of the facts, by the ideas and the theories... Only ideas can overcome ideas." Mises saw the evolution of ideas as the main determinant of public policies and programs, and interest groups as secondary³⁰. Roemer sees dominance of special (capitalist) interests over public opinion. Transition to market socialism would require some independence of thought to overcome the alleged power of capitalist class. But if ideas are both important and independent of wealth concentration, then Roemer is wrong about private profit being the main cause of policy orientated negative externalities.

Given the bias against accumulation in politics, democratic market socialism could deliver rates of growth similar to those of the Soviet system. Even if Mises was wrong about socialism leading to capital depletion, there are good reasons to expect laissez faire capitalism to deliver higher growth rates than democratic socialism. Since even small differences in growth rates compound into large differences in living standards over time, we should expect laissez faire capitalism to vastly outperform democratic socialism in the long-term. In any case, the Bardhan-Roemer program would politicize investment. Political interference with investment decisions surely played a role in the demise of the Soviet Union, and such problems would almost certainly plague democratic socialism as well.

³⁰ Hayek (1948) develops the von Mises argument concerning the importance of ideas.

SUMMARY AND CONCLUSION

Since Mises conceived of democracy in terms of equality of opportunity rather than equality of results, he saw no conflict between equity and efficiency. Capitalism requires inequality, and market determined inequality *is* equitable in his terms. Mises rejected socialism as antidemocratic, as far as the consumer's democracy of the market is concerned, and inefficient in terms of the dynamics of capital accumulation. Lange and Dickinson associated democracy with egalitarianism, and tried to avoid any tradeoff between equity and efficiency with their accumulation critique of capitalism. Since the capitalist accumulation critique is illegitimate, and Lerner's critique is irrelevant, market socialism involves a real tradeoff between Lange-Lerner notion of democratic equity and dynamic efficiency.

If Bardhan and Roemer believe that it is important to divorce management of socialist enterprises from politics, they should also see advantages in divorcing capital investment from politics. The examples of political bias against accumulation mentioned in this paper support the von Mises critique of socialist accumulation. Roemer's own public choice arguments regarding the power of vested capitalist interests indicate that his proposals are either utopian or unnecessary. It should also be noted that Roemer (2007) finds that equalizing labor skills through improved education would do more to realize egalitarian aims than would equalizing ownership of the means of production.

The academic world ignored Mises when he first advanced his accumulation critique of socialism. The failure of dictatorial socialism indicates that his warnings should have been heeded. This paper has demonstrated that Mises critiqued both democratic and dictatorial socialism. Modern democratic socialists should either provide counterarguments and counterevidence to the elaboration of the von Mises critique of socialist accumulation in this paper, or admit to the incompatibility of democratic socialism and dynamic efficiency.

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