

Study Guide to *Human Action* by Robert P. Murphy

Chapter XXVI. The Impossibility of Economic Calculation Under Socialism

Chapter Summary

1. The Problem

To illustrate the central problem of socialism, consider the socialist director who wishes to construct a house. There are many different technical methods that may be used to achieve the construction of a house satisfying prespecified requirements (square footage, etc.). The director may have numerous physical and chemical facts, as relayed by his subordinates. But he cannot reduce these various reports into a common denominator, allowing him to use arithmetic operations. There is no way for him to quantify the cost of each different technologically possible procedure for constructing the house, and thus there is no way for him to construct his desired house while impairing his ability to satisfy other wants to the smallest extent possible.

The paradox of "planning" is that it cannot plan, because the lack of economic calculation means that the planners cannot compare the benefits and costs of a possible use of scarce resources.

2. Past Failures to Conceive the Problem

Although a few economists touched on the calculation problem for socialism, they did not stress it, and the insights were lost. It was the mathematical economists who were to blame for this failure to conceive the fundamental problem of socialism. In their formal models, the mathematical economists focus on static-equilibrium states, and so there is no need for entrepreneurship. Furthermore, economic calculation appears possible even without the use of money. This misled many thinkers into believing that socialism was a workable alternative to the private ownership of the means of production.

3. Recent Suggestions for Socialist Economic Calculation

For much of its history, the socialist theorists neglected the problems of economic calculation. However, the criticisms of economists forced them eventually to offer alleged solutions. All of the schemes are untenable. For example, efforts to value goods based on their inherent labor content ignore the heterogeneity of labor and the contribution of other factors of production. For another example, proposals to value goods according to their units of "utility" fail because utility is an ordinal ranking, not a cardinal quantity that could be measured. (Other suggested schemes are dealt with in the sections below.)

4. Trial and Error

The socialist planner cannot resort to trial and error because, without the market test of profit and loss, there are no telltale signs that his plan has been a success or a failure.

5. The Quasi-Market

Initially, the characteristic virtue of socialism was its substitution of one conscious will for the "anarchy" of capitalist production. By replacing the wasteful competition of private ownership with selfless and rational cooperation, the socialists believed they would increase total output and distribute the results according to ethical principles. In light of this historical position, the more recent schemes for "market socialism" are an admission of unconditional defeat. When socialists (conversant with mathematical economics) recommend that planners give instructions to plant managers to behave "as if" they were in a market economy, they concede that the original socialist vision was untenable.

The schemes for socialist citizens to "play market" are as untenable as the original vision. They ignore the fact that under capitalism, the entrepreneurs must decide when and where to *build* plants; the problem is not simply the economical administration of a given factory. Misled by the static-equilibrium solutions of mathematical economics, the socialist theorists advocating a quasi market concentrate on managerial tasks, and overlook the operations performed in the so-called capital and money markets in a capitalist society.

6. The Differential Equations of Mathematical Economics

Some socialist theorists have suggested that the central planner rely on the tools of mathematical economics to guide his valuation of the means of production. But this too is a vain proposal. The differential equations of mathematical economics describe a long-run stationary equilibrium state. The equations do not shed light on how the planner should take the present world as it is—complete with misallocated capital goods and workers trained in superfluous fields, according to the planner's value scale—and move toward the desired end state, all the while maintaining as satisfactory a condition as possible during the transition phase.

Why It Matters

This is a tremendously important chapter, laying out the impossibility of economic calculation under socialism. Without private ownership of the means of production, there are no market prices for capital goods and other resources. Consequently, the planner cannot calculate the cost—the value of foregone opportunities—of his orders to his subordinates. This is a far more fundamental critique of socialism than the problem of incentives and the possibility of corruption, stressed by previous writers.

Technical Notes

- (1) On pages 695–696, Mises concedes that even in a market economy, where entrepreneurs can rely on prices and engage in economic calculation, mistakes are made. However, these mistakes occur because of faulty forecasts of future conditions. In contrast, under socialism, the director has no way of gauging the merits of his planned use of resources, even according to his anticipation of future events at the moment of decision. In a market, people make mistakes, but they at least are made aware of them through the suffering of losses. No such feedback is provided in a socialist arrangement.

- (2) On pages 704–705, Mises points out that the quasi-market solution cannot be extended to handle his objection that capitalism is an entrepreneurial system rather than a managerial system. For, even if a socialist theorist suggested that comrades under socialism should be allowed to act in the role of speculators, futures traders, and moneylenders—turning over the profits to the common chest for redistribution—it would be immediately clear that the difference in incentives would render the analogy impossible. One cannot mimic a market speculator if one has no personal wealth at stake and will not enjoy the fruits of one's successes. Moreover, even setting aside the problem of incentives, if the socialist planners really were to endow "socialist capitalists" with such powers, they would merely be transferring their dictatorship to a different group. The fundamental problem of economic calculation would still remain.
- (3) To fully understand Mises's discussion, the reader needs to be conversant with the historical socialist calculation debate. In 1920, Mises published his first exposition of the calculation argument in a German-language article, which he expanded for his 1922 book. In response, many socialist theorists took up Mises's challenge and tried to prove that socialist economy was theoretically possible (though perhaps not practical). The "market-socialism" solution, which instructed the planners to rely on the description of economic efficiency in formal models, was offered by economists such as H.D. Dickinson and Oskar Lange in the 1930s. Friedrich Hayek joined Mises's side in the debate, stressing the practical problems that Dickinson et al. were ignoring in their proposals.

Study Questions

1. The Problem

- Does Mises assume that economic calculation in a market is infallible? Does this affect the validity of his critique of socialism?

Comment: "The paradox of 'planning' is that it cannot plan, because of the absence of economic calculation."

2. Past Failures to Conceive the Problem

- How does mathematical economics lend credence to the feasibility of socialism? What is the most significant critique of mathematical economics?
- Why were Soviet Russia and Nazi Germany apparently able to evade the chaos of which Mises warns?

3. Recent Suggestions for Socialist Economic Calculation

- What are the six suggested solutions for socialist calculation? Give a short overview.

4. Trial and Error

- How does the example of searching for a missing wallet relate to the problem with trial and error as a solution to socialist economy?
- Why is it impossible to compare input and output by the methods of arithmetic in a socialist commonwealth?

5. The Quasi-market

- Why do the new socialist theorists want to keep market institutions intact even if they are in favor of abolishing private property? Why aren't these attempts feasible?

Comment: "The capitalist system is not a managerial system; it is an entrepreneurial system."

- Why is it impossible to *play* investor and speculator? What are the risks that are associated with being a businessperson?

6. The Differential Equations of Mathematical Economics

- What do the equations of mathematical economics describe?
- Why can't these equations provide the necessary information about future conditions? Can these equations be used to determine actions for someone under today's conditions?
- More recent mathematical models in neoclassical economics do not simply describe the long-run equilibrium state. They also can characterize the (equilibrium) transition path to such a steady state. Does this development vitiate Mises's critique of the mathematical approach?