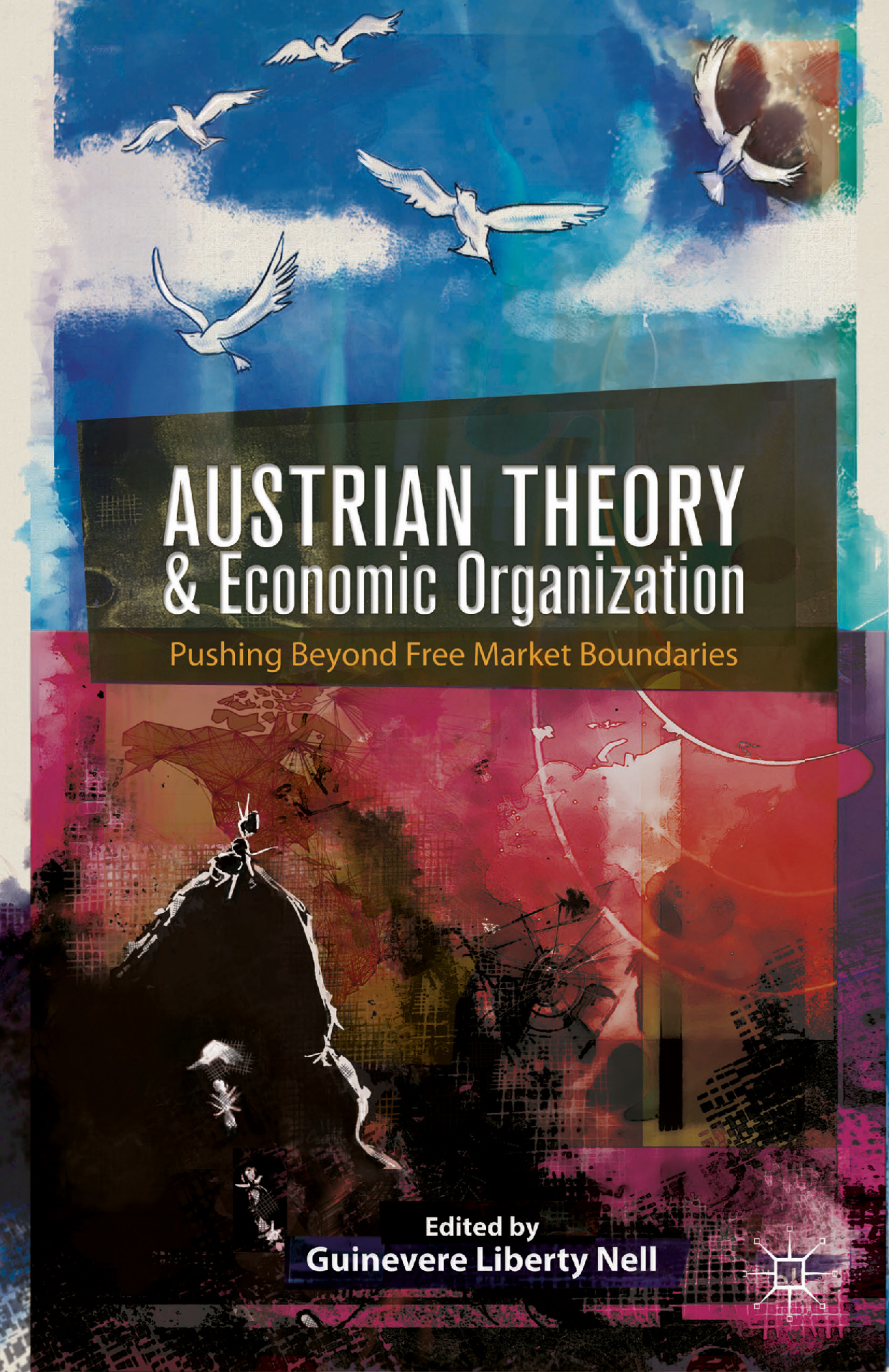
AUSTRIAN THEORY
& Economic Organization
Pushing Beyond Free Market Boundaries
Edited by
Guinevere Liberty Nell

# Austrian Theory and Economic Organization

## Reaching Beyond Free Market Boundaries

Guinevere Liberty Nell

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# Introduction

Austrian school economics has contributed significantly to modern economics, especially by forcing economists, who sometimes have over-simplified and static or aggregative models, to consider dynamic and disaggregated consequences. F. A. Hayek famously did this during the socialist calculation debate, and when the Berlin Wall fell so did the illusion that he had lost, and conventional economics finally fully embraced his arguments. The primary model, or framework, out of which these arguments and insights emerge is that of spontaneous order. This framework can be used to study the market, but it is not limited to this one application, as Hayek—the Austrian economist who coined the term—well knew. However, as economists, Austrians tend to focus mainly on this one spontaneous order, omitting many kinds of cultural and social considerations from their analysis, and treating the public sector as a planned, rather than spontaneous, order, and therefore not suited to that core Austrian framework.

The Austrian school is well known to be free market, and is often accused of being more ideological than it is judicious and scholarly. More than three decades ago, during an interview of Hayek the economist Axel Leijonhufvud said of the label "Austrian school" that, "the meaning of the term has changed." At one time, he said, it was used to describe methodologies used and theories advanced "quite irrespective of the political consequences" of those theories and use of the methodology. "It was the marginal utility analysis which to us was the Austrian school," he explained.

Today, of course, marginal utility analysis is accepted by virtually all economists, and for many in the profession, Austrians are distinguished primarily by their extreme free market views. They are known for concluding, based on literary (nonmathematical) models, that compared with private solutions intervention by the state is an inferior way of achieving economic goals *in virtually all cases*. Austrian economists argue that this is a conclusion that they have come to through use of their models, but any who do not reach this conclusion are quickly denied the title "Austrian" by many in the school, leading one to question whether methodology, and not ideology, can be said honestly to be the defining feature of the school.

A primary goal of this book is to extend Austrian school models and explore the possibilities of the school when it is not constrained by mandatory free market conclusions. The essays explore the margins, boundaries, and horizons of the school, and even begins to give a rough shape to a post-Austrian economics. Unconstrained by laissez-faire, the collection will take Austrian analysis to places it has rarely, if ever, gone before. After stretching and flexing the spontaneous order framework in the first section, we will consider capitalist central planning, ask whether firms are authoritarian, consider cooperatives and the nature of contracts, and then we'll consider a post-Austrian school and market socialism. The essays will hopefully pave the way for others who may develop the school in these new directions.

Comparison of different ways to organize the economy is an important function and theme of economic theory and analysis. It found new life with the end of the cold war—the resurgence is evidenced by the popularity of institutional economics and theories of the firm and the market. The wave of proposals, starting in the early 1990s, for a *new* post-communist "market socialism" should in turn breathe new life into Hayek and the Austrians. Is it possible to surmount both the inefficiencies and authoritarianism of socialism *and* the inefficiencies (chapters 2 and 8) and authoritarianism (chapters 4 and 5) of capitalism? What if there is central planning in capitalism too (chapter 3)? What about the harsh "social Darwinism" (or lack thereof) of capitalist economies (chapter 1)? Do we need more state (chapter 7) or no state at all (chapter 6)?

Austrians are correct that free market organization can assist in developing an economic system with sustainable growth and effective and efficient resource utilization, and that central planning cannot. However, a completely laissez-faire system is not required for this.

In Chapter 1, "Improving Spontaneous Orders," Randall G. Holcombe asks whether spontaneous orders can be improved through human design. Spontaneous orders may not be ideal. They may produce outcomes that violate social norms, and they may be inefficient. Theoretically, changes could be made that would improve social welfare, or be

Pareto efficient; however, what if, due to the effect of the consequences of interference in dynamic social orders, the only way to improve upon the system is to facilitate voluntary and mutually advantageous interaction? In order to avoid unintended consequences, we may have to be cautious about disrupting order that is created as the result of human action but not of human design. This chapter provides an Austrian foundation that should be kept in mind as the reader considers the arguments made in later chapters about the shortcomings of a fully laissez-faire market system.

Market organization is idealized in many economic models, and this arguably applies to Austrian models as much as to mainstream neoclassical ones. Daniel Kuehn argues that Austrians wrongly assume that markets produce full employment as an equilibrium state. Noneconomists are concerned with unemployment, not merely the "labor surplus" that economists concern themselves with. Kuehn argues for shelving the misleading and meaningless unemployment definition used by economists, since using it, according to Kuehn, results in an overstatement of the social value of the laissez-faire labor market.

In Chapter 3, Kevin Carson argues that large corporations suffer from calculation, knowledge, and incentive problems similar to those of centrally planned economies. The internal transfer pricing system under American corporate management accounting works almost identically to that the one used by Soviet firm managers and ministers, with the same resulting distortions and misallocations of resources. The same potential exists for principal-agent problems so long as organization is hierarchical. Carson makes the case for institutional rules and organizational forms that are fundamentally grounded in democratic procedures.

Is hierarchy inevitable in large firms? In Chapter 4, Per Bylund addresses the question of hierarchy within the firm by asking whether authority is part of what transforms a set of contractual relationships into a firm. After some exploration, Bylund makes the case that a lasting network of lateral (horizontal, not vertical) relationships is possible and can retain the important attributes of a firm. However, given that, like all action, firms require planning—they are, in fact, "the process by which a specialized production process is organized or put together" (and might suffer from the problems of planned economies if large enough, as Carson, chapter 3 argues)—might they also similarly form into hierarchies despite conscious attempts to keep them democratic, as planned economies tend to do? Must firms always end up this way, and is hiring someone an authoritarian thing to do? Or can contracts, even employment contracts, remain lateral? Bylund argues that they can remain lateral as they are merely a system of contracts and therefore can be internally organized in any number of ways.

Gus diZerega (chapter 5) also studies the contract, considering the implications of Spain's Mondragon cooperatives. Austrians argue that free trade should be given credit for the incredible prosperity that has lifted billions out of poverty. The idea that trade benefits all and can "lift all boats" appears to naturally follow from the logic of a contract: each party has something to gain from trading with the other, which is why they voluntarily choose to make the trade; and after the trade both parties must be better off. However, this simplified story is about the abstract idea of contract, whereas real people, real contracts, and real life are not abstractions. DiZerega explores the implications of this truth through close analysis of employment contracts in the real world, questioning how voluntary they truly are in many cases, and through study of the Mondragon cooperatives.

In Chapter 6, Caleb J. Miles and Edward Peter Stringham provide evidence that many of the benefits we think of as historically rooted in the introduction of a state were actually provided by nonstate organizations first. They provide examples of privately produced order, refuting the common perception that the existing order could only be created by state force. Just as the economic debate on the benefits of free markets have changed the way we think about central planning and free trade, examples of privately produced order may influence public opinion, and economists should keep these examples in mind when considering the possible ways that an economy and society might be organized.

In Chapter 7, Andrew Cumbers writes about the importance of diversity and variety in new forms of ownership, and argues for allowing both state and nonstate forms of public ownership to work alongside each other. In developing new ideas about public ownership we should not make the mistake of creating a new all-encompassing model and vision, he argues. Only having varied and interacting different forms of ownership, and allowing experimentation, learning, and evolution can we hope to combat the centralization and concentration of economic power and decision making.

Finally, in Chapter 8 Nell argues that Austrians should embrace a modified framework—a post-Austrian framework that looks beyond the limits imposed by utopian laissez-faire, and can be used to develop a new market socialism. This modified Austrian framework will provide a powerful theoretical starting point for analyzing existing and historical economies and for conceiving of a new system that avoids the pitfalls of planning and capitalist market systems.

# Part 1

# Order and Efficiency in Free Markets

CHAPTER 1

# IMPROVING SPONTANEOUS ORDERS

RANDALL G. HOLCOMBE

## INTRODUCTION

One of the most remarkable discoveries in intellectual history is the insight that an orderly outcome can emerge spontaneously, without a conscious mind having designed it. The idea is perhaps most associated with Darwin's (1859) analysis of biological evolution, but it substantially predates Darwin in the social sciences. Adam Ferguson (1767) clearly articulates the concept of spontaneous order when he notes that "every step and every movement of the multitude, even in what are termed enlightened ages, are made with equal blindness to the future; and nations stumble upon establishments, which are indeed the result of human action, but not the execution of any human design" (Part III, Section II). Adam Smith (1776) described this same idea by noting how people are led by an invisible hand, to use one of the most well-known phrases coined by an economist. Friedrich Hayek (1948, 1967) published collections of essays that further explained and supported the idea that a society can have orderly and productive institutions that are "The Results of Human Action but not of Human Design," to use the title of one of his 1967 essays.

Perhaps the best example of a spontaneous order, for purposes of illustration, is language. Nobody invented language. It evolved as the result of human action but not of human design. Sounds came to be associated with things and were recognized as nouns, whereas other sounds represented actions and were recognized as verbs. Some sounds were used to modify the meaning of others, so adjectives and adverbs became part of language. Who invented adverbs? Nobody. They are the result of human action but not of human design. This example makes the concept of spontaneous order understandable, and people can see that language evolved over a short period of time as new words entered the lexicon and the nuances associated with existing words changed.

Examples of spontaneous order abound in economics. Nobody invented money, as Menger (1871) explained. It emerged as the result of human action but not of human design, as people observed that some commodities were easier to trade away than others. Those commodities evolved into a medium of exchange. People would accept them in trade even if they had no use for them, with the intent of trading them away later. Menger referred to money as the most tradable of commodities. Once money was established as a medium of exchange, governments started modifying it, so components of the current monetary system are the result of human design. Did government intervention improve upon the spontaneous order, or erode the value of what spontaneous order created? This chapter investigates the question of how human design might improve spontaneous orders.

Even after governments had taken over the production of money, payments systems continued to evolve. Merchants allowed people to buy on credit, which led to the issuance of credit cards by individual merchants for use by their customers. This in turn led to the introduction of credit cards, such as Visa and MasterCard, that are accepted by many merchants. Nobody designed the payments system as it exists today. It evolved as the result of human action but not of human design.

The same is true of stock markets, which began with the simple trading of ownership shares in businesses among individuals. These bilateral exchanges of ownership led to the establishment of an organized market in which ownership shares in businesses could be easily traded. Indeed, the market economy itself is the result of human action but not of human design. Spontaneous orders exist naturally in economies because people find ways to transact for their mutual benefit. The same is true of society in general. People discover ways of interacting that are mutually advantageous, and as they become widespread the unintended consequences of their actions produce a more orderly society.

Along with this spontaneous order came planned orders at two levels. First, individuals plan their own actions, and that planning can often scale up to the interactions of large numbers of people. Two well-known examples are Henry Ford's assembly line production with interchangeable parts, which not only allowed the Ford Motor Company to scale up but also affected Ford's suppliers and dealer networks, and Walmart's innovations in inventory management which, in similar fashion, allowed that firm to scale up and affected suppliers to Walmart and other retailers. Coase (1937) noted that firms constitute a planned order within an economy and interact with other firms, suppliers, and customers through the spontaneous order of the market. Coase was referring to the division between the planned order of the firm and the spontaneous order of the market, but the example carries over into other activities. People plan their individual activities, as firms do, but interact with others through the spontaneous order of market institutions. At the second level, a planned order is imposed on spontaneous orders from above, typically by government but perhaps by other institutions such as religions, gangs, or mafias. People trade in the spontaneous order of the market but within the planned order created by police protection of property rights, regulations set by government, and dispute resolution undertaken through courts.[1]

Ideally, those interventions that direct and modify the results of human action but not of human design from above improve the well-being of people in a society. The benefits of a market economy can only be realized if property rights are protected, which in most places is done by government. In this sense, the spontaneous order is improved by an element of planned order imposed on it, as Buchanan (1975) argued.[2] Individuals make their own plans to further their own interests, and, ideally, when they do so they will be led by an invisible hand to do what is best for everyone. That might not always happen—in a prisoners' dilemma setting individuals pursuing their own interests work against the best interests of the group—so there may be room for order imposed from above to improve upon the spontaneous order.

## Unintended Consequences

Spontaneous orders create social benefits beyond those foreseen by individual decision makers because of the unintended consequences of human action. Consider the evolution of money from barter as an example. Jevons (1875: 1) begins his book with an amusing story of a Parisian singer who performed in the Society Islands, where, lacking a currency, the receipts consisted of livestock and various fruits and vegetables. Jevons relates, "This amount of live stock and vegetables might have brought four thousand francs, which would have been good remuneration for five songs. In the Society Islands, however, pieces of money were very scarce; and as Mademoiselle could not consume any considerable portion of the receipts herself, it became necessary in the mean time to feed the pigs and poultry with the fruit." Barter has its drawbacks!

Jevons's example illustrates that in a barter economy it would be better to accept a durable good in exchange than a perishable one if the recipient did not intend to consume the good. A durable good might hold its value longer and could eventually be traded away. Individuals have motivation only for accepting those goods that can either be consumed or that will be suitable for trading in the future. An unintended consequence of individual decisions on what to accept in trade is that some goods become recognized by others as readily tradable. People then willingly accept those goods in exchange even when they have no personal use for them and eventually some goods become generally accepted as a medium of exchange (a result of human action but not of human design).

The individual motivation is for people to avoid accepting in exchange items they will be unable to use or trade away later. In so doing, individuals are led by an invisible hand to produce an institution that was not part of their intentions: a medium of exchange. The spontaneous order in which trade is facilitated by a medium of exchange is an unintended consequence of human action: the result of human action but not of human design.

The example could be extended to the financial institutions that facilitate exchange, and indeed to the entire market economy. The concept applies to language as well: People who first uttered sounds that others tried to interpret did not intend to create a language. Social conventions follow the same framework. The legal environment created through common law is another example. The determination of a just outcome in specific cases leads to a framework in which the common law environment evolves into an order that improves everyone's well-being, as Rubin (1977), Priest (1977), Benson (1990), and others have described. People engage in activities for their own benefit, which can lead to the creation of an order that improves everyone's well-being.

Unintended consequences are not always positive, as Ikeda (1997) points out. Sometimes people perceive a problem and design a remedy in the form of a public policy, and that policy causes unforeseen disruptions and problems. This may lead to a call for more intervention to design a solution for the new problems. In this way, the political system can lead to an increasing amount of interventionism, an unintended consequence of what initially appeared to be a desirable change. Unintended consequences of human action are often beneficial, but not always.

One factor that can make a difference is whether individual actions are undertaken voluntarily or by force. Money and language evolved as a result of human action but not of human design because individuals saw the advantages of interacting with each other using money and language. They voluntarily participated. The interventions Ikeda (1997) discusses were imposed by government. People had no choice but to participate, and negative consequences from those interventions were not anticipated. This suggests that if one is interested in improving spontaneous orders, there are advantages to making participation optional. The differences between voluntary and imposed participation are discussed later in this chapter.

## Individual Interest and the Public Good

Often, individuals pursuing their own interests are led by an invisible hand to further the general public interest, but the possibility exists that people can find themselves in a prisoners' dilemma situation in which following their own narrow interests leads to negative outcomes for everyone. Axelrod (1984) wrote an insightful volume on the prisoners' dilemma in which he argued that these situations are rarer than many social scientists believe, because the same forces that lie behind the emergence of spontaneous orders also serve to turn prisoners' dilemma situations into ones in which people are able to find mutually beneficial courses of action. Axelrod argues that people who find ways to cooperate benefit themselves at the same time that they benefit those with whom they cooperate, so cooperative behavior tends to displace noncooperative behavior, and outcomes that benefit everyone tend to evolve out of prisoners' dilemma settings.

Extending Axelrod's argument (beyond where he extended it), there may be no need to interfere with spontaneous social orders for the benefit of those acting within them, because evolutionary forces tend to produce more efficient outcomes out of less efficient ones. The common sense of this is that every inefficiency is a profit opportunity. In overcoming an inefficiency, there is an opportunity for gains that can be shared with everyone, so everyone should buy into the change.

This argument falls short when one considers the possibility that some people will behave opportunistically. Axelrod's analysis indicates that opportunistic behavior ultimately leads individuals to be worse off.

Opportunistic behavior tends to be displaced by cooperative behavior in Axelrod's framework, but real-world observation suggests that some people still behave opportunistically. If people leave their homes unattended, opportunistic burglars might break in, so people go to the expense of buying locks for their homes, installing burglar alarms, and in some cases hiring armed guards. People lock their cars to prevent others from stealing their contents, or even the entire car. People are continually victimized by muggers, and by unscrupulous individuals engaging in financial fraud. Even though these people run the risk of being caught, and for many of them their opportunistic behavior costs them more than they benefit, such opportunistic behavior still occurs.

Thinking about improving spontaneous orders, places that have government-imposed rule of law, with competent and noncorrupt law enforcement and judicial systems, seem to better control opportunism than places that do not. Even recognizing the advantages of spontaneous orders and that social institutions tend to evolve toward cooperative and efficient orders, perhaps there are ways in which spontaneous orders can be improved. Within the prisoners' dilemma framework, the key is to find ways to encourage people to engage in cooperative behavior rather than predatory behavior. People choose the noncooperative outcome in a prisoners' dilemma game with the rationale that they can benefit at the expense of others. People choose the cooperative outcome with the rationale that there are mutual gains from cooperation. The payoff matrix makes that clear to the players. Can spontaneous orders be improved to push people to engage in cooperative behavior more often?

## Cooperation versus Predation

People can interact with each other either through cooperative behavior or predation. There is little need to defend in any detail the efficacy of cooperation over predation as a way of improving the individual's long-term well-being. Even when one party is powerful enough to take the resources of another, over the long run both the weak and strong can benefit through exchange, in what Holcombe (1994) refers to as the exchange model of government. Government provides protection in exchange for tribute paid by citizens (often called taxes), and both citizens and those in government are better off as a result of the exchange of protection for tribute. In a similar argument, Olson (2000) makes the distinction between roving bandits and stationary bandits, drawing an analogy between stationary bandits and government, to show how cooperation can be more productive for everyone than predation. In Coase's framework (1960), even when there are potential gains from trade, transaction costs can be high enough that predation could be the more profitable opportunity for some people in some circumstances.

For every individual there will be a group of insiders for whom transaction costs are low enough that the individual will strive to engage in cooperative behavior with those in the group, and a group of outsiders for whom transaction costs are too high to engage in cooperative behavior. The individual will either avoid interacting with outsiders or prey on people in that group, especially if the individual views those outsiders as not just benign, but potentially harmful.

In groups like families, friends, and perhaps other social groups like clubs, people engage in cooperative behavior with no expectation of reciprocity for specific cooperative acts, even though members do view the benefits of membership as exceeding the costs. People offer assistance to others in those groups with no anticipation of reciprocity, whereas they would not offer the same assistance to a stranger. Dealing with people beyond those intimate groups, people tend to cooperate when they expect benefits. Seen in this way, the market is an institution that allows people to engage in cooperative behavior with strangers—people outside their group—because through market exchange they can benefit from cooperative behavior. The market system's design produces mutually beneficial interactions to those who choose to engage in exchange. Customers cooperate with vendors, and vendors cooperate with customers, because of an institutional structure in which both parties expect to be better off because of that cooperation. The larger the group of cooperating individuals, the greater the potential gains from trade, so enlarging the group has the potential to make everyone better off. The challenge of institutional design, whether those institutions spontaneously arise or are constructed, is how to enlarge the group of cooperating individuals for everyone's benefit. Outsiders often can be ignored, but they may not be if individuals view them as potentially harmful, or if individuals are opportunistic and believe they can take resources from the outsiders for their own benefit. At a local level, most people can be safely ignored, but robbers and thieves will engage in predatory activity to gain control over the resources controlled by others; meanwhile, potential victims will try to protect themselves through individual actions like locking up their possessions or carrying weapons to defend themselves, and will try to protect themselves collectively by cooperatively establishing police forces, courts, and jails. At a collective level, nations have engaged in predatory activities beyond their borders since the beginning of recorded history. In the twenty-first century, terrorist groups engage in predation rather than cooperation while their targets engage in predatory activity against those groups. The drones the United States uses to kill terrorists are even named Predators.

From interpersonal relations on the street, where some people want to mug others while those others seek to imprison the muggers, to international relations, predation occurs even when there are potential gains from trade through cooperation. Apparently, the transaction costs are too high, so, when they are accounted for, predation appears preferable (in the view of predators) to cooperation.

## Institutions and Cooperative Order

Nearly all cooperation occurs as a result of institutions that facilitate it: the family is an institution; the market economy is an institution (or, more accurately, a set of institutions); the legal structure is an institution (or, again, really a set of institutions). Institutions that facilitate cooperation naturally arise as a result of human action but not of human design, because when such institutions develop, people are better off as a result and have an incentive to act to reinforce the institution. People have an incentive to transform outsiders into insiders, and to make cooperative behavior less costly to engage in and therefore, more profitable for everyone.

International travelers can show up at hotels in countries they have never visited, and where they know nobody personally, and be welcomed and offered high quality food, lodging, and other amenities. They are treated like insiders because they carry credit cards, indicating their willingness to assure their hosts that they intend to make any interactions mutually beneficial. This is but one example of the spontaneous order of the marketplace that allows people who do not know each other personally to engage in cooperative behavior for their mutual benefit. Meanwhile, rule of law protects international travelers from being assaulted by those people they have never met and will probably never see again (protects them most of the time anyway), just as it protects individuals in their own communities from assault (again, most of the time). These institutions work better in some places than in others. Even in the same city, some areas may be generally safe to walk through while others may not be.

Discussing institutional development, North, Wallis, and Weingast (2009) make the distinction between what they call limited access orders and open access orders. Limited access orders rely on personal relationships for cooperation, so one's personal identity matters in these societies. Open access orders allow interpersonal relationships in which one need not take into account the personal identity of those with whom they interact. For example, the fact that the international traveler has a credit card allows the person to have (some) interpersonal relationships independent of that individual's personal identity. The person is recognized as a credit card holder, and therefore, someone who can be interacted with beneficially.

North, Wallis, and Weingast (2009: 33) divide people's identities into two components: individual attributes and socially ascribed attributes. People cooperate with their friends because of their individual attributes; likewise people take heavy account of the individual attributes of family members, although the socially ascribed attribute of being a family member also is a factor. In business, individual attributes tend to play a small role relative to socially ascribed attributes. A salesperson deals with a purchasing agent based on those socially ascribed attributes, and should the purchasing agent leave for another job, the salesperson will then deal with the new purchasing agent the same way as with the old.[3]

In government, Western democracies have evolved to the point where socially ascribed attributes overwhelm individual attributes. The power of a president or prime minister comes from the position, not from the individual. When those individuals leave office, the socially ascribed attributes go to the new office holder, and do not stay with the individual who left office. This is the characteristic of open access orders. Dictatorships are typically limited access orders in which the individual attributes of the dictator determine the dictator's power. Fidel Castro and Muammar Gaddafi maintained power because of their individual attributes, whereas the president of the United States and the prime minister of Britain maintain their power because of the socially ascribed attributes of the position. When a new president or prime minister is elected, the power shifts from the former office holder to the new one. North, Wallis, and Weingast (2009: 23) note that "only over the past five centuries did the identity of an organization become independent of the identity of its members."

Cooperation is greatly facilitated in open access orders, where people are able to deal with each other based on socially ascribed attributes such as their positions and job titles, or even (as in the traveler discussed earlier) their ownership of a credit card. In a limited access order people may be able to buy on credit if the seller knows the buyer personally and can trust the buyer to make good on the debt, whereas in an open access order the credit card provides that identity, even though neither the seller nor the people who work in the company that issues the credit card know the holder of the card personally. Institutions serve the function in an open access order that personal relationships serve in a limited access order, and those institutions allow cooperation on a much broader scale. Spontaneous orders can be improved if mechanisms can be designed to push them away from limited access orders toward open access orders.

One challenge in the development of institutions is creating the institutions that facilitate the transformation from a limited access order to an open access order. Market institutions do this by facilitating cooperative behavior among individuals who have no personal knowledge of each other because those individuals expect to benefit from the cooperation. The importance of institutions that develop as a result of human action but not of human design has already been recognized. Can these institutions be improved upon by imposing order from above, through human design?

## Order from Above: Codification versus Design

Government intervention might improve spontaneous orders through two different pathways: codification or design. Codification occurs when an existing informal order is formalized from above. Design occurs when overseers create institutions that impose order to augment or replace the status quo.

Codification can occur through government, which often means the existing order that arose spontaneously is mandated, although both government and private organizations can formalize informal orders without mandating them. Consider, for an example of a codification and mandate, the creation of an orderly flow of motor vehicle traffic that is facilitated by all traffic staying toward the right side of the road. Rules like this emerge spontaneously, but once they do government can codify the rule and mandate it so that it is a law.[4] Weights and measures provide another example, but in this case without the mandate (in most cases). Governments did not invent measures like the inch, the meter, the pint, the liter, or the gram, but once those measures evolved as the result of human action but not of human design, governments codified them and made them official within their boundaries. People are still free to use other measures if they prefer. Money provides another example of something that, as noted earlier, evolved as a result of human action but not of human design, but then was taken over and codified through government. Similarly, as Benson (1990) documents, the common law emerged as a spontaneous order, and still has some of those attributes, as Rubin (1977) and Priest (1977) note, but was taken over by government.

Codification of spontaneous orders bring obvious and immediate advantages because they convey more certainty regarding the actions of others. If staying to the right of the road was merely a custom rather than a law, there would be more traffic collisions, as one can see by walking on the sidewalk where staying to the right is, in fact, just a custom and not a law. Interoperability of electrical devices is possible because connection plugs and receptacles are standardized, which provides an obvious advantage. However, codification also limits flexibility and innovation. The immediate advantages of codification of spontaneous orders must be weighed against the barrier codification places to innovation.

Order can also be imposed by design, to refine or displace an order (or disorder!) that has spontaneously emerged. A good example is zoning for land use, which has evolved into more general land use planning. The original motivation for zoning was to separate incompatible uses of land, but land use planning goals have been extended to try to create better land use patterns to accomplish various goals. Numerous studies have evaluated land use planning, sometimes finding it improves land use patterns and sometimes finding that it does not. Critical analyses are found in Holcombe and Staley (2001) and Holcombe and Powell (2009). A more extreme example is the central economic planning that occurred in the Soviet Union and other Eastern bloc countries in the twentieth century. Most observers would agree that the designed order of central economic planning did not work well. Another example of a designed order is the interstate highway system that was built in the United States in the second half of the twentieth century. The interstate highway system is generally considered a success, in contrast to central economic planning.[5] What are the differences that make some designed orders more successful than others?

Think about the interstate highway system in the context of adaptive architecture, which is the idea of building to accommodate the way people use space. An example of adaptive architecture would be building sidewalks where worn paths indicate where people already walk. Rather than having a developer build sidewalks around new buildings or larger developments, wait to see where people are walking and put the sidewalks where people walk, rather than expecting people to walk where a planner chooses to put sidewalks. Now consider the interstate highway system, which was built to connect places where people already were traveling. The designers of the highways did not plan where they thought people should go; they looked at where people already were going and planned the system to facilitate trips that people were already taking.

The design of the interstate highway system is more like the codification of the travel that arose in a spontaneous order, rather than a design of a travel plan from the top down. The system was successful because it built upon the already-existing spontaneous order that had emerged as automobile travel grew over the decades. Once it was in place that top-down design had its own effects, perhaps unintended, of encouraging more long-distance automobile travel, of increasing development in locations that were conveniently located near highways, and of reducing economic activities in locations that were bypassed by the system.

Central economic planning in the Soviet Union and other Eastern bloc countries was designed to replace the spontaneous order of the marketplace with a designed order, and hindsight shows that despite the planning done by experts, it did not work well. These two examples illustrate that designed orders created to facilitate an underlying spontaneous order work better than planned orders designed to replace spontaneous orders.

## Designed Order: Imposed versus Voluntary

Even when designed orders are planned to reinforce spontaneous orders, issues can arise if those orders are imposed rather than voluntarily adopted. When orders are mandated, people have an incentive to try to alter them to their advantage, which leads to inefficiencies, special interest politicking, and cronyism. Consider the interstate highway system, cited here as a successful designed order that built upon a preexisting spontaneous order. When the system was being designed, landowners and local governments lobbied to alter the routes to benefit interest groups. Having property adjacent to an exit vastly increased the value of that property; being bypassed by the highway diminished the value of property. So, there was a substantial amount of rent-seeking that resulted in special interest benefits to some at the expense of others even in this successful project. Those benefits tended to go to people who had political connections, producing cronyism.

Not all spontaneous orders are voluntary. In Hobbesian anarchy, where life is a war of all against all, the strong may coerce the weak. But many spontaneous orders, ranging from language to the market system, are voluntary. People participate in communicating through the written and spoken word, or in market exchanges, only because they find it to their mutual advantage. When they do so, all parties expect to benefit; the evidence being that if this were not the case they would not choose to participate. When order is imposed on people, the use of force opens up the possibility that some will use that force for their benefit at the expense of others, which can lead to the cost of the imposed order being greater than the benefit. While it is likely that the overall benefit of the interstate highway system in the United States exceeds the cost, it is also likely that were it not for the political influences and cronyism that led to some alterations in its planned routing, the benefits would have been even greater. Even when the designed order builds on and reinforces a spontaneous order, if it is imposed on people, those with the power to impose it can benefit at the expense of others who pay the cost. Cooperative institutions increase welfare; predatory institutions lead to cronyism.

Consider the system of weights and measures, which codifies an order that arose spontaneously. National governments standardized measures like pound, yard, gallon, meter, and liter, but the use of those measures is largely voluntary. Some automobiles use parts with English measurement sizes while others use the metric system, but there is nothing to stop a manufacturer from using another system if it works better for the design of that manufacturer's product. The standards are helpful, and their creation enhances a spontaneous order, but the standards are voluntary. Sometimes those voluntary standards can be mandated, however, which can lead to inefficiencies. For example, some states mandate the sizes of containers in which beer can be sold, turning a voluntary standard into a mandated one. Typically, this will be done to create a barrier to entry to sellers who package their products—beer in this case—in a size that an interest group wants to block from the market.

If designed orders are created to codify spontaneous orders, they can improve upon the spontaneous order by codifying it to make it more predictable, more consistent, and easier to understand. The order is voluntary, but more useful because it is more consistent. However, once the codification takes place, the opportunity exists for making the voluntary designed order mandatory if the mandate would benefit an interest group with sufficient political power. That unintended consequence is a problem even with designed orders that are initially beneficial.

## Institutions and Spontaneous Order

Social institutions that emerged spontaneously, like language and markets, did so because people found that they could mutually benefit by interacting within that institutional framework. The key element here is that when people are in an institutional framework within which they benefit from mutually beneficial activity, everyone has an incentive to look for ways that they can provide benefits to others. Adam Smith (1937: 14) famously noted, "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest." These spontaneous orders produce beneficial results for everyone because individuals can benefit themselves only if they provide benefits to others.

If one is intent upon improving spontaneous orders, then improvements should be designed to reinforce the characteristic of beneficial spontaneous orders that encourage individuals to benefit from interactions that benefit others, and to prevent interactions that harm others. This is how the market works. Thus, designed institutions that protect property rights and that establish rule of law—where everyone is treated the same under an objective set of laws—stand the best chance of improving spontaneous orders. Those institutions reinforce the spontaneous order of the market, consistent with the arguments made here. The argument seems correct in theory, but also in practice. As Mokyr (1990) and Landes (1998) have noted, throughout history everywhere in the world, nations with established institutions that protect property rights and establish rule of law have prospered, while those without have not.

Gwartney, Lawson, and Hall (2012) provide empirical support for a substantial body of literature that demonstrates which intuitional features lead to prosperity. These institutional features, which Gwartney, Lawson, and Hall refer to as economic freedom, provide a good place to look for ways to improve spontaneous orders. Some of them are positive designs, such as protecting property rights and establishing rule of law. Others involve limiting or removing designed institutions, such as reducing taxes and government spending, removing barriers to international trade, and reducing regulations on credit markets, individuals, and businesses. The common element in all of these institutions of economic freedom is that they facilitate people engaging in voluntary exchange, and prevent people from engaging in predation. If one is looking for ways to improve spontaneous orders, a good place to start would be to look for ways to facilitate voluntary interaction and to prevent coercive and predatory interaction.

## Conclusion

Few people would argue that there is no way for human design to improve upon spontaneous social orders.[6] Look at the civilized societies in the United States, Europe, Japan, and so much of the rest of the world, which developed largely as the result of human action but not of human design, but also with a substantial amount of human design imposed by governments—governments which make up well over a third of the economic activity in those countries. Buchanan (1975) imagines an experiment in which people return to a state of anarchy, with no designed institutions, and finds it implausible that people would prefer a spontaneous order that evolves from anarchy to the combination of designed and spontaneous orders that make up today's civilized societies. Buchanan (1975: 3) says, "The anarchist utopia must be acknowledged to hold a lingering if ultimately spurious attractiveness. Little more than casual reflection is required, however, to suggest that the whole idea is a conceptual mirage."

At the same time, looking at the experience of the centrally planned dictatorships of the twentieth century, little more than casual reflection is required to see that attempting to improve the human condition by designing an order to replace even a part of a spontaneous order is likely to make things worse rather than better. Central economic planning is another conceptual mirage that appeared attractive to a wide range of intellectuals right up until the fall of the Berlin Wall and the break-up of the Soviet Union. The challenge is to try to understand under what conditions the results of human design can improve upon a spontaneous order.

That challenge is not easily met because of the unintended consequences of both spontaneous and planned orders. Spontaneous social orders coordinate people's behavior in ways that are often not obvious, so altering a spontaneous order can disrupt coordination in ways that are not easily anticipated. Meanwhile, planned orders can produce unintended consequences that interfere with the goals that were planned. To take one example, the Social Security system in the United States, and government benefits for the elderly in general, lessen people's dependence on family members, because government will take care of them in their old age. This lessened dependence disrupts the spontaneous order of the family structure, weakening bonds within the family. This observation implies no normative judgment (people may be better or worse off if they are not so heavily dependent on relatives), but notes that the planned order has had unintended consequences that have been disruptive to a spontaneous order. The designers of social insurance did not intend for their programs to weaken family bonds.

Meanwhile, if people are less dependent on their children for support in old age, there is less incentive to have children, which has contributed to a decline in the birth rate in modern welfare states. Again, no normative judgment is implied regarding the lower birth rate, but because these social insurance programs were designed with the idea that taxes on working people would support elders, the lower birth rate has had the unintended consequence of undermining the financing of the planned order. Interfering with spontaneous orders will have unintended consequences that affect both spontaneous orders and the plans of those who designed the interventions.

How can the unintended consequences of attempts to improve spontaneous orders be minimized? This chapter offers four modest suggestions. First, planned orders should be designed to reinforce spontaneous orders, rather than replace them with something better. Second, modifications can be designed to expand the group of insiders, turning outsiders into insiders, in social groups. Third, designed orders can be voluntary rather than mandatory. Finally, modifications can reinforce incentives for cooperative behavior and reduce incentives for predatory behavior.

Consider for example the general rule that has spontaneously emerged (almost) universally that people do not kill others within their group. Governments have formalized this informal institution by creating legal sanctions with government punishment for murder. In this example, government has reinforced a norm that emerged spontaneously, rather than trying to design an order that replaces a result of human action but not of human design. Traffic laws may provide a similar example of formalizing the informal rules that emerge for avoiding collisions and creating an orderly flow of traffic. Spontaneous orders may be improved by designing a codification and formalization that makes them less ambiguous, more certain, and easier to understand. There is still good reason for being wary of unintended consequences that may emanate from attempts to reinforce spontaneous orders by design, but past attempts to reinforce an existing spontaneous order have produced better results than those that attempted to replace a spontaneous order with a designed one.

The second way in which spontaneous orders can be improved is by increasing the group of insiders in a social group, and the primary vehicle for doing so is the creation of institutions that recognize people more for their socially ascribed characteristics than their personal characteristics. Group size is limited when people interact only with those they know personally, but if people are willing to deal with others based on socially ascribed characteristics, this enlarges the group and enables coordination. Often this evolution occurs as the result of human action but not of human design. The use of credit cards, for example, has grown because people wanted to facilitate individual transactions, and as an unintended consequence, credit cards can serve as an introduction throughout the world and allow people to be treated as friends rather than foes. The evolution from personal to socially ascribed characteristics has also occurred in the planned order of government, so it is common for people in government to be recognized by their office rather than by their person. People interact with political office holders based on their socially ascribed characteristics in many countries, in contrast to recent political leaders like Fidel Castro, Muammar Gaddafi, and Hugo Chavez, who maintained their holds on political power at least as much because of their personal characteristics as because of their socially ascribed characteristics. Early twenty-first century Russia is an interesting case that may be making a transition in this regard, although it appears that Vladimir Putin has wielded political power there because of his personal characteristics more so than his socially ascribed characteristics.

When designed improvements to spontaneous orders are voluntary rather than mandatory, they stand a better chance of success because people can take advantage of those designed improvements when they improve their welfare and disregard them if they do not. The adoption of a standard set of weights and measures provides an example in this regard.

Finally, note the mechanism by which spontaneous social orders work to improve people's well-being. People engage in mutually advantageous activities for their own benefit, and an unintended consequence is that institutions (like language and markets) emerge as the result of human action but not of human design. The key aspect of individual behavior in these cases is voluntary agreement and mutually advantageous interaction. This suggests that the design of institutions that facilitate mutually advantageous interaction, and that discourage coercion and predation, can improve spontaneous orders.

Can spontaneous orders be improved through human design? Perhaps, if changes are designed to reinforce spontaneous orders, to move from a limited access order to an open access order to create a social system that recognizes people more by their socially ascribed characteristics, and to facilitate voluntary and mutually advantageous interaction. But because there are always unintended consequences, there is good reason to be cautious about disrupting order that is created as the result of human action but not of human design.

## Notes

1. Benson (1990) notes that while governments legislate laws, imposing a planned order, much law originated spontaneously through the common law process, so law has components of imposed, planned order and a spontaneous order.
2. Not everyone would agree with Buchanan's argument that the imposition of government on a market economy is an improvement. See Rothbard (1973, 1982) for an example.
3. Note that the individual attributes of both parties may facilitate their business dealings, but even in this case, people have an incentive to tailor their personal behaviors to facilitate cooperation in commercial settings. People have an incentive to be friendly to each other, even when they are not friends.
4. Note that in Britain and a few other places, codification of the traffic rule put traffic on the "wrong" side of the road, where vehicles stay to the left rather than to the right. Evidence that even the British realize this keep-left rule is "wrong" appears on London streets, which often have "Look Right" painted in crosswalks to warn unwary pedestrians that traffic is approaching from the "wrong" direction. Such warnings are unnecessary in New York, Paris, or Berlin, where traffic drives on the "right" side of the road.
5. The interstate highway system still has its critics. Some criticize the system because it encourages more driving—which undoubtedly is true—and has

crowded out alternative modes of transportation. Perhaps rail travel would be more common in the United States, as it is in Europe, were it not for the interstate highway system.

6. See Rothbard (1973, 1982) and Friedman (1973) for examples of those who would disagree.

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CHAPTER 2

# THE PROBLEM OF UNEMPLOYMENT WHEN MARKETS CLEAR

DANIEL KUEHN

## INTRODUCTION

There is a substantial disconnect between the way many economists and noneconomists envision the problem of unemployment. Noneconomists generally rely on official unemployment statistics that count an individual as unemployed if she is not currently working, actively looking for work, and willing and able to start working. This version of unemployment, which the general public seems to care about, takes no account at all of *what wage* unemployed individuals are willing to accept. Economists, on the other hand, often think of unemployment as a labor surplus problem that emerges when the quantity of labor supplied at a market wage is higher than the quantity of labor demanded. Market organization is commonly idealized in the sense that it is assumed to produce full employment as an equilibrium state. As long as markets are thought to clear, economists tend to ignore the problem of unemployment. The fact that noneconomists and economists concern themselves with fundamentally different concepts of unemployment is an impediment to deriving useful insights from these labor surplus models of unemployment. It also overstates the social value of pure market organization of the labor market.

This chapter presents the history of these conflicting definitions of unemployment and identifies the biases implicit in a labor surplus view that places undue emphasis on the importance of clearing markets.

It argues that this market test is less valuable than most economists suppose. The arguments presented here are not an indictment of market processes. Instead, they constitute a case for avoiding the treatment of clearing markets as a goal in itself. This chapter (1) distinguishes between labor surplus and market clearing unemployment, (2) discusses two "market clearing" alternatives: search theory and demand shortfalls, (3) reviews the policy biases implicit in labor surplus views of unemployment, and (4) concludes in favor of a three-tiered combination of these types of unemployment, which cutting-edge work in economics already acknowledges. Special attention is given to the contributions of W. H. Hutt, an economist often associated with the Austrian school, and William Beveridge, a Keynesian. Despite the association each has with current schools of thought, both were highly independent thinkers who anticipated modern equilibrium views of unemployment incorporating job search and demand shortfalls.

## Conflicting Definitions of Unemployment

In October 2009, the seasonally adjusted national unemployment rate as reported by the U.S. Bureau of Labor Statistics (BLS) (2013) peaked at exactly 10 percent. Although a menagerie of economic and social metrics were tracked and discussed during the financial crisis of 2008 and the subsequent recession, the unemployment rate ranked high in the public imagination as an indicator of the state of the economy. Since employment is the principal source of income for most families, labor market weakness is understandably an important concern during hard times. Guided by the social import of the problem now and in past economic crises, economists have expended considerable effort toward understanding the determinants of unemployment. However, there is a fundamental disconnect between the concept of unemployment used by economists and the phenomena as it is measured by the BLS, reported in the media, and understood by the public. Unemployment, as understood by many economists, is a problem of labor surplus and labor market disequilibrium. In contrast, the phenomenon measured by the BLS does not require this strict identification of unemployment with a surplus, allowing unemployment to emerge as a phenomenon in clearing labor markets. Insofar as the public places value on low unemployment as defined by the BLS, the technical distinction between these two understandings of unemployment raises important doubts about clearing markets and market organization as a sufficient guarantor of full employment.

### Unemployment as a Labor Surplus

A prominent view of unemployment among economists, and certainly in casual discussion of labor markets in the classroom, is one of labor market surplus in which, at a given wage rate, more workers supply their labor than firms demand. Unemployment is thus a disequilibrium phenomenon, so that the emphasis is on re-equilibrating problems or sources of persistent disequilibrium. Peter Howitt (2002) introduced a review of Truman Bewley's highly regarded 1999 field analysis of sticky wages with a concise summary of this view of the relationship between wages, unemployment, and labor markets: "When *unemployed workers are available*, why don't firms cut wages until *excess supply* is eliminated, as would happen in the ideal markets depicted by conventional economic theory?" (Howitt 2002: 125, emphasis added). Howitt identifies unemployment with excess labor supply and puzzles over a phenomenon that would present no puzzle to someone who accepts that unemployment can emerge in a clearing labor market. Perhaps the most notable proponent of the view that unemployment does not naturally occur in a clearing labor market was Cambridge economist Arthur Cecil Pigou in *The Theory of Unemployment* (1933). Pigou asserted that

> The state of demand for labour, as distinguished from changes in that state, is irrelevant to unemployment, because wage-rates adjust themselves in such a manner that different states of demand, when once established, tend to be associated with similar average rates of unemployment. . . . With perfectly free competition among workpeople and labour perfectly mobile, the nature of the relation will be very simple. There will always be at work a strong tendency for wage-rates to be so related to demand that everybody is employed. Hence, in stable conditions everyone will actually be employed. The implication is that such unemployment as exists at any time is due wholly to the fact that changes in demand conditions are continually taking place and that frictional resistances prevent the appropriate wage adjustments from being made instantaneously. (1933: 252)

Unemployment could result from demand shocks, but only because labor market frictions generated short-run disequilibria and labor surpluses. In the long run with no additional labor shocks, after the labor market was allowed to grind through these various frictions (or, what is the same, in the case of perfectly frictionless labor markets), Pigou claimed that "everyone will actually be employed." Of course he did not mean by this that every member of the population would be employed, from small children to retirees. The claim is instead that labor markets will clear and that under those circumstances there *will be no unemployment*. Frictions are a fundamental cause of disequilibria and labor surpluses in the short run for Pigou, although other causes—such as policy interventions—are plausible. For economists, frictionally generated short-run labor surpluses have always been particularly attractive as an explanation of unemployment because they are less idiosyncratic and exogenous than, for example, unemployment-generating labor market policy interventions.

After John Maynard Keynes's ([1936] 1997) criticisms of Pigou, the frictional (or "structural") explanation was generally considered to be, if not exactly right-wing, at least thoroughly anti-Keynesian. However, Robert Hall (1970) points out that the labor surplus or disequilibrium understanding of unemployment was common among all partisans in the postwar macroeconomic debates:

> The problem of defining and measuring unemployment has concerned economists since the Great Depression, when it became clear that unemployment was the single most important indicator of economic distress in an industrial economy. The simple disequilibrium view has dominated thinking about the definition of unemployment since then, even in periods like the late 1960s when aggregate excess supply plainly did not exist in the labor market. The major debate of the late 1950s and early 1960s between advocates of the structural and deficient-aggregate-demand views of the prevailing high rates of unemployment was carried out largely within the definition implicit in the disequilibrium theory. (Hall 1970: 373)

Support for the labor surplus view became even more apparent with the emergence of New Keynesianism in the last quarter of the twentieth century, which, because it relied so heavily on frictions and rigidities, implicitly adopted Pigovian microfoundations as the basis of a more broadly Keynesian framework. The perspective is not limited to academic economists. In a 2009 economic commentary, David Rosenberg, chief economist of the wealth management firm Gluskin Sheff and Associates, Inc., called the dramatic climb in the ratio of unemployed workers to job openings "the truest picture of excess labour supply," rather than a labor market in equilibrium, but below full employment (Rosenberg 2009).

## Unemployment When the Labor Market Clears

The U.S. Bureau of Labor Statistics (BLS) calculates the unemployment rate using responses to the monthly Current Population Survey (CPS), a nationally representative household survey commonly used in economic research. A respondent to the CPS is classified as "unemployed" if he or she is not working, has actively looked for work at some time in the last four weeks, and is able to start work if a job is found. Workers on lay-off from a job that indicate they expect to be called back to work are classified as unemployed whether or not they are actively searching for work (BLS 2009). The public seems to care about this BLS definition of unemployment and not the definition used in economics textbooks. This is a subjective assessment—a value judgment. There is nothing wrong with being concerned about this, and thus no reason to privilege the problem as outlined in introductory textbooks.

The BLS definition of unemployment, which is the metric that makes headlines and moves elections, is broader than the labor surplus concept of unemployment that is casually (and in some cases formally) of interest to economists. The critical feature of this definition is that it can emerge when labor markets clear; when the supply of labor is equal to the demand for labor and there is no labor surplus. The CPS does not ask respondents about the wage they would be willing to work for and classifies workers as unemployed regardless of whether their reservation wage (the lowest wage a worker would be willing to accept) is higher than the prevailing market wage. The market, therefore, could be in equilibrium with quantity of labor demanded and supplied at the prevailing wage equal, and individuals with reservation wages above the prevailing wages would still be counted as unemployed by the BLS.

Nevertheless, some maintain that a labor surplus concept is still far too narrow to accurately measure labor market weaknesses (see, for example, Miller 2009). The principle objection is that over time unemployed workers conclude that jobs are not available for them and give up actively searching for work. These individuals, who still want to work and are left without a source of labor income, are referred to as "discouraged workers." The significance of the discouraged population relative to the unemployed population can be substantial (Benati 2001). In some cases they may even be passively looking for work (e.g., continue to check help-wanted ads). In particularly tight labor markets, when employment opportunities are plentiful, consumers of labor market data may reasonably wonder whether discouraged workers are genuinely interested in supplying their labor to employers, but in times of extended hardship the case for the requirement of active job search weakens. These objections have particular salience in the case of populations facing persistently weak labor markets, such as racial minorities (see the discussion in Kuehn 2013b). Cognizant of these objections, in 1962 the President's Committee to Appraise Employment and Unemployment Statistics recommended that the BLS collect information on discouraged and other "marginally attached" workers (Hall 1970). Although these statistics have been collected and reported since that time (currently, in table A-15 of the BLS's regular Economic News Release), the unemployment rate still receives the lion's share of the public's attention.

The position taken here, that these two views of unemployment are not equivalent, is not new. Although the point has independently nagged the author of this chapter for many years, it was raised in the literature decades ago, at least as early as Lucas and Rapping's (1969) classic paper on aggregate labor supply. They point out that

> the government generates an unemployment series based on the number of persons who answer "yes" to the question: "Are you actively seeking work?" There is a strong temptation to assume that respondents to this survey take the question to mean, "Are you seeking work at the current wage rate?"—but it is important to recognize that this assumption is simply a hypothesis the truth of which is far from obvious. In our model, it has been implicitly assumed that this interpretation is not correct, since the current wage is assumed to equate quantity demanded and quantity supplied exactly each period. (Lucas and Rapping 1969: 735–736)

The Lucas and Rapping article is widely cited, although usually for its contributions to economic theory and empirics (specifically, the estimation of the wage elasticity of the aggregate labor supply function; a neglected topic in the empirical macroeconomic literature at that time). It is less often cited for its shrewd insights into the misinterpretation of unemployment statistics.

## "Sticky Wages" in a Clearing Market

An empirical regularity commonly cited as evidence for the labor surplus view of unemployment is the relative downward rigidity of nominal wages, called "sticky wages." Constant nominal wages in the face of a negative labor demand shock that occurs with unemployment is commonly

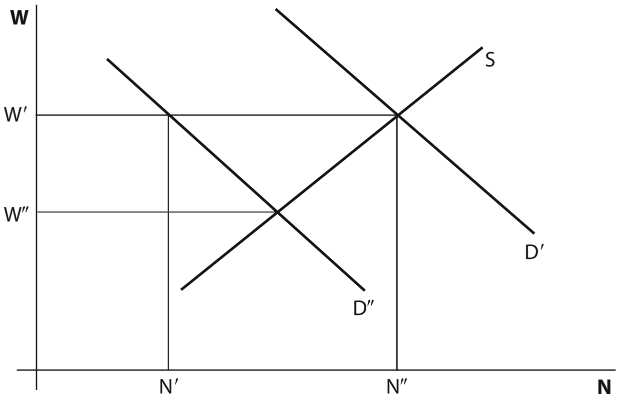


Figure 2.1 The labor surplus view of sticky wages.

thought to corroborate the labor surplus view of unemployment, because the sticky nominal wage rate is assumed to be associated with a real wage that is above the new market clearing price (i.e., price level changes are not sufficient, and certainly not in the short run, to maintain equilibrium through the real wage rate).[1] This explanation of the observed behavior of wages and employment is illustrated in Figure 2.1. Employment is on the horizontal axis and the real wage rate is on the vertical axis. This presentation of the problem should be familiar to most undergraduates, as it is found in popular textbooks (e.g., Case, Fair, and Oster 2008, chapter 14). In Figure 2.1, before the shift of the demand curve, the real wage w′ clears the market, but after the shock the maintenance of w′ introduces a labor surplus equal to N″ – N′ (here we assume for simplicity that there are no unanticipated changes in the price level, although of course price level changes could result in a real wage greater than w″ and less than w′ that would still result in a labor surplus). Wages would have to fall to w″ to clear the market in this case. Sticky wages therefore provide a link between demand shocks and unemployment that seems—in this construction of the problem—to imply the tight identification of unemployment with a labor surplus. However, other constructions of the problem are possible.

Consider the case of workers who acquire habits as well as debt obligations (e.g., car, credit card, home, and college loans) after working a job at a particular wage level. These habits of consumption result in a labor supply curve that is increasingly elastic over time for employed workers to the left of the market equilibrium. This situation is illustrated in Figure 2.2.

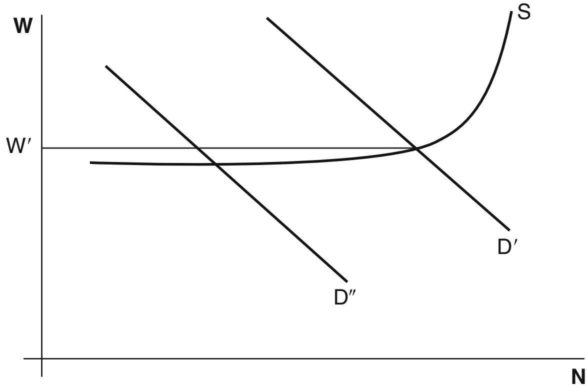


Figure 2.2 A market clearing view of sticky wages.

As long as demand is stable or increasing, wage growth will proceed normally. Consumption habit formation should not occur to the right of market equilibrium because there is no wage rate for anchoring habits. This is consistent with the generally held view that wages are not upwardly rigid; they only exhibit rigidity in response to negative demand shocks. A negative demand shock will not result in substantial wage reduction in this case, even if the labor market clears. In other words, Figure 2.2 presents a plausible mechanism for relatively stable wages in the case of a negative demand shock. The "sticky wage" phenomenon is explained without recourse to labor surplus assumptions. Other explanations are available for observed wage rigidity as well. In the Post-Keynesian tradition, Ingrid Rima suggests that institutions and the exercise of power sets wage rates independent of fluctuations in labor demand (see Pressman 2007, for a summary of Rima's contributions).

Bellante's (1994) discussion of sticky wages from an Austrian perspective comes to the same conclusion, but by a very different route. He also argues that sticky wages may play a role in some circumstances, but that they represent a "secondary" concern and do not merit the primary role as a labor surplus generator accorded by most economists. Gallaway and Vedder (1987), also writing from the Austrian perspective, more dismissively juxtapose what they call the "progressive" wage rigidity view with a Misesian perspective on the labor market. Bellante suggests that instead of sticky wages, the most important driver of unemployment is the Austrian explanation of the initial causes of economic downturns, related to the discoordination of the capital structure. This view of the causes of unemployment is echoed in Boettke and Luther's (2012) discussion of the jobless recovery from the Great Recession from an Austrian perspective. It is beyond the scope of this chapter to evaluate claims about the importance of Austrian business cycle theory for explaining unemployment. Kuehn (2013a) provides a comprehensive treatment of the reasons to doubt such claims. The empirical case for the labor surplus view, which relies on observed sticky wages, is thus far less obvious than proponents suggest.

## The Beveridge-Hutt View of Unemployment

The reality that many of those considered "unemployed" are often actively searching for work has long been acknowledged, despite the prevalence of the labor surplus view. Job search and gradual labor market adjustment was quite openly accepted as the reality of how idealized models of the market worked in "the real world." Nevertheless, job search was typically considered to be "frictional"; an inevitable reality in the process of grinding the gears of the labor market toward a new equilibrium, rather than an equilibrium phenomena in itself that constituted an independent component of unemployment. Perhaps the most notable proponent of frictional unemployment as a consequence of the working of labor markets in the real world was Pigou in *The Theory of Unemployment* (1933).

Newer thinking on job search as an equilibrium and indeed a productive phenomenon came with the robust discussion of unemployment during the Great Depression (Feinberg 1978). The principal expositors of this view were William H. Hutt, in *The Theory of Idle Resources* (1939), and William Beveridge, in *Full Employment in a Free Society* (1944; although antecedents to Beveridge's most important contribution came in *Unemployment: A Problem of Industry* (1909).

Hutt and Beveridge came from opposing poles of a common liberal tradition. Hutt was a founding member of the Mont Pelerin society who maintained laissez-faire sensibilities. He felt a deep affiliation with Classical economics, published an important rehabilitation of Jean-Baptiste Say, and relentlessly attacked Keynes. Although it is difficult to classify Hutt as an Austrian economist per se, his work has been embraced enthusiastically by the Austrians. Beveridge, in contrast, was the guiding force behind labor exchanges, the welfare state, and the National Health Service in Britain. Politically he was a Fabian Socialist, and economically a Keynesian.

## Hutt and the Theory of Idle Resources

Hutt's *The Theory of Idle Resources* is a taxonomy of the reasons that resources may not be employed at a given point in time, with a special emphasis on individuals not working in paid employment. In laying out the plan of the book, the author stresses the importance of definitions, dedicating an appendix in the first chapter to the subject of careful definition in economics. As such, there is little analysis in the book in the modern sense of models that develop our understanding of the mechanisms that generate unemployment. Nine types of idleness are defined and discussed by Hutt, although Horwitz (1997) suggests that we can collapse these into three principal forms: preferred idleness, pseudo-idleness, and price-driven idleness. The first two are Hutt's own categories, while the third combines several of Hutt's definitions.

Preferred idleness is a motley category from the perspective of the modern definition of unemployment, mixing the unemployed with those who are out of the labor force entirely. Horwitz identifies it with leisure, presumably for those who have opted out of the labor market. Hutt, however, also includes the case of household work or home production (Hutt [1939] 2011: 40–41) and, more relevant for the case of unemployment, those who are not working because they would prefer to work for a wage above the equilibrium wage. Hutt attributes this to pride in many cases, although there are other reasons for refusing low-wage employment in hopes of finding more remunerative work. As discussed in the previous section, large fixed expenditures or habits of consumption may make it worth waiting temporarily in a state of unemployment in hopes of finding a higher paying opportunity at some future date.

In any case, remaining without work because you are trying to find a higher wage than the market equilibrium does not exclude a worker from being considered "unemployed" under current definitions. Hutt does not wholly reject the idea that "preferred idleness" amounts to unemployment, but he does come dangerously close to such a labor surplus perspective when he writes that

> the cause of unemployment in this case is a preference. It implies no wrong use of resources given the social will. If it is a condition which we happen to deplore on moral grounds, then the method of reform lies either in changing the preference directly (through preaching or teaching) or in changing the environment which apparently gives rise to the despised preferences. (Hutt [1939] 2011: 40)

If an unemployed individual's reservation wage is above the equilibrium, then their unemployment is consistent with what Hutt calls "the social will" by definition. If no employer is willing to purchase labor at that wage (given the availability of other lower cost options), then the market cannot generate a solution in which the high-reservation wage job seeker is employed *and* private interests are satisfied. As a result, preferred idleness seems to be more consistent with the perspective of the naïve labor surplus view of unemployment that ignores the possibility of unemployment in a clearing labor market.

Hutt is best remembered for his discussion of pseudo-idleness, which anticipated later search theoretic models in which unemployment emerges in equilibrium, and not necessarily as a result of a labor surplus (Feinberg 1978). Hutt contends that many jobless workers are idle because they are remaining available for jobs if they are offered, forming a labor reserve comparable to any other sort of excess productive capacity held in anticipation of demand increases. Workers' availability during unemployment is a specialized use of labor that would be eliminated if they were to take jobs in an alternative or lower paying field. Job searches during such a period of availability are referred to as "prospecting" and are considered by Hutt to be a productive investment of time when a worker puts forth effort on his own account to ensure future employment. What is troubling is Hutt's treatment of this activity as something other than unemployment ("mistaken for unemployment") simply because workers in this state of pseudo-idleness are occupied in rational and productive activity. Rather than simply professing that he does not share the same concerns as most of the public about a large class of the unemployed (job seekers), he accuses others of being "mistaken" in their definition of unemployment! This is in sharp contrast with Beveridge, who also highlights the importance of job search activities but who does not write these workers out of the problem merely by virtue of the fact that they are productively occupied.

Most of the rest of *The Theory of Idle Resources* considers what Horwitz terms price-driven idleness, which can largely be classed as a labor surplus theory of unemployment. Horwitz writes of price-driven idleness, "what it generally is referring to is the idleness created when some or all of the factors of production are able to coercively maintain wages or prices above market clearing levels" (Horwitz 1997: 211). Price-driven idleness includes joblessness imposed by the price system as a result of coercive behavior holding wages above their equilibrium value (with union activities of special interest for Hutt). By dismissing preferred and pseudo-idleness as not legitimately unemployment ("mistaken as unemployment" in Hutt's words [1997: 23]), the remaining case of price-driven idleness and the firm rejection of Keynesian analysis leaves Hutt *himself* firmly in the naïve labor surplus view of unemployment. This is reinforced by Hutt's comment that the idle resources he discusses "would be 'fully employed'. . . if there would be no advantage in attracting other resources to cooperate with it" (1997: 9); that is, if the labor market was in equilibrium. However, it is worth considering Hutt in the context of the larger search theoretic literature, which identifies equilibrium search behavior as a means of explaining the prevalence of unemployment without *necessarily* invoking the *deus ex machine* of a labor market intervention. For more from this perspective, we can turn to Hutt's contemporary, William Beveridge.

## Beveridge and Full Employment in a Free Society

William Beveridge's contribution to the literature on unemployment began with his 1909 book, *Unemployment: A Problem of Industry*, which principally considered the forces that would be taken up by Pigou: frictions preventing labor market adjustments in the short run. This work addressed what is today referred to as mismatch theory, without reference to general deficiencies in demand. To a far greater extent than Pigou, Beveridge discussed the frictions associated with finding new work explicitly in reference to a search and matching process that he argued was disorganized and inefficient. His subsequent *Full Employment in a Free Society* (1944) repeated the themes from 1909 and added the insights about general demand deficiency of the Keynesian revolution. The book also had a distinct social agenda, seeking to do for full employment policy what Beveridge's report on social insurance (1942) did for the welfare state. The goal was to institutionalize the economics of Keynes in the United Kingdom. Indeed, Beveridge considered it a "sequel" to the earlier report.

Although Beveridge echoed Keynes, the idea most associated with *Full Employment in a Free Society* was that unemployment resulted "not simply from deficiency or misdirection of demand but also from the way in which industries are organized to meet demand, in particular from their methods for engaging men" (Beveridge [1944] 1945: 170), or in modern parlance, the matching of firms and workers. He was primarily interested in practical ways of addressing the problem, rather than its theoretical exposition, and the solution entailed both public and private "organization" of the matching process. The dock and harbor service industries are highlighted for special consideration as a case exhibiting "a high rate of unemployment because of the way in which it is organized, rather than because of a declining demand for its services" (Beveridge [1944] 1945: 84). Matching efficiency in the industry improved after formalization and increased explicitness in the labor contract, along with hiring through employment agencies. Required registration at labor exchanges in order to receive unemployment benefits and special career guidance for youth graduating from school were proposed as methods for broadening the benefits of an efficient matching process through the public sector.

Beveridge assessed the success of the labor exchanges using data on the number of vacancies filled for each unemployed worker in the labor exchanges (Beveridge [1944] 1945: 80). This match rate analysis anticipates the form in which his contributions would be applied to modern macroeconomics: the function describing the generation of job matches that has unemployment and vacancies as arguments. This is known interchangeably as the UV curve (U for unemployment and V for vacancies) and the Beveridge curve. The Beveridge curve is downward sloping, with points on a high vacancy and low unemployment position on the curve indicating a relatively tight labor market, because many job opportunities are available for each unemployed worker. Job matching processes that are more efficient produce more matches for any given vacancy and unemployment combination. The Beveridge curve as it is known today was first plotted by Dow and Dicks-Mireaux (1958) using British data. For Dow and Dicks-Mireaux and many early users of the curve, its primary purpose was to indicate whether the labor market was tight or loose. The Beveridge curve was a supplement of sorts for the output gap, very much in the spirit of Okun's Law (Rodenburg 2010).

With the development of search theory, the curve took on independent significance as an important component in determining the labor market equilibrium for models with job search. The canonical example is Pissarides's equilibrium unemployment theory (2000: 19–20), with widely cited application by Shimer (2010: 21) and integration into a Keynesian model by Farmer (2010: 21). In these newer models we see that the critical insight of Beveridge's brand of search theory is the same as Hutt's work on pseudo-idleness. Many individuals who are classified as unemployed are involved in productive (and, in the case of the modern Beveridge curve, equilibrium) job search behavior, which in some cases may include individuals whose reservation wage is above the market clearing wage. Although Hutt's work is conceptually quite similar to modern search theoretic models, that literature emerged out of the development of Beveridge's ideas and was not inspired by or derived from Hutt. Search theory and its antecedents represent a valuable improvement on the casual identification of unemployment with a labor surplus and even on the earlier "frictional" perspectives that understood search and matching as a disequilibrium phenomenon. In a Beveridge-Hutt labor market, unemployment can still emerge in equilibrium even when search itself is understood as a rational, equilibrium phenomenon.

## The Output Gap

The labor surplus view as rendered by Pigou, and the attending recommendation that wages must fall to achieve full employment, came under substantial criticism by Pigou's colleague at Cambridge, John Maynard Keynes. Keynes's counter-argument opened, or at least repopularized, another alternative to the labor surplus account of unemployment: a demand shortfall. The problem with the view that wages must fall to bring the labor market back into equilibrium (considered equivalent to eliminating unemployment) was that this was a partial equilibrium answer that ignored other general equilibrium effects. Partial equilibrium analysis, promoted vigorously by Alfred Marshall, investigates the operation of individual markets without reference to their interrelationships with other markets. Keynes pointed out that the general equilibrium effects of wage cuts were likely to undercut any progress in eliminating unemployment because of the prominent role that wages play in consumption and therefore in aggregate demand. Keynes writes that

> whilst no one would wish to deny the proposition that a reduction in money-wages *accompanied by the same aggregate effective demand as before* will be associated with an increase in employment, the precise question at issue is whether the reduction in money-wages will or will not be accompanied by the same aggregate effective demand as before measured in money. (Keynes [1936] 1997: 260)

Keynes goes on to list a number of reasons why a change in the level of wages may either positively or negatively impact aggregate demand. Reductions in the marginal propensity to consume due to a redistribution of national income toward individuals that do not rely as heavily on wage income rank high on Keynes's list of general equilibrium effects. However, the ultimate impact of a general wage reduction depends on a number of other factors, including whether it is interpreted as a signal of future decreases or increases in wages (which would weigh on investment decisions). Keynes lists seven avenues by which wage reductions may have unintended consequences for aggregate demand, although even this list is "not a complete catalogue" of the possibilities (264). For the purposes of properly conceptualizing unemployment, though, a complete catalogue is unnecessary. The important point from Keynes is that even if an excess supply of labor emerges and contributes to unemployment, this partial equilibrium perspective is neither sufficient for understanding the problem of unemployment (for reasons noted earlier), nor does it provide any obvious solutions; wage reductions suggested by a naïve labor surplus view may themselves reduce demand for labor.

In modern macroeconomics, the importance of demand shortfalls for determining unemployment is so widespread that unemployment is rarely treated explicitly. Okun's Law, the highly stable relationship between output and unemployment, has in practice rendered the aggregate supply curve (in price level and real output space) and the Phillips curve (in price level and unemployment space) essentially interchangeable; and, thus, output and unemployment are also interchangeable. Negative demand shocks reduce output and increase unemployment by shifting the macroeconomic equilibrium along these supply-side relations. This framework for modeling the relationship between aggregate demand and unemployment comes in a variety of forms, from older Neoclassical Synthesis Keynesian formulations, generally dismissed today as ad hoc and overly aggregated, to micro-founded New Keynesian versions with sophisticated modeling of agent expectations (Wickens 2008). Post-Keynesians structure their models in a somewhat comparable manner, although income distribution is typically added, and the determination of inflation in both the short and long run is significantly modified (Stockhammer 2011). Even outside of explicitly Keynesian schools of thought, the "new consensus" macroeconomics similarly identify unemployment with declines in output from potential, which is determined by a demand curve—a Phillips curve or aggregate supply curve—and a monetary policy reaction function (see, for example, Arestis [2011: 88–111] on new consensus macroeconomics; Romer [2000] and Ireland [2011] provide examples of New Keynesian economists advocating the use of models stripped down to these essential elements for ease of exposition). Enormous disagreements separate these renditions of Keynes's fundamental principle of effective demand, and these disagreements have shaped the course of modern macroeconomics. However, an enduring conclusion has been that demand shortfalls are critical to driving unemployment, independent of any labor surplus that may or may not exist. The labor market may clear (i.e., it may be in equilibrium), but if demand is weak it could be a low-employment (or high-unemployment) equilibrium. There is no law of economics guaranteeing that the market order is an order that we will always find entirely satisfying.

## The Economic Policy Biases of the Labor Surplus View

The labor surplus view of unemployment is suggestive of a fundamentally different suite of policy options than the more accurate conceptualization of unemployment as a phenomenon that can occur when labor markets clear. As a result, the prominence of the labor surplus view among economists advising policy makers has the potential to bias policy makers away from optimal solutions and orientations in favor of policies focused on combating labor surpluses. Three biases are discussed here: the wage reduction bias, the deregulation bias, and the Marxist bias. This set of biases does not have any single ideological flavor. Deregulation bias tends to be liberal while a Marxist bias is clearly interventionist. The bias toward wage reduction is more ambiguous, and is sometimes taken to require weakening the position of labor while in other cases implying an active, inflationary stance that allows real wages the opportunity to fall. Wage reduction bias follows the most naturally from the labor surplus view of unemployment, and is therefore considered first.

### Wage Reduction Bias

If the default conception of unemployment is a case of labor surplus, the natural solution to the problem is wage reduction. At a lower wage rate, quantity of labor demanded is increased and quantity of labor supplied is reduced, naturally closing the gap that is identified with the unemployment problem. Economists consider this a natural solution partly because wage reductions should occur as a part of the market process. Unemployed workers with reservation wages below the market wage should prefer (and therefore offer) to sell their labor to willing employers at a lower rate until the market converges to equilibrium. No additional planning or incentivizing is necessary aside from the natural pursuit of agents' own interests. This solution to the problem of unemployment is contingent, of course, on the identification of unemployment with a labor surplus.

Even if a labor surplus is a contributing factor to unemployment, other alternatives to wage reduction exist. For example, efforts to increase the demand for labor could bring the labor market back into equilibrium and eliminate any joblessness caused by the surplus. Often, though, measures that could bolster labor demand would also threaten the prerogative of employers to reduce their labor costs and therefore face more organized opposition than wage reduction. Similar arguments about the bias toward wage reduction were made by Adam Smith ([1776] 1981) in his discussion of wages and profits in *The Wealth of Nations*:

> Our merchants and master-manufacturers complain much of the bad effects of high wages in raising the price, and thereby lessening the sale of their goods both at home and abroad. They say nothing concerning the bad effects of high profits. They are silent with regard to the pernicious effects of their own gains. They complain only of those of other people. (115)

Diagnoses of unemployment as a labor surplus thus feed into existing biases of employers, who are likely to be more politically connected and certainly have greater resources at their disposal to impact policy than their workers do. If a labor surplus is indeed the primary source of unemployment, wage reductions could of course be beneficial. But if this is a misdiagnosis, as the incongruity of public and naïve labor surplus understandings of unemployment suggests, wage reductions are likely to hurt precisely those individuals they are intended to help.

### Deregulation Bias

A wage reduction bias in response to the characterization of unemployment as a labor surplus is natural because by definition a surplus indicates that the market wage is higher than the equilibrium wage rate. However, since workers and firms are expected to naturally gravitate toward the equilibrium wage rate, a common assumption is that labor market regulation imposes labor surpluses and therefore unemployment. As a result, another bias that attaches itself to casual labor surplus assertions is that of labor market deregulation. Identifying regulations that interfere with labor markets becomes an essential component of the response to unemployment. In the case of the Great Depression, this search for regulatory culprits led researchers to the New Deal (Higgs 1997; Horwitz 2011), the minimum wage (Mulligan 2012), and the Affordable Care Act (Mulligan 2013).

One of the classic alleged regulatory culprits associated with unemployment is the minimum wage. The simplest version of a labor surplus requires a binding price floor, making mandated minimum wages a natural target. Although the inflation-adjusted minimum wage has oscillated around seven or eight 2013 dollars for most of its history, regular increases in the nominal value of the federal minimum wage provide a steady stream of opportunities to associate unemployment problems with labor market regulation.[2] An important exchange on the relationship between the minimum wage and unemployment occurred within the first decade of the legislation's existence between Richard Lester (1946, 1947), Fritz Machlup (1946, 1947), and George Stigler (1946, 1947). The principal purpose of the discussion was to assess the merits of marginalism in economic theory. Most historians of economic thought affirm that Machlup and Stigler presented the stronger case on this point in defense of marginal theory. However, a major strength of Lester's original article and response was his observation that a partial equilibrium perspective is insufficient for thinking about the consequences of labor market regulation and that aggregate demand mattered for the volume of employment at the level of the firm. Machlup and Stigler present a false dichotomy between price theory (in this application, the labor surplus view) and the aggregate demand perspective. Lester was, at the very least, correct in identifying this as a false choice. Gallaway and Vedder's (2003) study of ideology in the emergence of modern labor economics treats Lester's position as being the "ideological" view surpassed by Stigler and Machlup's "scientific" perspective. This is an unfortunate oversimplification. Lester may not have been justified in his skepticism of marginalism but he was every bit as scientific as Machlup and Stigler; he simply did not equate unemployment with labor surplus in the same sense that partial equilibrium price theory does. For Lester, unemployment was also determined by macroeconomic adjustments and institutional factors.

This is not, of course, a blanket case against deregulation. Many regulations may be odious or counterproductive and in need of repeal. Trouble arises when unemployment is assumed to be the same as a labor surplus and labor surpluses are assumed to principally be the result of interferences in the labor market, biasing the search for solutions toward deregulation. This chapter argues that each link in that chain of reasoning is weaker than commonly acknowledged and that there should be a broader range of solutions to unemployment.

## MARXISM BIAS

The similarities between the labor surplus view of unemployment and the Marxist idea of the reserve army of labor introduces a potential Marxist bias into discussions of unemployment that are reliant on labor surplus interpretations. To the extent that a labor surplus view of unemployment is identified with the reserve army, unemployment in a capitalist economy becomes a state of disequilibrium deliberately maintained by capitalists for the extraction of surplus value (i.e., the difference between what a worker produces and what a worker earns). In this case, class conflict and zero sum solutions replace Pareto improvements as a course of action.

One of the difficulties of tying Marx's reserve army to the labor surplus view is that his analysis predates the concepts underlying the labor surplus perspective. The exposition of the labor surplus view of unemployment developed here is heavily dependent on Marshallian concepts and modern partial equilibrium thinking about the labor market encapsulated in the familiar supply and demand diagram. Indeed, modern understandings of "unemployment" emerged in the late nineteenth century at around the time that Marshall provided his definitive account of neoclassical theory. John Arthur Garraty's history of unemployment (1978) points out that the English word *unemployment* and the German equivalent *Arbeitslosigkeit* both came into use in the 1890s. Marshall's *Principles of Economics* was published in 1890, but his highly regarded lectures had reflected the same concepts for many years prior to the book's publication.

Although modern prejudices in understanding the concept of unemployment did not substantially predate the 1890s, similar concepts did exist before the rise of neoclassicism and continued to influence the discussion of unemployment into the twentieth century. Before Keynes, the political economist who was arguably the most deeply concerned with the problem of unemployment was Karl Marx (along with his collaborator, Friedrich Engels). Marx and Engels's theorization of the importance of the "reserve army of labor" to the functioning of capitalism closely mirrors modern modeling of unemployment as a labor surplus, albeit enlisted in the cause of a critique of capitalism. For Marx, labor surpluses are cultivated by capitalists over the course of a capital accumulation process that favors investment in fixed capital over variable capital (i.e., funds for hiring workers). The resulting labor surplus is similar to

Hutt's account of the pool of "available" workers in a state of pseudo-idleness, which

> belongs to capital just as absolutely as if the latter had bred it at its own cost. Independently of the limits of the actual increase of population, it creates a mass of human material always ready for exploitation by capital in the interests of capital's own changing valorization requirements. (Marx, [1867] 1990: 784)

Since Marxist concerns rely on a labor surplus view of unemployment—the "reserve army"—misdiagnosis and misuse of the labor surplus concept opens the possibility of an undue reliance on criticism of capitalism and in some societies the collective ownership of the means of production.

Characteristically classical ideas about distribution and class conflict (reflected, for example, in the writings of Adam Smith and Karl Marx) are revived in Kaleckian (and other Post-Keynesian) macroeconomic models. Kaleckian economics, although a close cousin to Marxist analysis, provide an alternative to the more dystopian conclusions of the Marxist model. Unemployment is a result of demand shortfalls that emerge from a distribution of income that is too heavily weighted toward the owners of capital. This is in contrast to the more active and exploitative process of surplus extraction found in Marx, and leads Kaleckians naturally to Keynesian macroeconomic management rather than Marxist eradication of the exploitative classes. Keynes's "euthanasia of the rentier" is both limited in its scope (i.e., not applying to capitalists themselves, but only to the rentier class) and, of course, entirely figurative—two caveats that cannot be said for many Marxists in theory and practically all Marxists in practice. In this way, Kaleckian economics takes Marxist distributional concerns and assumptions, redirects the analysis away from Marxist labor surplus diagnoses of unemployment, and in the process provides a basis for reformism rather than radicalism.

## A Broader Perspective of Unemployment in Market Economies

Clearly a naïve labor surplus interpretation of unemployment is inappropriate for studying the actual social phenomena that the public cares so much about. While labor surpluses can play a role in determining the total volume of unemployment, a surplus is neither necessary nor sufficient for unemployment to emerge. Beveridge ([1944] 1945) offers a broader perspective, with three types of unemployment, which is prescient in that it reflects the dominant views held by contemporary macroeconomists who work on the problem of unemployment. Beveridge writes:

> The volume of unemployment at any time in any community depends upon factors of three kinds: on the factors determining the quantity of the effective demand for the products of industry; on the factors determining the direction of demand; and on the factors determining the manner in which industry responds to the demand. There will be unemployment if effective demand is not sufficient in total to require use of the whole labour force of the community. There will be unemployment if effective demand, though adequate in total, is misdirected, that is to say, is demand for work of a kind which cannot reasonably be performed by the available labour, or in a place to which the available workmen cannot reasonably be expected to move. There will be unemployment if industry is so organized, that in meeting effective demand it carries excessive reserves of labour standing by to meet local and individual variations of demand, or if there are obstacles which prevent labour from following changes in demand. (Beveridge [1944] 1945: 24)

Beveridge's principal concern is the standard Keynesian worry about sufficient aggregate demand, often referred to today as the "output gap," which is tied with considerable statistical regularity to the level of unemployment. Next he notes the concerns with which he is personally most closely identified: mismatches between the kind of labor supplied and demanded in a given region that interrupts the search process. Finally, he expresses the labor surplus view by referencing a build-up of "excess" workers. Each plays a role in throwing workers into a state of unemployment in the broader sense understood by the public: involuntary joblessness without reference to a reservation wage.

Cutting edge work in macroeconomics incorporates all three elements, so there is no need to read this criticism of common understandings of unemployment among economists as a counsel of despair. The Pissarides-Mortensen theory of job search was designed in part to understand the interaction of search and matching processes with labor surplus problems associated with policy interventions. The final component of a demand shortfall has been added to job search models by a variety of recent authors, including Walsh (2003, 2005), and Gertler and Trigari (2009). None of these contributions are driven by a labor market surplus; they principally rely on the processes highlighted by Keynes, Hutt, and

Beveridge. The problem, therefore, does not lie in the careful work of economists who dedicate careers to understanding these problems or a public that recognizes that clearing labor markets cannot guarantee food on the table and a roof overhead.

Edward Nell (2000) argues in reference to the fundamental Keynesian theory of effective demand that "in practice, unemployment does not seem to be all that complex," and that "only after long years of graduate study does it become difficult" (69). The argument here is somewhat different. Long years of study have produced sophisticated and important elaborations on job search behavior and demand shortfalls as determinants of unemployment. The problem lies with economists who speak casually and sophomorically about unemployment as if it were simply a question of labor surpluses, and with the policy makers who find these stories to be politically convenient. Therefore, the market is not the problem so much as unrealistic expectations of what markets can accomplish and inappropriate uses of markets to achieve desired ends.

## Notes

1. Although the most natural application of sticky wages is as a justification for the labor surplus view of unemployment, it has an arguably more important technical use for macroeconomists: it serves as a justification for the upward slope of the short-run aggregate supply curve.
2. Before the 1950 increase, the federal minimum wage was much lower.

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Part 2

# The Firm in the Economy

Chapter 3

# Economic Calculation Under Capitalist Central Planning

Kevin Carson

## The Corporation as Self-Perpetuating Managerial Oligarchy

Ludwig von Mises tried, in *Bureaucracy* (2007 [1944]), to make the bureaucratic or entrepreneurial character of an organization a simple matter of its organizational goals rather than its function. He argued that the corporate hierarchy as such was not a bureaucracy. He defined bureaucracy as rules-based management, with processes set on Weberian lines, rather than profit-based management, because it produced no marketable product and its output had no market price. The large business enterprise, on the other hand, was—thanks to the miracle of double-entry bookkeeping—an extension of the entrepreneur's will. The entrepreneur could track the profits and losses of each subdivision, and accordingly shift investment between subdivisions and discipline or replace managers. The motivation of all corporate employees would be profit seeking, their wills in harmony with those of the shareholders, because they belonged to the shareholders' organization. By treating the firm as permeated by the entrepreneur's will, Mises, like the neoclassicals, essentially treated it as a unitary actor in the marketplace and its internal workings as a black box. Although at one point he explicitly denied that the entrepreneur was omnipresent, in practice Mises viewed his entrepreneur as a brooding omnipresence whose influence guided the action of every employee from CEO to janitor.

Because of this effect of double-entry bookkeeping, Mises viewed the separation of ownership from control, and the agency problems resulting from it, as largely nonexistent:

> It is the system of double-entry bookkeeping that makes the functioning of the managerial system possible. Thanks to it, the entrepreneur is in a position to separate the calculation of each part of his total enterprise in such a way that he can determine the role it plays within his whole enterprise. Thus he can look at each section as if it were a separate entity and can appraise it according to the share it contributes to the success of the total enterprise. . . . Thus the entrepreneur can assign to each section's management a great deal of independence. The only directive he gives to a man whom he entrusts with the management of a circumscribed job is to make as much profit as possible. An examination of the accounts shows how successful or unsuccessful the managers were in executing this directive. (Mises 1966: 305)

Mises also identified outside capital markets as a control mechanism limiting managerial discretion. He dismissed the popular theory of managerial control as

> disregard[ing] entirely the role that the capital and money market, the stock and bond exchange, which a pertinent idiom simply calls the "market," plays in the direction of corporate business. . . . In fact, the changes in the prices of common and preferred stock and of corporate bonds are the means applied by the capitalists for the supreme control of the flow of capital. The price structure as determined by the speculations on the capital and money markets and on the big commodity exchanges not only decides how much capital is available for the conduct of each corporation's business; it creates a state of affairs to which the managers must adjust their operations in detail. (1966: 306–307)

Try as he might, however, Mises could not exempt the capitalist corporation from the problem of bureaucracy, or define bureaucracy out of existence, simply by using the word "entrepreneur."

Shareholder ownership is a myth, in the sense that a particular corporation is the property of its stockholders in any real sense. In practice, the management of the large corporation is a self-perpetuating oligarchy in control of a free-floating mass of unowned capital—much like the bureaucratic management of the old USSR.

The mythical nature of shareholder sovereignty is borne out by Martin Hellwig's analysis, which shows that Manne's "market for corporate control" (Manne 1965) is more myth than reality. Hellwig argues that the concept of residual claimancy applies less to the shareholders than to management, which has the power "to disfranchise outside shareholders . . . [and] that in all circumstances not otherwise provided for . . . has the effective power to set the rules of decision making so as to immunize itself against unwanted interference from outsiders" (Hellwig 2000: 98).

The theory that management is controlled by outside capital markets assumes a high degree of dependence on outside finance. But in fact management's first line of defense is to *minimize* its reliance on outside finance. Management tends to finance new investments as much as possible with retained earnings, followed by debt, with new issues of shares only as a last resort. Issues of stock are important sources of investment capital only for startups and small firms undertaking major expansions. Most corporations finance a majority of their new investment from retained earnings, and tend to limit investment to the highest priorities when retained earnings are scarce (see Hellwig 2000: 100–101). As Marxist economist Doug Henwood, editor of New Left Review, pointed out, in the long run "almost all corporate capital expenditures are internally financed, through profits and depreciation allowances" (Henwood 1997: 3). Between 1952 and 1995, almost 90 percent of investment was funded from retained earnings.

The threat of shareholder intervention is also diluted by stock buybacks. According to Henwood, between 1981 and 1996, U.S. nonfinancial corporations retired some $700 billion more stock than they issued (Henwood 1997: 3, 72–73).

Hellwig makes one especially intriguing observation about financing from retained earnings. He denies that reliance on retained earnings necessarily leads to a "rationing" of investment, in the sense of underinvestment; internal financing, he says, can just as easily result in overinvestment, if the amount of retained earnings exceeds available opportunities for rational capital investment (Hellwig 2000: 114–115). This can result in structural misallocations and irrationality, to the extent that retention of earnings prevents dividends from returning to the household sector to be invested in other firms, so that overaccumulation in the sectors with excessive retained earnings comes at the expense of a capital shortage in other sectors (Hellwig 2000: 117). Henwood contrasts the glut of retained earnings, under the control of corporate bureaucracies with a shortage of investment opportunities, to the constraints the capital markets place on small, innovative firms that need capital the most (Henwood 1997: 154–155).

This tendency is exacerbated by standard management accounting rules, which treat capital expenditures as a fixed cost to be incorporated into general overhead, rather than a variable unit cost.

The high corporate debt to equity ratio might seem to cast some doubt on the primacy of internal financing. But the overwhelming bulk of corporate borrowing goes to finance takeovers or stock buybacks, not new investment. The mergers and acquisitions of the 1980s and 1990s were the cause of $1.9 trillion in debt (Henwood 1997: 73–76). So the corporate economy finances new investment almost entirely independently of the capital markets.

Hellwig's thesis is reinforced by management's role in making the very rules by which the corporation is governed, including the rules by which shareholders exercise whatever power they have. Management, as the primary influence on the internal bylaws of the corporation, has considerable power to dilute the power of shareholders (Hellwig 2000: 109, 112; Estes 1996: 64–67). And the board of directors, which theoretically represents shareholders and oversees management in their interests, is usually composed mostly of inside directors who take their positions at the invitation of management and are controlled by management's proxy votes. As a result, they are likely to engage in mutual logrolling, with management supporting the directors' continued tenure, the directors rubber-stamping large salary increases for the CEO, and the oligarchy perpetuating itself through cooptation rather than outside election (Estes 1996: 64–67; Baker 2000: 42–43).

Of course this still leaves the threat of hostile takeover, which entrepreneurial theories of the corporation tend to emphasize. But this threat is overrated for the same reason as other alleged instruments of entrepreneurial control: management controls the rules. Hostile takeovers tend to occur in waves every few decades, and to run their course in a few years as management devises new strategies for deflecting the threat. In fact, as Hellwig argued, the rise in hostile takeovers in the 1980s was the immediate result of some very specific innovations, such as junk bond financing, and quickly lost steam as management developed new bylaws to limit the threat of hostile takeover. There were a significant number of takeovers and mergers in the 1990s, but they were for the most part friendly takeovers: strategic attempts to increase market shares and to take advantage of alleged synergies, rather than hostile takeovers motivated by governance issues (Hellwig 2000: 111).

In the case of mergers and acquisitions, the "market for corporate control" argument makes an unwarranted assumption that takeovers are hostile and opposed by the management of the acquired firm, and that the acquisition is motivated by the interest of the acquiring firm's stockholders rather than that of its senior management. But in fact most mergers do not "work to the advantage of the acquiring fund's stockholders . . . Thus, either corporate officials are consistently misjudging merger opportunities, or a great deal of merger activity is motivated by managerial interests" (Branch 1973: 26).

Surveying the literature on post-merger corporate performance, in mergers and acquisitions from the turn of the twentieth century through the 1980s, Doug Henwood found that both acquiring and acquired firms tended to do worse, in terms of profits and stock performance, after a merger. The active parties in hostile takeovers were not "entrepreneurial" stockholders, but empire-building managers (Henwood 1997: 278–281).

And as the example of "Chainsaw Al" Dunlap (a corporate hit man who made a career of downsizing corporations) shows, Mises's celebrated double-entry bookkeeping isn't much of a panacea for principal-agent problems when the agent is keeping the books. Dunlap was a master at figuring out how to make a company appear profitable on paper. He left Nitec Paper Corporation with an enormous severance package, in the face of a threatened walkout by the rest of the management team, after he gutted that company of its human capital. After he left, it was discovered that he had used "creative accounting" ("expenses, inventory, and cash on hand had all been adjusted") to transform a $5.5 million deficit into a $5 million increase in profit. He did the same at Sunbeam, with the help of the magicians of Arthur Andersen (Huffington 2003: 62–65).

If things aren't already opaque enough for Mises's entrepreneur, we can throw in the investment banks, who have a vested interest (in collusion with corporate management) in using stock analysis to drive up share prices and promote sales (Huffington 2003: 154–169).

Corporate management is very good at manipulating data to confuse outside investors. For example, according to Martin Hellwig (2000), incumbent management tends to buttress its security with company resources, accumulating and decumulating hidden reserves (such as real estate investments) that can be used to smooth out cash flow (Hellwig 2000: 119).

The problem, from the perspective of outside investors, is determining the *significance* of red or black ink. How does the large-scale investor distinguish red ink that results from senior management's gaming of the system in its own interest at the expense of the productivity of the organization, from red ink that results from the normal effects of the business cycle? And the "gaming" might be purely defensive, a way of deflecting pressure from those above whose only concern is to maximize apparent profits without regard to long-term productivity.

The problem is complicated when the same organizational culture—determined by the needs of the managerial system itself—is shared by all the corporations in an oligopoly industry, so that the same pattern of red ink appears throughout the industry. This is further complicated when the general atmosphere of state capitalism enables the corporations in a cartelized industry to operate in the black, despite excessive size and dysfunctional internal culture. It becomes impossible to make a valid assessment of why the corporation is profitable at all: does the black ink result from efficiency, or from some degree of protection against the competitive penalty for inefficiency?

If the decisions of executives to engage in asset stripping and hollowing in the interest of short-term profitability result in long-term harm to the health of the enterprise, they are more apt to be reinforced than censured by investors and higher-ups. After all, they acted in accordance with the conventional wisdom found in the "Big MBA Handbook," so *that* can't have caused them to go in the tank. Must've been sunspots or something.

## PROBLEMS OF ECONOMIC CALCULATION

Mises argued that economic calculation was impossible for centrally planned socialist economies, in which all the factors of production were owned by the state. A market in factors of production is necessary for pricing production inputs, so that a planner may allocate them rationally. Absent such input prices, there is no way the planner can compare the final product's price to the value of the inputs and decide whether that was the most efficient allocation of inputs (Mises 1966: 698–701).

Still, Mises argued that socialist governments directing nationalized economies were able to more or less approach economic rationality by setting their internal input prices with reference to foreign prices in countries where markets still prevailed. They would be able to function to some degree, despite the absence of market prices for producer goods, because "these were not isolated socialist systems. They were operating in an environment in which the price system still worked. They could resort to economic calculation on the ground of the prices established abroad" (Mises 1966: 703).

In *Man, Economy, and State*, Rothbard applied the calculation argument to the private sector firm in a market economy, raising the question of "the role of implicit earnings and calculation in a vertically integrated firm" (1993: 545). The firm, like Soviet planners, evaluates internal allocations of resources as though it were selling itself capital goods and unfinished products, with reference to external prices.

But this would not work in cases where a firm had a complete monopoly on an intermediate good:

> In that case, it would have no way of knowing which stage was being conducted profitably and which not. It would therefore have no way of knowing how to allocate factors to the various stages. There would be no way for it to estimate any implicit price or opportunity cost for the capital good at that particular stage. Any estimate would be completely arbitrary and have no meaningful relation to economic conditions.
>
> In short, if there were no market for a product, and all of its exchanges were internal, there would be no way for a firm or for anyone else to determine a price for the good. . . . Not being able to calculate a price, the firm could not rationally allocate factors and resources from one stage to another. (Rothbard 1993: 547)

Hence, insuperable calculation problems would make it impossible for a pure monopoly to arise from a free market. The requirement that "*for every capital good, there must be a definite market in which firms buy and sell that good*" means that "One Big Cartel" can never own the whole economy, nor can mergers occur until

> One Big Firm owns all the productive assets in the economy. . . . The force of this law multiplies as the area of the economy increases and as islands of noncalculable chaos swell to the proportions of masses and continents. As the area of incalculability increases, the degrees of irrationality, misallocation, loss, impoverishment, etc., become greater.

The free market's limit on the size of the firm is another way of saying "the limits of *calculability* on the market." This limit is set by the need for a firm, in calculating the profits and losses of each branch, to "be able to refer its internal operations to *external markets* for *each* of the various factors and intermediate products." The disappearance of these external markets, through absorption by the firm, destroys calculability; the firm is no longer able to rationally allocate the factors previously priced by those external markets. "The more these limits are encroached upon, the greater and greater will be the sphere of irrationality" (Rothbard 1976: 545–549, 585).

Later, Rothbard further elaborated on this argument in "Ludwig von Mises and Economic Calculation Under Socialism." The theory, he said, wasn't about "socialism" as such, but applied to "*any* situation where one group has acquired control over the means of production over a large area"—whether that group was a state with "Socialist central planning" or "One big Firm" that "own[ed] or control[led] the entire economy."

> One Big Firm would soon find itself suffering severe losses and would therefore disintegrate under this pressure. . . . It seems to follow that, as we *approach* One Big Firm on the market, as mergers begin to eliminate capital goods markets in industry after industry, these calculation problems will begin to appear, albeit not as catastrophically as under full monopoly. . . . If, then, calculation problems begin to arise as markets disappear, this places a free-market limit, not simply on One Big Firm, but even on partial monopolies that eradicate markets. Hence, the free market contains within itself a built-in mechanism limiting the relative size of firms in order to preserve markets throughout the economy. (Rothbard 1976: 75–76)

The main shortcoming of Rothbard's analysis is that "Rothbard is making a claim only about the upper bound of the firm, not the incremental cost of expanding the firm's activities (as long as external market references are available)" (Klein 1996: 15).

And external factor prices are a highly imperfect guide for internal transfer pricing of inputs within the firm. In Rothbard's view, external markets do not have to be perfectly competitive. "For Rothbard, 'thin' markets are adequate: all that is necessary to have a genuine 'external market' is the existence of at least one other producer (seller) of the intermediate good" (Klein 1996: 14n13).

But this is unsatisfactory. The whole purpose of a price system is for prices to fluctuate so as to equalize the quantities demanded and supplied in a specific environment. The conditions of supply and demand by which spot prices are set in an outside market are highly unlikely to duplicate the exact conditions of supply and demand within a firm, and will therefore be highly inefficient for regulating the flow of inputs within the firm. They will be average, not marginal, prices. The outside market price is as approximate and distorted, from the standpoint of the firm's internal planners, as market prices in the West were to Soviet state planners. Or at least the unsatisfactoriness and approximateness are similar in kind, if not degree. If all that matters is that external markets continue to exist, no matter how unrepresentative of conditions within the firm, then a state-planned economy should also work just fine with implicit pricing based on foreign markets.

Just as Mises said of the USSR, the larger and more vertically integrated the corporation, even when outside markets continue to exist for all its inputs, the further removed are its internal conditions from the immediate conditions under which prices are formed moment to moment in the outside market. The external market prices reflect the situation of market actors outside the firm rather than the situation within the firm. Pricing based on the available supply and the valuation of purchasers under the spot conditions of the market may lead to irrational allocations given different conditions of supply and valuation within the firm. If nothing else, the fact that the firm is "exchanging" factors internally, rather than bidding in the outside market, distorts the price in the outside market so that it is different from what it would be if the firm were a participant in it. The outside market's prices are atypical or misleading precisely to the extent that they do not incorporate the valuations of the firm in question. Rothbard himself admitted as much: "The implicit price, or opportunity cost of selling to oneself, might be less than the existing market price, since the entry of the Jones Company on the market might have lowered the price of the good, say to 102 ounces" (Rothbard 1993: 900–901n56).

As Per Bylund notes (Chapter 4, this volume), Coase's view of the firm puts strong emphasis on its ability to internally simulate the action of outside markets in allocating resources, as a measure of efficiency. On the other hand, there's a considerable contradiction between this and Coase's argument that the advantage of the firm lies in reducing the transaction costs involved in price discovery and contracting by replacing the price mechanism with authority.

In any case, regardless of the usefulness of the prices of basic factors of production set in outside markets, the practical effect, even of Rothbard's argument, results in a size threshold for calculational problems far lower than Rothbard would likely have been comfortable with. He explicitly stated that the requirement for "factor markets" applies not only to basic raw materials, but to intermediate components or unfinished goods. If many or most of the component parts of a complex consumer good are unique and differentiated from the components of competing versions of that good, in ways that prevent generic pricing of the components, the firm must set an internal transfer price for the component that is estimated on some cost-plus basis. In this case, Rothbard seemed to argue, the more indirectly the transfer price is derived from the actual market prices of higher order producer goods, the further removed from reality are the firm's attempts at calculation. If this is taken as Rothbard's explicit doctrine, then most oligopoly manufacturing corporations probably exceed Rothbard's threshold.

When no external market exists for intermediate products or components, the usual practice is to estimate the transfer price on a cost-plus basis, or perhaps to allow the buying and selling divisions to bargain in an internal "market." Rothbard dismissed such a transfer price as "only an arbitrary symbol" (Rothbard 1993: 547). Peter Klein adds: "At the very least, any artificial or substitute transfer prices will contain less information than actual market prices" (Klein 1996: 14).

Economist John Menge's account of transfer pricing seems to bear out speculations on the pricing of intermediate goods unique to a particular firm (Menge 1961). In his case study of the automobile industry, intermediate goods were assigned to three categories for the sake of transfer pricing: Class X (goods for which no outside market exists—"integral, non-substitutable, components of the finished product"); Class Z (goods that are readily available in the outside market); and Class Y goods, which are both produced internally and available on the market. In the case of Class Y and Z goods, management is in roughly the same situation as state socialist planners relying on outside prices. If they are bought on the outside and then traded between units, the price in outside markets will not fully reflect the supply and demand for the goods inside the firm from one day to the next. If they are produced internally, but also available in outside markets, the outside price may be a very poor reflection of the internal costs of producing it.

In the case of Class X goods, intermediate goods unique to the firm, transfer pricing is far more arbitrary. Transfer prices "are to be established on the basis of the estimated costs of an efficient producer plus a markup equal to the divisional profit objective on the assets utilized" (Menge 1961: 420).

"The principal determinants of this price are estimates of material costs, direct labor costs, overhead costs, starting or tooling costs, unanticipated program acceleration costs, return on assets employed and standard volume" (Menge 1961: 225).

At the time he wrote, Menge observed that the portion of intermediate goods in Class X had fallen from 75 to 65 percent in the previous five years; but the process seemed to have reached a saturation point beyond which little further reduction was feasible. He speculated that Class X goods would always represent a majority of intermediate goods in the industry (Menge 1961: 218).

The problem is exacerbated by interdivisional politics, because, as Gary Miller points out:

> The executives in each division are normally compensated on the basis of their own division's book profits. . . . Therefore, the user division has every incentive to try to obtain the other division's product for as little as possible. . . . Similarly, the supplier division has every incentive to charge the other division as much as possible for its product. (Miller 1992: 131)

Thus, the divisions often end up engaging in hostilities around the set of issues known as "transfer pricing."

As an amusing aside, in considering the parallel application of the calculation argument to the state and corporate planned economies, Kenneth Arrow suggested an expedient for corporate transfer pricing much like Oskar Lange's proposal for simulating the market in a planned economy: let each manager set initial transfer prices based on guesswork, observe the relative inputs and outputs, and then adjust them to internal "market" clearing levels (Arrow 1964: 205). So there is some justification for Roderick Long's dismissal of market-based management: "as far as I can tell, MBM is just a way of simulating markets *à la* market socialism" (2008).[1]

The difference between transfer pricing of intermediate goods for which there is no external market and reliance upon outside spot prices for establishing transfer prices within a firm, is really only one of degree. In both cases, they rely on estimates based on outside prices. The difference is that establishing transfer prices of unique intermediate goods relies on indirect cost-plus calculations from the prices of even more basic components. But both are indirect to a large extent, and involve relying on spot market information that is removed from the immediate conditions of supply and demand inside the firm. If the cost-plus pricing of intermediate goods is unacceptable to Rothbard, then so also should be the reliance on "thin" outside markets for pricing generic intermediate goods.

So in fact the corporation's internal planning and transfer pricing systems resemble nothing so much as Oskar Lange's model of market socialism.

And since allocation decisions are made by a management that is really independent of shareholder control, senior management—like Lange's market socialist factory managers—are engaged in the same act of "playing entrepreneur" (a phrase Mises used to dismiss price setting in Lange's model)—gambling capital which they did not contribute from their own past efforts, and which they do not stand personally to lose, on the chance that they might win big if the gamble pays off.

Rothbard's assertion that "far lesser evils prevent entrepreneurs from establishing even islands of incalculability," under corporate capitalism, is quite doubtful. He neglects the extent to which the large corporation, as an island of incalculability, is insulated from the market penalties for calculational chaos.

The existing state capitalist system has promoted economic centralization and large scale to the extent that it is impossible for any decision maker to aggregate the distributed knowledge necessary to take both entrepreneurial and technical questions into account in making a rational decision. But the large corporate firm operates in an environment of restraints on competition, shared cultures of inefficiency with other firms in the same industry, and push distribution models, so that it is insulated to a considerable degree from the consequences of irrational decisions.

In fact, the parallels between the kinds of uneven development and misallocation that exist under state socialism, and the equivalent phenomena under state capitalism, are striking. The corporate economy, as a whole, operates in nearly the same atmosphere of calculational chaos as the Soviet planned economy. Like the Soviet planned economy, it is able to stagger on because it does at least translate production inputs into real use-value. Most Soviet refrigerators and microwaves worked after a fashion, and even if they were not the most efficient allocation of the inputs they consumed they were at least more valuable than the raw materials left in the ground. But like the Soviet planned economy, corporation managers have little idea whether the use-value produced came at the expense of some other, greater use-value that might otherwise have resulted from the same inputs. Like the Soviet economy, the firm has little idea of the comparative efficiency or inefficiency with which productive inputs have been used. Like the Soviet planned economy, although to a lesser extent, it is insulated from competition by those who might more accurately assess the needs of consumers or organize resources more efficiently in meeting those needs.

The problem with a state economy, as Mises pictured it, was not that it would be incapable of technical sophistication. A state socialist economy might produce use-value. The problem is that the planners would have absolutely no idea whether the use-value created was worth the cost: did it absorb inputs that might have been used for some greater use-value? "All economic change . . . would involve operations the value of which could neither be predicted beforehand nor ascertained after they had taken place. Everything would be a leap in the dark" (Mises 1951).

Richard Ericson remarked on the ability of communist systems to achieve great feats of engineering without regard to cost: "When the system pursues a few priority objectives, regardless of sacrifices or losses in lower priority areas, those ultimately responsible cannot know whether the success was worth achieving" (Ericson 1991: 21).

Consider also Hayek's prediction of the uneven development, irrationality, and misallocation of resources within a planned economy:

> There is no reason to expect that production would stop, or that the authorities would find difficulty in using all the available resources somehow, or even that output would be permanently lower than it had been before planning started. . . . [We should expect] the excessive development of some lines of production at the expense of others and the use of methods which are inappropriate under the circumstances. We should expect to find overdevelopment of some industries at a cost which was not justified by the importance of their increased output and see unchecked the ambition of the engineer to apply the latest development elsewhere, without considering whether they were economically suited in the situation. In many cases the use of the latest methods of production, which could not have been applied without central planning, would then be a symptom of a misuse of resources rather than a proof of success. (Hayek 1948: 149–50)

As an example he cited "the excellence, from a technological point of view, of some parts of the Russian industrial equipment, which often strikes the casual observer and which is commonly regarded as evidence of success."

To anyone observing the uneven development of the corporate economy under state capitalism, this should sound familiar. Entire categories of goods and production methods have been developed at enormous expense, either within military industry or by state-subsidized R&D in the civilian economy, without regard to cost.[2] Subsidies to capital accumulation, R&D, and technical education radically distort the forms taken by production. Blockbuster factories and economic centralization become artificially profitable, thanks to the Interstate Highway System and other means of externalizing distribution costs.

This discussion of communist central planning also describes the environment of pervasive irrationality *within* the large corporation: management featherbedding and self-dealing; "cost-cutting" measures that decimate productive resources while leaving management's petty empires intact; and the tendency to extend bureaucratic domain while cutting maintenance and support for existing obligations. Management's allocation of resources no doubt creates use value of a sort—but with no reliable way to assess opportunity cost or determine whether the benefit was worth it.

In addition, the standard management accounting metrics used in the large American corporation lead to many of the same irrationalities as central planning in the former Soviet bloc countries. American corporate accounting metrics are part of a larger family of similar accounting systems that Paul Goodman called the "great domain of cost-plus" (1965: 115). What all these systems have in common is equating the consumption of inputs to an output—that is, setting the value of the output based on the value of the inputs required to produce it, regardless of the amount of waste. The most egregious example is the military contractor and the regulated utility, which are guaranteed a certain profit margin and therefore have an incentive to maximize rather than minimize costs (Melman 1974). GDP calculations, similarly, measure the sum-total of the values of inputs consumed in producing a given output. So the more of Bastiat's "broken windows" there are, the higher the GDP; and the higher the artificial scarcity rents charged for monopoly goods, also the higher the GDP. Conversely, technologies that result in radical price deflation from increased efficiency and ephemeralization will lower GDP, as does shifting activities from the cash nexus to the informal, household or gift economy.

In the case of the corporation, the domain of cost-plus takes the form of what Waddell and Bodek call "Sloanist accounting" (2005), which was named for Alfred Sloan, CEO of General Motors, whose colleague Donaldson Brown first introduced it as the accounting system at DuPont. Sloan went on to transfer both Brown and his accounting system to General Motors.

Sloanist accounting metrics define production labor as the primary "variable cost," so that all "cost-cutting" and "efficiency" measures focus almost entirely on downsizing the labor force (despite the ways that human capital increases both the productivity and book value of an organization).

Meanwhile, both management salaries and capital expenditures are treated as fixed costs, to be incorporated into general overhead and from there (via the miracle of "overhead absorption") into the price of goods "sold" to inventory—at which point they count as assets on the balance sheet (Waddell and Bodek 2005: 135–141) American factories frequently have warehouse shelves filled with millions of dollars' worth of obsolete inventory, which is still there "to avoid having to reduce profits this quarter by writing it off." Inventory is a liquid asset that adds to the book value of the company—even if there are no orders (132). Under these conditions, it didn't matter whether a particular production output was needed right away "in order to consummate one of these paper sales. The producing department put the output into inventory and took credit" (75). The result was a high-overhead, high-inventory, low-flow production model:

> By defining the creation of inventory, including work-in-process, as a money-making endeavor, any incentive to encourage flow went out the window. The 1950s saw the emergence of warehouses as a logical and necessary adjunct to manufacturing. Prior to that, the manufacturing warehouse was typically a small shed out behind the plant. . . . By the 1960s warehouse space often equaled, or exceeded, production space in many plants. (Waddell and Bodek 2005: 97)[3]

The whole point of overhead and inventory jugglery is concealment: "Every dollar of overhead that is added to the cost of a product for inventory valuation purposes increases the incentive to produce in volume rather than eliminate waste" (Waddell and Bodek 2005: 233).

Since inventory is as good as cash, and management salaries are a fixed rather than variable expense, management understandably filters out overhead—and the management salaries and irrational expenditures that contribute to it—when it comes to finding ways to cut costs; the overall effect is that corporate management automatically thinks of downsizing production workers as the first and only cost-cutting alternative (Winner 1986: 77).

When we couple the fact that the standard corporate accounting metric treats capital expenditures as a fixed cost with the abundance of retained earnings as a source of investment capital with a shortage of rational projects to spend it on, the result isn't pretty.

Large capital expenditures in large corporations are typically made in an environment of calculational chaos, with little idea of their opportunity cost and no realistic estimate as to their likely effect on the organization's productivity. Management's choice of which productive resources to decimate, and which to leave largely untouched, reflects no discernable criterion of efficiency. In fact the calculation problems in the corporation make any such efficiency judgments largely arbitrary, so that management has little idea of the opportunity costs of the capital investments it does make.

When managers makes large capital investments, they are apt to resemble Hayek's predictions (discussed earlier) for a planned economy: uneven development with productive resources underfunded or gutted in some sectors and overbuilt in others, and no clear idea of the comparative cost or likely productive returns of spending anywhere.

Capital investment decisions are made in a prevailing atmosphere of groupthink and bureaucratic toadyism in which critical analysis is unwelcome. Corporate capital investments are also likely to be made in "an environment in which it's common for estimates of project duration and sales to be excessively optimistic" ("How Companies Spend Their Money" 2007).

> Another indication of executive optimism comes from the responses of a subset of executives who were asked to estimate a single project's rate of return compared with other similar projects approved in the past. Roughly half say the new investment would have a return greater than 25 percent—a figure hard to reach in competitive market economies. Such findings are consistent with a strong tendency toward managerial optimism highlighted in other research. ("How Companies Spend Their Money" 2007)

Management is especially prone, as Oliver Williamson (1975) writes, to persistent refusal to abandon sunk costs. He quotes management guru Peter Drucker's quip that "no institution likes to abandon anything," and elaborates that "budget based institutions are more prone to persist with unproductive or obsolete projects than are revenue based institutions" (122).

And since labor is the only direct, variable cost, corporate bean counters tend to focus obsessively on reducing labor hours as the only conceivable way of cutting unit costs. As Daniel Gross (2006) points out, this irrational cost-cutting approach is especially prone to focus on downsizing human capital:

> This type of self-defeating cost-cutting often occurs at knowledge businesses whose only real asset is smart, motivated employees.
>
> To be sure, if companies were indifferent to costs across the board, they wouldn't be in business. But the penny-pinching is aimed

> squarely at the vast productive middle. Top executives are generally unaffected.

Most personnel downsizing is counterproductive in terms of its stated rationale. According to Richard Sennett, downsizings typically lower the productivity of the organization and result in lower profits. Studies from the early 1990s by the American Management Association and the Wyatt Companies found that repeated downsizings resulted in "lower profits and declining worker productivity." Less than half of the companies carrying out downsizings actually achieved their expense reduction goals, less than a third increased profitability, and less than a fourth increased productivity. Worker morale and motivation fell sharply after downsizing (Sennett 2000: 50).

So despite the fact that production workers' wages and benefits are typically 10 percent or less of total unit costs, without fail, MBAs obsessively eliminate every spare second of direct labor—meanwhile gulping down overhead from administrative costs and capital-spending ratholes by the oceanful.[4]

And downsizing undoes the long-term and painstaking process of building human capital. It amounts to hollowing out a company, the moral equivalent of eating the seed corn.

All these things together—Sloanist "overhead absorption," the system of internal transfer pricing based on the consumption of inputs, and the passing on of costs to the consumer via cost-plus markup—mean that any consumption of inputs that can be incorporated into the "price" of finished goods is, as such, an output—just like according to the accounting system at the Soviet planning committee Gosplan. And the perverse accounting incentives mean the corporation's administrative costs and Rube Goldberg–style organization typically resemble those of the Ministry of Central Services in the film *Brazil* and the allocation of investments in physical plant and equipment typically resemble the uneven development of a centrally planned economy.

## Problems of Authority and Distorted Information Flow

The flow of information within a hierarchy is distorted not just by errors of replication—the problem illustrated by the child's game of "telephone" and the story of the blind men and the elephant—but by systematic filtering in a particular direction. R. A. Wilson (1988) argues that information is distorted by power relationships within a hierarchy: "In a rigid hierarchy, nobody questions orders that seem to come from above, and those at the very top are so isolated from the actual work situation that they never see what is going on below" (Shea and Wilson: 388).

But in addition to these cognitive difficulties resulting from self-isolation or the sheer logistical problems of transmission, there are informational problems resulting from an actual conflict of interest between parties to communication:

> A man with a gun is told only that which people assume will not provoke him to pull the trigger. Since all authority and government are based on force, the master class, with its burden of omniscience, faces the servile class, with its burden of nescience, precisely as a highwayman faces his victim. Communication is possible only between equals. The master class never abstracts enough information from the servile class to know what is actually going on in the world where the actual productivity of society occurs. . . . The result can only be progressive disorientation among the rulers. (Shea and Wilson 1975: 498)

The result is that the organization itself suffers from the same kind of break with reality as an individual who is unable to obtain accurate sensory feedback from her environment:

> A civilization based on authority-and-submission is a civilization without the means of self-correction. Effective communication flows only one way: from master-group to servile-group. Any cyberneticist knows that such a one-way communication channel lacks feedback and cannot behave "intelligently."
>
> The epitome of authority-and-submission is the Army, and the control-and-communication network of the Army has every defect a cyberneticist's nightmare could conjure. Its typical patterns of behavior are immortalized in folklore as SNAFU (situation normal—all f*****-up). (Wilson 1988)

Radical organization theorist Kenneth Boulding (1966), in similar vein, wrote of the value of "analysis of the way in which organizational structure affects the flow of information":

> hence affects the information input into the decision-maker, hence affects his image of the future and his decisions. . . . There is a great deal of evidence that almost all organizational structures tend to produce false images in the decision-maker, and that the larger and more authoritarian

> the organization, the better the chance that its top decision-makers will be operating in purely imaginary worlds. (8)

James Scott (1999) draws a connection between *mētis* (tacit, task-specific knowledge that cannot be verbally summarized and conveyed) and mutuality—"as opposed to imperative, hierarchical coordination"—and acknowledges his debt to anarchist thinkers like Kropotkin and Proudhon for the insight (1999: 6–7). *Mētis* flourishes only in an environment of two-way communication between equals, where the person in contact with the situation—the person actually doing the work—is in a position of equality.

Interestingly, R. A. Wilson had previously noted the same connection between mutuality—bilateral communication between equals—and accurate information. And he included his own allusion to Proudhon, no less:

> Proudhon was a great communication analyst, born 100 years too soon to be understood. His system of voluntary association (anarchy) is based on the simple communication principles that an authoritarian system means one-way communication, or stupidity, and a libertarian system means two-way communication, or rationality.
>
> The essence of authority, as he saw, was Law—that is, fiat—that is, effective communication running one way only. The essence of a libertarian system, as he also saw, was Contract—that is, mutual agreement—that is, effective communication running both ways. ("Redundance of control" is the technical cybernetic phrase.) (Wilson 1988)

Anyone who has ever spent any time in a hierarchy knows exactly what all these people are talking about.

The very process of enculturation in a managerial hierarchy implants cognitive biases that degrade the ability of someone in authority to process information effectively. Jonah Lehrer (2010) described the findings of psychologists' experiments on how power affects one's view of the world. According to Lehrer, the experiments found that people in a position of power display behavior patterns commonly associated with damage to the portions of the cerebral cortex that govern empathy and the ability to imagine the world from others' perspective. Power, in other words, kills the ability even to understand that there are other perspectives than those of the hierarchy.

One thing in particular was interesting: after being assigned to superior and subordinate positions in a role-playing game, participants were exposed to fake cell phone ads. Some of the ads emphasized product quality and price while others "featured weak or nonsensical arguments." Interestingly, subjects who had been role-modeling positions of authority "were far less sensitive to the quality of the argument" (Lehrer 2010).

> This suggests that even fleeting feelings of power can dramatically change the way people respond to information. Instead of analyzing the strength of the argument, those with authority focus on whether or not the argument confirms what they already believe. If it doesn't, then the facts are conveniently ignored. (Lehrer 2010)

I think part of the explanation for the outcome of the cell phone experiment might be that people in power are encultured to shut off their capacity to critically evaluate communication based on internal logic or sense, and instead to evaluate it based on how authoritative the source is. After all, if they're not at the very top of the pyramid, they're expected to "buy in" to whatever comes from above and uncritically pass it along down the conveyor belt. The fastest way to get your career sidelined, if you're trying to advance in a hierarchy, is to evaulate the statements of those in authority in terms of logic.

## Problems of Distributed Knowledge and Knowledge Hoarding

Friedrich Hayek's groundbreaking 1945 article on distributed knowledge was written in the context of the ongoing socialist calculation debate, and was directed primarily at the inability of state central planners to replace the price mechanism as a system for processing information. But it is also highly applicable to similar attempts by central planners within a corporation to replace the market and horizontal peer networks with hierarchy.

> *If* we possess all the relevant information, *if* we can start out from a given system of preferences and *if* we command complete knowledge of available means, the problem which remains is purely one of logic. . . .
>
> This, however, is emphatically *not* the economic problem which society faces. . . .
>
> The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.

> The economic problem of society is thus not merely a problem of how to allocate "given" resources—if "given" is taken to mean given to a single mind which deliberately solves the problem set by these "data." It is rather a problem of how to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, it is a problem of the utilization of knowledge not given to anyone in its totality. (Hayek 1945: 519–520)

Hayek's list of assumptions in the first paragraph, by the way, sound remarkably like the neoclassical model of the firm as a simple "production function," with the most efficient combination of factors determined by technical considerations. His allocation of "given" resources, likewise, foreshadows Harvey Leibenstein's concept of "x-efficiency" as opposed to "allocative efficiency" (1966). Improved x-efficiency results, not from an increase in capital or labor inputs, but from an increase in the efficiency with which existing workers and machines are used.

Hayek went on to apply his concept of distributed knowledge more specifically to the production process, coming up something much like Michael Polanyi's "tacit knowledge." At any rate, Hayek (1945) wrote:

> A little reflection will show that there is beyond question a body of very important but unorganized knowledge which cannot possibly be called scientific in the sense of knowledge of general rules: the knowledge of the particular circumstances of time and place. It is with respect to this that practically every individual has some advantage over all others in that he possesses unique information of which beneficial use might be made, but of which use can be made only if the decisions depending on it are left to him or are made with his active cooperation. We need to remember only how much we have to learn in any occupation after we have completed our theoretical training, how big a part of our working life we spend in learning particular jobs, and how valuable an asset in all walks of life is knowledge of people, of local conditions, and special circumstances. . . .
>
> If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. (521–22, 524)

Polanyi described "tacit knowledge" in quite similar terms. The basic rules of an art, he said, are useful only when integrated into a practical knowledge of the art, which is gained by experience; otherwise, they are mere maxims (Polanyi 1962: 50). The practical knowledge, in many cases, cannot be reduced to a verbal formula for transmission.

> An art which cannot be specified in detail cannot be transmitted by prescription, since no prescription for it exists. It can be passed on only by example from master to apprentice. This restricts the range of diffusion to that of personal contacts, and we find accordingly that craftsmanship tends to survive in closely circumscribed local traditions.

A great deal of technique cannot be reduced to a verbal formula because it is unconscious, based on an acquired feel for the tools in one's hand, and built into one's muscular memory like the technique for riding a bicycle (Polanyi 1962: 61–62).

James Scott's (1999) concept of "*mētis*" (Μητις) is the culmination of a long line of previous thought. *Mētis* "practical knowledge," or "knowledge embedded in local experience," as opposed to *techne* (a systematic body of formal, general, abstract knowledge that is deducible from fundamental principles) (Scott 1999: 311, 320). It represents

> a wide array of practical skills and acquired intelligence in responding to a constantly changing natural and human environment. Any experienced practitioner of a skill or craft will develop a large repertoire of moves, visual judgments, a sense of touch, or a discriminating gestalt for assessing the work as well as a range of accurate intuitions born of experience that defy being communicated apart from practice. (Scott 1999: 329)

*Mētis* is acquired through—and applicable to—"broadly similar but never precisely identical situations requiring a quick and practiced adaptation that becomes almost second nature to the practitioner . . . [and] resists simplification into deductive principles which can successfully be transmitted through book learning" (Scott 1999: 315–316).

Hayek (1945) elaborated further on the kinds of idiosyncratic knowledge involved in the production process:

> To know of and put to use a machine not fully employed, or somebody's skill which could be better utilized, or to be aware of a surplus stock which can be drawn upon during an interruption of supplies, is socially quite as useful as the knowledge of better alternative techniques. . . .
>
> Is it true that, once a plant has been built, the rest is all more or less mechanical, determined by the character of the plant, and leaving little

> to be changed in adapting to the ever-changing circumstances of the moment? . . .
>
> In a competitive industry at any rate—and such an industry alone can serve as a test—the task of keeping cost from rising requires constant struggle, absorbing a great part of the energy of the manager. How easy it is for an inefficient manager to dissipate the differentials on which profitability rests, and that it is possible, with the same technical facilities, to produce with a great variety of costs, are among the commonplaces of business experience which do not seem to be equally familiar in the study of the economist. (522)

In other words, x-efficiency. This is quite close to what Barry Stein wrote on the importance, cumulatively, of incremental changes in the production process, which might well have a greater effect on productivity than simply building a new factory with the latest generation of equipment. And as Stein pointed out, in largely the same terms as Hayek, the workers directly engaged in the production process are, more than anyone else, possessed of the specialized knowledge of how to tweak the process in order to improve productivity.

The effective use of such distributed knowledge, possessed by the production workforce, is disrupted and sabotaged by managerial policies (e.g., the relentless downsizing of human capital and the appropriation of increased efficiency benefits as management compensation).

It is disrupted not only by the sheer cognitive problems of a hierarchy in processing a large volume of information efficiently, but also by the conflicts of interest built into the system.

A corporate hierarchy interferes with the judgment of what Hayek called "people-on-the-spot," and with the collection of dispersed knowledge of circumstances, in exactly the same way a state does. Most production jobs involve a fair amount of *mētis*, and depend on the initiative of workers to improvise, applying skills in new ways in the face of events that are either totally unpredictable or cannot be fully anticipated (Scott 1999: 314). Rigid hierarchies and rigid work rules only work in a predictable environment. When the environment is unpredictable, the key to success lies with empowerment and autonomy for those in direct contact with the situation.

Hierarchical organizations are—to borrow a wonderful phrase from Martha Feldman and James March—*systematically* stupid (1981). For all the same Hayekian reasons that make a planned economy unsustainable, *no* individual is "smart" enough to manage a large, hierarchical organization. *Nobody*—not Einstein, not John Galt—possesses the qualities to make a bureaucratic hierarchy function rationally. Nobody's that smart, any more than anyone is smart enough to run Gosplan efficiently—that's the whole point.

No matter how insightful, resourceful, and prudent a person is, hierarchies insulate those at the top from the reality of what's going on below and *force* them to operate in imaginary worlds where all their intelligence becomes useless. No matter how intelligent managers are *as individuals*, a bureaucratic hierarchy makes their intelligence less *usable*. The only solution is to give discretion to those in direct contact with the situation. As Bruce Schneier (2003) writes in regard to security against attack:

> Good security has people in charge. People are resilient. People can improvise. People can be creative. People can develop on-the-spot solutions. . . . People are the strongest point in a security process. When a security system succeeds in the face of a new or coordinated or devastating attack, it's usually due to the efforts of people. (133)

The problem with authority relations in a hierarchy is that, given the conflict of interest created by the presence of power, those in authority cannot *afford* to allow discretion to those in direct contact with the situation. Systematic stupidity results, of necessity, from a situation in which a bureaucratic hierarchy must develop some metric for assessing the skills or work quality of a labor force whose actual work they know nothing about, and whose material interests militate against remedying management's ignorance. When management doesn't know "what a good job of work is" (Goodman 1965), they are forced to rely on arbitrary metrics.

In a hierarchy, managers are forced to look "in a glass darkly"; their vision of reality is obscured because they are not directly engaged in it. They are forced to carry out the impossible task of developing accurate metrics for evaluating the behavior of subordinates based on the self-reporting of people with whom they have a fundamental conflict of interest. The paperwork burden that management imposes on workers reflects an attempt to render legible a set of social relationships that by its nature must be opaque and closed to them, because they are outside of it. Each new form is intended to remedy the heretofore imperfect self-reporting of subordinates. The need for new paperwork is predicated on the assumption that compliance must be verified because those being monitored have a fundamental conflict of interest with those making the policy, and hence cannot be trusted; but at the same time, that paperwork relies on subordinates' self-reporting as the main source of information. Every time new evidence is presented about a task not being performed to management's satisfaction or a policy not being followed, despite the existing reams of paperwork, management's response is to design yet another—and equally useless—form.

Weberian work rules result of necessity when performance and quality metrics are not tied to direct feedback from the work process. It is a metric *of* work *for* someone who is neither a creator/provider nor an end user. And the rules are necessary because those at the top of the pyramid cannot afford to allow those at the bottom to use common sense. A bureaucracy cannot allow its subordinates such discretion, because someone with the discretion to do things more efficiently will also have the discretion to do something bad. And because the subordinate has a fundamental conflict of interest with the superior, and does not internalize the benefits of applying her intelligence, she cannot be trusted to use her intelligence for the benefit of the organization. In such a zero-sum relationship, any discretion can be abused.

An organizational culture of cooperation and mutual trust is a very important form of human capital that takes a great deal of time and effort to build up and can be destroyed overnight by self-serving executives who think laying off half the workforce is a good way to increase stock options. The result of layoffs is the inability of the master class—in R. A. Wilson's words—to abstract sufficient information and this perception of management by workers as "a highwayman" result in the hoarding of information by those below and their use of it as a source of rents.

A horizontal organization, on the other hand, in which workers are equals and trust each other, can manage information quite effectively. While one-way communication creates opacity from above, two-way communication creates horizontal legibility. To quote Michel Bauwens:

> The capacity to cooperate is verified in the process of cooperation itself. Thus, projects are open to all comers provided they have the necessary skills to contribute to a project. These skills are verified, and communally validated, in the process of production itself. This is apparent in open publishing projects such as citizen journalism: anyone can post and anyone can verify the veracity of the articles. Reputation systems are used for communal validation. The filtering is a posteriori, not a priori. Anti-credentialism is therefore to be contrasted to traditional peer review, where credentials are an essential prerequisite to participate.

> P2P projects are characterized by holoptism. Holoptism is the implied capacity and design of peer to [peer] processes that allows participants free access to all the information about the other participants; not in terms of privacy, but in terms of their existence and contributions (i.e. horizontal information) and access to the aims, metrics and documentation of the project as a whole (i.e. the vertical dimension). This can be contrasted to the panoptism which is characteristic of hierarchical projects: processes are designed to reserve "total" knowledge for an elite, while participants only have access on a "need to know" basis. However, with P2P projects, communication is not top-down and based on strictly defined reporting rules, but feedback is systemic, integrated in the protocol of the cooperative system. (Bauwens 2005)

## Agency and Incentive Problems

It's questionable to what extent the authority relation actually exists within the firm. In Chapter 4, Bylund cites Herbert Simon's argument that the wage contract entails the employee's "abdication of choice." But in fact human agency is never truly alienated. It has been widely observed that the wage labor contract is an incomplete contract. The only thing it establishes for certain is that the employee is obliged to show up at certain times and take direction from the employer's designated managers for the duration of such times. Beyond that, everything else, such as how much actual effort they expend, is an open question. As Dave Coull, an anarchist comrade in Scotland, was told by an old hand where he went to work as a bricklayer: "We get our pay for the inconvenience of showing up when we're told to. Everything extra is negotiable."

The incomplete labor contract is why—as I've argued elsewhere (Carson 2008, chapter 9)—slowdowns, "going canny," working to rule, and the like are effective labor tactics (further enhanced by the fact that workers have more knowledge about what they're doing than their employers do), and are entirely legitimate within a free market intellectual framework. The workplace, in short, is contested terrain, which means, as Bylund puts it, that the supposedly pure "authority relation" turns out to look an awful lot like an internal spot market.

It is entirely feasible to supersede market pricing, but not with authority. The conflicts of interest and agency problems inherent in authority more than cancel out the transaction cost savings. Rather, the only really efficient internal governance system for superseding market pricing is what David Graeber (2013) calls "everyday communism" or "horizontalism"—essentially the internal model of social units ranging from families and clubs to medieval open field villages, workers' cooperatives, collectives and peer-production groups—in which the direct producers themselves fully appropriate the advantages of their own cooperation and all experience the negative consequences of their decisions.

While management cannot afford to willingly grant workers full discretion to apply their superior situational knowledge effectively, subordinates cannot afford to contribute the knowledge necessary to design an efficient work process. The inherent conflict of interest built into the zero-sum relation between labor and management means that cooperation is impossible where it is most needed for an optimally functioning organization.

R. A. Wilson's "highwayman" analogy is a good one. Sanford Grossman and Oliver Hart (1986) argue that the firm's assignment of property rights affects productivity, because vesting residual claimancy in one party reduces the incentive of the other to invest in the firm. The party with residual claimancy will "use [its] residual rights of control to obtain a larger share of the ex post surplus," which will cause the party without residual claimancy to underinvest. So residual claimancy should be distributed in accordance with contributions to productivity (716–717). Given that equity in a typical corporation is worth several times the book value of its physical assets, and given the enormous contribution to productivity made by human capital, the implication is clear.

The problem is that it is in management's perceived self-interest to engage in self-dealing even at the expense of the overall productivity of the firm. So workers under the standard model of MBA-driven cowboy capitalism wind up (using James Scott's (1999) terminology) minimizing their legibility to management and any chance that the increased productivity resulting from their hidden knowledge will be used against them or expropriated.

Hierarchy exists, not because it is the most "efficient" form of organization in some generic sense—there's no such thing as generic efficiency, after all—but because it is the most efficient way for eliciting effort from people with no rational reason to provide more than the minimum necessary cooperation.

This was beautifully illustrated, in a fictional venue, by Ursula LeGuin in *The Dispossessed*. Her protagonist Shevek, a traveler from the libertarian communist world of Anarres, recalls his conversation with an elderly conservative (Atro) on the authoritarian and capitalist world of Urras:

> Atro had once explained to him how this was managed, how the sergeants could give the privates orders, how the lieutenants could give the privates and the sergeants orders, how the captains . . . and so on and so on up to the generals, who could give everyone else orders and need take them from none, except the commander in chief. Shevek had listened with incredulous disgust. "You call that organization?" he had inquired. "You even call it discipline? But it is neither. It is a coercive mechanism of extraordinary inefficiency—a kind of seventh-millennium steam engine! With such a rigid and fragile structure what could be done that was worth doing?" This had given Atro a chance to argue the worth of warfare as the breeder of courage and manliness and weeder-out of the unfit, but the very line of his argument had forced him to concede the effectiveness of guerrillas, organized from below, self-disciplined. "But that only works when the people think they're fighting for something of their own—you know, their homes, or some notion or other," the old man had said.

Later, Shevek came to understand why the Army was organized as it was:

> It was indeed quite necessary. No rational form of organization would serve the purpose. He simply had not understood that the purpose was to enable men with machine guns to kill unarmed men and women easily and in great quantities when told to do so. (LeGuin 1974: 305–306)

The hierarchical organization, in other words, is a clumsy Rube Goldberg (over-engineered) device for eliciting effort from people with absolutely no interest in the leadership's goals, and no logical reason to be willing to expend unnecessary effort or increase output or productivity.

> We all know what it feels like to be told how to do something by someone else, particularly when that person does not do it every day. This is not a problem of ineffective individuals but of management as a system. Whenever someone in a superior position gives us orders, our natural responses are either:
>
> - Blind, robotic obedience, not caring whether it is done well
> - Unspoken, passive-aggressive resistance, or what employees sometimes call "public compliance and private defiance"
> - Hostility, opposition, and rebellion
>
> Through years of experience, employees learn that it is safer to suppress their innate capacity to solve problems and wait instead for commands from above. (Cloke and Goldsmith 2002: 10)

Conflict of interest is built into a hierarchy. The relationship between any higher and lower levels in a hierarchy is, by definition, zero-sum. Those in authority benefit by shifting work downward while appropriating rewards for themselves. Since they do not appropriate the fruits of increased effort, subordinates benefit by perfunctory cooperation, and exploiting their private information to reduce effort.

To repeat, the most efficient form of organization for eliciting effort and motivating production workers to invest their distributed knowledge in increased efficiency is to vest residual claimancy in workers to the extent that their social capital contributes to the value of the organization.

But this is obviously out of the question, since it violates the fundamental logic of exploitation. Exploitation is a zero-sum game in which it is only possible to extract a surplus from others by using one's power at their expense. And the hierarchical institution is set up for the primary purpose of efficiency at exploitation.

Self-serving management policies undermine the trust required for workers to invest their human capital in the enterprise.

The rents that result from the private knowledge of skilled workers, given the zero-sum relationship between management and labor, are an unacceptable barrier to the appropriation of labor's product. Increasing management's control of the work process, and hence the appropriability of the output—making the organization more legible so as to increase the net appropriable product—is the real agenda at the heart of deskilling strategies like Taylorism. When given a choice between efficiency and control—between a larger pie and a larger slice of a smaller pie—management usually prefers to maximize the size of their slice rather than the size of the pie. As Scott (1999) argues, control trumps efficiency:

> As Stephen Marglin's early work has convincingly shown, capitalist profit requires not only efficiency but the *combination* of efficiency and control. The crucial innovations of the division of labor at the sub-product level and the concentration of production in the factory represent the key steps in bringing the labor process under unitary control. Efficiency and control might coincide, as in the case of the mechanized spinning and weaving of cotton. At times, however, they might be unrelated or even contradictory. "Efficiency at best creates a *potential* profit," notes Marglin. "Without control the capitalist cannot realize that profit. Thus organizational forms which enhance capitalist control may increase profits and find favor with capitalists even if they affect productivity and efficiency adversely. Conversely, more efficient ways of organizing

> production which reduce capitalist control may end up reducing profits and being rejected by capitalists." (336)

The goal of Taylorism was to abolish hidden knowledge and the attendant rents on it: a way by which "human labor as a mechanical system . . . could be decomposed into energy transfers, motion, and the physics of work. . . . [This] simplification of labor into isolated problems of mechanical efficiencies [facilitated] scientific control of the entire labor process" (Scott 1999: 98). And scientific control meant legibility and expropriability.

> The genius of modern mass-production methods, Frederick Taylor, saw the issue of destroying metis and turning a resistant, quasi-autonomous, artisan population into more suitable units, or "factory hands," with great clarity. "Under scientific management . . . the managers assume . . . the burden of gathering together all of the traditional knowledge which in the past has been possessed by the workmen and then of classifying, tabulating, and reducing this knowledge to rules, laws, formulae. . . . Thus all of the planning which under the old system was done by the workmen, must of necessity under the new system be done by management in accordance with the laws of science." In the Taylorized factory, only the factory manager had the knowledge and command of the whole process, and the worker was reduced to the execution of a small, often minute, part of the overall process. (Scott 1999: 336–337)

This could sometimes result in an increase in efficiency, but was *always* "a great boon to control and profit."

But *mētis* and dispersed knowledge can never be completely Taylorized out of the production process. Attempts by those in authority to minimize discretion by reducing tasks to standardized routines and anticipating all possible contingencies in the rules can only result in a serious degrading of efficiency, precisely because it is impossible to anticipate all contingencies or to come up with general rules that will not require exceptions in the face of unexpected circumstances. But his has not stopped management from trying:

> David Noble has described the well-funded attempt to make machine tools through numerical controls because it promised "emancipation from the human worker." Its ultimate failure came precisely because the system had designed out *mētis*—the practical adjustments that an experienced worker would make to compensate for slight changes in material, temperatures, the wear on or irregularities in the machine, mechanical

> malfunction, and so forth. As one operator said, "Numerical controls are supposed to be like magic, but all you can do automatically is produce scrap." This conclusion could be generalized. In a brilliant ethnography of the work routines of machine operators whose jobs appeared to have been thoroughly de-skilled, Ken Kusterer has shown how the workers nevertheless had to develop individual skills that were absolutely necessary to successful production but that could never be reduced to formulas a novice could immediately use. (Scott 1999: 337)

In the incident Scott alluded to, as Noble described it,

> The workers increasingly refused to take any initiative to do minor maintenance (like cleaning lint out of the tape reader), help in diagnosing malfunctions, repair broken tools, or even prevent a smash-up. The scrap rate soared . . . along with machine downtime, and low morale produced the highest absenteeism and turnover rates in the plant. Walkouts were common and, under constant harassment from supervisors, the operators developed ingenious covert methods of retaining some measure of control over their work, including clever use of the machine overrides. . . .
>
> The part of the plant with the most sophisticated equipment had become the part of the plant with the highest scrap rate, highest turnover, and lowest productivity. (Noble 1984: 277)

In fact hierarchical organizations depend on the willingness of workers to treat authority-based rules as a form of irrationality and to route around them. The large corporation tacitly depends on the workers who develop workarounds and disregard irrational rules, to keep production going in spite of management, in the same way that the Ministry of Central Services in *Brazil* depended on people like Harry Tuttle.

Scott writes that it is impossible, by the nature of things, for everything entailed in the production process to be distilled, formalized, or codified into a form that is legible to management.

> The formal order encoded in social-engineering designs inevitably leaves out elements that are essential to their actual functioning. If the [East German] factory were forced to operate only within the confines of the roles and functions specified in the simplified design, it would quickly grind to a halt. Collectivized command economies virtually everywhere have limped along thanks to the often desperate improvisation of an informal economy wholly outside its schemata. (Scott 1999: 351–352)

Taylorized systems of formal work rules, under hierarchical control, Scott argues, are "in fact subsystems of a larger system on which they are ultimately dependent, not to say parasitic.

> The subsystem relies on a variety of processes—frequently informal or antecedent—which alone it cannot create or maintain. The more schematic, thin, and simplified the formal order, the less resilient and the more vulnerable it is to disturbances outside its narrow parameters. . . .
>
> It is, I think, a characteristic of large, formal systems of coordination that they are accompanied by what appear to be anomalies but on closer inspection turn out to be integral to that formal order. Much of this might be called "*mētis* to the rescue." . . . A formal command economy. . . is contingent on petty trade, bartering, and deals that are typically illegal. . . . In each case, the nonconforming practice is an indispensable condition for formal order. (Scott 1999: 351–352)

Management simply cannot reduce the complexity of a process to a map, from which it is possible in turn to reconstruct the process in its fullness.

> In each case, the necessarily thin, schematic model of social organization and production animating the planning was inadequate as a set of instructions for creating a successful social order. By themselves, the simplified rules can never generate a functioning community, city, or economy. Formal order, to be more explicit, is always and to some considerable degree parasitic on informal processes, which the formal scheme does not recognize, without which it could not exist, and which it alone cannot create or maintain. (Scott 1999: 310)

And, formal disobedience aside, the difference between what Oliver Williamson called "consummate cooperation" and merely "perfunctory cooperation"—a distinction that hinges on the worker's active contribution of her dispersed knowledge or *mētis* to the production process, as opposed to doing the bare minimum necessary to avoid being fired—makes an enormous difference in its level of functioning.

> Consummate cooperation is initiative in an instrumental way. Perfunctory cooperation, by contrast, involves job performance of a minimally acceptable sort. . . . The upshot is that workers, by shifting to a perfunctory performance mode, are in a position to "destroy" idiosyncratic efficiency gains. (Williamson 1975: 69)

As J. E. Meade (1975) argues, it's simple utility-maximizing behavior. A wage employee "will have to observe the minimum standard of work and effort in order to keep his job; but he will have no immediate personal financial motive . . . to behave in a way that will promote the profitability of the enterprise. . . . Any extra profit due to his extra effort will in the first place accrue to the entrepreneur" (Meade 1975: 395).

And hidden knowledge means that it's impossible to "determine whether workers put their energies and inventiveness into the job in a way which permits task-specific cost-savings to be fully realized" (Williamson 1975: 69). As Paul Milgrom and John Roberts (1988) put it, "only the agent knows what action he has taken in pursuit of his or the principal's goals, or only the agent has access to the specialized knowledge on which his action is based" (S155).

Williamson's concepts of consummate and perfunctory cooperation are implicit in the quote from Hayek, "The Uses of Knowledge in Society," on putting existing machines to better use, or finding hidden reserves of capacity, once a plant has been built. And Williamson (1975) wrote, in the same vein, that

> almost every job involves some specific skills.
>
> Even the simplest custodial tasks are facilitated by familiarity with the physical environment specific to the workplace in which they are being performed. The apparent routine operation of standard machines can be importantly aided by familiarity with the particular piece of operating equipment. . . . In some cases workers are able to anticipate the trouble and diagnose its source by subtle changes in the sound or smell of the equipment. Moreover, performance in some production or managerial jobs involves a team element, and a critical skill is the ability to operate effectively with the given members of the team. (62–63)

The willingness of the workforce to cooperate consummately rather than perfunctorily, to contribute their dispersed knowledge, is arguably the primary determining factor in the potential range of costs with a given set of technical facilities. And the human capital of the enterprise—the hidden knowledge and repertory of task-specific skills that management is seldom even aware of because they cannot be communicated through a hierarchy, the network of personal relationships on which production depends—is the source of a great deal of a firm's equity and accounts for the gap between its equity value and book value (i.e., the market value of its physical assets). Yet management treats labor and its skills as a direct cost under the conventions of Sloanist accounting, rather than as a capital asset that costs money to replace, and does its best to periodically decimate the firm's human capital.

When workers decide to stop propping up the system by disregarding irrational rules, they can in effect, by their very obedience, step back and allow it to destroy itself through its own irrationality. Scott points to the work-to-rule strike as a practical application, from the worker's point of view, of the dependence of formal organization on the larger system of informal processes:

> In a work-to-rule action . . . employees begin doing their jobs by meticulously observing every one of the rules and regulations and performing only the duties stated in their job descriptions. The result, fully intended in this case, is that the work grinds to a halt, or at least to a snail's pace. . . . In the long work-to-rule action against Caterpillar, the large equipment manufacturer, for example, workers reverted to following the inefficient procedures specified by the engineers, knowing they would cost the company valuable time and quality, rather than continuing the more expeditious practices they had long ago devised on the job. They were relying on the tested assumption that working strictly by the book is necessarily less productive than working with initiative. (Scott 1999: 310–311)

Unfortunately, workers trying to degrade the efficiency of production by working to rule may find that they are unable to keep up with management. The practice of corporate downsizing in recent years has amounted to a systematic destruction—by management!—of the set of informal processes that the productivity of the organization depends on.

## Conclusion

The large corporation survives in spite of internal diseconomies from information problems because it is part of a larger coercively maintained system in which the state intervenes in the market with subsidized inputs, coercively enforced monopolies and entry barriers, regulatory cartels, artificial scarcity rents, and state enforcement of labor discipline and other restrictions on the bargaining power of labor, all of which insulate it from the competitive ill effects of inefficiency.

Because of the greater inefficiency costs of hierarchy, the hierarchical firm can only exist in a monopoly market, and the length of hierarchies varies inversely with the competitiveness of markets (McAffee and McMillan 1995). The firm must be a net beneficiary of monopoly, so that the inefficiency costs of hierarchy can be subsidized by rents drawn from the rest of the economy (399–426). Because hierarchy carries inefficiency costs that hurt competitiveness, "hierarchies need rents in order to function"; hence "a firm with a long hierarchy may not be viable in a competitive market" (399). When an industry is competitive, on the other hand, firms tend to be smaller.

In an oligopoly market, the typical firm can afford to be inefficient and bureaucratic because all the firms in the industry share the same institutional cultures, the same management assumptions, and the same conventional patterns of organization. Indeed, when the state's subsidies and protections for large size such as entry barriers, patents, and other regulatory restrictions on competition cause large size to be typical in a given market, the typical firm cannot be efficient.

Corporate managerial culture has been a "success" because when all the major firms in an oligopoly market share the same approach to management, nobody suffers competitive harm from it. As William Waddell and Norman Bodek (2005) argue, it was the monopoly position of American heavy industry after World War II and the common Sloanist managerial culture that enabled them to get away with such an inefficient internal planning system:

> The theory was that a good manager could run any business. It was all done by the numbers, and knowledge of the product or the manufacturing process was not important. The theory was correct, because it was self-fulfilling. Every one of the big, public companies was managed exactly the same way, although they all spun their systems with slightly different lingo. . . . As it turns out he would not have been doing much good at any of them, but no one knew that at the time. They all managed by the numbers, and they all calculated the numbers the same way. (Waddell and Bodek 2005: 96)

The dominant players in an oligopoly market can get away with all these forms of irrationality—the suppression of newer, more efficient technologies, de-skilling their workforce, and substituting *techne* for *mētis,* because the big boys share the same organizational culture. Competition in price and quality has been suppressed by cartelization, and the market is controlled by a handful of giant oligopoly firms that share same dysfunctional internal culture.

For our purposes, the Soviet Union can be treated as a case in which a single corporation owned an entire national economy, with the Politburo as board of directors, the KGB as Pinkertons, and the industrial ministries as production divisions within a gargantuan M-form structure. Because the entire Soviet economy was owned by a single conglomerate, with autarkic barriers to competition from outside, the only limits on the level of inefficiency it could afford were set by the need to prevent economic or political collapse. Or to invert the comparison, the large corporation is a microcosm of the Soviet planned economy.

Ultimately, however, corporate capitalism is unsustainable for the same reasons as the Soviet command economy. The demand for subsidized inputs grows exponentially, and the growing socialization of corporate costs drives the state to bankruptcy (see O'Connor 1973). Meanwhile, the artificial scarcities and property rights that most corporate profit depends on are becoming unenforceable for technological reasons. Corporate capitalism depends on information control (via draconian "intellectual property" law, Digital Millenia Copyright Act takedowns and government shutdowns of file-sharing sites) for the same reason the Soviet *nomenklatura* depended on controlling access to the photocopiers used to distribute *Samizdat* pamphlets. And the proliferation of new technologies like bittorrent, encrypted currencies, and proxies means these legal monopolies are rapidly becoming toothless.

The days of corporate capitalism, are numbered.

## NOTES

1. And while we're on the subject, there's another parallel between the Lange model of market socialism and the incentive system within the corporation: the lack of symmetry between management's rewards for profit, and management's risk from losses, that results from their lack of real ownership of the capital assets at risk. This lack of real ownership by enterprise managers under market socialism, Mises argued, was a major flaw: because they would not be risking their own assets, their incentive would be to take risks with a very large potential payoffs, in situations where the risk aversion of a real owner would probably lead her to reject them.
2. Two of David Noble's works, *Forces of Production: A Social History of Industrial Automation* (New York: Alfred A. Knopf, 1984) and *America by Design: Science, Technology, and the Rise of Corporate Capitalism* (New York: Alfred A. Knopf, 1977) are a good starting point on this subject. Miniaturized circuitry, digital control systems for machine tools, cybernetics, and quality control systems—just to name a few examples—were all direct spillovers from the military economy.
3. Huffington provides illustrations of the popular practice of "earnings restatements," typically coming out after the usual suspects have fully profited

from earlier glowing reports of outstanding performance (Huffington 2003: 173–176).

4. Back in the 1990s, David Noble said labor costs were typically around 10 percent of total unit costs in the metalworking industries, compared to 35 percent for overhead. But 75 percent of management cost-cutting effort went into cutting labor, compared to 10 percent to cutting overhead (Noble 1995: 105).

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Chapter 4

# The Firm and the Authority Relation: Hierarchy vs. Organization

Per L. Bylund

Research in the modern theory of economic organization predominantly addresses issues relating to one or a combination of three fundamental questions originally posed or implied by Ronald Coase (1937): Why are there firms? What are the firm's boundaries? And how is the firm's organizational structure determined? (Foss 1997: 175; Foss and Klein 2008: 426; cf. Garrouste and Saussier 2008: 23). A common starting point for this research, which is often referred to simply as the "theory of the firm," is the assertion of a dichotomy between market and organization. Market transactions are coordinated in a decentralized manner through the "high-powered incentives" of the price mechanism (Williamson 1985: 131–162; 1988), while transactions "within firms" depend on the fiat power in formal, hierarchical organization to coordinate transactions under low-powered (cost plus) incentives.

The view of the firm follows tautologically from this assertion. As Coase (1937: 389) notes, the "distinguishing mark of the firm is the supersession of the price mechanism." The firm, and economic organization in general, is hence defined simply as "all but" market. As opposed to the market, it is commonly understood that the firm must include and potentially rely on some form of direction-based coordination through authority or coercive hierarchy (Leibenstein 1987; Schreuder 1993). Yet this presents a problem: What is the source of this authority? It cannot be the market, since the market is defined as the opposite of hierarchy.

Herbert A. Simon (1951, 1957a) finds the basis for an "authority relation" in the hierarchical nature of the employment contract (Barnard 1938; Masten 1988), which subjects employees to the will of employers and managers. This hierarchy is then assumed to facilitate the explicit and centralized governance necessary to coordinate transactions under low-powered incentives (Williamson 1975, 1985, 1996, 2002). Indeed, Coase, the founding father of the modern theory of the firm, holds the relationship between employer and employee as very similar to "the legal relationship normally called that of 'master and servant'" (1937, 403). But whereas this special status of the employment contract presumably explains the "authority" exercised in firms, the reference to government's coercive powers dodges the real issue: it offers neither a necessary condition for the firm nor a sufficient economic rationale for organizing. In fact, the *economic* question of organization and, consequently, what a firm "is," is avoided rather than answered.

This chapter aims to shed light on the shaky foundation of the modern theory of economic organization, specifically the theory of the *firm*, and explicate the differences between hierarchy and organization. The next section discusses the "authority relation" and its origins in the nature of the employment contract. Thereafter, I expound on the legal fiction of the firm and discuss the effects and implications of contracting. I also draft a framework for analyzing differences between and conditions for hierarchy and organization in the market. I end by discussing a possible alternative view of the firm and draw conclusions.

## THE AUTHORITY RELATION

### RONALD COASE AND THE FIRM AS HIERARCHY

Though the history of seeing the firm as a hierarchy or authority relation likely predates the modern theory of the firm by many decades, it was not made a formal part of the study of organization until the publication of Coase's groundbreaking transaction cost theory in 1937. Coase notes that economic theory views the market as a system that lacks central control and therefore "works itself." But he realized that this "gives a very incomplete picture of our economic system" (1937: 387), because the real market includes numerous "islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk" (Robertson 1923: 85). Indeed, the modern economy is primarily organized in and around the structured firm, within which "the description [of market] does not fit at all" (Coase 1937: 387). Due to the prevalence of firms, Coase argues, we must consider top-down planning "typical of a large sphere in our modern economic system" (388).

Even so, Coase assumes the main positions in the then ongoing debate on the feasibility of economic planning as bases for his identified dichotomy (Bylund forthcoming). Since both of the antithetic economic systems rely heavily on rational planning of economic activity—in the market firms, and for socialism "Lenin had said that the economic system in Russia would be run as one big factory" (Coase 1988c: 8)—the real friction between bottom-up market and top-down planning exists *within the market system*. Indeed, Coase sets out to study this friction based on the assertion "that the distinguishing mark of the firm is the supersession of the price mechanism," which leads to "a gap in economic [market] theory between the assumption (made for some purposes) that resources are allocated by means of the price mechanism and the assumption (made for other purposes) that this allocation is dependent on the [manager]" (Coase 1937: 389).

As long as the firm's manager successfully "reproduce[s] distribution of factors under atomistic competition within the business unit" (Coase 1988c: 4), Coase assumes that the firm is as efficient as the market. But since the firm relies on "conscious power" to direct resources, it must consequently avoid "the most obvious cost of 'organising' production through the price mechanism[, which] is that of discovering what the relevant prices are" (Coase 1937: 390). The firm can therefore be cheaper than the market. Core to Coase's analysis is the finding that the best means of coordination comes down to a simple cost tradeoff, since both firms and the market may be allocatively efficient. The authority relation is for that reason necessary, since a firm without the manager's power to "direct the other factors of production" (Coase 1937:, 391) is neither different from the market nor has the means to outdo it. The firm, thus, is authority.

The way to institute such authority and consequently save on the transaction costs of the market is for owners and directors of factors to establish long-term contractual relationships rather than negotiate a separate contract for each exchange transaction. This means that for a "series of contracts is substituted one" where "the factor, for certain remuneration . . . agrees to obey the directions of [a manager] *within certain limits*" (Coase 1937: 391; emphasis in original). Coase further notes that "it would be possible for no limits to the powers of the [manager] to be fixed" in the contract, but that this is undesirable since it "would be voluntary slavery" and therefore legally "void and unenforceable" (Coase 1937: 391 fn. 2).

Yet even though the authority relation is contract-based, Coase hesitates to make the employment contract sufficient for establishing the authority relation in the firm. In general terms, he says, "the employer-employee contract approaches the firm relationship," and it is therefore an important part of it. But it is not until "several such contracts are made with people and for things which cooperate with one another, you get the full firm relationship" (Coase 1988b: 30). This may be an adequate description of most firms in the empirical market, but it deviates from Coase's previous definition—that the firm is simply "the supersession of the price mechanism"—by noting specific qualities that only in certain quantities appear to add up to a "firm." Perhaps for this reason, Coase later retracts from his use of "the employer-employee relationship as the archetype of the firm"; he notes that this was "one of the main weaknesses of my article" as it "misdirects our attention" in the study of the firm (Coase 1988a: 37).

The question remains as to the source of fiat within firms. On the one hand, the firm is by its very definition the internal hierarchical authority that supersedes the price mechanism and therefore avoids the transaction costs of the market. This authority appears to be due to either the vast open-endedness of the employment contract or its legal special status, both of which supposedly makes it distinct from all types of market contracts. Yet on the other hand, Coase notes that it is not the nature of the employment contract, regardless of whether we consider its legal status or supposedly unique structure, that makes the firm. In order to fully constitute a firm there must be "several" such contracts instituted around a single manager so that the latter can direct production as he or she sees fit. But to Coase this recognition of the nature and quantity of employment contracts "misdirects our attention" from what truly constitutes a firm. So while Coase asserts and bases his theory on seeing the firm as fiat, he finds his own derivation of the source of such power insufficient and a main weakness of his overall argument.

## AUTHORITY THROUGH CONTRACT

In Williamson's (1975, 1996, 1985) later reformulation of Coase's transaction cost approach, the role of the employment contract as source of within-firm fiat is brought to the forefront and augmented. Williamson relies heavily on the work of Herbert Simon, who coined the term "authority relation" and places it at the core of the definition of formal organization. To Simon (1957a: 124), "authority is the one [mode of influence] that chiefly distinguishes the behavior of individuals as participants of organizations from their behavior outside such organizations."

Authority is, to Simon (1957a: 126–127), a vertical relationship that requires obedience by a subordinate. It is distinct from horizontal, consent-based influence. He thus strengthens and makes more explicit the definition of the firm as plain authority, thereby shifting focus from Coase's emphasis on the comparative analysis of the firm-market dichotomy to the nature of direction by fiat. To Simon, "it is authority that gives an organization its formal structure" (1957a: 124), and his view of authority is similar to Coase's view of the employment contract as open-ended, which thus constitutes a shift in the distribution of decision-making power. In this sense, it is also related to Pfeffer's (1981: 4) definition of authority as "legitimized" power, which "derives from having something that someone else wants or needs, and being in control of the performance or resource so that there are few alternative sources, or no alternative sources, for obtaining what is desired" (Pfeffer 1981: 99; cf. Blau 1964; Emerson 1962; Thompson 1967).

Simon's view of power is similar to Pfeffer's (1981) in that it recognizes one party's ability to make decisions or set up rules with which the subject must comply, but it does not stress that employers (or firms) have something that employees lack but want. Rather, the nature of the firm's authority is strictly relational and does not depend on a resource-based advantage. The basis for fiat lies in the subject's "abdication of choice" (Simon 1957a: 127), and thus the acceptance ex ante of being directed by the designated authority. This vertical relationship between the employer and the employee is established through drawing up an employment contract that specifies who has the decision-making power and thus residual control rights. It is different from the list of specific obligations common in market contracts:

> We will say that *W* enters into an employment contract with B when the former agrees to accept the authority of the latter and the latter agrees to pay the former a stated wage ($w$). This contract differs fundamentally from a sales contract – the kind of contract that is assumed in ordinary formulations of price theory. In the sales contract each party promises a specific consideration in return for the consideration promised by the other. The buyer (like *B*) promises to pay a stated sum of

> money; but the seller (unlike *W*) promises in return a specified quantity of a completely specified commodity. Moreover, the seller is not interested in the way in which his commodity is used once it is sold, while the worker *is* interested in what the entrepreneur will want him to do. (Simon 1957b: 184)

The ultimate source of the power established by the employment contract lies therefore in the ex ante agreement between the parties to *not* include specific terms, which therefore establishes one party's contractual prerogative to make decisions about the other's actions. The authority relation therefore does not emerge due to one party controlling a limited supply of what the other party wants, even though this may of course be a reason for one or both parties to enter such a contract, but can be a fully voluntary and informed choice. It is the *effect* of the specific terms of the contract—specifically, the lack thereof—that establishes authority.

Of course, this definition shifts our attention from the origin of what upholds authority to the contract enforcement mechanism or legal "regime" for upholding such contracts (Williamson 1991) and the contract's terms for expiration and regulation of exit from the relationship, without which the employment contract could degenerate to "voluntary slavery" (Williamson, Wachter, and Harris 1975). Also, it again raises questions about the distinctiveness of the employment contract—Simon's focus in the discussion on the firm's authority relation—since it is this type of contract's open-endedness that produces an authority relation. Market contracts certainly include varying degrees of specificity in the requirements for each party. Indeed, both Coase and Williamson acknowledge short-term or instantaneous exchange as well as the existence of long-term market contracts, and Coase (1937) notes that "owing to the difficulty of forecasting, the longer the period of the contract is for the supply of the commodity or service, the less possible, and indeed, the less desirable it is for the person purchasing to specify what the other contracting party is expected to do" (391). In other words, the distinction between market and employment contract is not as unambiguous as Simon appears to assume, but there seems to be a continuum from instantaneous exchange in the spot market (all terms are specific) to long-term contractual relationships (with less specific terms) such as the employment contract. Market contracting exists throughout the continuum and thus includes a whole range of contractual types with differing terms and specificities. Market contracts include long-term market relationships such as strategic alliances, agreements for cooperation, or highly specialized and streamlined supply chains, and may be open-ended and lacking specific quantities. When we recognize, as Coase (1937: 391) does, that employment contracts include restrictions on what the employee can be asked to do, the nature of the employment contract no longer appears distinct from market contracts.

What remains of the authority relation is the distinction between whether the contract is "horizontal" or "vertical." But we have seen that both Coase (1937) and Simon (1951, 1957a) refer to the nature of the employment contract to substantiate this difference, which makes the argument circular. The crux of the problem is summarized by Grossman and Hart (1986: 693), who pose a revealing question: "Is a firm that calls its retail force 'employees' more integrated than one that calls its retail force 'independent but exclusive sales agents'?" The difference between long-term market contracts and employment contracts is far from obvious; rather, their characteristics can and do overlap. Does this then mean that what truly matters is simply whether the selling party is a person, which makes it an employment contract, or a supplier, which makes it a market contract? In other words, is the firm a firm simply because we call it a firm?

## Authority from Ownership

While Coase argues that authority in the firm is necessary to supersede the price mechanism, more recent literature in the transaction cost tradition employs a different argument. Rather than considering exclusively the ex ante "discovering what the relevant prices are" (Coase 1937: 390)—what Arrow (1969: 48) calls the "costs of running the economic system"—the analytical emphasis is here on ex post costs of being bound by contract. Long-term market contracts may come at lower cost than writing up a new contract for each repeated transaction, but contracts that stretch far into the future are necessarily incomplete as we cannot fully foresee all events.

This "bounded rationality" is augmented by the view that people "are given to opportunism, which is a condition of self-interest seeking with guile" (Williamson 1985: 30). The combined effect suggests a highly uncertain context for market relationships, since there is a risk that considerable costs arise when the contract is in force (Hill 1990; Klein 2010; Williamson 1993). Williamson (1985: 21) delineates four categories of such ex post transaction costs:

1. The maladaption costs incurred when transactions drift out of alignment
2. The haggling costs incurred if bilateral efforts are made to correct ex post misalignment
3. The setup and running costs with the governance structures
4. The bonding costs of effecting secure commitments

The proper response for contractual parties is to choose the maximizing (cost-minimizing) form of governance structure in advance of the transaction. They thus rationally and discriminatingly align incentives through their choice of governance (Williamson 1991). Where the costs are predictably high, as is the case where the transaction will require an investment that is specific to the contractual relationship (Joskow 1993; Williamson 1971, 1991, 2002), the proper choice is to establish unambiguous ownership of it. Hence, parties expecting a transaction to necessitate substantial specific investments establish a common governing body to avoid possible opportunistic behavior. In equilibrium the nature of a transaction is thus expected to align perfectly with the governance structure adequate for such transactions.

While ownership appears straightforward, empirical ownership rights are almost never well-defined (Cook and Iliopoulos 2000). Also, ownership can be seen not as a single right but as a *bundle* of rights (Demsetz 1967); for instance, Furubotn and Pejovich (1974) discuss ownership as the right to use, the right to change, and the right to appropriate returns from the asset. The latter is expounded on by Grossman and Hart (1986), who argue that it may be optimal at the outset to allow one party to purchase all residual rights where specific rights are costly.

Since a firm generally has full ownership and contractual control over resources located (legally or spatially) within the firm, integration may be valuable since it frees the decision maker. The manager or owner of a firm has a contract with each employee within the firm, which is not the case with suppliers. Supplier contracts are between bundles of resources acting as firms, so the manager can selectively configure the firm's resource bundle by buying/selling individual assets and hiring/firing individual workers. This, argues Hart and Moore (1990) may be a more effective and efficient economic solution and thus an argument for the firm.

But ownership again points to the issue of enforcement and thus under what legal regime contracting takes place. Williamson (1991) notes that the legal regime in the market is different from that inside the firm: market transactions are legally governed by "contract law" whereas the legal system's approach to conflict or contractual disputes within a firm is primarily "forbearance." In other words, what constitutes the authority relation in the firm is a product of government's legal system. What then remains is simple contracting where acknowledged and protected owners (whether of firms, assets, or their own labor) contract freely with each other, but where the legal regime allows special status to conflicts in organizations constituted by centralized *asset* ownership. The fact that the owner-manager's view takes precedence within the firm follows from his or her ownership of the assets used in production (that is, the tools used by contracted laborers), but this state of affairs is affirmed and strengthened by the legal system's allowing "internal" issues to be solved according to the forbearance doctrine. This legal special status of the firm, where it enjoys the privilege of judging its own cases as long as they are considered "internal," emerges as its real—and possibly only—source of authority.

## The Firm as a Legal Fiction

As noted earlier, there are fundamental problems with studying and defining the firm as primarily an "authority relation." While there may certainly be some type of authority involved in economic matters, at least in the sense of controlling one's property, the arguments used to substantiate the claim that the firm is in essence fiat are weak and troublesome. Indeed, the arguments give the appearance of being based on sound empirical observation or theory, but the real basis is a mixed bag of strange or poorly argued contentions. There are definitional issues, assertions of conceptual differences that fade when scrutinized, more or less implicit references to legal status under the guise of being economically based, and circular reasoning. There also seems to be a fair amount of ideology-based sloppy thinking. This does not mean, of course, that there is no authority, only that the claims of such relations have not been properly corroborated.

Alchian and Demsetz (1972) argue that there is good reason why scholars have had such difficulty producing a cogent argument for the authority relation in the firm: there is none. They write that while it "is common to see the firm characterized by the power to settle issues by fiat, by authority, or by disciplinary action superior to that available in the conventional market . . . this is a delusion" (Alchian and Demsetz 1972: 777). The firm, they continue, "has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people"—in fact, an employer "can fire or sue, just as I can fire my grocer by stopping purchases from him or sue him for delivering faulty products." The point is that different types of contracts in the market are still only contracts—even if they compose a "firm." The significance of the firm is hence primarily *legal* (Masten 1988) and it should for economic purposes be seen as a "legal fiction," an "artificial construct under the law which allows certain organizations to be treated as individuals" (Jensen and Meckling 1976: 310 fn. 12) and therefore work as "actors" in the market. The core problem is that if we still choose to accept the economic "firm" as a worthwhile concept how do we determine its boundaries? If the firm is but a "nexus of contracts," then there is in principle no difference between contracts that tie resources "inside" the firm to each other and contracts establishing a relationship between "the firm" and "its" suppliers. It follows that the type of contract cannot be a determinant of the firm's boundaries and, in reality, "long-term contracts between employer and employee are not the essence of what we call a firm" (Alchian and Demsetz 1972: 777).

Yet the nature of the firm, as it is a market creation and common economic institution, must above all be contractual (cf. Cheung 1983) even if it is nothing more than a "nexus of a set of contracting relationships" (Jensen and Meckling 1976: 311). The "legal fiction" may not formally amount to anything more than a set of market contracts, but the firm is still distinct through its common usage of resources and its vertical formation. The firm can therefore be seen as "the *centralized contractual agent in a team productive process*—not some superior authoritarian directive or disciplinary power" (Alchian and Demsetz 1972: 778; emphasis in original).

Alchian and Demsetz (1972) find in the firm a solution to *metering* problems in team production. Team production suggests an information problem that makes workers unable to identify who does what and, more important, if someone shirks (similar to opportunism, as noted earlier). As the workers are self-interested and prefer to save their energy than lift "for others," their joint production tends to decrease as they take advantage of the fact that their shirking cannot be fully identified. For this reason, workers hire a "manager" to help maximize output and pay him or her the value produced in excess of expected normal output: the manager thus becomes the residual claimant, which suggests a power to direct workers as well as a high-powered incentive to coordinate production for maximum output. The firm then emerges as a means for workers to minimize information costs and thereby control their input in team production.

Jensen and Meckling (1976) instead trace the value of the firm as a "nexus of contracts" to the costs of financing production. They see the present market structure as the culmination of a process that has weeded out less efficient organizational forms: "the law and the sophistication of contracts relevant to the modern corporation are the products of a historical process in which there were strong incentives for individuals to minimize agency costs" (Jensen and Meckling 1976: 357). The firm, regardless of specific organizational form, emerges as a means for finding optimal capital structure through minimizing agency costs of equity and debt financing.

What makes these conceptions of the firm interesting, especially considering the approaches in the previous section, is that they explicitly do away with the legal basis for the definition of the firm. While they acknowledge the legal (and thus government-sanctioned) special status enjoyed by the corporation and other forms of recognized organizations, their analyses go beyond the particularities of legal rules and consider first and foremost a fundamentally economic argument. Thereby, rather than assuming the firm as distinct from market exchange and then attempting to delineate how they work as opposed to the market, they indicate that there is an original economic rationale—a value—in organization. It should thus be possible to explain the emergence of economic organization without reference to legal special status or privilege.

## ORGANIZATION WITHOUT HIERARCHY?

While we have seen that there may be an economic rationale for the firm that does not depend on a formal "authority relation" enforced and upheld by the state's legal apparatus, this does not provide conclusive evidence for the nonexistence of authority in firms. Rather, the core assertions and arguments in several of the most influential theories of the firm are not, as they claim to be, economic, but are primarily *legal*. As such, they contribute to a confused overall picture of the firm as an authority relation, thereby diverting our attention from the proper analysis of the possibility of establishing hierarchical economic relationships through organization. In other words, it may be the case that the firm is not by definition an authority relation, but this does not prove that the firm exists without being dependent on authority. The dichotomy between firm and market is asserted in terms of their source or means of coordination. The distinction is between centralized planning and decentralized "spontaneous" coordination (Bylund forthcoming). Seen as opposite ends of a continuum, where we can think of the ends as spot market exchange (market) and integrated transactions in a firm (as noted by Williamson [2005]), most (if not all) forms of negotiated contracts are neither. Instead, they are intermediate, "hybrid" solutions for coordinating transactions (Ménard 1995, 2004, 2010).

As contract is core to the modern economy, and the foremost regulator of exchanges and a principal means for temporal and spatial coordination in the market, it provides a good starting point for analyzing coordination and authority. The question we henceforth address is essentially the same as noted earlier, but from the perspective of possible contractual relations rather than at the outset assuming an authoritative firm. We ask if contracts can establish authority and examine whether the firm as an authority relation can emerge without legal support.

## CONTRACTUAL COORDINATION AND AUTHORITY

A contract forms a binding agreement between parties with respect to specified variables (prices, quantities, etc.), thereby limiting their natural variability. The intent is to restrict the inherent uncertainty of the future and thus make specific expectations reliable—and provide recourse when regulated expectations are not met. In this sense, the contract limits the possible (or "allowed") courses of actions for the parties and thus effectively "restricts a person's actions" (Coase 1988b: 29). It thus constitutes an "abdication of choice," as Simon (1957a: 127) prefers to call it, by restricting or doing away with a person's future optionality. Yet the effect may very well be the opposite: it can be argued that mutually binding agreements restrict some choices but at the same time (and because of this restriction) facilitate greater optionality in others because they provide a situation characterized by enhanced predictability that ultimately enables new choices.

To the extent that contracts are entered voluntarily, the self-imposed restriction of a contract is of the same nature as any choice or decision made: the party bears its opportunity cost by not choosing alternatives. The economic cost of any choice is the potential value of the most valued forgone option. As individuals are expected to choose the course of action that they, at the time of making the choice, consider most valuable to them, the expected benefit always exceeds the expected cost. It follows that the contract, like any action, can be considered a burden only if conditions unexpectedly change in such a way that the benefits are much smaller than expected or are no longer realizable. Contracts are in this sense an institution that offers an extension through time and place to the concept of economic action, and thus allows parties to overcome problems that would otherwise be insurmountable. Contracts enable transactions through establishing mutually beneficial restrictions on parties engaged in economic exchange.

The reason contractual restrictions are valuable and have become a core component in the modern economy is that complex production processes in the specialized market, which rely on extensive social cooperation necessitated by and brought about through the division of labor, must be coordinated. Coase (1937) was in this sense perfectly correct to identify coordination of production as the bottom line of the functioning of the specialized market economy. He was also right in seeing a difference between "spontaneous" (bottom-up) coordination through the price mechanism on the one hand, and coordination by direction on the other. Yet as Alchian and Demsetz (1972) argue, the latter does not necessitate (or even imply) authority: coordination across tasks, in joint production, or of a complete production process can also be established through market contracts. In fact, the division of labor makes management a specialization and thus a tradable labor service (Robinson 1934), which means there can be a market for management as well as for the specific production skills of laborers (Fama and Jensen 1983).

The contractual subjection of labor to managerial direction or other types of centralized coordination can take several forms. For example, the construction of a new building depends on the coordinated contributions of numerous suppliers of specific services: carpenters, concrete workers, electricians, painters, and so on. Using the market contract, and thus relying on the price mechanism, as means for coordinating the construction process, an entrepreneur assumes the full risk of the project when contracting with independent suppliers of services to be coordinated. Doing so undoubtedly subjects the whole project to contracting (transaction) costs, especially since the individual services are interdependent with respect to the production of the building. As Coase (1937) notes, however, it is possible for the entrepreneur to write long-term market contracts with suppliers so that their services can be used at multiple construction sites. This makes it possible to account for unforeseen events such as delays, since suppliers can be "redirected" to sites where their specific services can be implemented. But while the entrepreneur employs (and his or her role thus represents) centralized coordination of the entire project, this is neither a firm nor an establishment of an authority relation. Contracting between the parties is still horizontal, even though we may prefer to see the individual entrepreneur, as coordinator of the construction efforts, as being at the "top" (by which we really mean the center). The next level of integration, still not so fully integrated as to form into a firm, would suggest more extensive contractual relationships between the entrepreneur, who acts as coordinator of the construction project, and the suppliers of specific services. Rather than establishing the terms for simple (though possibly repeated) exchanges, the contracts here establish more comprehensive collaboration and therefore "deeper" relationships between parties. These strategic alliances establish long-term coordination across the legal and economic boundaries between buyer and seller, and may subject the operations of each to limiting rules and perhaps common decision making and even requirements of unanimity for certain issues central to the alliance. The collaboration can be further strengthened through the creation of a separate entity that is jointly owned by the parties and is dedicated to carrying out transactions common to the parties.

Integration of these services under one roof, and thereby the formation of a single firm through a full merger, does not constitute much change to the previous types of contractually established and regulated relationships. Employment, to the extent we can consider it distinct from market contracting, may (or may not) include exclusivity requirements—but so may joint ventures, strategic alliances, and even market contracts establishing quantifiable terms for repeated exchange. It thus seems the firm's internal structure here constitutes no further authority than any collection of common market contracts, which corroborates Alchian and Demsetz (1972). Contracts restrict future options, but do so on a basis of voluntarism; and any such contracts are horizontal. Across the continuum from simple market exchange via different types of contract to the integrated firm (based on contract), there exists no basis for authority over and beyond the regulation of expectations through the specified list of binding agreements in mutual contracts.

## Hierarchy and Organization

In the construction example, the full risk of the project is assumed by the coordinating entrepreneur, who thereby acts as investor or capitalist and so claims the residual (profit or loss). But there also appears to be no ground for authority through contract, even if there is a centrally positioned coordinating agency. The question is then what the purpose (and, indeed, definition) of the firm is, other than a "nexus of contracts."

Alchian and Demsetz (1972) see the firm as a contractual configuration to regulate team production by providing coordinating and decision-making power to a single party who is also the residual claimant. But the construction example needs little elaboration to show that this can also be established through contracting in such a way that we do *not* generally refer to it as a firm. For example, we do not refer to a building contractor and his subcontractors as a single firm but as independent contractors collaborating on a construction project. The same applies or would apply to a school with subcontracted teachers, automobile or airplane producers with subcontracted parts manufacturers, or even a chain restaurant's headquarters and its franchisees. Neither do strategic alliances or the creation of commonly controlled entities (joint ventures) result in mergers of the original businesses; they remain separate "firms."

This points to an issue that Coase identified in his original article and that the theory of the firm literature has since attempted (but failed) to resolve. Despite the assertion of an authority relation, intended to provide support for the identification of the firm as "all but" market, Coase (1937: 392 fn. 1) notes that "it is not possible to draw a hard and fast line which determines whether there is a firm or not" because "there may be more or less direction" in the firm. In other words, he saw the possibility and use of directional authority of varying degrees both in the market and in organizations. Coase (1937) thereby hints at the view of the firm as but a nexus of contracts as championed by Alchian and Demsetz (1972) and Jensen and Meckling (1976), which suggests an inherent contradiction in Coase's thinking: the firm cannot be both distinct from the market as exemplified by being organized by authority *and* without a "hard and fast line" separating the firm from the market. If authority (direction) permeates the economy, though perhaps at varying degrees of pervasiveness, then it cannot be the definitive explanation for one of two distinct and mutually exclusive means of coordination. Yet perhaps this is the problem that Coase originally identified and attempted (but perhaps failed) to "bridge" in his original article: that directed coordination is brought about but relies on two very different means.

If we adopt this view, which is undeniably compatible with Coase's work, coordination emerges as simply the process by which a specialized production process is organized or put together. This type of organizing is in itself unspecific, but can take formal or informal forms and rely on horizontal or vertical structures. Informal coordination or organizing of production translates into undirected, "spontaneous," bottom-up market exchange and trade, which is similar to Coase's and other theory of firm scholars' identification of the market as lacking direction. The difference between horizontal and vertical relationships fades, however, as we recognize how informal organizing or coordination of production processes must be brought about by voluntary exchange and contract. Contracts can distribute or even centralize decision-making power, but are fundamentally voluntary agreements that parties enter into for their mutual benefit. We have previously seen how contracts can establish both strictly horizontal and seemingly vertical relationships, and any possible alternative arrangements along the continuum between these end points. Without external coercive powers in addition to what is voluntarily agreed to, however, the contract remains a horizontal agreement regardless of specifics of the arrangement. In other words, while the outcome of informal coordination through contract may indeed appear vertical or hierarchical, its origin and basis is strictly horizontal.

Our distinction suggests that formal coordination could also take two forms: it can be either vertical (hierarchical) or horizontal, both of which could be denoted firms due to their formal organizing. Contemporary theories of the firm target almost exclusively the vertical or hierarchical form, and predominantly rely on legal explanations for it. The relative absence of a discussion on horizontal organization can partly be explained by the all but universal reliance on the asserted firm-market dichotomy, and partly on the empirical structure of the contemporary market. The latter can perhaps be explained by the evolution of laws supporting and regulating the market (Jensen and Meckling 1976), but should have many potential explanations. One can easily formulate arguments based on for example the central role of coercion (through the state) in modern society, as well as historically determined path dependency or privilege.

Nevertheless, there is a limited literature on formal horizontal organizing through cooperatives (see e.g., Chaddad and Cook 2004; Cook and Chaddad 2004; Hansmann 1999; Holmström 1999), mutual networks, and nongovernmental institutions (North 1990; Ostrom 1990). While this literature shows interesting solutions to problems of lacking coordination in the market, it is often tainted by potentially distortive legal aspects of organizing in the same way as that on the theory of the firm. A cooperative, for example, enjoys certain legal privileges that on the one hand can increase the organization's viability and on the other restricts possible alternative solutions, agreements, and organizational experimenting.

The common perspective adopted in these literatures is the focus on governance or structuring of the organization's operations. The theory of the firm literature generally assumes a hierarchical structure similar to that of the modern corporation (for a discussion on this, see Chapter 3 in this volume) that is determined and administered by managers, while the literature on institutions and cooperatives studies the problems arising due to its common governance, such as the inefficiencies and potential conflicts of direct democracy, and attempted solutions through statutes and bylaws. The object studied is commonly the formal rules themselves rather than their function, distinctive significance, or economic origin.

This partly diverts our attention, however, since studying the governance of cooperatives misses the point. Cooperatives are often formed to administer commonly owned means for providing a necessary service that is otherwise potentially unattainable. A milling cooperative is but a mill that is commonly owned (and administered) by the member farmers utilizing it. The function of the cooperative is in this sense primarily a cost-saving mechanism through sharing of a capital-intensive service; it is in many respects similar to a political body (such as a village council) and suffers from the same problems. Its purpose is not economic production—this is the aim of *its members*—but to provide members with access to equipment, services, or processes that are underutilized and thus prohibitively costly if not shared.[1] It provides resource access to member producers but lacks the type of coordinative function provided by the price mechanism: the milling cooperative coordinates the flour production process in the same sense and to the same extent that an industry association coordinates member corporations' production or a labor union coordinates the productive efforts of its members. It is quite distinct from coordination of productive processes or allocation of resources across tasks.

Nevertheless, the cooperative is problematic from our point of view since, if we choose to see it as an economic organization, it is formal and may appear vertical with its executive and advisory boards and governing council. But, at the same time, the cooperative consists solely of its equal and horizontally cooperating members who include the cooperative-administered productive resources in their individual production processes. Much like the crew of a pirate ship, the members of a cooperative elect their "captain," but the elected is not charged with extraordinary or governing powers. He or she is an appointed caretaker of the commonly owned resource and subjected to the members' will (Bylund 2010; cf. Leeson 2009). This, by no means, constitutes authority of the vertical-pyramidal type associated with firms.

This brief discussion on cooperatives illustrates the difficulty of comprehending a formal entity that is horizontal rather than vertical or hierarchical. The concept of formal economic organization implies the existence of a common, formal governance structure and thus a means for shepherding its resources. There must therefore be some form of *centralization* in ownership or decision-making power; but we have also seen that this does not necessarily denote hierarchy in the common sense of the word. As we have seen, it is difficult to produce an argument for the existence of an authority relation in the firm (or, if we accept the common assertion, find its origin). If the firm is "authority," then we must also identify authority in market contracts and even in making choices. But this strips the word of all meaning. The question thus remains: if the firm does not compose an authority relation, what is it? And correspondingly, if we disregard firm legal mandates, and impacts thereof, what is the purpose of the firm in the market?

## Is There a Role for the Firm?

Interestingly, Coase developed his original transaction cost view of the firm and the market in contrast to the then-prevailing view that the firm was characterized primarily by superior productivity due to its internal structure (Bylund forthcoming). The latter view can be traced at least to Adam Smith's *Wealth of Nations*, in which he notes how productivity at a pin factory improves when the work is divided "into a much greater number of parts" (Smith 1976: 8–9). In the same vein, Karl Marx notes in *Capital* how the division of labor in society and in the firm "differ not only in degree, but also in kind" (Marx 1906: 389). Indeed, the firm's division of labor "reacts upon and develops and multiplies" that of society and, consequently, the market (Marx 1906: 387–388).

This "classical" view is the theoretical approach that Coase (1937) challenged by focusing on simple cost comparisons. With the modern theory of the firm that later emerged, the economic analysis of organizations came to focus exclusively on costs and the comparative institutional analysis that Coase introduced. Across the board, from the transaction cost view to the "nexus of contracts" or "legal fiction" view, the theory of the firm focuses on costs rather than productivity. It therefore constitutes a distinct approach in which the economic analysis of complex productive structures (i.e., their composition and economic meaning) is generally neglected.

Only recently has the productivity aspect of organizing reemerged in the study of the firm, primarily due to scholars working in the Austrian school of economics (Bylund 2011; Foss and Klein 2012; Foss, Klein, and Bylund 2012; Lewin 2011). Partly building on the classical theory of economic organization, these scholars identify that there may be sufficient rationale to establish formal organization for the purpose of realizing innovation. The argument notes that the market is indeed efficient in allocating resources (as Coase also acknowledged), and that its rational bottom-up, price-based allocation of resources works well for already existing goods and services. But it may therefore be a poor facilitator of previously unseen products or production processes. Entrepreneurs imagining and seeking to realize profit opportunities outside the realm of what can easily be procured in the marketplace must work outside the limits of the existing market and must therefore themselves establish the means. In other words, products or processes that are dependent on skills, routines, or resources that are not available in the market, or where new modes of production must be developed, are realizable only under radical uncertainty (Knight 1985). Neither the details nor specifics of the imagined innovation can be fully foreseen, and therefore entrepreneurs may be better off establishing separate "islands" of specialization where problems can be teased out through controlled experimentation and what Foss, Foss, and Klein (2007) call "proxy-entrepreneurship."

The firm here emerges as a means to overcome or sidestep the limits of the market. It requires an upfront investment of sufficient magnitude to acquire resources and reimburse labor while the specifics of the process, routines, and service or product are sufficiently worked out and the necessary means of production are developed. The capitalist or entrepreneur bears the uncertainty of the entire project through his or her initial (and any additional) investment, and therefore claims profits and bears losses. While the firm is purely contractual and thus does not entail an authority relation, it is distinct from the market by being internally organized according to a different principle and utilizing a different (more intensive) division of labor. The boundaries of the firm are represented by the different degrees and kinds of division of labor that exist within the firm and in the market, respectively. In this sense, the firm can be analyzed as a distinct phenomenon while being embedded in and dependent on the state of the market.

It remains to be seen whether this new approach to the firm as a market institution that facilitates entrepreneurial innovation will gain influence in the literature. It is interesting to note, however, that it does not rely on any assertions about the specific nature of the firm's internal organizing—only that the firm is in fact different (and thus distinguishable) from the market. This is an expected consequence of an approach that views the firm as the entrepreneur's (or entrepreneurs') vehicle or means to coordinate novel, imagined, and yet-to-be-realized production processes; it must itself be open-ended as entrepreneurs' imagined production structures and supporting organizations cannot be foreseen. As resources and competencies for novel production processes must be created, contracts must be open-ended and unspecific. But while the theories of the firm discussed earlier may derive authority from this, a profitable firm-as-implemented-innovation is completely dependent on the particular (indeed, unique) competencies and knowledge of the laborers and resources developed internally. As there is not yet a market for these services, the entrepreneur is equally—if not more—dependent on his or her employees as they are on the entrepreneur. The authority relation, therefore, may in this sense be thought of as bi-directional if we derive authority from contractual relationships.

## NOTES

1. Our focus here is economic production and efficiency, and we therefore disregard cooperatives organized for political reasons or to enhance the social bonds of a community. We also disregard other formal organizations that are not primarily economic in purpose or function.

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# Part 3

# Freedom, Contracts, and the State

Chapter 5

# Contract, Freedom, and Flourishing: The Implications of Spain's Mondragon Cooperatives

Gus diZerega

## Part I. Thinking Clearly about Contracts

Historically, libertarians and other advocates of unregulated markets have argued that freedom of contract and secure property rights generate prosperity that lifts all boats toward greater wealth and well-being. This outcome seems to come from the logic of a contract: each party has something desired by the other and, upon making the exchange, each ends up with something that is more valuable to them than what they gave up. Everyone gains. At this abstract level the logic is impeccable.

But real people are not abstractions. Every exchange they make exists within a concrete context that combines their personal qualities with their historical situation in a certain society at a certain time. In addition, any given exchange occurs within a time frame where its results reflect the context in which it occurred and influence what comes next. Looking at contracts at very high levels of abstraction is a good way to have very little of value to say about them.

Contexts are partly unique to each exchange. But only partly. They also reflect patterns of resource ownership preceding a particular exchange and the legal framework within which it is made. Additionally, even assuming no mistakes of evaluation by either party, each exchange leaves both in different positions regarding their abilities to make additional exchanges. For example, the consumer who pays money for a product is more constrained in future exchanges than is the person who sold it because money is more fungible than a car, computer, shirt, or gallon of milk. Both gained from the exchange, but the gain from one was increased capacity for a wide range of future exchanges while the other ended up with a narrower range.

In other words, in isolation the abstract logic of exchange can be a poor picture of what actually takes place in market contracts. Nowhere is this truer than when people exchange their "labor power," or time, for a wage.

To explore this point more deeply I will start with an example of the most abstract possible framing of an 'exchange.'

### Example 1

I am walking along a deserted street when a mugger threatens me: "Your money or your life." I give him my money. At the end of the exchange we are both better off than if I had declined it. He has the money and is not guilty of murder, and I have my life, which otherwise would have been forfeited. Economists would say, and I agree, that this is a bad example of a contract because it was not mutually voluntary. But *how* was it not voluntary? I was not physically held down and my wallet taken. I reached into my back pocket and gave it to him. In a different context the same act would have an entirely different meaning, for example an act of charity.

In the case of the mugger it was the *context* that made the exchange a coerced one rather than any actual coercion. The context was that if I had not made the exchange the mugger would have done something that threatened my well-being, something he threatened only to convince me to make the exchange. Minus the threat, no exchange would have taken place.

### Example 2

My property was lost in a war or natural disaster and you offer me and my family food and shelter, but only if I become your slave. My alternative is probable starvation for my family and myself. I might well make the deal. My loved ones and I are better off because we are not starving to death.

My "owner" is better off because he has a slave. Is the contract a voluntary one? Many libertarians would say yes (Nozick 1974: 333). I was rendered propertyless as a result of aggression or other circumstances beyond my control, and someone took advantage of my misfortune to exact a very high price for staying alive. But it was one I willingly paid. The other party did not act aggressively, but only took advantage of an opportunity to make a formally voluntary exchange.

Some libertarians and classical liberals would agree that this contract is invalid. They would argue that we cannot sell "ourselves." There are two dimensions to this argument, and both weaken this orthodox libertarian case against slavery. First, if we cannot sell ourselves what happens to the prime libertarian principle that we "own" ourselves? Ownership implies what is owned can be alienated because ownership is not the same as being identical to something. We do not control our "selves" as we control objects, we *are* our "selves," considered as centers of focused awareness and choice. The libertarian argument of self-ownership breaks down at its inception.

Setting that problem aside, another one arises. For thousands of years slaves were bought and sold between willing buyers and sellers. In the antebellum American South there was a market price for slaves that arose the same way a market price existed for horses and cotton. But "selves" were not bought and sold. Slaves were.

In a very real sense what constituted slavery did *not* include ownership of the core "self." Slaves were never property in the way a horse was. If my horse kicked you, I was liable. If my slave kicked you, the slave was liable. The slave owner did not own the slave's "self," he or she simply owned all that could be owned.

Owning property is not an all or nothing issue. We know today that property rights are a bundle of discrete rights. That is why I can own (legally) a house to which I have sold the right to live for a specified time in a rental agreement. When I rent a car the company gives up control over it during the time of my rental. For all practical purposes I "own" the car, so long as I act within the contract's terms. But the company still owns some of the rights to the car and will eventually have them all.

Given this fact, there is no logical barrier in my selling you control over me except for my inalienable personal responsibility for my actions, including those that hurt others. This quality is not mine to sell. It is an essential part of who I am. But in practice slavery has always recognized this fact. In other words, the argument by some libertarian and classical liberal Austrians against slavery does not have the weight they think it has. *Every quality of how I act other than my moral responsibility can be defined and given over to legal control by another*. If this happened the result would be slavery. In practice this is what slavery was.

Many advocates of "free markets" would be discomfited by this argument, but its flaws cannot be derived from any abstract principles of property and contract. For many it is the *context* of external necessity that leads a person to subordinating themselves so completely to another that bothers them. In addition, if property ownership consists of a bundle of rights, that bundle is limited by what can be considered *appropriate* rights to ownership. Such control over another might not be considered appropriate. Some things are appropriate with regard to objects, but not to subjects. For example, many societies consider the right to torture an animal as not one of the rights in a bundle of appropriately owned rights. But in every society I can legally break my pencils. Property either exists *within* some ethical conception of appropriate relationships or it is simply an exercise in, as William Blackstone (1979 [1765–1769]) defined it, despotism (see Steinberg 1994: 13–14). Yet again we return to the importance of context.

Let me now add a slight modification.

## EXAMPLE 3

Consider the same conditions holding as for my second example, but slavery is illegal. I cannot sell the entire bundle of rights that can theoretically be sold. Therefore, to preserve my life and the lives of my family, instead of being a slave I must sell a smaller bundle: to be that person's servant for fourteen hours a day, doing any and everything I am commanded to, for a term of forty years. During this time my "boss" controls with whom I can talk, when I can eat, what I can read, and how I spend my time. Further, my contract binds me to a term I cannot legally break. But even if I could get out of it, I do not have the time to look for other alternatives nor am I able to accumulate enough wealth to quit in order to look for a new job and still feed my family.

I am close to describing many modern day employment relations, especially under conditions of high unemployment, except that today the hours are usually shorter. They once were not, and continue to be in the developing parts of the world, such as China, India, and Bangladesh. There is little real difference between slavery and this not-so-hypothetical arrangement except that at the end of the allotted time for my workday I am free to feed my kids, wash up, and go to bed as a "free" man. *Formal equality can mask enormous inequality and the resulting imposition of something very close to private despotism under the rubric of free contract.*

A traditional Austrian or other classical liberal might respond that the relationship remained voluntary because I am free to quit. But that freedom, important as it certainly is, requires viable alternatives to make any real difference. Each person's practical freedom is greater the more attractive the available alternatives. By the same token, the fewer such alternatives the more practically constrained their freedom becomes, no matter how great it is formally. Again, *context matters*.

## The Vexing Issue of Equality

Let's approach this issue from another direction. What would a truly voluntary contract among concrete as well as formal equals look like? It might resemble something approximating the following:

- Each person has something the other would like to have.
- Each person can get along reasonably well without what they desire from the other.
- Each person has other options that, while not as desirable as what they hope for from dealing with one another, are not regarded as deeply undesirable.

In such a case any exchange between parties will leave them both better off and be fully voluntary *in contextual as well as formal terms*. For example, for many years I sold my artwork on stationery, envelopes, and note cards. The money I made paid for my dissertation research as well as other things. My customers had many alternative sources for cards and writing paper. I had many customers, none economically crucial to me. In any given case each of us hoped to gain from the exchange but in our own estimation neither of us would be seriously impacted if we did not make the exchange. We were equals insofar as the word can apply to a concrete relation between human beings.

The further we get from this ideal the further away we are from a fully voluntary relationship. In other words, again, *context matters.*

Against my argument some people will contend that once we depart from purely formal legal definitions of equality the term becomes too uncertain to have real meaning. Indeed, if people were concretely equal in every respect they would all have the same attributes and things, and there would be no need for any exchanges at all.

Considered at the concrete level equality is only a rough guide to ideal relationships among adults, a useful approximation, because most relationships are only possible when some kind of inequality also exists so both parties gain by entering into them. About the only exception I can imagine is when people need one another for company because they are lonely.

Once we begin discussing concrete relationships the term "equality" easily becomes a source of confusion. It is best reserved for describing purely abstract relationships. *But this does not make the issue of what constitutes noncoercive relationships go away, because coercion itself is not an abstract concept.* Its definition *requires* considering context.

## The Nature of Coercion

Physical violence can be coercion, but not always. Two prize fighters in a contest are seeking to inflict physical damage on one another, but violent as the fight is, it is not coercion in *this* legal and ethical sense. It is the context of unwillingness on the part of one that makes violence coercive. For violence to be coercive *and* unjust the one being coerced must be justified in their unwillingness. They must be a victim.

What about the *threat* of violence, as in my mugging example? Most would agree it is coercive because of the context of threat. But what are we to make of the following possibility? I am walking along a deserted street and a number of people surround me on all sides. One steps forward and demands my wallet while the others take smaller steps in my direction. No weapon is displayed nor is an explicit threat made. As the recent spate of "stand your ground" killings demonstrates, "threat" is anything but an impersonal objective issue. Nor need it necessarily involve physical violence.

We can carry this point further. Consider a person threatening to fire a woman if she does not grant him sexual access, when that woman has a family to feed and unemployment is high. Many of us would properly consider such a threat coercive. Yet in different contexts we would, most of us, agree an employer has the right to fire an employee.

Sustained verbal abuse can have a catastrophic impact on children. In some cases it can drive a child to suicide and in others leave lifelong scars impeding the child's ability to live a fulfilling life. Sometimes it leads him or her to repeat the pattern on his or her own children. By definition, abuse inflicted on another is coercive, and if the victim is not free to leave it is even more so. Whether coercion is done physically or by other means is a secondary issue.

"Violence" and "coercion" are complex terms bleeding off into non-physical realms where the dividing line between what is and what is not coercion or violence is not clear. That is why the *recipient's* experience is so important. But significant as it is, it is not all-important. In addition, we often add the term "physical" to violence in some contexts, "verbal" in others, and "psychological" in still others. In all these cases whether it qualifies as aggression against another depends on the context in which it takes place.

Among Austrians these insights could have been built upon long ago for they were compatible with the work of Carl Menger. He explicitly recognized not all contexts for "free" choice were the same (2007 [1871]: 122–123). Sadly the increasing insistence on the impossibility for making "interpersonal comparisons of utility" prevented many Austrians from exploring this rich area of understanding. This was particularly true for Austrians seeking to develop a "praxeological" approach to economics (Mises 2010; Rothbard 2009). If we take Mises and Rothbard's arguments seriously, praxeological economics has nothing at all to say about whether well-being is increased or decreased by any act of coercion or violence against *any* number of people. It is useless.

## Flourishing and Labor Relations

Exchanges and contracts are not desirable because they exemplify formal equality or are formally voluntary. They are desirable because of their capacity to enrich lives and increase people's well-being. Robinson Crusoe was free when alone on his island, but he and almost anybody else would quickly give up this freedom for rescue and subsequent immersion in a society far less free but more conducive to flourishing. *We—as a people—are trying to maximize flourishing, not merely equality or freedom alone.* Freedom is valuable as an essential component of flourishing, but not as an ultimate good in itself. The same is true for equality. No one wants pure freedom or pure equality, standing alone on Crusoe's island.

In appropriate contexts the freedom to make voluntary contracts expands the opportunities for flourishing to all parties involved. In Hayekian terms, in this regard the market is a discovery process superior to all others. But some contexts do not work out this way and "free market" thought has great difficulty recognizing them because so much of it is stuck at the level of purely formal reasoning, blind to the realities of human existence.

In a recent critique of orthodox libertarian thought, I pointed out that "many workers are seeking a few jobs and so a few employers have their choice among many workers. For all too many people, exercising power over subordinates is enjoyable. Were it the other way around, working conditions would be very different" (diZerega 2013b: 97). With greater equality than is the norm today, leaving a bad job would be easier or hiring a replacement employee would be more expensive. Movie and music stars and good professional athletes stand in a reversed position to most every other employee. They can demand greater salaries and perks than almost anyone. Inequality of bargaining positions can cut both ways, but it rarely does. The rarity of these alternative examples proves the rule.

This practical inequality in contractual relations can and does have tragic consequences without violating *any* principles of formal equality in contractual status. For example, in 1911, seamstresses were locked in their place of work at the Triangle Shirtwaist Factory. They could not leave until the workday was done. When the building caught fire, the inadequate fire escape collapsed and there were only 27 buckets of water to put out the fire. A total of 146 girls and women, most age sixteen to twenty-three, died horrible deaths. The owners were not convicted of manslaughter, as they should have been. They ultimately lost a civil suit in which plaintiffs won $75 compensation per deceased victim. The company's insurance paid the owners about $400 per casualty (diZerega 2013b: 100).

These immigrant girls and young women died because the context of external necessity they confronted led to their "voluntarily" giving up so much freedom that ultimately they died, imprisoned in what had become a death trap. As similar events continue to occur in newly industrializing countries we see that the issue is not culture, it is how power can manifest in the market.

Authority relations in industry are one of the largest blind spots in so-called free market thinking. By defining freedom and coercion to eliminate context, free market thought blinds itself to comprehending many examples of coercion and violence. It also ignores many possible routes to greater freedom and well-being. In other words, it injures itself at both ends, defending serious exploitation and coercion while ignoring much of what freedom and contract can accomplish.

## PART II. RETHINKING THE ISSUE: THE MONDRAGON COOPERATIVES

Markets play an essential role in maximizing the possibilities for human well-being, but not in the way orthodox free market thinking imagines. In 2012, I was part of a group that traveled under the auspices of the Praxis Peace Institute to Mondragon, Spain, in Basque Country. We were the latest in a series of groups the institute regularly sponsors to study the most impressive example of worker cooperatives in the world today. This example should deeply interest anyone concerned about the relations between markets and human well-being. But first a few revealing facts:

- The Mondragon cooperatives have almost 90,000 worker-members engaged in high-tech and traditional manufacturing, banking, retail sales, housing, education, social services, and agriculture.
- Management within each cooperative is chosen from among its worker-members *by* the worker-members. To be a part of the Mondragon system top management can never be paid more than six times the lowest paid wage in that particular firm.
- Today there are more than 120 Mondragon cooperatives. In all its history only two have failed, and one of those after more than fifty years of success.
- When the Mondragon cooperatives were started the Basque region was the poorest in Spain. It is now the country's richest.

The Mondragon cooperatives constitute eloquent proof of how free people within a contractual regime and market economy can create prosperity for themselves, their children, and their region. At another level they constitute a powerful critique of the intellectual, moral, and historical poverty of almost all free-market thought dealing with employment relations.

### A BRIEF HISTORICAL OVERVIEW

The Mondragon cooperatives are contractual market institutions. Although they arose within Falangist Spain and endured the Franco dictatorship, they were established entirely through bottom-up initiatives within the Basque region, which had been largely ignored by the central government. Their organizing values were based on Catholic social theory that placed economic activity within a larger moral universe rather than, as is so often the case today, seeking to reduce all social life to economic concepts. This alternative outlook emphasized labor's primacy over capital and held that enterprises should be governed by those who work in them. Pope John Paul II (1981) summarized this outlook:

> A way towards that goal could be found by associating labor with the ownership of capital, as far as possible, and by producing a wide range of intermediate bodies with economic, social, and cultural purposes; they would be bodies enjoying real autonomy with regard to the public powers, pursuing their specific aims in honest collaboration with each other and in subordination to demands of the common good, and they would be living communities both in form and in substance, in the sense that the members of each body would be looked upon and treated as persons and encouraged to take an active part in the life of the body.

The moral and intellectual "spark plug" for Mondragon's development was a parish priest, Fr. Jose Maria Arizmendi. Today he is widely recognized in Basque Country as responsible for Mondragon's existence and for many of its most impressive achievements. Despite his remarkable accomplishments Fr. Arizmendi remained a parish priest until his death in 1976.

The Basque region had a long historical and cultural connection with cooperatives, but this connection had been largely destroyed during the Spanish Civil War. The "Mondragon miracle" began in 1943 when Fr. Arizmendi founded a "professional college," really a small local institution that trained engineers as well as instilling the values of Catholic social theory. Its first class of twenty graduated in 1947. The graduates had a hard time matching their values with the traditional employment opportunities they encountered, and in 1956 five founded a small factory for producing paraffin stoves. They organized it as a workers' cooperative.

The factory prospered, and by 1958 had 143 members. They also started assisting the creation of other workers' cooperatives. In 1959, at Fr. Arizmendi's urging, they started a savings bank, Caja Laboral Popular (Bank of the People's Labor). This bank was also a cooperative governed by its founders as well as its own employees. David Ellerman interviewed one of the men who was an original founder of the bank: "We told him, yesterday we were craftsmen, foremen, and engineers. Today we are trying to learn how to be managers and executives. Tomorrow you want us to become bankers. That is impossible" (Ellerman, 1982: 6).

Creating Caja Laboral, (now called Laboral Kutxa) was a crucial step for the Mondragon cooperatives. In banking terms it was a success, for Laboral Kutxa is now the seventh largest bank in Spain and in better economic shape than many of the others. But its greatest importance lay elsewhere. It enabled Mondragon to become self-financing. In addition, the bank was the first of what are called second-tier cooperatives, cooperatives able to perform a variety of services for member cooperatives that are too small or specialized to do for themselves.

In some ways like a credit union, the difference is that control rests with member cooperatives, not depositers, and also with those who work in the bank (Ellerman 1982: 22). This principle has applied to all subsequent second-tier cooperatives.

## Property Rights and Personal Rights

Political theory sheds more light on why the Mondragon cooperatives have succeeded than does economic theory because political theory (except when impoverished by subordination to economics) deals with the whole person rather than fragmenting individuals into categories, such as consumer, worker, and entrepreneur. To the concept of property rights, political theory adds personal rights, a crucial distinction I first encountered in Ellerman's work. Some personal rights are inalienable, as Jefferson emphasized, others are contextual. Mondragon is an example of contextually defined personal rights. So is citizenship.

In traditional businesses control is a property right, separate from the person, and so is able to be sold or given away. Businesses typically arise from people taking advantage of entrepreneurial opportunities within a context of contractual private property rights. They combine land, labor, and capital as factors of production to create products. When entry by competitors is open, consumers benefit. If profits are high, others are attracted to compete and drive prices down. This perspective seems so obvious to us today that it is rarely questioned. Joseph Tuck, the CEO of California's Alvarado Street Bakery, which is organized along Mondragon's lines, explained to me that "Nobody owns the cooperative." The term "cooperative" is misleading, and grasping this took me a while to understand. David Ellerman has done the most to clarify this issue: "A workers' cooperative corporation is a democratic work-community, an industrial democracy which assigns membership rights to the people who work in it just as a township or municipality is a democratic living community which assigns the voting rights to the people who live or reside in it" (1984: 261). To clarify the distinction Ellerman writes, "One acid test to distinguish between personal and property rights is . . . inheritability. . . When membership rights are personal rights assigned to a functional role, the rights are extinguished when a person ceases to play that role" (1984: 261). Mondragon and other workers' cooperatives cannot be understood in terms of property rights. Purely economic categories can't enable a person to understand the Mondragon system.

Perhaps this is why it took men in an obscure and impoverished part of Europe, inspired by a priest whose focus was ethics rather than economics, to develop the Mondragon model (Ellerman 1982: 13). Its creation reflects thinking outside the traditional theoretical box.

Fr. Arizmendi and the initial worker-members who created the first Mondragon cooperative avoided a fatal mistake: using traditional concepts of property rights to structure ownership and the powers and responsibilities that go with it. Traditionally a cooperative was considered analogous to a corporation, except that no one could own more than one share. As in a corporation, voting power and all aspects of ownership were located in who owned the shares. If a cooperative prospered, shares grew in value. As shares increased in value future worker-owners were priced out of the market (Ellerman 1984). Further, workers might want to deplete current profits, leaving inadequate financing for the company's future.

These problems do not exist for Mondragon and similar cooperatives.

## Citizenship Over Ownership

Once accepted to a cooperative, a worker is a member only as long as he or she works there. If a worker retires or goes to work elsewhere he or she loses the right to vote and the right to a share of the cooperative's net future profits. The cost of their share is refunded. While this arrangement is like being a member of a democratic community, property rights do play an important if secondary role.

The worker's share of the cooperative's net profits is paid out in a way resembling a wage. Like a wage it will not necessarily increase in an unusually profitable year because higher profits are often reinvested back into the company. In lean years members often vote to reduce their "wages" to enable the company to survive hard times. In normal to exceptional years, profits that exceed what is paid to workers as "wages" ultimately return to workers by another route, as property rights. Worker-members accrue a portion of the company's net worth, based on the length of time they are involved. When a new member buys in they immediately begin accruing value from their portion of the capital accumulated during their membership. It is banked in what is called an internal capital account. But he or she only receives this portion when no longer a member, usually upon retirement. Should a worker die, this account becomes part of their estate. Like any property right, it can be transferred to another member. During the worker's time in the company, increases in capital value are kept within the enterprise to be used for business needs. When they retire they receive their accrued portion *over and above their pension*.

Because the American legal framework is different from Spain's, in the Alvarado Street Bakery each year workers receive their portion of the company's net worth above that going to maintain the enterprise. Again, their portion is based on hours worked rather than on monthly income. In 2013 this portion averaged $18,000 on top of a "wage" averaging $68,000. Joseph Tuck explained that many workers received a greater share of this income than he did even though he was the CEO, because they put in more hours.

In either the Spanish or the American case, by having membership rights attached to *work,* as personal rights, but property rights to accrued capital attached to the *person* working, Mondragon and Alvarado Street solved the problem of future workers not being able to afford membership in a successful ongoing enterprise. No worker has to come up with the enormous amount needed to buy in, and every worker benefits when their company does well.

Within the Mondragon cooperatives, shares cost approximately $5,000. If the prospective member cannot afford this sum they receive it as a loan from Caja Laboral, paid off by regular deductions from income received while working. The interest rate is at a very low percentage, sometimes zero. This way shares can be kept substantial enough to be taken seriously, but remain affordable. It guarantees "skin in the game" but not the worker's entire pelt.

Not everyone who works wants the responsibilities and risks of ownership. A small number of workers can be regular employees rather than members. They get a wage, can be laid off, and do not have the responsibilities of membership. Among such workers are those whose specialized skills enable them to receive higher wages than the basic ratio set by the cooperative. But in such cases they are not allowed to join. Their higher wages must also be approved by the workers as a whole. In the Mondragon cooperatives, the maximum number of nonmember workers allowed is 5 percent of the total workforce.

This unique form of ownership provides the first "leg" of what people at Mondragon sometimes call a stable table of four legs that make a cooperative society possible.

### Second-Tier Cooperatives

The second leg is the second-tier cooperatives, such as Laboral Kutxa. Organized by pure worker cooperatives, second-tier cooperatives provide a wide range of services to the worker cooperatives as a whole. They include financial services, social security, medical care, education, and research and development. Second-tier organizations are also organized as cooperatives with membership split between those who work there and the Mondragon cooperatives as a whole. In Caja Laboral and other second-tier cooperatives, (along with agricultural and consumer cooperatives) the principle of staff self-management applies; traditional employee-employer relations are absent.

To a large degree second-tier functions provide the equivalent of the public values supplied by traditional democratic political systems. Public values are those that members desire to be provided in greater quantity or quality or with more accessibility than would be the case if their provision were left solely to the whim of market forces. National parks and public health organizations are clear examples of public values in the American context. Second-tier cooperatives demonstrate successful and attractive alternatives often exist to both governmental and traditional private sector institutions. That these successes have received so little attention from scholars and journalists is a comment on the ability of orthodox economic theory (Austrian or otherwise) to ignore what does not easily fit its abstract categories.

### The Socialization of Entrepreneurship

The third leg of the table is the socialization of entrepreneurship. One of Mondragon's most important innovations was creating an entrepreneurial division to institutionalize founding new cooperatives. Early on, Caja Laboral's lending power combined with this entrepreneurial organization to vastly increase the presence of worker-cooperatives in the Basque region. Among Mondragon style cooperatives, in more than fifty years there was only one failure, a success rate for new business endeavors that dwarfs that in the United States, where 51 percent of new businesses survived five years and only 26 percent survived at fifteen or more (SBE Council 2014). Today there are over 120 workers' cooperatives within the Mondragon system, with over 80,000 members.

Virtually every dimension of a market economy, including industry, education, housing, agriculture, and retail marketing, is successfully accomplished within a Mondragon-style organization. The all-too-common image of entrepreneurs as somehow radically different people than those who provide "labor" is demonstrably wrong. To pick one example from Austrian theory, Mises wrote to Ayn Rand in 1958: "You have the courage to tell the masses what no politician told them: you are inferior and all the improvements in your conditions which you simply take for granted you owe to the effort of men who are better than you" (Mises and Rothbard 2007: 11). It was false when he wrote it and still is today.

Had Austrians paid more attention to context and not focused simply on the most abstract levels of analysis, perhaps such serious, even catastrophic (and, I would argue, immoral) errors in understanding society and human beings could have been avoided. Markets can manifest in many different ways, some far more humane and successful than the dominant American and similar European models.

## Education

The workers who founded the first Mondragon cooperative had been students at the small engineering college Arizmendi founded. This school taught basic engineering skills but it also emphasized the Catholic social philosophy Arizmendi believed could liberate Basque working people. The cooperatives were formed once graduates learned that traditional employers were uninterested in this approach to labor. Absent any awareness of these alternative possibilities workers were trapped in the formally contractual but deeply coercive relations exemplified by traditional bosses and their employees.

Today the Mondragon cooperatives provide education from the earliest years through the university level. They are seeking to make their values a part of the common cultural heritage of their country. The success of the Mondragon system is evidence is that they are succeeding. In addition, as the problems with capitalism become increasingly obvious, attentive observers around the world are beginning to examine these accomplishments.

## Keeping Power in the Workers' Hands

As Americans now know, formally democratic institutions can become so dominated by undemocratic organizations in and out of government that many of the most important political decisions and policies are insulated from normal democratic processes. In addition, as many formally democratic labor unions demonstrate, often their leadership becomes insulated from member control in the phenomenon often described as the "iron law of oligarchy" (Lipset, Trow, and Coleman 1956). Michels's iron law has a small number of exceptions, leading Giovanni Sartori to suggest that if it is not quite iron, it is at least bronze (1987: 149). The Mondragon cooperatives can now be added to the very small number of exceptions, and numerically they are by far the largest. They have avoided this fate even though they are now approaching sixty years of age and have more than 80,000 members. How do they accomplish this?

Ultimate authority is the general assembly of workers. The assembly elects a board of directors for four-year terms, staggered every two years. In addition, a management council serves as an interface between board and management. But historically, institutions such as these have been unable to prevent management from becoming a powerful independent force within ostensibly democratic organizations. However the Mondragon cooperatives have two additional institutions that appear to be successful in preventing this degeneration.

- The Watchdog Council: This institution can obtain, monitor, and verify financial information and any other information requested by the general assembly. Unlike what happens to share owners in U.S. corporations, it helps keep members' independence from being controlled by the board of directors and management because they *must* divulge any information requested.
- The Social Council: Members elected to this council are from within small sections of ten to twenty workers. It possesses advisory power over personnel affairs and binding power on safety, pay scale, and social welfare issues. In 1982 the greatest pay difference between the lowest- and highest-paid members in a business was 3 to 1. Today it is 6 to 1. In the thirty-year-old Alvarado Street Bakery it is 3 to 1.

Today the pay gap between top management and that of the lowest paid employee in American publicly held corporations is many hundreds to one. In some cases 500 to 1. Yet research indicates there is no apparent gain in managerial performance when incomes rise so high (White 2012). Unlike Mondragon, large public corporations appear no more immune to Michels' famous "iron law of oligarchy" than other large organizations, from labor unions to political parties (diZerega 2014).

In many ways the watchdog and social councils perform the functions of a trade union, but in an institutional setting where the interests of the workers and the company are the same. Interests are harmonized rather than divided. At the same time they provide a check on the results of management's interests *not* necessarily being the interests of the company.

## Size

The Mondragon model seems immune to the centralization of control we see in conglomerates and sprawling business empires, whether corporate or private. This immunity is structural.

Unlike traditional business models the Mondragon cooperatives are under no pressure to expand by buying up other companies. Incorporating other companies means incorporating other members/citizens with equal rights to any profits the enlarged company makes. Ownership cannot be concentrated and so neither can profits. In fact, expanding in this context makes sense only when all worker-members stand to benefit by doing so. This reality is another factor in preventing the rise of a permanent ruling clique controlling nominally democratic processes (Davidson 2011).

By creating second-tier cooperatives, Mondragon has enabled small- and medium-sized cooperatives to benefit from the marketing and research resources that come with larger size, while continuing to profit from the advantages of smaller size. Ellerman writes that the ideal upper limit of a member cooperative is usually considered around 400 or 500 members (1982: 9). One major exception is Eroski, a chain of retail outlets across Spain with thousands of worker-members. Here the advantages of large size work to the advantage of every worker member.

The Mondragon model demonstrates that innovative and viable institutions can arise within a market where all parties possess a rough concrete equality of decision-making power. The result is the rise of institutions able to focus on the welfare of all as their first priority. Capital is subordinated to labor rather than, as in so much of America today, human beings subordinated to capital.

## When the Going Gets Tough . . .

Until recently, while Mondragon had created more than 120 cooperatives, only one had failed, a fisherman's cooperative. That changed in 2013. At this writing, Spain is in the midst of a serious economic crisis. Even so, the Basque Country and the Mondragon cooperatives in general have done far better than the country as a whole. Spain currently has unemployment exceeding 25 percent. The Basque region is in better shape, with a rate of 15 percent. Until recently the Mondragon worker-owned cooperatives had 0 percent unemployment.

In late 2013 FAGOR, Mondragon's largest manufacturing plant, entered chapter 11, a casualty of the financial crisis and competition from low-wage manufacturing in China. Over 1,000 worker-citizens are now being relocated into other Mondragon cooperatives, a process that may take a year to complete. Meanwhile they continue to receive 80 percent of their pay as well as all benefits. Retraining opportunities are open to those who wish to learn new skills. At the end of 2013, about 500, almost half, of these workers had been successfully relocated.

Despite the scale of the problem and the fact that FAGOR is closing, Mondragon's response reflects the same approach and values they have employed whenever a member cooperative enters into rough times. Rather than laying people off, they are transferred to other cooperatives because the association is large enough to be able to do this.

## Part III. Returning to Theory

### A Tocquevillian Moment

In *Democracy in America* Alexis de Tocqueville voiced three concerns about the new American democracy that in so many other ways had deeply impressed him. Today two of the three are well known. Significantly the third is rarely mentioned. But Tocqueville thought the third equally important and our considering it sheds important light on the other two.

The first of his concerns was the growth of a narrow individualism unconcerned with the broader community. Tocqueville hoped institutions like the jury and New England's town meetings would prove a check to this problem, but today the jury is atrophied from the institution it was during Tocqueville's time. A similar fate has befallen New England's town meetings. In my opinion, the unprecedented popularity of Ayn Rand's writings demonstrates that Tocqueville's concern was well founded. Thinking like a citizen is no longer a part of our national discourse.

Tocqueville's second concern was the growth of a well-meaning "soft" authoritarianism that gradually subjected people to ever more extensive bureaucratic control. He wrote that, if despotism were established in a democratic society, "it would be like the authority of a parent, if, like that authority, its object were to prepare men for manhood; but it seeks on the contrary to keep them in perpetual childhood." He added that "the will of man is not shattered, but softened, bent, and guided: men are seldom forced by it to act, but they are constantly restrained from acting . . . till each nation is reduced to be nothing better than a flock of timid and industrious animals, of which government is the shepherd" (1972 [1840]: 381).

This famous passage is usually interpreted to refer to the rise of a managerial liberalism that treats people as perpetual clients. And this interpretation is certainly justified. But this issue is also reflected in so many people becoming industrious, timid, and obedient parts of giant corporate organizations; individually insignificant cogs within a machine vastly bigger than they are, going along to get along. In a world where most are dependent on others' authority and power to keep their jobs, the problem Tocqueville described is as prevalent in large private organizations as in citizens' relation to public regulatory bureaucracies.

Most Americans have few opportunities to learn the kind of citizenship and personal skills Tocqueville regarded as essential to reserve a free democratic society. They rarely if ever exercise real authority over their own working lives beyond the "freedom" to work for one big organization rather than another. In all areas of life beyond the most private they are increasingly subject to the will of a "they" that acts independently from them.

Sadly, Tocqueville's third concern is almost never mentioned, although it provides much of the reason why the first two were so well founded.

## The Rise of a New Aristocracy

Tocqueville also warned of the rise of a new aristocracy and the growing subjugation of most people to it. As he wrote:

> A theory of manufactures more powerful than manners and laws binds [the worker] to a craft, and frequently to a spot, which he cannot leave: it assigns him a certain place in society, beyond which he cannot go: in the midst of universal movement, it has rendered him stationary. In proportion as the principle of the division of labour is more extensively applied, the workman becomes more weak, more narrow-minded, and more dependent. The art advances, the artisan recedes On the other hand . . . wealthy and educated men come forward to embark in manufactures [because the] magnitude of the efforts required, and the importance of the results to be obtained, attract them. Thus, at the very time at which the science of manufactures lowers the class of workers, it raises the class of masters. (1972 [1840]: 191)

Tocqueville argued that "in proportion as the mass of the nation turns to democracy, that particular class which is engaged in manufactures becomes more aristocratic." He concludes his discussion as follows:

> I am of the opinion that the manufacturing aristocracy which is growing up under our eyes, is one of the harshest which ever existed in the world; but at the same time it is one of the most confined and least dangerous. Nevertheless the friends of democracy should keep their eyes anxiously fixed in this direction; for if ever a permanent inequality of conditions and aristocracy again penetrate into the world, it may be predicted that this is the channel by which they will enter. (193–194)

In return for subordinating much of their waking life to control by others, people are encouraged to consume, the more the better. And most do. When the consumer replaces the citizen as the ideal role in a free society, Tocqueville's "narrow individualism" will have overcome the qualities he argued were necessary to preserve freedom and well-being. We can consume alone, but we cannot be citizens alone.

Today we see around us the rise of an elite rooted in finance and business and no longer subject to the rule of law. If the law impedes them, they get it changed. Tocqueville's prediction is coming true before our eyes.

John Stuart Mill (1970 [1848]) shared Tocqueville's concern over the rise of this new aristocracy, and sought to find some means of addressing the new forms of domination that had arrived with industrialization. His recommendation was very close to what took place in the Mondragon cooperatives and deserves serious attention by market advocates. Deeply disturbed by the severe subordination of working people to the power of factory owners he saw around him, Mill wrote:

> The form of association . . . which, if mankind continues to improve, must be expected in the end to predominate, is not that which can exist between a capitalist as chief, and work-people without a voice in the management, but the association of laborers themselves on terms of equality, collectively owning the capital with which they carry on their operations, and working under managers elected and removable by themselves. (133)

There is an interesting, revealing, and almost completely ignored connection between these observations by the great liberals of the past and the most perceptive of the classical liberals of the present.

To my mind F. A. Hayek's contribution to our understanding the differences between "spontaneous order" and "organization," or *cosmos* and *taxis*, was among the most important achievements in social science during the twentieth century (diZerega, 2013 a). Hayek wrote worriedly that employed people naturally came to see society as "one great hierarchy" (Hayek, 1960, 119). Years later he elaborated:

> One reason why in recent times we have seen a strong revival of organizational thinking and a decline in the understanding of the operation of the market order is that an ever growing proportion of the members of society work as members of large organizations and find their horizon of comprehension limited to what is required by the internal structure of such an organization. . . . The growth of big enterprise and of the great administrative bureaucracies has brought it about that an ever increasing part of the people spend their whole working life as members of large organizations, and are led to think wholly in terms of the requirements of the organizational form of life. (1976: 134)

Hayek's observation has been ignored, much like those of Tocqueville and Mill. This problem is daily reinforced by employment relations in large capitalist organizations where, in almost *1984*-style reasoning, ever-narrowing realms of personal freedom are replaced by ever-widening areas of control, such as when to pee, what to wear, when to talk, whom to talk to, having their bodies and possessions searched, and being banned from smoking or drinking at home or saying objectionable things in private conversations off the job (Bertram 2012).

To my knowledge Hayek never examined the other half of this issue or the alternative perspective for dealing with it as Mill suggested. For a long time Hayek was entirely focused on the issue of state socialism versus "the market," and later broadened this into a concern about spontaneous orders as contrasted with organizations. Throughout, he apparently assumed that the market, as it manifested, was to be taken largely for granted. Given the challenges Hayek confronted during the core of his creative life, his myopia is understandable. What is not so understandable is that today, when virtually no one believes in the efficacy of central planning, these other issues are ignored, issues major liberal thinkers had emphasized from at least Jefferson's time and with increasing urgency by Tocqueville and Mill.

As the years pass Mondragon increasingly situates its worker-owners in an institution that predates them and will likely outlast them. Each member is enmeshed within an ongoing network of relationships encouraging a broader view of his or her relationship to society than is the case with a traditional employment relationship. Individuals comes to see themselves as existing within layered relationships of their enterprise, its existence within the Mondragon association, and the larger economy as a whole to which they must respond. Further, unlike traditional capitalism, they are in a position to take values other than the purely financial into consideration when making decisions for their community.

In this respect membership at Mondragon operates in many ways like Tocqueville's analysis of New England town meetings and jury duty. To exercise effective self-governance workers must look beyond the next quarter's returns and take into consideration the situations of others than themselves. Workplace democracy may be an essential element of any viable democracy over the long run (Ellerman 2009).

Mondragon's two-tier model enables it to provide a wide range of social services to its members while preserving substantial "grass roots" power. Contemporary democratic political constitutions are weak and cannot protect against elite domination as it manifests in political parties and incestuous relations between elites in government, business, and the media. Tocqueville's first two concerns are addressed directly.

The same is true for his third concern.

By subordinating capital to labor rather than the other way around, Tocqueville's new aristocracy is blocked at its inception. No major payoff exists in unchecked expansion and consolidation. In addition, the spread of income within businesses is limited at 6 to 1, checking at its inception abuses such as those occurring in contemporary American corporations.

Mondragon and similar cooperatives in the United States appear to be democratic and contractual solutions to Tocqueville's concerns about a new aristocracy and confirmation of the possibilities Mill saw in a free society, possibilities able to be valued by men and women of a wide variety of religious, philosophical, and ideological backgrounds. They also address Tocqueville's concerns about a narrowly self-regarding individualism undermining the vitality of democratic societies as well as the rise of powerful organizations that reduce those subject to them to increasingly passive obedience.

For classical liberals and libertarians, Mondragon demonstrates that the voluntary relations described through contractual relations can address a much wider and deeper set of values than purely market ones. This replaces the need for many actions people historically look to government to provide, and does so in a framework of voluntary cooperation.

For genuine conservatives, people who emphasize our immersion in society and its traditions, and the limitations of our knowledge of how complex orders maintain themselves, Mondragon demonstrates the continued viability of Edmund Burke's (1999) "little platoons." Within this structure, such groups continue to be effective and powerful. Mondragon integrates the market firmly within civil society.

For progressives, Mondragon demonstrates how rank and file working people can take over and manage the major decisions that impact their working lives, and do so with greater prosperity and security than within any demonstrated alternative. Wage labor dominated by impersonal market forces modified by the power of bosses is abolished, as their members become self-governing individuals and communities. Markets assist people in living their lives rather than dominating them.

For American liberals Mondragon shows a way out of the increasing subjugation to corporate and financial hierarchies whose only real justification today is that there is no viable alternative. Mondragon demonstrates that attractive alternatives exist.

By cutting across ossified ideological boundaries, Mondragon and similar companies such as Petaluma's Alvarado Street Bakery, demonstrate the promise of expanding the freedom and prosperity for all that was the initial promise of the American Revolution and characterized the best of liberal thinkers is far from dead.

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CHAPTER 6

# ELIMINATING THE PERCEIVED LEGITIMACY OF THE STATE

CALEB J. MILES AND EDWARD PETER STRINGHAM

## INTRODUCTION

Where does the state come from and can it be instructed to act as an agent of the public? According to contractarians such as James Buchanan (1975), a constitutionally constrained state is summoned when a populace joins together and draws up guidelines for state activity. Behind a veil of uncertainty people do not know where they will end up, so they will agree to form a state that will make everyone better off. When faced with a choice of chaos without a state and order with a state, people will choose the latter (Grossman 2002; North, and Thomas 1973). Mueller (2003) describes the process of agreeing to live under a state as fundamentally similar to people joining a club. People select the rules by which they wish to be governed just as club members select the rules of their club. They select the rules for themselves and for those who will administer the state. Whether the issue is eliminating prisoners' dilemmas or solving other collective action problems, the state is instructed to work as an agent on behalf of the public (North 1990; Olson 1965).

A problem for this set of theories is that no state ever was created or ever has been constrained in such a fashion (Block and DiLorenzo 2000). Research from scholars ranging from Marxist anthropologists to free-market anarchist economists shows that law and order actually predates states by millennia and that states arrogating a monopoly of force is a relatively recent phenomenon. Once the state successfully claims a monopoly of force, it uses force in ways that would be widely illegitimate and illegal (e.g., war, conscription, incarceration, taxation) if attempted by nonstate actors. Starting with Weber's definition of the state (1946 [1918]), we discuss how the state must legitimate itself to the public to gain and remain in power. States are legitimated in part by the important myth that states create order. This chapter draws on cross-cultural work on state formation from archaeologists and anthropologists and discusses how society and order preceded states. The historical emergence of states is inconsistent with the theories of contractarians and constitutional political economists who believe that the people contracted with the state to eliminate a state of disorder. We conclude that the more people recognize the myth of state-created order, the less states will retain their legitimacy and ability to use force.

## The State as a Legitimized Monopoly Over the Use of Force

In his 1918 Munich University lecture, "Politics as Vocation," Max Weber gives one of the most well-known definitions of the state: "a human community that (successfully) claims the monopoly of the legitimate use of physical force within a given territory."[1] Walter Scheidel (2013) provides a recent, cross-disciplinary overview of major definitions of the state in the social sciences and finds that most rightfully avoid overt equations of the state with society itself, "the common will," vox populi, and others all but preclude the possibility of the state acting against the welfare of the populace. Let us briefly consider the major aspects of Weber's definition to discuss ways in which it helps give a more realistic view of the state.

The first part of Weber's definition emphasizes that the state is comprised of humans. In even quite recent eras, many thinkers found necessary the explicit restatement of this banal and obvious fact (Friedrich 1939). As Mises (1944) writes, "The state is a human institution, not a superhuman being." We have never understood the logic of the thinking that (1) human nature is bad and (2) we therefore need to have a government comprised of humans."[2] Pointing out that humans control the state is a salient point as even certain public choice economists analogize the state as a disinterested giant (Hogarty 1972) or even an alarm clock (Buchanan 1975: 93).

Nevertheless, emphasizing its human aspect may distract from an important characteristic of the state. Even though those who control the state are humans with their own objectives, the state does have a status in popular conception as an abstract, suprapersonal entity.[3] Historian Martin van Creveld (1999: 1) grounds his very definition in this particular feature:

> The state, then, is an abstract entity, which can be neither seen, nor heard, nor touched. This entity is not identical with either the rulers or the ruled; neither President Clinton, nor citizen Smith, nor even an assembly of all the citizens acting in common can claim that they are the state. On the other hand, it includes them both and claims to stand over them both.

In an important sense, the state has a persona of its own beyond the mere identification of those persons who administer state apparatuses at any given time. It "stands over" them but is not equivalent to aggregate "society." Jasay (2010: 7) adopts a similar view and differentiates between the terms "state" and "government," writing "whereas the state is best understood as an abstract entity, the government is both abstract and physically existent, consisting of real persons, some of whom can be more completely identified with the government than others." From this perspective one may understand the state as the institutionalization of popular thought and behavior that legitimates a monopoly of the force, whereas the government is the group of human individuals that exercises the use of force. In a very important sense the state is suprapersonal, an ideational persona ficta, which claims to perform as agent for some transcendent or holistic principal such as "the gods," "the public interest," or "the nation." The state may in fact not have a direct line to God or knowledge of everyone's wants (Stringham 2001, 2010), but it often does market itself that way (Crone 2003).

The next part of Weber's definition of state is that it "(successfully) claims a monopoly of the legitimate use of physical force." An entity that claims the ability to use force but is popularly disregarded may be state-like but is not a state. Two aspects of a claim to legitimacy must be differentiated: is something normatively or morally legitimate versus is something widely perceived as legitimate. To Jasay (1985: 54) this latter, positivist sense is important for analysis: "legitimacy" is "not an attribute of the state, but a state of mind of its subjects."[4] Likewise Rothbard

(1975: 7) explains the state has "social legitimacy," which exists "in the eyes of the majority of the public." That perceived legitimacy allows the state to commit certain acts involving force (war, conscription, incarceration, taxation) that would be resisted as illegitimate violations of law if attempted by any nonstate agent. Today pretty much everyone considers the Third Reich as morally illegitimate, but at the time many or most citizens perceived it as legitimate (Mayer 1955) and that helped enable its infamous actions.

The final part of Weber's definition refers to the monopoly of the use of force within "a given territory." The extent of the area wherein the state exerts power is a key aspect of statehood. If state territory in fact referred to individual private plots of land and each person's home was his castle, such a world would have billions of states and approximate anarchy. If, however, a given territory refers to larger areas beyond that of private plots, then where states claim the ability to use force becomes important. Where market relationships are determined by buyers and sellers voluntarily trading or abstaining from trading, the relationship between citizens and the state are much different and that includes amount of land in a state's territory. As Mises (1951: 375) explains:

> Nowhere and at no time has the large-scale ownership of land come into being through the working of economic forces in the market. It is the result of military and political effort. . . . Neither at their formation or in their maintenance have economic causes operated. . . . The noneconomic origin . . . is clearly revealed by the fact that, as a rule, the expropriation by which they have been created in no way alters the manner of production. The old owner remains on the soil under a different legal title and continues to carry on production.

State territories are acquired and maintained via means significantly different from typical private property convention. State territories arise based on the extent of state's capacity to tax and legislate covering immense areas of unowned and already-owned property. For example, one of the causes of the American Revolution was the British Crown asserting ownership and ability to hand out large amounts of land in New York and Vermont that had been privately owned for over a hundred years (Rothbard and Liggio 1975). The state can only claim control of a large territory because of its special capacity to use force. How states claim and maintain a legitimate monopoly is of utmost importance for the emergence and persistence of the state.

## Eliminating the Myth that Citizens Contracted with the State to Create Law and Order

States have been justified for millennia in part by the idea that disorder would prevail in their absence, and this view is advanced by countless academics. To Buchanan (1972, 1975) rational actors in a state of anarchy recognize the conflict and insecurity of property rights and contract to have a state, and to Grossman (2002) those in a state of anarchy want to eliminate lawlessness and call out "Make us a king." These economists are only echoing the extensively held belief that the state was created to produce order. Yet empirical work shows that property and markets existed for thousands of years before statism. We are not arguing that prestate societies were comprised of noble savages who had a different nature or lived in perfect harmony. We are also not arguing that their markets or the transactions were as sophisticated as Wall Street.

Nevertheless, evidence indicates that property, markets, legal rules, and various private dispute resolution mechanisms predate the state, and the implication of this fact should be skepticism regarding justifications of the state based on its necessity in providing these services. Hayek (1979: 159–160) identifies three stratified sources of rules: genetically inherited instinct, culturally evolved convention, and deliberately designed construct. These three sources in concert produce inter alia the content of law. Both instinct and convention evolve, the latter potentially much more rapidly. Hayek (1973: 72) defines law as "enforced rules of conduct" and Fuller defines law as "the enterprise of subjecting human behavior to the governance of rules" (Fuller 1964: 106). Neither of these theorists are anarchists, but both of their definitions of law do not require that law be imposed by a state. As Avner Greif and Christopher Kingston (2011: 41) put it, regarding "situations in which enforcement of the 'rules' must be considered as an endogenous outcome rather than taken as given," operating institutions are best understood as structures of self-enforcing interaction and expectation equilibria. Accordingly:

> The aggregated expected behavior of all the individuals in society, which is beyond any one individual's control, constitutes and creates a structure that influences each individual's behavior. A social situation is 'institutionalized' when this structure motivates each individual to follow a regularity of behavior in that social situation and to act in a manner contributing to the perpetuation of that structure.

To Hayek (1973) institutionalized legal rules form a stable legal order when manifested with regularity as a "matching of the intentions and expectations that determine the actions of different individuals" (36). A stable legal order can facilitate productive coordination and can be considered effective (i.e., law in practice) when its general compliance is respected with regularity.

Since early human customary law (and pre-human animal behavior), and before the formation of what can be considered anything close to a state, individuals or households generally owned ornaments, trinkets, dishes, clothing, stones, tools, or other items they made themselves, found, or received as gifts (Bowles and Choi 2002, 2013). Bowles and Choi note that when land became sufficiently scarce and valued, private property was extended to it as well. Furthermore, the general rule of just acquisition was roughly first personal possession—roughly, whoever acquired the land first was the perpetual owner. These findings are remarkably consistent with the normative theory of property rights advanced by liberals from John Locke to Rothbard (1973) and also with Demsetz's (1967) positive theory of the evolution of property rights, which discusses how people extend property rights at the margin. Furthermore, the ownership criterion of first possession has been substantiated as likely instinctual in modern humans—"the property instinct"—through a burgeoning experimental psychology literature (e.g., Friedman 2010; Friedman et al. 2011; Stake 2004). In modern times conventions like common queuing and presumption of good title persist (Jasay 2006). And they emerged and persisted independent of what the state was or was not doing.

As Dunbar (1992) and Kelly (1995) have shown, society itself, for almost the entirety of humanity's existence as a species, consisted chiefly of small, isolated, homogenous, mobile groups of a few dozen to a few hundred individuals comprising bands of hunter-gatherers or foragers.[5] Stone (2010) reviews Hayek's work on cultural evolution in light of contemporary evolutionary psychology and finds it conforming to Hayek's theory that customary law emerged across generations in an evolutionary process of group selection.[6] Customary law disputes in kin-based bands were typically negotiated by parties involved or, less frequently, informally arbitrated by mutually respected third parties (Claessen 2003). Members enforced law primarily through direct reciprocity, personal sanction, reputation effects, and, ultimately, ostracism (Benson 1990). This was easily effective because, in such small and isolated groups, each person practically needs to directly and repeatedly interact with most fellow members. Ostracism is especially effective for mobile groups because intensely incompliant individuals can usually be left behind (Claessen 2003, 2004).

Rather than viewing society as a monolithic entity where everyone suddenly agrees to follow government law, we can analyze the relations including rule based or legal that existed before the emergence of the state. Figures 6.1 and 6.2 represent a small-group legal order in which circles represent individuals and lines represent regular interaction.

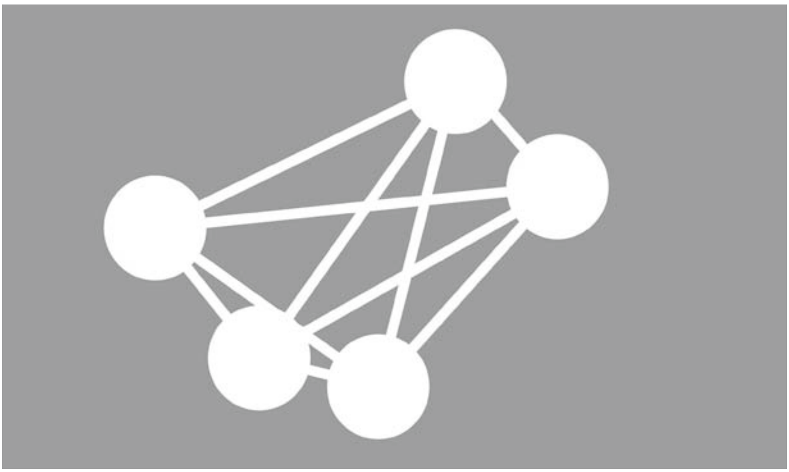

Figure 6.1 Small, isolated, mobile group of individuals limited to direct interaction.

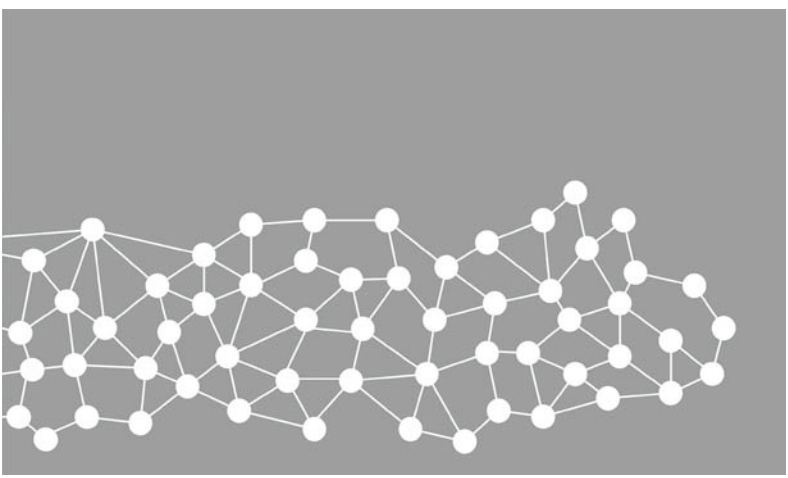

Figure 6.2 More permanent settlement and extended order of indirect interaction.

In Figure 1 each person knows the other and the relationship is known. With humanity's gradual transition from mobile hunter-gatherer bands to more permanent settlements (a transition punctuated some 10,000 years ago in the Mesopotamian Neolithic Revolution), order expanded into ever-growing networks of impersonal and indirect interaction involving many more people than any single individual could directly interact with or personally know, and for this, new legal orders developed (compare Figures 6.1 and 6.2). Increasingly extended social order meant that much interaction was impersonal and took place outside small kin groups or bands. Law more and more required formal third-party adjudication, matching convention to circumstance. Roberts (1979) argues that evolution toward sedentary settlement meant that "dispute has to be solved where it arises, in the context of continuing face to face relations, without the ready solution of immediate changes in group composition" (110).

A memorable description of adjudication on this order is found in Homer's *Iliad*. A number of competing elders in a Greek city's agora hear a dispute regarding appropriate material recompense for a crime. Each in turn publicly articulates a judgment. The elder who gives the most compelling case for his judgment according to the audience or participants is rewarded with gold put up by the litigants (Claessen 2004; Edwards 2000: 214–215). Adjudication resulting in material recompense for redress, as opposed to corporal retribution or imprisonment, is typical of many stateless legal systems (Benson 1990; Stringham and Miles 2012).

Explicit conventions regarding general rules of conduct arise out of such formal, frequently third-party, frequently deliberative, frequently ritualistic adjudication (Claessen 2004; Hasnas 2008: 534ff.). Claessen (2003) describes how legal rules were imitated by and taught to the young, sprouting the incalculable seeds of effective law from ancient civilization to medieval globalization to current day. Social sanction, reciprocity, reputation effects, and ostracism remain important mechanisms of interpersonal enforcement (Benson 1990; Friedman 2008; Jasay 1996), but they were somewhat diluted by the human transition to sedentism and by the increasingly impersonal and intergroup nature of interactions in the extended order, making at least a somewhat greater use of threat of force necessary for enforcement (Claessen 2003, 2004; Hayek 1973, 1979). Law, according to this functionalist perspective, chronologically precedes the state and has continuously operated outside the state.

Building on the work of anthropologists, Benson (1988, 1990) and other anarchist economists show that effective law can be provided in many different ways. Law may be formal (e.g., codified law) or informal (e.g., customary law). It may be polycentric (e.g., common law) or monocentric (e.g., statutory law). It may be articulated, adjudicated, and enforced by a jurisdictional center (e.g., territorial courts) or by multiple independent individuals or organizations (e.g., law merchant) (Anderson and Hill 2004; Boettke, 2005, 2012; Johnsen 1986; Leeson 2009; Powell and Stringham 2009; Stringham 2007; Stringham and Zywicki 2011). Enforcement sufficient to achieve some predictable regularity of interactional behavior as well as the resolution of interpersonal disputes in accordance with mutually understood, general, impersonal rules is critical for effective law. This understanding opposes "legal positivism" and similar notions that posit law as necessarily *legislation* or some entity's deliberate creation; rather, law is "older than legislation" and in a real sense "coeval" with society itself (Hayek 1973: 72).

## The Emergence and Expansion of States through a Combination of Persuasion and Force

As Bowles and Choi (2002, 2013) point out, the state emerged thousands of years after the Neolithic Revolution and the rise of land as private property. As civilization preceding it, the state was not suddenly invented or imposed in totality. How did it in fact come about? The origins of the state offer insight into the workings of the institution (Vu 2010). Thus we will briefly survey some of the multidisciplinary literature on state formation.

At least three extensive and occasionally overlapping literatures can be distinguished across academic disciplines on the subject of state formation (Scheidel 2013). The first concerns the formation of pristine or primary states—the first states to arise de novo in a given region isolated from preexisting states.[7] Information regarding pristine state formation is chiefly garnered from archaeological research on the emergence of states in prehistory and anthropological accounts of state establishment in more recent, isolated stateless societies.

Canadian archaeologist Bruce Trigger, in a well-respected and comprehensive comparative study, finds that there is noteworthy uniformity in the rise of primary states across the world from disparate nonstate societies (Trigger 2003, see also Cohen 1978). Hence a general theory of primary state formation is at least plausible. A second literature concerns early state proliferation and development into grander, more stabilized, more bureaucratic, more complex polities, such as empires. Information on this state proliferation and development is gathered from across social science and history, and often attributes a significant causal role to technological disparities in war-making (e.g., Turchin et al. 2013) and governance strategies that required increased bureaucratization (e.g., Spencer 2010). The third literature concerns the emergence of the modern state, of those states that eventually became the contemporary nation-states whose territories cover most arable land on Earth today. Modern state literature often focuses on the development of states in post-feudal Europe and also frequently attributes a causal role to disparities in war-making technology, most famously put by Charles Tilly's (1985) dictum that "states make war and war makes states" (see also Finer 1975, 1997).

Theories of primary state formation may be divided into two general categories (e.g., by Scheidel 2013; Yoffee 2005). Voluntaristic or benefit-based theories posit that the state was formed because of public goods it provided to a populace, such as mutual security, social coordination, welfare-enhancing wealth redistribution, property rights enforcement, or the management of risk and complexity. Such voluntaristic theories often align with normative notions of a "social contract." A famous instance is Karl Wittfogel's irrigation theory, contending that states arose to provide the public good of irrigation (Wittfogel 1957). Irrigation theory has been widely discredited since the discovery of complex irrigation operating prior to and independent of states (Davies 2009).

As opposed to voluntaristic theories, coercive or conflict-based theories of state formation attribute the state's genesis to struggle between groups, with states forming to more permanently position a dominating group over a subservient group (Scheidel 2013). Marxist theory of state formation, holding that the state formed as a tool for the "economically dominant class" to also become "the politically dominant class and so acquire new means of holding down and exploiting the oppressed class" (Engels 1972 [1884]: 231), is one prominent and also widely criticized example of such a theory (Claessen and Skalnik 1978a: 6–9; Gailey and Patterson 1987: 6-10; Haldon 1993: 19–69; Sanderson 1999: 72–74). Franz Oppenheimer's (1926) theory is another prominent example.

In contemporary social science, the most conspicuous coercive theory of state formation has been Robert Carneiro's circumscription model (Scheidel 2013). Carneiro argues that increasing population density and conflict over concentrated resources in mobility-bounded (circumscribed) localities leads to conquest warfare, and that conquest warfare is the mechanism of political evolution that brings about state formation and expansion via more forceful internal administration and cohesion within warring groups (Carnerio 1970, 1978, 1988, 2012). Despite Carneiro's declaration that "only a coercive theory can account for the rise of the state" (1970: 734), the mechanism of conquest warfare in primary state formation (as opposed to state expansion and proliferation) has been much disputed on empirical and conceptual grounds.[8] Beliaev, Bondarenko, and Korotayev (2001) note that

> Carneiro's theory of state formation . . . implicitly assumes that all communities want to conquer their neighboring communities. Only if we accept this assumption does Carneiro's theory make sense. All the available data, however, seems to show that conquest-warfare is a relatively recent phenomenon which does not appear to be found in independent communities . . . Only at the state level does [conquest warfare] become the predominant warfare type. Thus, conquest warfare should be regarded not as a cause of chiefdom and state formation but rather as one of its outcomes.

Similarly, Claessen and Skalnik, in well-known volumes comparing early states, find that "state formation is not caused by war but is greatly promoted by war" (1978b: 625). Whereas conquest warfare did not largely predate states, sacralizing ideologies did. Muller (2008) and Claessen (2005, 2012) give prominent instances of state formation where warfare is absent. Furthermore, a number of prominent primary states did not arise in mobility-bounded localities (Claessen 2012; Trigger 2003: 398). For these reasons, Claessen (2012: 41) suggests that "there is no reason to consider Carneiro's theories as generally valid" with regard to state formation but rather that conquest warfare is seen as a great promoter of state expansion and proliferation.

Scheidel (2013) suggests, at large, that voluntaristic and coercive theories are not necessarily at odds and can be complementary. Indeed they may merely "highlight different aspects of interdependent processes" (Johnson and Earle 2000: 305). Prominent historian David Christian argues that understanding state formation requires both perspectives (Christian 2004:, 249–252). So does archaeologist Norman Yoffee (2005: 14), who notes that "one need not rigidly champion either a benefits or conflicts/coercion model, since both forces must be assessed as dynamic parts of the theory of social change" and further that benefits/voluntaristic theories highlight aspects of "ideology" whereas conflicts/coercive theories highlight aspects of "power" in state formation.

A well-known theory that takes into account both voluntaristic and coercive elements is Henri Claessen's "complex interaction model" of state formation (Scheidel 2013). Claessen, a Dutch anthropologist and foremost contemporary researcher of early states (Bondarenko and Korotayev

2003), argues the state arose gradually and that "the development into statehood, in all cases, was triggered off by some action or event which took place a long time before, and was not directed especially towards this goal" (Claessen 2002: 17). However, the structure and pattern of state formation distinguishes it from antecedent emergent institutions such as law. This structure and pattern can be investigated by looking at what preconditions were widely necessary for a state to arise in comparative study. Of the factors in empirical record associated with sociopolitical change, the preconditions that have been found "necessary" (Claessen 2002) for a state to form are: sufficient population in some region, more or less permanent settlement, a feasibly extractable and economically significant surplus of wealth, popular ideology that can legitimate state activity, and some event to trigger the state-building process (Claessen 2000: 130; 2002; Claessen and Oosten 1996).

Sufficient population and settlement permanence were provided by the transition from mobile hunter-gatherer societies to sedentary agriculture. A feasibly extractable and economically significant surplus of wealth is of utmost importance in providing incentive to engage in state-forming activity (see e.g., Sanchez 2014) and was provided following the Neolithic Revolution by the stored goods of sedentary agriculture (Mayshar, Moav, and Neeman 2011). Events that triggered state-forming processes included "a shortage of food or goods, population pressure, war, the introduction of new ideas, . . . the necessity to protect trade and markets, or the coming into power of an ambitious ruler" (Claessen and Hagesteijn 2012: 6).

### State-Legitimating Ideology

State-legitimating ideology for early states is provided by the idea that a subgroup of ruling individuals had uniquely transcendent or sacral status, usually owing to the detail that they were gods, demigods, chiefs, or sole providers of some necessary public good (Claessen and Oosten 1996). Regular, voluntary giving of tribute by most of the general populace to a sacred leader, chief, or "earth priest" (as Claessen [2002] put it, the "exchange of goods for 'Good'") accompanied the spread of such ideology (Yoffee 2005). This is illustrated in Figure 6.3. The hollow circle at the top represents the potential state subgroup, other circles represent individuals, and lines represent interaction such as voluntary tribute.

How does a coercive state emerge from formerly voluntary interaction? Over time, the giving of regular tribute becomes institutionalized,

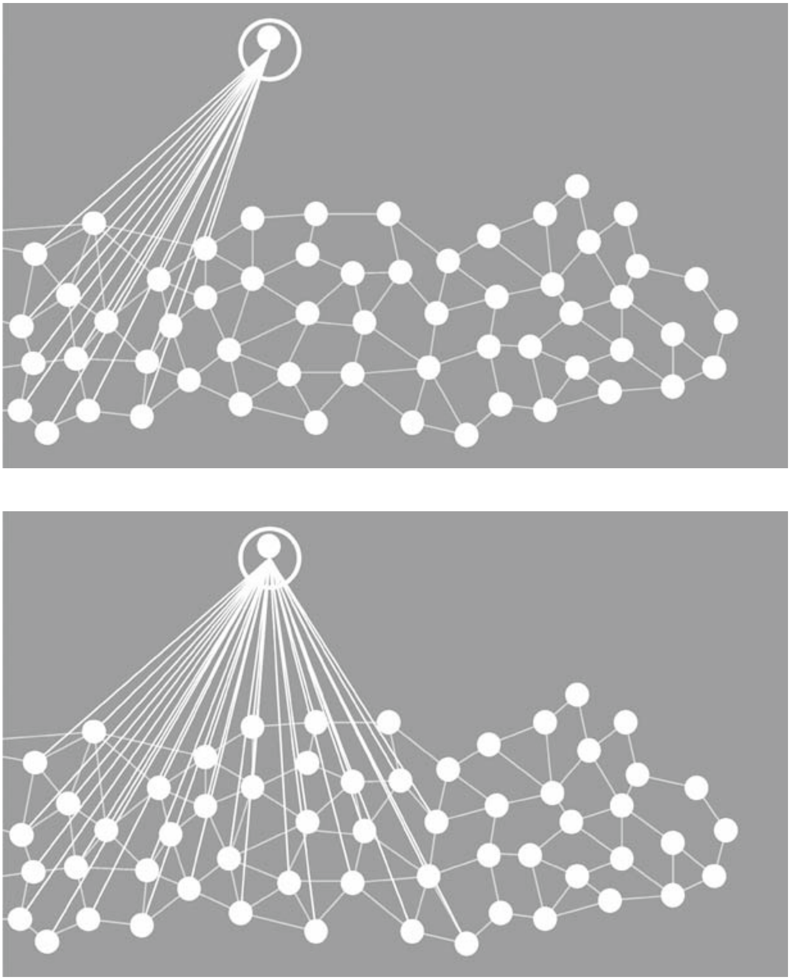

Figure 6.3 The spreading of belief in a centralized subgroup accompanied by voluntary tribute.

evidenced in a self-enforcing arrangement of interpersonal behavior regularity and expectations. Claessen explains:

> A certain degree of obedience was expected of the followers of the earth priest or sacred leader. Any socio-political leader—thus, also the earth priest—has to cope with the problem how to make his followers act according to the norm . . . People do not obey rules and regulations just

> automatically. They often seek to escape obligations. Leaders thus had to develop measures to cope with deviant behavior. This made a certain coercion on the leader's side inevitable. Once the leader (the earth priest) decided to coerce disobedient members of his society, a further step in the direction of an early state organization was set. (2012: 39)

Voluntarily obeying and giving tribute may become rote to many, but naysayers will always exist. Some people may not wish to voluntarily pay

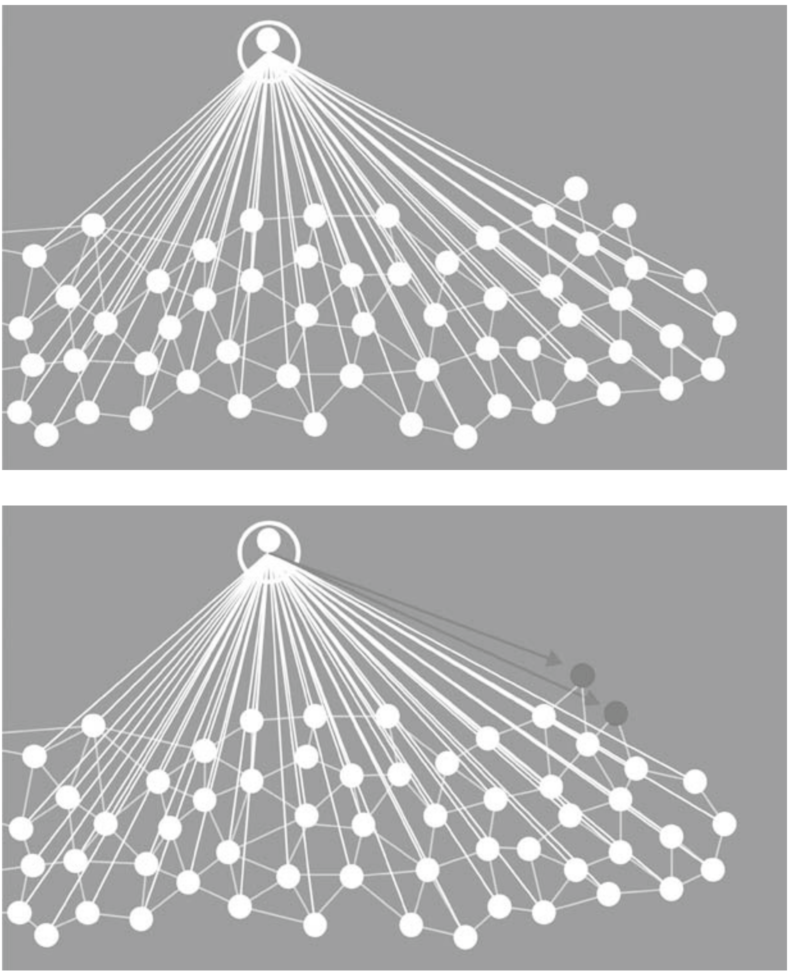

Figure 6.4 The emergence of legitimated violation of law by a subgroup—the state.

tribute or fulfill some other obligation. If the situation is sufficiently institutionalized, and especially if belief in the special status of a subgroup is popularly believed with enough intensity, agents of the subgroup can, to some degree, viably use coercive force to acquire goods or obedience (Benson 1999; Claessen 2012). This is illustrated in Figure 6.4 with arrows representing coercion used against those who choose to resist.

Humans did not starkly move from an anarchic world of violence to a violence-free society governed by states as some philosophers and economists have imagined. Rather the state gradually arose and expanded over time, and not in the same way that markets gradually evolved over time. Institutionalized state-legitimation (via belief, behavior, expectations) reduces the risk of enforcement (via reputation effects, physical resistance) of general rules when violated by agents of the state, making such violation uniquely cheaper for the subgroup (Levi, Sacks, and Tyler 2009).[9] Human enterprise is reduced in its capacity to disincentivize violations of law by agents of the state. Hence state power entails a "comparative advantage" in such violations (North 1981: 21). Particular subgroups of persons (i.e., governments) may come and go but the institutionalized, suprapersonal state remains. The populace tolerates and funds such violations even if many may find them distasteful. From this point onward, any individual knows that if he doesn't pay the tribute (now taxation) or comply with state commands (now legislation), the same could credibly happen to him.

Successfully stable states produce a "snowball effect"—positive feedback loops of general rule violation and legitimation (Claessen 2002). Institutionalized legitimation enables violation, which functions to fund the reinforcing of legitimation via threats, feasts, rituals, public services, monuments (think pyramids), special interest catering, conquest warfare, and so on (Benson 1999; Hallpike 1986 235ff; Inomata and Coben 2006; Spencer 2010; Turchin et al. 2013; Yoffee 2005). A large part of the path-dependence of such institutionalized state legitimation is eventually due to rote habit; as Jasay (1985) observes, "habit is probably nine parts of any good explanation of political obedience" though it may ultimately be still motivated by "latent threats . . . or political hedonism the sons inherited in the form of 'common knowledge' from their contractarian fathers and which the state continued to nurture by an economical drip-feed of rewards" (54).

Hence the formation, maintenance, and expansion of the state entail both voluntaristic and coercive elements. Ideological reasons for voluntary obedience to the early state were largely based on exaggerated, false, or superstitious claims of public good provision (Crone 2003)[10] and supernatural mediation (Trigger 1993).[11] Nevertheless, many in pre-state and early state societies held such ideology and acted accordingly. This has been likened to contemporary religious cults (e.g., Kulke 1993). States emerged when these cults grew teeth and began utilizing cost-discounted coercion to enforce obedience.

It is important to note here the nonmoralized use of the term coercion in this chapter. Violations of preexisting general rules by agents of the state are often specifically indicated by reference to the state's monopoly on "violence" (e.g., Obama 2008[12]), "physical force" (e.g., Weber 1946 [1918]), "coercion" (e.g., Hayek 1960), or "organized theft" (e.g., Rothbard 1975). Such terms are dependent on a presupposed background of general rules of just conduct—especially regarding property—for their definition in ordinary language and law. All that is required for the purposes of this chapter is that such actions are violations of general interpersonal rules of conduct, typically by an ideationally suprapersonal subgroup.

Earliest states were of a "thoroughly theocratic nature" (Service 1975: 307). However, with the advance of civilization, new state-legitimating ideas became institutionalized as the old ones fell into obsolescence. Few in developed countries today believe or act as if their political leaders are gods or have a divine right to rule according to supernatural law. Such ideas were replaced in recent centuries with more "secular" notions of common will and popular sovereignty, ideas of nationhood and majority-elected representation (Friedrich 1939; Hayek 1988). As Buchanan (2005) puts it, "the death of God and the birth of the national state, and especially in its latter-day welfare state form, are the two sides of the coin of history."

## How Reducing the Perceived Legitimacy of the State Reduces Its Ability to Use Force

Research by anthropologists and modern economists documents how law and order preceded government and indicates that only later did the state claim a monopoly over the use of force. States have expanded their power partially by promoting the idea that chaos prevails without states and that they are working on the behalf of "the gods," "the public good," or some noble cause. The more people believe that myth, the greater the perceived legitimacy of the state. To Jasay (1985, 2010) states are best understood as seeking to maximize discretionary power rather than actually seeking to protect the peace or maximize the public good. Any hope otherwise is unrealistic.

Given the reality that the state is created to advance interests and use force, the final question becomes whether we can do anything about it. Pessimistic anarchists throw their hands up and say that the state is morally illegitimate but inevitable (Holcombe 2004; Rutten 1999). Others recognize that states require perceived legitimacy and that a decrease in perceived legitimacy leads to less power (Hummel 2001; Stringham and Hummel 2010). Many classical liberals including Hume (1987 [1777]), Mises (1966), and Hayek (1979: 34) put forward popular opinion as a basic determinant of institutions and thus an ultimate constraint on the state (Caplan and Stringham 2005).[13] Each of these theorists viewed states as necessary but their logic about popular opinion limiting what states can do might also apply to limiting the existence of states. Inasmuch as popular legitimation—via substantive opinion or behavioral habit—is a necessary condition for the ongoing fiscal viability of any state, these institutional determinants are an effective constraint against states.

If everyone believed that states do not create law and order, then states would have less perceived legitimacy, and consequently less power. A power hungry teen gang member can only get so far when everyone else views him as nothing more than a thug. Yet this constraint does not require 100 percent of people to know that states were not invented to create law and order and instead invented to advance special interests and force. The more people know that the state was created to use force and advance special interests, the less power the state will have. Although the state today has much more power than we prefer, it almost certainly has much less power than those controlling it prefer, and that power is limited by how much the public will let states get away with. In 2008–2009 the U.S. federal government got away with nationalizing firms, massive bailouts, and expansion of the military and many other illiberal programs, but soon after there was a backlash in the public that limited the state's ability to expand without limit. Today only 20 percent of Americans say they trust "the government in Washington all or most of the time" (compared to 75 percent of Americans just fifty years ago), and a poll asking whether big business, big labor, or big government is the biggest threat to the country in the future, 72 percent answer big government (compared to 25 percent just forty years ago) (Gallup 2013; Pew 2013).

Viewed in this light, anything that reduces the perceived legitimacy of the state can reduce state power, even if the state cannot be eliminated in the short run just as weakening the power of teenage gangs is possible even if they cannot be eliminated in the short run. The more teens and others recognize that street gangs are not a force for good, the less likely teens will be to join or the public will be to tolerate them. The same is likely true of citizens and states. Although we would like to see the state delegitimized, perceived legitimacy of states can still be reduced at the margin. The fewer people that view the state as their protector the less power the state will have.

Perceived legitimacy of states may be reduced in a few ways. The first is through the spread of ideas and influence on public opinion. Page and Shapiro (1983), Althaus (2003), North (2005), Caplan (2007), and Tasic (2010) provide evidence that ideas that shape popular opinion also shape policy and institutions. Claessen shows that many early states collapsed entirely for lack of popular legitimation, and writes, a "ruler who did not live up to norms and values and issued laws that were impractical or went against the prevailing morality would disqualify himself as a god-given ruler and seriously endanger his position."[14] Scott (2009) discusses how the people in upland Southeast Asia had deeply held beliefs that helped them resist states and they have done so successfully for thousands of years. Others advocate showing the benefits of statelessness by creating order independent of states within or across state boundaries.

Within states, many proprietary communities or private cities exist. Disney's Celebration, Florida, for example, is a for-profit private city that creates rules about everything from lot size to the design features one is allowed to have on one's home. Celebration's various zoning regulations cover most of the things that others believe must be done by government and the result is housing prices much higher than those found in nearby communities (Clark, Miller, and Stringham 2010). The city has 10,000 residents, double the number of residents in the entire state of New York when Stringham's ancestors first arrived in the seventeenth century. Similarly Las Vegas's City Center is a multiuse development with more than 5,000 hotel rooms and handles far more guests than the typical town. Their private security guards are also protecting more assets than the typical government police officer. Similarly college campuses can be analyzed as proprietary communities, many of which have fully deputized police (Stringham forthcoming).

In contrast to states, private providers of rules must compete for customers and keep customer well-being at the forefront. In the land lease model described by MacCallum (1970, 2002), Foldvary (1994), and Deng, Gordon, and Richardson (2007) private communities have incentives to provide what others characterize as public goods. When rules and their enforcement are bundled with real estate, the quality of the rules becomes priced into the real estate (Stringham 2006). In modern times, the rules at Disney's Celebration, Las Vegas's City Center, and college campuses are constrained by the state (for example, they could not fully legalize recreational drugs if the state desired otherwise), but they need not. Companies that treat their customers well will earn profits and those that fail to do so will lose.

Some propose creating privately run cities or even floating islands to show that purely private order can exist (Friedman and Taylor 2011; Vaubel 2008; Wohlgemuth 2008). Others discuss how conducting business in digital communities not controlled by states will become increasingly possible (Friedman 2008). Others propose halfway solutions where the private city provides most public goods but the city is ultimately overseen by the state (Fuller and Romer 2010). The Prince of Lichtenstein, Hans-Adam II (2010), predicts that large centralized states will not survive the twenty-first century and will have to be transformed into something resembling a "public service company." This perspective presents states as losing much of their monopoly status whether they like it or not.

The more examples of privately produced order we can point to the fewer people will assume that existing order was created by state force. Just as economic discussion of the benefits of free markets and the tremendous success of places like Hong Kong have convinced many that markets can work wonders (Gwartney, Lawson, and Block 1996), highlighting successful examples of privately produced order may have a similar influence on public opinion. Because states depend on perceived legitimacy, the more people recognize that states were not invented to eliminate disorder, the less legitimacy and power states will have.

## NOTES

1. Rothbard (1977a: 2) presents a consistent description about how states "arrogate to themselves a compulsory monopoly of police or judicial protection."
2. For a critique of such logic see Powell and Coyne (2003).
3. Bastiat (1848) actually criticizes the popular "personification of the state" among nineteenth-century Frenchmen because it encourages the illusion that state programs may occur at the expense of some "metaphysical abstraction" rather than at the expense of one's flesh-and-blood.
4. Jasay (1985: 52) puts forward a definition of the state as that of "the organization in society which can inflict sanctions without risk of disavowal and can disavow sanctions by others." David Friedman (2008: 1) offers a

similar definition of government (here synonymous with state): "My preferred solution is to define rights in terms of the set of mutually recognized commitment strategies by which individuals constrain how other individuals act towards them, and to then define a government as an institution with regard to which those strategies do not apply, an institution which can violate what individuals view as their rights with regard to other individuals without setting off the responses by which such rights are normally defended."

5. See also Vernon Smith's (1985) discussion.
6. Hayek (1973, 1988) expounds on this theory.
7. Primary and early states are sometimes related to the concept of chiefdom. Claessen and Skalnik (1978a: 222) define chiefdoms as sociopolitical organizations that have some elements of centralized governance but "no formal, legal apparatus of forceful repression, and without the capacity to prevent fission." Pauketat (2007) gives a skeptical but thorough overview of the chiefdom concept. By this conception, chiefdoms are commonly considered one precursor to the early state as they introduce the feature of centralized authority in a chief (e.g., Carneiro 1981).
8. The tenth-anniversary issue of the journal *Social Evolution & History* (2012, 11 [2]) is titled "Origin of the Early State: A Reconsideration" and includes a lead essay by Carneiro (2012) in which he reformulates his circumscription model of state formation in light of major critiques, followed by often very critical commentary from over twenty scholars of state formation including Claessen (2012).
9. Levi, Sacks, and Tyler (2009) study African states and find that political obedience is dependent on a sense of obligation and willingness to obey state officials—that is, the intensity and prevalence of viewing the state as *legitimate*, and this view is largely dependent on whether one sees the government as trustworthy and procedurally just.
10. Patricia Crone (2003) surveys premodern societies and looks for commonalities in early states, finding that "while the provision of welfare and dispensation of justice were upheld as ideological claims, actual governance tending to be minimal, providing at best a 'protective shell.' The state's success in providing law and order was necessarily rather limited: given deficient policing, harsh punishment had to serve as a symbolic deterrent. Self-help remained crucial for law and order" (56–57). Crone writes that "since the state could neither penetrate nor integrate the society it ruled, it sat on top of a myriad of ethnic, linguistic and religious communities and a myriad of self-help groups over which it had little control, regulating the surface without getting very far underneath."
11. Trigger (1993) notes that "in the modern equivalent of the social contract theory," the "ideas of rationality and freely given consent have been replaced by ones that evoke religious fear as the main reason an exploited majority was initially prepared to support" the early state (81).

12. The forty-fourth president of the United States (2008) remarks: "If you start building a military premised on the use of private contractors, . . . I think you are privatizing something that is what essentially sets a nation-state apart, which is a *monopoly on violence.*" Italics ours.
13. As Hayek (1979) explains, "the highest source of deliberate decisions cannot effectively limit its own powers" but "it is itself limited by the source from which its power derives, which is not another act of will but a prevailing state of opinion" (34). Ludwig von Mises (1966: 178) similarly puts forward "ideology" meaning "the totality of our doctrines concerning individual conduct and social relations" as ultimate constraint.
14. The same is likely true today in the dozens of countries around the world with weak or failed states (Leeson and Williamson 2009; Powell, Ford, and Nowrasteh 2008). The problem in these countries, however, is that the state has done much damage to and prevented the growth of private institutions of civil society (Coyne 2006).

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Part 4

# Austrian Economics and Market Socialism

Chapter 7

# Responding to Hayek from the Left: Beyond Market Socialism on the Path to a Radical Economic Democracy

Andrew Cumbers

## Introduction

The left and the cause of radical economic democracy have never properly recovered from Hayek's critique of the relationship between planning, collective ownership, and economic decision making. His withering attack at the end of the Second World War was a rear guard action against what he saw as the creeping inevitability of socialism and central planning, which had become the common sense of the time (Hayek 1944). Subsequently, his ideas have become the bedrock for neoliberalism and its dominance of the global economic policy agenda.[1] Whatever the inconsistencies in the arguments of Hayek and others from the Mont Pelegrin Society, or as Mirowski aptly names them, the Neoclassical Thought Collective (Mirowski 2013), they have become the common sense of our times.

Hayek's central thesis of the links between markets and private ownership on the one hand, and liberty and democracy on the other, has been absorbed faithfully by the mainstream political classes in North America and Europe in the period since 1980. It is predicated upon a set of arguments between knowledge and economic decision making that are an important challenge to traditional versions of socialism. Despite the overwhelming evidence of the deepening inequities between economic elites and the broader mass of the population, neoliberal ideas have survived the recent economic crisis remarkably intact (Crouch 2011; Mirowski 2013), largely because they continue to serve the interests of political and economic elites. There is a growing disconnect between economic realities and mainstream discourses bringing home Gramsci's important point about the deepening relationship between civil society and the state in the exercise of hegemonic power as capitalism becomes more advanced and complex (Gramsci 1971). Elites are often able to strengthen their position during economic crises, rather than there being an opening up to challenges from below, because of their continuing grip on the institutions of civil society and their ability to combine new coercive measures through the state (e.g., increased welfare retrenchment) with dominant meta-narratives.

For those on the left seeking to tackle the grip of Hayekian ideas, it is not enough to continue to highlight the nefarious impact of unfettered and deregulated markets, as indeed Orwell did long ago in his review of Hayek's work.

> Capitalism leads to dole queues, the scramble for markets, and war. Collectivism leads to concentration camps, leader worship, and war. There is no way out of this unless a planned economy can somehow be combined with the freedom of the intellect, which can only happen if the concept of right and wrong is restored to politics. (Orwell 1944)

We must also engage more critically with Hayekian critiques of older versions of socialism, which still hold massive sway over critical policy discourses. In particular, I argue in this chapter that if we are to move along a path to a more radical and egalitarian political economy, we need to address these criticisms as part of a project to re-embed economic decision making in collectivist institutions that can pursue more progressive ends through democratic means.

Recent work by Burczak and others on market socialism has been an important starting point in engaging with Hayek from the left but does not exhaust the possibilities for reconnecting democracy, freedom, and pluralism in a socialist economic project. Engaging critically but sympathetically here with Burczak's work, I also draw upon further critiques of Hayek by O'Neill and Neurath to prepare the ground for rethinking the relations between economic democracy, markets, and planning. As part of this project I close with some suggestions about some basic principles for forms of public ownership[2] that would stimulate participation, pluralism and deliberation in economic decision making.

## Hayekian-Inspired Critiques of Socialism and Public Ownership as State-Centralized Planning

Hayek's argument against socialism, associated in his eyes with planning and collective or public ownership as evidenced in his most influential book, *The Road to Serfdom* (1944), is that it leads to the centralization of economic power and decision making and the crushing of individual freedoms and democracy. Hayek believed that once attempts were made to consciously plan and strategically design the economy, however progressive the intention, the unintended consequences would be a pathway to tyranny and authoritarianism. The increasing concentration of power associated with socialist planning would lead to an immense and uneven build-up of power with one center at the expense of all else.

> By concentrating power so that it can be used in the service of a single plan, it is not merely transferred but infinitely heightened; that by uniting in the hands of some single body power formerly exercised independently by many, an amount of power is created infinitely greater than any that existed before. . . . There is in a competitive society nobody who can exercise even a fraction of the power which a socialist planning board would possess. (1944: 149)

The implications for Hayek are that private ownership and competitive individualism (even if that takes a large corporate organisational form), voluntary exchange, and free markets are therefore preferable in the achievement of economic democracy. A competitive market of private interests is the "only system designed to minimise by decentralisation the power exercised by man over man" (1944: 149).

The historical record of actually existing state socialisms in the twentieth century, from China to Cuba to the former Soviet Union, does much to bear out Hayek's warnings with regard to the relations between central planning, state ownership, and democracy. The growth of the state in market economies under more social democratic auspices in Britain, France, and elsewhere in the post-1945 era also tended toward more centralized forms of public ownership with little progress made in devolving economic decision-making power away from elites toward workers and citizens.[3] Furthermore, Hayek argued that planning and public ownership would also stifle innovation and the evolutionary dynamics essential to any well-functioning economy.

While his arguments about the relations between markets and democracy may be wearing a little thin in the global capitalist economy of the twenty-first century, his critique of the "knowledge problems" (Hodgson 1999) of collective centrally planned economy remain pertinent. Summarizing his argument, Hayek disputed the ability of socialist planners to plan an economy effectively because of their limited knowledge about conditions on the ground.

> If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. (Hayek 1948: 26)

While Hayek did not dispute that planning was important to some areas of economic life, notably the "public utilities" (Hayek 1944: 51), the complexities of the modern economy in most other areas meant that planning would be hopelessly ineffective compared to the market:

> It is the very complexity of the division of labor under modern conditions which makes competition the only method by which such coordination can be adequately brought about. There would be no difficulty about efficient control or planning were conditions so simple that a single person or board could survey all the relevant facts. It is only as the factors which have to be taken into account become so numerous that it is impossible to gain a synoptic view of them, that decentralisation becomes imperative. (Ibid.)

In other words, the diverse array of tacit knowledge required to understand the everyday workings of the economy could not possibly be codified adequately for a centralized plan. For Hayek, once it is clear that uncertainty and knowledge problems required decentralized decision making in constantly changing conditions of supply and demand, the price mechanism becomes the only instrument that can deliver effective solutions. It is precisely the anarchy of the market order that gives it its strength in these terms in promoting both democratic decision making and innovation. Dispersed decision making, independent of the control of central authorities, allows experimentation and creativity that can deal with uncertainty.

Hayek viewed markets under capitalism as voluntarist forms of exchange, which, so long as they are regulated through legal contracts, serve the interests of society as a whole through organizing resources efficiently. In this schema, private ownership and the wage relation are also viewed positively because all economic actors are nominally free to make rational choices about the extent to which they engage in market relations. For Hayek, the market is preferable to socially planned models because it is seen as arbitrary and not underpinned by moral or ethical presumptions (see O'Neill 1998: chapter 2 on this point).

The limits to Hayekian market utopias have been exposed after three decades of neoliberal market deregulation processes carried out in his name. Unrestrained market forces have resulted in a growing concentration of decision-making power, rather than its decentralization, and the alienation of most people on the planet (arguably consumers as much as producers) from the key decisions that affect their lives. Globally, economic policies inspired by Hayek's vision are leading to an accumulation of wealth in fewer hands in which the private appropriation of public assets has played an important role. The heightened financialization and commodification of everyday economic life can also hardly be described as contributing to the more open-ended and decentralized forms of knowledge production that Hayek argued would flow from market relations. Indeed, as Mirowski has wonderfully captured in his recent tome, neoliberal capitalism seems to thrive on promoting ignorance and muddle among the general populace about how the economy actually functions (Mirowski 2013). Certainly, today's corporate and financialized global economy is a long way from the decentralized market utopia of innovation, discovery, diversity, and experimentation suggested by Hayek.

In spite of the gap between neoliberal rhetoric and reality, Hayek's insistence on the importance of decentralized decision making and the potential inherent in markets as one means of achieving this remains prescient in any discussions about institutional and organizational forms, and ways of creating more democratic economic systems. As Geoff Hodgson has put it:

> No convincing scheme for durable economic decentralisation has been proposed, without the equivalent decentralisation of the powers to make

> contracts, set prices, and exchange products and property rights, through markets or other forms of property exchange. This does not mean that markets are regarded as optimal or ideal, nor that an entire economy is made subject to 'market forces'. It does mean, however, that markets and exchange are necessary to sustain genuine economic pluralism and diversity. (1999: 31)

The underlying point here is inescapable. A system of completely centralized planning contains serious flaws, in terms of economic efficiency, social need, and democratic accountability. Economists who have been sympathetic to socialist ideals have long recognized the limits to central coordination and the need for "de-centered" and more spontaneous mechanisms for day-to-day decisions. This is because the forms of knowledge that lead to new innovations in products, services, and processes do not arise in the main from formal planned research administered by committees (whether of multinational companies or state bureaucracies), but take place through social interaction in the coming together of individuals in a free, open, and democratic exchange of ideas. Taking seriously the dynamic and evolutionary nature of the economy and its implications, in terms of tacit institutions, rules, habits, customs, and the deeply rooted practices of economic life, is critical in devising new socialist ideas around economic democracy.

However, this does not mean that there is no place for planning or deliberative processes in addressing socioeconomic problems. Indeed the argument here, and returned to later, is somewhat different (see also Cumbers 2012; Cumbers and McMaster 2012). The failure to treat knowledge production and economic action as socially embedded and interactive is a criticism that can be leveled today at most of mainstream economics with its analytical tools of methodological individualism and rational choice (see Fine and Milonakis 2009; Keen, 2011) while the same knowledge problems that Hayek foresaw confronting state planners would today apply to the executive officers of global corporations operating in pyramidal systems of management and coordinating vast globally dispersed supply chains.

## Buczak's Creative Response to Hayek

The most common response for those socialists and Marxists prepared to engage with Hayek was to advocate various versions of market socialism (e.g., Hodgson, 1984; Lange and Taylor 1938; Nove 1983) in which market discovery mechanisms are combined with more collective forms of ownership. Perhaps the most sophisticated and compelling variant to date is Theodore Burczak's proposal of a competitive market economy consisting of employee-owned firms (Burczak 2006). Given the limited space available I will greatly simplify Burczak's arguments here, but essentially he brings together a Marxist sensibility around issues of labor appropriation with a Hayekian perspective on markets as discovery processes. Therein, he is able to recapture liberty and democracy from its appropriation by the right in a revised project for social justice and emancipation.

Following De Martino (2000, 2003), Burczak points out that a project for social justice should concern itself with "appropriative justice" in addition to "distributive justice." Distributive justice can be dealt with through proposals such as minimum income guarantees and wealth taxes that provide individuals with the resources that allow them to make "choiceworthy" decisions (Burczak 2006: 95). But what is compelling for our argument is his response to Hayek in addressing appropriative justice. For Burczak, the source of a Marxist concern with exploitation and alienation under capitalist social relations is the employment relations rather than private property. In this framing, exploitation occurs not because we have a market society per se but because we have forms of ownership that can be privately appropriated by a few—the one percent in today's parlance—at the expense of the majority—the 99 percent. A minority therefore appropriates undemocratically the labor of the vast majority of direct producers. Drawing upon Amartya Sen, Martha Nussbaum, and others, and in a direct attack on negative conceptions of liberty advanced by Hayek, John Rawls, and others before them, most notably John Locke, Burczak rightly recognizes this exploitation as an assault on human dignity. As he puts it: "a prerequisite for universal human dignity is that people cannot treat others as tools to achieve their ends" (Burczak 2006: 117).

Burczak's solution to these problems is a form of socialism consisting of worker-managed firms operating in competitive markets. Markets are still able to perform the Hayekian functions regarding discovery, knowledge production, innovation, and the stimulation of entrepreneurship and even competition, but worker-managed firms would eliminate what Burczak sees as the fundamental basis of exploitation of capitalism: the private appropriation of collective labor.

For Burczak, the source of capitalist exploitation is not private ownership but rather the "ability of the owner of the means of production to appropriate the entire output of an enterprise that employs wage labor" (2006: 110). His solution therefore is the abolition of the wage relationship in the capitalist labor process, rather than the abolition of private ownership.

The focus upon work and labor appropriation is important as a reminder of why exploitation and alienation do not go away through statist forms of socialism and public ownership in which, despite the replacement of private ownership by nominally collective ownership under state control, the appropriation of the value of labor still takes place (Wolff, 2012). A private elite is replaced by a state elite; hence the term state capitalism, preferred by many writers on the left when describing twentieth-century models of state socialism (e.g., Resnick and Wolff 1994; Wright 2010). Indeed alienation and exploitation can greatly intensify, especially if there is an overarching centralization of economic decision-making power in the manner suggested by Hayek.

Burczak's proposals would meet Hayek's objections about the limits to planning and centralization yet are revolutionary in providing workers with ownership and decision-making power in the economy. Essentially, his project involves re-reading Hayek in postmodern terms because of the latter's convincing arguments about the imperfectibility of knowledge, the limits to scientific rationality, and the universalism of Enlightenment thought, which have informed both socialist and (though this has not been acknowledged by Hayek and his followers) market utopias. Notably, Burczak's acceptance of the market as the premier organizing device is not an acknowledgement of the neoclassical view of markets as price mechanisms that provide optimum outcomes under equilibrium conditions. Far from it! Instead it is his recognition of the market as an important instrument for dealing with Hayekian knowledge problems and information deficits. But Burczak departs from Hayek around questions of ownership (or rather the collectivization versus the individualization of ownership), democracy, and social justice. Where Hayek viewed private capitalist forms of ownership backed up by legal contracts as sufficient to promote a "thin" version of the common good, Burczak retains the Marxist insight about the uneven nature of power under capitalist institutions.

Perhaps the most innovative and compelling aspect of Burczak's work in this regard is the way he turns Hayek's economic arguments back on themselves in political terms. To this end, he uses Hayek's well-made arguments about the context-laden nature of economic life to expose Hayek's underplaying of institutional power in a capitalist system. Hayek's faith in the ability of legal institutions under capitalism to arbitrate neutrally between economic actors (e.g., worker and manager) is naïve in the extreme, forgetting that like all other institutions they are socially constructed and context dependent. In other words, they too will be infused with the dominant power relations in society. The elimination of the capitalist wage nexus is a much better guarantor for Burczak of the elimination of pernicious institutions that work against the common good than legal protection of private property rights.

With others (notably Prychitko 2002) Burczak demonstrates that on purely scientific, rather than ideological, grounds, there can be no Hayekian objection to a worker-managed economy "in the context of widely held private property and market exchange" (Burczak 2006: 120). Worker-managed firms would act no differently from capitalist-managed ones; indeed, they may even perform better in terms of their ability to take a longer-term perspective and their greater willingness to use their tacit knowledge to improve the productivity and performance of the firm. Indeed they may well be more efficient because workers will have more incentive to improve productivity, less of a tendency toward work-shyness, while at the same time lessening the need for expensive monitoring and disciplining procedures (Bowles and Gintis 1993).

These are important arguments and help to dispel many of the assumed (but largely unsubstantiated) efficiencies under hierarchical forms of capitalist management in mainstream debates. Clearly, there is considerable scope for cooperative and worker-owned forms of organization alongside the continued use of markets in particular sectors of the economy, particularly consumer sectors that require more devolved decision making in the context of dynamic and complex forms of demand and individual preference (such as clothing or consumer electronics). However, the primacy attached by Burczak to market forms and the rejection of other forms of public ownership beyond private labor-appropriating enterprises needs a little more consideration and appraisal.

## Beyond Market Socialism in Creating Institutional Diversity

Appealing and innovative as Burczak's approach is, the continuing emphasis upon markets and private (albeit collective) ownership as generalized solutions to all economic questions seems to run counter to his own statement preference for a more open and pluralistic perspective in keeping with a postmodern and radical institutional sensitivity. Leaving this aside, there are also some problems with the uncritical acceptance of the market form as the ultimate arbiter of human fate. The emphasis upon capitalist exploitation within the labor process leads to a neglect of the market's own role in processes of uneven development. From Marx onwards the process of "primitive accumulation" or "accumulation by dispossession" in a more recent conceptualization (De Angelis 2007; Harvey 2003) refers to the ongoing dynamic within capitalism to bring noncapitalist spheres of economic and social relations—often held under more traditional and sometimes communal systems of rights—under conditions of accumulation and profit maximization. Key for us here is the point that it is the opening up of hitherto collectively organized nonmarket orders to competition and the "free market" that can create exploitative sets of social relations and appropriative practices in the first place.

Even for those with more orthodox Marxist outlooks, this does not necessarily mean that all market forms lead inevitably to conditions of gross exploitation and inequality. In this regard, Hodgson approvingly cites Diane Elson's plan to refashion the labor market along more equitable grounds, "the market can take a wide variety of forms, and some of these are much more objectionable than others" (Hodgson 1999: 97). Moreover, as the varieties of capitalism approach have demonstrated (e.g., Hall and Soskice, 2001), markets are ultimately socially constructed institutions that vary widely in time and space and are fashioned out of existing social and cultural norms and practices, rather than having a universal set of principles. Thus, Nordic and Germanic capitalisms are often compared favorably to Anglo-Saxon ones because markets are more embedded in social institutions that promote the common good over Hayekian negative individualistic freedoms.

More specifically, the point is that the unleashing of a neoliberal-inspired deregulated market regime globally in the past three decades has intensified the level of appropriation of common and public resources for private and elite ends at the expense of the multitude. A parallel argument to Burczak's position on private property relations might be to say that there is nothing wrong with the institution of the market per se as a solution to some problems of economic allocation—after all, markets predate capitalism—but there is a problem with the particular forms of actively deregulated markets under capitalism that have become hegemonic under neoliberalism policy doctrine.

Even accepting a role for the market in a socialist economy, it is of a different order of magnitude to allow it to be the only form of resource allocation. Recognizing Karl Polanyi's warning about the destructive powers of a dominant market order over society means that we need to be mindful of totalizing projects that, at the same time, unleash a narrow selfish individualism as the dominant value in economic practice. It is precisely the incursion and spread of "free market values" and norms—through heightened commodification processes—into all areas of economic life that should be resisted and rolled back if wider social goals are to be achieved, such as environmental sustainability, decent and "choiceworthy" lives, and social justice. Accepting that the market form should be preeminent ignores the diverse ethical and value systems that are required if social need and environmental sustainability are to be given priority in a more democratic and egalitarian economy.

The main issue is the dangers of monotheism and centralization of economic power and decision making, whether under monopoly, "late" capitalist regimes, or Soviet-style socialism. My argument is that this can be achieved without rejecting the continued role of planning and other nonmarket forms of organization in economic life. This point is well made by Antonio Callari in his otherwise sympathetic critique of Burczak's proposals.

> Now, as I see it, the problem with *Socialism* [*After Hayek*] is not with the idea of worker ownership and surplus appropriation, nor is it with the introduction of markets into the idea of socialism. I find totally plausible a rejection of socialism as a centrally planned calculation . . . The problem is, rather, with the presumption, central to the rhetorical force of *Socialism*, that these two elements (worker ownership and markets) exhaust the theoretical outline of a thickened socialism. There is no room, in this outline, for forms of ownership and appropriation other than those consonant with market processes . . . and social accounting of values other than through the lever of profit. (Callari 2009: 368)

It is exactly this concern that a market socialist order results in the narrowing of our value system to the pursuit of self-interest that motivates my argument. Surely, a more genuine collectively organized economy, organized into employee-owned firms and other forms of cooperative would want to engage with and encourage other moralities and value systems (e.g., Gibson-Graham 2006). How much of a revolution would it be if private and selfish capitalist rationalities were to be replaced by the same private and selfish rationalities of the collective direct producers? In a world characterized by a growing proportion of people who are marginalized from the labor process completely, this would seem to me a major omission.

## Socialist Diversity, Democracy, and Tolerance

Developing an economy that is genuinely open, diverse, and libertarian (in the genuinely radical egalitarian sense) means that we need to transcend the monotheism of the market and the private, not just the capitalist, wage relation. This means a rethinking of what public ownership and planning might offer. Yet market socialists such as Burczak seem to be set against such possibilities. Public ownership of the state ownership variety is implicitly rejected here on the grounds that it is fundamentally undemocratic; regimes that replace private ownership with state ownership replace one type of elite appropriating the product of labor with another.

Arguing in a similar vein, Hodgson criticizes traditional left thinking of the socialist rather than anarchist variety—by both revolutionary communists and the reformist wing of social democracy from Marx onwards—for its insistence on an economy in which private ownership and markets have been completely abolished and replaced by a form of common ownership of the means of production. For Hodgson, Marx and Engels's failure to take markets seriously was equated with a monolithic vision of state ownership: "in their sparse words on the economic organization of socialism, they betrayed an overwhelming adherence to the national ownership and organization of the means of production without any space or favour for economic pluralism and a mixed economy" (Hodgson 1999: 22).

Accordingly, this failure was perceived as an albatross around the socialist neck right up until the 1950s when the British Labour Party and the German Social Democrats, along with some eastern European regimes, began to accept the role of markets alongside planning. In other words, Hodgson reads into the Marxist rejection of markets and the commitment to common or public ownership—a lack of pluralism, diversity, and by implication democracy in economic institutions and forms. This is something of a conceptual leap; while the state socialist regimes of the twentieth century could be criticized on these grounds, it is something else entirely to suggest that a commitment to public ownership per se need always be associated with a lack of pluralism, diversity, and democracy. In this way, Hodgson seems to fall into the mistake of equating pluralism and diversity solely with some form of mixed economy in which market mechanisms, because of their price-setting and knowledge-discovery advantages, must have the pivotal role.

An important counterargument in defense of socialist diversity with nonmarket forms comes from John O'Neill (1998, 2003, 2007). Drawing upon the work of the associational socialist Otto Neurath, who was involved with socialist experiments in decentralized planning in Munich and Vienna in the 1920s and 1930s, O'Neill rejects the scientific rationality of both mainstream economics and orthodox Marxism in favor of a pluralistic perspective that accepts the limitations and provisional nature of knowledge claims. This is important because it rejects both market and socialist solutions to economic problems that seek to universalize decision making on the basis of making so-called rational choices: "The unpredictability in science in general entails that the technocratic ideal of the discovery of an optimal solution to social decisions is untenable" (O'Neill 2003: 191).

Despite agreeing with Hodgson and Hayek about the imperfectability of knowledge and the role of uncertainty in economic life, O'Neill draws very different conclusions, suggesting that markets are the not the only organizational form that can handle the complexities of local and distributed tacit knowledge. He uses the scientific and academic communities as exemplars par excellence of decentralized nonmarket orders that very effectively allow the development and exchange of knowledge in what we might term a global commons. The internet too, through innovations like Wikipedia (Wright 2010), is very good at creating nonmarket, nonhierarchical knowledge exchange. O'Neill points out that it is exactly the threat of growing marketization and commercialization that is likely to reduce processes of innovation and discovery exchange in these spheres: "The danger in the current introduction of market mechanisms into public science is that it will slow rather than increase the rate of innovation. Conflicts around the development of new intellectual property regimes center on the control of knowledge crucial to innovation" (O'Neill 2002: 147). It is the private corporate enclosure of the global commons that is the real threat to free exchange in the twenty-first century.

Neurath himself was critical of the idea that an economy could be subsumed to a totalizing logic, whether from market or centrally planned solutions, because of the problems inherent in imposing universal systems of value. He condemned attempts to impose a universal theoretical solution to social or intellectual problems through rational enquiry as "pseudo-rationalist." Solutions are always provisional. Thus, to offer up the market as means of resolving knowledge is a mistake, as he pointed out in an exchange with Hayek in the 1940s. The problem of low predictability and imperfect knowledge faces all human actors tasked with making decisions so that Hayek's advocacy of the market resulted in the same flawed logic that in his eyes afflicts socialist planners. Neurath neatly turns the tables on Hayek by invoking the "intolerance of the market economy" and stressing that "it is possible for forms of economy of various kinds to exist without being forced into competition" (Neurath 2003 [1920]: 397).

Following Neurath, the task for socialists seeking to marry together problems of resource allocation with social justice is to open up economic decision making to collective but also diverse processes as a general philosophy. Contra Burczak, Hodgson, and others, diverse forms of public ownership that allow different groups of citizens to have some level of participation and stake in the economy (compared to the situation at present where a small minority globally [the 1 percent!] hold most of the key decision-making power) are critical to this task.

## The Importance of Dialogue, Pluralism, and Diversified Public Ownership in Creating Economic Democracy

One problem that Neurath identified with socialist or communist projects of the early twentieth century was their intolerance of different traditions of collective ownership. His early career in researching the economies of ancient societies gave him a broader and more diverse canvas to articulate his own perspectives on public ownership. His recognition and respect of older traditions of mutualism and cooperation was in stark contrast, of course, to many of his contemporaries, who regarded older forms of social relations as inevitably conservative and antiquated. While Neurath still held to the vision of an overall grand plan in the 1920s, he did advocate a tolerance of older forms of collectivism that could be an important element in strengthening broader social support for public ownership:

> Today's socialism has many intolerant traits . . . Why could the peaceful movements for community-oriented economy not be united? Community economy, guild economy, social economy characterise certain periods, but they also exist side by side and give satisfaction to different types of human being. (Neurath 2003 [1920]: 402)

Ultimately, public ownership needs to be forged in a manner that respects such differences in economic identity and practice (Gibson-Graham 2006). What unified the different traditions of central planning and state ownership in the twentieth century was a radical modernist centralism that deliberately sought to destroy older and more localist collectivist economic cultures and traditions as well as more private and market-based forms.

The most compelling critiques of nationalization and public ownership from Hayek and others is of their strong tendency to centralize and concentrate powers in party and state bureaucracies far removed from the everyday lives of workers and consumers. However, this is not inevitable. While any economy will continue to require planning and strategic decision making at higher scales, these do not have to be concentrated within institutions, people, or places. Within any territorial form of political governance, the key decision-making functions for different economic activities can and should be dispersed. We might here contrast the decentralized and federalized polity of post-1945 Germany favorably with the growing concentration of political and economic power in the United Kingdom (despite recent devolution) around London and the southeast of England. The right institutional arrangements can decenter knowledge, power, and decision making within any broader polity.

An economy organized around public ownership should therefore be one that also disperses administrative units, knowledge production, and competence and has a plurality and diversity of organizations (e.g., mutual bodies, trade union research networks, small business associations, government, and autonomously funded think tanks) to offer alternative and competing interpretations of economic problems. Of course, there are no guarantees in any economic system that elite or special interests cannot capture policy agendas to the detriment of the social body as a whole, but dispersing functions, knowledge, and institutional capacity does at least provide important countervailing tendencies.

The implications of this are critical, for it implies that there should not be any one dominant model of ownership or governance. While we might agree on a common or shared set of rules and principles for public ownership, such as a commitment to production for social needs rather than exchange values, the pursuit of social equality, economic democracy, and environmental sustainability, the principle of organizational diversity should also be enshrined in a new approach to public ownership (Cumbers and McMaster 2012). Diverse forms of collective social relations would act as a further brake in preventing the emergence of totalitarian power structures.

Open dialogue and democracy in this sense require a degree of diversity and variation in economic practice. This commitment to diversity implies that there is no one definitive form of public ownership but a range of collective forms can and should coexist. Neurath clearly shares some libertarian concerns with an overweening and centralizing state insofar as he is distrustful of the militarism of nation-states and prefers self-governing associations (O'Neill 2003). This did not mean that there could not be an overall coordinating body charged with a "general plan"; in effect this is what elected governments do at present.

But, underneath this, and enacted in Neurath's proposals for the socialization of the Bavarian economy following the brief post-1918 revolutionary period, was a commitment to organizational diversity:

> The programme of socialization here discussed makes an attempt at a simultaneous realization of socialism, solidarism and communism . . . It provides for cooperatives for peasants and craftsmen, for collectivist settlements on a communist basis and for large-scale socialist production in agriculture and industry to exist side by side, in order to do justice to their different aspirations to realize a collective economy in their own way. (Neurath 2003 [1920]: 354)

The diversity and pluralism celebrated by Neurath would decisively shift people's identities and allegiances away from what he saw as the "intolerance" of the market economy or nationalisms towards a set of more dispersed identities and loyalties. In a review of Hayek's *Road to Serfdom*, Neurath described his system of associational planning whereby people would be members of many different associations at overlapping scales and spheres of life, would advance genuine solidarity and mutualism between peoples and social groups by developing a "multiplicity of ways of life" and "non-conformism" (Neurath 1945), which would guard against the totalitarian demand for one loyalty to "devour" all others.

While there are clearly some problems with Neurath's account, most notably how this diversity of forms can work and coexist in practice, there are important insights that help to take the debate beyond the standard critiques of socialist planning and public ownership. The Hodgson critique of democratic planning is not entirely overcome here, given globalization and the increasingly complex nature of the capitalist economy. Nevertheless, one does not have to sign up to Neurath's vision of a market-free decentralized socialism to recognize the importance of his arguments in overcoming the totalitarianisms of free market thinking or centralizing state projects. Reclaiming the diverse heritage of, and possibilities for, public ownership as an important element of creating democratic and pluralistic forms of economic relations is very much in the spirit of the arguments advanced in this chapter.

## Conclusion

My purpose in this chapter has been to argue for a more serious engagement on the left with Hayek's critique of socialism, planning, and collective ownership as leading to tyranny, and his celebration of markets, competition, and capitalism as the protector of democracy and individual liberty. Hayek's intellectual arguments in particular have been compelling in seeking to come to grips with the flaws apparent in dealing with the issues of uncertainty, pluralism, and democracy. Many have taken up this task with gusto, none more so that Theodore Burczak in his recent attempt to reformulate a market version of socialism (2006). While accepting Hayek's critique of socialist planning for its omissions in dealing with knowledge problems, central issues for any economic system, Burczak's ingenious appeal to competitive markets under collective ownership is an important riposte. Burczak's insightful thesis around worker ownership and the important issue of "appropriative justice" is an important theme to take forward from these debates.

However, I would argue that Burczak and others cede too much ground to Hayek in considering the economic institutions that can bring together technical proficiency and social justice. Two points are critical in the argument laid out in this chapter. First, the continued emphasis upon the market as a form to promote innovation, diversity, and economic tolerance has its own problems and indeed is no more likely to resolve some of the issues apparent under forms of state and public ownership. While there is clearly a role for some types of markets in the organization of a socialist economy, it is quite a big leap to dismiss alternative nonmarket institutions and mechanisms for coordinating the economy out of hand, or to put quite so much emphasis upon market forms. The reframing of an economic agenda around socialism and economic democracy also has to go beyond market values to incorporate nonmarket forms and ethics. Not only are the market's powers to stimulate knowledge and diversity exaggerated but the competitive and profit-driven ethos is not and should not be the only "economic identity" that shapes economic decision making (Gibson-Graham 2006). Accepting the economy as ultimately a socially and politically embedded phenomenon, the task is to create institutions that both protect and encourage noninvidious, market, and nonmarket forms. At the core of these arguments is the need for institutional rules and organizational forms that are fundamentally grounded in democratic procedures, advance a pluralist society, and are concerned with deliberative forms of decision making. The precise nature of how this emerges will vary over time and space, and is context dependent.

The second related point, drawing upon O'Neill and Neurath (and implicitly from Hayek and Hodgson), is the importance of diversity and variety in new forms of ownership, allowing both state and nonstate forms of public ownership to work alongside each other. The key criticism in this respect is that in developing new ideas about public ownership we do not fall back into the mistake of the all-encompassing model and vision. Public ownership needs to take on more variegated forms that are both respective of geographical variations in preexisting economic practices and cultures but also takes diverse, dispersed, and overlapping forms as a way of combating the centralization and concentration of economic power and decision making.

## Notes

1. Prior to becoming Prime Minister, at a meeting of the Institute of Economic Affairs, Margaret Thatcher famously quipped, "This is what we believe," brandishing in her hand as she spoke a copy of Hayek's *Constitution of Liberty* (Lister 2011, 1).
2. Here I will henceforth use the term "public ownership," but I define the term broadly in terms of all those attempts both outside and through the state to create forms of collective ownership in opposition to private ownership (e.g., including employee-owned firms, producer, and consumer cooperatives) as well as those that involve state ownership. See Cumbers 2012 for an extended discussion of these definitional issues.
3. See Cumbers 2012, chapter 1, for an overview.

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CHAPTER 8

# THE POST-AUSTRIAN SCHOOL AND THE NEW MARKET SOCIALISM

GUINEVERE LIBERTY NELL

## 1. BACKGROUND AND RATIONALE: WHY MESS WITH A GOOD THING?

Austrian economics has much to say for it; however, Austrians often seem to work from a conclusion backward to prove that private property produces the more efficient outcome, with the best effects for everyone. Certain blind spots and double standards persist among Austrians who otherwise offer a dynamic and useful framework.

### 1.1 AUSTRIAN BLIND SPOTS AND DOUBLE STANDARDS

All economic schools have blind spots, double standards, and other flaws; the Austrian school is surely neither better nor worse than any other. Still, there are some important areas that could be improved in a post-Austrian school and it might not be unreasonable to imagine that it is wishful thinking on the part of many Austrian economists to assume that markets are superior to government for every purpose and in every case.

Austrian economists have a tendency to omit from their models simple and well-known truths, such as collective action and public goods problems in critical areas where the market may fall short of producing socially desirable outcomes. Austrians often overlook collective action problems, as well as income disparities, that reduce labor's power compared to large firms, both in general (see Burczak 2013), and when it comes to affecting legislation (even when rent-seeking is impossible for obtaining subsidies because they are constitutionally outlawed, it may be possible to affect tax levels).

Also overlooked are collective action problems that reduce consumer power with respect to boycotts, which reduce the likelihood that firms will be held accountable by the public for gross misconduct. Although Austrians stress the market's power of reputation, multinational firms have acted with extreme negligence and outright criminal behavior and continued to thrive for decades afterward. Consider, for example Nestlé (Muller 2013).

Austrians tend not to account for the public goods' aspect of charity and other similar issues that reduce the effectiveness of markets to bring about socially desired outcomes. Rothbardian Austrians argue (based on Rothbard 1956) that government reduces social welfare, and charity is more efficient and effective than government transfers. They argue this despite the reluctance that people may have to donating to charity given that they know their own contribution will have little effect by itself, even though they stress this reluctance when it comes to discussions on voting (frequently citing Caplan, 2008, a libertarian—though not Austrian—economist) and even though they are well aware of the issue as it affects incentives in socialist economies.[1]

Voters rely upon others voting, and in particular others voting with them. Without this cooperation, voting is hardly worthwhile. Charitable giving suffers from the same phenomenon; however, Austrians cite the effect when discussing voting and socialism (public sector applications) but not charity (a private sector application). Yet it is a well understood problem, and could result in too little of the good, which, in the case of charity, means the poor and disadvantaged, who would have no public sector help in an Austrian world, could be left suffering, even starving. Some might argue that Austrians are only capable of dismissing such effects because they come from privileged backgrounds (white, male, upper class). Christian Bay (1971) makes a case along these lines.[2]

They also ignore this factor when they suggest that taxes should be paid voluntarily, for example in response to Warren Buffet's famous call for an increase in taxes on the rich, and the reply that if he wanted to pay more he should do so voluntarily. It is easy enough to suggest Buffet simply volunteer the money, but even his substantial contribution would be just a drop in the ocean of America's budgetary needs. So it is not surprising that he would be reluctant to pay more without others joining him, to increase the impact and share the burden.

Similarly, Austrians frequently overlook the difficulty in unilaterally increasing wages, when they suggest that companies calling for minimum wage laws ought to simply increase their own wages paid if they believe it to be the right thing to do. Austrian David R. Henderson (2013) recently wrote: "'Employers like me need to do our part by paying a decent minimum wage,' says Jon Cooper. OK. So why doesn't he? Why does he need a law to force him to do what he says he should do?"

How is it that suddenly basic price theory is beyond Austrian analysis? Obviously, in many cases firms cannot raise wages unilaterally without risking losing business, since either their prices must rise to cover the higher wages or their profits will drop, hitting their stock price or ability to invest and expand. The evolutionary aspects of the spontaneous order of the market that Austrians emphasize make this inevitable, so Austrians should be the first to answer their own question.

Austrians argue that firms (like Walmart) calling to raise the minimum wage are trying to "hurt" their competition, especially if they already pay above the minimum wage. However, it could be that they are not trying to hurt their competition but to stop their competition from hurting workers. Their competition might be lowering wages below what they would be willing to pay, in order to out-compete them, and thereby forcing them to hurt workers (by reducing their wages) in order to keep up.

Austrians tend not to dwell on the different circumstances that poor and disadvantaged members of society face, while dismissing inequality as irrelevant and redistribution as inefficient, ineffective, and unjust. They come to their conclusions only because they fail to give time and attention to the different circumstances faced by the poor in wealthy countries and the poor in developing countries working for multinationals.[3] This avoidance allows Austrians who favor anarcho-capitalism to maintain the illusion that private property protection without any democratic government would not lead to concentration of economic power even more extreme than exists anywhere today.

Austrians argue that private property rights should help to resolve the problems produced by externalities and public goods (which Austrians consider to be fundamentally the same problem). Halbrook (2003) describes several arguments Austrians make against the mainstream theory, which proposes market-based solutions for the problem (either Coasian or contract-liability). However, he finds a flaw in both these solutions: If the monetary award "accounts only for the market value of destroyed property, the externality will not be 'corrected' for objects with any sentimental value."

Halbrook (2003) then asserts that a more modern Austrian argument is Rothbard's, which argues (in Halbrook's words) that externalities "are irrelevant to the study of economics" because it is not possible to calculate them precisely (because they must be determined without reference to human action) nor to compare utilities between two different individuals. Austrians are not consistent in this belief.

Austrians implicitly recognize the greater utility of money and necessities to the poor than the rich, and in general the validity of making a comparison, in their writings. It is implicit when, for example, they argue that labor-saving home appliances and falling food prices (which, they say, come with economic growth) help the poor more than they help the rich or oppose lump-sum taxes on the grounds that they are essentially regressive because a $1,000 tax affects the poor more than the rich (it is a clear double standard to not apply the logic in reverse) (Horwitz 2009; Lynch 1971; Matthews 1997: 193).

Nell (2013) explores in more detail the flaws in Rothbard's argument (see also Burczak 2013 and Miller 1989a).[4] Burczak (2013) shows that the error is linked to another double standard, in which he sees a "join-or-starve" coercive situation for workers with regard to unions, but not when they face a "private" monopolistic employer and fear of starvation. He explains that, "there consistently is a much lower bar to pass for union activity to be deemed coercive. . . . The alleged choices workers have when facing a capitalist employer disappear when workers (and owners) face the union . . . [such as] employment in the unorganized sector . . . starting one's own business . . . selling their capital equipment . . . to walk away from the picket" (53). Burczak concludes that "ideology clearly colors Hayek's discussion of coercion," and this is even more true of Rothbard. Far from inefficiency and coercion, trade unions may empower individual workers and the community, and may even strengthen the economy in some cases. Hayek's (1945) emphasis on tacit knowledge, coupled with the ability for trade unions to channel information and develop rules for conflict resolution, argues in favor of strong trade unions in some industries (Niechoj 2008). So long as corporations and other firms are powerful, and potentially monopolies in their local area, trade unions may be critical for balance. Austrians seem to let the perfect *ideal* be the enemy of the good. They hold an ideal of freed markets and, in the meantime, allow the incumbent powerful firms to remain so and the powerless worker-individuals to suffer.

Austrian Walter Block argued that the concept of externalities is faulty because almost any good will provides some benefits or costs to third parties. "What about socks? Doesn't the fact that other people wear socks, and I don't have to smell sweaty feet all day, provide me with a benefit for which I'm not paying? Must socks, therefore, be considered a public good?" (Callahan 2001). Block is correct in that there are externalities from nearly anything, including socks. However, the positive benefits of, for example, education and high-quality media and journalism, and the negative effects of poor quality, are far greater than the positive externalities of socks; and they are obviously of a more important type.

Therefore, social governance over goods like socks can be left to informal institutions, such as the cultural and social controls known as "courtesy," "manners," and the like, while education, media, and other things that produce really significant, important positive externalities should probably not be left to be governed by tradition, culture, or other informal rules and rule enforcement—at least if those informal institutions are not working well.

Austrians do not accept mainstream economic arguments regarding the positive externalities of education and media upon culture and "human capital," nor arguments regarding public choice issues, which recommend public funding for education and educational media. The forces of supply and demand may be good for many things, but there are exceptions. For example, media and schools should not necessarily respond to demand. This is because those making use of them (and others affected as third parties) do not know what they should be demanding.

This is not entirely a matter of asymmetrical information (such as when a patient does not know what his or her doctor knows, or a customer and car mechanic, etc.), but is also because short-term instant gratification may be clear but the benefits of good media that go beyond this and the benefits of good education that demands more of the student than they would prefer, is long-lasting, widespread across society, and actually helps to create a good society. It is of great benefit to the "customer," too, though he or she will not recognize it until after it has made its impact.

Responding to students and parents as customers reduces educational content, as the desire of the customer-student supersedes education as a goal, making the teaching of history and uncomfortable subjects, like racism, impossible. A clear example of this occurred recently in Minnesota:

> Back in January 2009, white students made charges of discrimination after Gibney suggested to them that fashioning a noose in the newsroom of the campus newspaper—as an editor had done the previous fall—might alienate students of color. More recently, when Gibney led a discussion on structural racism in her mass communication class, three white students filed a discrimination complaint because it made them feel uncomfortable. This time, MCTC reprimanded Gibney under their anti-discrimination policy. (Cottom, 2013)

Austrians tend to downplay issues like racism, sexism, and the effects of education on culture. However, culture is largely made up of the "externalities" created by things like education and media, as well as technology. Culture and what Marxists call "[class] consciousness" or "enlightenment" is very clearly critically important, and Austrians *are* aware that that culture affects economy, but their theory does not fully *integrate* this knowledge. Hayek's theory of cultural evolution (1960, 1979) is nearly complete in itself, but its implications for the rest of Austrian theory have not been developed adequately.

The importance of culture can be seen when considering different populations with similar income and poverty levels, not merely between rural and urban areas or between different countries, which may have different levels of technology and other factors, but even between two urban areas in the same city, one in a crime-ridden ghetto and one in an immigrant community, for example. Austrians are aware of the importance of the "work ethic" in the latter, and the effect of an "entitlement mentality" in the former, caused by public housing and welfare. However, the importance of these and other factors is left merely as an observation, not explored in order to determine the full meaning of the cultural factor upon Austrian models.

Austrians stress the ways that markets have helped to advance culture and reduce racism and sexism through the force of competition, but when the old culture is stronger than the progressive culture, markets can channel the former into profits. Profits become dependent upon firms catering to the worst and most backward aspects of culture—e.g., racism--in order that those adhering to the culture continue to do business with the firm. For example, recently a restaurant in western Indiana that shared its food with the poor was forced to stop by other nearby business owners, who repeatedly called the police to complain because they "felt that the free lunches were scaring away customers" (Keyes 2013). The same story "has played out in countless communities." After bullying the restaurant owner, typically laws are passed to support and reinforce the preferences of the culture.[5]

Austrians also tend to give *complete* credit to free markets (trade, division of labor, specialization, etc.) for the incredible wealth of recent centuries. Surely it played some role, but what about the simple factor of scientific advance and accumulation of technology (which began before the free-market era that Austrians credit), which compounds and ultimately results in exponential growth, and also the interaction of the creativity and creations of the people in an ever-expanding population that continues to interact more and more? It could be coincidence or reversed causation: as wealth grew, the desire for free trade emerged in order for those with wealth to capitalize on it. If these factors were significant then Austrians give far too much credit to laissez-faire for the economic miracle of modern times.

Another blind spot involves seeing a dichotomy between market and government where there isn't one—where the benefits of markets actually may also exist in a democratic order but are not even considered, or are dismissed as impossible without careful consideration. This is why a "democratic process theory," to complement the Austrian "market process theory," is so important. Austrians also attribute to markets, and to capitalist market exchange in particular, what should be attributed to other systems, such as cooperative exchange. For example, Bylund (2010) shows clearly in just a few pages the error that Peter Leeson makes in his book (and earlier papers) on the economics of pirates. Leeson (2009) describes pirate systems as market exchange, while they are actually much more accurately described as cooperatives.

Austrians tend to be highly skeptical of the idea of cooperatives and other alternatives to purely profit-seeking private firms and "free" private property economies, arguing that if they were efficient they would succeed in the (capitalist) "free market," without carefully considering whether property rights *as we know them* are truly unbiased and the only possibility for maximizing freedom. Geoffrey Hodgson (2015, forthcoming) argues that Mises and Hayek conflate property with possession and pay insufficient attention to the details of private property law, including employment contracts and financial systems. See also the analysis of Gus diZerega (chapter 5, this volume) on how theoretical abstractions used for modeling employment contracts "hides from market advocates both its major shortcomings and ways for overcoming those shortcomings."

Finally, Austrians criticize government intervention and firms that make use of it, but conveniently ignore the use by multinational firms of the interventions of non-U.S. governments; for example, the use by Walmart of China's highly interventionist (nominally communist!) government. Although they criticize firms that rely upon U.S. government aid, arguing that they survive when in fact they should fail, they do not hold those same firms to account for relying upon foreign governments. History warns of the possible consequences of both—empire building has made use of slave labor and markets have allowed customers abroad to blindly support the slave owners. Elizabeth Abbott describes in great detail how this occurred in the sugar industry. Slaves were used almost exclusively in the sugar industry for many decades, and the purchase of sugar abroad at cheap prices, due to the use of slave labor, supported this practice. She quotes Voltaire

> In Voltaire's *Candide*, a maimed Surinamese slave explains why he is missing one arm and one leg: "When we work in the sugar mills and we catch our finger in the millstone, they cut off our hand; when we try to run away, they cut off a leg; both things have happened to me. It is at this price that you eat sugar in Europe." (Abbott, 2010: 89)

Of course, Americans may not learn Voltaire, nor discuss slavery at length, if Austrians succeed in simplifying education and shaping it to the benefit of firms and customer-students.

## 1.2 Theoretical Shortcomings

Austrian economists famously stress the benefits of markets and the shortcomings of government solutions. For some Austrian economists, including Murray Rothbard and his followers, there is nothing that government can do that would raise social welfare. Rothbard's theory is critically flawed (for detailed analysis, see Nell 2013). Rothbard, Hayek, and other Austrians also define the terms "freedom" and "voluntary" as consisting of an absence of coercion, and in turn, "coercion" as an active and conscious coercive act on the part of one party against another.

However, are we not just as unfree if a physical obstacle prevents us from moving as if a person does? David Miller (1989a: 29–30) argues this case convincingly.

The concept of demonstrated preferences relies on the cyclical aspect of the market—that one is free to earn, and hence to consume, as much as he or she wants. Even with full property rights and freedom, the cycle of earning and consumption remains incomplete so long as there are natural or luck-based discrepancies in earning power, most obviously among those unable to work at all. The Rothbardian conclusions regarding "demonstrated preferences" are entirely unwarranted: all "demonstrations" of preference are not equal, and all relevant preferences are not demonstrated. The demonstrated preferences concept has a very obvious flaw: It conflates *willingness to pay* and *ability to pay* (Nell 2013), treating them as interchangeable and implicitly assuming that anyone wishing to purchase something will be able to do so.

Even when they fall short of Rothbard's attempt to prove laissez-faire as perfectly efficient, Austrians still tend to make attempts to show the efficiency of markets and the ideal of the spontaneous order of the market, which in itself may not be value-free (Aydinonat 2010), but not the perfect efficiency of any other spontaneous order. Though Hayek showed some consistency with his respect for tradition, he would not have argued that the efficiency and purity of the spontaneous order of tradition mean that there must be no intervention, that is, no forces that might replace the spontaneous informal rule with a centrally determined command. For example, Hayek would not likely have condemned a public service announcement aimed at changing an unsafe hygienic, sexual, or general health practice; yet this would arguably be as much an intervention in the spontaneous order of tradition as are the policies Hayek rejects as interventions in the economy (i.e., the spontaneous order of the market). It seems he values one spontaneous order over the others, which is another double standard.

Hayek recognized that even if progressive taxation may be inefficient and as such should be avoided, there may be strong arguments for using other kinds of taxation that reduce wealth disparities. In particular, he supported inheritance taxes for the duel purposes of "greater social mobility and greater dispersion of property," saying that such taxes "may have to be regarded as important tools of a truly liberal policy" (Hayek 1948: 118).

If the market is slanted or tilted toward the lucky and the active participants, this outcome in turn affects market participants' preferences. Individuals are influenced by what those around them purchase, but also the prices and availability of goods is determined by what the most active producers and consumers have already purchased. Despite modeling many evolutionary attributes of markets, Austrians also fail to account for the endogenous effect on preferences that must occur, and must in turn affect the society, in an evolutionary system—especially one in which preferences play the large role that they do in markets (see Nell 2013 and Hodgson 1998: 165).

With fixed preferences there is a lack of evolutionary feedback; but in the real world preferences are not fixed but mutating, and are influenced by the system itself. Austrian economists describe the market in evolutionary terms. The omission of endogenous effects on preferences, personalities, and ultimately culture shields Austrians from the reality that markets only fulfill the preferences of market participants, preferences created by the market, and not necessarily the preferences those individuals might have if they lived in another system. Nor do they fulfill the needs of society nor allow for the society that might exist if the economic system were different.

Boettke, Coyne, and Leeson (2008: 338) stress the importance of "local knowledge resulting from practical experience," which includes "skills, culture, norms, and conventions, which are shaped by the experiences of the individual." Austrians recognize the importance of culture for supporting the rule of law and the market system, but do not account for all the implications of the effect of culture upon individuals and individuals upon culture. Because of the central place they give methodological individualism and subjectivism Austrians are especially unaware of the full implications of the social nature of the individual. As Wildavsky (1987) puts it, "All of us may be self-interested, but our conceptions of what is "self," and of what is in the interests of this self, may differ" (312). Even rationality is (at least somewhat) culturally dependent. "An act is culturally rational," Wildavsky writes, "if it supports one's way of life."

This actually follows from Hayek's model of cultural evolution. An honest and well-developed Austrian framework in the Hayekian tradition must incorporate an evolving social-cultural order. This order is not only critical to whether private property institutions are accepted and efficient (as Austrians know) but also to the effectiveness of public sector provision and democratic governance. Once this is accepted, Austrian reliance on the public choice school, and assumptions regarding inefficiency of the public sector, begin to fall apart—this is explored further in *Austrian Economic Perspectives on Individualism and Society* (Nell 2015, forthcoming).

As Austrians are well aware, the rich help the poor by purchasing luxury goods while they are still very expensive, and through purchasing replacements for durables more often than strictly necessary (sometimes far more often), thereby paying off the research costs and creating a secondary market for second-hand durables (for example used cars), thereby helping to drive down prices until the poor can afford to buy them. This means that theoretically the poorest in society could choose to wait until prices bottom out in a secondary market, and narrow the gap in consumption inequality between rich and poor considerably.[6] We are nowhere near this point, as many poor purchase many goods new (including brand-new and expensive sneakers, for example), and they do this because of culture, primarily. The goods in question (luxury goods) are by definition not necessary and so with very few exceptions there is no rational or justifiable "need" for poor households to purchase them new, nor to buy them before their prices drop considerably. The poor need not stand in line to buy a new iPhone when there are many cheaper phones that can do what they need a phone to do. (Of course need is somewhat subjective, but see Menger 2004 [1871]: 122–123). Still, the importance of the psychological and cultural reasons that the poor tend not to purchase goods secondhand, and have difficulty living within their means, should not be underestimated.

### 1.3 Anarchism: Capitalist, Communist, and Populist

There is a significant subsection of the modern Austrian school that refers to itself as anarchist. Anarchists other than anarcho-capitalists tend to call themselves socialist or anarcho-communist; however, there is a third type who arguably avoid the errors of both the two "extremes," and who might be called anarcho-populists.[7] Post-Austrian market socialists can learn much from the debates among anarchists, all of whom are against the state and in favor of self-organization. A few things that need to be overcome to bring these differing viewpoints, in some ways opposites, together: Austrian and other anarcho-capitalists may think of anarchy as favoring completely free markets and no state, whereas many anarchists define their position as being against both state *and* market. These anarchists are against all forms of oppression and exploitation and (contra chapter 4) consider private ownership of capital, and capitalist firms, as inherently hierarchical and authoritarian.[8] The anarchist writers' blog Infoshop.org (2010c) makes the point that not *all* anarchists oppose markets. The writer explains: "Individualist anarchists favour it while Proudhon wanted to modify it while retaining competition. For many, the market equals capitalism but this is not the case as it ignores the fundamental issue of (economic) class, namely who owns the means of production."

The natural Austrian response to this is, whoever owns the capital owns it and by definition becomes "the capitalist." He or she is just the individual who comes to own the capital in question at that given moment in time. The theory of Marxists and many socialist-anarchists is that the solely capitalist individual is of the capitalist class, while the worker who owns his or her own capital can remain in the working class given the right system (such as a cooperative-based market socialism), and this, they argue, makes all the difference. Austrians tend to omit from their models any representation of classes as social groups, despite Hayek's model of cultural evolution and group selection, which might offer a framework for including classes in their analysis and despite the possible insights that this might offer for understanding the effect of markets on social change (e.g., bourgeois virtues).[9] Another Infoshop.org entry states:

> Capitalism is unique in that it is based on wage labour, i.e. a market for labour as workers do not own their own means of production and have to sell themselves to those who do. Thus it is entirely possible for a market to exist within a society and for that society not to be capitalist. For example, a society of independent artisans and peasants selling their product on the market would not be capitalist as workers would own and control their means of production. Similarly, Proudhon's competitive system of self-managed co-operatives and mutual banks would be non-capitalist (and socialist) for the same reason. (2010a)

A market-based society divorced from the peculiarities of capitalism, where instead of free markets there are markets based on different property rules, and produced and cultured by policies and rules that even the playing field and support individuals and communities, will still allow the decentralized knowledge creation that Austrians stress. Such a system would also alter radically the social structure and culture experienced by citizens. The Infoshop post goes on to argue that capitalism creates authoritarian relationships and points out the error in ignoring social relationships by concentrating purely on the economic, which of course economists have a tendency to do:

> Anarchists object to capitalism due to the quality of the social relationships it generates between people (i.e. it generates authoritarian ones). To concentrate purely on "*markets*" or "*property*" means to ignore social relationships and the key aspect of capitalism, namely wage labour. That right-wingers do this is understandable (to hide the authoritarian core of capitalism) but why (libertarian or other) socialists should do so is less clear. (2010a; italics in original)

This is an argument that Bylund (chapter 4, this volume) would take issue with, arguing that this is not a necessary feature of the private market exchange relationship. Yet, the existing culture and social relations of a society have a huge impact on this relationship between contracting parties, potentially leading them to contract in a hierarchical manner. The capitalist market rules will also affect the available choices, which will differ from those available under another set of rules set up for a different kind of market-based society, such as a market-socialist one. Together these two factors may create a path-dependent cycle wherein there are endogenously determined culture-specific actions, options, and relationships, which may produce a work environment that is authoritarian, and which in turn affects the available options, the culture, and the social system. This is insufficiently recognized by Austrians, who appear to have a blind spot with regard to community-driven policies, social groups like classes, and cultural concerns like racism and sexism.

Hayek and Austrians working in the Hayekian tradition consider themselves to be the foremost economists in the field of self-organization. However, they appear not to recognize how anarcho-capitalism might lack rules to help guide bottom-up solutions; purely free-market property laws promote inequality and concentration of at least economic—and arguably as a consequence also political—power. Of Hayek, Hodgson (2015, forthcoming) writes: "He promoted a competitive market economy with small producers, blaming the state for concentrations of capital and corporate power. He never came to grips with the real sources of inequality under capitalism," such as (arguably) those described in the first section of this chapter (1.1).

What about the socialist form of anarchism, or anarcho-communism? Might it be superior to market socialism? In many cases, Marxists have been replaced with theorists under different banners who are, one might say, red on the inside. Often what they call anarchism is indistinguishable, in means and in ends, from the goal of the most radical Marxists. Infoshop.org (2010d) provides an answer the question "what do anarchists want to replace the 'smashed state' with?" The answer reads very much like a Marxist (or utopian collectivist, see Nell 2014) answer:

> During the 1905 and 1917 revolutions, Kropotkin expressed his support for the soviets created by the workers in struggle. He argued that anarchists should "enter the Soviets, but certainly only as far as the Soviets are organs of the struggle against the bourgeoisie and the state, and not organs of authority." After the 1917 revolution, he re-iterated this point, arguing that "idea of soviets . . . of councils of workers and peasants . . . controlling the economic and political life of the country is a great idea. All the more so, since it necessarily follows that these councils should be composed of all who take part in the production of natural wealth by their own efforts." (Infoshop 2010d)

So, the Soviets should only be used for struggle against the capitalists and the state and not as organs of authority, and yet they should control the economic and political life of the country (*especially*—not even *only*—if all who take part in them democratically continue to be workers)? How can they control all economic and political life and not be organs of authority? They seem not to have learned any lessons from the experience of Marxist parties that put their ideas into practice.[10] "Therefore, Fisher's comments are totally untrue. Anarchists have been pretty clear on this issue from Proudhon onwards" (Infoshop 2010d), the website entry continues, which seems ironic, given this stark contradiction.

Anarcho-capitalism and anarcho-communism have clear contradictions and difficulties, but anarcho-populism may not, and may well coincide with Hayekian ideas, and with ideas from market socialism. I argue in the next sections that Austrians should embrace the market socialism framework and explore the ideas of anarcho-populism and evolutionary social theories from all disciplines to find solutions that remain libertarian and continue to use markets but overcome the issues with laissez-faire.

## 1.4 Market Socialism: The Old and The New

Well before the socialist calculation debate, Eugen von Böhm-Bawerk (1890) and many other classical liberal ("bourgeois") economists (e.g., Edward Stanley Robertson [1891]) had already pointed out both the obvious problems with defining value in the "objective" way that socialists did, basing it on labor and the inevitable incentive and calculation problems that socialism would face in a dynamic economy with changing demand.[11]

After the collapse of the Soviet Union, the issue was reopened as economists recognized that Hayek may have been correct in his analysis after all. Those who reopened the question included economists from former communist countries who belonged to the *new* market socialist school. New market socialists are aware of the issues with state planning in the Soviet Union, and many of them are aware of Hayek's arguments and Austrian school critiques of state planning, and form their theories with these critiques in mind.

Institutional choice distinguishes economic systems—socialism or capitalism—as well as individual policies. The theory of the firm (Coase 1937) is about the efficiency trade-off between market coordination and planning. Janos Kornai (1985), who studied the Soviet economy and the Eastern European socialist countries, distinguishes between bureaucratic and market coordination and defines and characterizes the "soft-budget constraint" versus the "hard-budget constraint" and the "shortage economy," which command allocation induces. Yet, there has been little crossover from the framework used by Sovietologists, and that used by the mainstream of economics (Ellman 2009; Nell 2010).

Having come to terms with the failures of central planning, the *new* market socialists are those who came to the conclusion that the use of markets (in some form) by society is necessary, but that laissez-faire is not. While old market socialists from the socialist calculation debate were theoretical economists building idealized models, the new market socialists were born out of a wave of realism resulting from their inevitable encounter with real-world economies dealing with issues of transition.

Market socialists recognize that the defects of state socialism or central planning include not only its inefficiency, but also its restrictions on freedom. They also recognize that free markets lack "social justice," which Hayek argued was a mirage, but which still remains important to most people (according to polls) and, if defined as total welfare of all, is what Rothbard attempted unsuccessfully to argue that free markets offer. Pierson (1995) cites Keynes's three goals for the ideal social and economic system—economic efficiency, social justice, and individual liberty—saying that it is the reconciliation of these that market socialists strive to realize.

Market socialists also stress certain shortcomings of the laissez-faire market; for example, although rewarding merit is a positive and useful aspect of markets, markets are not entirely meritocratic and a system based entirely on meritocracy would also be unjust (failing those born with biological disadvantage) and unsocial (catering only to "merit" and not compassion, and other virtues).

They also point out other more subtle disadvantages; for example that sometimes we have too much choice and that free markets also can be bureaucratic. In the area of health care, it is not just Medicare that is bureaucratic in the United States, but private insurance as well. The combination is far more bureaucratic for the patient than is the UK's National Health Service. Do we even need choices in health insurance? We all want the same thing: all the care we need when we need it. Yes, some are young and healthy and libertarians may argue that they should pay less for insurance, but they are only young and healthy now. Insurance works when payments occur over a lifetime, and the young and healthy will be old and sick later, or if not, their loved ones may be.

### 1.5. What (Post-)Austrian Market Socialism Can and Cannot Be

The critique of Austrian economics above does not undermine its contribution to the socialist calculation debate. The Austrian economic school was the only neoclassical (subjective) school to predict and explain the problems of calculation in a socialist society, and to apply the implications of this to government intervention in markets, as well for use in analyzing the benefits of markets and market competition. Although market socialists have taken many lessons from the experiment with central planning, and have cited Austrian economists in this regard, they sometimes rely upon mainstream neoclassical economics for their critique of markets and their predictions of the benefits of government intervention. A post-Austrian economics would do well to consider carefully at least the Austrian-based market socialist critique of the market, and of Austrian models.

A post-Austrian economics must also take the Austrian school critique of intervention, based upon its critique of planning, very seriously, even if it may conclude that it has gone too far. The school should put it to the test rather than ignore it. If Austrian theory is lacking then the conclusions reached may differ in that the knowledge, calculation, and incentive problems of socialism, and lesser issues with intervention, may have to be weighed against the problems of a market system; for example, that it may fail to provide a segment of the population with a decent living standard, fail culturally, and offer hierarchy instead of freedom. Still, it is important to consider Austrian arguments against intervention, and "partial planning" of the economy as they are based upon the same models that warn against central planning.

There are strong Austrian arguments against many market socialist proposals, especially proposals to socialize all capital goods or all large corporations, and the Austrian arguments remain true and relevant even given Austrian "blind spots" and the lopsided nature of markets. David Prychitko (e.g., 1991) and N. Scott Arnold (1994) have contributed much in this area.

A market socialist proposal need not completely overturn the economy; a basic income provided for the purchase of a portfolio of stocks, given to each citizen when they come of age, might be considered a libertarian market socialist proposal for redistribution of the value earned from capital goods. Although such a proposal may face public choice problems, it would not suffer from calculation and knowledge problems, as with common ownership over capital. John Roemer's model—one of the best known new market socialist models (Nursey-Bray 2002)—almost certainly does.

Roemer argues that his models surmount the planning problems of centralized investment by only modifying interest rates (in a nationalized banking system), and he argues that interest rates suffer from problems of market failure in laissez-faire economies. He accepts Austrian analysis of central planning, but relies upon a (non-Austrian) neoclassical framework. Centralized determination of interest rates underlies Austrian Business Cycle Theory, and Roemer would advocate far more extreme adjustments than those Austrians have criticized. Austrians would also question whether nationalized banks would be able to use the same criteria to determine investment that commercial banks do (as he suggests), given the incentives they would have. It should be noted that Roemer (2013) now questions whether his model works, especially as it would be possible for greedy people to circumvent its purpose; he now argues that social democratic methods work better in practice than market socialist proposals of the type he advocated in the 1990s.

Yunker (2001) relies heavily on neoclassical methodology for his critique of the market, but does address certain arguments made by Mises that apply to his proposal. David Schweickart proposes a market socialism he calls "Economic Democracy" that completely eliminates the stock market and replaces interest paid to private individuals with a general capital tax.[12] New market socialists should know better: in the Soviet Union a capital charge was introduced (similar to Schweickart's tax), and investment was highly inefficient and contributed to "misallocation" of resources and shortages of critical consumer goods (Nell 2010a). Although Keynes (1936: 378) argued that animal spirits affect "aggregate demand" and cause business cycles, and hence "that a somewhat comprehensive socialisation of investment will prove the only means of securing an approximation to full employment," economists long before and long after Keynes have recognized the role of the investor and private creditors in resource allocation.

David Prychitko (1991: 86) analyzes Branko Horvat's "self-governing socialism," arguing that the calculation problem pertains to it as well, despite the decentralized nature of such a system, so long as ownership of capital goods is not private. Horvat's arguments closely resemble Oskar Lange's (1956 [1936–37]) case for market socialism:

> Spontaneous pricing of capital goods is eliminated through the social planning requirement of self-managed socialism: "the task of the Planning Bureau is to accomplish ex ante coordination of economic activities on the basis of the relevant set of preferences." The notion of consumers' sovereignty—a market for consumer goods—will apparently supply the information that reveals "the relevant set of preferences."
>
> With this in mind, Horvat's argument that the market can be used to "inform" the plan becomes more understandable, in theory. The data supplied by the consumer goods market can be used to socially plan the capital structure, imputing the equilibrium values of lower-order goods to higher-order goods (the socially owned means of production). This is similar to Joseph Schumpeter's claim (in defense of Oskar Lange's model) that equilibrium prices in the consumer goods market can be used to technically impute the values of corresponding higher-order capital goods. (Prychitko 1991: 86)

Prychitko reminds readers that this is not possible, for the reasons Hayek brought to light during the socialist calculation debate: a market for capital goods is required for economically rational decision making in the process of production. "[The market] allows those within an enterprise, using their limited and tacit knowledge of their particular horizon, to integrate their timely production plans in the complex structure of the community of producers as a whole" (Prychitko 1991: 86). However, this is only possible with private ownership, exchange, and profit and loss—or at least cost and benefit—accounting.

This was the central argument of the Austrian school against Marx and against Lange. In fact, consumer goods markets existed to about the same extent in the Soviet Union as they did in Lange's model of market socialism (Nell 2010b). The problem, as Mises (1996 [1949]) explained, is that without a capital goods market, the consumer goods market is not a true market—producing firms must be able to bid on capital goods in order to produce what consumers demand efficiently and in the right amounts—just as the "internal markets" that large corporations create to try to determine the cost of intermediate goods (see Carson, chapter 3) are not true markets, and mirror the pseudo-markets of Soviet firm managers (see Nell 2010a). Prychitko (1997) makes essentially the same case against the "left anarchism" of Murray Boochkin.

Other market socialists offer proposals that attempt to walk a fine line between full socialization of capital and simple redistribution of the income from capital (see, e.g., Bardhan and Roemer 1993; Le Grand and Estrin 1989; Miller 1989a, 1989b). In some of these proposals, workers manage or own large firms while in others investment funds are managed by the state, or shares are tradable but not saleable for cash. Although some of the problems with centralized investment might be surmounteds, many Austrian criticisms of intervention, such as price distortion or knowledge problems, may still apply.

Austrians have offered important insights about intervention that market socialists often miss when they rely upon mainstream neoclassical (e.g., market failure) models. They recognize the problems with planning and price controls, but often propose very creative policies that affect markets in potentially problematic ways. As an example, a market socialist might suggest that to encourage low consumer prices, and avoid price controls, a sliding-scale tax should be put on products with prices that are significantly higher than the high end of industry costs for that product. Assuming that there is a solution found for issues around reporting of costs, it might seem to be a better policy than a simple profit tax, as it should drive innovations in cost-cutting and lower prices. However, Austrians would immediately recognize a second-order consequence that could greatly reduce the total benefit for those the policy is intended to help. Namely, that businesses frequently fund the research and development required for new technologies (e.g., iPhones) by initially charging a very high price, affordable only by the rich, and then lower the price after a time in order to reach more customers, then lower it again once other firms enter the market induced by the huge profit the high price made possible. As mentioned earlier, the rich help the poor in this way; and subsequently competition (and innovation it induces firms to undertake) drives down the price until it becomes affordable for all. By encouraging firms to first focus on lowering costs, the expected benefits might appear but in the longer run innovation in the economy might drastically fall. Although mainstream models may be capable of predicting this, Austrians are more likely to predict this outcome as they are more aware of this kind of dynamic market consequence.

Austrians are less aware of the ways that markets *can* be modified safely. They are less aware, for example, that the need for a capital goods market is distinct from the need for a stock market, and certainly does *not* imply the need for the complex financial products of modern capitalist economies or the particular rules and incentives surrounding short-term investment (e.g., day trading). Although Austrians often imply or assert that these are *all* necessary for efficient allocation of resources, it is not obvious that existing rules are ideal: they encourage short-term holding by stockbrokers and repackaging that hides risk, arguably clouding rather than aiding price information and efficient allocation. Austrians have a blind spot here too, seemingly unaware of the massive influence that this elite top 0.01 percent has. Wealthy bankers, stock-brokers, and stockholders choose the rules that create wealth for them, and these rules are often not the ones that benefit everyone else because often they allow forms of insider trading, manipulation of profits and interest rates, and other tricks that substitute accounting tricks for real information similar to the way managers in the Soviet Union manipulated their numbers in order to "fulfill the plan." There are many modifications to existing institutions that might increase both efficiency and fairness.

## 2. Modifying Austrian Theory: A Post-Austrian Economics?

Austrians argue that culture is as important as institutions for facilitating market cooperation. This should apply equally to the culture around public property institutions. The Austrian lack of focus on society and cultural factors has prevented the school from recognizing potential forces that might be harnessed within a transparent and accountable public sector. This can be analyzed by "democratic process theory," which should complement Austrian "market process theory" and could form the basis for a feasible market socialism.

### 2.1 Earlier Attempts: Burczak's Hayekian Market Socialism

Theodore Burczak takes on the Austrian arguments directly and respectfully in *Socialism After Hayek* (2006) and in his article *Why Austrian Socialism?* (2009), making similar arguments to those outlined earlier. Burczak argues against Hayek's dismissal of 'social justice,' and makes a case for a 'shareholder society' and worker self-management of firms. Burczak's book is well respected by Austrian economists. An issue of the *Review of Austrian Economics* (2009) and a panel at the Institute for Humane Studies were devoted to it (IHS, 2009).

Although his rethinking of socialism with Austrian criticism in mind was unique, Burczak's proposals are not, having been proposed by many libertarian socialists, among others:

> The resulting book, *Socialism After Hayek*, is both interesting and frustrating. Interesting because it discusses ideas anarchists have long held dear—workers self-management, the end of exploitation, the necessity for decentralisation and free agreement. Frustrating because Burczak seems utterly ignorant of libertarian socialist ideas which means that while he thinks he is being extremely innovative, he is often merely reinventing the wheel. (Anarcho 2011)

The libertarian socialist school is outside of the economic and political science field that Burczak is most likely to be familiar with, and is not a large movement at this time, so it is not a surprise that he did not cite them. Burczak might have come across some of the market socialist economists who wrote after the collapse, and he did indeed discuss Roemer (Burczak 2006: 124–130). Burczak (2006: 101) argues that Roemer (1994) relies "on general equilibrium reasoning," and his plan is "[exposed] to Hayek's knowledge problem critique," and that in order to overcome the concerns his plan must be "stripped of its element of investment planning and pared down to a coupon stock market" (2006: 137).

Austrian economist Steven Horwitz (2007) reviews Burczak, somewhat favorably, but remains unconvinced. Horwitz highlights Burczak's emphasis on the implications of the Austrian recognition of the social construction of the individual:

> Burczak offers a fascinating reading of Hayek that lines up nicely with the work of many younger Austrian economists . . . Burczak emphasizes that Hayek's economics is distinctly different from the mainstream of the discipline in that it takes seriously the fact that human beings are, to some degree, socially constructed. That is, we are born into and shaped by institutions we did not design, especially language, but also markets, money, moral rules, the common law, and countless different social norms and practices.

Burczak (2006: 82) asks "what principle of justice does it make sense to use to help determine a welfare-enhancing distribution of property rights?" He settles on a "capabilities" approach. Horwitz (2007) is skeptical: "One question a Hayekian might ask is whether the democratic state can actually achieve the outcomes required by the capabilities approach. Is the state really better than civil society at improving the nutrition, health care, or housing of a population?"

By assuming self-interested, individualistic, political actors, caring only for their atomistic selfish desires, and by not taking into account the whole process as a "democratic process theory" (which includes not just changing human nature but also the social process that evolves and produces institutions that keep selfishness in check), Austrians would conclude that "the state" will indeed produce worse outcomes. If you take this all into account then you might come to an entirely different result. Although knowledge problems and calculation may still (at least for some time and perhaps forever) pose problems, bureaucracy, rent-seeking, and other immediate behavioral issues may, under the right cultural and institutional conditions, pose much smaller problems than Austrians assume.

Horwitz cites Prychitko's discussion of labor-managed firms, and the Austrian argument that they are compatible with a free market, so long as they are not mandated. He does not consider the market-socialist arguments regarding how the "free market" as we know it, with the institutions protecting land, inheritance, and corporations, might make it impossible for labor-managed firms to compete on equal terms with large corporate firms. If Austrians can rise above their certainty about the superiority of laissez-faire, and see past their blind spots, they might see that labor-managed firms are put at a disadvantage by their concept of free markets, not because they are inferior but because existing property rights, individualism, and inheritance combine to put them there.

A post-Austrian democratic process theory might agree with the capabilities approach that, "what is required for a truly human life," includes "participating in social institutions and relations with dignity." Horwitz (2007) argues that "not agreeing on a conception of the good life is a virtue of the liberal order, not a vice." However, there are some fundamentals that we do agree on. Austrians should recognize this, as Menger (2004 [1871]) stressed the importance of these necessities in his theory of marginal utility (Nell 2013). Horwitz argues that "if we agree to allow multiple conceptions of the good life to coexist, we don't have to fight over what the good life is and how the spoils to make it possible should be divided." Of course multiple conceptions of the good life should, must, and will always exist. This does not mean that there are no parts of the good life that we can agree on, and if we do recognize these we can better ensure that we all are able to achieve this good life, including the aspects of it that we must create collectively, as a society.

Such a democratic process theory would be necessary to ensure that there is collaboration and the virtue of public conversation, along with different interpretations of the good life. Democracy does not mean that the state. society, or any individual should try to plan anyone's life. Conversation and the development of social awareness tends to lead to agreement on leaving *most* everything to the individual, because most people *do* want most things about the good life to be decided freely by individuals. That is why so few (if any) places have ever democratically elected a communist government; and the further along that the evolution of a democratic society has come, the less likely the people will be to vote for central planning or any other extreme form of social control (including religious), because the people will come to spontaneously ordered solutions and will recognize their own ability to find solutions without centralized control.

### 2.2. The Great Promise of Austrian Theory: Hayek and Ostrom

There are certain branches in Austrian theory that offer promising avenues out of which a post-Austrian market socialism might emerge. These include Hayekian analysis and the modern Austrian interest in the work of Elinor Ostrom.

Austrian economists have argued that money emerges from barter and the market economy is a spontaneous order, whereas a planned economy is imposed upon the people. The political process may also be a spontaneous order in a democracy (diZerega 2011). Austrians argue that such a spontaneous order would likely be inefficient as it would be captured by rent-seeking by legislators interested only in their own constituency, or interest groups seeking their own interests, rather than the common good. Legislative decisions may emerge through a process similar to an auction, with legislators "bidding" for certain legislation. Hence, the way for a spontaneous order to produce good results must be either for sectional interests to lead to good results (given the institutions) or for the parties to not seek sectional interests.

Just as many of the problems with a fully socialist economy may have been due to the imposition of the socialist economy upon the people (Nell 2014), Austrians Boettke, Coyne, and Leeson (2008) argue that rent-seeking is in some cases "caused" by imposed institutions, citing British colonial rule in Kenya that "substituted explicit contracts for the tacit norms governing land usage in practice." The contracts "did not codify an existing" practice but were instead in "direct conflict" with existing practices, which meant that the existing institutions governing land were disrupted and "the long-term viability of the common land was destroyed. . . . this destruction undermined the existing Maasai social structure that enabled cooperative agriculture and created a situation of rampant conflict among formerly cooperative agents that manifested itself in the form of rent-seeking activities" (342–343).

Spontaneous orders, in order to be efficient, must emerge from endogenous choices by the people involved, rather than imposed upon a society from without. Boettke, Coyne, and Leeson (2008) cite the "important work by Elinor Ostrom," which they say

> highlighted the importance and success of endogenously emergent institutional solutions to a range of coordination problems, as well as the potential for unintended, undesirable outcomes when political authorities artificially construct institutional solutions to these problems. (333)

Boettke et al. argue that "the endogenous emergence of the institution points to its desirability as seen from indigenous inhabitants' point of view." To the extent that this is true, it means that endogenously emerging public programs that co-evolve with the culture should be more efficient and better managed than those, for example, that are imposed by an external body, such as the World Bank or the European Union. Similarly, a more local government body's programs, emerging from the local culture rather than a more distant government, might perform better for this reason. Austrians argue for the efficiency of decentralization in part because of knowledge problems—a distant government will not know the needs and resources of each local community—an argument in fact closely related to the issue of culture and emergent law and legislation.

Public programs and uses of public monies can emerge in the same way that common law, currency, language, and other social tools emerge. Austrians argue that the expectations, habits, and culture around legal institutions are as important as the institutions themselves, or are perhaps more important. For example, Boettke et al. (2008) describe the emergence and "stickiness" of the culture surrounding the common law system of merchant law, *lex mercatoria*, as even more important perhaps than the protection of property rights for traders. Because the institutions emerged from evolved customs of traders they have persisted, and the culture continues to govern trade today.

Customs, expectations, and culture do more than competition and property laws ("exit") can do alone. Similarly, the customs, expectations, and culture around public transactions and provision may do more than the political rules and competition ("vote") alone can do. The same arguments about the emergent culture governing private property institutions and facilitating market cooperation apply equally to public property institutions, if such a culture is allowed to develop and facilitate democratic cooperation. This is the basis for a democratic process theory to complement Austrian market process theory.

Rent-seeking may occur in spontaneous orders such as common law and democratic legislatures, or these orders may offer beneficial frameworks for institutional evolution. Austrians may argue that this will depend on how the orders come into being (whether they emerge endogenously or are imposed from without); that is, they argue that it is critical whether these orders co-evolve with culture, so that they self-regulate. Marxists may argue that their efficiency and effectiveness depends on whether people have enlightened consciousness or whether they are self-interested. For some kinds of spontaneously ordered institutions, these may be the same thing; for example, the culture that is necessary to produce an efficient democratic process may be one in which voters and representatives understand their part in it, seek the common good rather than personal interest, and care for the common property. Marxists call this "enlightened consciousness," while Austrians argue that this is the culture that may emerge if the process has evolved naturally and endogenously. Enlightened (informed and not self-interested) consciousness is part of the culture that leads the voters and legislators to seek the common good and exclude rent-seeking.

Lenin believed that the only way to achieve the ends he sought was to seize the society's property and name it as state-public property. The ownership and use was centralized with the state first and then he attempted to impose the development of common governance. Attempting through state imposition to develop toward communal use—instead of coming from the private property side, which people were used to, and co-operatizing, for example—might have meant that the culture, the society, was not ready.

As summarized by David Sloan Wilson (2010), Elinor Ostrom's "eight ingredients that enable groups to manage their own affairs" explains how a society must organize its affairs in order to successfully administer its property in common:

1. a set of rights, and the society in which they are accepted by the people must be defined
2. the people of the society must negotiate a reward system that ensures people are rewarded proportionately to their contribution
3. the people must create their own rules and make their own decisions by consensus
4. there must be monitoring to prevent free- riding and exploitation
5. there must be levels of sanctions graduating in severity
6. there must be conflict resolutions agreed as fair by the group
7. the group must have the right to organize its own affairs without meddling from an external body
8. the group that works best if small must be part of a larger social system comprised of nested groups, each with this kind of autonomy

What is the over-arching system that can best accommodate Ostrom's ideas? As she indicates, the group that can govern resources commonly must be small for the best result but can be part of a system of nested groups, gradually getting larger while retaining certain kinds of autonomy from external decision making. Yet for larger groups to have any purpose they must have some kinds of rules, power, or common function. If these groups gradually serve a more abstracted role—similar in some ways to federalism or to ideas of a libertarian socialism—they could stay out of the hair of the inner group while still protecting it. Some form of market socialism, perhaps one with a cooperative structure, supplemented by decentralized democratic forums governing public property and redistribution might fit the bill.

In any case, this basic outline can support a democratic process theory, which could be used to determine the precise kind of system that might work for each society. Of course, each society will have a different best-fit system, which must emerge from that society together with the culture that will support that system and ensure its efficiency.

### 2.3. A Post-Austrian Economics: Individualism and Democratic Process Theory

Austrians argue that individuals are more free when they are able to make unilateral choices about how to use their own property, rather than having merely a single vote among many in a democratic process (Salter 2014; Nell 2010a). Imagine having to vote with your whole country on what you (and everyone else) should have for dinner—clearly, you would feel more free making that decision alone. Therefore, they argue, private property offers more freedom than collective ownership, even when that ownership offers completely democratic management over the resources.

This argument leaves several important factors out of consideration, including lack of resources for many and ownership of resources by some who may then control others (especially those lacking resources) privately through, for example, authoritarian employment situations. Even putting those issues aside, Austrians assume majority rule when they discuss democracy; what if there is another kind of democracy?

David Graeber (2004) discusses many societies that have had democratic systems that worked using forms of unanimous consent and other forms of democracy without majority rule. The latter tended to be coordinated through conversation and agreement, rather than through parliamentary-congressional procedure. According to Graeber's account (2004: 40), they did not suffer from the same problems of self-interested rent-seeking and power-seeking, and did not restrict freedom in the same way that majority rule arguably does.

How realistic this is clearly must depend on the formal and informal institutions of the society, and the culture that emerges and evolves to facilitate democratic decision making. It is possible that instead of lazy bureaucrats, there might be friendly and supportive civil servants. This will depend on how the public sector emerges from the public discussion, how the institutions evolve to support the work of the public sector, and how the evolving culture affects the preferences, attitudes, and reactions of the people. In *Why Market Socialism: Voices from Dissent* David Belkin (1994: 19–21) points to the authority relation within the firm (or, the assumption of it) as the root of free-rider and other public/collective choice problems, and network cooperation as a solution for economic organization. After making the case that the corporation has the same problems of free-riding and other problems caused by hierarchical authority-relations as found in a planned economy (on this, see chapter 4, this volume), he asks:

> But is there a cooperative "third way" between these two imperfect allocative mechanisms—in Michael Best's words, "an alternative to either extra-firm (market) or intra-firm (hierarchical) coordination?" And does positive political economy betray its own deficiencies by failing to adequately comprehend this alternative?
>
> According to Best and a number of other sophisticated critics (mostly on the left), the answers are yes and yes. As Michael Dietrich puts it, "resource allocation involves three principal governance structures: markets, hierarchies, and networks . . . Networking involves mutual trust and cooperation with a long-term perspective and respected codes of behavior" and arises as a dominant strategy out of repeated interactions among mutually dependent parties.

Networking, emergence, and complex systems theory all have the goal of understanding not just the individual but the group, and, for the study of economics, the ways in which society and culture are as important as individual rationality. Complex systems theory has found that social scientists "cannot assume that methodological individualism can exhaustively explain human behavior in social groups," and that there must be "multiple levels of analysis: individuals, their communication language, and the group" (Sawyer 2005: 7). Hence, the "explanation of any given social system cannot be provided by psychology, sociology, or economics alone; it will require interdisciplinary teams." Again, Austrians should be aware of this. Hayek (1974) famously said in his Nobel Prize speech that "nobody can be a great economist who is only an economist—and I am even tempted to add that the economist who is only an economist is likely to become a nuisance if not a positive danger."

This is precisely the reason for the field of sociocultural theory (Steiner and Mahn 1996), and if Austrians fully took this on board, together with

Hayek's cultural evolution, spontaneous order, and socially constructed individual, they would be forced to rethink their position on methodological individualism and individualistic rationality, and to therefore rethink their public-choice assumptions about the efficiency of the public sector and ultimately their laissez-faire conclusions.

Austrian economics—not only since Hayek, but from its very inception when it broke from what became the mainstream neoclassical school—has been rooted in a dynamic understanding of the social sciences, and has stressed realism and the complexity of social systems. Methodological individualism, because it does not account for the social individual and the dynamic culture, undermines the school's ability to follow this approach to fruition and portray the economy in a truly realistic manner (see also Nell 2015, forthcoming).

The conclusions of the Austrian school must be modified to take account of Hayek's understanding of evolving social orders. Markets based purely on private property are not necessary for economic efficiency; bureaucracy, corruption, rent-seeking, and power-seeking are not the only possible outcomes from public ownership. For example, public ownership of the media need not lead to centralized control by the state and to censorship, as Austrians argue, and it can be seen that censorship might result even from private ownership (e.g., when corporations own media outlets and censor them to protect their reputations or promote their ideology). Insights from Elinor Ostrom and others may even reveal how an evolutionary form of democratic public ownership might produce superior results than pure laissez-faire.

In short, assumptions about self-interest underlie much of economic analysis. But what if voters are capable of voting for the true common good instead of for their own pet projects? What if "bureaucrats" were to be true "civil servants" and representatives were to care about doing what is right, rather than about their personal payoff? This could result in the collapse of much of "public choice" economics and of Austrian analysis. To determine the extent of the efficiency effects, a parallel to Austrian *market* process theory must be introduced. There must be a *democratic* process theory, and this might form the basis of a post-Austrian economics.

The tools of an effective democratic order help to develop culture and the public discourse. This may include a nonprofit and/or public role in media, helping it to be more educational and informative instead of catering to the whims of fads and instant gratification. Austrians often argue that the market tells us what people want—if the media gives the people game shows and reality television then this is clearly what they want—but this fails to account for the nature of human desire, which differs in the short and long term. The assumption also relies upon the knowledge (or education) of the individuals at the time in question. In addition, since the market is a process that affects the participants—in other words, since there are endogenous effects—we cannot assume that the media the market gives us is the media we really want.

The Austrian lack of focus on endogeneity and social influence among the people of a society, and within the system itself, has prevented the school from recognizing potential forces that might be harnessed within a transparent and accountable public sector, existing within a broader system. Using modified Austrian theory, possibilities for economic organization that harness the power of transparent and effective democracy can be discussed, keeping in mind the central problems previously experienced (in socialist and capitalist countries) due to self-interested political and economic actors.

Austrian economists do not always take their own models and theories to their full conclusion. This may be true of all schools, but it seems particularly evident and troublesome within Austrian circles, where many scholars come to fairly extreme and sometimes harsh conclusions while omitting from their models any possibility of studying aspects of society and culture that are not only very evident in the real world but are also important to each of us, including the Austrian scholars themselves, which would radically change their conclusions if accounted for. This has led to support for dictators like Pinochet (by Hayek, see Farrant, McPhail, and Berger 2012) and to radical statements (by Rothbard 1956, and his followers, see Nell 2013), such as that government cannot possibly raise social welfare and the homeless must prefer to live without homes.

### 2.4. Why Austrians Should Be—Or Already Are—Market Socialists

Austrian economists are well aware that there is no model free market country, and are aware of the 'crony capitalism' nature of, for example, the United States. If they took this fact seriously, in keeping with their desire to model economies in a way relevant to the real world it would make sense to consider the existing system as just one possible kind of "market-socialism," using the term in the way that the new market socialists use it when advancing their models. Cumbers (chapter 7, this volume) argues, "It is the private corporate enclosure of the global commons that is the real threat to free exchange in the twenty-first century."

This is in part because of the feature of markets that means wealth grows exponentially, building upon itself, combined with the ability of the wealthy to exploit the taxpayers through use of state power even in a small-government limited-state form of capitalism. As Cumbers points out, this can occur when the state is shrinking: “Globally, economic policies inspired by Hayek’s vision are leading to an accumulation of wealth in fewer hands in which the private appropriation of public assets has played an important role.”

Austrians recognize that corporations are already entities with state-enforced privileges and protections. The organization of the American economy looks very much like that of a corporatist economy, except that today in America the unions have far less power and there is less explicit state-aided wage and price negotiation. The American system (and many other market systems around the world) is just a form of market socialism, though less socially minded—corporatist but lacking a voice for labor.

This does not make it less organized and more free than traditional corporatism, it merely offers a different balance of power. Introducing a true market socialist economy would change the balance of power, toward, for example, unions, workers, communities, or stakeholders. It is already a state-aided elite minority dominating and driving the “market” economy—so changing from one to another would not make the society any less “free market” than it already is. Realizing this, Austrians could choose a system that at least watches out for the least advantaged.[13]

Austrians might argue that this is irrelevant because they would like to see true decentralization and dissipation of state power by *freeing* the market. However, it may never be possible to bring about a truly free market given inheritance and the other aspects of private property that affect opportunity—otherwise a small elite will continue to get more from private property laws than others. In any case, until such a time as a truly free market system is achieved, the modeling of systems that market socialists use is most capable of accurately portraying and analyzing the U.S. system, as well as European systems and possible alternatives.

Existing capitalist economic systems are already basically a form of market socialism, just a very unfair one—corporatism without the voice of labor, or crony capitalism—hence Austrians should study it the same way that market socialists analyze proposals, instead of assuming that free markets are fair, meritocratic, and perfectly efficient. The intellectually honest Austrian should be a market socialist. Idealized profit-driven laissez-faire should not be the one-size-fits-all answer for allocating resources in every social system. Possible ways to support cooperatives, start-ups, nonprofits, and spontaneous order *democratic* solutions should be discussed and debated; but doing this makes one a "market socialist," and using Austrian-type models makes one a "new" market socialist, or post-Austrian economist. Rather than taking a hard line that only a freer market, and ultimately a completely "free" market, is best, if Austrians joined this conversation, arguing for why one systemic policy solution is better than another, and what category existing economies fall into, this would be much more productive and allow Austrian economists to engage with other economic schools far more than they currently do.

The Mondragon cooperatives (see chapter 5, this volume) are an example of a solution that can bring together Austrians and market socialists. Cooperatives have also been linked to Polanyi's economic theories and his contribution to the socialist calculation debate (Valderrama 2013). Some Austrians, or those with Austrian school influence, have pointed to Mondragon as an example of a private sector solution (though some are skeptical it could be replicated and sustained, see Arnold 1994: 167–169), and new market socialists have frequently cited it as well (e.g., Nursey-Bray 2002).[14] Nonprofit and many cooperative solutions may not be able to compete in existing private property economies, but if not-for-profit private cooperatives can flourish without hierarchy or authority (Bylund, chapter 4), and if these can even include cooperatives like Mondragon (diZerega, chapter 5), is this not enough?

Possibly, but consider the conditions under which hierarchy may be inevitable in large firms; such that they form into hierarchies despite conscious attempts to keep them democratic. In chapter 4, Per Bylund shows that authority is not necessary to convert a set of lateral contractual relationships, a "nexus of contracts," into a firm. However, if the task the firm faces—the reason lateral contract relationships have transformed into a single organization—is complex enough, it might also convince owners that a hierarchical order would be helpful for organization, transmission of information, incentivizing desired behavior, and so on (as Lenin and the Bolsheviks concluded that "one-man management was necessary for early Soviet firms, see Nell, 2014). All tasks require planning, individuals plan before acting, and so on, and hence all firms must plan, but there is no reason that this cannot be democratic planning; but, large corporations are known to suffer from the problems of planned economies (see Carson, chapter 3), and problems of planning tend to lead those in charge to substitute authority for democracy (Hayek 1944; Nell 2011); so, isn't it possible that the same forces that drive a firm to form might also drive it to become hierarchical and authoritarian as it continues to grow under the same conditions, and that outside changes to incentives or additional help may be necessary to prevent hierarchy and authoritarian nature from forming? Market socialism is about offering such outside help, something other than purely the profit motive.

The promotion (through property and contract law or taxation) of nonprofits, worker-managed firms, cooperatives, and the like, and the communities described by Elinor Ostrom are both examples of culture (see Nell 2015, forthcoming for the importance of culture) and alternative property forms coming together to allow for a system other than laissez-faire to emerge and to better serve the community. These systems can be analyzed using the tools of the new market socialism, with a post-Austrian approach. There are many possibilities for alternative market-socialist societies, including societies advocated by libertarians and anarchists, such as "seasteading" (private communities in international waters); and there are also opportunities *within* existing society to change the way the economy works; if changes are made in this way, there can be a great variety (offering the diversity discussed in chapter 7), and the state might even be unnecessary (as discussed in chapter 6) not only for enforcing private contracts but also for actively intervening to create a more just (market socialist) society, redistributing, and so forth. One inspiring example is what the Occupy movement did to help the poor in debt:

> Across the United States, 2,693 people have received a letter in the last few months, which identified a debt and read: "You are no longer under any obligation to settle this account with the original creditor, the bill collector, or anyone else." This is the work of the Rolling Jubilee project—a non-profit initiative which buys personal debt for pennies on the dollar in the secondary market (where debt is sold to companies who then resell it to collection agencies) but then simply cancels it. (Andreou, 2013)

This can be seen simply as a charitable project, but when the Austrian "blind spots" are illuminated, and the severity of the debt problem recognized,[15] it also contains an important message. It indicates the potential power of market socialism and the convoluted nature of the current structure of capitalist economies, especially their stock markets. The debt incurred by the disadvantaged can be bought for pennies on the dollar, yet the disadvantaged are burdened with ever-growing massive debt, often having to work long hours in order to pay the accumulating compounding interest, which they pay *to the most privileged in the society* (who may not work at all). The debt is usually bought by individuals and firms who sell it on, as just another short-term profit-making opportunity available to the wealthy. However, the Rolling Jubilee project is evidence that it is not only the super-rich who can buy debt in the secondary market for pennies on the dollar; when people come together they can do things that the wealthy do. If there were one hundred initiatives like Rolling Jubilee, leveraging new financial instruments and information technology and created on a large enough scale, could they begin to change the balance of power in the economy? Might this be the start of a spontaneous order market socialism?

Austrians concede, but do not seem to take seriously and account in their models for, the problems with the existing crony-corporatist "market socialism," including its lack of—property rights-based or other—solutions for caring for common goods such as the environment. When inheritance, luck, and genetics, and the many possibilities regarding how property rights *might* be allocated, along with a more complex understanding of culture and society, are all accounted for, it is clear that merely calling for a freeing of markets within the *existing* system falls well short of ensuring an improvement upon the status quo for everyone, let alone the best of all possible solutions. Austrians need to shed their certainty about laissez-faire and embrace the tools of the new market socialism in order to begin to discover what might be the best solution for any given society.

## NOTES

1. Charity is the same essentially as public sector work and payments (taxation). As Hodgson (2014: 191) describes it, this is the issue that Schäffle was referring to when he "considered a society with a million workers":

> My income from my social labour is conditional upon my 999,999 co-operating comrades being as industrious as I. . . . Socialism would have to give the individual at least as strong an interest in the collective work as he has under the liberal system of production.

This problem of incentives with large numbers haunts any socialist scheme of large-scale cooperation. If everything is shared, then incentives for extra individual effort or innovation can be much less than likely rewards" (2014: 191).

This is the same problem as when individuals contribute to charity but the other 999,999 individuals in the society might have to give something to the charity in order for it to succeed in truly changing the lives of those the charity aims to help.

2. Bay (1971: 122) describes his own book in order to contrast it with Hayek's, as follows: "My own volume, too, can be called a book of special pleading, to be sure. But my "special plea" is for the freedom of all men equally, not for the liberties favored mainly by certain classes of already favored individuals. . . . Or, in other words, in a society aspiring toward freedom, the most basic freedoms, or human rights, must take precedence over the less basic freedoms, as well as all social privileges. And I stipulate that the first priority concern of every government must be to protect and enlarge the basic freedoms of the least free, by way of expanding and enforcing human rights. Thus construed, the 'cause of freedom' requires freedom from physical violence, and freedom from severe want, prior to freedom to invest, and prior to freedom from confiscation of many categories of property." Of course, Austrians will argue rightly that confiscation of property can be not only an infringement upon the freedom of any who have property, but also any who aspire to own such property, and more critically with regard to the poor and disadvantaged, may disrupt economic activity, making it impossible or very difficult and expensive to obtain basic goods, employment, etc. However, Bay is primarily focused on prioritizing care for those in severe need over complete protection over investment rights of the very rich, for example ensuring that there is no limitation on the extent of individual ownership of capital, or restrictions on short-term capital trading, etc., limits that would not be likely to destroy a market system).
3. In Marxist terms: how the actually existing wealthy *capitalist* countries allow an elite class of individuals—the rich by birth and privilege—to take advantage, or *exploit*, those at the other end of this class spectrum or ladder, through use of laws, monopoly, law-formation using the state, and through economic power in the market both as customers and as employers, in all areas of the capitalist economy.
4. Rothbard defines coercion in such a way as to enable him to ignore the similar loss of freedom encountered in situations in which government is not to blame (for examples, see Burczak 2013 and Nell 2013).
5. "In Los Angeles, the city council is considering a proposal to ban distributing food to homeless people in public because of complaints from neighbors. In Raleigh, a charity that for years had served meals to the needy was threatened with arrest if they continued. In Orlando, police arrested people

who violated a city ordinance by feeding the homeless in public" (Keyes 2013).

6. Where the cut-off would be and how long the goods would take to reach the low prices the poor can afford, if every household below the cutoff chose this route, is an unknown. It depends upon how this behavioral change affects the price drops and second-hand market, and so whether and when all needs can be met with second-hand goods if only the rich purchase new goods.
7. In "The Philosophy of Russel Brand," a BBC radio program, this was the term used to describe David Graeber, Russel Brand, and the Occupy movement. http://www.bbc.co.uk/programmes/b03srj6m
8. "So Reclus simply stated the obvious when he wrote that 'the anti-authoritarian critique to which the state is subjected applies equally to all social institutions' Proudhon, Bakunin, Kropotkin, Goldman and so on would all agree with that. While they all stressed that anarchism was against the state they quickly moved on to present a critique of private property and other forms of hierarchical authority" (Infoshop 2010b). In this volume, see chapter 3 on the corporate structure and its internal hierarchy and issues with planning, chapter 4 on the inevitability of the firm's authoritarian nature, and chapter 5 for further discussion of contracts and freedom, and possible alternatives including cooperatives like the Mondragon cooperative in Spain. Carlo Zappia (1995) also has a fascinating discussion on spontaneous order, contracts, and market socialism.
9. Roemer suggests another possible use for modeling classes: "Roemer has developed a theory of exploitation in which classes are the primary subjects and objects of exploitation. Individuals are said to be exploited only derivatively insofar as they are member of the exploited class" (Arnold 1994: 268–269 n5).
10. Indeed, section 1.2 quotes from Oskar Anweiler's *The Soviets*: "Because Bakunin . . . was always very close to the reality of social struggle, he was able to foresee concrete aspects of the revolution. The council movement during the Russian Revolution, though not a result of Bakunin's theories, often corresponded in form and progress to his revolutionary concepts and predictions" [*The Soviets*, pp. 8–11] (Infoshop 2010c).
11. Böhm-Bawerk (1890) explained that the labor theory of value (LTV) would mean that a shoddy design or a useless product or service could be worth more than a useful one if it took more labor, and that different kinds of labor (skilled and unskilled, for example) would be valued as if they were of equal worth to society. Using economic calculations based upon the LTV, and adjusted only intermittently to accommodate noticeable supply or demand fluctuations, would mean accurate comparisons would be impossible between different uses of productive resources. These were

problems that Soviet Marxists experienced in practice (see Nell 2010a for detailed analysis).

12. "In Economic Democracy there is no stock market, for there are no stocks . . . each enterprise is run democratically . . . [and] must pay a tax on the capital assets under its control. (This tax may be thought of as rent paid society for access to the collective property of society.) Economically this tax functions as an interest rate on capital—and thus obviate the necessity of paying interest to private savers. Generating the investment fund by taxing enterprises rather than by "bribing" individuals to save not only shuts down a major source of capitalist inequality, namely interest payments to private individuals, but it frees an economy from its dependence on the "animal spirits" of savers and investors" (Schweickart 1998: 17).
13. For theoretical justification and guidance, Austrians could consider a "maximin" rule (maximizing the minimum benefit), in which social and economic inequalities "are to be of the greatest benefit to the least-advantaged members of society" (Rawls 1971:152), or the extension of this idea, the "leximin" rule (see Sen 1986).
14. "Gar Alperovitz, professor of economics at the University of Maryland, speaks on Real News Network about the potential and limits of worker cooperatives, contrasting them with the planned economy of Walmart." (Naked Capitalism, posted on January 27, 2014 by Yves Smith http://www.nakedcapitalism.com/2014/01/gar-alperovitz-mondragon-potential-worker-owned-co-ops-d-economy.html)
15. The average debt for college seniors is $29,000; in the past ten years, student loan debt has tripled, to over 1.2 trillion dollars, which is more than credit card debt; and about one-third of federal loans are in default (Mason 2014); Between 2001 and 2011, the median amount that older homeowners owed on mortgages rose 82 percent to $79,000; and the percentage of senior homeowners with mortgage debt increased from 22 to 30 percent. This is "jeopardizing retirees' financial security," according to the Consumer Financial Protection Bureau (Waddell 2014).

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