

Information and the Market Economy: A Note on a Common Marxist Fallacy

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Marxists have seldom been noted for much economic sophistication in their critique of the capitalist market economy. Marxist reasoning was essentially easy game for Mises ([1920] 1990) in his classic initiation of what came later to be called “the socialist calculation debate.” However, later market socialist contributions to this debate were for a long time believed to have provided the definitive answer to Mises’s challenge. As we all know well today, this understanding is completely fallacious (Lavoie 1985; Salerno 1993; Steele 1993), and as result of the Austrian critique of socialism, many contemporary socialists have become unsure of the viability of the socialist project (for example, Gamble 1986; Hahn 1990).

However, socialists have certainly not given up hope. In a relatively recent article, the Marxist John O’Neill (1989) put forward a radical critique of the market order; one that has often been given more implicit articulation by other socialists, but had not been given its fully explicit statement until O’Neill’s article. I will here argue that this critique amounts to a fallacy.

Although O’Neill’s critique was directed towards the increasing prominence of market socialism, he primarily argued against perhaps the best known Austrian defense of the market, that is to say, Hayek’s conceptualization of the market as an information providing mechanism. Hayek’s conceptualization and corresponding defence of the market in knowledge terms is well-known and influential among recent market socialist writers.

Mises’s ([1920] 1990, 1949) different and even more fundamental conceptualization of the calculation problem as one of

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The Review of Austrian Economics Vol.8, No. 2 (1995): 127–134
ISSN 0889-3047

appraisal, rather than optimal provision of information (Salerno 1993), has not been noticed or separated from the Hayekian argument. It is doubtful whether O'Neill's critique can be directed against Mises's understanding of the calculation problem as one of appraisal.

Furthermore, in this note, I argue that O'Neill's argument has a little bite against Hayek's arguments in particular and the capitalist market system in general. I wish in this connection to call the attention of Austrians to the important work of the British subjectivist economist, George Richardson, on the coordination of producers' plans and how the market economy allows rational plans to be made (see also Foss 1994, 1995). This is probably best done by later demonstrating the pertinence of Richardson's insights in the present context. Let us begin by briefly examining O'Neill's argument.

O'Neill on Information in a Market Economy

According to O'Neill the Austrian (Hayekian) conceptualization and defense of the capitalist market system is untenable. In fact, it is vulnerable to an essentially Marxian critique: the market is "anarchic," precisely because it *fails* to distribute the information that is necessary for rational decisions with an intertemporal orientation. Specifically,

that information that is relevant to economic actors, in order that they be able to coordinate their activities, is not communicated, and . . . no mechanism exists to achieve the mutual adjustment of plans. The market *in virtue of its competitive nature* blocks the communication of information and fails to coordinate plans for economic action. That feature of the market is specific to the market as a system of independent producers in competition with one another for the sale of goods. It is not a consequence of complexity or change. (O'Neill 1989, p. 109)

What is here meant by the expression "in virtue of its competitive nature" is that "independent producers in competition with one another" have little or no incentive to disclose much of the information that is relevant to their decisionmaking. This is argued in terms of the (one-shot) prisoners' dilemma: "Given that all parties are self-interested, the competitively stable strategy is non-cooperation" (ibid.). Mutual exchange of information may benefit everybody, but instead the suboptimal situation is realized.

The reasoning behind this seems to be the following: In the absence of communication of information on future-directed production plans, producers in a market may, for example, invest too much, and realize losses when the new more roundabout processes of production mature with a larger output that drives prices down. The new equilibrium price is much lower than the price that would have resulted from the communication of information on investment plans.

In contrast to Hayek, prices will *not* act to satisfactorily coordinate plans, for prices only reflect past and present wants and scarcities, not future ones. (Note that this critique cannot be directed against Mises's future-oriented conceptualization of the calculation problem.) As a result, plans will not be coordinated, and the door is open for Marxian business cycles caused by maladjustments of producers' plans (somewhat reminiscent of ordinary pig-cycles). Since they are fundamentally based on market organization, market socialism schemes are also vulnerable to such objections. The solution lies in some cooperative, socialist economy with a mechanism that efficiently distributes information, and thereby "does the job that Hayek falsely claims the price mechanism performs" (O'Neill 1989, p. 109).

O'Neill's assertions are open to critique on numerous counts. For example, he neglects that current prices to some extent reflect producers' plans, since these plans result in factor demands that are registered in prices. Also, forward markets exist for some products and services. Finally, producers may form reliable expectations based on competitors' past actions. To some extent, all this dampens the severity of intertemporal coordination failures.

Here I shall, however, restrict myself to the following critique of his reasoning: it is not true that the capitalist market system lacks mechanisms for coordinating plans among independent but not interdependent producers. To believe so is to operate with an impoverished understanding of "the economic institutions of capitalism" (Williamson 1985); an understanding that is, ironically, best represented by older versions of neoclassical economics. In fact, the capitalist market system does contain cooperative mechanisms for information dissemination.

In other words, while O'Neill's critique may be pertinent in connection with specific (and outdated) economic models, it is much less pertinent in connection with economic reality and with sophisticated theories of this reality. In the following section I

¹See Steele (1993, pp. 248–53) for some points not recounted here.

draw primarily on the work of George Richardson and also refer to the so-called "new institutional economics" in order to underscore this assertion.

Hayek, Richardson, and the New Institutional Economics

O'Neill's discussion largely centers around the work of Friedrich A. Hayek. In his article, "The Use of Knowledge in Society," Hayek explained how the price system solves "the economic problem of society" by making all the dispersed pieces of knowledge that underlie decisionmaking mesh. By providing incentives to react rationally to changing scarcities, for example, substitute one raw material for another, the price system may in some strained sense be said to transmit information. But notice that producers do not actually receive the information that caused prices to change. To borrow Hayek's famous example, when a tin mine closes down, it is not necessary for the efficient functioning of the economy that *this* information should be disseminated. What is, however, necessary is that the price system should register the diminished supply of tin. Hayek's claim is that the price system in fact does this, and that the market economy therefore operates with an information minimum, that is to say, economizes on information costs.

Now, Hayek can in fact be understood as talking about one very special situation, though one that neoclassical economists are traditionally very fond of: perfect competition equilibrium. Seemingly, he says that the *only* signal producers need in order to make a rational decision that dovetails with the decisions of other producers is the price. If that is what he says, he is talking about an perfect competition equilibrium situation; for it is only here that price provides sufficient guidance to action. Outside of this situation, producers will have to think strategically, that is form conjectures on each others plans and actions. They will have to perform appraisals. But can they do this? Can they form reliable expectations on each others plans and actions? O'Neill denies that. However, as we shall see, this inability to coordinate actions is a feature of a specific economic model; it is not a feature of reality. In order to criticize the perfect competition model on grounds that are closely related to O'Neill's critique of the market system, George B. Richardson in his 1960 contribution, *Information and Investment* suggested the following *Gedanken*-experiment: suppose that producers under perfect competition—but without any forward markets—are suddenly hit by some increase in demand that affects them all and is expected to persist. What will be their

responses?; how much plant should they order? The problem is that the information on other firms' investment decisions that would be necessary for calculating optimal investments is not available to anyone, given the assumptions of the model. Firms may guess, of course, but those guesses must involve the guesses of other firms, which would seem to lead into an infinite regress. The endogenous uncertainty thus created implies that there is no equilibrium in the sequence of guesses. On the whole, producers are logically unable to make any rational decisions, specifically, to rationally invest.

It could be argued of course that the reason for the result lies in the particular set-up chosen, namely the perfect competition model with its assumption of strictly local information, etc. True, the result depends on the setup—which is in fact precisely what Richardson wishes to demonstrate. Richardson's main, and constructive, point is that a number of institutions, practices, norms, etc., that exist in the reality of the capitalist market system, but are completely inexplicable within the perfect competition model, in fact has the beneficial consequence that the severity of the coordination problem is strongly reduced.

The importance of "imperfections" for the effective working of the economy is perhaps most obvious in the case of the coordination of investment projects that are *complementary* to each other, in the sense that the sum of their returns when undertaken simultaneously is greater than if they are undertaken in an isolated way. Richardson denies that the price-mechanism generally will do the job of coordinating complementary investments unassisted. However, "imperfections" such as reputation, trust, and contractual agreements perform the tasks of easing knowledge flows over stages of production and contributing commitments, that is, they reduce information costs and align incentives. This promotes the coordination of investment plans.

In the case of *competitive investments*, the kind of investments O'Neill seems to be talking about, cartel arrangements, price notification schemes and numerous other "restrictive" trade practices allow producers to anticipate each others actions, for example, by providing information (e.g., price notification schemes). Thus, Richardson suggests a rationale for a much less restrictive antitrust attitude towards such arrangements; a view that any Austrian would clearly endorse. His basic position is that markets and their so-called "imperfections" are essentially information structures, and that overly interventionist public policies may destroy this information provision. Arguably, this view dates back to the pro-business views of Alfred Marshall (Foss 1995).

In Richardson's celebrated 1972 article, "The Organization of Industry," he strongly emphasizes that this "Organization" is in reality more than hierarchical direction and is more than the operation of the pure price mechanism; to a large extent it is a matter of all sorts of cooperative relations between firms. Industry, says Richardson, can be thought of as composed of numerous "activities" (research and development, manufacturing, sales and service, etc.), which have to be carried out by firms with the requisite "capabilities." Thus, Richardson is inviting us to see the firm as a pool of productive and organizational knowledge (some of which may be tacit). Activities which require the same or closely related capabilities are "similar." Firms find it expedient, for the most part, to concentrate on similar activities, since incorporating "dissimilar" activities under the corporate umbrella implies numerous inefficiencies. This forms a basis for a theory of "cooperation," that is of inter-firm relations, such as long-term contracts, joint ventures, licensing agreements, etc. Firms enter into cooperative relations when they need access to complementary but dissimilar activities. Inter-firm coordination schemes also serve to stabilize the economic system.

To sum up on Richardson's work, a number of the economic institutions of the capitalist market system exist and have the beneficial effect, and may in fact exist because of this effect, of making interaction coordination problems much less severe.

This basic insight also informs much of the recent economic literature on institutions ("neo-institutionalism"). Although Robert Sugden's (1986) work on norms and Oliver Williamson's (1985) work on the contractual institutions of the capitalist market system—to settle on two of the most prominent examples—are in many ways far from each other, they are agreed on the basic insight that institutions can be understood as responses to social interaction problems à la Richardson's investment coordination problem. It is now a very general recognition in this literature—and in fact in economics in general—that in addition to information contained in market prices, social norms and in particular business practices, imposing some restrictions and coherence on the individual decisions and information generated by institutions external to the market, play important roles in achieving order in market processes.

Is this contrary to the Austrian vision of the market order? Not at all. Notice that Hayek's and Richardson's work are complementary. Richardson adds to Hayek's picture by pointing out that stocks of knowledge (capabilities) may not only stand in a

competitive relation to each other, but in reality may also be complementary. However, much of the knowledge that is relevant to economic affairs is tacit, a point that both Hayek and Richardson are eager to drive home. Partly because of such tacitness, individual firms will normally not have superior or even precise knowledge about the whole of the production process into which their products enter. It is likely that nobody will in fact possess all of this knowledge. Of course, this does not mean that “the industry” does not “know” how to produce. To paraphrase Hayek (1945) with a bow to Richardson, the marvel is precisely that competition *and cooperation* ensure that effective use is made of capabilities that are not possessed by any single firm. But firms are not completely self-contained; as Richardson points out (1972, p. 855), effective cooperation will normally require some knowledge of “neighboring” capabilities—those possessed by other firms—so that “their limited individual fields of vision sufficiently overlap so that . . . the relevant information is communicated” (Hayek 1945, p. 86).

Richardson also links up with the Austrian understanding of the market in a somewhat different way. In Richardson’s perspective, much of “the organization of industry” is a matter of discovering which capabilities are best for you as a producer, where and when. Now, Hayek saw “The Meaning of Competition” as primarily a matter of teaching us “*who* will serve us well; which grocer or travel agency, which department store or hotel, which doctor or solicitor, we can expect to provide the most satisfactory solution for whatever particular personal problem we may have to face” (Hayek 1946, p. 97). In other words, one of the benefits of the market system, including its modes of competition and cooperation, is precisely that it makes *capabilities* visible to the participants. This is completely contrary to O’Neill’s analysis; however, it is decidedly much closer to reality than O’Neill’s understanding of the capitalist market system.

I conclude that O’Neill’s information-based critique of the market economy, whether capitalist or socialist, does not hold water. His critique may justifiably be directed against the perfect competition model; however, it cannot be directed against neither real-world market systems nor recent neo-institutionalist economics. In reality numerous institutions support the operation of the pure price mechanism, thus stabilizing the social landscape and assisting the coordination of plans, partly through disseminating information. This is demonstrated in the work of George Richardson, which, because of its many affinities to Austrian economics, deserves to be more recognized among Austrians. In

other words, O'Neill's attempt to revive the Marxian theory of the business cycle, his critique of Austrian economics and his critique of market socialism are open to strong doubts. This is because they are based on a lack of understanding of both economic reality and recent economics.

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