The Morality and Efficiency of Market Socialism

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I. MORAL ISSUES

One can defend the moral legitimacy of the institution of public property in two ways: on grounds of rights and on egalitarian grounds. An argument against public ownership on grounds of rights is presented by Robert Nozick, and rebutted by G. A. Cohen.[1] Nozick's argument is well known and hardly need be rehearsed here. A person has a right to appropriate part of the natural world as his private property, as long as the consequences of the appropriation are such that no one is worse off than he would have been had the property remained in its natural state. In this way, one can conceive of a scenario in which eventually no part of the natural world remains unowned and all objects that are made from it and labor belong to individuals. Cohen responds that Nozick has an implicit assumption that the natural world is, morally speaking, originally unowned and, hence, up for grabs. But why not postulate that, morally speaking, the natural world is originally publicly owned? What would this mean? That no one would have a right to appropriate part of it as his own unless the public so agreed (by whatever decision-making procedure it has). But would not the public approve appropriations if Nozick's condition held, that is, if an appropriation would leave no one worse off—or, to sweeten the pot, let's say if it would leave everyone better off—than before the appropriation? No. The public might only approve the appropriation if it could think of no better way of using the land, say, than the candidate appropriator proposes. Or, it might approve the appropriation only if 80 percent of the gains from the appropriation are distributed to the public and 20 percent to the appropriator, while Nozick would

1. R. Nozick, *Anarchy, State, and Utopia* (New York: Basic, 1974); G. A. Cohen, "Self-Ownership, World Ownership, and Equality, Part 2," *Social Philosophy and Policy* 3 (Spring 1986): 77–96. For an argument similar to Cohen's, see James Grunebaum, *Private Ownership* (London: Routledge & Kegan Paul, 1987), pp. 173 ff.

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permit the appropriation as long as 1 percent of the gains went to the public.

Cohen's challenge to Nozick, that the natural world in its unexploited state could be viewed, morally speaking, as owned by everyone, is appealing and might be motivated today by a green philosophy. We are all custodians of this planet for future generations of humans and other animals; this custodianship is better served by the planet's being publicly owned than privately owned. One might, then, attempt to ground public ownership of the world in a right of future generations to inherit a world not inferior to the one enjoyed by their predecessors. Nevertheless, I think such a rights-based approach would be less compelling than the egalitarian approaches that I outline next.

Nozickian rights theorists do not accept the premise that justice requires the equalizing of some opportunity or outcome among people, and I will not try to argue for that here. Suffice it to say that there are many arguments in political philosophy that attempt to establish egalitarianism, in some form, as a requirement of justice. Egalitarian theories can be classified in a number of ways; one is according to whether the equalisandum is an opportunity or an outcome. Primary among outcome-equalizing theories is equality of welfare. I do not think anyone defends an unadorned equality-of-welfare theory today, in part because it leaves persons not responsible in regard to their own efforts and ambitions.[2] Richard Arneson and G. A. Cohen come the closest, in their defense of equality of opportunity for welfare and equal access to advantage, respectively.[3] The nonwelfarist egalitarian theories can all be thought of as equality-of-opportunity theories. Rawls advocates equality of primary goods, as such goods are seen as necessary for anyone to realize her life plan. Hence, primary-goods equality establishes an initial condition under which all have equal opportunity to do what is important for them. Ronald Dworkin advocates (although he claims he is only defining, not advocating) equality of resources, where resources are defined in a comprehensive way, to include internal talents. Resources are, of course, things that enable one to achieve some outcome, and hence his is an opportunity-equalizing theory. Amartya Sen advocates the equalization of capabilities of a basic kind rather than primary goods or resources; his criticism against these other theories is that primary goods and resources are in fact only inputs into what everyone needs in order to achieve his life plan, namely, the capabilities to take some basic actions (move about, read,

2. See R. Dworkin, "What Is Equality? 1. Equality of Welfare," *Philosophy and Public Affairs* 10 (Summer 1981): 185–246.

3. R. Arneson, "Equality and Equal Opportunity for Welfare," *Philosophical Studies* 56 (1989): 77–93, and "Liberalism, Distributive Subjectivism, and Equal Opportunity for Welfare," *Philosophy and Public Affairs* 19 (Spring 1990): 158–94; G. A. Cohen, "On the Currency of Egalitarian Justice," *Ethics* 99 (1989): 906–42.

etc.), and if two people need different amounts of a primary good in order to be able to move about, then primary-goods equalization will not achieve what opportunity equalization requires.[4]

It is not difficult to argue that public ownership of the means of production will result in greater equality of all the above equalisanda than private ownership of such means will entail. Both the supporters of and detractors from public ownership agree on this. But equality is not the only goal; many believe that equality is trumped by Pareto optimality, in the following sense. Suppose there are two economic institutions, the first of which achieves equality of some equalisandum, while the second achieves an unequal distribution of that equalisandum but in which everybody has more of it than under the first institution. Most of us would prefer the second institution.[5] And this is the focal point of the debate that engages people in the world today on the question of public ownership. Many believe, on the basis of the experience of Communism in the Soviet Union and Eastern Europe, that public ownership of the means of production produces an allocation of welfare or resources or primary goods or capabilities that is Pareto inferior to what can be achieved with private ownership—in the sense that any of these equalisanda can be provided in greater amounts to all in a capitalist system, perhaps minimally modified with a welfare safety net, than in a socialist system with public ownership.

Thus, in one sense, one might say that the sixty-four-dollar question is not about ethics or equity but about efficiency. I believe, however, this is a false dichotomy. For, as I have posed the issue, the "efficiency" or Pareto superiority of one system over another *is* an ethical issue.

Suppose one is an egalitarian of the type I have described in footnote 5 (i.e., one who views equality as instrumental) and wants to argue for the moral superiority of socialism over capitalism. There are two general strategies one might employ. The first is to argue that, although capitalism (with a safety net) may Pareto-dominate socialism with respect to the provision of material goods, the equalisandum

4. These theories are put forward, respectively, in John Rawls, *A Theory of Justice* (Cambridge, Mass.: Harvard University Press, 1971); R. Dworkin, "What Is Equality? 2. Equality of Resources," *Philosophy and Public Affairs* 10 (Fall 1981): 283–345; and Amartya Sen, *Commodities and Capabilities* (Amsterdam: Elsevier, 1985). See also J. E. Roemer, "Equality of Resources Implies Equality of Welfare," *Quarterly Journal of Economics* (November 1986), pp. 751–84, for a critical discussion of Dworkin's resource egalitarianism.

5. Most, but not all, for some view equality per se as a goal. I am more attracted to the view that equality is merely instrumental for assuring that scarcity is equally shared. Put another way, the goal is not that everyone have the same amount but that everyone have enough. In most cases, there is not enough for everybody, so equality is a second-best desideratum. If everybody can have enough, then I think an argument for equality is much more difficult to sustain. Under conditions of scarcity of the thing to be equalized (i.e., there is not "enough" for everyone), a distribution, call it *A*, in which everyone has more than in some equal distribution, *B*, is socially preferred to *B*.

should be something else. Perhaps socialism dominates capitalism with respect to a self-realization index or a communitarian index. The second is to argue that capitalism does not Pareto-dominate socialism even along the index in which it excels, namely, the provision of material goods. Most people in the world today would not be moved by an argument of the first kind. Or, to be more precise, the failures of the European centrally planned economies to provide enough material goods for their citizens are so severe that people are suspicious of any argument that admits the inferiority of socialism as a mechanism for providing material goods yet claims, nevertheless, that socialism dominates capitalism for "spiritual" reasons. It is, of course, logically possible that such a socialism is possible, and that its spiritual advantages over capitalism would be so great as to compensate for its inferiority with respect to the provision of material goods.

In what follows, I shall take the second tack, and argue for the feasibility of a socialism that is not Pareto inferior to capitalism in terms of the provision of material goods. Moreover, equality of income (or material goods) will be greater in the socialist variant than under capitalism, and therefore, as an instrumental egalitarian, I argue that the socialist system is morally preferable to the capitalist one. It is not so important that income be the equalisandum—it could be primary goods or capabilities or resources, all of which, I believe are quite highly correlated with income. Markets, I shall argue, are an essential aspect of such a socialism; my task is to propose a blueprint for market socialism.

II. A COMMON FALSE INFERENCE ABOUT PUBLIC OWNERSHIP

All commentators on the right, and some on the left,[6] have written socialism's obituary based on the overthrow of the Communist regimes in Eastern Europe in 1989 and the present acute economic and political crisis in the Soviet Union. Among the quickest to toss socialism into history's dustbin are the intellectuals of the Eastern European countries, and this in itself, it would seem, is a powerful argument against socialism. The societies that failed, however, differed from Western capitalism along more dimensions than property rights, and so the experiment carried out in Eastern Europe was not one properly controlled for the variable 'ownership'. In particular, these societies were characterized by

1. noncompetitive (i.e., dictatorial) politics,
2. central administrative allocation of resources (as opposed to reliance on the market), and
3. public ownership of the means of production.

6. See, e.g., Robert Heilbroner, "Reflections (Capitalism)," *New Yorker* (January 23, 1989).

We have observed the failure of the politico-economic mechanism in which 1 + 2 + 3 hold. From this we cannot conclude that any system involving 3 must fail. In particular, the version of market socialism that I shall propose embodies (not 1) + (not 2) + 3. To put the matter less schematically, I conjecture that the failures of Communism are due to its noncompetitive politics and its abjuring of markets, not to its public ownership. (The reader may query whether public ownership is conceivable without a system of central allocation of resources. In what follows I will distinguish between these two characteristics of an economic system.)

I will not attempt to establish this conjecture by a painstaking analysis of the anatomy of the centrally planned politico-economic mechanism, an operation I am not equipped to perform competently. Briefly, I am convinced that it is impossible for an economy, in which literally millions of decisions must be made by a bureaucratic apparatus, to perform efficiently. The argument is well presented by Alec Nove.[7] The noncompetitive politics further exacerbate the problems, for without political competition there is no mechanism to prevent government agencies from entering into self-interested pacts with economic units such as firms.

Rather, my argument for the conjecture will be positive in that I will argue for the feasibility and success of a politico-economic mechanism embodying competitive politics, market allocation of most private goods,[8] and public ownership.

III. A BLUEPRINT FOR MARKET SOCIALISM

The viability of market socialism depends upon the claim that private ownership of the means of production is unnecessary for the successful operation of a market economy. In the blueprint which I shall now sketch, I attempt to support this claim. But we have, as yet, very little empirical evidence that would enable us to evaluate the claim in a rigorous way. The argument must be, at this point, theoretical.

The market socialism I envisage has these components: firms will be managed by managers whose goal will be to maximize profits, at going prices. That is, the firm manager will try to hire labor and produce output of that variety and quality which will maximize the long-run profits of the firm. Firm managers will either be elected by workers or appointed by boards of directors, about whose composition I will speak presently. What is important, however, is that managers try to profit-maximize. Labor will be hired on labor markets, and wages will be set by supply and demand, in the market. Almost all private

7. Alec Nove, *The Economics of Feasible Socialism* (London: Allen & Unwin, 1983).

8. Private as opposed to public goods; all economies, capitalist or socialist, must arrange for government intervention in the provision of public goods.

goods and services will be allocated on markets, and prices will be determined in these markets. The governments will continue to provide public goods, financed by taxation of profits and wages. Certain private goods, such as health services, may also be provided gratis to the population and financed from taxation—but this is nothing new, even for capitalist countries.

There are two socialist aspects to this economy. First, the government will have the power to intervene in the economy to direct the pattern and level of investment. One plank of the platform of a political party, in such a society, will be the direction that investment shall take should it be elected. The desired investment levels and pattern will not be implemented through a command system but by manipulating interest rates at which different industrial sectors can borrow funds from state banks. Thus, if the government's intention is to decrease the production of automobiles, it will raise above the market rate the interest rate at which the state banks lend to automobile firms. People will thus exercise some collective control, through democratic politics, over the use of savings in society. In this sense there will be public control of the use of the economic surplus, a phrase with a socialist ring. I do not propose that people vote on this particular matter, the composition of investment, because of that ring but because I think that the markets which would be necessary for investment to be allocated in a socially desirable way are necessarily absent (see Sec. IV below for further discussion). This is reflected in the extreme volatility of investment in large capitalist economies, a volatility responsible for the business cycle and therefore, in particular, the rise and fall of unemployment. (What I am saying is less true of small capitalist countries, where the demand for exports can lead the business cycle. But it is substantially the case that the demand for investment goods leads the business cycle in countries like the United States.)

The second socialist aspect of this economy is that the profits of firms will not go to a small fraction of the citizenry but will be divided, after taxes, more or less equally among all adult citizens, taking a form that Oskar Lange called the social dividend.[9] Thus, a citizen in this society will receive income from three sources: wage income, which will vary depending upon her skill and the amount of time she works, interest forthcoming from savings, which will also vary across households, and the social dividend, that will be, in principle, approximately equal across households. The social dividend will be a form of guaranteed income, or what some European writers have called a universal grant.[10]

9. Oskar Lange, *On the Economic Theory of Socialism* (Minneapolis: University of Minnesota Press, 1938).

10. Robert Van der Veen and Philippe Van Parijs, "A Capitalist Road to Communism," *Theory and Society* 15 (1986): 635–56.

I prefer not to call it a grant, since it is not a gift, which 'grant' connotes; it is that part of the national income which is not distributed as wages or interest but which belongs to the people as owners of the means of production. Of course, a society such as the one I am describing might decide to distribute profits in some other way to people, such as in proportion to the value of labor they have expended, but I personally would oppose that proposal.

What will taxes be used for in this society? All the usual things: public goods that a government provides, income transfers to those who are unable to work, subsidies to families who cannot earn enough to live decently, and so on. They will also be used to subsidize the government's intervention in the capital market, as follows. Suppose it is decided to encourage several large industries to invest more than they would have at an equilibrium where there was no government intervention. This is accomplished by providing loans to those industries at interest rates lower than the market rate. Such loans are financed by social savings, and citizens receive the market rate on their savings accounts. Thus, the banks will collect interest on loans to firms at low rates and must pay out interest to citizens on savings at a higher rate. The ensuing deficit must be financed by the government.[11]

Substantial inequality will continue to exist in this society, due primarily to the differential wages that people will earn and also, to some extent, to their differential savings behavior. What will be equalized is that part of income due to corporate profits. The income distribution will consequently be far more equal than in most, if not all, capitalist economies—even without further intervention to soften the wage differentials that will exist in a competitive labor market.

Why do I include as an integral part of this proposal the stipulation that firm managers maximize profits of the firm? Would it not be better to let workers manage the firms directly? The answer is that the firm belongs to everyone, and every household depends upon each firm as a source of part of its income, via the social dividend. Workers, in any case, should not be able to appropriate the profits of the firm they work in: that would lead to gross inequities across workers. We know, from economic theory, that profit maximization, under the right conditions (which include a competitive environment for the firm) leads to an efficient allocation of resources—that is the main reason to use profit maximization as an instrument. Now profit maximization may lead to some antisocial behavior, and that will have to be regulated. But we have no example of a large economy that has

11. For precise details, see I. Ortuño, J. Roemer, and J. Silvestre, "Investment Planning in Market Socialism," in *Democracy and Markets: Participation, Accountability, and Efficiency*, ed. S. Bowles, H. Gintis, and B. Gustafsson (Cambridge: Cambridge University Press, in press).

operated successfully without profit maximization as a goal of firms, and my attempt here is to propose a blueprint that is based, as much as possible, on the successes of capitalism, while deviating from capitalism in certain important ways.

These are the main lines of the blueprint.[12] I shall modify it somewhat below. If people continue to work about as hard as they do under capitalism, and technological change takes place about as it does under capitalism, then the two major differences between this kind of market socialism and capitalism are the direction of investment by a political process and a more egalitarian income distribution. What funds were used under capitalism to finance the consumption of capitalists (corporate profits) will here be distributed to all citizens. If capitalists consume a small fraction of national income, as in Norway, then the change in income distribution effected by market socialism will be small. If, as in Brazil, the rich consume 40 to 60 percent of national income, then the redistributive effect would be substantial.

The first question one must ask about this blueprint is, Will it work? There are various levels at which that question can be asked. One is at the level of economic theory. Is it possible for a market system to equilibrate an economy in which profits are distributed as I described, and in which the government intervenes in the investment behavior of the economy by manipulating interest rates as I described, if the managers of firms maximize profits, facing market prices, wages, and interest rates? This question is studied in the aforementioned paper by Ortuño, Silvestre, and me (n. 11). It is indeed possible for the government to achieve any of a large variety of possible compositions of investment for the economy by the setting of discounts and surcharges on the market interest rate; prices in all markets will adjust in such a way that an equilibrium is achieved, in which the demand for each good by consumers is equal to the supply of that good by firms. Furthermore, since managers are maximizing profits, the allocation of goods and labor at equilibrium is constrained Pareto efficient, given the investment vector that the government is implementing. The social control over investment is achieved without setting ten thousand prices, or one million prices—the figure for the Soviet Union varies, depending upon the source. Nor does the center tell any firm what to produce or where to acquire its inputs or where to ship its outputs. All these millions of decisions, supposedly but impossibly made by the planning system in Soviet-type economies, are left to individuals to arrange through markets. Yet by the adjustment of between five and twenty interest rates, the economy can realize the composition of investment that its planners aim to achieve.

12. The detailed models and characterization of equilibria of these models are studied in ibid.

Thus, I do not think that the lessons of the Communist experience include an admonition against planning as such, against the direction of the economy toward preconceived ends. The methods of Soviet planning were ineffective, and worse, because they did not use markets as a way of decentralizing millions of small decisions. Ironically, perhaps, the most effective planning requires the use of markets. What is not planned in this vision of market socialism is the composition of output, the prices of goods, or the distribution of labor; planned is just the composition of investment.[13]

Another level at which the can-it-work question can be asked is, Will the managers of firms be motivated to maximize profits in an economy where firms are not privately owned by investors? Will entrepreneurial spirit be forthcoming? Will technological innovation take place? This is the level at which most economists are skeptical concerning the feasibility of market socialism.

Let us first take up the question of managerial discipline. Stories abound about corrupt and incompetent management of firms in socialist economies. It is wrong to conclude from the observation of firms in a command economy what publicly owned firms would be like in a market economy. Managerial culture in the Soviet Union is demoralized, to say the least; for the main, one can only acquire the inputs one needs by bribery and barter. This culture would be different if inputs and outputs could be bought and sold on markets. But this, of course, cannot be the complete answer to the query. "Bourgeois" finance economics maintains that the only reason that managers pursue the interests of shareholders, which require maximizing profits rather than their own selfish interests, is the threat of losing their jobs. The discipline is provided via the stock market. If a firm is being poorly managed, its profit prospects will darken and its stock price will fall. It will become an attractive target for a takeover by investors who will buy the firm cheap, put in better management, and return the firm to a profit-maximizing program. The stock market has therefore been called the market for corporate control. What mechanism can a market socialist economy use to substitute for the capitalist stock market to keep managers doing their job?

A clue to a possible answer comes from the experience of Japanese capitalism. In Japan, the stock market was relatively unimportant in the economy until recently. Firms are organized into groups, called *keiretsu*. Each *keiretsu* is associated with a main bank, whose responsibility it is to arrange loans for the firms in its group and to monitor the firms' managements. The investment projects proposed by firms are

13. We could design an economic mechanism that plans, e.g., the allocation of labor rather than the allocation of investment. We chose to plan investment for reasons discussed both above and in Sec. V below.

evaluated by the staff of the bank, and in this way the bank is able to monitor the firms' behavior. These main banks also defend firms in their group against takeovers from firms outside the group. This system has been successful (if we take Japanese capitalism as a successful capitalist variant). But there is no market for corporate control in Japan—at least, it does not take the form that it has in the United States, and capital is not directed to its profitable uses via a stock market. This last point is worth emphasizing, for another plank of capitalist ideology is that bureaucrats cannot decide how to allocate capital; that is best done by a stock market, where millions of people express their opinions by voting with their dollars. Yet in Japan, apparently the accountants, economists, and industrial experts working for the big banks are sufficiently savvy to pass good judgment on investment proposals of firms and do the job that supposedly requires a stock market.

Bardhan has proposed a system wherein firms in the kind of market socialist economy I outlined above could be organized into groups modeled after the Japanese *keiretsu*.[14] Each group would consist of firms whose products are somewhat related—but direct competitors would never be in the same group. Say firms *W*, *X*, *Y*, and *Z* are in one group, with bank *B*. Each firm would own some shares of the other firms in the group, and the bank would also own some shares of each firm. The board of directors of a firm would consist of representatives of its shareholders, that is, of the various firms and banks in the group. That part of profits of firm *W*, say, not going to the bank, the other three firms, or directly to *W*'s own workers would go to the state and would be distributed to all citizens as part of the social dividend. The fraction of firm *W*'s profits going to firms *X*, *Y*, and *Z* by virtue of their ownership of shares of *W* would constitute a significant other part of the social dividend of the workers of *X*, *Y*, and *Z*. Thus, every worker in the economy would receive his social dividend from two sources: a centralized dividend from the government, comprising a small share of profits of all firms in the economy, perhaps consumed as public goods and services, and a decentralized part, consisting of a fraction of the profits of the other firms in his group. The function of this decentralization is to give firms *X*, *Y*, and *Z* an interest in monitoring the behavior of firm *W*. In particular, if firm *X* thinks firm *W* is not profit-maximizing, then it can sell to the bank its shares of *W*. This in turn puts pressure on the bank to force *W* to do better.

Bardhan's proposal is not equivalent to introducing a stock market; it is a mechanism for decentralizing the accountability of firm man-

14. Pranab Bardhan, "Risk Taking, Capital Markets, and Market Socialism," Discussion Paper no. 91-154 (University of California, Berkeley, Department of Economics, 1991).

agement to a small number of institutions, in this case, other firms and banks, which are capable of monitoring the management. Complete equality in the social dividend received by citizens would be sacrificed in the interests of creating a mechanism for decentralizing the monitoring of firms.

A word about innovation. Again, it would be wrong to conclude from the experience of firms in command economies that firms that are not privately owned will not innovate. I think that if there is sufficient competition, innovation will occur in these market socialist firms. To the extent that innovation takes place as a consequence of research and development in large firms anywhere, it can just as well take place in a socialist firm.

Now, it might be said that the kind of innovation that will not occur under market socialism will be that of the lonely inventor, who, spurred on by the prospect of becoming a multimillionaire, invents a new kind of computer. Under capitalism, these people exist; if they succeed, they form small firms, and are in almost all cases eventually bought out by large firms. If this source of innovation appears important, then I suggest that such private firms be permitted in market socialist economies. They should be nationalized, with proper compensation to the owners, at some given size. The government would buy out the small computer firm instead of IBM's buying it out. Or the publicly owned IBM could buy out the small firm, subject to the usual antitrust considerations, which will be necessary under market socialism as well. This mechanism should provide almost as much incentive to the entrepreneurial spirit as capitalism provides.[15]

To sum up, I think it is possible to use markets to allocate resources in an economy where firms are not privately owned by investors who trade stock in them with the purpose of maximizing their gain, and that the government can intervene, in such an economy, to influence the level and composition of investment. The principal skepticism about the model I propose concerns the possibility of designing incentives to get managers to maximize profits. My argument against this skepticism is that a similar agency problem exists in modern capitalism, where private owners of firms must induce hired managers to maximize profits. The necessary, and perhaps sufficient, condition for the solution of the agency problem in capitalist corporations is taken, by most finance economists, to be the concentration of large quantities of the firm's stock in the hands of a small number of investors, who therefore have the incentive to spend the resources necessary to monitor the

15. A more careful discussion of the prospects for innovation under market socialism is found in J. Berliner, "Innovation, the USSR, and Market Socialism" (Russian Research Center, Harvard University, 1991, mimeographed).

management.[16] (Small investors have no such incentive, because the costs to them of monitoring exceed their expected gains. Of course, they could collectively hire a monitor, but that only shifts the agency problem to one between them and their monitor.) Bardhan's proposal exploits this conventional wisdom and designs a system wherein the ownership of firms is concentrated among several other firms and banks. Because of the significant dependence of workers in one firm on the profits of another firm in its group, via the decentralized formula for the social dividend, each firm has an incentive to monitor the activities of the other firms. Indeed, the board of directors of a firm would consist of representatives of its shareholders and the main bank in its group.

At this point, the skeptical laissez-faire economist will argue that the bankers would not perform their job of pressuring or replacing non-profit-maximizing firm management, because they would not be responsible to shareholders cracking the whip. The chickens of public ownership will always come home to roost, they say, in this form: there is no principal at the end of the sequence of decision makers whose fortune depends upon profit maximization of the firm. To paraphrase the challenge, who will monitor the monitor?

First, there must be constitutional safeguards preventing the interference of the government in the short- and medium-term policies of banks. Banks must act in an environment where economic considerations determine their decisions, not political ones. Thus, if a firm should, for economic reasons, be declared bankrupt, it must not be possible for politicians to prevent its reorganization because of the disruption involved in the lives of workers. Of course, there must be concommitant retraining and relocation programs for workers. Second, the *keiretsu* system will induce banks to monitor carefully firms in their jurisdiction, because the ability to arrange loan consortia for these firms depends on the bank's reputation for running a tight ship. Moreover, new firms will want to join corporate groups whose banks have a reputation for securing loans on good terms for their firms. Thus, a bank that does not perform its monitoring job well will soon find itself losing money and under attack from the firms in its group for not being able to sell their bond issues on good terms. Thus, competition between and political insulation of banks are the aspects of the design that should induce the monitor to monitor.[17]

16. For a fascinating debate on the efficacy of the stock market in the U.S. economy as a monitoring device of firm management, see Michael C. Jensen, "Eclipse of the Public Corporation," *Harvard Business Review* (September–October 1989), pp. 61–74.

17. For further discussion of this problem, and of the "soft budget constraint," the reader is referred to P. Bardhan and J. E. Roemer, "Market Socialism: A Case for Rejuvenation," *Journal of Economic Perspectives* (in press).

IV. THE POLITICAL DETERMINATION OF INVESTMENT

I wrote above that my advocacy of the political determination of the pattern and level of investment in the market socialist economy is not based upon the Marxist view that "the people should control the use of the economic surplus." In principle, under certain conditions, I do not think that socialism requires that there be popular control of the investment decision in the economy, by which I mean that market determination of investment is not in principle antisocialist. Suppose that we are nonpaternalistic and accept peoples' preferences for consumption over time as their business. (We do not seek to protect the future selves of citizens from their present selves.) Or we may not be principled nonpaternalists, but we believe that conditions are such that the preferences people have developed reflect their true interests. Suppose that capital markets are perfect, that futures' markets for all commodities under all possible states of the world exist, and that externalities are absent. Then the competitive (market) equilibrium of the economy will be Pareto efficient, which implies, in particular, that no different allocation of investment could make everybody at least as well off, and some better off.[18] On what further grounds might we object to this equilibrium? On equity grounds—but those grounds are limited, as we have already divided corporate profits among households in an equal way. That is to say, there is no reason left to modify the economy's investment decision as such, although there may be reason to modify further the income distribution the inequality of which now depends mainly on differential wages.

I believe that political control of the investment vector, or the planning of investment, is desirable not as a deep socialist principle but for instrumental reasons.[19] These reasons come under the rubrics of paternalism and market failure.

By paternalism, I do not suggest that the state as a disembodied actor should decide the pattern of investment because people do not know what they need: rather that the person as citizen may decide in the voting booth that she, as consumer, behaves in a way contrary to her real interests. (One might call this intrapersonal paternalism.) When faced with the decision of whether to spend an extra thousand dollars to purchase a refrigerator that does not use chlorofluorocarbon

18. This is shown in G. Debreu, *Theory of Value* (New Haven, Conn.: Yale University Press, 1959), chap. 7.

19. In contrast, Roberto Ungar advocates the political control of investment as a deep democratic principle. Despite this difference in motivation, his "rotating capital fund" is one institutional proposal, friendly to my views, for implementing the democratic control of investment. Ungar advocates using both interest rate intervention and rationing to achieve a socially desirable allocation of investment funds. I am indebted to Will Kymlicka for referring me to Roberto M. Ungar, *False Necessity* (Cambridge: Cambridge University Press, 1987), pp. 491–502.

(CFC) technology, the person as consumer may well decide not to. But in the voting booth the same person might decide to authorize the government to subsidize investment in pollution-superior technologies to an extent that will cost her a thousand dollars more in taxes and price effects than otherwise would have been the case. Now, there is one sound economic reason for this apparently contradictory behavior. If the consumer buys the clean and green refrigerator, her act has a miniscule effect on the ozone layer. If, however, a law is passed subsidizing clean refrigeration technology, then everyone must contribute a thousand dollars, and the effect will be substantial. Besides this public-good rationale, however, the behavior of people when voting may be more civically oriented than when purchasing.[20] I am suggesting that the more reliable guardian of a person's true interests may be her civic persona rather than her economic one, a view challenged by George Stigler, who maintains that people only act responsibly when they must bear the costs of their actions.[21] (A citizen's vote is irresponsible because it only makes a difference in the costs she must bear in the infinitesimally likely case that she breaks a tie in the election.)

There are many types of market failure that can motivate the need for political determination of investment. The refrigerator example is the conventional one of an externality. The purchase of CFC refrigerators by others affects the ozone layer which I consume. Markets do not induce a socially optimal amount of refrigerators in this case. The political process is one way of resolving the Prisoners' Dilemma that afflicts the market place.

Another market failure which recommends the planning of investment is due to the nonexistence of markets for goods in the future contingent upon the realization of various possible states of the world. It is probably this market incompleteness that explains the volatility of investment in capitalist economies. But there are externalities, as well, that compound the problem of reaching an optimal investment plan because there are missing markets. Makowski shows that, in the absence of a complete set of markets, the set of goods that a private ownership economy will produce is not a Pareto-optimal set of goods. That is, certain goods which could be innovated will not be, because of the lack of markets,[22] and all would be better off with a set of goods different from what exists at the market equilibrium. Finally, there is

20. For the rationality of such behavior, see Amartya Sen, "Rational Fools: A Critique of the Behavioural Foundations of Economic Theory," *Philosophy and Public Affairs* 6 (Summer 1977): 317–44. See also Cass Sunstein, "Preferences and Politics," *Philosophy and Public Affairs* 20 (Winter 1991): 3–34.

21. George Stigler, "Economic Competition and Political Competition," *Public Choice* 13 (1972): 91–106.

22. Louis Makowski, "Perfect Competition, the Profit Criterion, and the Organization of Economic Activity," *Journal of Economic Theory* 22 (April 1980): 105–25.

the relatively new literature on "endogenous growth," in which it is argued that investment itself increases technological know-how, which then makes possible more rapid innovation and growth.[23] If this is the case, then, even with a complete set of markets, the equilibrium amount of investment will be too low from a social point of view.

V. IS MARKET SOCIALISM JUST?

It is wrong, in my view, to maintain that any market system, with or without capitalists, allocates resources and incomes justly. What perfectly working competitive markets do is pay people according to the evaluation that other people in society put on their contribution. In a capitalist economy, a person's contribution consists not just of her labor contribution but also of the contribution of her capital. Leftists have usually attacked the justice of the capitalist income distribution on the grounds that capitalists are not the rightful owners of their capital, and hence their receipt of profits constitutes an injustice and, moreover, exploitation of those to whom the capital should rightly belong. The problem with this argument is that it does not go far enough. For I do not think that a distribution of income in which each is paid the value of his labor contribution to the rest of society is just either. For it is surely the case that different people make contributions of very different values to society, due in large part to their differential training. (It is wrong to say, as utopians sometimes do, that the contribution of an unskilled worker is just as valuable to society as that of a physician; it could be if, counterfactually, almost no one had the capacity to be an unskilled worker and almost everybody with no training could be a physician. Value must be measured not, as Marx said, just as the labor embodied in producing the thing but as the total real resource cost that people are willing to sacrifice to make the thing available.)

Under market socialism, people will receive differential wages, and that will reflect their differential economic value to society. But they will not deserve those wages nor be entitled to them, because I do not believe they deserve or are entitled to returns to their arbitrarily assigned genetic compositions and familial and social environments, which largely determine their skills. This is an old Marxist point; in the introduction to the *Critique of the Gotha Program,* Marx wrote of payment according to the value of one's labor as "bourgeois right."

I view the differential wages that will accompany a market socialist system as justifiable for only one reason: they are a by-product of using a labor market to allocate labor, and there is no other known way to allocate labor more efficiently in a large, complex economy than by use of a labor market. Now, there are various ways of decreasing

23. Paul Romer, "Increasing Returns and Long-Run Growth," *Journal of Political Economy* 94 (1986): 1002–37.

real-income differentials of workers which could be used by a market socialist society—to the extent, of course, that a democratic society condones using them. One practice of the social democracies is to tax income sharply and progressively and to redistribute it by providing some goods, such as health services, on an equal basis to all at no fee.

The job of a socialist economist is to design an economic mechanism that would provide each person with sufficient material income to pursue her self-realization, consistent with an equal degree of opportunity for self-realization provided for others. (Perhaps this particular egalitarian proposal is just another version of what Arneson, Cohen, Dworkin, Rawls, and Sen are getting at.) This is pretty vague, and I shall not try to sharpen it up here, but the quick statement is that equality of income is a goal, subject to various caveats.

If some inequality is one undesirable feature of market socialism, a second is, as G. A. Cohen puts it, that the market "motivates contribution not on the basis of commitment to one's fellow human beings and a desire to serve them while being served by them, but on the basis of impersonal cash reward."[24] Indeed, one should not idealize the behavior of people in a market socialist economy. Firms may advertise deceptively and try, as they do under capitalism, to create in people tastes for goods by exploiting their feelings of insecurity and incompetence. Workers will need unions to protect them from overzealous managers, even if they have the power to remove management. More generally, conflicts between different groups of people based upon their different interests will continue to exist. Environmentalists and workers in the lumber industry will continue to clash. The political arena will be the site of sharp contests.

A remark is required on the position I have taken above on the management of the firm. Worker control of the firm is not an essential part of the blueprint I offer—indeed, it would be in tension with the blueprint if such control would cause the firm to pursue a goal other than profit maximization. One might argue that the control of the workplace is sufficiently important to the welfare or self-realization of workers that the society would be willing to sacrifice income to enable worker control. My instinct is to disagree, but I have no hard evidence to offer. There might be, however, another reason to introduce worker control that I have not pursued here, as I have not discussed in any detail the politics of a market socialist society. Such a society would have to take steps to prevent managers from becoming a class in the political sense, a class that has political power to influence state policy. One check of managerial power might be to stipulate that workers have the power to hire and fire managers. I leave this question open.

24. G. A. Cohen, "The Future of a Disillusion," *New Left Review* (in press).

Market socialism would dominate capitalism from the point of view of justice, for the reasons outlined in the first section, if it can indeed succeed in significantly equalizing the distribution of income with little efficiency cost, a possibility I have tried to argue is feasible. It is not the only road away from standard capitalism: Scandinavian social democracy may do about as well as market socialism can do in equalizing the distribution of income, and I have not argued that market socialism is intrinsically better for people than social democracy because, for instance, of the nonexistence of a capitalist class in the former.[25] But for many countries in the next fifty years, market socialism might be a desirable option, while social democracy might not be; if the economy is insufficiently productive, it can be the case that social democracy would not suffice to redistribute income to a satisfactory extent, while market socialism would.[26] This motivates its serious study by social scientists and philosophers.

25. This is not to say such arguments cannot be made; indeed, a society without capitalists is likely to have quite different politics from a social democratic society. For an economic argument developing this point, see my "Would Economic Democracy Decrease the Amounts of Public Bads?" Working Paper no. 376 (University of California, Davis, Department of Economics, 1991).

26. See J. Roemer, "Laissez-faire Capitalism, Trade-Union Capitalism, Social Democratic Capitalism, and Market Socialism" (University of California, Davis, Department of Economics, 1990).