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Socialism and Entrepreneurship: A Rational Choice

Approach to an Issue of Compatibility

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## ABSTRACT

A theoretical study of the feasibility of socialism. Politically, socialism is characterised by equality, democracy and liberty. Economically, it is assumed (i) that the feasibility of socialism depends upon its ability to generate growth, and (ii) that growth is secured through entrepreneurial activity. Economic theory is used to delineate the concept of entrepreneurship and to explore the nature and limitations of capitalist entrepreneurship and political theory is used to identify possible incompatibilities between socialism and entrepreneurship. Underlying many of these arguments is a claim for the existence of a trade-off between efficiency and equality. The capacity of market socialism to either transcend or minimise this trade-off is considered.

Three forms of market socialism are examined. The first is drawn from Joseph Carens' work on moral incentives, the second from theories of the labour-managed firm and the third from new public management. The socialist credentials and capacity of each to generate entrepreneurial activity are appraised. Examples drawn upon include Israeli Kibbutzim, the Spanish Mondragon cooperative, British nationalised industries and the Japanese computer industry.

Economic new institutionalism, welfare economics and Austrian economic theory are all on occasions used but the principle methodology is rational choice. Specifically, game theory, principal agent analysis and William Niskanen's account of the budget-maximising bureaucracy are shown capable of illuminating

discussion. Given even the assumption of egoism it is argued that through careful institutional and organisational design, tensions between socialism and entrepreneurship can be alleviated.

## **Acknowledgements**

This thesis has taken just under four years to write and Brunel University, the London School of Economics, Durham University and on occasions my wife, Jane Langham, provided the resources which allowed me to continue. Responsibility for teaching courses in rational choice, British politics, West European history, British political history, quantitative data analysis, public policy, public management and political theory frequently distracted me but perhaps encouraged a broader focus for my work.

The real debt I owe is to my supervisor, Keith Dowding. Without his constant nagging, criticism and support this thesis would not have been completed. In my experience doctoral students have a understandable habit of privately complaining about their supervisor to friends whilst publicly lauding them in the acknowledgements to their finished work. Is my endorsement simply another example of self-interested guile? Those who have suffered the misfortune of watching the gradual development of my argument will understand that it is not.

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## Preface

The entrepreneur has become the focus of political as well as economic interest. Allegations of neglect has been a stick the Conservative Party has used to beat social democracy and the post-war consensus. The construction of an 'enterprise economy' is now established as the fundamental goal of economic policy whilst 'entrepreneurial' has become the ultimate accolade a minister can bestow on a business, government department or university faculty. For Lady Thatcher, entrepreneurs are economic and cultural heroes: the shock troops of a revolutionary regime. A political monopoly has been claimed. The Conservatives portray themselves as the entrepreneur's friend and depict the Labour Party as the entrepreneur's implacable opponent. A Labour government, it is claimed, will roll forward the frontiers of the state, raise taxation, impose red tape and stifle individual initiative.

Socialists have done little to assist their own cause and when faced with this indictment frequently act as if the best form of defence is capitulation. The belief that socialists are more comfortable discussing the distribution rather than the creation of wealth has not been dispelled. The sacred text of the post-war Labour Party, Anthony' Crosland's The Future of Socialism (1964), is assembled around the assumption that economic constraints have been loosened and that sustained growth is assured. Ever since in Karl Marx's work they became an agent of exploitation, the entrepreneur has been viewed ambivalently. For those on the left

of the Labour Party, Robert Maxwell, Asil Nadir and Ernest Rachman embody an entrepreneurial spirit of greed and corruption, securing wealth for themselves at the expense of the welfare of others. Times are perhaps changing. 'New Labour' has reconciled itself to the existence and importance of the entrepreneur and promised to tend to their needs and respect their achievements. Peter Mandelson and Roger Liddle (1996, 3) pledge that a Labour government will not only tackle 'vested interests and class barriers' but release 'entrepreneurial energy in business and the public services'. But New Labour has only been able to embrace the entrepreneur, critics suggest, because it has abandoned socialism.

This doctorate examines, clarifies, defends, develops and challenges the assumption that socialism and entrepreneurship are in some way incompatible. Two immediate justifications can be offered for this choice of topic. First and as suggested in Chapter One, socialists cannot afford to ignore the entrepreneurial function because entrepreneurs generate economic wealth. If socialism and entrepreneurship cannot be reconciled, the future of socialism is uncertain. Second, the relationship between socialism and entrepreneurship remains largely unexplored. The issue has become a political football but has rarely troubled social scientists. Of course 'madmen in authority' are distilling their frenzy from somewhere and there are numerous justifications of and attacks on the economics of socialism. But with a few notable exceptions, the entrepreneur remains largely hidden in the background of these disputes.

The relationship between socialism and entrepreneurship is analyzed using rational choice theory. The choice may seem a surprising one. Particularly in American Universities, rational choice offers a formalistic and perhaps even sterile approach to the study of politics. To its critics, rational choice copes with the complexity of individual behaviour by either ignoring it or reducing it to a set of simple mathematical axioms or utility schedules. Rational choice does not seem to lend itself to popular images of the entrepreneur as a dashing individualist.

The entrepreneur is certainly resistant to many of the conventional tools of political and economic analysis but the difficulty of a topic does not itself justify its neglect. To study the relationship between entrepreneurship and socialism it is necessary to approach the entrepreneur indirectly. Entrepreneurs do not operate in an economic vacuum. Their incentives to act and the efficacy of their action depends upon the environment in which they operate. Laws of taxation, property, patent and bankruptcy can make or break the entrepreneur. A discussion of the compatibility of socialism and entrepreneurship can be brokered through a examination of the affinity between socialist values and the institutions and organisations necessary to create, animate and direct entrepreneurial action. Above all much will be seen to depend upon the relationship between entrepreneurship and the market and the market and socialism. In the preface to his rational choice defence of democracy, Donald Wittman (1995, 1) writes that 'most controversies in the social sciences are ultimately arguments

over the nature of the market'. The argument here offers little comfort for those who would wish to dispute Wittman's conclusion.

As this description suggests, the scope of this thesis is extremely broad. The entrepreneur is encountered in and lessons drawn from a wide variety of settings: Israeli kibbutzim, capitalist corporations, Spanish cooperatives, nationalised industries and public bureaucracies. Diversity is an inevitable consequence of studying the entrepreneur but it raises the danger that disparate observations will frustrate generalization and leave discussion lacking coherence. It is for this reason that rational choice is valuable. A commitment to a small number of methodological principles allows for both the imposition of a stable framework and the use of a set of established theories. The entrepreneur is the subject of the argument: game theory, budget-maximising and principal-agent analysis the method of approach.

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## Chapter One

### Creating a Context: Three Assumptions and a Methodology

- 1.1 Introduction
- 1.2 Defining the Terms
  - 1.2.1 The Meaning of Entrepreneurship
  - 1.2.2 The Meaning of Socialism
- 1.3 The Failure of Socialism
  - 1.3.1 Socialism, Economic Growth and Entrepreneurship
  - 1.3.2 Przeworski's Evasion
  - 1.3.3 The Limits of Growth
- 1.4 Rational Choice and Socialism
  - 1.4.1 The Meaning of Rational Choice
  - 1.4.2 Rational Choice and Socialism: The Case Against
  - 1.4.3 Rational Choice and Socialism: Initial Defence
- 1.5 Concluding Comments and Future Directions

'We believe that the creation of wealth is a social process - one which involves the co-operative efforts of countless men and women. No one person - nor indeed any one family or group of shareholders - can be said to 'create' great wealth, great companies or great estates. It is the people who create; it is the fortunate few, blessed by the customs and laws of the land, who are deemed to own. We intend to change those customs and laws - to begin to load the scales in favour of greater equality' (The Labour Party Programme, 1982, quoted Crick, 1987, 76)

'the personal qualities that make for entrepreneurial alertness [are]: restive temperament, a thirst for adventure, ambition and imagination. All such qualities may be nurtured or suppressed. They are presumably similar .... in Korea North and South of the 38th parallel ... but the results are very different according to the institutions created by government. In some environments, the innate urge of mankind to discover new techniques and new ideas is given freest rein in competitive markets. In others men of the same race, culture and instincts are not allowed to express these qualities' (Seldon, 1980, XI-XII)



## 1.1 Introduction

In 1951 South Korean citizen Kim Sun-myung was arrested for proclaiming his loyalty to the North Korean Government. Having refused to recant, he was jailed, tortured and finally released forty four years later. In his report of the story, Nicholas Kristof comments

Mr. Kim's courage seems especially poignant because of the way the world has changed under him ... South Korea, impoverished and dictatorial when it imprisoned Mr. Kim is now a prosperous democracy ... North Korea, once the great economic and social hope ... today stagnates in poverty and dictatorship (The Guardian, 21st August, 1995, p. 8).

South Korea's status as a democracy is questionable. Its prosperity and North Korea's political and economic bankruptcy are not. The unleashing of entrepreneurial forces has contributed to the South's success and their emasculation to the North's failure. As the article remarks, if the South Korean regime had wanted to break Mr. Kim's resolve it should simply have sent him on a visit to the North. Scores of South Korean's have been arrested in recent years for political 'subversion' but few have expressed support for Kim Il-Sung. Given the choice between living in a economically flourishing or a economically stagnant dictatorship, most individuals choose the former.

Mr. Kim, it appears, is made of sterner stuff. Upon his release and having been driven through Seoul's city centre, he remarks

this kind of thing doesn't impress me, because there are still a lot of poor people. These tall buildings are the labour of poor people. Did you ever see any rich people digging on a construction site? The fight against poverty goes on (The Guardian, 21st August, 1995, p.8).

To a socialist, such sentiments are admirable. As the extract from Labour's 1982 programme indicates, socialists believe that the creation of wealth is a social process from which all must benefit. But if the opportunity cost of equality is prosperity, socialism's political future is uncertain as Britain and America's embrace of 'conservative capitalism' suggests that most voters are willing to sacrifice social(ist) justice for economic affluence (Hoover and Plant, 1988).

If socialism can be shown capable of sustaining both economic success and social justice, the electoral prospects of socialist parties will be enhanced. Critics deny the feasibility of this objective and assert the necessity of a trade-off between efficiency and equality (Okun, 1982). Through an examination of the concept of entrepreneurship, this thesis examines whether and to what extent they are right to do so.

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## 1.2 Defining the Terms

### 1.2.1 The Meaning of Entrepreneurship

Whilst Cole (1959) describes the entrepreneur as the central figure in economics, economists have struggled to understand their activities. In a much quoted article, Peter Kilby (1971, 1) employs the following analogy.

The search for the source of dynamic entrepreneurial performance has much in common with hunting the Heffalump. The Heffalump is a large and rather important animal. He has been hunted by many individuals using various ingenious trapping devices, but no one so far has succeeded in capturing him. All who claim to have seen him report that he is enormous, but they disagree on his particularities. Not having explored his current habitat with sufficient care, some hunters have used as bait their own favourite dishes and have then tried to persuade people that what they caught was a Heffalump. However, very few are convinced, and the search goes on.

Different theories of entrepreneurial behaviour are considered in Chapter Two. Here, entrepreneurship itself is defined in terms of three functions: innovation, coordination and the bearing of uncertainty.

(i) Innovation Whilst this is the activity most closely associated with entrepreneurship in the popular imagination, its importance is frequently neglected. Despite the experience of the industrial revolution, British classical economists like Adam Smith, John Stuart Mill and David Ricardo ignored innovation, leaving it to the German's, Max Weber (1930) and Joseph Schumpeter (1943, 1961). Schumpeter (1934, 64) contrasts innovation with both invention and imitation. Its effects are likened to those of a revolution, involving sudden and massive change.

That kind of change arising from within the system which so displaces its equilibrium point that the new one cannot be reached from the old one by infinitesimal steps. Add successively as many mail coaches as you please, you will never get a railway thereby.

The process of innovation is not restricted to the introduction of new goods. As Schumpeter emphasises, it also includes the introduction of new methods of production, the introduction of new raw materials into the production process and the use of new methods of business organisation.

(ii) Coordination Successful innovation is comparatively rare. Most entrepreneurial activity is less ambitious and consists of 'market-making': attempts by individuals to either find new customers for existing products or to sell to existing customers

at a more profitable price. Coordination can be easily contrasted with innovation. The latter involves the destruction of an existing equilibrium and the former its painful reconstruction through a large number of distinct transactions. The significance of coordination was first recognised by a French businessman and economist, Richard Cantillon. He observes that if the price of food varies between Paris and outlying rural districts individuals will

buy at the low price the products of the villages and transport them to the capital to be sold there at a higher price (quoted Hebert and Link, 1982, 18).

Coordination continues until markets are cleared and equilibrium prices reached. Cantillon's insight is important as his arguments are refined and developed in the work of Friedrich Hayek (1935a, 1982a) and Israel Kirzner (1973, 1985): trenchant critics of socialism whose work will be examined in Chapters Two and Three.

(iii) Uncertainty Bearing Cantillon (1931, 85) also emphasises that when entrepreneurs engage in trade they do so 'without an assurance of the profits [they] will derive'. The sources of uncertainty in the entrepreneurial process are numerous: changing prices, competitor's actions, erratic demand and government policy. The entrepreneur accepts uncertainty, seeing in it a potential source of profit. The significance of uncertainty for the entrepreneur was celebrated by G.L.S Shackle (1955, 1966) and Frank Knight (1971) but Schumpeter (1942, 75) and other Austrian

economists (see Wu, 1989, 79) deny that the bearing of uncertainty is an entrepreneurial function. Professional gamblers bear uncertainty and attempt to profit from it but are not entrepreneurs. Uncertainty, Schumpeter argues, whilst a salient feature of the entrepreneurial environment does not describe what the entrepreneur does. Uncertainty is only an input, innovation and coordination the outputs. To an extent, this argument is accepted and subsequent chapters concentrate on innovation and coordination. Socialism is compatible with entrepreneurship to the extent that it can cope with each of these functions. At the same time, entrepreneurship is seen as an inherently uncertain activity and it is argued that this uncertainty creates particular difficulties for the concept of socialist entrepreneurship.

### 1.2.2 The Meaning of Socialism

Definitions of socialism are problematic. Socialists can disagree with both friends and critics about its meaning. As Anthony Crosland (1964, 64) remarks

the word does not describe any present or past society, which can be empirically observed, and so furnish unimpeachable evidence for what is or is not 'socialism'. Thus statements about socialism can never be definitely verified ... there is therefore no point in searching the encyclopedias for a definitive meaning; it has none, and never could.

In this thesis, socialism is seen to require the pursuit of three values: equality, democracy and freedom. Working definitions of these terms are presented but no attempt is made to (i) explore their development within socialist thought, (ii) to trace in any detail the contours of philosophical debate about their meaning, (iii) to justify the exclusion of other possible values like community or self-realisation, (iv) to devise possible priority orderings between them, or (v) to distinguish between different variants of socialism.<sup>1</sup>

(i) Equality Equality generates the most passionate criticism of socialism and most clearly differentiates socialism from capitalism. Equality can be described as the 'classical principle of socialism' (Berki, 1975, 25) and for this reason subsequent chapters devote considerable attention to the tensions between entrepreneurial efficiency and equality. Brian Barry (1990, 120) distinguishes between strong and weak equality. Weak equality embraces the demand that 'people's opportunities for satisfying whatever wants they may happen to have should be equal' (Barry, 1990, 120). If weak equality means only equality of opportunity then socialists are unimpressed. Preference is given to 'strong equality' in which 'all the members of a group get an equal share in some (tangible or intangible) good regardless of any personal characteristic' (Barry, 1990, 122). A more precise specification of equality is given in Chapter Four. The good on which attention is focused in subsequent

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<sup>1</sup> Chapter Four draws a distinction between socialism and social democracy on the basis of the nature of the trade-off between efficiency and equality.

chapters is income and this provides the first criterion by which the compatibility of socialism and entrepreneurship can be assessed.

Criterion One

Socialism is compatible with entrepreneurship to the extent that equality of income does not adversely affect the volume of entrepreneurial activity generated within an economy. The greater the degree of inequality required to generate a particular volume of entrepreneurial activity, the more incompatible socialism and entrepreneurship can be said to be.

(ii) Democracy Socialists see in democracy a means of ensuring that outcomes - particularly economic ones - 'fall under collective control' (Barry, 1988, 146). It is not necessary that control be exercised at any particular level or in any particular way. Chapter Six, Labour Managed Firms and Socialist Entrepreneurship, examines a form of socialism in which control is exercised by workers at the level of individual firms. Chapter Eight, Bureaucratic Entrepreneurial Socialism: Structure, envisages a system in which decisions are taken at the national level. The demand for control nonetheless suggests a second criterion by which the compatibility of socialism and entrepreneurship can be judged.

Criterion Two

Socialism is compatible with entrepreneurship to the extent that collective control of economic decisions does not adversely affect the volume of entrepreneurial activity generated by a society. The greater the number of areas that must be sheltered from collective control to generate a particular level of entrepreneurial activity, the more incompatible socialism and entrepreneurship can be said to be.



(iii) Freedom Socialists are much exercised by the distinction between positive and negative freedom. As positive freedom will be secured through the extension of equality, priority is given to negative freedom by which is meant the absence of coercion and where by coercion is meant

the control of the environment or circumstances of a person by another such that in order to avoid a greater evil he is forced to act not according to a coherent plan of his own but to serve the ends of others (Hayek, 1960, 20).

Schumpeter (1943, 212) imagines a socialist society to be one in which individuals are punished by the state if they do not act in desired ways. Entrepreneurs will be warned that if they do not innovate and coordinate they will be imprisoned. This is not a socialist society and freedom provides the final criterion by which the compatibility of socialism and entrepreneurship can be judged.

#### Criterion Three

Socialism is compatible with entrepreneurship to the extent that the absence of coercion does not adversely affect the volume of entrepreneurial activity generated by a society. The greater the degree of coercion required to generate a particular volume of entrepreneurial activity, the more incompatible socialism and entrepreneurship can be said to be.

### 1.3 The Failure of Socialism

#### 1.3.1 Socialism, Economic Growth and Entrepreneurship

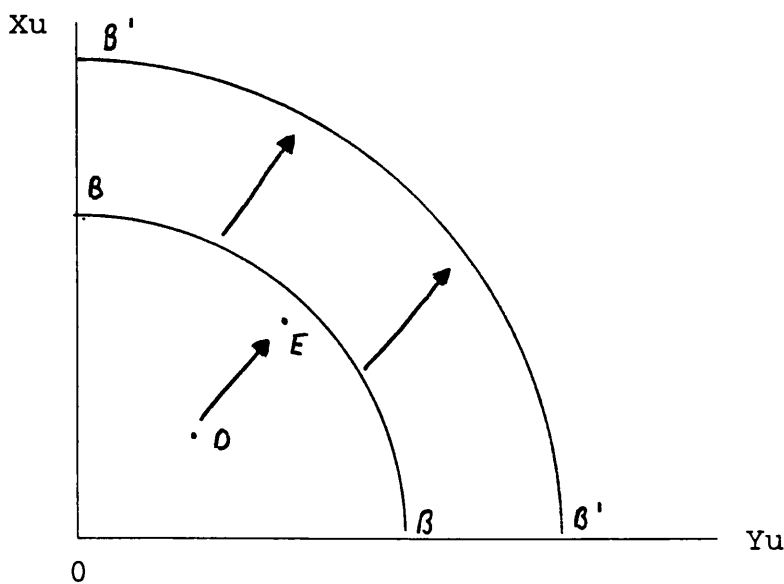
Although the demise of capitalism has long been predicted, democratic socialist parties have rarely attained let alone retained elected office. One frequently cited explanation for capitalism's continued success is its record of generating economic growth (Friedman, 1962, 190, Rand, 1967, 298, Seldon, 1990, 15-17). The triumphs of capitalism can be exaggerated. Growth is interrupted by frequent recession and has not eliminated pockets of absolute poverty in Britain and America. First world affluence exists alongside and may only be bought at the expense of third world deprivation. But much has changed. The working class has more to lose than their chains and socialists must recognise that economic growth has generated a 'culture of contentment' (Galbraith, 1992).

What causes economic growth? Economists variously emphasise the importance of institutional arrangements (North, 1990), population size (Malthus, 1970), division of labour (Smith, 1993) and the influence and extent of pressure group activity (Olson, 1982). In this thesis, attention is focused on entrepreneurship. This is the first of the three assumptions alluded to in the title to this chapter. To achieve economic growth it is necessary to stimulate entrepreneurial activity.

Economic growth is desirable because it allows for welfare

growth. In Figure 1.1. The utility ( $u$ ) of two individuals, X and Y, is shown on the vertical and horizontal axis respectively. It is assumed that utility is derived from the consumption of goods and services. The greater the volume of consumption, the greater aggregate utility. The production possibility frontier (B-B) indicates maximum possible consumption given existing resource constraints and technical knowledge. Economic growth is represented by movement away from the origin. There are two kinds of entrepreneurial growth. The first, innovation, results in movements in the production possibility frontier itself (B-B  $\rightarrow$  B'-B'). The second, coordination, results in movements toward the existing production possibility frontier (D  $\rightarrow$  E). In each case, growth results in increases in utility.

Figure 1.1 Entrepreneurship and Economic Growth



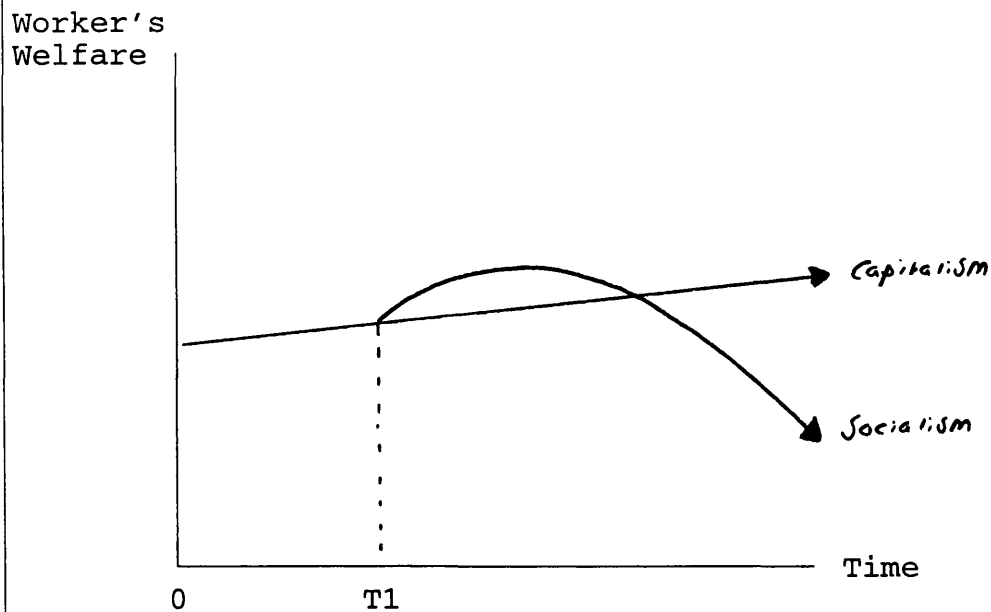
Despite claims for the emergence of a 'post-material' society (Inglehart, 1977), voters show few signs of tiring of growth.

Whether the case [for economic growth] is accepted by writers and intellectuals, the people themselves are quite determined on a rapid improvement in their living standards; and government will have to attend to their wishes (Crosland, 1964, 287-8).

Socialism's success is contingent upon its ability to convince individuals that it is not economically inferior to capitalism. This is the second of the three assumptions to be introduced in this chapter.

When socialists discuss economic efficiency, they frequently do so in terms of static efficiency. Roy Jenkins (1952) and Roy Hattersley (1987, 135) argue, for example, that because the utility of income is subject to diminishing marginal returns, redistribution of income will secure greater total utility. Socialism's critics retort that redistribution retards entrepreneurial activity and undermines dynamic efficiency. Reference is usually made to the importance of creating rather than distributing wealth. In Figure 1.2 worker's (material) welfare in a capitalist system is mapped against the passage of time. The embrace of socialism at T1 leads to a temporary surge in welfare - a 'valley of bliss' - but the eventual consequences are deleterious.

Figure 1.2 The Transition to Socialism



### 1.3.2 Przeworski's Evasion

Adam Przeworski (1985) offers an apparently interesting exception to the general rule that socialists discount the importance of dynamic efficiency. His argument is worth examining as it illustrates the casual way socialists treat the entrepreneurial function. Przeworski recognises that if it is to survive, a socialist government must (i) satisfy worker's material interests more effectively than capitalism, and (ii) generate economic growth in order to do so. Neither creates any problems for socialism. Przeworski (1985, 236) argues that even in the 'worst case', socialism will only be as efficient as capitalism. In his model, workers retain an allegiance to capitalism not because it is economically superior to socialism but because (i) the

dynamics of party competition erode class consciousness, and (ii) worker's fear a 'valley of transition' caused by capitalist disinvestment.<sup>2</sup> The practical lessons socialists can draw from Przeworski's argument are political: the limitations of the parliamentary road to power and the need to seize immediate control of state and society once socialism becomes politically feasible.

Much in Przeworski's argument depends on the claim that socialism is better able to satisfy worker's interests. If untrue, problems of transition - real though they may be - are largely irrelevant. Why is socialism economically superior to capitalism? The engine of growth in Przeworski's model is investment and investment is made possible by the capture of profit. In a capitalist system, not all profit is used for investment as some is taken by the capitalist for the purposes of conspicuous consumption. Investment and growth is retarded.

If the capitalist were personally [only] as well off as the rest of the people ... the rate of growth would be much higher. In general, the inequality between personal incomes derived from profits and from wages means that the growth of consumption over time is inferior to one that would have been achieved in an egalitarian society when other conditions are the same (Przeworski, 1985, 151-2).

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<sup>2</sup> The assumption of a 'valley of bliss' in Figure 1.2 is inspired by but is the inverse of Przeworski's concept of a 'valley of transition'.

Socialism is economically superior to capitalism because investment funds will be deducted directly from gross product and investment decisions taken by 'all citizens' (Przeworski, 1985, 175). The assumption in his argument that all other things will remain equal can be challenged. Investment may be a necessary but it is not a sufficient condition for growth. It is not only the quantity but the quality of investment that determines growth. Resources must be invested effectively. In capitalist economies, entrepreneurs take responsibility for investment decisions but Przeworski simply ignores the role of the entrepreneur and offers no explanation of why investment decisions by 'the citizens' will be of a higher quality than those taken by Richard Branson or Bill Gates. Workers may find it in their interests to tolerate the use of some profit for consumption instead of investment if the alternative is the sacrifice of entrepreneurial excellence. Przeworski's argument is presented as being dynamic but it is rigidly static.

### 1.3.3 Socialism and Limits to Growth

Economic growth requires entrepreneurship and socialism requires economic growth if it is to prosper. Two objections to the second of these assumptions can be raised. The first is inspired by the Marxist theory of historical materialism which sees capitalism's function as being that of promoting growth to the point where economic abundance is achieved. When demand for all goods and services is satisfied and additional consumption yields either

zero or negative marginal utility, capitalism will 'subvert itself and give way to a classless society' (Cohen, 1978, 198-9). Some (socialist) economists still defend the concept of abundance (Mandel, 1986) but drawing a distinction between needs and desires, most dismiss it as utopian. Whilst needs are finite, desires are infinite and further growth will always be required. The need to travel can, for example, be satisfied by a car but the desire for cars is insatiable as they can always be designed to travel faster in more comfort and with louder speaker systems. Aidan Foster-Carter (quoted Nove, 1991, 18) insists that

abundance is out: arguably it was always a meaningless notion, but henceforth, scarcity will have to be accepted as more than just a bugbear of bourgeois economics.

A second objection to the assumption that socialism requires growth is more serious. Green political thought is critical of the economics of both socialism and capitalism, seeing in them a regrettable commitment to a 'super ideology' of industrialism and growth (Porritt and Winner, 1988). Green political theorists challenge the assumption - found in Figure 1.1 - that economic growth is always welfare-enhancing. The opportunity cost of unending growth is, they argue, frequently the satisfaction of basic needs: to breath clean air, to eat non-toxic foods and to have open and natural public spaces in which to relax.

There are certain affinities between the Marxist and Green



argument. In the former and beyond a certain point, growth ceases as further growth becomes unnecessary. In the latter and beyond a certain point, growth must cease as further growth becomes deleterious. In both cases, economic justifications for capitalism and the economic deficiencies of socialism become irrelevant. The compatibility of socialism and entrepreneurship is unimportant as socialism will not have to cope with the demand for continued economic growth.

The Green argument appears intuitively plausible and now attracts the support of once zealous free marketeers (Gray, 1993). This does not mean that the assumptions on which this thesis is built need be abandoned. To see why, a basic distinction can be drawn between environmentalism and ecologism (Dobson, 1990). Environmentalists believe (i) that limits of growth have not yet been reached, and (ii) that they need not be reached if adequate changes are made to the economic process. The key concept for environmentalists is that of 'sustainable development'.

All economic growth in the future must be sustainable:  
that is to say, it must operate within and not beyond  
the finite limits of the planet (Porritt, 1986, 120).

The demand for sustainable growth is not equivalent to the demand for zero growth and recognition of the limits of growth may require not less but more innovation in, for example, technologies that economise on scarce resources (Dobson, 1990, 17). Even if resources are exhausted and innovation becomes

impossible, efficient coordination will still be required to maximise welfare within this constraint. Environmentalism does not free socialism from the entrepreneurial imperative.

Ecologists believe that (i) the limits of growth have already been reached, (ii) that additional growth will be harmful, and (iii) that negative growth may well be desirable. Rudolf Bahro (1986, 18) illustrates the difference between the two by suggesting that whilst environmentalists favour fitting all new industrial chimneys with filtering devices, ecologists oppose the building of new chimneys. By conventional economic standards, ecological societies will be poorer (Bunyard and Morgan-Grenville, 1987) as economic growth is sacrificed in favour of spiritual development (Daly, 1977, Roszak, 1979, Devall, 1988, Naess, 1989). Ecologism does render the compatibility of socialism and entrepreneurship immaterial but the prospects for the acceptance of ecologism in the immediate future appear remote. The assumption that socialism will need to generate growth and for this reason stimulate entrepreneurial activity is maybe regrettable but is tenable.

## 1.4 Rational Choice and Socialism

### 1.4.1 The Meaning of Rational Choice

The compatibility of socialism and entrepreneurship is assessed using rational choice theory.<sup>3</sup> Iain McLean (1987, 1) sees rational choice as a tool, a means of studying politics. The core assumptions of this tool are methodological individualism (MI) and rational action.

(i) Methodological Individualism The clearest definition of this term is found in the work of Karl Popper. Having condemned holistic approaches to the study of social science, Popper (1957, 136) argues that

the task of social theory is to construct and to analyze our ... models carefully in descriptive or nominalist terms, that is to say, in terms of individuals, of their attitudes, expectations, relations etc.

Rational choice theorists believe it is both possible and desirable to explain and predict outcomes on the basis of individual action and action in terms of an individual's beliefs and desires. The claim that events can be explained solely with reference to individual actors does not imply a demand that every

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<sup>3</sup> The term rational choice theory is treated as being equivalent to that of public choice.

event be explained in this way but it does mean that any explanation which does not give analytical primacy to individual action can be so revised without damaging the initial conclusions (Dowding, 1991, 13).

(ii) Rational Action The actors in rational choice models are assumed to have preferences between possible outcomes. Rational choice demands that these preferences be (i) complete: individuals must prefer one outcome to another or be indifferent between them; (ii) Transitive: if outcome A is preferred to outcome B and outcome B to C then outcome A must be preferred to C; (iii) Translated into action: if outcome A is preferred to outcome B and individual X is offered a choice between A and B they must choose A all things being equal. From this assumption is derived the expectation of utility maximisation and from this the capacity to predict individual behaviour.

The lines of battle between rational choice theorists and sociologists, historians and assorted political scientists are clearly drawn. Donald Green and Ian Shapiro (1994) argue that rational choice lacks supporting evidence for most of its predictions. Barry Hindess (1988, 1989) objects to its structural determinism whilst Daniel Kahneman, Paul Slovic and Amos Tversky (1982) and Herbert Simon (1982) provide ammunition which others have used to challenge the assumption of rational action. A further criticism is that rational choice is anti-socialist and, if true, the implications of this are serious. It would be inappropriate to assess the compatibility of socialism and

entrepreneurship using a method that is itself incompatible with socialism and for this reason, the claim of ideological bias must be carefully considered.

#### 1.4.2 Socialism and Rational Choice: The Case Against

The charge of ideological bias is made in two very different ways. At the 'macro' level, Patrick Dunleavy and Brendan O'Leary (1987), Desmond King (1987), Peter Self (1993) and Hugh Stretton and Lionel Orchard (1994) identify a close relationship between rational choice theory and the policy output of the New Right. These authors focus on rational choice's political status and proclaim guilt by association. Supplementing and substantiating their work are those who find the source of the problem to lie in the assumptions employed by rational choice theorists. This is the 'micro' approach within which four distinct arguments can be identified.

(i) The assumptions of MI and rationality lead rational choice to place too great an explanatory emphasis on the mechanics of individual decision-making. The extent to which class structure, political culture and power relationships determine preferences and the constraints under which choices are made is ignored. Capitalism leaves individual preferences as much structured by life as determinants of it and does so in ways that are harmful to the individual. By denying or at least ignoring this, rational choice discounts a large part of the socialist case.

(ii) The assumption of rational action is held to carry within it a covert commitment to the postulate of self-interested behaviour. Theorists like George Stigler (1981, 190) assert that all action is self-serving and given this assumption, rational choice sees its normative task as being one of

constructing, or re-constructing, a political order that will channel the self-serving behaviour of participants towards the common good in a manner that comes as close as possible to that described for us by Adam Smith with respect to the economic order (Buchanan, 1978, 17).

The belief that self-interest can always be reconciled with the public good is contestable and socialists assert both the possibility and necessity of individuals acting altruistically. As rational choice demands egoism and egoism is incompatible with socialism, socialism is incompatible with the use of rational choice.

(iii) From this a related claim is drawn: that rational choice justifies and encourages selfish behaviour by propagating the myth that to act in any other way is irrational (Stephens, 1991, 429). Such reasoning lends itself to a 'logic of accommodation' (Stephens, 1991, 430) in which individuals accept sub-optimal (capitalist) outcomes believing collective action to be impossible.

(iv) Completing the indictment, it is argued that the exclusive attention paid to endogenously determined individual preferences promotes the belief that individuals are all that counts, that 'there is no such thing as society'. Robert Nozick's (1974, ix) declaration that 'individuals have rights, and there are things no person or group may do to them' is built into the rational choice programme.

#### 1.4.3 Rational Choice and Socialism: Initial Defence

The assumptions rational choice makes and the portrait of human behaviour it offers are aesthetically unappealing but there are six reasons for doubting the claim that rational choice is 'inherently' (King, 1987, 104) anti-socialist.

(i) Just as it is possible to point to anti-socialist rational choice theorists, so too is it possible to identify if not socialist, then certainly anti-conservative theorists. John Roemer (1982) uses rational choice to illuminate the concept of capitalist exploitation and Alan Carling (1991) to account for the origins of sexual and racial discrimination. Jon Elster's (1985) analysis of Marxism is frequently scathing but does affirm Marx's critique of capitalism. Elsewhere, Michael Taylor (1987) uses game theory to establish the feasibility of anarchism whilst Keith Dowding (1991) finds in rational choice a tool capable of illustrating the importance of power in determining outcomes in a capitalist society. The value of such examples is not to be easily dismissed but by themselves they cannot establish the

absence of bias. It may occasionally be possible to derive support for socialism even if there is a methodological force pushing conclusions in the opposite direction. For this reason, it is necessary to return to rational choice's 'micro' assumptions.

(ii) Rational choice can deny that rational action leads inexorably to the assumption of self-interest. David Collard (1981) and Howard Margolis (1982) have shown that it is possible to construct models in which individual utility is in part a function of the utility of others. The assumption of self-interested behaviour is nonetheless retained in subsequent chapters and this is the third of the three assumptions to be introduced in this chapter. Any form of socialism that rests on assumptions about the emergence of an altruism is vulnerable to accusations of utopianism. This is not to deny that preferences might indeed change in a socialist society but it is to assert that the feasibility of socialism should not come to depend upon such a transformation. In subsequent chapters, attention is focused not on the psychological make-up of the entrepreneur but on the institutions and organisations which surround and constrain their action.

(iii) Markets are not incompatible with socialism but socialists are not slaves to the market. They recognise that it (i) exists within and is moulded by a wider social environment, and (ii) frequently generates undesirable outcomes. Analysis of market failure is facilitated by the use of rational choice. Barry



(1988, 147) goes so far as to claim that 'the paradigm of socialism is the prisoner's dilemma'. In the place of markets, socialists frequently invoke the need for collective action. Critics are mistaken when they see in rational choice an assertion of the impossibility of collective action. Successful collective action may be problematic but Mancur Olson (1965), Dennis Chong (1991), Russell Hardin (1982) and Keith Dowding (1994a) all assert its feasibility. Furthermore, the difficulty of collective action can be used to justify coercive state action.

(iv) A more general response is to assert that the nature of the conclusions drawn from rational choice models depends largely upon 'auxiliary assumptions'. William Niskanen (1971) suggests that bureaucrats derive utility from larger budgets. Patrick Dunleavy (1991, 202) offers an alternative account in which bureaucrats value collegiate atmosphere, proximity to political power, stimulating work, co-operative work patterns and high-status social contacts. The models share the same 'core assumptions' but reach very different conclusions about bureaucratic behaviour. In the absence of such 'auxiliary assumptions' there is no easy route from MI and rational action to either bureau-shaping or budget-maximising and critics have failed to show why auxiliary assumptions need be 'anti-socialist'. Similarly, whilst socialists affirm the value of freedom, critics argue that the use of rational choice and specifically the assumption of MI leads to a myopic focus on individual preferences. In some respects, this argument is truly

bizarre. There is no reason to believe that a methodological focus on individual preferences need lead to their canonization. Those who study anarchism need not become anarchists. The sanctity of individual preferences is a normative auxiliary assumption.

(v) Rational choice offers positive descriptions of political events. From these, rational choice theorists offer (frequently right-wing) policy prescriptions. Socialists should realise that they can accept the initial analysis without having also to embrace the policy advice. Take the treatment of democracy. Many rational choice theorists argue that decisions taken in the political marketplace are necessarily inferior to those taken in the economic one. Attention is paid to the difficulty of aggregating individual preferences, of the absence of feedback mechanisms, of economic electioneering in the run-up to an election and the possibility of collusion between parties. For these reasons, James Buchanan (1984, 1988) claims that the frontiers of the state should be rolled back. Democratic socialists recoil and rid themselves of the message through efforts to discredit the messenger. It is open to socialists to offer more palatable accounts of democracy (Wittman, 1995) but in the absence of such attempts, the necessity of democratic privatisation is not the only message that can be drawn. Radical democrats could also, for example, assert the desirability of selecting politicians by lot for fixed periods of time (Goodwin, 1992) as this will not only secure legislative independence and prevent electoral manipulation but ensure a more substantive form

of political equality.

(vi) Finally, it does not follow that the (disputed) existence of any bias in rational choice means that the method is of no value for socialists. If rational choice is to be condemned as right-wing its travelling companions within the social sciences are sociology and Marxism which have long been considered the preserve of the left. Looking at these two, it seems that the effect of their perceived bias has been to reduce the value of their academic coinage. Sociologists who decry the pernicious impact of capitalism are dismissed precisely because they are sociologists. The other side of this coin is the significance attached to sociologists who reach 'anti-socialist' conclusions through the use of a 'socialist' method. For so long as critics assert the prejudice of the method, socialist rational choice theorists are in an enviable position. Critics argue that socialism suppresses entrepreneurship and by using a anti-socialist method to assess this claim, any pro-socialist conclusions drawn will be more impressive for having strayed on to what is considered enemy territory. But Socialist rational choice theorists are in a 'win-win' situation as anti-socialist conclusions generated by the method can be dismissed precisely because the method is anti-socialist. The academic probity of this tactic is debatable but its political value significant.

### 1.5 Concluding Comments and Future Directions

'Feasible socialism' (Nove, 1991) has recently attracted considerable attention and philosophers and economists like Jon Elster (1989), John Roemer (1994), Philippe Van Parijs (1995) and Gerry Cohen (1995) have invigorated its study. Of this group, Roemer's work comes closest in spirit to capturing the intentions of my work. Six parallels can be identified which can be used to locate my argument. First, discussion is constrained by the assumption of self-interested behaviour. Second, the intrinsic superiority of socialist over capitalist values is assumed rather than established. Discussion is of whether these values can be realised without sacrificing economic prosperity. Third, the competitive market is seen as both a necessary and desirable feature of an established socialist society. Fourth and partly as a consequence of the assumption of self-interest, it is considered appropriate to study the feasibility of socialism using rational choice. Fifth, the possibilities for and the particular difficulties caused by the transition from capitalism to socialism are largely neglected.<sup>4</sup> Finally, the intention in discussing models of feasible socialism is not to construct a detailed blueprint but to identify the mechanisms, institutions and organisations on which socialism can be constructed.

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<sup>4</sup> Elster (1989) examines the transition to socialism. Cohen (1995) thoroughly justifies the choice of socialism whilst expressing reservations about the compatibility of socialism and the market (Cohen, 1995).

This thesis is neither a review or a development of Roemer's work. Subsequent chapters consider different arguments and develop distinctive proposals. Three principal contrasts with Roemer's work can be noted. First, strong equality is seen as a necessary feature of socialism (cf Roemer, 1994, 11). Second, the feasibility of socialism is seen to depend on the compatibility of socialism and entrepreneurship. In this respect and although the study of entrepreneurship requires a general sensitivity to economic theory, the focus of the work is narrower. Finally, Roemer's favoured economic tool, neo-classical economics, is abandoned in favour of less orthodox approaches. Chapter Two accounts for this choice in terms of the analysis of entrepreneurship.

The argument is developed in eight chapters. The next three provide the necessary background to the debate, the fifth and sixth evaluate established models of market socialism and the final three develop an alternative model of socialist entrepreneurship. Having defined the term capitalism, Chapter Two, Capitalist Entrepreneurship, distinguishes between three images of entrepreneurial activity: new right, elitist and neo-pluralist. The compatibility of socialism and entrepreneurship depends upon the compatibility of socialism with each of these three. The challenge facing a socialist economy is not insurmountable. Although capitalism generates growth it nonetheless systematically undersupplies entrepreneurial innovation and coordination. Socialism can fail to match capitalism in some respects but still remain superior to it.

Chapter Three, Socialism and Entrepreneurship: The Case Against, identifies barriers to the realisation of socialist entrepreneurship. The principal source of the argument is the 'calculation debate' conducted between socialists like Oskar Lange and Friedrich Taylor and 'Austrian' economists, notably Ludwig von Mises and Friedrich Hayek. The Austrians believe that competitive markets are essential for economic rationality. As an examination of the relationship between bureaucracy and entrepreneurship indicates, any assertion of the compatibility of socialism and entrepreneurship must deal with Mises' and Hayek's objections.

Chapter Four, Equality, Efficiency and Socialism, reviews and clarifies earlier arguments through a discussion of the trade-off between efficiency and equality. In the final part of the chapter, much of the Austrians' argument is conceded and this means that if it is to sustain new right entrepreneurship, socialism must be 'market socialist'. Acceptance of market socialism does not, as David Miller (1989) seems to believe, require the use of labour-managed firms. Market socialism is not a specific solution but a general direction to be taken in the search for a solution. All forms of market socialism are distinguished by a reliance on the market but their organisational and institutional features are in other respects very different. The search in subsequent chapters is for the type of market socialism that can best generate entrepreneurial activity without sacrificing socialist values.

Chapter Five, Moral Incentives and Socialist Entrepreneurship, is a detailed examination of Joseph Carens' Equality, Moral Incentives and the Market (1981). This is the most ambitious variant of market socialism considered as it promises to eliminate the trade-off between equality and efficiency. Using game theory, Carens' argument is defended against the accusation that it depends on the presence of altruism. Reservations are nonetheless expressed. Moral incentives can only motivate action in particular circumstances and the example of the Israeli Kibbutz is used to show that these conditions frustrate the emergence of neo-pluralist entrepreneurship.

Economic democracy offers a more familiar alternative to capitalism and its feasibility is explored in Chapter Six, Labour Managed Firms and Socialist Entrepreneurship. Using the example of the Spanish Mondragon cooperatives and the methodology of New Institutional Economics, labour managed firms are shown in many respects to be more efficient than capitalist firms. Although the value of this form of socialism is not dismissed, it is argued that labour managed firms will struggle to generate elite entrepreneurship.

The final three chapters are used to develop a form of socialist entrepreneurship based on state ownership of the means of production. Chapter Seven, Bureaucratic Entrepreneurial Socialism: Incentives, addresses an objection first raised in Chapter Three: that in the absence of private ownership, markets fail to generate sufficient incentives for entrepreneurial

action. Principal-agent theory is used to assess the merits of procedures that generate incentives by binding compensation to performance. The use of ordinal tournaments between entrepreneurs as an institutional supplement to the market is recommended. Whilst tournaments do not eliminate the trade-off between efficiency and equality they do reduce it. It was also argued in Chapter Three that markets and bureaucracy are incompatible as the former also depends on the presence of private property. In the first part of Chapter Eight, Bureaucratic Entrepreneurial Socialism: Structure, this argument is rejected. Tournaments offer a different but equally effective means by which entrepreneurial competition can be stimulated. Having further justified their use, the second part of the chapter builds tournaments into a particular organisational design.

Rational choice theory has been used to deride the assumption that politicians will act in the public interest (Buchanan, 1984). In Chapter Nine, Bureaucratic Entrepreneurial Socialism: Politics, this insight is used to generate a sustained attack on socialist entrepreneurship. Politician's can be expected to subvert potential efficiency in their pursuit of elected office. The challenge for socialism is of finding a means by which to tame the 'Leviathan' of the state without having also to sacrifice the pursuit of democracy.

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## Chapter Two

### Capitalist Entrepreneurship

- 2.1 Introduction
  - 2.2 The Concept of Capitalism
  - 2.3 Images of Capitalist Entrepreneurship
    - 2.3.1 False Start: Neo-Classical Economics
    - 2.3.2 Elite Accounts: Joseph Schumpeter
    - 2.3.3 New Right Accounts: Israel Kirzner
    - 2.3.4 Neo-Pluralist Accounts: John Kenneth Galbraith
    - 2.3.5 Preliminary Conclusions: Socialist Entrepreneurship
  - 2.4 The Limitations of Capitalist Entrepreneurship
  - 2.5 Conclusion: The Unfortunate Legacy of Karl Marx
-

'Systems that create the widest opportunities for entrepreneurship - commonly known as capitalism - are everywhere richer than those societies that suppress it' (Seldon, 1980, xi).

## **2.1. Introduction**

'What (if anything) can justify capitalism' (Van Parijs, 1995)? Its respect for civil liberties (Friedman, 1962, 7-21), its compatibility with democracy (Hayek, 1944), its acknowledgement of desert (Arnold, 1987), or recognition of entitlement (Nozick, 1974)? Or all of these? As Chapter One indicated, the defence of capitalism with which we are concerned is not ethical or political but economic. Capitalism is preferable to socialism if it generates more economic growth, if it is better able to stimulate entrepreneurial activity.

What is capitalist entrepreneurship? As a preliminary to answering this question, this chapter considers three ways in which capitalism can be defined: concomitant to these definitions, the third section identifies three different accounts of capitalist entrepreneurship, elitist, new right and neo-pluralist. Each offers distinct accounts of how and by who the functions of innovation and coordination are undertaken in a capitalist society and each is of relevance to an understanding of socialist entrepreneurship. Finally, the limitations as well as the strengths of capitalist entrepreneurship are documented.

## 2.2 The Concept of Capitalism

Peter Rutland (1989, 199) argues that capitalism and socialism are built on 'irreconcilably divergent' values. Given the definition of socialism in Chapter One, can capitalism therefore be defined as a system that promotes democracy and freedom but frustrates 'strong' equality? Such a conception is appealing for reasons other than aesthetic symmetry as it is the failure of capitalism to sustain equality that generates the demand for socialism. The definition has political bite. For our purposes, the value of this approach is limited. To assert the compatibility of socialism and entrepreneurship is to claim that it is not the entrepreneurial process itself but some feature of capitalist entrepreneurship that causes inequality. If capitalism is defined in terms of its consequences, this issue is obscured. Instead of building toward an argument that 'capitalism causes inequality' we must commit ourselves to the proposition that 'inequality causes inequality'.<sup>1</sup>

Max Weber (1978) and Joseph Schumpeter (1943) define capitalism in terms of a particular set of cultural values. The hallmark of capitalism is a pervasive spirit of acquisition, 'a desire [for] bettering our condition which ... comes with us from the womb, and never leaves us till we go into the grave' (Smith, 1993,

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<sup>1</sup> This is not necessarily a meaningless proposition. As an empirical claim it may well be true that 'inequality causes (further) inequality'. In a capitalist society, the rich are likely to get richer and the poor poorer. It is in the context of a discussion of socialist entrepreneurship that the definition is less useful.

240). Out of this desire emerges a distinct rationality, economic, egoistic and maximising. Capitalism is a society

cast in a purely economic mould: its foundations, beams and beacons are all made of economic material. The building faces toward the economic side of life. Prizes and penalties are measured in pecuniary terms. Going up and down means making and losing money (Schumpeter, 1943, 73).

Gerry Cohen (1978, 198-9) suggests capitalism will give way to socialism when all material desires are satisfied and the spirit of acquisition withers. It was argued in Chapter One that this point of abundance will not be reached and that socialism will need to generate economic growth if it is to retain political support. Given this argument, defining capitalism in terms of its spirit of acquisition does not allow a distinction to be drawn between capitalism and socialism. Furthermore, if a maximising, calculative rationality is a consequence only of scarcity and a distinguishing feature of capitalism, problems emerge in the use of rational choice theory as this assumes the presence of precisely such behaviour.

The solution is to describe capitalism in terms of its economic mechanisms. According to both critics (Dobb, 1958, 5-6) and champions (Seldon, 1990, 1-2), the most important of these are (i) private ownership of the means of production, and (ii) markets. The brief definition of the terms offered here is

preliminary to later and more detailed discussion. In a legal sense, full ownership comprises

the right to possess, the right to use, the right to manage, the right to the income of the thing, the right to the capital, the right to security, the rights or incidents of transmissibility and absence of term, the prohibition of harmful use, liability to execution, and the incident of residuarity (Honore, 1961, 113).

Private ownership suggests that the title to these rights are located with a limited number of individuals or organisations and can be contrasted with common ownership in which

there is no delimitation of .... rights to any private party [and in which] no one has the right to exclude others from using it, and all are free to compete for its use (Cheung, 1987, 504).

The market is distinguished by its concern with the exchange rather than use-value of products. Capital (M) is used to produce commodities (C) in the expectation that they can be sold for a greater amount of money (M') which can be used to finance future production. It is this 'never ending metamorphosis of M-C-M'' (Heilbroner, 1987) which characterises market transactions. To understand capitalist entrepreneurship is to understand how the functions of innovation and coordination are performed in an

economy founded on private ownership and the use of the market.

## **2.3 Images of Capitalist Entrepreneurship**

### 2.3.1 False Start: Neo-Classical Economics

The most obvious place to search for a theory of capitalist entrepreneurship is economics but economic theory is frequently reluctant to acknowledge the significance of entrepreneurship. Why? The neo-classical proof that competitive markets characterised by perfect information and zero transaction costs generate Pareto optimal outcomes (Arrow and Debreu, 1954, McKenzie, 1959) has been used to defend capitalism against socialism (Buchanan, 1984, 14-15) and neo-classical theory against rival approaches. But the way the proof is constructed undermines the capacity of neo-classical economics to recognise the need for a theory of entrepreneurship. Take, for example, the assumption of perfect information. In their neo-classical model of technical change, Partha Dasgupta and George Stiglitz (1980) assume that managers have complete knowledge of not only existing but future production frontiers: that managers know today what the innovations of tomorrow will be, how much they will cost and when they will be introduced. But innovation implies discovery and the acquisition of additional knowledge. To assume perfect information assumes away the entrepreneurial function and obscures important questions about the motives for and institutional arrangements that encourage entrepreneurial action.

Two additional problems with neo-classical economics can be identified. First, its pervasive concern with the properties of equilibrium. Whereas the neo-classical world is static, entrepreneurial activity implies constant change as risks are reassessed, methods of production pioneered and new markets opened. Israel Kirzner (1973, 26), whose theory of entrepreneurship is partially built on the failings of the neo-classical model observes that 'in equilibrium there is no room for the entrepreneur'. Neo-classical models are further compromised by their failure to specify in any detail the process through which equilibrium is attained (Wu, 1989, 15-49, Kirchoff, 1994, 9-33). The impression given is not only that the neo-classical world is perfect but that perfection is spontaneously attained. Again, the role of the entrepreneur is ignored.

Second, neo-classical economics assumes that whilst individuals may differ in resources they share the same cognitive capacities: all maximise and all maximise in identical ways. As Mark Casson (1982, 13) argues, 'neo-classical economics ... depersonalises the market'. The champions of capitalism reach a very different conclusion. Whilst all individuals maximise, they react differently to the same event because they perceive it in different ways. Entrepreneurs are the embodiment of Nietzsche's 'herenmensch'; their success is due precisely to their willingness to challenge conventional wisdom, to act and react differently from others. A theory of capitalist entrepreneurship must account for such variations.

Casson (1982, 9) prefaces his work on entrepreneurship by saying that 'it may be stated quite categorically that at present there is no established theory of the entrepreneur'. As Casson recognises, the problem is not one of too little but of too much theory. The entrepreneur may have escaped the clutches of the neo-classical economist but she has fallen prey to numerous others. Rather than attempt a synthesis of their arguments, this section emphasises differences between competing theories of entrepreneurship and presents each as token representatives of broader schools of thought within the social sciences. Patrick Dunleavy and Brendan O'Leary (1987) identify elitist, new right and neo-pluralist theories of the state. Here, I identify elitist, new right and neo-pluralist theories of capitalist entrepreneurship.<sup>2</sup> All three are best seen as 'ideal types' in the sense that they are not descriptions of reality but explanatory tools which reflect particular elements of what is taken to constitute that reality. As Talcott Parsons (1968, 601-3) emphasises, an ideal type is neither a hypothesis to be tested, an average or a common denominator. An ideal type

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<sup>2</sup> A discussion of the compatibility of new right entrepreneurship and socialism may seem curious. For those eager to read too much into a name, the term pluralist entrepreneurship may be preferred and Chapter Three identifies the points of connection between them.



is formed by the one-sided accentuation of one or more points of view and by the synthesis of a great many ... diffuse and occasionally absent concrete individual phenomena, which are arranged according to those one-sidedly emphasized viewpoints into a unified analytical construct (Weber quoted Sassower, 1985, 45).

The relationship between these theories and their relevance to socialist entrepreneurship will be considered presently.

### 2.3.2 Elite Entrepreneurship: Joseph Schumpeter

'Classical' elite theory as found in the work of Gaetano Mosca (1939), Robert Michels (1915) and Vilfredo Pareto (1935) is grounded on four propositions. First, that elites, be they political, cultural or economic, emerge and impose themselves on particular societies. Second, that to understand any society it is necessary to recognise the existence of elites. Third, that political transformation threatens particular elites but does not threaten the existence of an elite. Fourth, that the suppression of elites, even if possible, is undesirable.

It is Schumpeter's work on democracy that is normally associated with and taken to mark a development of 'classical' elite theory. Schumpeter defends democracy by demonstrating that, through a competitive struggle for votes, accountability and representation can be secured even in the presence of an elite (Miller, 1983).

But it is in his economic theory (1934, 1939, 1943, 1947) that Schumpeter's elitism is most clearly evident.

Schumpeter's argument rests on a distinction between two phases of economic activity, the 'circular flow' and 'creative destruction'. The former is characterised by vigorous competition between established firms and might be described as perfect competition. Schumpeter is dismissive of the economic value of such activity, denying that it can generate significant economic growth. Thankfully, at some - largely unspecified - point, the circular flow gives way to a period of creative destruction. An entrepreneur discovers a new market or method of production and in doing so destroys the existing equilibrium. Moments of creative destruction are rare but shape subsequent economic activity. Stephenson's 'Rocket', Henry Ford's introduction of assembly lines and Bill Gates' launch of Microsoft are obvious examples. Following the moment of creative destruction, the entrepreneur enjoys a virtual monopoly as existing firms struggle to adapt to the new circumstances, many closing in the process. Eventually, the entrepreneur's competitive advantage is undermined as others react to and improve upon the entrepreneur's actions. Creative destruction gives way to circular flow and the process starts again.

Within this framework, four elements - some already implicit in this account - are worth emphasising. First, very few individuals are capable of performing the entrepreneurial function.

To act with confidence beyond the familiar range of beacons ... requires aptitudes that are present in only a small fraction of the population (Schumpeter, 1943, 132).

Second, attempts at entrepreneurial action are rarely successful. Entrepreneurs must surmount not only others natural resistance to change but the fallibility of their own judgement. The dilemma facing a entrepreneur is this. Only a person blessed with entrepreneurial talent will be successful but an individual cannot know whether they have that talent until they attempt entrepreneurial action. Finally, even those with entrepreneurial talent often fail.

[Rewards] are not proffered at random; yet there is a sufficiently enticing admixture of chance: the game is not like roulette, it is more like poker ... though the incompetent men and the obsolete methods are in fact eliminated, sometimes very promptly, sometimes with a lag, failure also threatens or actually overtakes many an able man (Schumpeter, 1943, 73-4).

Failure is certainly a pervasive feature of capitalist entrepreneurship. Sixty three per cent of American firms go bankrupt within five years (Dunne, Roberts and Samuelson, 1988) and sixty per cent of new British firms suffer the same fate within three years (Stanworth and Grey, 1991, 11).

Third, those entrepreneurs who do succeed are rewarded with 'spectacular prizes much greater than would have been necessary to call forth the particular effort' (Schumpeter, 1943, 73). Schumpeter himself does not claim that entrepreneurs are motivated by the (remote) prospect of pecuniary success. He instead emphasises the desire 'to conquer, the impulse to fight ... the joy of creating' (Schumpeter, 1943, 93-4). Capitalist entrepreneurs themselves appear eager to confirm the importance of non-pecuniary incentives (Young, 1990, 11) and a developing literature on female entrepreneurship reaches the same conclusion (Young and Carter, 1992, 22). At the same time and without reservation, David Robinson (1990, 101) concludes his study of capitalist entrepreneurship with the assertion that 'all the available research shows that it is the drive to become rich which is the prime motivator'. The issue is controversial and further discussion postponed.

Finally, Schumpeter emphasises the relationship between monopoly and entrepreneurship. Monopoly is the inevitable price of economic progress, its presence during moments of creative destruction to be treated as a sign not of economic stagnation but of vitality.

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The introduction of new methods of production and new commodities is hardly conceivable with perfect - and perfectly prompt - competition from the start ... perfect competition is and always has been temporarily suspended whenever anything new is being introduced (Schumpeter, 1943, 105).

### 2.3.3 New Right Entrepreneurship: Israel Kirzner

Dunleavy and O'Leary (1987, 74) argue that the origins of new right philosophy lie in public choice theory and Austrian economics. Kirzner's (1973, 1979, 1980, 1985) work is inspired by the latter but his assumptions and prescriptions echo mainstream rational choice arguments. Specifically, his work can be considered as belonging to the new right for the following reasons. First, it is robustly individualistic. Not only are all the actors in Kirzner's economic world individuals but each individual is endowed with different capacities. Second, it is subjectivist. The mind of each individual is taken to be the ultimate source of knowledge and uncertainty and individual's limited capacities to process information are emphasised. Third, 'invisible hand' explanations are favoured. The pursuit of self-interest in the market allows individuals to serve the interests of all. Finally, government is treated as a malevolent force.

Kirzner's criticisms of the neo-classical model have already been encountered. Kirzner argues that no account is given within neo-classical theory of how economies are pushed toward equilibrium

and he uses this oversight as the foundation for his own theory of entrepreneurship. In any disequilibrium, he argues, there will by definition be the possibility of further profitable trades. Disequilibrium means that apples are selling for twenty pence that can be sold for a profit at twenty one pence. The entrepreneur is the person who is 'alert' to, 'discovers' and acts upon these previously overlooked opportunities. Through a series of such actions undertaken by a large number of individuals, the economy is pushed toward equilibrium.

In the absence of such complete equilibrium coordination of decisions, a market process is set in motion in which market participants are motivated to learn to anticipate more accurately the decisions of others: in this process, the entrepreneurial, profit-motivated discovery of the gaps in mutual coordination of decisions is a crucial element (Kirzner, 1985, 43).

In the absence of entrepreneurship it is only out of the purest chance that market transactions by different pairs of buyers and sellers are made on anything but the most widely inconsistent forms (Kirzner, 1985, 59).

Presented in this way, Kirzner's model of capitalist entrepreneurship is remarkably simple. The complications and implications of his work are examined in Chapter Three. For now, four points can be emphasised. First, whilst entrepreneurs

forever push the economy toward it, equilibrium is never attained as consumer's tastes change and new products are forever being introduced. There is always a requirement for entrepreneurial action. Second, perpetual change means that uncertainty pervades the entrepreneur's world. Individual expectations about the future can diverge in innumerable ways from what actually happens. The entrepreneur cannot eliminate this uncertainty but is the person who (i) is prepared to act despite it, and (ii) events reveal as having made the most accurate judgements about the future. Third, the concept of profit is central to the account. Kirzner (1973, 76) goes so far as to argue that 'the notion of entrepreneurship is inseparable from the opportunity for profit'. This is for two reasons. First, profit acts as a signal that the possibility for entrepreneurial action exists and as a confirmation, when captured, that the action was successful. Second and because 'human beings tend to notice that which it is in their interest to notice' (Kirzner 1985, 28), the possibility of making a profit stimulates entrepreneurial alertness. Kirzner accepts, in principle, that individual's interests need not be egoistic but remains sceptical of the salience of such motives.

It is doubtful in the extreme if ideals such as benevolence or patriotism can be relied upon to enable a potential discoverer to identify his own personal interest with that of the discovery of an opportunity (Kirzner, 1973, 32).

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#### 2.3.4 Neo-Pluralist Entrepreneurship: John Kenneth Galbraith

Neo-pluralism is less coherent than either elitist or new right theory. Whilst the politics, methodology and analytical interests of neo-pluralist theorists are diverse, it is possible to discern the following and related points of agreement. First, a preoccupation with the distinctiveness and complexity of modern society. Second, a conviction that prevailing social science orthodoxies are obsolete. Third, a recognition of the political and economic significance of the growth of corporate organisation. Fourth, awareness of the growing importance of technocracy. Fifth, a claim that traditional distinctions between left and right, markets and planning, public and private sectors are breaking down.

John Kenneth Galbraith's (1965, 1967, 1973, 1975) work is central to neo-pluralism. For our purposes, Galbraith's most significant claim is that the 'classical' entrepreneur and small firm which drove the industrial revolution have been eclipsed by the technocrat and the giant corporation.

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In the past, leadership in business organisation was identified with the entrepreneur - the individual who united ownership or control of capital with capacity for organising the other factors of production and, in most contexts, with a further capacity for innovation. With the rise of the modern corporation, the emergence of the organisation required by modern technology and planning and the divorce of the owner of the capital from control of the enterprise, the entrepreneur no longer exists as an individual person in the mature industrial enterprise (Galbraith, 1967, 85).

Corporations are themselves an innovation: a response to the demands of high-technology whose potential was first recognised by imaginative business leaders. The source of the competitive advantages corporations enjoy can be traced to their greater size. First, their additional resources allow them to absorb the cost of occasional failures, costs that would either paralyse or bankrupt a small company. Second, their resources allow them to finance entrepreneurial activity internally. Freed from the burden of paying interest on loans, entrepreneurial activity is more profitable: ventures that small companies are unable to undertake become viable. Third, size allows the corporation to employ a large number of specialists. Rather than having to rely on the experience and knowledge of one individual, the corporation can draw on the talents of

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a large group of anonymous specialists, a balanced team of product planners, engineers, advertising and sales executives, public relations men, scientists, lobbyists, accountants, economists and others (Reisman, 1980, 7-8).

As Galbraith argues and as Schumpeter (1943, 132) foresaw, capitalist entrepreneurship has become more predictable, driven less by the flash of occasional inspiration and more by committees and collective decision-making. The motives for entrepreneurial action have also changed. Technocrats do not acquire spectacular prizes when a successful new product is launched and it is shareholder's and not technocrat's capital that is lost when projects fail. Technocratic entrepreneurs act in the expectation of promotion or wage rises. 'The marketing man who successfully persuades the public to buy some abnormally improbable artifact ... [is] promoting himself along with the product' (Galbraith, 1975, 118).

Galbraith views the rise of the corporation with ambivalence. On the one hand, corporations have facilitated increased entrepreneurial activity.

No important technical development of recent times - atomic energy and its applications, modern air transport, modern electronic development, major agricultural innovation - is the product of the individual inventor ... individuals still have ideas. But - with rare exceptions - only organisations can bring ideas into use (Galbraith, 1965, 88).

But corporations exist to serve their own interests and frequently do so to the detriment of broader social ones. Two specific concerns are raised. First, the resources of corporations allow them to subvert the market process: to manipulate consumer preferences through mass advertising in such a way as to create a demand for products prior to their launch. Whether consumers 'really' want the fruits of corporate research and development is, Galbraith argues, disputable as corporations can 'create the wants [they] seek to satisfy' (Galbraith, 1973, 151). Second, corporations invade the political arena and use the state to secure their economic objectives. Sources of assistance are numerous. First, government uses monetary and fiscal policy to minimise the chance of recessions which threaten corporate sales strategies. Second, government secures for corporations the collective good of a skilled workforce free of charge. Third, government subsidises research activity and underwrites the debts of corporations faced with closure. Finally, through military and civilian contracts, government offers corporations high-profit, low-risk, contracts.

### 2.3.5 Preliminary Conclusions: Socialist Entrepreneurship

What can we learn about the likely nature of and demands to be placed upon socialist entrepreneurship from this? For two reasons it could be argued very little. First, because socialism and capitalism are very different, capitalist and socialist entrepreneurship, it might be suggested, will be very different. Capitalism is built upon private ownership. Galbraith's description is of the actions of a privately owned corporation and for this reason has little relevance to socialist entrepreneurship. This argument is rejected. There is no immediate reason for believing that socialism and capitalism must be mirror images of each other as the former has been defined in terms of political values and the latter in terms of economic mechanisms. Socialism may require the elimination of either the market or private ownership or both but the definitions of socialism and capitalism do not demand this.

More generally, the three models emphasise aspects of the entrepreneurial process which apply independently of the political system. The transition from capitalism to socialism will be associated with massive but not total change. The laws of physics and at least some of the laws of economics will remain constant: objects will fall when dropped and for most goods marginal utility will diminish as consumption increases. Furthermore, it was assumed in Chapter One that individuals will remain egoistic. Particular features of the entrepreneurial process will also remain. Galbraith argues that large

corporations are more able than small firms to stimulate entrepreneurial activity. The argument does not hinge on questions of ownership but on economies of scale and applies to socialism as well as to capitalism.

Second, it might be argued that lessons cannot be drawn as the three accounts are contradictory. Kirzner and Schumpeter emphasise the importance of individual action and Galbraith that of teams of individuals within organisations. Schumpeter sees entrepreneurship as uncertain whilst Galbraith does not. Schumpeter presents entrepreneurial activity as pushing the economy away from equilibrium whilst Kirzner does not and whilst Galbraith and Schumpeter (albeit for different reasons) argue that the capitalist entrepreneur creates a demand for their product, Kirzner maintains that they simply 'discover' an existing one. Must one of these accounts be sacrificed or do all contain important truths? Ideal types emphasise different features of reality and this reality is sufficiently complex and varied to allow for the co-existence of different and competing ideal types. Capitalism generates both innovation and coordination. Whilst Schumpeter tells a plausible story about innovation, Kirzner tells an interesting one about coordination. Capitalist entrepreneurship is driven by both large corporations, as Galbraith suggests, and by the formation of small firms, as Schumpeter implies. Capitalist entrepreneurship is frequently risky, at other times routine; sometimes a matter of 'creation' at other times of 'discovery'. Capitalism prospers because it is flexible because capitalist entrepreneurship is elitist, new

right and neo-pluralist.

The three accounts can be used to formulate six requirements which socialist entrepreneurship must satisfy. Later chapters will show how this seemingly innocuous set of demands generates considerable difficulties.

Requirement 1. The compatibility of socialism and entrepreneurship demands that socialism offer a mechanism through which information about consumer's preferences for goods can be judged and translated into entrepreneurial action. If this mechanism is to be profit-driven markets, their compatibility with socialism must be established. If this mechanism is not to be profit-driven markets the efficacy of an alternative mechanism must be established.

Requirement 2. The compatibility of socialism and entrepreneurship demands that socialism offer a mechanism through which the success of any particular entrepreneurial venture can be judged. If this mechanism is to be profit-driven markets, their compatibility with socialism must be established. If this mechanism is not to be profit-driven markets the efficacy of an alternative mechanism must be established.

Requirement 3. The compatibility of socialism and entrepreneurship demands that socialism must provide reasons for a sufficient number of individuals to remain alert to the possibility of entrepreneurial discovery.

Requirement 4. The compatibility of socialism and entrepreneurship demands that socialism must offer a 'balanced' cost-benefit schedule. For Schumpeter, entrepreneurial activity is risky but promises large rewards. For Galbraith, entrepreneurial activity is safe but promises only minor rewards. If socialist entrepreneurial activity is costly and/or risky possible rewards must be spectacular.

Requirement 5. The compatibility of socialism and entrepreneurship demands that socialism must offer a mechanism through which new entrepreneurs can be drawn into economic activity and through which unsuccessful ones can be removed.

Requirement 6. The compatibility of socialism and entrepreneurship demands that socialism be capable of generating the kind of activity described in neo-pluralist, elitist and new right theories of capitalist entrepreneurship

## 2.4 The Limitations of Capitalist Entrepreneurship

As Allen Buchanan (1985, 29) rightly observes, criticisms of capitalism are telling 'only if there is a feasible alternative' but before determining in subsequent chapters whether socialism is feasible, it is first appropriate to establish whether socialism can hope to exceed or only match capitalism's performance. For if capitalism offers the perfect shell within which entrepreneurial activity can take place, the prospects for socialism are uncertain.

Marxist and welfare economics have been used to construct a number of economic charges against capitalism. Many are now familiar and form a standard part of any appraisal of economic systems. Various, it is argued that capitalist growth is impeded by a lack of coordination manifested in periodic recession, a falling rate of profit (see Elster, 1985, 155-61), monopolies and other forms of imperfect competition (Nove, 1991, 3, Winter, 1989, 150, Miller, 1989, 191) and entrepreneur's reluctance to introduce products or methods of production that will undermine their dominant position as capitalists (Braverman, 1974, Marglin, 1976). The debate has become increasingly stale, each side having settled in for a war of attrition in which criticisms and defences have become well honed.<sup>3</sup> Rather than simply review the arguments, a new line of attack is opened: one

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<sup>3</sup> Van Parijs (1995, 186-233) offers a reasonable summary of the arguments. Objections framed in terms of monopoly and a lack of coordination need to be seen in the context of Schumpeter's and Kirzner's models of entrepreneurship respectively.

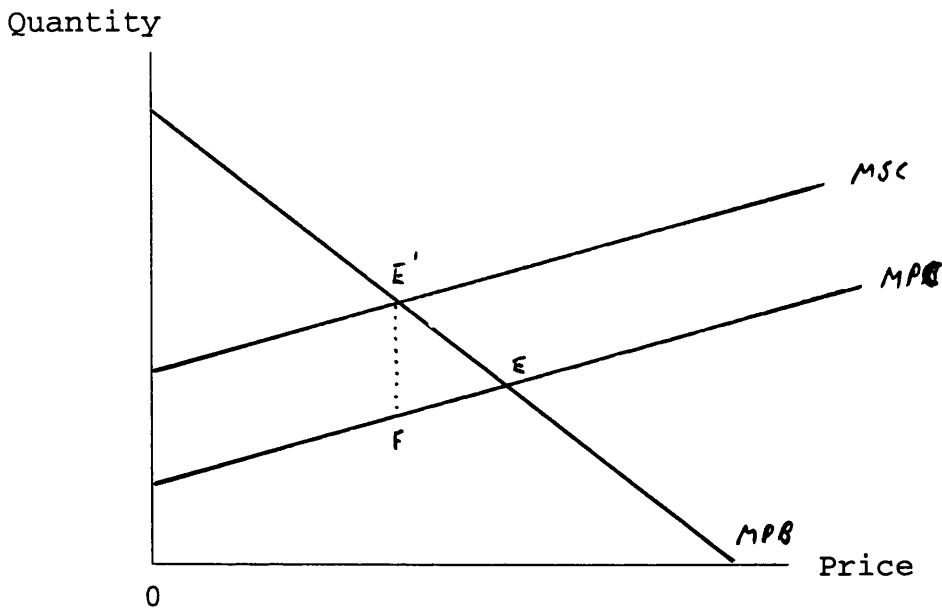


derived from the concerns of welfare economists about the impact of externalities. In Chapter Six, a further assault on capitalist efficiency is mounted in the context of a discussion about economic democracy.

'Invisible hand' arguments like Kirzner's are frequently used to defend market arrangements. The pursuit of individual interest leads, unintentionally, to the realisation of the broader social interest. Welfare economists are likely to respond that externalities generate market failure, with either too much or too little being produced by entrepreneurs. In their standard economics text, David Begg, Stanley Fischer and Rudiger Dornbusch (1984, 334) write that 'an externality arises whenever an individual's production or consumption decision directly affects the production or consumption of others other than through market prices'. Consider first the example (Figure 2.1) where the marginal social costs (MSC) of production are greater than marginal private costs (MPC) of production. Through a series of discoveries, entrepreneurs push the economy toward equilibrium at point E where consumer's marginal benefit of production (MPB) is equal to entrepreneur's private MPC. Because  $MSC > MPC$  welfare will only be maximised if production takes place at point E'. Entrepreneurial action generates a welfare loss of  $E'EF$ . Too much is sold by entrepreneurs at too low a price. Environmental pollution is often taken to be an example of this kind of market failure (Dryzek, 1987, Barry, 1988). One possible implication is that capitalism generates too much entrepreneurship. Presumably, if socialism is unable to generate as much entrepreneurial

activity it is to be preferred for this reason.

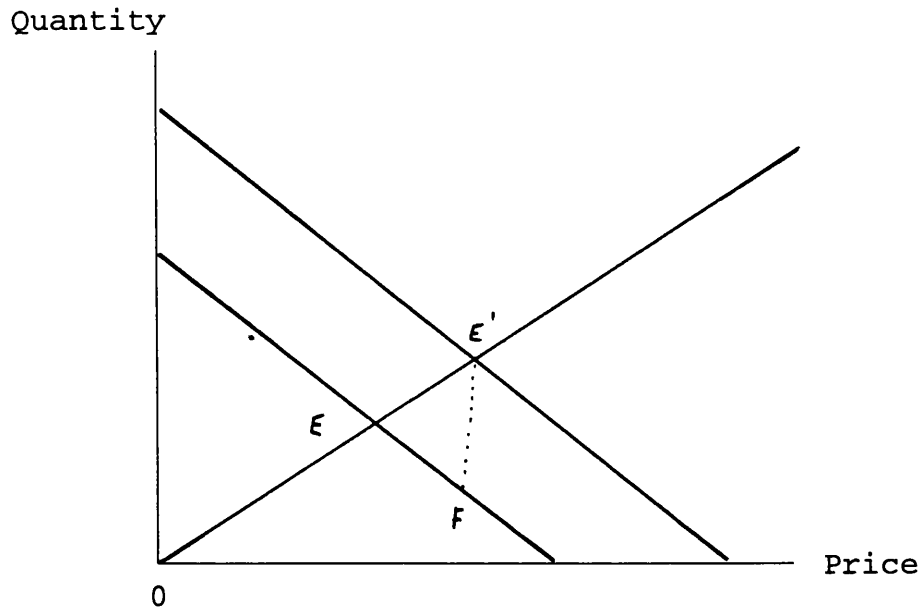
Figure 2.1 The Social Cost of Negative Production Externalities



Source: Begg, Fischer and Dornbusch (1984), 335)

Markets fail in the presence not only of negative but of positive externalities. To take another standard example, a gardener's neighbour as well as the gardener herself derives utility from planting flowers in her front garden. The marginal social benefits (MSB) of the action are greater than the private marginal benefits (PMB). As Figure 2.2 indicates, in these circumstances capitalist equilibrium (E) generates a welfare loss (EE'F) as too little is produced.

Figure 2.2 The Social Cost of Positive Production Externalities



Source: Begg, Fischer and Dornbusch (1984), 336)

Let us return to the issue of entrepreneurship. Private ownership and markets generate inequality. 'Trickle-down' theory of which several variants will be considered in Chapter Three, offers a justification for this inequality. Raymond Plant (1991, 89) provides a succinct summary of its logic.

[Trickle down is] the view that a dynamic economy requires inequalities if it is to be innovative. Innovation requires rich people to provide demand for new products, but once produced these products do not remain the preserve of the rich. At one time it was only because the rich were able to provide a market - to take, for example, air travel and refrigerators - that these things were developed to any extent, but once developed they trickle down gradually to the rest of the population (Plant, 1991, 89).

If a wealthy individual pays an entrepreneur to provide them with supersonic travel then they both benefit. The entrepreneur expects to make a profit and the wealthy individual expects to satisfy a previously unrealised preference. 'Trickle-down' suggests that eventually a third party, 'the poor', benefit from this trade. Although the exchange is bilateral there is a positive externality. Because markets founded on private ownership do not account for this externality, capitalism generates an inefficient volume of entrepreneurial action. A specific example can be used to illustrate the argument.

Thatcherism promoted the economics of capitalism. Through deregulation and privatisation, the government sought to promote the market and private ownership. More specifically, Thatcherism sought to recreate Britain as an enterprise society; to change

the entire culture of a nation from anti-profits, anti-business, government dependent lassitude and defeatism, to a pro-profit, pro-business, robustly independent ... optimism (Lawson, 1992, 65).

The flagship of the enterprise culture was not the corporate sector which was felt to have grown fat on government support (Keat and Abercombie, 1990, 56) but small business. But growing unemployment in more traditional sectors of the economy and ministerial exhortations did not themselves stimulate sufficient entrepreneurial activity and the Conservative Party was forced to recognise the limitations of capitalism and the need for non-market, government, action.

In part, this took the simple form of tax reform. Most obviously and in an attempt to make the spectacular prizes on offer to entrepreneurs ever more spectacular, the top rate of taxation was cut in the 1980 and 1988 budgets. From 1980, absolute tax exemption was offered on the building of new premises by small firms and in 1988 corporation tax on small companies was reduced to twenty five per cent and tax relief made available to entrepreneurs who borrowed money to launch new ventures. Finally, it was also announced in the 1988 budget that losses sustained by entrepreneurs in the first three years of a new business would be made eligible for tax relief. But support went further than tax reform and also included direct financial assistance. The Department of Trade and Industry's Loan Guarantee Scheme offered credit to entrepreneurs hoping to start a new business who had

been unable to attract commercial backing. The British Technology Group was also given responsibility for providing finance for new, small, high-technology firms. At the same time, the level of welfare benefit for unemployed individuals who started their own company was increased. In 1985 the government announced the introduction of the Small Firm Merit Awards scheme which offered additional funding for companies engaged in innovative activity. Finally, all this took place in the context of an increase in the number of enterprise zones which offered entrepreneurs exemption from local authority property tax, development tax and, in most cases, local authority planning restrictions for three years.

It is possible to argue that the government's policies were successful. By 1987, over three hundred new businesses were being started each week (Sedgwick, 1992, 38) and total employment in the small business sector trebled during the 1980's (Stanworth and Grey, 1991, 4). But if this was a battle won for capitalism it was not won by capitalism. It was not markets and private ownership but government power that stimulated entrepreneurial endeavour.

## 2.5 Conclusion: The Unfortunate Legacy of Karl Marx

The bourgeoisie, during its rule of scarce one hundred years, has created more massive and more colossal productive forces than have all preceding generations together. Subjection of nature's forces to man, machinery, application of chemistry to industry and agriculture, steam-navigation, railways, electric telegraphs, clearing of whole continents for canalization of rivers, whole populations conjured out of the ground - what earlier century had even a presentiment that such productive forces slumbered in the lap of social labour? (Marx, 1848, 85).

The Communist Manifesto recognises capitalism's achievements which, it argues, make possible the transition to Communism. But Karl Marx is reluctant to acknowledge the role of the entrepreneur in stimulating growth (Flew, 1988, 187). Explanatory primacy is instead given to the 'capitalist' but as discussion of the three models of capitalist entrepreneurship reveals, whilst individuals may be both capitalists and entrepreneurs, 'the entrepreneur's function is distinct from the capitalist's function' (Schumpeter, 1934, 556). Critics argue that capitalism constrains entry into the entrepreneurial market as 'credit is only given to him who already has' (McLellan, 1977, 114) but this is to confuse the entrepreneurial and capitalist function for as Kirzner (1973, 19) observes, the only resource the entrepreneur

requires is alertness. 'An entrepreneur needs no assets to engage in profitable market participation. A producer need not own any resources to engage in production' (Kirzner, 1973, 19). Furthermore, Galbraith points to the degree to which not only the function but the organisational role of capitalist and entrepreneur are distinct. Capitalist corporations rest on a division between not only ownership and control (Berle and Means, 1969) but between shareholders who do not innovate and technocrats who do not have property rights. The entrepreneur and the capitalist are not one and the same. For socialism, the conclusion is positive because if it is possible to have entrepreneurship without capitalists it is possible to imagine socialist entrepreneurship.

For Marx, it is not only economic credit but moral blame that is attached to the entrepreneur. Moral blame because the capitalist exploits the worker through the extraction of surplus value.

How that [surplus] value originated we know perfectly well. There is not one single atom of its value that does not owe its existence to unpaid labour. The means of production, with which the additional labour is incorporated .... are nothing but component parts of the surplus-product, of the tribute annually extracted from the working-class (Marx, 1867, 582).

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Again, Marx's conclusion can be challenged. Entrepreneurship is the single most important factor of production as entrepreneurs



enhance the value of all other factors, including labour. Schumpeter and Kirzner both emphasise the extent to which a single individual can transform the economic environment and generate enormous wealth. Are workers exploited by entrepreneurs in a capitalist system? John Roemer (1982) suggests that they are if they can improve their economic position by withdrawing from the existing society along with their per capita share of alienable resources. By this criterion, entrepreneurs do not exploit non-entrepreneurs as resources acquire their value through the actions of entrepreneurs. Capitalist entrepreneurs not only own but create unequal amounts of wealth. Capitalism prospers because markets and private property give individuals an incentive to exercise their entrepreneurial talent, to acquire spectacular prizes much greater than would have been necessary to call forth the particular effort' (Schumpeter, 1943, 73). Socialist entrepreneurship is a logical possibility but a practical uncertainty. Can socialism offer to entrepreneurs as palatable an environment as capitalism? The next chapter argues that it cannot.

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## Chapter Three

### **Socialism and Entrepreneurship: The Case Against**

- 3.1 Introduction
- 3.2 Markets and Entrepreneurship
  - 3.2.1 The Calculation Debate: Concerns and Contours
  - 3.2.2 Entrepreneurial Knowledge and the Dynamic Economy
  - 3.2.3 The Communication of Entrepreneurial Knowledge
  - 3.2.4 The Discovery of Entrepreneurial Knowledge
  - 3.2.5 Markets and Entrepreneurship: Objections and Conclusions
- 3.3 Socialism and the Market
  - 3.3.1 Socialism and Equality
  - 3.3.2 Entrepreneurship and the Prospect of Inequality
  - 3.3.3 Entrepreneurship and Prior Inequality
- 3.4 Bureaucracy, Socialism and Entrepreneurship
  - 3.4.1 Bureaucracy and Entrepreneurship: The Legacy of Max Weber
  - 3.4.2 Public Entrepreneurship: The Legacy of Hyman Rickover
  - 3.4.3 Budget-Maximising: The Legacy of William Niskanen
  - 3.4.4 Bureaucracy, Profit and the Market
- 3.5 Conclusion

### 3.1 Introduction

A detailed critique of the idea of socialist entrepreneurship is a necessary prelude to the (re)construction of specific models of socialist entrepreneurship. The intention in this chapter is to present a set of general arguments which can be subsequently applied, developed and questioned. The challenge is to find ways in which arguments against socialism can be tied to and illuminated by the notion of entrepreneurship. The danger lies in the erection of a straw man which can be easily knocked down. The defence adopted against this temptation is to concentrate on the work of two influential and trenchant critics of socialism, Friedrich Hayek and William Niskanen.

The chapter is divided into three sections. Section 3.2 considers the relationship between markets and entrepreneurship. The foundation of this part of the argument is the pre-war 'calculation debate' between socialist and Austrian economists. Willem Keizer (1994, 207) calls this the 'greatest economic debate of the twentieth century' and it is used to explain why entrepreneurial action is stimulated by the decentralised market. Section 3.3 assesses the compatibility of markets and socialism and draws two conclusions. First, that James Meade (1964, 13) is right to argue that 'prices used for .... efficiency purposes result in a very undesirable distribution of income and wealth'. Second, that the imposition of equality necessarily results in the destruction of markets. Developing this argument, section 3.4 identifies a further barrier to socialist entrepreneurship, the

inadequacies of public bureaucracy.

### **3.2 Markets and Entrepreneurship**

#### 3.2.1 The Calculation Debate: Concerns and Contours

In the first part of this century, economists rarely questioned the economic credentials of socialism (Cockett, 1995, 9-56). Joseph Schumpeter (1943, 172) was typical in lamenting what he saw as the inevitable passing of capitalism but proclaiming that 'there is nothing wrong with the pure logic of socialism'. The claim that socialism could not only match but surpass the economic efficiency of capitalism was challenged principally by Austrian economists who argued that a commitment to neo-classical economics led socialists to misunderstand the nature of the market process. Friedrich Hayek and Ludwig von Mises do not, as many claim (see Lavoie, 1985, 14), argue that socialism is unattainable. More modestly, they maintain only that socialism threatens economic prosperity (Hayek, 1935b, 36-7). Whilst Hayek's defence of the market often rests on ethical considerations (Sheamur, 1994), his argument here is more narrowly utilitarian and centres on the capacity of the market to 'improve for all of most the prospects of having their needs satisfied' (Hayek, 1982c, 64-5).

Before detailing the nature of the dispute, it is appropriate to identify points of agreement between the participants. First, it is accepted that the economic viability of socialism depends upon

its capacity to effectively allocate scarce resources - or value - between competing uses. Socialists like Oskar Lange and Friedrich Taylor do not hide behind the assumption that socialism will emerge only in conditions of economic abundance. Second, it is recognised that allocation requires the use of the price mechanism to balance demand and supply (Hoff, 1949, 202). Third, it is agreed that allocation should be determined by consumer and not producer or government preferences (Lange, 1964, 72). Finally, it is believed that socialism requires public ownership of the means of production and central planning of the economy (Mises, 1935, 89, Hayek, 1935b, 15).

Taylor (1964) and Lange's (1964) initial proposal to allocate resources rested on the use of mathematics rather than entrepreneurs. Having recognised the need to price resources it is argued that having collated exhaustive economic data a central planning board (CPB) could use powerful computers to 'calculate the prices at which general equilibrium would be reached in a socialist economy by solving a series of complicated systems of simultaneous equations' (Roemer, 1994, 28). In this way, Lange could argue that the market is simply a 'computing device of the pre-computing age' (quoted Lavoie, 1985, 95). Socialist economists later came to accept that the CPB was not omnipotent and could not work alone and the 'competitive' solution was instead advanced.<sup>1</sup> The CPB's role became that of an

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<sup>1</sup> The use of the term 'competitive' should be treated with extreme caution. It has passed into the literature as a description of Lange's model (Lavoie, 1985, 10-16) and is for this reason used here. But the intention of the argument in this chapter is to show that competition is, at best, 'pseudo-

'auctioneer', offering particular sets of prices to the managers of publicly owned production units. Having calculated their minimum costs, managers are to report how much they are prepared to supply at a particular price and in conditions of excess supply, the CPB responds by lowering prices and in conditions of inadequate supply by raising them. After a period of time, this trial and error method reveals equilibrium prices, allowing production to commence.

As Don Lavoie (1985, 13) demonstrates, many economists argue that the socialists won the calculation debate. Robert Lekachman (1959, 396) is representative in arguing that it was

proved that a central planning board could impose rules upon socialist managers which allocated resources and set prices as efficiently as a capitalist society of the purest stripe, and much more efficiently than the capitalist communities of experience.

This interpretation is challenged. Hayek and Mises present a series of unanswered objections to the (then) economics of socialism and while the term is rarely used by participants, many of their arguments are best formulated in terms of the possibility of entrepreneurial action. Rather than offer a chronological account of developments, subsequent sections

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competition' (Hayek, 1935c, 217).

identify specific and recurring themes within the argument that surround, respectively, the durability, communication and creation of entrepreneurial knowledge.

### 3.2.2 Entrepreneurial Knowledge and the Dynamic Economy

Knowledge is fundamental to an understanding of the entrepreneurial process. Accurate knowledge about changing consumer preferences, new methods of production and construction costs promotes successful entrepreneurial action. If entrepreneurs fail to recognise new sources of consumer demand, the market will fail to achieve equilibrium. Israel Kirzner's entrepreneurs who are alert to new profit opportunities are hoping to acquire greater knowledge.

Capitalist entrepreneurship is animated by interaction between consumers and entrepreneurs. Whether mathematical or competitive, socialist entrepreneurship requires an additional and pivotal role to be played by the CPB. Given the incredible volume of knowledge which this body has to process, one obvious disadvantage of socialist entrepreneurship are delays in the pricing of resources. In the competitive solution and because price and income elasticities differ, an incorrect price for just one good necessitates the recalculation of all others. Hayek (1945, 187) alludes to such difficulties when contrasting decentralised capitalist markets with centralised socialist ones.

The difference between a system of regimented prices and a system of prices determined by the market seems to be about the same as that between an attacking army in which every unit and every man could only move by special command and by the exact distance ordered by headquarters and an army in which every unit and every man can take advantage of every opportunity offered to them.

The irritant would be a minor one if the economy were static or the number of goods limited. Time would be lost but equilibrium eventually attained and in these conditions Mises (1935, 102-3) accepts that socialism is feasible. But in a dynamic economy the costs of organising economic activity in this way are prohibitive. As economic conditions change, the CPB is forced to constantly modify its prices. Assuming that it takes time to recalculate prices and that change is constant, equilibrium is never reached. Lange and Taylor neglect this obvious possibility because they operate within the constraints of a neo-classical model of economic activity. Only by imposing static solutions on a dynamic world, only by assuming away the very possibility of entrepreneurial action, can socialists claim to offer a feasible solution.

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### 3.2.3 The Communication of Entrepreneurial Knowledge

Lange and Taylor's socialism depends on the centralisation of knowledge. In either its mathematical or competitive variants, information is passed up a hierarchy to the CPB and passed back down to managers. Whilst socialists recognise that the volume of information required is immense, powerful computers are seen to finally establish the practicality of the process. But Hayek's fundamental objection does not concern the volume of information required but its particular nature. Knowledge, he argues, is frequently 'tacit', of a kind that cannot really be said to 'exist at any moment of time' (Hayek, 1935c, 210) and because such knowledge cannot be effectively communicated, the relationship between the CPB and production managers will break down.

Michael Polanyi (1967, 20) offers instructive examples of the nature and kinds of tacit knowledge and of the difficulty of translating it into simple rules and precepts which can be easily clarified and relayed.

The skill of a driver cannot be replaced by a thorough schooling of in the theory of the motorcar; the knowledge I have of my own body differs altogether from the knowledge of its physiology; and the rules of rhyming and prosody do not tell me what a poem told me ... the aim of modern science is to establish a strictly detached, objective knowledge. Any falling short of this ideal is accepted only as a temporary imperfection, which we must aim at eliminating. But suppose that tacit knowledge forms an indispensable part of all knowledge, then the ideal of eliminating all personal elements of knowledge would, in effect, aim at the destruction of all knowledge.

Entrepreneurial knowledge is frequently tacit. Whilst the socialist manager can send to the CPB a simple statement about the amount they can produce at a given price, they cannot communicate intuitions about likely developments in consumer demand, the reliability of suppliers and the efficiency of workers. In demanding that managers produce at the lowest cost, the CPB will not always be able to say precisely how this can be achieved as the ability to produce at the lowest price does not consist of a simple set of rules but is rather a 'technique of thought' (Hayek, 1935b, 210).

The decentralised, competitive market offers a framework within which this problem can be resolved. Because information does not have to be collected before being acted upon, it allows the

inclusion in pricing decisions of tacit information. The benefit of the division of knowledge within the market is as important as the division of labour within the firm. It allows for the

spontaneous interaction of a number of people, each possessing only bits of knowledge, bringing about a state of affairs in which prices correctly correspond to costs, etc., and which could be brought about by deliberate direction only by somebody who possessed the combined knowledge of all those individuals (Hayek, 1937, 35).

#### 3.2.4 The Discovery of Entrepreneurial Knowledge

Hayek emphasises the capacity of markets to communicate and coordinate information, Ludwig von Mises (1920), Don Lavoie (1985) and Mirini Biachini (1994) the importance of the 'discovery' of knowledge through rivalrous competition. Verification rather than creation of knowledge is perhaps the more appropriate description as markets offer entrepreneurs the opportunity to test their tacit knowledge by launching new products or adopting different prices. The capture of profit shows that their intuitions are justified and signals to other entrepreneurs a need to respond. Willem Keizer (1994, 216) argues that 'the competitive price mechanism discovers ... the specific information individuals need'. This is also misleading. It is alert entrepreneurs who discover and verify knowledge. Free markets provide the framework within which they act.

The suppression of the decentralised market and its replacement by a centralised one frustrates the creation of knowledge. In part and as suggested presently, this is because centralisation requires the extension of public ownership and the elimination or distortion of entrepreneurial incentives. It is also because centralisation is achieved at the expense of individual discretion. Socialist managers respond to prices set by the CPB and must treat these prices 'parametrically' (Lavoie, 1985, 24). Individuals are not free to test their competing beliefs about the market. Knowledge may be discovered but entrepreneurs lack the opportunity to verify it and as intuition cannot be communicated, potential knowledge is wasted. Lavoie (1985, 107) doubts whether, in these circumstances, managers can even be described as entrepreneurs as 'the element of entrepreneurship is absent not only from the end state of equilibrium itself - as it must be - but also from the proposed process of adjustment toward that equilibrium'.

One further problem caused by the centralisation of knowledge can be identified. It has been emphasised that entrepreneurship is inherently risky. Even the most able of entrepreneurs will on occasions fail. By giving entrepreneurs the opportunity to test competing and conflicting knowledge, the market sustains the pluralism necessary to ensure that some projects succeed. The CPB will not only struggle to find a single 'right' answer but will have to commit itself to only one guess about the future (Butler, 1983, 71). Given the uncertainty which must surround any guess about the future, the placing of all economic eggs in one basket

is undesirable.

Is it really likely that a national planning office would have a better judgement of the number of cars, the number of generators, and the quantities of frozen food we are likely to require in, say five years, than Ford or General Motors, etc., and, even more important, would it even be desirable that various companies in an industry all act on the same guess? (Hayek, 1978, 240) (emphasis added).

### 3.2.5 Markets and Entrepreneurship: Conclusions and Objections

Decentralised competitive markets provide a suitable framework within which new right entrepreneurial action can occur. Attempts to either replace the market - the mathematical solution - or to centralise it - the competitive solution - distort and retard entrepreneurial action. This conclusion appears vulnerable to two objections. First, the Austrian eulogy to the market cannot account for neo-pluralist entrepreneurship and Galbraith's argument that capitalism too has forsaken the market. Second, the mathematical and competitive models are particularly extreme examples of centralisation which few socialists now recommend. Socialism, it may be argued, can regulate and guide the market without eliminating it.

John Kenneth Galbraith (1974, 17) emphasises the importance of corporate organisation in modern industrial society but

exaggerates the autonomy of corporate organisation from the market. Certainly full markets do not operate within organisations.<sup>2</sup> Employees are tied to long-term wage contracts and are paid, in the short-term at least, independently of the value of their output but the suppression of the market within capitalist organisations has not meant the suppression of markets between organisations. General Motors and Ford are free to set different prices for their products and can do so without reference to any CPB. The market is an imperfect one, distorted by barriers to entry, manipulation of demand and government subsidy but it is still a decentralised market. Galbraith's confusion stems from his account of planning. The mathematical and to a lesser extent the competitive solutions depend on planning by the CPB. Because capitalist organisations plan their pricing and marketing strategies, Galbraith suggests that there is little difference between the two. But as Meade (1968) observes, it is inappropriate to compare planning that takes place in the context of market competition with planning that is formulated as an alternative to the market. Planning in the latter involves the imposition of decisions on others: the CPB decides and eventually managers implement. Planning in the former is non-coercive. Consumers do not have to purchase products whose development has been carefully planned by companies.

Hayek and Mises arguments suggest another and more damning response to Galbraith. In so far as the neo-pluralist model

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<sup>2</sup> Reasons for the suppression of the market within organisations are examined in Chapter Six.

establishes the possibility of entrepreneurial action independently of the market, it also confirms the value of the market. For in the 'revised sequence' of the new industrial society, it is not the consumer but the organisation which can 'create the wants [they] seek to satisfy' (Galbraith, 1973, 151). The neo-pluralist model violates one of the values upon which both socialists and Austrians agreed solutions must be established: consumer sovereignty. There is a tension between this and the first argument. If neo-pluralist entrepreneurship is dependent on the market then the market, too, is damned by its subversion of consumer preferences. Either the first or second arguments can be discarded. Alternatively, the simple and absolute distinction between market and non-market allocation can be abandoned. The critic of socialism may then argue that neo-pluralism is a hybrid form that offers a warning of the dangers of a more complete suppression of the market.

Whereas the socialism of Lange and Taylor eliminates the market, social democrats hope only to regulate and mould it through indicative planning, price ceilings, minimum wages, safety requirements, tariff protection and licensing requirements. In an extension of Hayek and Mises' argument, Israel Kirzner (1985) condemns such interference. Because regulation constrains but does not entirely destroy the decentralised market, he concedes that it will be less damaging. It might also be noted that for this reason regulation will be less likely to realise socialist values. Nonetheless, Kirzner claims that regulation will retard the process of entrepreneurial discovery and the verification and

coordination of knowledge.

Several examples given by Kirzner can be easily dealt with as they echo the logic of arguments already developed. First, licensing requirements and safety laws act as a barrier to entry and reduce competition. By limiting the number of participants, market pluralism is constrained. Second, price ceilings and wage legislation block the discovery of knowledge and discourage entrepreneurs from remaining alert to potentially profitable trades. Instead, entrepreneurs will divert their attention to the discovery of possible loopholes in legislation, to 'wholly superfluous ... and not necessarily desirable opportunities for entrepreneurial discovery' (Kirzner, 1985, 144).



### 3.3 Socialism and the Market

#### 3.3.1 Socialism and Equality

The last section established the compatibility of market allocation and entrepreneurship and the incompatibility of non-market allocation and entrepreneurship. The question of socialism's compatibility with entrepreneurship comes to hinge upon its compatibility with the market. Here, hope can be found for socialism as the definition employed by Mises and Hayek in terms of public ownership is very different to that adopted in Chapter One. There is no immediate reason why socialism should not use the market. Furthermore, the narrow set of values chosen as embodying socialism - liberty, democracy and equality - allow us to treat as irrelevant arguments that socialists should oppose the market as it destroys feelings of fraternity (Buchanan, 1985, 51) and encourages exploitation (Roemer, 1982, 1988).

As it has been defined, is socialism compatible with the market? Of the three values, the relationship between liberty and the market appears least problematic. Socialists (Selucky, 1979, Miller, 1989) can simply mimic the arguments of socialism's critics that markets secure individual freedom through minimising coercion (Friedman, 1962). The relationship between the market and democracy has provoked greater concern (Lindblom, 1977, 172-88) but normally only on the assumption that markets generate inequality and it is on this third value that attention is focused.

Capitalism appears to promote inequality. In Britain, the 'rolling back of the state' in the 1980's was accompanied by a growth in relative poverty. In 1979, the poorest fifth of the population claimed just under ten per cent of national post-tax income. By 1989 this share had fallen to seven per cent (Gilmour, 1992, 138). In this section it is argued that market allocation necessarily leads to inequality. Two propositions are developed. First, incentives which result in inequality are necessary to motivate entrepreneurial action. Second, the prior existence of inequalities facilitates successful entrepreneurial action.

### 3.3.2 Entrepreneurship and the Prospect of Inequality

Capitalist markets are animated by private ownership of the means of production. Entrepreneurs enter the market having staked their own resources and if successful acquire 'spectacular prizes' (Schumpeter, 1943, 73). Entrepreneurs have powerful incentives to remain alert to the discovery of additional knowledge. As Alan Williams (1991, 7) comments, 'profit-seeking behaviour is the mainspring of the enterprise system, and is the fundamental source of a nation's wealth'. In a capitalist economy, unsuccessful entrepreneurs will have lower incomes than successful ones and successful entrepreneurs will have larger incomes than individuals who choose not to accept the risk of entrepreneurial action.

Attempts to ensure a more equal distribution of income stifle entrepreneurial incentives and reduce the income of the poorest.

As Peter Bauer (1983, 380) concludes, 'to make the rich poorer does not make the poor richer'. Given the assumption of egoism it cannot be claimed that in a socialist society entrepreneurs will be motivated by a love of their fellow man and the belief that entrepreneurs might be motivated by non-pecuniary rewards like, for example, a knighthood or life peerage, is a poor foundation on which to build a model of feasible socialism. To deny individuals the chance to acquire spectacular prizes it will be necessary to restrict private and extend public ownership but as Schumpeter and Mises argue, lacking sufficient incentives individuals will then be insufficiently alert to the possibility of entrepreneurial discovery.

[T]he entrepreneur's commercial attitude and activity arises from his position in the economic process and is lost with its disappearance .... it is not a knowledge of bookkeeping, of business organisation, or of the style of commercial correspondence, or even a dispensation from a commercial high school, which makes the merchant, but his characteristic position in the production process, which allows of the identification of the firm's and his own interests (Mises, 1935, 121).

[S]omething of the psychology of the salaried employee ... his will to fight and to hold on is not and cannot be what it is was with the man who knew ownership and its responsibilities (Schumpeter, 1943, 156).

### 3.3.3 Entrepreneurship and Prior Inequality

Arguments about equality are usually intended to demonstrate that only the prospect of capturing spectacular prizes will motivate entrepreneurial action. Less attention is paid to the importance of the prior existence of inequality in facilitating and securing the success of entrepreneurial action. Two examples are given of the ways in which existing inequalities can stimulate entrepreneurship.

First, inequality among entrepreneurs is valuable. Profits and losses lead to inequality but also send necessary signals to others in the market. An entrepreneur whose venture is unsuccessful because they entered an already saturated market provides a salient warning to others. As Hayek (1993c, 71) comments, 'we can make use of ... dispersed knowledge only if ... we allow the principle of negative feedback to operate'. Equally, an entrepreneur who is successful and captures large profits invites competition. Eventually and as Kirzner argues, coordination is improved and profits eliminated. In the pursuit of equality, socialism will have to eliminate profit and so reduce the capacity of the market to transmit and subsequently coordinate knowledge.

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It is impossible, not only to replace the spontaneous order by organisation and at the same time to utilise as much of the dispersed knowledge as possible, but also to improve or correct this order by interfering in it by direct commands (Hayek, 1982b, 51).

Second, inequality among consumers is also valuable. When new products are introduced, they are likely to be both relatively expensive - reflecting research costs and the burden of entrepreneurial risk - and unreliable - reflecting initial production difficulties. Only the relatively wealthy will be able to purchase such goods and in doing so ensure entrepreneurial profit and product refinement. The subsequent entry of new producers attracted by initial profits increases coordination and eventually goods once considered luxuries will be available to all. This is the 'trickle-down' effect championed by Hayek. The market works and works best in conditions of prior inequality.

If today ... the relatively rich can have a car or refrigerator, or aeroplane trip or radio at the cost of a reasonable part of their income, this was made possible because in the past others with large incomes were able to spend it on what was then a luxury (Hayek, 1982b, 44).

The imposition of equality retards this process. The effect is not absolute as individuals who have a particular preference for a certain kind of good, for example, computers, will still be

willing to spend a large(r) amount of their money on a new product. But for any given intensity of preference, the capacity to act upon it is reduced by equality. With the chances of successfully launching a new product reduced, entrepreneurs have less reason to remain alert to the possibility of new discoveries.

### **3.4 Bureaucracy, Socialism and Entrepreneurship**

#### 3.4.1 Bureaucracy and Entrepreneurship: The Weberian Legacy

The concept of bureaucracy is a contested one. Martin Albrow (1970) identifies seven distinct senses in which the term is used. The study of bureaucracy only really began with and continues to be influenced by the work of Max Weber (Albrow, 1970, 37) whose work provides a natural starting-point for discussion. In its most rational, or 'ideal' form, Weber (1978, 218-9) sees bureaucracy as characterised by (i) the personal freedom of individual employees, (ii) the existence of a clear hierarchy, (iii) a precise division of labour, (iv) reliance on contracts of employment, (v) selection through competitive examination, (vi) the determination of remuneration by position within the hierarchy, (vii) employees having no other major occupation, (viii) prohibitions on employees appropriating either the post or its resources for their own use, (ix) promotion according to seniority or merit, and (x) the existence of a unified control system. Bureaucracy can also be recognised, Weber suggests, by its essential subservience. Not only are individual bureaucrats appointees (Albrow, 1970, 42, Mises, 1944, 3) but bureaucracy itself is established by others to perform functions on its behalf. Bureaucracy is a means to realise ends selected by others. Eugene Kamenka's (1989, 157) definition neatly summarises Weber's position.

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Bureaucracy means a centrally directed, systematically organised, hierarchically structured staff devoted to the regular, routine and efficient carrying out of large-scale administrative tasks according to policies dictated by rulers or dictators standing outside and above the bureaucracy.

Whether in the form of Soviet Communism or English Fabianism, socialism has historically relied upon bureaucracy. This is no coincidence as the decentralised market must be suppressed and central planning promoted if equality is to be realised. A necessary condition for effective planning is coercive allocation. If, for example, it is decided by the CPB that the price of a disposable biro should be twenty pence, it is essential that those producing bios sell them at that price. The pluralism which characterises the decentralised market is the antithesis of central planning. Defined precisely by its lack of autonomy, bureaucracy is the organisational form consistent with the requirements of planning.

Weber is frequently interpreted as asserting the efficiency of bureaucracy. Anthony Downs (1987, 296) claims that Weber has a 'generally positive' view of bureaucracy whilst Peter Blau (1956) presents himself as Weber's heir in championing the merits of bureaucracy. It is not difficult to find passages within Weber's work that can be used to support this conclusion.



Bureaucracy is, from the purely technical point of view, capable of attaining the highest degree of efficiency and it is in this sense the most rational known means of exercising authority over human beings (Weber, 1978, 223).

The fully developed bureaucratic mechanism compares with other organisations as does the machine with the non-mechanical modes of production .... Precision, speed, unambiguity, knowledge of the files, continuity, discretion, unity, strict subordination, reduction of friction, and of material and personal costs - these are raised to the optimum point in the strictly bureaucratic administration (Weber, 1946, 214).

That Weber asserts the efficiency of bureaucracy is disputed. David Beetham (1987, 66) chides Weber precisely for neglecting this issue. If Weber did believe bureaucracy to be efficient he did so, it can be concluded, in only a very limited sense. Specifically and having carefully distinguished between the entrepreneurial and the bureaucratic class, Weber suggests that bureaucracy will be unable to undertake the entrepreneurial function. Beetham (1987, 82) interprets him as arguing that 'the maintenance of any dynamism, whether in economic or social life, depends on the continuation of [the] entrepreneurial class'. Bureaucracy is an efficient administrative tool, offering a means through which policies determined outside of the bureaucracy can

be implemented. But entrepreneurial action rests on the appropriate selection of ends as well as of means. The entrepreneur must decide not only how best to produce a new product but must first perceive the need for this product (Kirzner, 1985, 49). Those characteristics of bureaucracy which make it an efficient administrative machine also frustrate entrepreneurial action.

Bureaucracy is hierarchical. Before pursuing an entrepreneurial discovery, a bureaucrat must first receive the permission of their superior. At the very least, this will take entrepreneur's time and energy. Furthermore, bureaucrats will be reluctant to recommend the adoption of novel courses of action as this may be taken to imply criticism of a superior who authorised the pursuit of existing policies (Thompson, 1977). Ultimately, the presence of hierarchy implies the existence of only one entrepreneur: the person at the apex of the hierarchy. Dangers in eliminating entrepreneurial pluralism have already been identified but in this case particular concern can be expressed as the senior individual in a public bureaucracy will be a politician. Not only are politicians unlikely to have sufficient ability to judge accurately the merits of competing proposals but and as will be argued in Chapter Nine, politicians may have incentives to undermine entrepreneurial efficiency in the pursuit of reelection.

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Bureaucracy is hierarchical and hierarchy rests on the precise specification of clearly defined roles for each bureaucrat and

rules for them to follow (Weber, 1946, 51). For three reasons, the presence of rules retards entrepreneurial action. First and as Robert Merton (1952) argues, the formulation of rules is likely to lead to 'goal displacement': a process that occurs when bureaucrats follow rules so rigidly they frustrate the realisation of goals the rules were intended to realise. Second, the importance of tacit knowledge within the entrepreneurial process is such that it must be doubted whether any set of rules can ensure entrepreneurial alertness. Third, the specification of rules will give bureaucracy an inherently conservative disposition. Rules ensure the preservation of the status quo but entrepreneurship demands its (creative) destruction. As James Wilson (1989, 69) observes, 'all [bureaucratic] organisations by design are the enemy of change'.

The capitalist entrepreneur is not only unconstrained by existing rules but can profit by her refusal to accept received wisdom. For this reason, it is difficult to reconcile Schumpeter's general endorsement of bureaucratic socialism with his recognition of the 'depressing influence' bureaucracy exerts 'on the most active of minds ... due to the difficulty, inherent in the bureaucratic machine, of reconciling individual initiative with the mechanics of its working' (Schumpeter, 1943, 207). Weber recognises the significance of this constraint, seeing in bureaucrats individuals who

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need 'order' and nothing but order, who are so totally adjusted to it that they become nervous and cowardly if this order falters for a moment, and quite lost if they are torn away from it (quoted Beetham, 1987, 81).

Contingency theory can be used to clarify this difference. Tom Burns and Gordon Stalker (1961) distinguish between mechanical organisations characterised by the presence of hierarchy and rules and organic organisations which have a more fluid structure. They argue that the efficiency of either depends upon the environment in which it functions and the nature of the tasks it is called upon to perform. Mechanical organisations are suited to conditions of stability, certainty and technological simplicity. Organic organisations cope better in conditions of instability, uncertainty and complexity. As Weber's definition reveals, bureaucracy is a mechanical organisation but entrepreneurship is best undertaken within organic organisations.

#### 3.4.2 Public Entrepreneurship: The Legacy of Hyman Rickover

At the end of the Second World War, the United States Navy was largely composed of increasingly vulnerable aircraft carriers, lacked any clear enemy and faced demands for rapid demobilisation. The future of warfare was thought to lie in the development of nuclear weapons and the Navy had played only a peripheral role in the Manhattan project and did not have a role to play in the delivery of nuclear weapons. The Navy's position

was further jeopardised by the decision in 1946 to create and give to the Atomic Energy Commission (AEC) a legal monopoly on all matters of nuclear policy.

The Navy's saviour, Captain Hyman Rickover, was an unlikely hero. The Navy promoted generalists over specialists and Rickover, already recommended for retirement, was a technician, Director of the Engineering Division of the Bureau of Ships. But Rickover alone saw that because nuclear powered submarines could remain submerged and therefore invulnerable to attack, nuclear power could revolutionise naval warfare. Through persistent lobbying, Rickover convinced first his superiors in the Bureau of Ships, then the Navy and finally Congress to commit research money into what was felt at the time to be a technically infeasible project. By 1949, Rickover had been promoted to Admiral, tasked with the creation of the Naval Reactors Division of the Bureau of Ships and given sufficient funds to develop two prototype submarines. The first of these, The Nautilus, made its maiden voyage in 1953. By this time, Rickover had persuaded Congress of the need to build not only a fleet of nuclear submarines but to convert almost the entire navy to nuclear power. Growth in the Naval budget outstripped that of the other armed services and most of this money flowed through the Naval Reactors Division of the Bureau of Ships. In 1954 and again against the wishes of the AEC, Rickover was given the first contract to build a civilian nuclear reactor.

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Rickover's achievements, alongside those of FBI director,

Edgar Hoover and architect of New York's post-war reconstruction, Robert Moses, are presented by Eugene Lewis (1980) as examples of bureaucratic entrepreneurship. This term - which has recently attracted frenzied academic attention (Osborne and Gaebler, 1992) - is frequently used in a purely metaphorical way as shorthand for any bureaucratic success. In Rickover's case, it is not merely embellishment. The application of nuclear energy was a genuine innovation, an example of creative destruction. Rickover himself acted as both innovator and coordinator, directing technical research, courting publicity and marshalling resources.

To achieve his goals - the Nautilus was launched three years ahead of schedule - Rickover subverted traditional bureaucratic practise. Rickover did not work alone as he had to rely on the organisation of the Bureau of Ships but as Lewis (1980, 60) comments, 'it was organisation as it had never been seen before. It was unroutinised: formal rules meant little; existing structure altered as fast as the task environment did'. Naval rules about procurement and testing were ignored, individual bureaucrats were simultaneously assigned to perform several functions and Rickover emphasised the importance of technical knowledge over hierarchical position. In short, the Bureau of Ships was turned from a mechanical into a organic organisation.

The critic may respond by arguing that bureaucratic entrepreneurs are an exception to a general rule of bureaucratic inertia and that they succeed despite not because of their bureaucratic status. Nonetheless, the example casts doubt on the conclusion

that bureaucracy frustrates entrepreneurial action. As Lewis (1980, 244) concludes, 'the public entrepreneur ... is an emulator of his more earthly capitalist predecessor'.

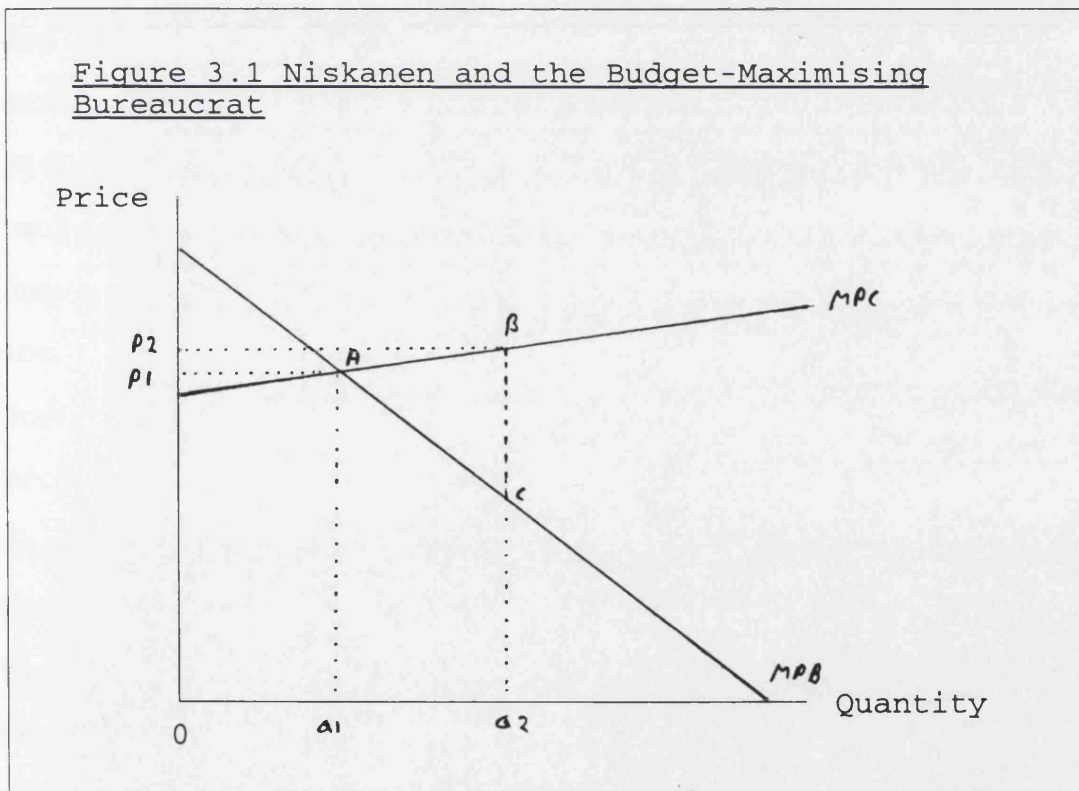
### 3.4.3 Budget-Maximising: The Legacy of William Niskanen

William Niskanen's has been the most influential rational choice model of bureaucracy. His argument rests on a behavioural assumption about the source of bureaucratic utility and a equilibrium argument from which conclusions about bureaucratic efficiency are drawn. The behavioural assumption can be easily stated.

Among the several variables that may enter the bureaucrat's utility function are the following: salary, prerequisites of the office, public reputation, power, patronage, output of the bureau, ease of making changes, and ease of managing the bureau. All of these variables except the last two are a positive monotonic function of the total budget of the bureau during the bureaucrat's tenure in office (Niskanen, 1971, 38).

Senior bureaucrats will attempt to maximise the size of the bureau's budget. As in Figure 3.1, marginal private costs of production (MPC) rise and the marginal benefits of production (MPB) - as valued by the bureau's sponsors - fall as output increases. Niskanen suggests that an efficient output is at point

A where marginal costs are equal to marginal benefits and consumer surplus (DAE) is maximised. This is the equilibrium to which the capitalist market is pushed through entrepreneurial coordination. Output  $Q_1$  will be produced at price  $P_1$ . Monopoly power and information asymmetries allow bureaucrats to make 'take it or leave it' offers to their political sponsors. Bureaucracy will locate at B where the welfare gain of 'efficient' production (DAE) is equal to the welfare loss of excessive production (BCA). This is the bureau's budget constraint and output  $Q_2$  will be produced at price  $P_2$ .



It appears that Niskanen's account of bureaucracy conflicts with Weber's 'ideal type' in which bureaucrats pursue only others goals but Weber is aware that in practise, bureaucrats will often attempt to exceed their authority and pursue their own goals



(Beetham, 1987, 74-5). Niskanen's model builds upon and formalises this insight with the difference that bureaucrats are seen to pursue their self-interest rather than, as Weber assumes, the interests of the social class from which they are drawn.

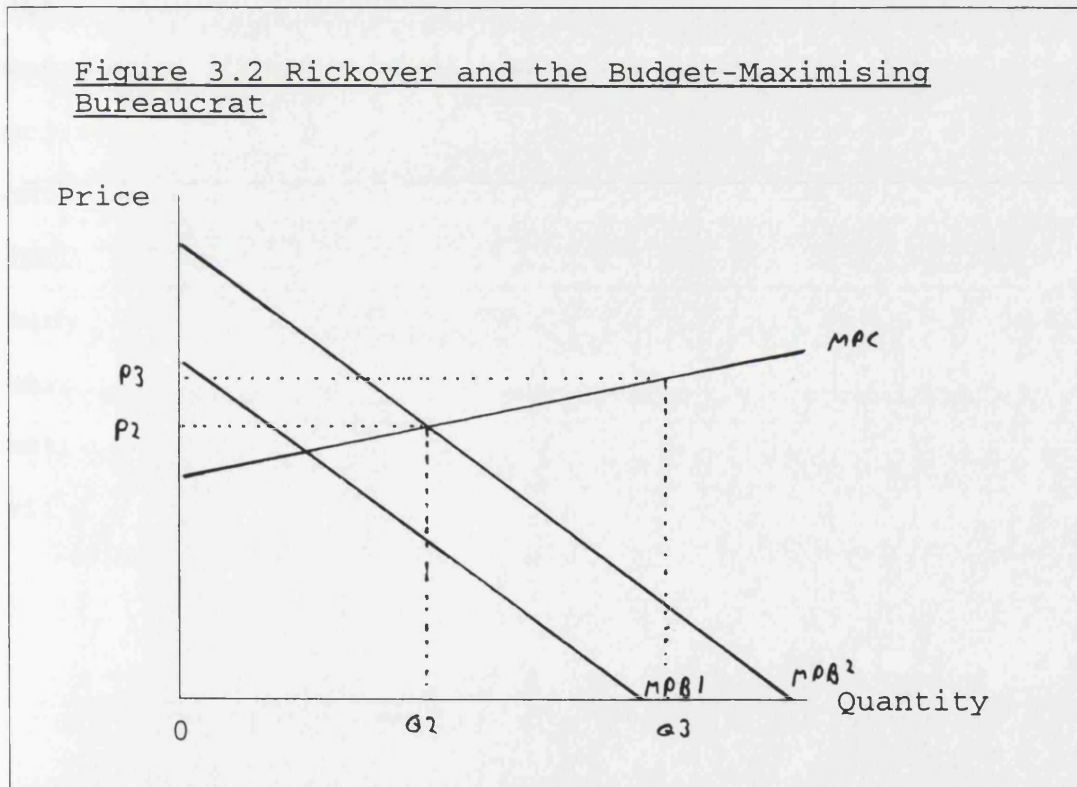
One previously neglected implication of Niskanen's argument can be used to account for the actions of individuals like Hyman Rickover. Bureaucrats have an incentive to undertake entrepreneurial action to the extent that this can be used to secure larger budgets. This will be the case where innovation or coordination either lowers the marginal costs of production or inflates marginal benefit. The argument is illustrated with reference to Rickover's actions in Figure 3.2. In the late 1940's, the United States was at war with North Korea and confronted a superpower rival, the Soviet Union, that had just conducted its own atomic tests. Rickover's entrepreneurial action convinced the Navy that the marginal benefits of expenditure on nuclear submarines had been increased (MPB1-MPB2). Rickover was promoted and the (budget-maximising) output of the Bureau of Ships expanded from Q2 to Q3. Relative to capitalist entrepreneurs, Rickover's utility gains were perhaps minimal. Rickover retired not a millionaire but an Admiral on a state pension. But the costs of entrepreneurial failure were also reduced. As with the neo-pluralist model, it was the American taxpayer's and not Rickover's money that was staked on the success of the project.

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Recognition of the possibility of entrepreneurial action

transforms the budget-maximising model. Bureaucrats have an incentive not only to maximise utility within existing cost-benefit schedules but to actually create, to 'discover', new ones. Because entrepreneurial action 'requires aptitudes that are present in only a small fraction of the population' (Schumpeter, 1943, 132), not every bureaucrat will manage to budget-maximise in this dynamic sense but this is a constraint which also limits capitalist entrepreneurship.

Figure 3.2 Rickover and the Budget-Maximising Bureaucrat

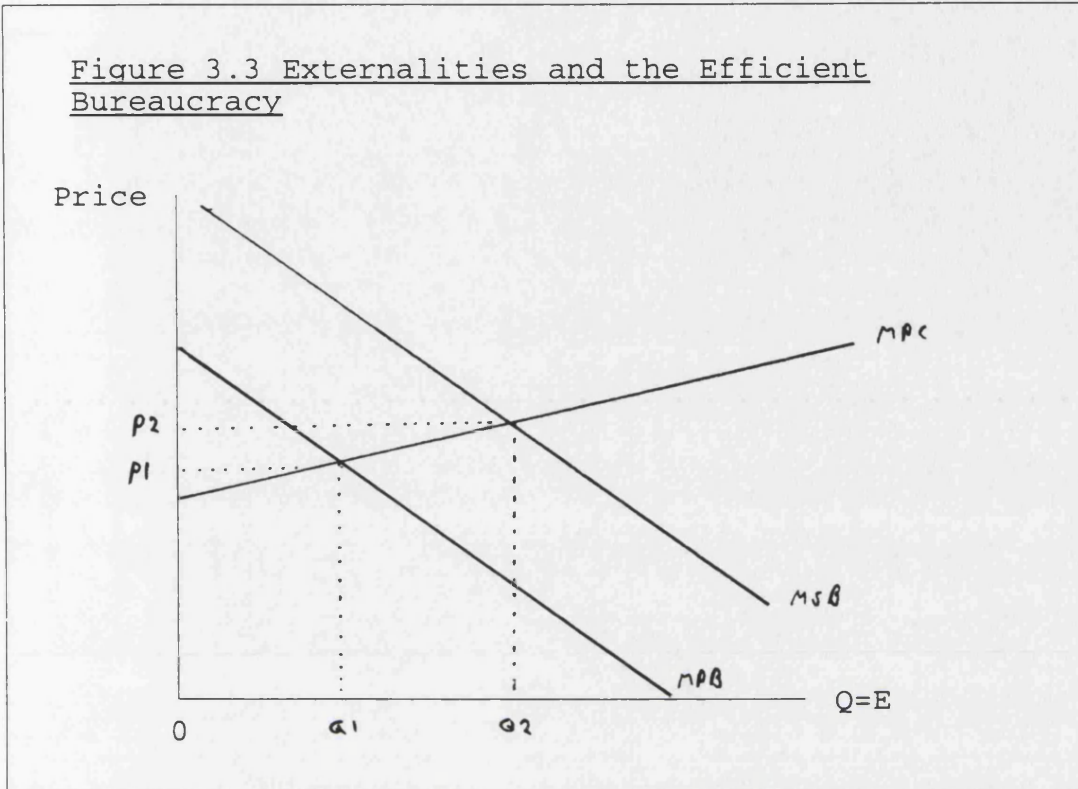


The famous conclusion Niskanen (1973, 33) derives from his budget-maximising model and one from which important policy recommendations follow is that 'all bureaus are too large ... both the budget and the output of the bureau may be up to twice that of a competitive firm'. Ironically and given Niskanen's

assumptions about efficiency it now appears that the problem with bureaucracy is one not of too little but of too much innovation. But it is precisely the claim of capitalist efficiency which we had reason to question in Chapter Two. Because entrepreneurial action generates positive externalities, capitalist markets do not maximise consumer welfare and bureaucratic entrepreneurial budget-maximising may actually fully compensate for this inefficiency. This possibility is illustrated in Figure 3.3. Here, output ( $Q$ ) is assumed to be a function of the level of entrepreneurial activity ( $E$ ). Capitalist firms will locate at point A ( $Q_1-P_1$ ). Because marginal social benefits (MSB) of entrepreneurial action are greater than marginal private benefits (MPB) this results in a welfare loss of ABC. A budget-maximising bureaucracy will produce at point B ( $Q_2-P_2$ ) and in doing so maximise welfare. Bureaucracy can not only generate entrepreneurial activity but may inadvertently generate an efficient volume of it.

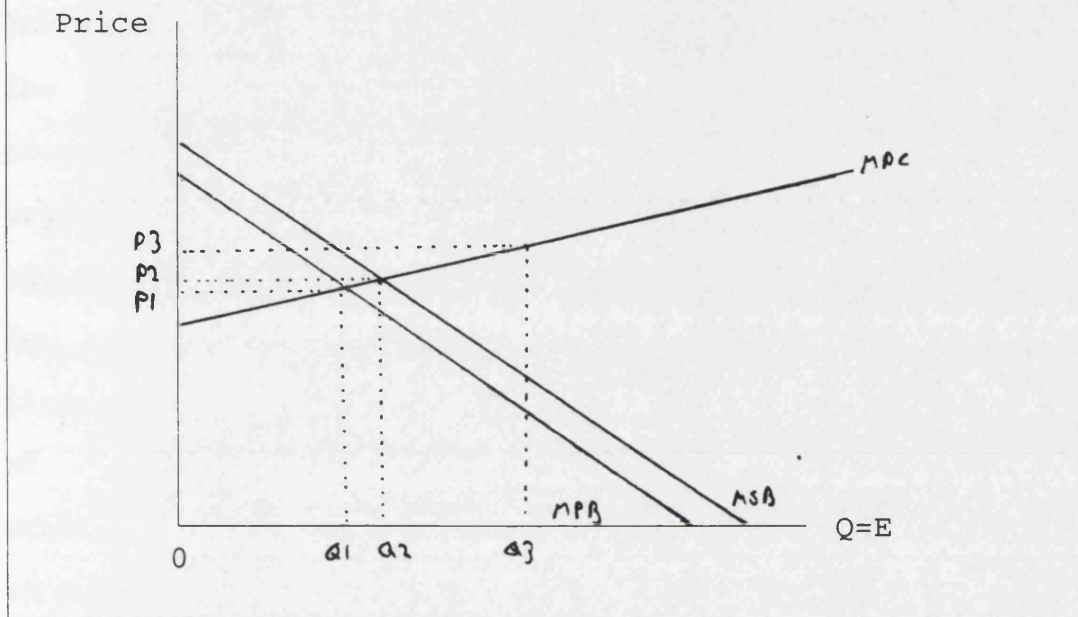
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Figure 3.3 Externalities and the Efficient Bureaucracy



It of course possible that bureaucratic budget-maximising production will lead to a greater welfare loss than capitalist production. In Figure 3.4, marginal private costs (MPC) and marginal private benefits (MPB) are held constant and marginal social benefits reduced (MSB'). Here, capitalist production ( $Q_2-P_2$ ) will take place closer to the optimum level ( $Q_1-P_1$ ) than bureaucratic production ( $Q_3-P_3$ ). Neither capitalism or bureaucracy are intrinsically efficient. Without a precise quantification of the divergence between private and social marginal benefits, nothing, it appears, can be said of the relative merits of bureaucracy and capitalism.

Figure 3.4 Externalities and the Inefficient Bureaucracy



#### 3.4.4 Bureaucracy, Profit and the Market

The analysis in this section has twisted from one conclusion to another and necessitated - for the critic of socialist entrepreneurship - some uncomfortable concessions. In this section, the case against bureaucracy is reconstructed in the context of earlier arguments about the efficacy of markets. Bureaucratic entrepreneurs may, as Weber suggests, be unable to appropriate the resources of office in the form of profit but they can enhance their own welfare through budgetary growth and for this reason have incentives to budget-maximise. Rickover's example demonstrates that budget-maximising may require entrepreneurial action but this need not always be the case.

In his discussion of bureaucracy, Charles Wolf (1988) suggests that bureaucrats may have both a predilection for and an aversion to technological innovation. As an example of the former he cites the American armed forces. For the latter, he points to the American educational establishment and its resistance to 'even the experimental use of new technology like videotaping for presentations to large classes' (Woolf, 1988, 73). Within Woolf's argument, the tension between these two is not resolved. Within the framework of Niskanen's analysis, it is perfectly explicable. New and ever more complex technology can sometimes be used, as Rickover demonstrates, to inflate budgets but the introduction of video technology allows a smaller number of teachers to conduct classes for a larger number of students. Here, technical innovation, as Woolf (1988, 73) notes, will 'reduce the demand for teachers' and frustrate budget-maximising. Neither does the bureaucrat have any incentive to cut organisational costs for if they were to do so, either their sponsor would require that they produce the same amount for a lower budget or produce more for the same budget. Either way, bureaucrats will not personally benefit from this form of entrepreneurial activity (Hayek, 1935c, 230). The relationship between budget-maximising and entrepreneurship is purely contingent.

Capitalist firms are superior to public bureaucracies because entrepreneurs are motivated directly by the search for profit and will pursue entrepreneurial discoveries even if this reduces the demand for or costs of their product. Capitalist markets generate entrepreneurial activity because they are animated by private

property and allow for the capture of profit. Socialist bureaucracies retard entrepreneurial activity because they rest on public ownership and deny entrepreneurs the opportunity to capture profit.

A further difference between bureaucratic socialism and capitalist firms can be observed. Bureaucracy derives its revenue from budget appropriations (Mises, 1944, 47, Downs, 1967, 29-30, Niskanen, 1971, 25). To secure funds for entrepreneurial action, the bureaucrat must convince superiors of the merits of their proposal. The valuation of marginal benefit of output is a political process and is undertaken by politicians. Capitalist entrepreneurs derive revenue from the sale of output to consumers. Before committing funds to entrepreneurial action, the capitalist entrepreneur must form a judgement about the likely demand for and costs of the product and capitalist entrepreneurs succeed and prosper to the extent that their judgement is vindicated. Bureaucratic entrepreneurs have less of an incentive to form accurate judgements as it is not their money which is being risked. Bureaucratic entrepreneurs will have an incentive to pursue funding for a project even if they suspect that a better use of resources can be made in another area of government activity. For this reason, bureaucratic entrepreneurs also have an incentive to exaggerate to politicians the benefits of any project and to underestimate its costs. When a review of Rickover's nuclear programme was finally authorised in 1963 - ten years after the launch of the Nautilus - it was, for example, concluded that the programme represented poor value for money and

that the Soviet threat had been wildly exaggerated by defence staff (Lewis, 1980, 45).

Politicians and not bureaucrats are the real entrepreneurs in a socialist system. They arbitrate between competing proposals, monitor costs and authorise funding. There are a number of reasons why they are unlikely to do so effectively. First, like bureaucrats, they lack a direct financial stake in the success of any project. It is taxpayer's and not politician's capital which is risked. Second, their abilities and training as politicians may not equip them to take such decisions. The politician may be impressed by the bureaucrat who is the best advocate and not the one who has the best proposal. Third, politicians are likely to be unduly risk-adverse. When funded by government, entrepreneurial failure may lead to political embarrassment. The capitalist entrepreneur does not have to account for his actions to a political opposition eager to establish culpability (9.2). Fourth, politicians are unlikely to authorise expenditure on competing projects. Capitalist entrepreneurs are free to pursue conflicting and contradictory projects, each believing that they alone have 'discovered' valuable opportunities. Given inevitable limits to individual knowledge, the resulting pluralism ensures at least some success. Finally, politicians may have preferences that extend beyond profit-maximisation. Proposals that, for example, generate jobs in marginal constituencies may be given more favourable attention.



Since state ownership places the machinery of the whole economy in the hands of politicians, it is naive to expect that production can ever be 'depoliticised'. On the contrary, it will invariably be subject to the ever-changing political winds. Important though efficiency, growth, technical advance, and so on, remain as tasks, they can be pushed quite easily into second place if the day-to-day considerations of politics so require (Kornia, 1993, 49).

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### 3.5 Conclusion

Spanning many decades and numerous areas of research, Hayek's career can be seen as an attempt to establish the fallacy of one proposition: that 'human institutions will serve human purposes only if they have been deliberately designed for these purposes' (Hayek, 1982b, 8). A fallacious knowledge derived from neo-classical economics encouraged socialist economists to advocate the suppression of functioning although imperfect spontaneous orders (nomos) and their replacement with organisations designed to perform in particular ways (taxis). In this way it was hoped that central planning could be used to both enhance economic prosperity and secure the realisation of socialist values.

No matter how exhaustive the preparation or dedicated the technicians, such ambitious organisational goals can never be realised as the necessary knowledge is too great, is dispersed among countless individuals and is frequently tacit, of a kind that cannot be communicated to others. The belief that such knowledge can ever be known by one individual Hayek (1982b, 14) calls the 'synoptic delusion'. Only the market can make use of dispersed knowledge and as Hayek (1982b, 51) concludes 'it is impossible ... to improve or correct this order by interfering in it by direct commands.

Hayek's contributions to the 'Calculation Debate' emphasise the limitations of human knowledge and the virtues of decentralised markets. At the time, his arguments were misunderstood and

thought to be of only marginal interest. The failure of central planning in the former Soviet Union vindicates his judgment and any form of socialism must now deal with the objections Hayek first raised nearly sixty years ago.

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## Chapter Four

### Equality, Efficiency and Socialism

- 4.1 Introduction
  - 4.2 Equality: The Nature of and Difficulties With
  - 4.3 Efficiency and Equality: Trade-Offs Found and Lost
    - 4.3.1 The Equality-Efficiency Trade-Off: Initial Formulation
    - 4.3.2 Pareto Efficiency
    - 4.3.3 The Equality-Efficiency Trade-Off: Initial Problems
  - 4.4 Socialism and Pareto Efficiency
  - 4.5 Beyond Pareto: The Efficiency-Equality Trade-Off Again
  - 4.6 Market Socialism and Socialist Entrepreneurship
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-

#### 4.1 Introduction

The value that most clearly distinguishes the aspirations of socialism from the reality of capitalism is equality. It is the pursuit of equality that has been argued to make socialism and entrepreneurship incompatible because whilst markets animated by private ownership are necessary to stimulate entrepreneurial activity, these markets generate inequality. Given its significance, section 4.2 examines the concept of equality more carefully and defends the choice made in Chapter One to define equality in terms of equality of income. Sections 4.3 and 4.5 examine the trade-off between efficiency and equality. As the term is commonly used, efficiency is an economic virtue. A more efficient economy is better able to secure individual wellbeing. As economic wellbeing depends on stimulating entrepreneurial activity (1.3.1) and because equality is fundamental to the definition of socialism, asserting the existence of a trade-off between efficiency and equality is equivalent to arguing that socialism and entrepreneurship are to some degree incompatible. Discussion of the nature of the trade-off between efficiency and equality generates a framework through which arguments in subsequent chapters can be understood. In the final part of the chapter, the focus of the argument shifts. To deal with the requirements of new right entrepreneurship, any form of feasible socialism will have to be market socialist. In section 4.6, a definition of this term is offered and the evolution of the theory of market socialism documented.

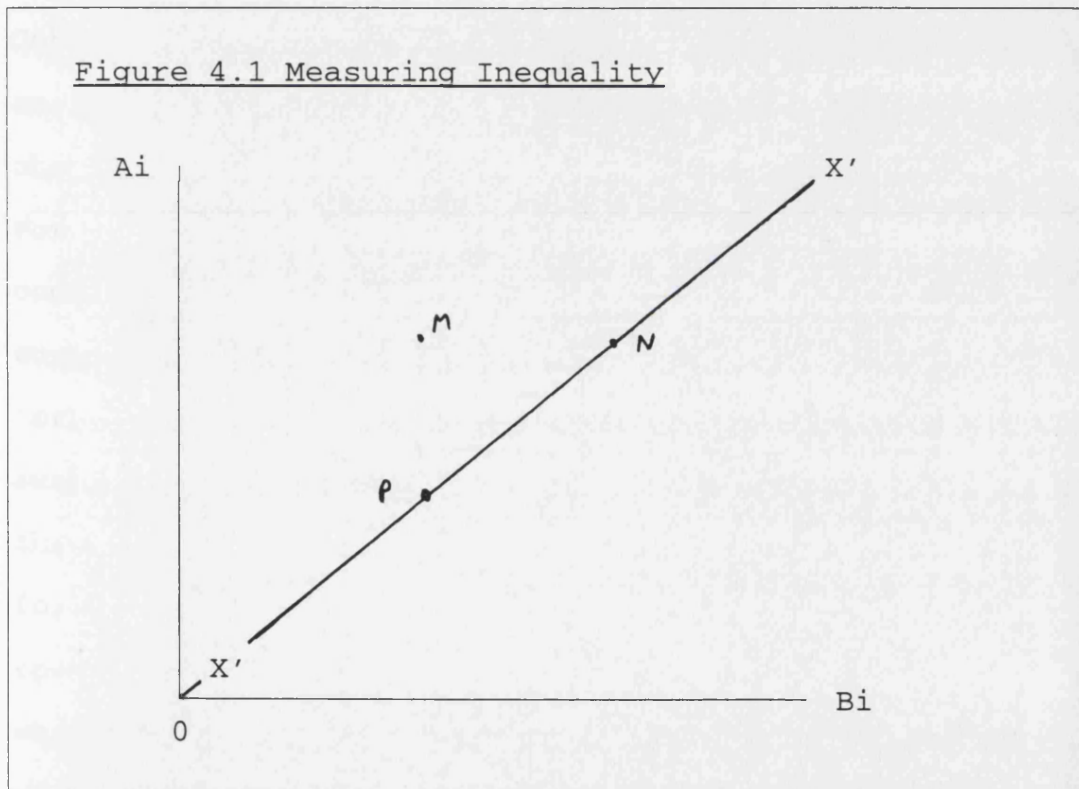
#### 4.2 Equality: The Nature of and Difficulties With

The concept of equality is a complex one. Douglas Rae (1981) distinguishes between over one hundred uses of the term. For our purposes, the relevance of many is limited as socialists will not, for example, be impressed by demands for equality of opportunity in the narrow sense favoured by neo-liberals. But the possibilities from which socialism can choose are still numerous and include equality of welfare, of potential welfare (Musgrave, 1974) of opportunity for welfare (Arneson, 1989), equality of resources (Dworkin, 1981), equality of status (Miller, 1993), equality of initial assets (Roemer, 1988), equality of basic capabilities (Sen, 1980), equal access to advantage (Cohen, 1989) and equality of relative benefit (Gauthier, 1986). Socialists now rarely advocate equality of income and given that equality in any one sphere may require inequality in others (Sen, 1992), it is necessary to justify this particular choice. The defence offered here is pragmatic. Other indices of equality are (i) more difficult to measure, and (ii) problematic in the context of a discussion of entrepreneurship. The argument will be illustrated with reference to specific alternatives.

It is often argued that it is impossible to make interpersonal comparisons of utility (see Hausman, 1994). If so, pursuing equality of welfare or some derivative of it is an impossible goal. In the absence of any agreed measurement, equality of status seems equally unattainable and Gerry Cohen accepts that equal access to advantage is vulnerable to the same objection.

Measuring equality of income is easier and this is a desirable feature as it means that discussion of socialist entrepreneurship can concentrate on issues of production rather than consumption. In Figure 4.1, the income ( $i$ ) of two individuals (A and B) is plotted. The line  $X'-X'$  marks all the points at which income is equally distributed. The greater the deviation from this line, the greater the inequality.

Figure 4.1 Measuring Inequality



Measuring equality of income is easier but is not easy. Two questions raised by this choice are (i) what assets should be taken as constituting income, and (ii) over what time period should equality and inequality be measured? The answer to the first of these depends on the form of socialism under consideration and particularly its pattern of ownership. No single answer can or should be given at this stage. The second

choice appears more fundamental and is of particular relevance to the discussion of entrepreneurship. If luck partially determines entrepreneurial success, individual entrepreneurs may have either more or less than the average income in the short-term but an average income in the long-term. It is an agreeable feature of many of the models of socialist entrepreneurship considered that they reduce such fluctuations.

Cohen (1989, 908) suggests that egalitarians should compensate an individual only for '(bad) brute luck when his bad luck is not the result of a gamble or a risk which he could have avoided'. For the same reason and subject to the requirement to provide compensation for the unlucky, individuals are, it must be supposed, to be rewarded for actions which are not the result of 'brute' good luck. There may be a clean path to income inequality such that distribution M in Figure 4.1 need not be less socialist than distribution N. Does this mean that as individuals are not forced to be entrepreneurs, socialists should tolerate their spectacular prizes? If so, a simple answer to the question of whether socialism is compatible with entrepreneurship is in sight. But this argument concedes too much ideological ground, bearing an uncomfortable resemblance to neo-liberal claims that entrepreneurs 'deserve' their success (Arnold, 1987). Socialists can respond to such claims by emphasising the salience - acknowledged by Friedrich Hayek (1982c, 81) as well as Joseph Schumpeter (1943, 73-4) - of luck in determining entrepreneurial success but in attempting to untangle the relative importance of brute luck and skill, problems of measurement again arise.



By defining equality in terms of equality of income, the arguments of Chapter Three can be directly confronted. Entrepreneurial alertness partially determines entrepreneurial success and (genetic) luck partially determines individual's capacity to remain alert (Rawls, 1971, 74). Do socialism's critics have to disassociate themselves from the second part of this statement? No because they can also claim that incentives partially determine entrepreneurial success and that socialism eliminates entrepreneurial incentives. Equality of income is where the critique of socialism most clearly bites. If it can be shown that equality of income is compatible with entrepreneurship, equal access to advantage or equal welfare should not pose additional difficulties. In Chapter One it was suggested that the efficacy of socialism is best tested by assuming egoistic behaviour as the severity of the assumption means that any 'pro-socialist' conclusions reached are of greater value. Income equality is used for the same reason.

### 4.3 Efficiency and Equality: Trade-Offs Found and Lost

#### 4.3.1 The Equality-Efficiency Trade-Off: Initial Formulation

The arguments of Chapter Three can be taken to imply the existence of a trade-off between efficiency and equality. Because markets generate inequality socialism will have to rely on central planning but as Hayek (1935a, 37) argues

in so far as it had been hoped to achieve by means of central direction of all economic activity ... a distribution of income independent of private property in the means of production and a volume of output which was at least approximately the same or even greater than that procured under free competition, it was more and more generally admitted that this was not ... practicable.

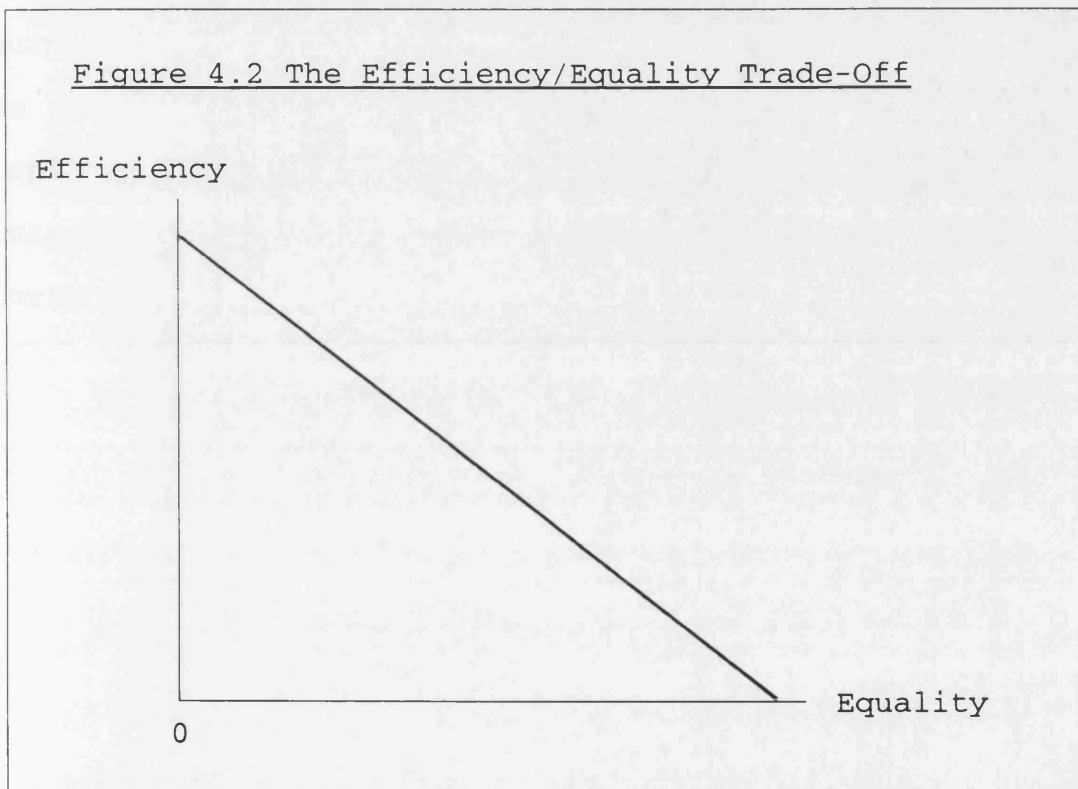
One way of depicting this trade-off is illustrated in Figure 4.2.<sup>1</sup> Here, more equality means less efficiency. Whether in these circumstances priority should be given to achieving equality or efficiency will provoke (political) argument but it is significant that writers as diverse as Milton Friedman (1962),

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<sup>1</sup> The example is taken from Brian Barry's Political Argument. Barry rejects the suggestion that if a choice is to be made between two values that it must be possible to compare them in terms of a common denominator. Using the examples of equity and efficiency he argues that 'one can sensibly speak of rational choices on the basis of principles which are not all reducible to a single one provided that ... the choices show a consistent pattern of preference' (Barry, 1990, 4).

James Meade (1964), John Rawls (1971), Arthur Okun (1975) and Gary Dymiski and John Elliot (1988) accept the existence of this trade-off. John Roemer (1992, 151) suggests that 'the view that equality of income and efficiency .... inherently conflict has become almost a dogma in the West'.

Figure 4.2 The Efficiency/Equality Trade-Off



#### 4.3.2 Pareto Efficiency

The trade-off between equality and efficiency has been introduced in the absence of any clear definition of efficiency. Allen Buchanan (1985, 4) suggests that the 'most widely accepted concept of efficiency' is Pareto efficiency and goes on to argue that 'the Pareto optimality and Pareto superiority principles appear to provide the most comprehensive tools for assessing a system's efficiency' (Buchanan, 1985, 7). The Pareto principle

is employed on the assumption that (i) each person's preferences are the only appropriate indicators of their welfare, (ii) that the welfare of a society is composed only of the welfare of the individuals within it, and (iii) that interpersonal comparisons of utility are impossible. Robert Sugden (1992, 343) suggests that the first two of these judgements are 'for most economic purposes ... probably fairly acceptable'. The Pareto principle is useful as it allows economists to comment upon the welfare implications of different policies without having to make interpersonal comparisons of utility. The Pareto Principle is worth stating in Vilfredo Pareto's own words.

Let us consider any particular position and let us suppose that a very small move is made compatible with the relations involved. If in doing so the well-being of all the individuals is increased, it is evident that the new position is more advantageous for each one of them; vice-versa, it is less so if the well-being of all individuals is diminished. The well-being of some may remain the same without these conclusions being affected. But, if on the other hand, this small move increases the well-being of certain individuals and diminishes that of others, it can no longer be said that it is advantageous to the community as a whole to make such a move. We are, hence, led to define a position of maximum ophelimity as one where it is impossible to make a small change of any sort such that the ophelimities of all individuals with the exception of those that remain constant, are either all increased or all diminished (quoted Cirillo, 1979, 43).<sup>2</sup>

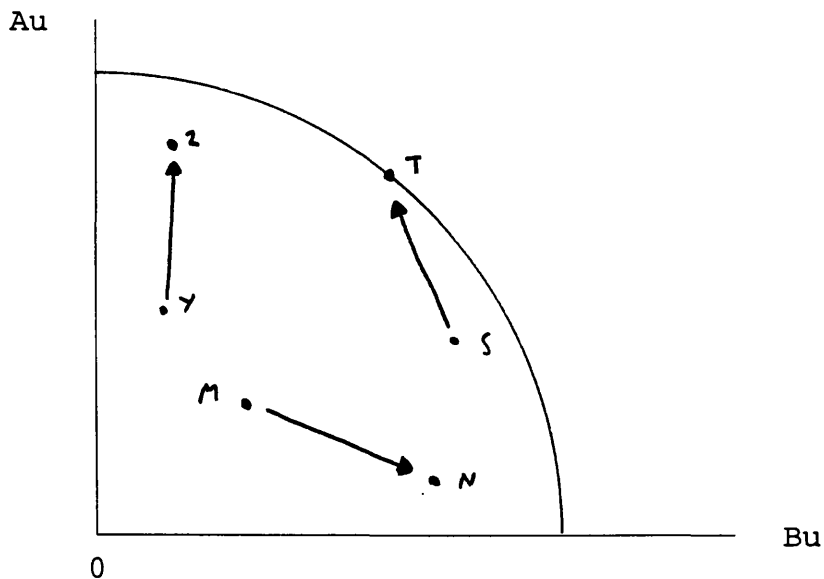
A distinction is drawn between Pareto-superiority and Pareto-optimality. A Pareto-superior change is one which increases the utility of at least one individual without decreasing the utility of any. Because none lose and at least one gains, a Pareto-

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<sup>2</sup> Pareto draws a distinction - since abandoned - between ophelimity which the individual derives from market purchases and utility which the individual derives from pursuing the entire range of their desires. Pareto's ophelimity has become today's utility although Pareto also believed that it was possible to make interpersonal comparisons of utility.

superior change necessarily increases the welfare of society. In Figure 4.3, the utility ( $u$ ) of two individuals, A and B, is shown on the vertical and horizontal axis respectively. The move from Y to Z is Pareto-superior as A benefits and B does not lose. Conversely, the move from M to N is not Pareto-superior as A benefits but B loses. Pareto-optimality is achieved when possibilities for making Pareto-superior moves have been exhausted. Any point along the frontier  $D'-D'$  is Pareto-optimal. As in the move from Y to Z, Pareto-superior moves do not necessarily result in the achievement of Pareto-optimality and as in the move from S to T, movement to points of Pareto-optimality need not be Pareto-Superior.

Figure 4.3 Efficiency: The Pareto Criterion



### 4.3.3 The Efficiency-Equality Trade-Off: Initial Problems

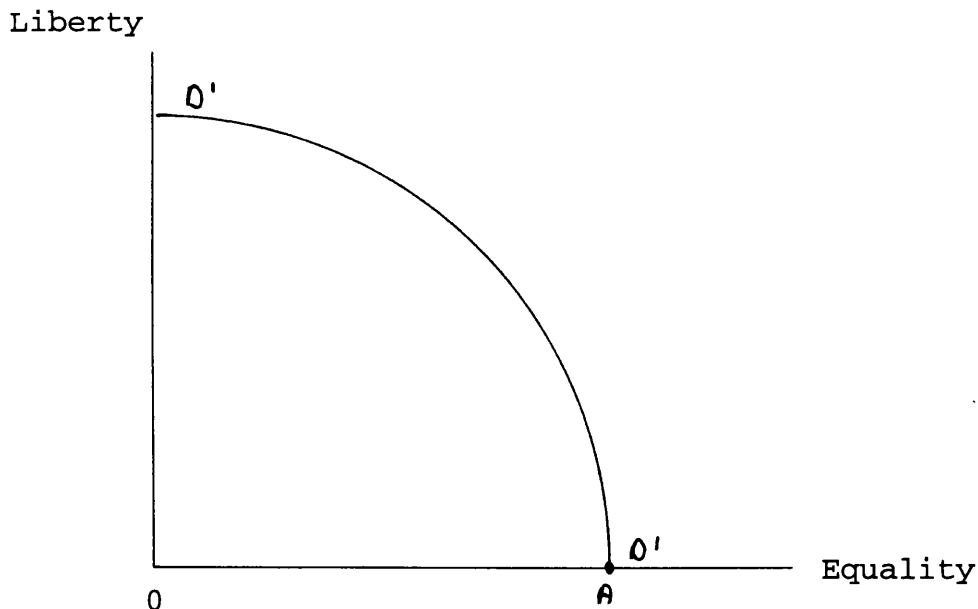
Commitment to the Pareto principle casts into doubt the existence of a trade-off between efficiency and equality. Although different from, my argument is grounded on Julian Le Grand's (1990, 1991) observation that efficiency in the Pareto sense should not be treated as a political value to be traded off against others.

There are two values, for example, liberty and equality both of which are valued and between which there exists a trade-off. In Figure 4.4, the line  $D'-D'$  shows the maximum possible combinations of liberty and equality which can be realised. At point A, for example, equality is absolute and this point corresponds to all points  $X'-X'$  in Figure 4.1. Society can locate on or within this frontier but not beyond it. Applying the Pareto principle, efficiency demands that society locate on the frontier ( $D'-D'$ ) as the possibility of making Pareto-superior moves exists at any point within it. Statements about the efficiency of any location can be made but efficiency itself cannot be traded-off against either liberty or equality as it refers only to the desirability, or efficiency, of trade-offs made between other values.

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The notion of a trade-off is meaningless. For acceptance of this interpretation implies that efficiency can be defined only in relation to the ability of social and economic organization to attain their primary objectives and that therefore efficiency cannot itself be one of those primary objectives ... Efficiency is not an objective in the sense that [equality] ... is an objective; rather, it is a secondary objective that only acquires meaning with reference to primary objectives (Le Grand, 1990, 560).

Figure 4.4 Efficiency and Value Trade-Offs





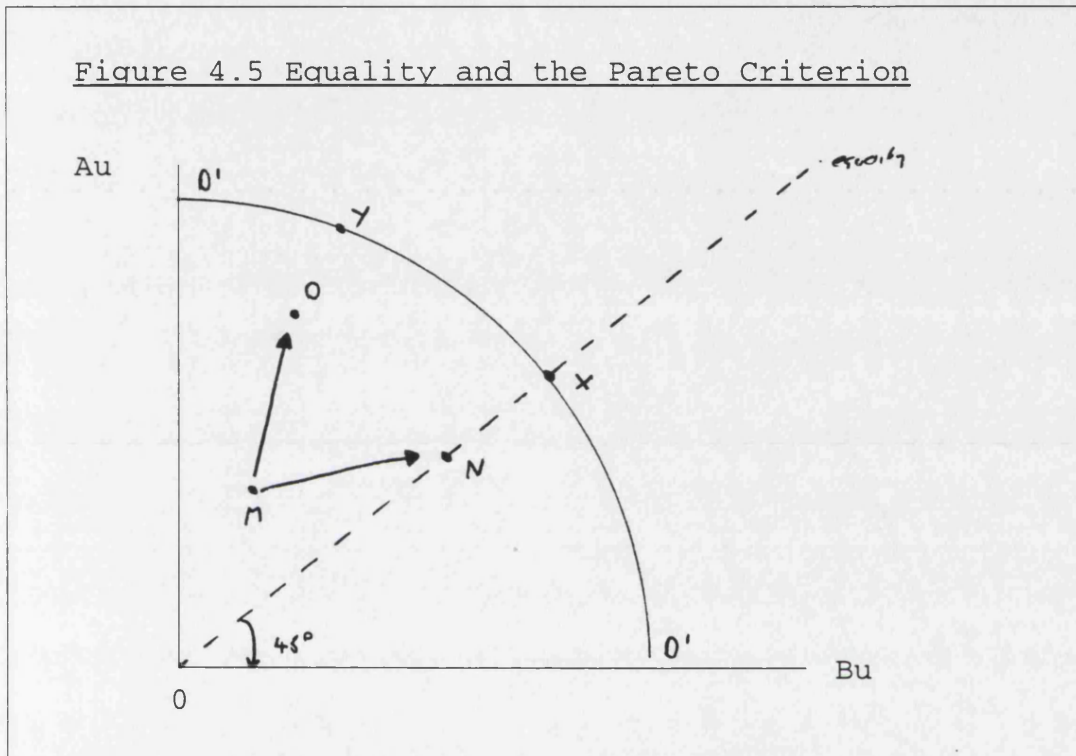
#### 4.4 Socialism and Pareto Efficiency

A definition of efficiency has been gained but the notion of a trade-off between efficiency and equality and with it a way of representing the conflict between socialism and entrepreneurship apparently lost. In this section it will be argued that the definition of efficiency gained is, for socialists, problematic. James Buchanan and Gordon Tullock (1962, 172) describe the Pareto principle as 'a very weak ethical postulate' which 'must be accepted by those who accept any form of individualistic values'. At one level, reasons for rejecting this claim can be easily found. Socialism is characterised by a commitment to equality, by a concern with redistribution and the Pareto principle is blind to considerations of redistribution.

As a natural consequence of ethical neutrality, Pareto dismissed the problem of an optimum distribution of wealth as one of concern to social ethics rather than economics (Cirillo, 1979, 43).

In the case of Pareto-optimality, no grounds exist for saying, in Figure 4.5, that position X is preferable to position Y. It is the absolute utility of individuals rather than relative distribution which drives the principle of Pareto-superiority. Pareto-superior changes which result in greater equality - from M to N - are no more likely and have no more appeal than those that result in greater inequality - from M to O. The case against the Pareto principle is straightforward. That redistribution

should be treated as irrelevant is itself a value judgement and one which socialists reject (Little, 1950, 87, Stretton and Orchard, 1994, 147).<sup>3</sup>

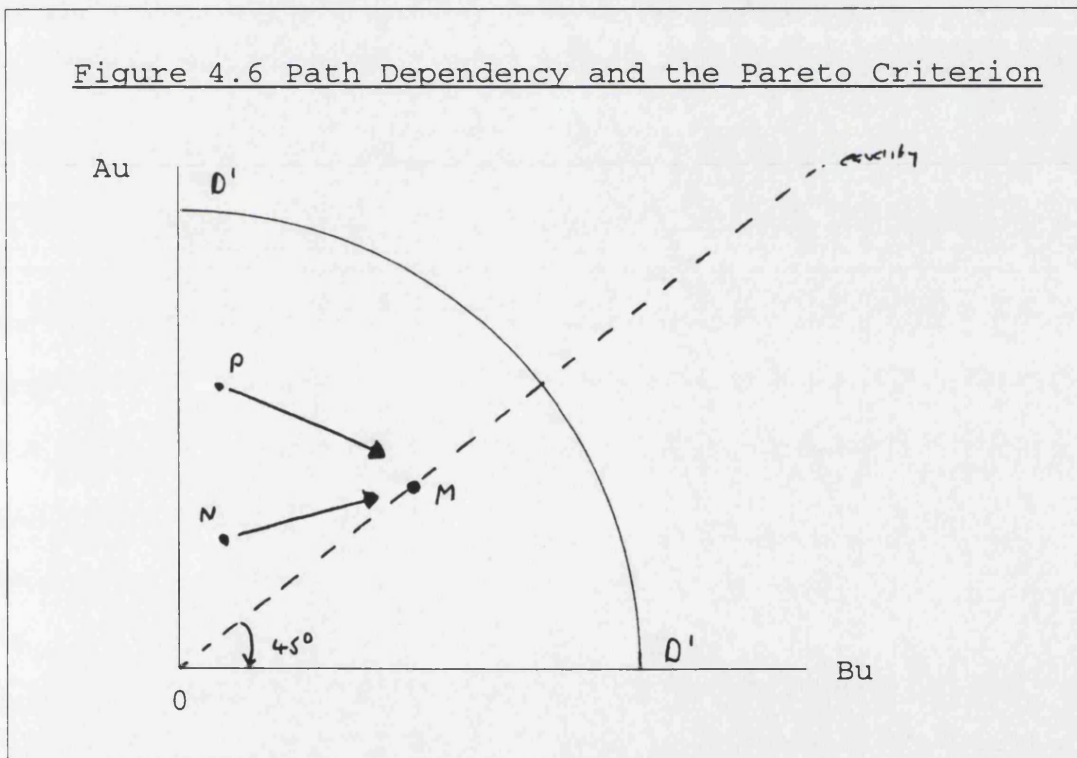


The Pareto principle's dependence on initial conditions can also be questioned. What constitutes a Pareto-superior move is 'path dependent'. In Figure 4.6, movement to point M is Pareto-superior if the initial starting-point is point N but not if it is point P. The Pareto principle has the effect of giving existing distributions a privileged position. The privilege carries less weight if the starting-point is near the origin (0) but is restrictive if the initial starting-point is near the Pareto

<sup>3</sup> Again, the criticism is really directed not at Pareto but at his disciples. Pareto (quoted Barry & Hardin, 1982, 140) is careful to emphasise that 'considerations foreign to economics ... ethics, social utility or something else' should also be used to determine policy'.

frontier. Why is this so bad? Socialism operates with a 'patterned' rather than a 'process' theory of justice (see Nozick, 1974, 155-60). This means that the desirability of distributions is judged in terms of the distribution itself and not in terms of the way it was attained. Equality is valued regardless of whether the existing distribution is equal or unequal and for this reason, the conservatism of the Pareto principle is anathema to socialism.

Figure 4.6 Path Dependency and the Pareto Criterion



Buchanan (1985, 7) suggests that the Pareto principle offers the 'most comprehensive' tool for assessing efficiency but this claim can also be challenged. The limitations of the Pareto principle are technical as well as political. Whilst the Pareto principle can be used to pronounce on the welfare implications of movements between points, it is frequently unable to say which of two points is itself preferable. In Figure 4.6, the movement from P

to M is not Pareto-superior but points P and M are themselves Pareto-incomparable. Whilst the Pareto principle can be used to support the conclusion that point M is better than point N, it cannot be used to derive a complete and transitive preference ordering between all points.

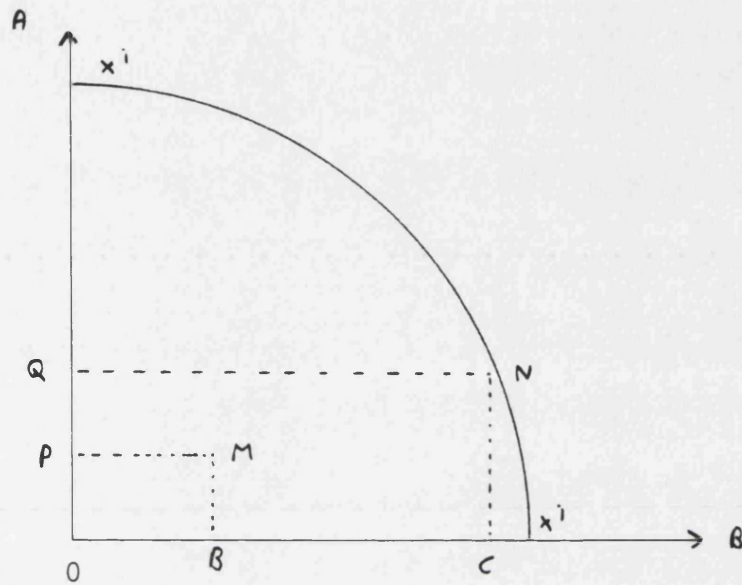
The same objection can be raised against the use of equality of income. To return to Figure 4.1, equality can be used to establish the desirability of N over M but not that of N over P or between any points that are equally equal and this may also be taken to constitute not only a technical but a political limitation as, intuitively, point N appears preferable to point P. Socialism can rely upon its other values to generate a complete and satisfactory preference ordering. Even if points N and P are equally democratic and free, elections can be expected to yield a preference for N over P as individuals will be unlikely to vote for the latter. Alternatively, socialism can make use of the Pareto principle as a second order means by which to rank otherwise equal outcomes as point N is Pareto-superior to P. Many rational choice theorists use the Pareto principle in a stronger way. In Buchanan and Tullock's (1962) hands the claim that Pareto-superior moves should be made is joined by the far stronger and more controversial claim that only Pareto-superior moves should be made (Barry, 1990, 51-2). That the conclusions they then reach are anti-socialist is not surprising but this does not mean that the Pareto principle need be anti-socialist if it is used more sparingly. The socialist should only object

to its use as a 'fully fledged ultimate principle' (Barry, 1990, 50).

#### 4.5 Beyond Pareto: The Equality-Efficiency Trade-Off Again

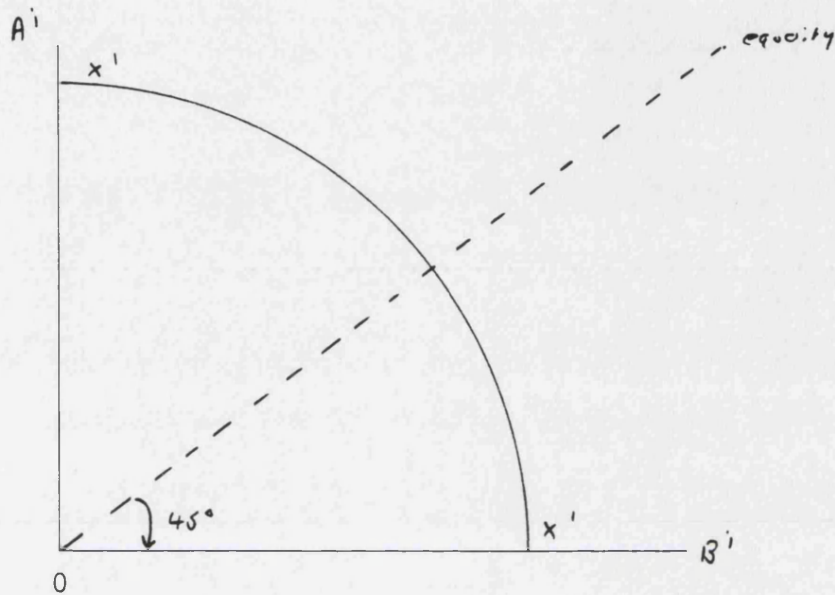
If the trade-off between efficiency and equality is to be reconstituted, an alternative definition of efficiency must be found. Rather than define it in terms of allocation, efficiency is here thought of in terms of productive efficiency and to tie discussion to entrepreneurship use is made of the concept of the production possibility frontier (PPF). In Figure 4.7, combinations of two goods, A and B, which it is feasible to produce are shown along the PPF, X'-X'. The greater the number of goods produced, irrespective of the mix, the greater the efficiency of the economy. At point M, total production is O-B-M-P and at point N is O-C-N-Q. All possible points within and on the PPF will be either more, less or as efficient as all others. The ranking will be both complete and transitive. Entrepreneurial coordination - movement toward the PPF - and entrepreneurial innovation - movement beyond the existing PPF - increase efficiency.

Figure 4.7 Production and Efficiency



It has already been argued in Chapter One that productive efficiency is positively related to income. The discovery of profit opportunities through entrepreneurial action generates income growth. In Figure 4.8, the PPF is drawn against the background not of the production of two goods but of the income (i) of two individuals, A and B.

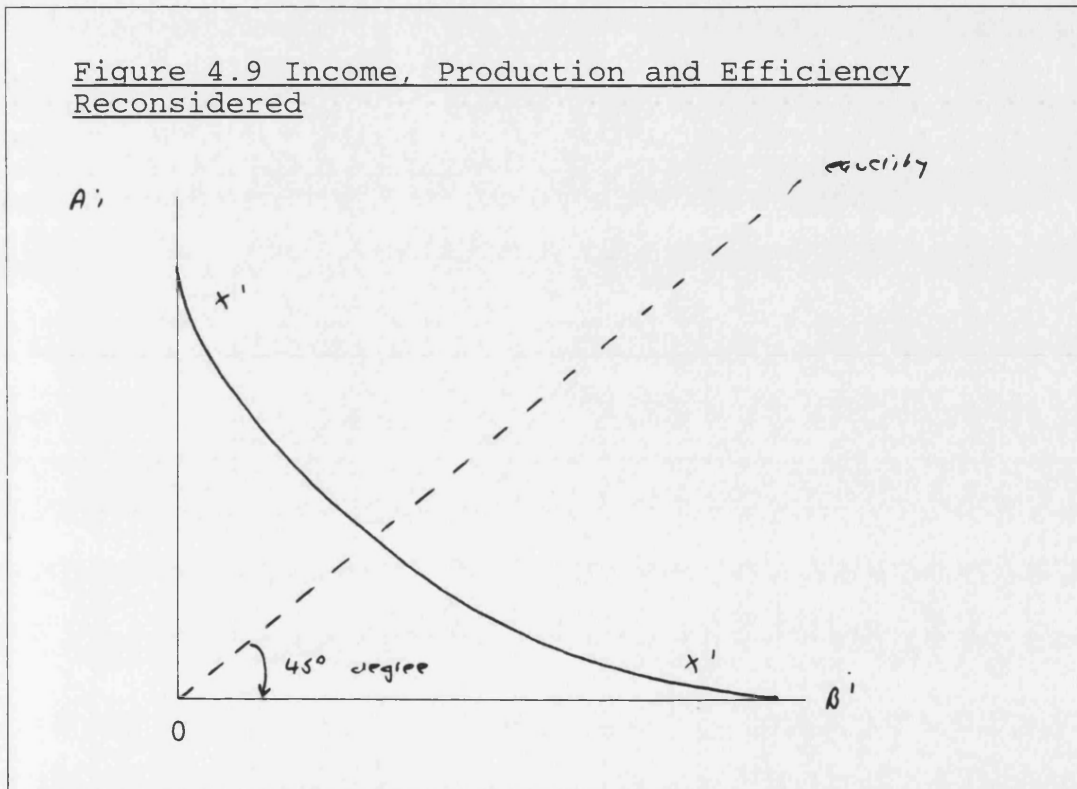
Figure 4.8 Income, Production and Efficiency



The PPF is equivalent to Le Grand's 'objective possibility frontier' and depends on knowledge of existing 'resources, economic system, individual's psychologies, etc.' (Le Grand, 1991, 26). In Le Grand's argument, in standard economic texts (Hardwick, 1982, 99, Beardshaw, 1984, 38, Eaton and Eaton, 1988, 24, Samuelson and Nordhaus, 1992, 25) and in Figures 4.7 and 4.8, it is assumed (i) that the PPF is convex to the origin, and (ii) that there is only one PPF. Both assumptions can be challenged.

Convexity in the PPF is built on the assumption of diminishing marginal returns. This is appropriate if, as in Figure 4.7, the PPF refers only to production of goods. The assumption of a positive relationship between income and production in Figure 4.8 complicates discussion. In Chapter Three it was argued that the

prospect of inequality and the prior existence of inequalities facilitates entrepreneurial action and increases efficiency. The PPF should, as in Figure 4.9, be concave rather than convex to the origin.

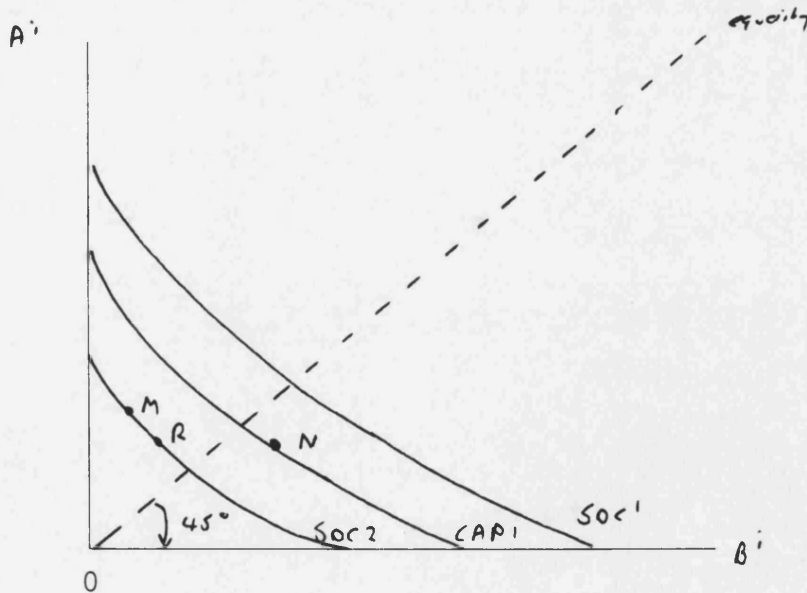


Le Grand, it will be recalled, isolates three factors which determine the position of the PPF and two of these three can be expected to remain constant following the transition to socialism. Individuals will remain egoistic utility maximisers and resources - at least natural ones like, for example, coal - will remain as plentiful. But capitalism and socialism are likely to have very different economic systems. In Chapter Two it was argued that capitalism is characterised by private ownership a



decentralised markets and in Chapter Three it was assumed that socialism is characterised by state ownership and central planning. Each system will be likely to have a different PPF. Furthermore, economists will disagree about their relative position. As shown in Figure 4.10, Taylor and Lange believe that the socialist PPF (SOC1) lies above the capitalist one (CAP1). Hayek and Mises argue that this claim rests upon an inadequate understanding of the nature of the market and of the importance of incentives. The 'true' socialist PPF (SOC2), they argue, lies below the capitalist one.

Figure 4.10 Political Argument and the Production Frontier



Further complication arises here. Socialism has been defined in terms not of ownership or allocation mechanism but of

political values. It was assumed by Lange and Taylor that to achieve equality it is necessary to suppress private ownership and markets but given the definition of socialism in Chapter One and even though it lies on the socialist PPF, point M in Figure 4.10 cannot be described as socialist as it depicts an extremely unequal distribution of income between A and B. Equally, it was argued in Chapter Three that private ownership and markets will not generate income equality. Whilst point N in Figure 4.10 lies on the capitalist PPF, it will not be reached. It is not possible to stipulate any thresholds beyond which a society becomes socialist. It cannot be said that point R in Figure 4.10 is socialist but not point M. It can only be said that point R is more socialist. The PPF's in Figure 4.10 cannot be drawn in such a way as to accommodate this insight but the qualification should not be forgotten.

Roemer (1993, 90, 1994, 54) argues that socialist values are no different from social democratic ones and may even be embraced by liberal egalitarians. Values like exploitation or community which might easily distinguish socialism from its rivals have been excluded from the adopted definition. In a sense, this should not be regarded as a substantive problem. If the reader wants to replace the word socialism with that of social democracy they are free to do so but the framework developed can be used to distinguish between them.

Social democrats hope to realise the values of socialism within a capitalist system. Whilst social democrats accept that

capitalism will not naturally achieve equality they argue that it can be made to do so through redistributive taxation. Through social engineering, social democrats attempt to push society toward those points - like N in Figure 4.10 - that would otherwise not be attained. Roemer (1994, 54) doubts whether in the absence of 'the very special conditions necessary for its success' social democracy is a viable strategy and although they start from a very different ideological position, Hayek, Mises and Kirzner agree. They argue that the long-term effect of interference in capitalism will be the destruction of capitalism as redistribution erodes incentives for entrepreneurial action. Without having to assess the merits of their argument, socialism can be distinguished from social democracy by its willingness to transcend capitalism, to move to a new PPF.

There are two trade-offs between efficiency and equality. The first occurs within production frontiers and the second occurs between production frontiers. In each case, equality - as measured by proximity to the 45' line - is sacrificed as efficiency - measured by total production - increases. As entrepreneurial activity is necessary if production is to be increased, the greater these trade-offs, the more incompatible socialism can be said to be with entrepreneurship. Compatibility is not absolute but relative. How this trade-off is best managed will provoke political disagreement but the concern of subsequent chapters is with the extent (if any) of the trade-off itself. Attention is focused not on the demand but on the 'supply-side' (Barry, 1990, 8). Hayek and Mises argue that the trade-off within

the mathematical and competitive models is severe but this does not exhaust the possibilities for socialism and given the limitations of capitalist entrepreneurship (2.4), it is possible that a socialist PPF can be found which lies close to or even above the capitalist one.

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## 4.6 Market Socialism and Socialist Entrepreneurship

### 4.6.1 Market Socialism: An Introduction

Market socialism has a powerful appeal. As social democracy has stumbled, the promise of reconciling capitalist efficiency with socialist values has attracted considerable attention (Plant, 1984, Miller, 1989, Le Grand and Estrin, 1989, Nove, 1991, Bardhan and Roemer, 1993, Roemer, 1994). All of the models of socialist entrepreneurship considered in subsequent chapters are market socialist in that they have three features in common.

First, the competitive, decentralised market is the primary forum within which economic decisions are taken. Critics argue that market socialism is flawed as it takes as its foundation spurious neo-classical arguments about the workings of the market (Stiglitz, 1993, Makowski and Ostroy, 1993) but whilst this is certainly the case with Lange and Taylor's models of market socialism, the variants considered presently are shown to be less vulnerable to Austrian attack. It is this feature which recommends market socialism as a solution to the problem of socialist entrepreneurship. To cope with the objections raised in Chapter Three, it is necessary that socialism use decentralised markets to stimulate the discovery, communication and coordination of entrepreneurial knowledge.<sup>4</sup>

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<sup>4</sup> This provides further justification for having dispensed with the Pareto principle. An important part of the neo-classical apparatus is the demonstration that all competitive equilibria are Pareto-optimal and the Austrian critique of the neo-classical model is also a critique of the Pareto principle. As Don Lavoie

Second, market socialism envisages the need to alter patterns of ownership if socialist values are to be realised (Bardhan and Roemer, 1993b, 15). Market socialists are not social democrats and social democrats do not become market socialists by accepting that 'without some market influence the economy will be inefficient and unresponsive to consumer's needs' (Hattersley, 1987, 163). The rejection of capitalist private ownership does not commit market socialists to any particular alternative. There is no single and unique form of market socialism. Models that rest upon common ownership, worker owned firms and state ownership are all considered. Third, market socialism embraces the political principle of liberty in a way that 'classical' socialism does not. As liberty has already been included in the definition of socialism, this feature of market socialism requires less explanation.

#### 4.6.2 The Evolution of Market Socialism

Roemer (1994) traces five stages in the evolution of market socialism. The first was marked by the recognition that prices would be needed in a socialist economy to allocate resources. The second was the mathematical and the third the competitive solution. The nature of the debate here and Mises' and Hayek's responses have already been examined. The fourth stage came with attempted market socialist reform in some Communist bloc

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(1985, 173) comments, 'Hayek was elaborating an approach to reeconomics that seeks to replace the neoclassical welfare criteria of pareto-optimality'.

countries: Yugoslavia after 1950; Hungary a decade later; Poland in the 1980's and the Soviet Union under Gorbachev. Confusingly, Roemer also argues that the fourth stage of the debate was distinguished by a new theoretical assault that accused market socialists of neglecting the importance of incentives. The fifth stage of the debate surrounds market socialist's response to these objections. Roemer (Bardhan and Roemer, 1993b, 8) suggests that this fifth stage has pushed debate beyond Hayek's arguments as he assumed the 'good intentions of most firm management'. This is incorrect. In pointing to the deleterious impact of attempts to impose equality, Hayek shows that he is aware of the importance of incentives. What can be said is that as market socialists have conceded ground to their opponents on, for example, the possibility of central planning, incentives have become central to the debate.

Market socialists accept that the market is necessary to successfully guide entrepreneurial action but deny that the market can only operate in conditions of private ownership and inequality. Instead and in ways to be shown, they argue that incentives can be designed in ways that will motivate entrepreneurial action without sacrificing equality. Critics suggest that it is impossible to have one without the other: that 'there is no real decentralization without private ownership' (Kornia, 1993, 52). Friedman (1981, 8) makes the same point.

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A second function that prices perform is to provide an incentive for people to adopt the least costly methods of production and to use available resources for the most highly valued uses. They perform that function because of their third function, which is to determine who gets what and how much - the distribution of income (1981, 8).

Subsequent chapters are part of the fifth stage of the market socialist debate in that they are specifically concerned with incentives for entrepreneurial action. Here, a commitment to rational choice analysis and the assumption of egoism is valuable as this framework lends itself naturally to the analysis of incentives.

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## Chapter Five

### **Moral Incentives and Socialist Entrepreneurship**

- 5.1     Introduction
  
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  - 5.2.1   Moral Incentive Socialism: The Proposal
  - 5.2.2   Efficiency: Moral Incentive Socialism and Capitalism Compared
  
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  - 5.3.1.1 Moral Incentives and the Possibility of Cooperation
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  - 5.4.1   Kibbutzim and Moral Incentive Socialism
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- 5.5     Conclusion

## 5.1 Introduction

Like capitalism, market socialism comes in many forms. The next two chapters review two models of market socialism and assess their compatibility with entrepreneurship. It is not claimed that these are necessarily the best or most sophisticated variants but they each raise interesting theoretical issues, are amenable to rational choice analysis and have the advantage of having actually been practised in some way. Joseph Carens's Equality, Moral Incentives and the Market (1981) is an ambitious and interesting attempt to square a theoretical circle. Carens' (1981, x-xi) suggests that 'moral incentives [can] be used to pry the organisational advantages of the market from [its] distributional disadvantages'. Moral incentive socialism (MIS) promises to transcend the trade-off between equality and efficiency and this chapter will present a heavily qualified defence of Carens' argument. Moral incentives can sometimes be used to motivate behaviour but only in the presence of specific extraneous conditions.

The chapter is divided into three sections. In section 5.2, Carens' argument and the assumptions which sustain it are introduced and it is argued that MIS can not only emulate but enhance capitalist efficiency. The possibility that MIS should be regarded as simply a utopian fantasy is considered and rejected. The principal objection to MIS is one not of desirability but of feasibility. Given the assumption of egoism

it appears unlikely that individuals will respond to moral incentives. Carens' defence, that socialisation can be used to secure cooperation, is examined in section 5.3 and the efficacy of this solution is shown to depend upon the presence of particular environmental features. In section 5.4, this theoretical argument is applied to a study of Israeli Kibbutzim. The ways in which the organisational structure and social environment of the kibbutz make possible the use of moral incentives is illustrated. Ultimately, the conclusion is a pessimistic one: the demands of neo-pluralist entrepreneurship lead to the reemergence of a trade-off between efficiency and equality.

## **5.2 Equality, Moral Incentives and the Market**

### 5.2.1 Moral Incentive Socialism: The Proposal

The foundations of Carens' argument echo the conclusions of earlier chapters. First, decentralised and competitive markets are a necessary prerequisite for economic efficiency. Specifically, this has been interpreted to mean that markets facilitate entrepreneurial coordination and innovation. Second, whilst central planning and public ownership protect equality they are significantly less efficient. Third, capitalism generates inequality and so frustrates the realisation of socialist values.

MIS envisages an economy in which the market remains the salient mechanism through which production is organised and wages, employment and profit levels determined. Subject to standard limitations, entrepreneurs are free to either employ, exchange, destroy or neglect their resources and in doing so will confront a hard-budget constraint: sustained losses will lead to bankruptcy. Price discrepancies and uncertainty will stimulate the discovery, communication and coordination of knowledge.

It is proposals for the distribution of income which distinguish MIS from capitalism. Rather than entrepreneurs retain their profits (and losses) and employees their wages, all income is placed in a central pool from which each individual draws an equal amount. In a sense, ownership within MIS remains private.

In Honore's terms (2.2), entrepreneurs retain the exclusive right to possess, use and manage the means of production. By this criterion, it appears that whilst MIS utilises the market and promotes equality it is not market socialist. The description nonetheless remains appropriate because (crucially) entrepreneurs do not retain the right to a (unequal) income from their property. The fundamental ethos of MIS is public rather than private.

Individuals in MIS are not required to attain what Carens (1981, 41) calls their 'maximum earning capacity': toiling twelve hours a day, seven days a week. Such behaviour is not characteristic of capitalist systems where individuals trade-off leisure against income. MIS requires only that individuals work as hard as they do under capitalism: that they deviate no further from their maximum earning capacity. Instead of working to secure 'income consumption satisfactions' for themselves, individuals are motivated by 'social duty satisfactions'. The three necessary and sufficient conditions for the success of MIS are that:

First, individuals in the [MIS] system believe they have a social duty to earn as much pre-tax income net income as they are capable of earning.

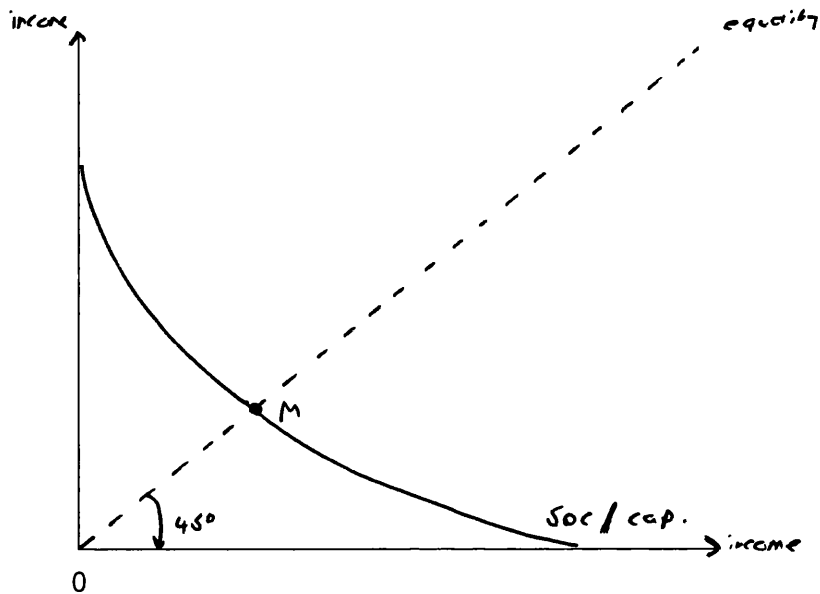
Second, individuals in the [MIS] system derive satisfaction from performing this social duty to earn as much pre-tax income as they can.

Third, individuals in the [MIS] system place the same relative value on the satisfactions derived from performing their social duty to acquire pre-tax income as individuals in the private property markets place on the satisfactions derived from acquiring income for consumption (Carens, 1981, 25).

### 5.2.2 Efficiency: Moral Incentive Socialism and Capitalism

MIS retains the methods of capitalist production but revolutionises its method of distribution. Carens' intention is to demonstrate that - given certain assumptions - socialism can be as efficient as capitalism. In terms of the discussion in Chapter Four, MIS argues (Figure 5.1) that the socialist (SOC) production possibility frontier can be raised to the point where it meets the capitalist (CAP) one and that the frontier can be reached at the point of absolute equality, M. The trade-off between efficiency and equality is eliminated.

Figure 5.1 Moral Incentive Socialism, Efficiency and Equality



Because MIS retains the capitalist system of production it will be burdened by the same entrepreneurial inefficiencies. Monopolies and periodic recession will, for example, still frustrate growth. The difficulty for MIS is that if it can never be more efficient than capitalism, any deviation from the pursuit of social duty satisfactions will mean that it is less efficient than capitalism. MIS lacks any cushion with which to protect itself. Whilst Carens satisfies himself with the conclusion that MIS can be as efficient as capitalism, it is useful to consider whether MIS has the capacity to be more efficient than capitalism.

First, capitalist inequality is itself a source of inefficiency. Poverty breeds crime and necessitates the expenditure of

resources on its prevention, detection and deterrence. Poverty also undermines health and psychological well-being and resources are squandered through both additional expenditure on health care and premature mortality. In an egalitarian society whilst crime and disease will not be eliminated they will be reduced and efficiency enhanced as additional resources become available for, say, government support of entrepreneurial activity.

Second, Carens assumes that the pattern of individual behaviour remains unchanged following the transition from capitalism. Given the difference in motivation, this assumption can be challenged as Carens (1981, 78) himself recognises that capitalism does not always encourage optimal entrepreneurial behaviour. Because income is subject to diminishing marginal returns, individuals are risk adverse and place more value on what they may lose than on what they may gain from entrepreneurial action. Capitalist entrepreneurs may decide that whilst a particular project is likely to be profitable in the sense that expected returns are positive, the risk is not worth undertaking. The costs of failure may outweigh the benefits of success and opportunities may be discovered but not exploited. Given the positive social benefits associated with successful entrepreneurial action, such decisions although rational for the individual frustrate growth. Because under MIS a entrepreneur will bear only a fraction of the costs or benefits of any action, this constraint will be removed and more entrepreneurial action will be undertaken. Society itself may be risk adverse but a single entrepreneur can still calculate that the actions of others will neutralise the impact of



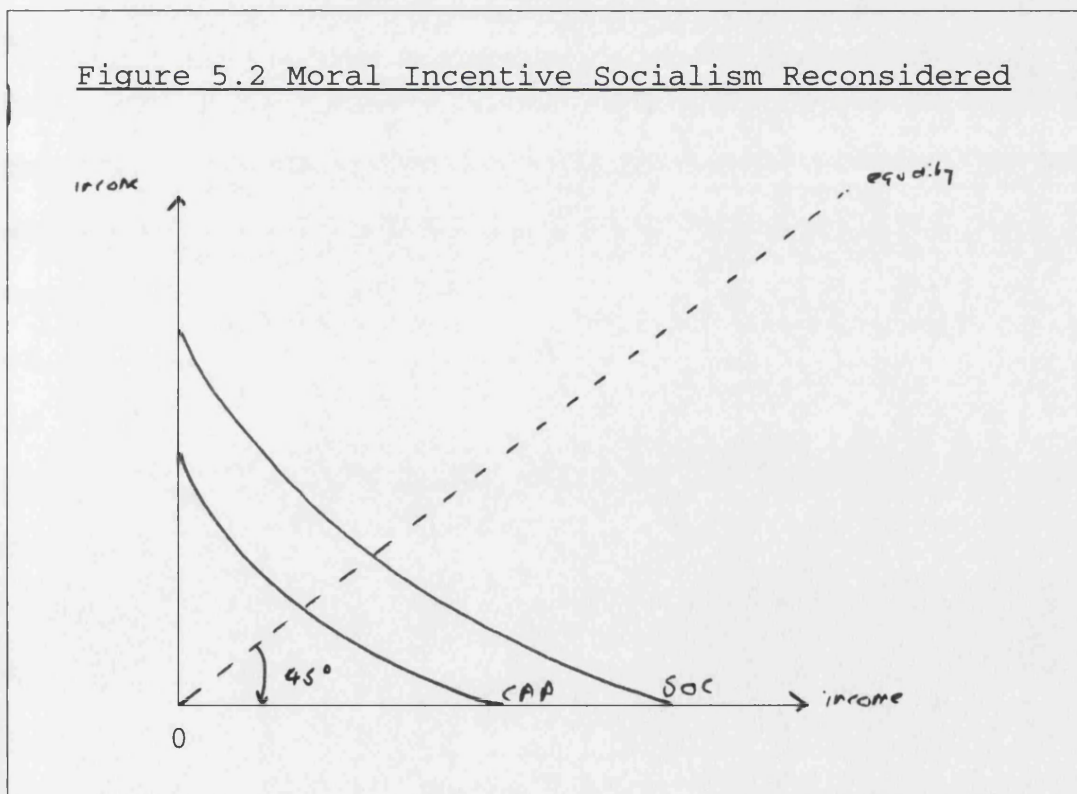
individual failure.

Third, capitalism encourages entrepreneurs not only to eschew particular ventures but occasionally to withdraw entirely from entrepreneurial activity. Again, diminishing marginal returns are central to the argument. If it is assumed that entrepreneurs are motivated by profit, the danger is that in acquiring wealth successful entrepreneurs lose their reason for being entrepreneurs. It is precisely the expansion in 'maximum earning capacity' which reduces the incentive to labour. Successful entrepreneurs are less likely to remain entrepreneurs than unsuccessful ones. Under MIS no such effect is found. Motivated by 'social duty satisfactions', the entrepreneur has no choice but to continue to work as hard as before.

Fourth, it was argued in Chapter Two that capitalism is inefficient because it encourages individuals to take account only of the marginal private benefits and costs of their action and so undersupplies entrepreneurial activity. Will entrepreneurs behave in the same way under MIS? It is easy to see why they may not. Intent on maximising total rather than personal income, individuals will have reason to account for the marginal social benefits of entrepreneurial activity. Average entrepreneurial profits will be reduced but total welfare increased through increased entrepreneurial activity. The argument here is perhaps speculative as the market is intolerant of externalities and many entrepreneurs will be forced into bankruptcy by supplying the optimal level of entrepreneurial activity but individuals may

reasonably calculate that their earning capacity is maximised in a occupation in which they make lower profits.

These arguments are a mixed blessing for MIS. Positively, they suggest that the socialist production possibility frontier (SOC2) may lie above the capitalist (CAP) one (Figure 5.2). Negatively, they suggest that even assuming the efficacy of social duty satisfactions, behaviour will change following the transition from capitalism. Here, the implications are to MIS's advantage but recognition that behaviour is dependent upon environment is used in the next section to question the feasibility of MIS.



Whilst MIS is a relatively simple theory, its assumptions are so radical that it is nonetheless tempting to dismiss Carens' argument as simply utopian. On occasions, Carens himself lends

credence to such an interpretation. Equality, Moral Incentives and the Market is subtitled An Essay in Utopian Politico-Economic Theory and Carens (1981, 20) asserts that MIS is possible only in the sense of being 'logically possible'; neither physically impossible or internally contradictory. But if MIS is a utopia, it is a strangely unappealing one. First, it perpetuates aspects of capitalist inefficiency. Second and although it secures income equality, MIS reaffirms capitalist power inequalities (Carens, 1981, 179). This does not jeopardise MIS's socialist credentials as equality has been defined purely in terms of income but neither was it claimed that socialism is utopian. Third and if it is purely utopian, MIS does not supplement the theoretical armoury with which capitalism can be attacked: an attribute that Barbara Goodwin and Keith Taylor (1982, 22) see as one of the primary justifications for utopian theorising. Is Carens simply affirming the inevitability of the existing trade-off between equality and efficiency in the 'real world'? If so, he is offering a powerful defence of capitalism. For these reasons, MIS is treated as a serious political programme: in Carens' (1981, 185) rather confusing terminology, as a 'realistic utopia'. The concern of subsequent sections is with identifying the 'empirically necessary prerequisites' (Carens, 1981, 20) of MIS and establishing the realism of the assumptions used.

### **5.3 Moral Incentives and Collective Action**

#### 5.3.1 Moral Incentives and the Possibility of Cooperation

After the transition to MIS, individuals will face a choice of whether to alter their behaviour. Individuals must decide whether to continue to realise the same percentage of their maximum earning capacity or to reduce their efforts. We will call these choices cooperation and defection respectively. Defection may mean an individual stopping work, not trying when at work or trying as hard in a job in which their maximum earning capacity is lower. The feasibility of MIS depends upon most individuals choosing cooperation rather than defection.

Carens (1981, 18) claims that his is a rational choice model of socialism. It was argued in Chapter One that rational choice models are composed of both 'core' and 'auxiliary' assumptions, the core assumptions being those of rational action and methodological individualism. Auxiliary assumptions attempt to describe the environment within which individuals operate. Expectations about individual behaviour are derived from both core and auxiliary assumptions. William Niskanen's (1971) budget-maximising model depends, for example, on the auxiliary assumption that politicians lack both the capacity and incentive to closely monitor bureaucratic behaviour and it follows that a change in the environment may change behaviour. If the number of politicians is increased or their pay made to depend upon performance then budget-maximising may cease.

MIS is characterised by a significant environmental change. In a capitalist system, individuals can either (i) work and be paid, (ii) work and not be paid, or (iii) not work and not be paid.<sup>1</sup> Some individuals choose to 'drop out' and not work and a thriving voluntary sector indicates that many choose to work and not be paid but most choose to work and to be paid for their work. MIS is characterised by the addition of another option: individuals can eschew their social duty satisfactions and defect, not working but continuing to be paid from the common income pool. Carens argues that this environmental change will not alter behaviour. Is he right to do so?

If individuals are altruists with 'complete social consciousness' (Sen, 1966) the argument is tenable but it has already been assumed that motivation will remain egoistic. Equally, if individuals derive utility from work and for this reason prefer cooperation to defection, behaviour will remain unchanged. Karl Marx employs such an assumption in his defence of communism (Elster, 1985, 526-7) and Carens (1981, 133) does briefly mention the possibility that individuals will develop a 'primary preference for work'. More generally, Carens implies that work will continue to be seen as a burden, undertaken only for instrumental reasons: to acquire social duty satisfactions. Besides, a primary preference for work does not insulate MIS from criticism. Individuals will still be expected to maximise their

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<sup>1</sup> It may reasonably be objected that (i) the presence of a welfare system gives individuals an option to not work and be paid (something), and (ii) that unemployment means that not all can choose to work and be paid.

earning capacity and will not be free to 'hunt in the morning, fish in the afternoon, breed cattle in the evening and criticise after dinner' (Marx, 1846, 169) even if this is what they most enjoy doing. MIS appears easy prey to those in the fourth generation debate who argue that market socialism destroys incentives. Brian Barry's (1990, 7) argument that, 'it is a bad idea to set things up so there is a ... incentive to do wrong' could have been written as the preface to a critical review of Carens' argument. Most individuals will not work to the same percentage of their earning capacity and efficiency will be impaired. Equality will be realised but only at a low level of low income.

Carens is not so naive as to deny the existence of this problem and the threat it poses to MIS. The solution he offers is the familiar one of socialisation.

I am claiming that there is sufficient evidence based on our empirical knowledge of the range of human cultural values to conclude that human nature is so flexible that, given the proper conditions ... almost any goals could be adopted on a widespread basis in a society (Carens, 1981, 104).

If successful, socialisation results in the emergence of norms of cooperation. Rational choice theorists are generally sceptical of the value of this approach. James Coleman (1990, 242) suggests that whilst

norms may be taken as axiomatic by many sociologists ... for others they constitute an unacceptable *deus ex machina* - a concept brought in at the macrosocial level to explain social behaviour, yet itself left unexplained.

If socialisation and norms are to be used to rescue MIS they must be given 'micro-foundations'. The most obvious route to take here and the one employed by Carens is to posit the maintenance of norms as being dependent on the application of sanctions. Sanctions are of two kinds: external and internal. Externally, individuals who defect will be chastised by colleagues and friends. Here, the desire for social acceptance will be sufficient to secure cooperation. Internally, Carens suggests that individuals will eventually regulate their own behaviour and cooperate even in the absence of external sanctions. MIS will still have a different option set from capitalism in that it will still be possible for individuals to not work and be paid but if sanctions are sufficiently severe, this option will not be taken.

Carens (1981, 96-9) accepts that internal sanctions will only emerge after external sanctions have proven effective. The feasibility of MIS therefore depends on the extent to which external sanctions can be used to regulate behaviour. Game theory can here be used as a tool of analysis, individuals being represented as participants in a prisoners dilemma. In the absence of sanctions, each will prefer the reward (R) of universal cooperation (work, paid) to the punishment (P) of

universal defection (not work, not paid). Individuals have an incentive to act strategically, defecting in the hope that others will work and that they will receive income. The temptation (T) (not work, paid) to defect will be increased by the fear of being the sucker (S), an isolated cooperator whose income will be divided amongst others (work, not paid). In a one-shot game and even though the outcome is not Pareto-optimal, the dominant strategy is one of defection. As Figure 5.3 shows, no matter what others do, defection will maximise utility. If others cooperate the individual will prefer to defect ( $T > R$ ) and if others defect the individual will prefer to defect ( $P > S$ ). As all will react in the same way, the outcome is the punishment of universal defection.

Figure 5.3. Moral Incentive Socialism and the Prisoners Dilemma

		<u>Others</u>	
		Cooperation	Defection
<u>Individual</u>	Cooperation	R, R	S, T
	Defection	T, S	P, P

Where    P = punishment    T = temptation  
           R = reward        S = sucker

and  $T > R > P > S$



It may be objected that MIS will be characterised by repeated interaction. Individuals will have to make a series of (daily) choices about whether to cooperate or defect and cooperation in an iterated game is more likely than in the one-shot game because individuals may be able to monitor others behaviour and apply sanctions if they defect. Robert Axelrod (1984) shows, for example, that by playing a strategy of 'tit-for-tat' and making cooperation conditional on the behaviour of others, utility can be maximised. Carens's solution no longer appears utopian: sanctions will emerge naturally over a period of time.

Alan Carling (1991, 187-9) ridicules the belief that cooperation cannot be sustained in a iterated prisoners dilemma and it is worth pausing here to examine his argument. The two actors in a capitalist economy, entrepreneurs and consumers, have two resources under their respective control: goods and money.<sup>2</sup> Both value the resource that they have but value the resource of the other more highly and this makes for the possibility of a mutually beneficial exchange. The entrepreneur is most satisfied with an outcome in which they keep their goods and gain the consumer's money and are least satisfied with an outcome in which they lose their goods and fail to gain money. Their second most preferred outcome is one in which they exchange goods for money and their third most preferred outcome is the absence of any exchange. The consumer most prefers an outcome in which they acquire the entrepreneur's goods and retain their money and they

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<sup>2</sup> Although the logic and presentation of the argument is identical, Carling speaks only of two actors, X and Y and two goods x and y which are owned by X and Y respectively.

are least satisfied with an outcome in which they lose their money and fail to acquire any goods. Their second most preferred outcome is one in which they exchange money for goods and their third most preferred outcome is the absence of any exchange. Using (G) to denote goods, (M) money, (+) for having and (-) for not having resources, their respective preference orderings are shown in table 5.1.

Table 5.1 Preference Orderings Under Capitalism

<u>Entrepreneur</u>	+G, +M	>	-G, +M	>	+G, -M	>	-G, -M
<u>Consumer</u>	+G, +M	>	+G, -M	>	-G, +M	>	-G, -M

If both cooperate and exchange resources, each will receive the reward of their second most preferred option. If neither cooperates and exchange does not take place, each will receive the punishment of their third most preferred option. Cooperation is Pareto-superior to defection but each will be tempted by unilateral defection and fear being suckered into unilateral cooperation. The situation is that of the prisoners dilemma and if it is argued that cooperation in such circumstances is unlikely it must be concluded that

beneficial exchange between beneficial owners of resources will not take place ... non-cooperative game theory is the theory par excellence of liberal individualism, yet the theory holds that free-market individuals can't get it together in a free-market relationships. Or, to choose a form of words which would ingratiate me among orthodox Marxists .... bourgeois persons don't behave in bourgeois fashion, according to bourgeois theory (Carling, 1991, 188-9).

The defence is complete. Cooperation is no less likely under socialism than it is under capitalism. The promise of 'spectacular prizes' (Schumpeter, 1943, 73) is not necessary to motivate entrepreneurs and the feasibility of MIS does not depend upon the emergence of altruism.

### 5.3.2 Moral Incentives and the Conditions for Cooperation

Carling's argument is instructive in that it can be used to establish important differences between capitalism and MIS. That cooperation occurs in the former does not mean that it will occur in the latter. That sanctions are sometimes capable of sustaining cooperation does not mean that sanctions are always effective. As the 'Folk Theorem' establishes, there is no dominant equilibrium in an iterated game: anything can happen (Heap and Varoufakis, 1995, 171).

At one level, Carling's argument seems to rest on a misunderstanding of game theory. The actors in his model are engaged in an exchange relationship and are free to confront each other within the market. In Albert Tucker's initial formulation of the prisoners dilemma, individuals are placed in separate police cells, are not free to communicate and are not engaged in an exchange relationship. Furthermore, cooperation within capitalism is made possible by the immediately conditional nature of exchange. The consumer only parts with her money when the entrepreneur hands over the goods. Some capitalist transactions depend on trust. With a mail order firm, the consumer must send her money and wait for the goods to arrive but the number of such non-simultaneous exchanges is low. Within MIS, a greater burden is placed upon trust. Individuals must work now in the hope of drawing from a common pool of income later.

Second, cooperation is made possible within capitalism by the presence of third parties like the state (North, 1990) but also, on occasions, bodies like the Mafia (Gambetta, 1993) who can enforce promises of exchange when transactions are non-simultaneous. Cooperation within MIS is not legally enforceable. Carens suggests that individuals should cooperate but not that they must cooperate. Given the example of the Mafia it may be objected that what matters in securing cooperation is not legal status but the strength of the sanctions brought to bear on participants. As MIS utilises sanctions, it is no different from capitalist economies. This is to neglect Michael Taylor's (1987, 22) and James Coleman's (1990, 273) argument that the the

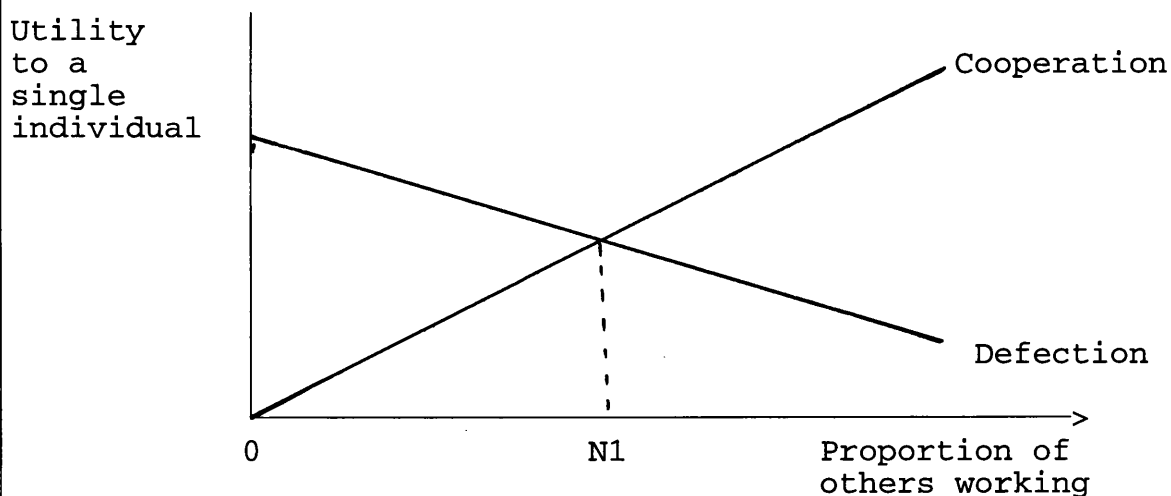
application of sanctions itself frequently depends on the resolution of a second-order collective action problem. The state enforces (legal) sanctions because in doing so it can justify collecting taxes. The mafia enforces (non-legal) sanctions to maintain its reputation for ruthlessness and because it profits from terror. It is not clear why individuals within MIS have an incentive to apply sanctions at a cost to themselves.

This is also to reveal a third important difference between MIS and capitalism. In a capitalist system, the severity of punishment administered to defectors is independent of the number of other defectors. In the case of non-legal sanctions this is not the case (Chong, 1991, 112). Consider a sanction that takes the form of withdrawing future cooperation from defectors. Those affected will still be able to interact with other defectors and if they form the vast majority of the population, the impact of the sanction will be negligible. Similarly, Russell Hardin (1982, 214-6) suggests that defectors suffer from losing their reputation and that having witnessed their defection, other potential partners will abandon them in favour of those with a reputation for fair play. If there are a large number of cooperators, such action is more likely to be exercised. At the margin, if there are no cooperators there can be no punishment.

The significance of the difference is illustrated in Figure 5.4. On the assumption that individuals gain utility from both leisure and income and that production is a monotonic function of the numbers working, the utility derived from either cooperation or

defection depends upon the number of others cooperating. The value of cooperation is shown as a function of the number of others cooperating. The larger the number of cooperators, the larger the pool of income from which an individual can draw. The configuration of the defection curve reflects the operation of two conflicting pressures. On the one hand, utility from defection rises in proportion to the number of cooperators as the size of the income pool increases. When all defect, individuals receive utility only from leisure as there is no common pool of income from which to draw. When all others cooperate, the single defector receives utility from both leisure and from income. At the same time, the utility of defection falls as social sanctions become more effective. If cooperators send defectors 'to Coventry', it matters how many cooperators there are. Between points 0-N1, defection remains the utility maximising strategy.

Figure 5.4 Cooperation within Moral Incentive Socialism



It may be objected that whilst in capitalist systems the actual punishment for defection is independent of others actions, this does not apply to the probability of detection and therefore the expected punishment of defection. But this is to suggest a fourth difference between capitalism and MIS. As Carling observes, whilst capitalist defection does occur, cooperation is the rule and it is easy to see in terms of Figure 5.4 how it is maintained. Comparisons between socialism and capitalism must be made with care as socialism has also to establish its capacity to induce as well as sustain cooperation.

The 'Folk Theorem' and environmental differences between capitalism and MIS suggest that cooperation is not certain. This is not to argue that cooperation is impossible. Carling (1991, 93) suggests that the possibility of cooperation depends upon the amount of fear and trust within a system and this argument is explicable in terms of previous analysis. Cooperation is more likely when (i) individuals fear punishment if they defect, and (ii) can trust in others to reciprocate their cooperation. The feasibility of MIS depends upon its capacity to generate fear and trust. Building on the work of Taylor (1987) and for any given sanction, six factors can be identified which will increase levels of trust and fear.

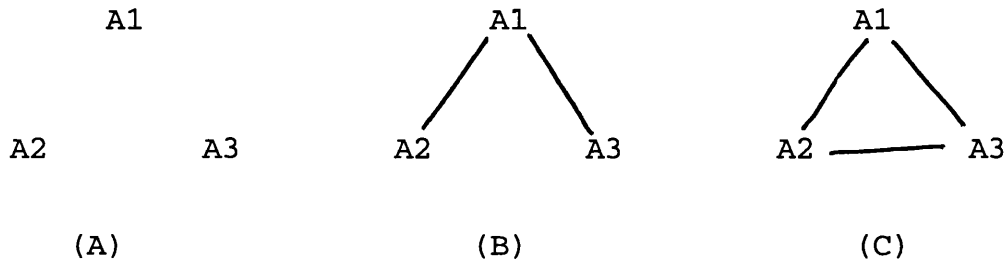
In the absence of selective incentives, cooperation is more likely in small groups (Olson, 1965, 48). In the presence of selective incentives, the impact of size is more ambiguous (Dunleavy, 1991, 49-50) but size may still be related to other

factors that induce cooperation. Second, cooperation is more likely amongst individuals who experience frequent interaction with each other. As already argued, iteration is important: if individuals meet only occasionally, fear and trust will erode. To return to earlier examples, withdrawal of social contact will matter less if social contact is already minimal and the entrepreneur will not fear the loss of their reputation if, for example, customers are only passing tourists (Hardin, 1982, 214).

Third, cooperation is more likely if networks of interaction are closed: if all individuals in a group interact with all others (Coleman, 1990). This is related to but distinct from the frequency of interaction which may simply be bilateral. If networks are closed, the effect of punishment will be amplified for the same reason that repeated interaction with any one individual encourages cooperation. In Figure 5.5, three possible networks between three individuals are shown. In the first (A) there is no interaction, in the second (B) there is interaction between A2 and A1 and between A1 and A3 but not between A2 and A3 and in the third (C) the network is closed. Cooperation is unlikely in (A) and is possible in (B) only on the condition that A3 and A2 can observe and learn from the other's interaction with A1 and react to each other accordingly. All other things being equal, cooperation is most likely in (C).



Figure 5.5. Sanctions and the Closure of Networks



(Coleman, 1990 277)

Fourth, cooperation is more likely to be sustained in conditions where punishment and trust 'spill-over' into different spheres of life. If those with whom individuals interact are not just business colleagues but also, for example, close friends, punishment will affect not only working but social life. Here, sanctions are more likely to be effective in establishing trust and fear.

Finally and to emphasise one specific implication of the second condition, fear and with it the possibility of cooperation will be reduced in groups from which individuals can easily leave. Sanctions are a form of voice and the probability of voice being exercised is inversely related to the opportunity for exit (Hirschman, 1970). Additionally, the actual impact of voice on those punished will fall as the possibilities of exit increase. An individual who is ostracised by colleagues for defecting is more likely to alter their behaviour if they cannot simply walk away from the organisation.

Groups where a large number of these conditions are present can be described as communities and the presence of a sense of community is the primary requirement for the success of MIS (Taylor, 1987, 105). Gerry Cohen (1996, 10) sees in community a value the pursuit of which distinguishes socialism from liberal egalitarianism and argues that socialists should pursue community as fervently as they pursue equality. In the case of MIS and given the more restricted definition of socialism in Chapter One, it can be concluded that community is not a goal to be pursued by but a prerequisite of a socialist society.

One final condition that returns us to a discussion of entrepreneurial action can also be identified as important in facilitating cooperation. Before being able to punish defectors, it is first necessary to know who has defected. If individuals are unable to monitor each others behaviour, cooperation will break down.

[cooperation] depends on reciprocation for the others action, inability to observe certain of the other side's activities makes it harder to achieve contract by convention (Hardin, 1982, 210).

Community encourages but does not always secure effective monitoring. Frequent interaction, small groups and closed networks are a necessary but not sufficient condition for cooperation. MIS raises particular difficulties for monitoring because producing less than others does not itself constitute

defection and therefore grounds for sanctioning. Carens demands only that individuals continue to reach the same percentage of their maximum earning capacity as before, not that they work as hard as others. Furthermore, sanctioning in MIS demands not only that individuals know how much effort an individual is putting into their existing occupation but also how much their earning capacity is elsewhere. An individual who works twelve hours a day as an accountant but who could have earned far more in eight hours as a surveyor is as guilty of defection as an individual who refuses to work after lunch. Immediately after the transition to socialism, it will no doubt be possible to point to individuals who are suddenly working less hours but this reference point will gradually disappear.

Certain occupations are also likely to frustrate effective monitoring. Putting to one side the peculiarities of MIS, if it is possible to observe individual output - the amount actually produced - it may be possible to know whether an individual has defected. Equally, if it is possible to observe individual input - the effort put into work - it may also be possible to detect defection. Occupations in which it is possible to observe both input and output (production organisations) are more likely to sustain cooperation. Occupations in which it is impossible to observe either input or output (coping organisations) are less likely to sustain cooperation. Figure 5.6 illustrates the possibilities.

Figure 5.6 Monitoring and Moral Incentives

		<u>Possibility of Monitoring Input</u>	
		High	Low
<u>Possibility of Monitoring Output</u>	High	Production Organisations	Craft Organisations
	Low	Procedural Organisations	Coping Organisations

It may be difficult to determine how hard an entrepreneur has tried by observing their output. If entrepreneurship depends on luck (Schumpeter, 1943, 73-4), individuals may try but still fail. It cannot be known whether an entrepreneur with an established record of successful ventures who suddenly loses large amounts of money is defecting or simply suffering from bad luck. The very concept of a maximum earning capacity for entrepreneurs is problematic. Much depends on the particular theory of capitalist entrepreneurship employed. Whilst Galbraith emphasises its predictable almost routine nature, Schumpeter stresses the vagaries of entrepreneurial life.

Entrepreneurship also resists the successful measuring of input. In other occupations, barriers are frequently physical. Journalism and forestry, for example, are necessarily solitary pursuits. The difficulties of monitoring entrepreneurial behaviour are cognitive rather than physical. It will be difficult to assess the alertness of an entrepreneur sitting at

their desk pondering future possibilities. Entrepreneurial knowledge is frequently tacit, of a kind that is resistant to monitoring. For someone to judge that an entrepreneur has not tried hard enough they will need to be aware of 'obvious' opportunities overlooked. The only person who can monitor an entrepreneur is another entrepreneur and anyone who discovers an overlooked opportunity will in doing so raise their own maximum earning capacity. If they are not themselves to be vulnerable to accusations of defection, the monitor will have to do more than monitor.

To conclude, it cannot be said that cooperation within MIS is either intrinsically likely or unlikely. Whilst there are important environmental differences between capitalism and MIS, these differences do not in themselves make cooperation impossible. Much will depend upon the particular features of the environment within which interaction takes place. Against the charge that MIS is utopian, the next section will show how these conditions have been realised within an existing economic community.

## 5.4 Equality, Cooperation and the Kibbutz

### 5.4.1 Moral Incentive Socialism and the Kibbutz

Martin Buber (1949, 2) describes the kibbutz as 'a utopia that did not fail'. Melford Spiro's (1972) work on kibbutzim is titled Kibbutz: A Venture in Utopia and Dan Leon (1969, 15) notes that the 'historical and spiritual sources which nourished the kibbutz movement in its early stages were not without certain traces of utopianism'. The first kibbutz, Degina, was formed in 1910. By 1964, there were over 300 kibbutzim whose members constituted ten per cent of the Israeli population. From austere beginnings, kibbutz life has been transformed. Leon (1969, 11-12) speaks of development from a

tiny camp of tents, housing a handful of barefooted pioneers in a malaria-ridden and hostile environment, into the flourishing settlements with hundreds of members which we take for granted today.

Kibbutzim are, in many respects, an embodiment of MIS. Equality is the foundation of the distributive process within the kibbutz and members are provided with basic necessities like clothing and food upon demand. For purchases that reflect individual tastes, members are given an identical yearly allowance. Much consumption is collective. Housing is often communal, members are given the opportunity to eat together three times a day and games and television rooms are open to all. Where equality of income is

abandoned, distribution is according to need rather than economic contribution (Rosenfield, 1983, 158).

Second, production is guided by the market. Each kibbutz is integrated into and competes with the rest of the Israeli economy. Kibbutzim do not strive for self-sufficiency. Products are sold in national and international markets and each kibbutz faces a hard budget constraint. Although all individual kibbutzim form part of a larger federation, few cross-subsidies occur and this creates a pressure to allocate resources efficiently. There is, for example, fierce competition between different branches of production for investment and skilled labour (Rayman, 1981, 106). In one final respect, kibbutzim appear more attractive than MIS in that all important decisions about the allocation of resources are made democratically in the General Assembly. This normally meets once a week and all members are entitled to speak and vote at it. Routine administration is undertaken by a Secretariat elected by members annually.

#### 5.4.2 Selective Incentives and the Kibbutz

In Chapter Three it was argued that an important and necessary function of markets is to provide incentives for entrepreneurial discovery. The promise of spectacular prizes is necessary to ensure spectacular entrepreneurial success. The achievements of kibbutzim belie this conclusion. Cooperation is not sustained by formal sanctioning for poor performance (Schwarz, 1954) as the constitution of nearly all kibbutzim expressly forbid cutting an

individual's allowance, of deviating from equality. Neither is cooperation due to the intrinsically satisfying nature of work on kibbutzim. If anything, the opposite applies. Most work is labour-intensive, manual and repetitive. General dissatisfaction is apparent in survey evidence which shows that only forty per cent of workers see their job as offering the opportunity to learn new skills and only forty three per cent as offering the opportunity to put new ideas into practise (Yuchtman, 1983, 184). Finally, it is unlikely that cooperation is sustained because kibbutz members are moral angels, immune to the logic of rational choice and oblivious to the temptations of defection. Whilst members suggest that collective decision-making in the General Assembly symbolises the values of kibbutz life, one sociologist found that attendance at these meetings was usually less than a third (Bowes, 1989, 19). Members fall victim to a collective action problem here but not elsewhere. Why?

Members cooperate because of the presence of selective incentives. These are both negative and positive. Positively, individuals who are deemed to be good workers are rewarded with the promise of more interesting work. Although promotion is informal, all start work in the most menial of jobs and rise through an established hierarchy. Technically specialised posts are especially valued as they offer the prospect of extensive training - funded by the kibbutz - in one of Israel's major cities. A reputation as a good worker is also essential for those wishing to stand for an elected office in which they will enjoy greater authority and status (Rosenfield, 1951, Darin-Drabkin,



1962). Negative sanctions are equally important. Indolence is seen as the worst kind of anti-social behaviour on the kibbutz and is ruthlessly punished. Poor workers are manoeuvred from one job to another and treated as social outcasts. Above all, any recalcitrant becomes the victim of kibbutz gossip, their sins exaggerated and extended to include all manner of social vices (Leon, 1969, 118, Rosenfield, 1983, 161, Bowes, 1989, 49-66).

The capacity of gossip to regulate individual behaviour and maintain social order has long been recognised by sociologists. Early accounts (Ross, 1901, Lumley, 1925) are crudely functional. Gossip is explained by reference to the positive effects that it has and it is implied that this is why it is undertaken. If nothing else, this explanation is unnecessarily complex. Jorg Bergmann (1993, 145-53) emphasises that as well as being an effective deterrent, gossiping is itself enjoyable. It allows individuals to affirm their superiority over those gossiped about (Wikan, 1980), to disclose their access to privileged information and to take another person into their confidence. In the previous section it was briefly mentioned that cooperation frequently depends on the resolution of a second-order collective action problem: sanctions can sustain cooperation but individuals must also have an incentive to apply sanctions. Gossip is an effective sanction because it is enjoyable. There is no temptation to free ride and the concept can easily be given 'micro-foundations'.

Selective incentives in general and gossip in particular work because kibbutz life is characterised by the presence of the

conditions identified at the end of the last section. First, kibbutzim are relatively small, having an average membership of only four hundred (Criden and Gelb (1974)). Second and largely as a result of their size, interaction between members is intense. Third, the kibbutz is a closed network. Job rotation and communal living ensure pervasive interdependency and although it occurs, interaction with individuals outside of the kibbutz is limited. Fourth, there is significant spill-over. Relationships are forged at work and sustained through friendship, marriage and communal living. Fifth, exit from the kibbutz although possible is costly. Because income - even contributions from relatives who are not members of the kibbutz - is shared, those leaving lack any means of financial support. Raised in an environment in which crime, isolation and unemployment are absent, exit, even for those who can afford it, is psychologically difficult.

All this is to say that the kibbutzim are characterised by a close sense of community. The word kibbutz itself is derived from the Hebrew word for group and the importance of a sense of collective identity is revealed in cultural traditions. Evenings often end with the 'Hora': a circular dance in which each participant is caught in a 'frenzied ... movement which becomes a sign of group unity, each dancer relying on the next for physical support' (Bowes, 1989, 23). Community provides the foundation of gossip. People are interested in maligning others because they know who they are. By contrast,

in the large community of the modern city, contacts in secondary groups tend to be impersonal, and escape into anonymity is possible. Under these circumstances, gossip and ridicule are less effective instruments (Ogbrun and Nimkoff, 1950, 141).

Finally, the primarily agricultural nature of kibbutz work also facilitates monitoring and therefore effective sanctioning. In 1968, eighty three per cent of kibbutz members worked in agriculture (Leon, 1969, 38). Inputs can be monitored as individuals rarely work alone or in groups of more than ten. The harvesting of banana plantations, a staple of the kibbutz economy, demands that individuals work in groups of three without the use of any machinery (Rayman, 1981, 64). Not only will defection be easily spotted but it will have an immediate impact on the performance of the team.

Because work is predominantly un-skilled, it is also possible to monitor outputs. Success is not dependent upon luck. There is no reason why, over a day, one group should be able to pick more fruit than another. Work practises on the kibbutzim here deviate from MIS. Individuals are sanctioned not for working at a lower percentage of their maximum earning capacity but for producing less than others. The difference is insignificant. The nature of the work is such that maximum earning capacities do not significantly vary between individuals.

### 5.4.3 Efficiency and the Kibbutz

Kibbutzim show that cooperation can be sustained in the absence of financial incentives. Nevertheless, there are weaknesses inherent in the kibbutz experiment which are relevant to a discussion of the possibility of socialist entrepreneurship. Although not unimportant, three can be easily disposed of. First, for many individuals, close bonds of community come over time to be viewed as stifling. Members frequently cite a lack of privacy and sense of personal identity independent of the group as reasons for leaving the kibbutz. Gossip although enjoyed by most is disdained by all as divisive interference in the affairs of others.

Second, equality is limited to income. It should be repeated that status and job satisfaction are not only rationed but allocated by merit. Finally, economic democracy imposes economic costs. Individuals need to acquire permission before pursuing a particular project. If successful, this takes valuable time and if unsuccessful may result in the squandering of entrepreneurial talent. The efficiency implications of economic democracy will be more closely examined in Chapter Six.

Recognition of a more serious limitation of kibbutzim pushes us closer to the trade-off between efficiency and equality. The success of kibbutzim in the post-war years may be unsustainable. When first formed, kibbutzim lacked any financial resources and consumption was shared for practical as well as ideological

reasons. The only way most could afford housing or television was to invest in communal television and housing. The successful application of selective incentives generated for many kibbutzim a significant growth in income. By the early 1960's, kibbutzim could afford to give each member a personal allowance, to build new houses in the place of communal dormitories and to purchase for each house a refrigerator and television (Rayman, 1981). Prosperity privatised consumption.

The decision to have refrigerators in each home [had] a major impact not only on eating patterns but on the community as a whole. It meant members could take out food from the central dining hall and keep it in their own units. As more and more units were built with full kitchenettes, including stoves, ovens and refrigerators, many members began eating their evening meals in their separate homes (Rayman, 1981, 126).

Affluence reduces contact between members, erodes the sense of community and reduces the efficacy of selective incentives. This is to suggest not that kibbutzim and by extension MIS cannot succeed, only that there are limits to their success. As Rayman (1981, 121) concludes,

the overall process [of economic growth] is characterised by a significant movement away from the fulfilment of community-desired norms to the fulfilment of individually determined desires and needs.

At one level, kibbutzim show how the trade-off between efficiency and equality can be avoided through the use of non-financial selective incentives. But the solution here serves only to create a need to make trade-offs elsewhere. Whilst income is distributed equally within each kibbutz, income between different kibbutzim varies depending upon their economic success. Socialist equality is realised at one level but frustrated at another. It may be objected that inter-kibbutz as well as intra-kibbutz redistribution could be secured through financial subsidy and perhaps the judicious transfer of particularly skilled workers but this would risk undermining the selective incentives upon which efficiency depends. A constant influx of new workers would endanger the sense of community and subsidies would soften the budget constraint each kibbutz faces, encouraging defection.

The limitations of the kibbutzim are economic as well as political. Historically, the kibbutz economy has been predominantly agrarian and in the 1960's many recognised that profits from agriculture were limited by intense competition and vulnerability to crop failure. To sustain growth, a decision was made to develop high-technology, innovation-driven manufacturing industries and financial support was provided by a government

itself set on economic 'modernization'. Many kibbutzim were awarded one third of their investment costs and given interest-free loans on the rest but in retrospect diversification was unsuccessful.

The main difficulty experienced was frequently that of size. Kibbutzim were simply too small to compete effectively on national let alone international markets. In documenting the difficulties experienced, Alison Bowes (1989, 57) comments that 'optimum sizes, as it turned out, were larger than the kibbutz workforces could manage'. A report on the experience of one kibbutz concludes that whilst

the factory turned out high quality products ... [it did so] at a minimal profit. This was due, according to the present manager, to the fact that little attention was directed to the economies of production' (Rayman, 1981, 109).

The obvious solution in a capitalist firm, expansion, was inconceivable as recruitment of additional members risked jeopardising the sense of community and the efficacy of selective incentives. Instead, many kibbutzim employed workers, frequently Palestinian, from neighbouring towns for fixed and frequently derisory wages. The principle of distribution according to need was abandoned and equality sacrificed. Economic modernization entailed an 'ideological letting-go' (Rayman, 1981, 254).

Additional problems were raised by the nature of industrial work. To be successful it was argued that modernization required a revision of work practises. Specialisation and hierarchy would have to be imposed and job rotation and egalitarianism sacrificed. But recognition of the importance of the entrepreneurial function cut against the need for kibbutz members to be able to constantly monitor each others behaviour. Kibbutz members were not unaware of the difficulties. Rayman (1981, 112) quotes one member, contemplating plant expansion, as stating that

the kibbutz veterans do not like industry. They think it's something foreign coming and stealing from them their romanticism, their ideal .... they think that industry will change attitudes ... the kibbutz with industry is not the kibbutz with agriculture.

The limits of kibbutzim and of MIS are economic and entrepreneurial as much as they are moral. The neo-pluralist model suggests that effective entrepreneurship is dependent upon economies of scale in organisation, finance and marketing. Kibbutzim cannot respond to this imperative. The new right model suggests that effective entrepreneurship is dependent upon a capacity to discover and exploit knowledge. Kibbutzim cannot seize opportunities that demand large-scale production without also undermining the foundations of their own success. Unable to exploit such opportunities, they will not remain alert to them. Ultimately, the tension between profit-seeking entrepreneurship and the ways of life pioneered on the kibbutzim cannot be evaded.



It is significant that the conclusion to one study of kibbutz life suggests that

the idea of progress, with its emphasis on performance, rationality and objectivity conflicts with [the kibbutzim's] spirit of communality which rests on highly personal, intimate and fraternal modes of social relations (Yuchtman, 1983, 184).

### 5.5 Conclusion

Many believe that it is the content of 'human nature' rather than the structure of social relations which determines the feasibility of socialism. It is argued that socialism will be characterised by and have as its prerequisite the emergence of new and morally enlightened people. Marxists look forward to the moment when capitalism will surmount economic scarcity and herald the dawn of a new and socialist era. Pessimists suggest that capitalism itself frustrates the very possibility of such a change. Peter Singer (1972, 314) argues that competitive markets 'discourage altruism and fellow-feeling' whilst Michael Taylor (1987) argues that whilst many alternatives to capitalism require workers to engage in concerted collective action, the presence of the state has robbed workers of the ability to act in required ways.

As first presented, Carens' model of MIS conforms to this tradition. He too seems to see the feasibility of socialism as depending upon a change in human nature. It is the desire to acquire social duty rather than income satisfactions which transforms capitalism. Against such a view, this chapter has sought to affirm the importance of structure. Kibbutzim offer an environment which makes possible cooperation and the realisation of socialist equality. The difference is not human nature. Kibbutz members are not moral supermen marooned in a world of capitalist egoists. The difference is structure. But whilst kibbutzim demonstrate the importance of environment they do not

themselves provide an appropriate environment for socialist entrepreneurship. That which encourages cooperation also frustrates the emergence of entrepreneurship.

## Chapter Six

### **Labour Managed Firms and Socialist Entrepreneurship**

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## 6.1 Introduction

Labour Managed Firms (LMFs) have an impressive pedigree, having been championed by John Stuart Mill (1970), Alfred Marshall (1920) and George Cole (1944). Once discarded in favour of central planning, LMFs are now, as Saul Estrin (1989, 165) observes, 'very much the flavour of the month ... on the left' and market socialists like David Miller (1989) and Pranhab Bardhan and John Roemer (1993a) express particular faith in their capacities. The standard objection to LMFs is that they are economically inferior to capitalist firms: inefficient, inflexible and unable to seize entrepreneurial opportunities. The failure of LMFs to displace their capitalist rivals is taken as further evidence of their deficiencies. Underlying these arguments is a belief that LMFs necessarily impair economic performance because they require restrictions upon the acquisition and transfer of ownership. Capitalist firms, it is implied, thrive because they place fewer 'restrictions on voluntary contracting by individuals' (Weisskopf, 1993, 123).

Part of this chapter is written as a defence of LMFs. It is argued that they offer a viable, albeit imperfect, form of socialist entrepreneurship. Objections to LMFs are compromised by their reluctance to acknowledge the limitations of capitalist organisation and their failure to account for the success of the Spanish Mondragon LMF. Having examined Mondragon's structure and performance, two very different explanations will be offered of its achievements. In the first and using the tools of new

economic institutionalism, it is argued that it enjoys specific advantages over capitalist firms. Earlier eulogies to the market's invisible hand here give way to a discussion of the very 'visible hand' (Chandler, 1977) of internal organisation and a critique of capitalism. As in the previous chapter, a qualified defence is followed by a discussion of the limitations of market socialism. Through a focus on entrepreneurial action it is argued that whilst Mondragon has prospered, it may have done so because of its position within an overwhelmingly capitalist economy.

## 6.2 Political Credentials and Economic Objections

### 6.2.1 Distinguishing the Labour Managed Firm

The giant corporation analyzed by Galbraith and the publicly owned bureaucracy have very different entrepreneurial capabilities but have one feature in common: they are not controlled by those who work for them. Corporations are owned by shareholders and public bureaucracies by the state. The LMF is owned by those individuals who work for it. At its simplest, a LMF is a firm in which 'labour hires capital rather than capital hiring labour (Estrin, 1983, 12). John Bonin and Louis Putterman (1987, 2) define such firms in the following way.

A productive enterprise the ultimate decision-making rights over which are held by member-workers on the basis of equality of those rights regardless of job, skill grade, or capital contribution.

Robert Oakeshott (1978, 13) draws attention to three particular features of LMFs. These are implicit in the above definition but are worth emphasising separately. First, residual profits belong to those who own the firm. Second, only those who work for the firm are entitled to ownership of it. Third, internal decision-making within the firm is democratic. All three serve to distinguish the LMF from both the capitalist and publicly owned firm and all three imply restrictions on private ownership of resources.

The democratic sovereignty of the LMF frustrates efforts at central planning. If LMFs are to be used, it must be within the context of a decentralised market economy: as a form of market socialism. Decisions about prices, investment and employment must be taken by individual firms. Each will compete to sell their products and in doing so will confront a hard budget constraint. So as to facilitate analysis of the likely impact of replacing capitalist firms with LMFs, it will be assumed that the role of the state remains unchanged.

### 6.2.2 Socialism and the Labour Managed Firm

Critics accuse capitalism of democratic schizophrenia. Whilst political decision-making within the state is democratic, economic decision-making within the firm is authoritarian. Individuals as citizens choose representatives but as workers are disenfranchised. Robert Dahl (1985) argues that this is intolerable: that there are no substantive grounds on which democracy can be championed in the political sphere but opposed in the economic one. Consequently, one reason socialists embrace LMFs is that they allow for - are indeed defined by - the extension of democracy. As Bonin and Putterman (1987, 6) argue, 'the self-management concept embraces values of participation ... that are almost universal in modern socio-political rhetoric'. In this respect, LMFs offer a more radical programme than MIS which is zealous in its pursuit of equality but in other respects relatively conservative.



The capacity of LMFs to realise a second socialist value, equality, appears more limited. There is nothing intrinsic to the definition of LMFs which prevents inequalities emerging both between and within firms. The integration of LMFs into the market will ensure that successful firms prosper and unsuccessful ones fail and democratic decision-making allows workers to vote for unequal pay. Market competition may even necessitate such a strategy. Whilst LMFs are in this respect less 'socialist' than MIS this is not, for two reasons, to suggest that they will simply replicate the inequalities of capitalism. First, democracy also allows individuals to vote for greater equality. At the very least, it enables workers to force their superiors to justify preferential treatment. Second, diffusion of ownership eliminates an important source of capitalist inequality, unequal ownership. Dahl (1989, 139) suggests that LMFs significantly increase levels of equality.

The important point is that major inequalities in wealth and income in countries like the United States do not flow from interfirm or interindustry differentials. They are caused primarily by two other factors: a highly concentrated ownership of property and very large payments to top corporate executives whose decisions are, for all practical purposes, independent of all effective external controls.

Finally, as LMFs are firmly embedded within the market, they protect liberty. Individuals as owners are free to decide what

to produce and who to employ; individuals as consumers are free to decide what to purchase and individuals as workers are free to decide which firm to join. One qualification should be noted. It is unclear from this account whether a market socialist economy will be one in which individuals are also free to establish privately owned capitalist firms and as will be seen presently this raises a number of difficult issues.

### 6.2.3 Economic Objections (1): The 'Micro' Case Against

Whether owners are scattered shareholders or individual entrepreneurs, capitalist firms seek to maximise profit. The prospect of personal gain encourages the discovery of knowledge and the price mechanism its subsequent communication and coordination. Bureaucratic inefficiency can be traced back to the incentive to maximise budgets rather than profits and the most frequently cited objection to LMFs takes a similar form. Benjamin Ward (1958) argues that members of LMFs will find it in their interest to maximise the average income of each member. As workers are owners and therefore derive income from profit, the difference, at first, may seem unimportant but Ward demonstrates that it is not. Because all members are entitled to an equal share of profit, employment decisions will be based upon not the marginal benefits and costs of production but upon the overall impact on member's income. Miller (1989, 85) offers a concise summary of the argument.

The capitalist ... will hire whenever marginal return exceeds marginal costs. If the employee can be hired for \$50 and makes \$51 profit for the enterprise he will be taken on. In the case of the co-operative ... since the new hand can only be taken on as a full member ... the hiring decision depends on whether the profit he can create raises or lowers the existing schedule. Suppose for simplicity's sake ... that the rate currently paid is \$55, then the extra worker will not be hired, since to do so will lower incomes all around.

For the same reason, it can be shown that LMFs will respond to a price increase not, as the competitive capitalist firm will, by expanding production but by laying off workers and will favour capital over labour intensive production (Milanovic, 1982, Bonin, 1983). The LMF will have a relatively inelastic supply curve (Putterman, 193, 133) and whilst firms may discover new opportunities for innovation and coordination they may have no incentive to act upon them. Entrepreneurial discovery may be followed by stagnation rather than expansion.

The 'micro' case against LMFs has been vigorously challenged. First, Joan Robinson (1967), Jaroslav Vanek (1969) and James Meade (1975) argue that members are unlikely to vote to shed labour as by doing so they may be endangering their own jobs. Against this it may be noted that if firms operate a 'last-in-first-out policy' redundancies may still occur. Alternatively,

the employment constraint may be realised through a reluctance to hire new members when older ones have retired. Second, it is argued that Ward's analysis holds only in the short-term, during a period in which only one factor of production, labour, is variable. In the long-term and assuming freedom of entry into the market, the inefficiencies of any one firm will be compensated for by the creation of others (Vanek, 1970, Estrin, 1989, 177). The vision of the LMF economy becomes one of a large number of small firms (Meade, 1975). This itself may represent an additional source of inefficiency if Galbraith is right to argue that some smaller firms must develop into giant corporations if entrepreneurial potential is to be fully realised. Furthermore, it will be argued that it is the assumption of unfettered entry into the market which raises acute problems for LMFs.

#### 6.2.4 Economic Objections (2): The 'Macro' Case Against

A second and now well worn argument against LMFs is constructed not at the 'micro' level of the individual firm but at the 'macro' level of the entire economy. The logic of the argument - which is not only compatible with but can be taken as a vindication of the micro analysis - is deceptively simple. Capitalism does not prevent individuals from starting a LMF. If they are either a viable or desirable organisational form it can be assumed that a preference for LMFs will have been revealed and the hegemony of capitalist firms challenged. That this has not happened demonstrates LMFs inferiority (Nozick, 1974, 250-3, Jensen and Meckling, 1979, Williamson, 1980, Alchian and Demsetz,

1986).

Proponents defend themselves from this inference in one of two ways. First, they deny the neutrality of capitalist competition and claim that either through business law (Carnoy and Shearer, 1980), employment law (Thomas and Logan, 1982) or general competitive practises (Hovart, 1975, 343) LMFs are discriminated against. Second, while conceding formal neutrality they question the extrapolation from the performance of individual LMFs in a predominantly capitalist environment to their likely performance in an economy where capitalist firms are the exception. It is argued that for market socialism to work, capitalist firms have to be prohibited and transformed into LMFs. This is the 'maximalist' strategy adhered to by, for example, Miller (1989, 92-3).

What creates difficulties for co-operatives is not producing for a market itself, but producing in competition with capitalist enterprises ... co-operatives operating in a capitalist environment may be 'unsuccessful' but a market economy made up entirely of co-operatives can be stable and efficient.

The maximalists agree that LMFs do not compete on a level playing field but add that LMFs generate positive externalities from which the broader economy but not the individual firm benefits. LMFs may not survive in a capitalist economy but are a more 'socially' efficient form of organisation. In this way, Peter Jay

(1980, 20) argues that LMFs are to be favoured as they forestall industrial conflict but that 'there is no private advantage from behaving in the jungle as if the rule of law applied'. Dahl (1985, 95) argues that participation within the LMF will encourage more responsible and intelligent citizenship but that the benefits will be imperceptible when LMFs are in a minority and David Levine (1993) claims that the very inflexibility of LMFs - documented by Ward - will have the positive effect of stabilising demand within the macro economy.

Two reservations can be expressed about the maximalist's case. First, it demands that voters take a major risk when voting for a socialist party committed to the extension of LMFs. It may well be true that difficulties will disappear when there are no capitalist firms against which LMFs have to (unfairly) compete but this argument will have to contend against evidence of the repeated failure of LMFs within the capitalist economy. Second, the argument discounts the possibility - pursued presently - that LMFs actually benefit from their co-existence with capitalist firms.

### 6.3 Mondragon

#### 6.3.1 The Significance of Mondragon

The arguments of the previous section are levelled against all LMFs. None will succeed because all are subject to allocative inefficiencies. An alternative position is that LMFs have failed not because of their inherent defects but because of the inappropriate design of individual firms (Estrin, 1989, 172). If correct, the argument can be used to sustain a strategy of 'minimalism'; the gradual displacement of capitalist firms by LMFs (Oakeshott, 1980, 46). This overcomes one of the primary objections to the maximalist position. The key requirement of this strategy, as Oakeshott (1980, 47) recognises, is that 'we should be able to point to a ... class of actual, and robustly prospering, co-operatives'. For some time, this is as far as the minimalists could proceed. They had identified the problem but not a solution: an organisational form which could vindicate their hopes. Eventually and to a chorus of academic approval, the answer was found in Spain's Mondragon group. The esteem with which this project is held is obvious in the following extracts from, respectively, the introduction and conclusion to one study.

A fascinating example of success in a form of organization for which failure is the general rule. The story of Mondragon is the most impressive refutation of the widely held belief that worker cooperatives have little capacity for economic growth and long-term survival (Whyte and Whyte, 1991, 3)

The striking economic success of Mondragon has conveyed worldwide the message that a worker cooperative need no longer be considered simply a utopian ideal (Whyte and Whyte, 1991, 282).

For the same reasons that the failure of LMFs was taken as confirming their inherent inferiority, the success of Mondragon throws into doubt the analysis of critics like Ward. Mondragon allows socialists to refute claims that LMFs are simply utopian, 'the pious dream of ... impractical other-worldly philosophers' (Zirakzadeh, 1980, 117).

### 6.3.2 Mondragon: Economic and Social Structure

Mondragon is the name of a small town in the Basque. The first Mondragon LMF, ULGOR, was formed in 1956 and the Mondragon group is now composed of over one hundred firms which, in 1990, employed over 19,000 members (Whyte and Whyte, 1991, 3). Within both the group and the academic literature on it, a distinction is normally drawn between 'first level' firms engaged in the actual production of goods and 'second level' firms that provide



a series of support services, including housing projects, hotels, technical schools, a supermarket chain and a bank.

All those who work for a Mondragon firm are members of it and membership is restricted to those who work for a firm.<sup>1</sup> When accepted, new members have to make a capital contribution to the firm equivalent to around a years wage. Members are paid a regular wage but as all are owners, the capacity of the firm to do so depends upon the capture of profit. Any remaining profits minus interest payments and depreciation costs are allocated to two collective and one individual account. The first collective account, the Social Fund, is used to promote local development and by Spanish law must amount to at least ten per cent of total profit. The second collective account, the Reserve Fund, is used as an economic bulwark against recession and now claims fifty per cent of total profit. Remaining funds are placed in member's individual accounts where they accrue interest. Since 1966, individual accounts are redeemed upon a member's retirement and are not used as a wage bonus (Whyte and Whyte, 1991, 42). Any losses sustained by the firm which cannot be covered through borrowing or the reserve fund are deducted from member's individual accounts.

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<sup>1</sup> Two qualifications must be noted. First, Mondragon rules have recently been changed to allow for the temporary employment of contract workers if no existing member has the necessary skills for a particular project. No more than ten per cent of a firm's workforce can be employed on such terms and in practise, few employ more than a handful (Whyte & Whyte, 1991, 225). Second, the ownership of second level firms is normally divided between actual employees and representatives from selected first level firms. It remains the case that ownership cannot be dispersed among individuals who do not work for Mondragon.

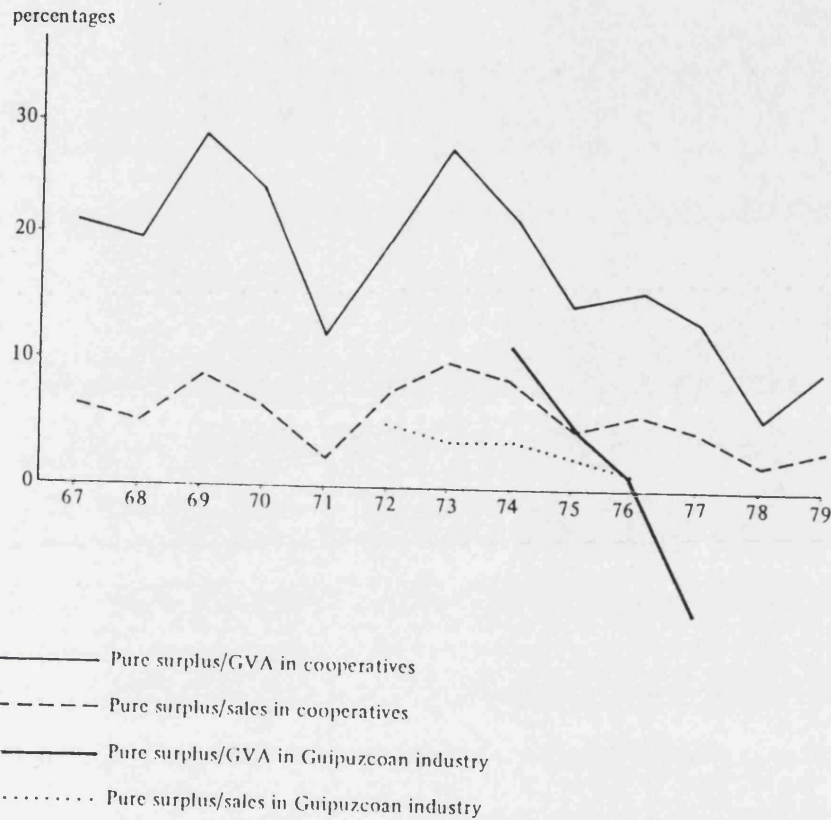
Mondragon embodies many of the advantages of LMFs identified earlier. The sovereign decision-making body within each firm is the General Assembly which meets at least once a year and at which all members are expected to attend and vote on the basis of one member one vote. The General Assembly elects individual members to serve on the Junta Rectora. This is equivalent to a board of directors and authorises day-to-day decision-making; appointing and monitoring the LMFs managerial team. Finally, each firm elects members to a Social Council which represents the interests of individuals as workers to the Junta Rectora and which has a right to be consulted on any matter directly affecting worker's welfare.

One of the key values of Mondragon is equality between workers (Whyte and Whyte, 1991, 273). Equality is promoted in three ways. First, residual profits are distributed equally between individual accounts. Second, each firm has imposed a pay policy such that the most highly paid worker cannot be paid six times more than the lowest paid one. Until 1987, the ratio was even stricter at three to one. Finally, there is considerable redistribution between firms within the Mondragon group. ULGOR, still the largest single firm, pools all of its profits, most around sixty per cent.

### 6.3.3 Mondragon: Economic Performance

The most obvious proof of Mondragon's success is its survival. In their survey, Keith Bradley and Alan Gelb (1983, 2) go further and argue that 'from virtually every perspective, it [Mondragon] appears to have outperformed the local capitalist environment'. Just two criteria will be considered to illustrate their claim. First, profitability. Gross value added (GVA) profits for the first level firms in the first years of the group were buoyant. Since then and as the world has slipped into recession, profits have fallen but as Figure 6.1 shows have remained well above those of capitalist firms in related industries located in the same administrative area (Guipuzcoan).

Figure 6.1 Mondragon Industrial Profit



Source: Thomas and Logan (1982), 111

Second and despite Ward's expectations, profit has facilitated employment expansion. Detailed figures are given in Table 6.1 for the period between 1960 and 1978. Since then, standards have been maintained. between 1976-86, Mondragon created an additional 4,200 jobs at a time when unemployment in the Basque as a whole rose by over 150,000 (Whyte and Whyte, 1991, 204).

Table 6.1 Mondragon's Employment Creation in First Level Firms

Year	Total Employment	Total Number of Firms
1960	395	8
1962	807	16
1964	2620	27
1966	4202	31
1968	6418	38
1970	8570	40
1972	10329	44
1974	1263	46
1976	13493	57
1978	14676	66

Source: Thomas and Logan (1982), 46-7)

The conclusion that Mondragon has performed well and that this gives some hope for the minimalist's cause requires little further justification. The interesting question rarely pursued in any detail by the various studies of Mondragon is why it has performed so well. Minimalists argue that Mondragon has 'discovered' the right structure but it is not clear what makes the structure right. Alongside a more detailed examination of the mechanics of the Mondragon group, the next section offers a theoretical explanation of its success.

## 6.4 Mondragon: A Transactions Costs Approach

### 6.4.1 New Economic Institutionalism

In Chapter Three it was argued that decentralised competitive markets offer a suitable environment for entrepreneurial action. But within capitalist systems, many economic actions are governed by and take place within hierarchical firms. The difference between the two is emphasised by Ronald Coase (1986, 73).

Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market, within a firm, these market transactions are eliminated.

Markets are characterised by the voluntary exchange of resources. Hierarchies exist when one individual is given the authority to direct the actions of another (Kreps, 1990, 113, Miller, 1992, 16). Although it has already been argued that hierarchical organisations still operate within a market environment, it nonetheless appear that the capitalist entrepreneurship which socialism must seek to emulate is characterised by both the 'nomos' of the market and the 'taxis' of organisation.

The emergence of hierarchy can be explained in a number of ways. Harry Braverman (1974) and Stephen Marglin (1976) emphasise the capacity of hierarchy to secure for the capitalist entrepreneur a stream of profit. Galbraith suggests the importance of

economies of scale. Giant corporations are more able to manipulate government policy, to sustain losses and to finance investment from internal profits. However the transaction costs of economic activity are also important. Transaction costs, which Kenneth Arrow (quoted in Williamson, 1985, 18) describes as the 'economic equivalent of friction in a physical system', are pervasive and include

the costs of deciding, planning, arranging, and negotiating the actions to be taken and the terms of exchange when two or more parties do business; the costs of changing plans, renegotiating terms, and resolving disputes as changing circumstances require; and the costs of ensuring that parties perform as agreed. Transaction costs also include any losses resulting from inefficient group decisions, plans, arrangements or agreements; inefficient responses to changing circumstances; and imperfect enforcement of agreements (Milgrom and Roberts, 1990, 60-1).

The language of transaction cost economics is unfamiliar but compatible with earlier analysis. The struggle for cooperation within MIS can, for example, be viewed in these terms. As a kibbutz grows, the (transaction) costs of enforcing selective incentives and monitoring behaviour increase and efficiency is reduced. As Keith Dowding (1994b) argues, new institutionalism - and certainly its economic rather than sociological variant - is compatible with rational choice. The actors in transaction costs

models are still individuals and are assumed to be the bearer of preferences which they seek to realise. These are the 'core' assumptions of rational choice. In addition, the claim of opportunistic motivation which Oliver Williamson (1985, 47) defines as 'self-interest with guile' poses no difficulties for the more general assumption of egoism. The additional assumptions of bounded rationality and radical uncertainty distinguish new economic institutionalism from neo-classical economics but this represents no sacrifice as the value of neo-classical economics to the study of entrepreneurship has already been challenged.

In particular circumstances, markets exacerbate and hierarchies minimise transaction costs. When this occurs, efficiency is maximised when economic activity occurs within the latter. Three examples throw into doubt Hayek's earlier defence of the market. First, precisely because exchange is voluntaristic, markets may encourage individuals to exploit each other. A standard example is that of the relationship between General Motors and a smaller firm, Fisher Body (Miller, 1992, 52-55). Dependent upon the supply of automobile shells, General Motor offered Fisher body the opportunity to specialise in production for them and over time both became unduly dependent on the actions of the other. If General Motors threatened to change supplier, Fisher Body would have been bankrupted. If Fisher Body threatened to raise prices, General Motors would have had little choice but to acquiesce if production were not to be halted. Each experienced the dangers of asset specificity. In these circumstances, markets will be unstable and the fear of exploitation might lead to



entrepreneurial discoveries being shunned. The solution here was to integrate Fisher Body into General Motors, giving them shared rather than conflicting interests; replacing market with hierarchy.

Second, the information which markets most readily expose entrepreneurs to is price. In circumstances where, for example, the quality of a product is certain, price may provide a sufficient foundation for successful exchange and subsequent entrepreneurial coordination. On other occasions, prices may not 'qualify as sufficient statistics' (Williamson, 1975, 5). In itself, for example, price may not indicate the commitment of one party to remain responsible for the long-term servicing of a product. More generally, prices do not always capture and reflect tacit entrepreneurial knowledge. Again, this deficiency may expose individuals to exploitation and threaten exchanges which enhance efficiency. Hierarchy is superior to markets because it allows a manager to force an employee to reveal detailed - and perhaps, for the employee undesirable - knowledge. Hierarchy also reduces incentives for opportunism. An employee can't always benefit from deceiving their employer in the same way that entrepreneurs can gain from misleading consumers or rivals. Whilst within a hierarchy profits are shared and interests converge, in a market profits are divided and interests diverge.

Third, entrepreneurs in a market have an incentive to bargain over price. Having (i) abandoned the assumptions of neo-classical economics, and (ii) defined entrepreneurship partly in terms of

the coordination of prices, it cannot be assumed that entrepreneurs are simply price-takers. Bargaining requires the expenditure of time and resources as entrepreneurs endeavour to discover other's preferences and establish reputations for toughness. Possible gains from trade may be dissipated. Within a hierarchy, such costs can be foregone. One individual can either set the price at which exchange will take place or simply demand the transfer of resources. Austrian accounts of market behaviour simply discount the existence of such costs and consequently exaggerate the efficacy of markets.

If one implication of new institutional economics is that hierarchies may displace markets, another is that firms whose internal structures are better able to minimise transaction costs will be more efficient. The comparisons encouraged by new economic institutionalism are not just between markets and hierarchies but between different kinds of hierarchies.

[J]ust as market structure matters in assessing the efficacy of trades in the marketplace, so likewise does internal structure matter in assessing internal organization (Williamson, 1975, 9).

In the rest of this section, a transaction cost comparison will be undertaken between capitalist firms and LMFs. It will be argued that in several respects, LMFs are better able to reduce transaction costs.

#### 6.4.2 Monitoring and the Labour Managed Firm

An individual entrepreneur who bears the entire risk of their action has every reason to maximise effort in an attempt to maximise profit. For the technocratic entrepreneurs identified by Galbraith and the ordinary employees of a firm, the relationship between effort and reward is less clear. Workers may have an incentive to shirk in the same way as individuals have under MIS. Firms attempt to control shirking through mechanisms of vertical control imposed on employees by employers. Behaviour is monitored and selective incentives whether positive - bonus payments and promotion - or negative - dismissal - applied.<sup>2</sup>

Vertical control is imperfect. For three reasons capitalist firms can reduce but not eliminate transaction costs. First, resources devoted to monitoring are themselves a cost. Second, the cost of monitoring also makes it unlikely that entrepreneurs will attempt to completely eliminate shirking as it will only make economic sense to devote resources to vertical control up to the point where the marginal benefit of doing so is equal to the marginal cost (Ben-Ner, 1987). Third, to deter shirking the entrepreneur may find it necessary to pay 'efficiency wages' set above market rates (Van Parijs, 1995, 89-132). Again, there is an entrepreneurial opportunity cost. Money spent on higher wages cannot be spent on research and development into new products.

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<sup>2</sup> Alchian and Demsetz (1972) define the entrepreneurial function precisely in these terms.

It is frequently claimed that one advantage of LMFs is their capacity to reduce, if not eliminate, shirking and therefore to preserve resources (Marshall, 1920, 225, Vanek, 1970, 233-54, Oakeshott, 1978, 5, Ireland and Law, 1982, 121, Bradley and Gelb, 1983, 47, Bowles and Gintis, 1993, 28). LMFs can employ the same vertical control mechanisms as capitalist firms. Within Mondragon, discipline is maintained through written warnings, fines, deductions from individual capital accounts and, eventually, expulsion (Bradley and Gelb, 1983, 18-19). Within the LMF vertical control may be more effective as the capitalist firm does not have the same range of punishments open to it precisely because workers are not owners and therefore can lose only their wage.

In addition, LMFs allow for the emergence of 'horizontal control'. Because the profits of each depend upon the performance of all, members have an incentive to themselves discipline shirkers. No foreman has to be employed and transaction costs are reduced. The efficacy of horizontal control will depend upon the resolution of a second-order collective action problem. Workers have an interest in applying selective incentives but may prefer another worker to do it. In Chapter Five it was argued that small size will facilitate sanctioning and this may offer a partial explanation of why Mondragon firms are rarely allowed to grow beyond 500 members before being fragmented into separate firms (Whyte and Whyte, 1991, 277). For now, it can be noted that the available evidence is that monitoring is effective within the Mondragon group. Absenteeism, for example, is only half the rate

of that in comparable capitalist firms (Thomas and Logan, 1982, 51). As well as being more efficient than capitalist firms, LMFs are superior to MIS. Whilst within the kibbutz 'horizontal control' is exercised, 'vertical control' is limited as income must be distributed equally. This need not mean that LMFs will be more unequal than Kibbutzim as the very possibility of exercising vertical control may deter shirking.

#### 6.4.3 Human Capital and the Labour Managed Firm

The problems posed by asset specificity apply not only to relationships between firms but also to those between individuals. Transaction costs exist within hierarchies as well as within markets. If a firm hires an individual and over a period of time and at considerable cost trains them to perform a specific function they will acquire 'non-trivial information advantages' (Williamson, 1975, 34). The specific assets that employees acquire may encourage them to either demand wage increases or defect to a rival. Fearing exploitation, employers may have either to reduce their investment in training or prevent the initial emergence of asset specificity by training several individuals to perform the same function. Each strategy has efficiency implications.

Within Mondragon, such costs are minimised as exit from the firm carries a higher cost for the individual. It has been noted that since 1966 individual accounts are only paid out upon retirement. If the member leaves before then, the firm is not legally obliged

to transfer the assets. In cases where an individual leaves because of family commitments or sickness, the Junta Rectora will countenance payment but if an individual simply leaves to join or create a capitalist firm it will not. In the Kibbutz, the barrier to exit which preserves membership and efficiency is psychological; the fear of the unknown. Within the LMF, the barrier is financial. Firms have more incentive to invest in human capital and less reason to pay efficiency wages which do not reflect the productivity of a member. Asset specificity remains but poses less of a problem.

#### 6.4.4 Labour Conflict and the Labour Managed Firm

Recognition of the importance of asset specificity has been used to demonstrate employers vulnerability to employees but employees are also vulnerable to employers. Employees acquire skills which may be of little value to other companies and face owners whose interests may be to maximise their own income by minimising wages. Historically, workers have protected themselves through trade unions and an insistence upon collective bargaining. This development altered the balance of power between employees and employers but did not eliminate the conflict of interest.

Adam Przeworski (1985, 132-69) offers a more positive interpretation. In certain circumstances, workers will maximise utility by eschewing wage militancy; protecting profits and facilitating investment upon which future profit and wage levels depend. As Przeworski (1985, 139) concludes, the 'current

realization of material interests of capitalists is a necessary condition for the future realization of material interests of any group under capitalism'. Workers have an interest in bread today so as to be able to eat jam tomorrow. The relationship is potentially positive rather than zero sum. As Przeworski (1985, 164) observes, 'crises of capitalism are in no one's interest'. The solution remains imperfect as parties will have to waste resources bargaining over the precise division of profits whilst eventual agreement will be hindered by uncertainty about future profit and by a fear that employers will renege upon any deal. Rapid turnover in either the workforce or management may mean that future gains are heavily discounted. These all represent considerable transaction costs. Furthermore and at great economic cost, cooperation does break down in many capitalist firms and productive efficiency is impaired not only by strikes but by employers attempts to protect themselves from the impact of strikes by increasing the use of capital.

Relative to capitalist firms, LMFs are able to minimise these costs (Jay, 1980). In one sense, the possibility of conflict between employees and employers is simply erased as all are simultaneously both members and owners. Members together decide upon pay and investment levels. There is no need for parties to build a reputation for tough bargaining, to fear exploitation or to be tempted by the prospect of exploiting another. Within Mondragon, strikes are not allowed as they are considered by members to be 'in contradiction with the cooperative arrangements' (Oakeshott, 1978, 196).

#### 6.4.5 Investment, Support and the Labour Managed Firm

Inadequate access to capital is frequently cited as a serious limitation of LMFs (Estrin, 1989, 179-82). There are three strands to the standard argument. First, LMFs are held to expose workers to excessive risks. Saving is enforced through individual capital contributions and instead of being diversified is concentrated in only one enterprise (Neuberger and James, 1973, 262, Meade, 1975, 420). Because the costs of saving are higher there will be a reluctance to save and a preference among members for consumption. If LMFs depend upon internal finance, their structure has the effect of starving them of necessary resources.

Second, it is claimed that this failing will be exacerbated by the reluctance of older members within the LMF to use profits for investment as they will know that profits may not be realised until after their retirement and consequently not be reflected in their capital account. Older members will find it in their interest to vote against ambitious investment plans. The conflict within LMFs, it is implied, is not between employees and employers but between younger and older members (Furbuton, 1976, Meade, 1980, 92, Miller, 1989, 84-7). The capitalist entrepreneur will face a different set of incentives as the value of any investment (whether yet realised or not) is reflected in the price they will be able to sell their enterprise for.

For these reasons it is suggested that LMFs will have to rely upon external finance. The third criticism is that the nature of



their borrowing requirements will further impede efficiency. Money raised by the LMF will have to be debt rather than equity as only workers are allowed to own the firm. This has two costs. First, lenders may be more reluctant to commit funds over which they will be unable to exercise any control. LMFs will be able to borrow but will have to pay a higher rate of interest and the opportunity cost of this will be investment in entrepreneurial coordination and innovation. Second, debt finance precludes takeovers from occurring. Henry Manne (1986), Eugene Farma (1986) and Michael Jensen (1989) argue that this mechanism ensures the efficiency of the capitalist firm as it allows managerial performance to be monitored by other firms. Consider the likely response to a decline in the performance of a capitalist firm reflected in its share price. Because exit is easy for disparate shareholders, it is unlikely that voice will be used to discipline managers (Hirschman, 1970) but this lack of commitment encourages takeover bids. If a rival entrepreneur concludes that a falling share price reflects avoidable inefficiency they may calculate that by buying at the lower price they will be able to capture a profit through subsequent recovery. Takeovers are a form of entrepreneurial coordination through which the price of a product - in this case the firm - is brought into line with its 'proper' value. By preventing takeovers, the ownership structure of the LMF offers no protection against inefficient management.

There are three problems with this account. As the alleged capital efficiency of capitalist firms is important not only to the comparison with LMFs specifically but to the comparison

between capitalism and socialism generally they will be examined in some detail. First, proponents exaggerate the efficacy of the takeover mechanism and consequently the defects of LMFs. As Thrainn Eggertsson (1990, 138) recognises, takeovers entail considerable transaction costs. Entrepreneurial resources have to be employed to manage the takeover, lawyers and management consultants fees have to be paid and hostile takeover bids will frequently fail.

Second and as Williamson (1975, 142) argues, uncertainty will further complicate the process. Firms considering a takeover will lack detailed knowledge about their rival. Changes in share price will impart some information but the firm will not know and the takeover target will be reluctant to reveal the detailed information necessary to judge whether decline is reversible. Problems of adverse selection again demonstrate the limited capacity of markets to communicate detailed let alone tacit knowledge when interests conflict.

Third, takeovers will be complicated by the existence of a collective action problem among shareholders. Each will hope that others sell their shares to a superior management team and that the price of their own shares will therefore appreciate. Because each will be tempted to free ride, inefficiency may be preserved (Gorfman and Hart, 1980). Finally, inefficient management teams can easily protect themselves from takeovers through the use of supermajority amendments (Williamson, 1975, 160-1).

It has been found that the average rise in stock price following a takeover is between eight and thirty per cent (Jensen and Ruback, 1983). Can we conclude from this that takeovers work? Without knowing whether and to what extent the prices of other firms would appreciate if taken over we cannot. The costs and difficulties of takeovers may be such that the market has no choice but to tolerate inefficiencies of less than eight per cent.

Second, even if the takeover mechanism works, it does not follow that entrepreneurial efficiency is necessarily enhanced. Whether they are individuals or institutional groups, shareholders heavily discount the value of future streams of income (Miles, 1993). To appease shareholders and deter takeovers, it is necessary for firms to zealously pursue short-term profit (Hutton, 1996). The more effectively the takeover mechanism works, the less likely it is that firms will be able to engage in long-term investment: to finance the development of innovative but risky products. To retain shareholder support, firms may have to eschew uncertain investments and ignore entrepreneurial opportunities. Furthermore, precisely because exit is easy and ownership diluted through the diversification of risk, few shareholders have any substantive commitment to the health of a firm. If share price declines following the failure of a particular project, a firm may become trapped in a vicious circle in which price continues to decline, denying to the firm the resources necessary to initiate reform. Finally, the desire to minimise risk will encourage investment in firms with established

reputations for success. New firms about which little will be known by the market will have to pay premium interest rates and the process of creative destruction will be retarded. All this is to suggest that the high levels of entrepreneurial failure associated with capitalism may be due not simply to the inherent risks of entrepreneurial activity but to the inadequacies of the financial system which supports entrepreneurial firms.

The third problem with this account of the efficacy of takeovers is that it does not reflect the experience of Mondragon. The profitability and growth of these firms suggests that they cannot have been starved of investment. Henk Thomas and Chris Logan (1982, 104) report that a comparison of gross investment with comparable private firms in the area shows that Mondragon invests, on average, four times as much. Individual capital contributions, sustained profitability and a climate of industrial relations which encourages long-term planning can be used to explain this success but studies often emphasise the role of the Caja Laboural Popular (CLP): Mondragon's own bank. This is a second level firm, owned jointly by its own members and by the members of other firms, which lends money exclusively to other Mondragon firms and receives money from (i) interest on these loans, (ii) interest on the reserve funds which firms have to deposit with the bank, (iii) commissions on banking transactions, and (iv) savings accounts held by individual members.

The champions of capitalism will argue that the CLP's structure and operations threaten the efficiency of Mondragon firms. First, joint ownership appears to encourage a conflict of interest. Firms may look to soften a hard budget-constraint through borrowing from a firm which because they own it cannot refuse their applications. Second, by lending exclusively to the still limited number of Mondragon firms, the CLP seems to be exposing itself to excessive risks. But it is precisely these 'deficiencies' that enhance performance.

First, joint ownership and the impossibility of takeovers encourages long-term investment. Second, joint ownership means that Mondragon firms have reason to be more open in their dealings with the bank. There will be less reason to guard and distort information for fear of a bank demanding repayment of any debts. Hierarchy is more efficient than markets. Within Mondragon, the communication of tacit knowledge is encouraged by the regular exchange of personnel. CLP executives are likely to have worked in the firm they are responsible for lending to and will be more aware of its position. The dangers of imprudent borrowing are also reduced by joint ownership as an investment proposal by any one firm will have to be authorised not only by the CLP's own directors but by other firms represented on the board of control. They will be unlikely to tolerate borrowing which will place their own resources in jeopardy.

The concentrated risk embraced by the CLP also facilitates entrepreneurial action. As the bank cannot afford a large number

of first level firms to fail, it has an incentive to do more than a capitalist bank to ensure their success. Only one Mondragon firm, a fishing cooperative, COPESCA, has ever been bankrupted and

the record of starting over one hundred firms, including some of the largest producers in Spain, in the last 25 years with only one failure must be seen as a quantum leap over the quality and type of entrepreneurship represented in America where 80 to 90 percent of all new small businesses fail within five years (quoted Dahl, 1985, 158).

Support is provided by the CLP's Entrepreneurial Division. When either the CLP perceives or a Mondragon firm first reports financial difficulties, it is obliged by its charter of contract with the bank to draw up a detailed recovery programme. If necessary, the CLP, acting upon the Entrepreneurial Division's advice, will suspend interest payments, offer new credit and occasionally engineer a change in management personnel. Because the bank is jointly owned and because risks are concentrated, the option of exit is never exercised. In one case, when no other viable solution could be found, the CLP even provided the finance to build a new production line for a entirely different product (Whyte and Whyte, 1991, 75).

When a new firm is established, the Entrepreneurial Division will appoint an experienced 'godfather' to work with within the firm

until such time as it begins to record a profit. The wages of the founding members will be paid for by the bank for eighteen months, training programmes provided and interest payments waived. The CLP's commitment to new firms is such that in 1979 per capita investment in Mondragon's smallest firms was three times the size of that in established ones (Thomas and Logan, 1982, 120). The intention of the CLP, articulated here by a senior bank official, is to

back up the first and necessarily difficult steps of the setting up of new industrial co-operatives ... money buys time, corrects defects and mistakes and, in difficult circumstances helps survival, just as in favourable ones it aids development (Campbell, Keen and Oakeshott, 1978, 7-8).

## 6.5 The Limits of Growth

### 6.5.1 Minimalism, Maximalism and Mondragon

The success of the Mondragon group is sufficient to cast doubt upon some of the more bellicose objections to LMFs. But minimalists claim that Mondragon is more than an exception to a general rule of failure and that Mondragon offers a method of organization which can be easily exported.

Mondragon spans a unique divide in that it is able to suggest solutions to pressing problems in both industrialized and developing countries (Bradley and Gelb, 1983, 82).

The approach adopted in the last section was designed to further the minimalist's cause. Transaction costs are a pervasive feature of economic life and capitalist firms - all capitalist firms - are in some respects less able to minimise transaction costs. Here, the minimalist argument takes on the universal claims previously associated with only critics of LMFs and maximalist advocates.

A weak link in the argument remains. If LMFs like Mondragon are so efficient why have they not already displaced capitalist firms? Williamson (1975, 132-5) may be right to argue that organisational innovations like the multi-divisional structure diffuse slowly but it is now nearly forty years since ULGOR was



founded and despite academic propagation, there is no evidence that LMFs are threatening the position of the capitalist firm. Maximalist's argue that LMFs (despite their innate superiority) are not allowed to compete fairly with capitalist firms but if so, Mondragon's own success must then be explained.

This section offers a very different account of Mondragon's record, one which throws doubts upon the strength of both the maximalist's and minimalist's arguments. Mondragon's performance can be explained by its particular and parochial advantages rather than the universal superiority of LMFs and this suggests that Mondragon cannot easily be exported. First, unique features of Mondragon's environment sustains its success and, second, Mondragon benefits from its location within a predominantly capitalist economy. The maximalist argument is turned upon its head. It is not possible to extrapolate from the performance of one LMF in a predominantly capitalist environment the likely performance of LMFs in a economy in which capitalist firms are the exception rather than the rule.

### 6.5.2 Political Entrepreneurship: Employment, Pay and Inception

if a regional planner had been asked at the end of the Civil War to select the future site of the most important industrial complex in the Basque country, Mondragon would have seemed like one of the most unlikely choices (Whyte and Whyte, 1991, 25).

Such claims are gist to the minimalist's mill. If an industrial LMF could work here, we are invited to conclude, they can work anywhere. But in many ways, Mondragon offers distinct advantages for the creation of an LMF. First, the area generally and the town of Mondragon particularly, has a long history of industrial production and a highly skilled workforce (Thomas and Logan, 1982, 21). Second, Mondragon has an established tradition of cooperative ventures stretching back to the Basque guilds of the sixteenth century. A consumer cooperative was established in Mondragon in 1884 and before the Civil War, political parties and the Catholic Church all offered financial support to other projects (Whyte and Whyte, 1991, 18). Mondragon's founders were able to apply knowledge generated by these experiments. Third and most significantly, Mondragon has a long history of nationalist fervour and political activism. Mondragon was the first town in the Basque to volunteer soldiers to fight in the Civil War (Oakeshott, 1978, 78) and the Basque language, Euskera, which is spoken by only twenty five per cent of the population in the Basque is spoken by over fifty six per cent in Mondragon.

This culture, history and political tradition was threatened by Franco in the years after the Civil War. Trade unions were banned, political representation repressed and the speaking of Euskera banned. The creation of a LMF was one of the few ways of displaying political autonomy and of protecting an egalitarian culture. A prominent minimalist, Oakeshott (1978, 172-3), concedes that

it would be hard to deny that the peculiar and particularly repressive conditions which prevailed in Mondragon after the Civil War contributed to the possibility of this outcome ... if Franco's authorities had allowed popular opinion to express itself in more normal ways .. there would have been no ULGOR, no Caja Laboural Popular, and no group of prosperous and dynamic cooperative enterprises (1978, 172-3).

Mondragon is as much a political enterprise as it is a economic one. It is sustained by a existing belief among members in equality and democracy and it is this ideology which allows Mondragon to prosper despite the inadequacies of LMFs.

Marshall (1925, 305) and Mill (1970, 792-3) argue that LMFs fail because they are unable to recognise and adequately reward entrepreneurial and managerial talent. This is a specific application of a general argument introduced in Chapter Three: markets are necessary not only to coordinate resource allocation

but to provide incentives. Within Mondragon, strict pay differentials mean that unskilled members are paid more than they would be in capitalist firms and skilled workers and managers less. One study in 1986 found that most senior grades would be able to secure between eighteen and forty per cent pay increases if they defected to a capitalist firm (Whyte and Whyte, 1991, 217). The Chief Executive of FAGOR, one of the largest firms within the Mondragon group, is paid less than half of the wage of a comparable capitalist manager. But Mondragon has experienced few problems in recruiting and retaining talented individuals and it may be that this is because income is not the primary motivation. In their survey of member attitudes, Bradley and Gelb (1983, 69) found that if offered a fifty per cent rise in a capitalist firm, only a quarter of workers in Mondragon firms would even consider moving.<sup>3</sup> Members may simply be trading-off wages against job security but for accomplished senior managers, unemployment is unlikely. The possibility that members are trading-off wages against their political preferences for working in a LMF in which pay is more egalitarian and decision-making democratic has to be considered. As an organisational form, Mondragon does not have to eliminate the trade-off between efficiency and equality: members already possess the values which models of socialist entrepreneurship are trying to realise.

Political beliefs may also sustain the programme of employment expansion. This 'open door' policy has been described as 'one of

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<sup>3</sup> Among capitalist firms, the figure was just over half. It was made clear to respondents that in moving they would also be compensated for any loss in their individual accounts.

the few major ideological commitments of the Mondragon group' (Oakeshott, 1978, 194). As expansion is not always in members narrow self-interest (6.2.3), the 'open door' policy may show that members are not egoists. Robinson (1967), Vanek (1969) and Meade (1975) certainly argue that employment will be sustained because members pursue 'collective' goals. But it is upon the assumption of egoism that any viable model of socialist entrepreneurship must depend.

Political beliefs can account for the success of Mondragon and the more general failure of LMFs but does this mean that LMFs are necessarily doomed? Mondragon survives because its members already possess socialist political values. Most individuals in most parts of the world do not share these values and so LMFs do not displace capitalist firms. But the prerequisite for the implementation of schemes of socialist entrepreneurship is the election of a socialist government which will presumably only happen when a majority of the population have come to believe in socialism. LMFs are cherished because they allow for the expression of socialist values and not because they will realise socialism in the absence of any commitment to socialism. One further example can be used to cast doubt upon this defence.

A entrepreneur who starts a capitalist firm is personally liable for its performance whether good or bad. A entrepreneur who starts a LMF will also be personally liable for its failure but if the firm succeeds, the entrepreneur must share future profits with other members. LMFs create an asymmetry in the costs and

benefits of entrepreneurial action and this violates a requirement of socialist entrepreneurship identified in Chapter Two. LMFs are inferior to capitalist firms not because they will not grow but because they are less likely to be started.

Recognising this problem, Dahl (1985, 151) proposes that entrepreneurs be allowed to start capitalist firms and have to convert them to LMF status only when they develop beyond a certain point. Until then entrepreneurs should be allowed to monopolise both profits and losses. The solution raises a number of problems. First, it represents an uncomfortable acknowledgement of the limitations of socialist entrepreneurship. Second, it discourages success. Having discovered a new opportunity, entrepreneurs will have no incentive to fully exploit it as sustained investment and expansion may take them beyond the critical threshold set by government. Finally, the solution still discourages the initial creation of a firm as the spectacular prizes an entrepreneur can acquire when a firm has developed are the necessary (ex poste) rewards for having committed personal resources.

Again, Mondragon appears to offer succour. Here, new firms are regularly created. In part, this is because of the role played by the CLP. By offering entrepreneurial support, risks are minimised and less spectacular prizes required to motivate individuals. The costs and benefits of entrepreneurial action are more closely aligned. But it is still necessary to account for the initial creation of the first firms whose profits later made

possible the establishment of the CLP. Here, attention is usually focused upon one individual. 'Historically, the Mondragon group owes an incalculable debt to one man ... a Basque priest, Father Jose Maria Arizmendi' (Campbell, Keen and Oakeshott, 1978, 23).

Arizmendi arrived in Mondragon in the aftermath of the Civil War, having narrowly escaped execution for his part in the production of a Republican magazine. He never held a formal position of authority within any Mondragon firm but pressed for the creation of ULGOR, the CLP and subsequent expansion. He was active in all aspects of decision-making and his judgement was trusted by all involved. But if Arizmendi was an entrepreneur, his motivation was political and spiritual rather than narrowly economic. He never profited from Mondragon's success and considered it a

social monstrosity that a system of social organisation in which some can take advantage of the work of others for their exclusive personal profit (quoted Whyte and Whyte, 1991, 254).

Mondragon's reliance upon such a figure is not unusual. The history of the cooperative movement is littered with such examples. Robert Owen founded 'New Harmony' for the purpose of political propaganda. In the 1970's and for largely similar reasons, the then Secretary-of-State for Trade and Industry, Tony Benn, committed millions of pounds of taxpayers money to three LMF's all of which subsequently failed: the Scottish Daily News, Meridan Motorcycles and Kirby Engineering. The Industrial Common

Ownership Movement in which one minimalist, Oakeshott, is personally involved is inspired, like the Rochdale cooperative movement, by Quaker philosophy. The initial finance came not, as in Mondragon, from collections among residents but from the legacy of a wealthy capitalist, Ernest Bader (Campbell, Keen and Oakeshott, 1978, 11).

The creation of LMFs depends on the presence of individuals whose commitment to equality is such that not only are they willing to forego future income but risk their own resources through the creation of a firm. This is to demand a great deal of individuals and it is unlikely that even if a majority of the population are converted to socialism that many will accept this level of commitment. Altruism and political entrepreneurship will always ensure the creation of some LMFs but socialism should not have to rely upon such individuals. Capitalist firms have the advantage of 'economising on virtue' (Brennan and Hamlin, 1995).

### 6.5.3 Free Riding and the Labour Managed Firm

When recruiting new members, Mondragon is attentive not only to applicants skills but to their values. An emphasis is placed upon recruiting those who exhibit a preference for cooperation over competition and such attitudes are reinforced by intensive training schemes (Bradley and Gelb, 1983, 19) and ultimately enforced by the right of the firm to expel a member after their first six months. Within Mondragon, such a strategy is viable for two reasons. First and as already seen, the town of Mondragon has



a long history of political radicalism. Second, Mondragon is an isolated LMF in a nation of capitalist enterprises. Mondragon does not have to compete against other LMFs for the attentions of a finite pool of the politically committed and can afford to exclude those whose motivation is more narrowly egoistic. If all firms were to become LMFs this would no longer be possible and performance would be likely to suffer.

In this way, Mondragon benefits from its isolation in a capitalist economy. In one further respect it does so more directly, deriving a positive externality from the existence of capitalist firms. To see why it is necessary to return to transaction cost analysis.

In terms of political values, the democratic structure of LMFs is appealing but substituting authority for democracy is also costly. First, providing the time and information necessary for democratic decision-making is itself expensive. Preparation for ULGOR's General Assembly in 1986 cost the firm over fifty dollars for each member (Whyte and Whyte, 1991, 227). Capitalist firms are not so encumbered as shareholders who have no substantial interest in their firm can rely upon share price to provide sufficient information. Second, democracy retards decision-making. Successful entrepreneurial action frequently requires immediate action. To place this in the context of Israel Kirzner's account, it is not enough that the entrepreneur is alert to new opportunities, they must also be ready to immediately act upon them before the opportunity disappears.

Within Mondragon, important decisions that cannot be taken by the Junta Rectora alone must be referred to the Social Council and ultimately the General Assembly.

Changes require an extended and complex process of discussion and negotiation ... major changes cannot be accomplished quickly (Whyte and Whyte, 1991, 100).

It has been repeatedly emphasised that entrepreneurial activity entails the acceptance of risk. Given the difficulties involved in ascertaining, for example, future demand for a product it can be argued that collective decision-making within the LMF is preferable to individual fiat within the capitalist firm. The Condorcet jury theorem demonstrates that so long as any one individual's chances of making the right decision are greater than 0.5, the larger the group the higher the probability that it will make the right decision (Gorfman and Held 1988). But rational choice more generally emphasises the difficulties of collective decision-making. Arrow's theorem (1963) shows that in the absence of a dictator, decision-making is vulnerable to instabilities, intransitivities, indecisiveness and manipulation. As Gary Miller (1992, 64) concludes,

firms that seek to realise the efficiency potentials in specialized, interdependent team production processes not only must create authoritative group decision structures, but must also centralize power (1992, 64).

Rational choice also suggests that in particular circumstances - principally when there exists a single issue dimension - decisions made by an electorate will converge upon the position of the median voter (Mueller, 1989, 65-7). Democracy will marginalise minority preferences and enshrine majority ones. This is significant as the elite model of entrepreneurship suggests that the best (ex poste) decisions are frequently those which (ex ante) are most likely to challenge received wisdom.

To act with confidence beyond the familiar range of beacons ... requires aptitudes that are present in only a small fraction of the population (Schumpeter, 1943, 132).

The comforting conclusions of the Condorcet jury theorem do not hold in the case of elite entrepreneurship as the chances of any one individual having the right answer are less than 0.5. LMFs constrain entrepreneurial action. Consider the position of an individual who has discovered the possibility of making a existing product in a new, untested and seemingly improbable way. In a capitalist system, if the individual is the owner of a firm they will be able to pursue their project whatever the doubts of employees.<sup>4</sup> Within a LMF, the entrepreneur will first have to convince other members of the merits of their idea. Even if they succeed, considerable effort will have to be devoted to changing others preferences. It is more likely that such efforts will fail

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<sup>4</sup> They may have to convince investment companies to support their project and it has been argued that capitalism starves innovative firms of necessary resources.

and that opportunities although discovered will be neglected. The radical entrepreneur will be shackled by their colleagues and this conservatism is manifested in Mondragon's record of industrial production.

The first Mondragon firm, ULGOR, manufactured paraffin lamps. There was no need for innovation as those involved simply bought a French lamp, dismantled it and without regard to patent laws simply copied it (Thomas and Logan, 1982, 20). As the group developed, firms came increasingly to specialise in the production of consumer electrical items, acquiring licences to produce the products of German companies behind Spain's tariff barriers. Today, the technology remains limited and borrowed. As Oakeshott (1978, 166) accepts, 'there are no computer manufacturers in the Mondragon group, nor any builders of nuclear power stations'. The development of IKERAN, Mondragon's own research centre, has improved but not revolutionised production.

The industrial cooperatives do a certain amount of research, but most innovations as far as technology and new products are concerned have been introduced after obtaining licences and patents from elsewhere (Thomas and Logan, 1982, 59).

Far from being discriminated against, it appears that Mondragon has benefited from the presence of capitalist firms. It has been able to free ride on the innovative activities of others. Mondragon firms do not so much produce as reproduce, exploiting

the comparative advantages which their organisational structure gives them in terms of static efficiency. Does this strategy simply reflect the unique circumstances of Mondragon's development? The inability of LMFs to cope with the demands of elite entrepreneurship suggest that it may not. Mondragon may not only be unwilling but also unable to pioneer new products. Two further arguments can be used to support the conclusion. First, elite entrepreneurship is particularly risky. Entrepreneurs will require greater incentives to start firms engaged in the process of creative destruction and it has already been argued that LMFs are unable to offer these incentives. Second and for the same reason, such projects will be less appealing to the CLP and other members of the group who will have to partly fund investment and who cannot afford a large number of failures. That Mondragon has restricted itself to the production of tried and tested goods for which a proven market exists suggests a very different explanation of the groups high success rate.

## 6.6 Conclusion: Stakeholder Socialism

The basic actor in a market economy is the firm. It brings material, money and labour together to produce goods and services (Hutton, 1996, 111).

One important conclusion of this chapter is that markets are a necessary but not sufficient condition for successful entrepreneurial action. To understand the achievements of capitalist entrepreneurship and the requirements of socialist entrepreneurship it is necessary to look inside the 'black box' of organisational design. Both neo-classical and Austrian economics are limited by their failure to do so. A second conclusion is that the precise form of organisation matters. The New Right's assumption that choice can be left to the evolutionary mechanism of the market is erroneous. Will Hutton (1996) argues that this policy has led to a lack of trust, a lack of investment and the squandering of entrepreneurial opportunities. He offers in its place a model of 'stakeholder capitalism' which has obvious parallels with Mondragon. Like John Roemer (1994, 41), Hutton looks to emulate the Japanese Keiretsu system which ties banks into a long-term development relationship with firms similar to that experienced between the CLP and first level firms. But whilst Hutton challenges particular forms of private ownership, he does not challenge private ownership itself. Stakeholder capitalism is not New Right capitalism but it is capitalism nonetheless. Mondragon is more radical in that it offers workers more than co-determination or employee share

ownership. Workers are made the exclusive owners of a firm and 'Individual accounts represent evidence to members that they are stakeholders' (Thomas and Logan, 1982, 184). By making exit more difficult and by eliminating the distinction between employers and employees, Mondragon ensures a 'positive collusion to maximise joint wealth' (Fitzroy and Cable, 1980, 120).

## Chapter Seven

### Bureaucratic Entrepreneurship: Incentives

- 7.1 Introduction
- 7.2 Bureaucracy, Principals and Agents
- 7.3 False Starts
  - 7.3.1 Principals, Agents and Monitoring
  - 7.3.2 Principals, Agents and Buy-Outs
  - 7.3.3 Principals, Agents and Risk-Sharing
- 7.4 Tournaments and Bureaucratic Competition
  - 7.4.1 Tournaments: Characteristics and Advantages
  - 7.4.2 Tournaments: Problems and Solutions
- 7.5 Efficiency and Equality: Return of a Trade-Off
- 7.6 Conclusion



## 7.1 Introduction

The last two chapters have taken us some way toward a theory of feasible socialist entrepreneurship but neither MIS or LMFs satisfy the requirement, introduced in Chapter Two, that socialism be capable of generating neo-pluralist, elitist and new right entrepreneurship. The use of decentralised markets ensures that both are capable of stimulating new right entrepreneurship but MIS is unable to sustain neo-pluralist and LMFs elite entrepreneurship. In the pursuit of an alternative, the next three chapters turn from an appraisal of established models of market socialism to the construction of a new one: bureaucratic entrepreneurial socialism (BES). Chapter Eight offers a detailed account of the structure and mechanics of bureaucratic entrepreneurship. In this chapter, attention is focused more narrowly on the specific issue of incentives for entrepreneurial action.

Capitalist markets animated by private ownership provide both a framework within which innovation and coordination can take place and incentives for the discovery of entrepreneurial knowledge. The prospect of acquiring spectacular prizes and the fear of personal bankruptcy ensures that entrepreneurs remain alert to new opportunities. Socialists cannot rely on capitalist incentives as they generate excessive inequality. If only capitalist markets offer sufficient incentives for entrepreneurial action then it would appear that there is a necessary trade-off between efficiency and equality. Although the

terms lack precision, subsequent analysis will benefit from a distinction between 'sensitive' and 'insensitive' incentive schemes.

When remuneration is closely tied to performance, incentives are sensitive. When remuneration is only loosely correlated with performance incentives are insensitive. Capitalist incentives are relatively sensitive and can be contrasted with those found in, for example, MIS where successful and unsuccessful entrepreneurs receive the same reward. Sensitive incentives secure entrepreneurial motivation but threaten equality whilst insensitive incentives secure equality but threaten entrepreneurial motivation. Socialists do not have to choose between these polar extremes and can devise any number of incentive schemes which are more sensitive than those found in MIS but less sensitive than those found in capitalism but it appears that in doing so, a trade-off between efficiency and equality cannot be avoided. Socialists can manage the terms of the trade-off but cannot eliminate it.

One problem with this simplistic account is that it fails to recognise the impact of environmental structure on incentives. It is, for example, the organisational structure of bureaucracy that William Niskanen (1971) claims creates incentives for bureaucrats to budget-maximise. The structure of LMFs discourage shirking and reduce the transaction costs of economic activity whilst small organisations which encourage frequent interaction between workers and from which exit is costly reduce shirking

within MIS. Incentives are not simply a function of the sensitivity of payment. Organisation matters and can reduce the extent of the trade-off between efficiency and equality.

In this chapter and having presented incentive problems in terms of principal-agent analysis, various other organisational devices for managing and reducing the trade-off between efficiency and equality are considered. Discussion of the necessary sensitivity of payments is postponed in favour of looking inside the black box of organisational design. A number of obvious candidates for cultivating entrepreneurial incentives are rejected on either political or technical grounds and a specific proposal which can provide a vehicle for efficient socialist entrepreneurship is introduced.

## 7.2 Bureaucracy, Principals and Agents

Building on seminal articles by Stephen Ross (1973) and Armen Alchian and Joel Demsetz (1972), principal-agent analysis (PAA) is now firmly embedded within several strands of the social science literature. Although in many respects an extremely useful tool, recent contributions have tended to be highly abstract, focusing upon specific mathematical problems of little relevance for policy debates (Arrow, 1984, 48, Moe, 1984, 773). One purpose of this chapter is to show the ways in which PAA can be used to illuminate issues raised in earlier chapters.

According to John Pratt and Richard Zeckhauser (1984, 2), 'whenever one individual depends on the action of another, an agency relationship arises. The individual taking the action is called the agent. The affected party is the principal'. This definition is extremely broad, placing all individuals in a market economy in an agency relationship with each other. Principal-agent relationships (PARs) can only be described as posing a principal-agent problem (PAP) - with which this chapter is more particularly concerned - when two further conditions are satisfied. First, the principal and the agent must perceive themselves as having conflicting interests. In James Coleman's (1990, 74) terms, the relationship between principal and agent must be 'disjoint' rather than 'cojoint'. Second, there must be some initial uncertainty on the part of either the principal or agent as to whether the other has or will act in intended ways (Levinthal, 1988, 156).

It may be briefly noted that the use of PAA sits comfortably alongside earlier assumptions and arguments. First and on the assumption that it will subsequently prove useful, PAA casts further doubt upon the efficacy of neo-classical economics. The importance of uncertainty and subsequent recognition of the need to look inside the black box of organisational design are largely discounted by neo-classical economics. Second and for the same reason, PAA can easily embrace the use of new economic institutionalism. PAA and the costs of any subsequent resolution of them can be classified as a transaction cost; one which frequently complicates the processes of coordination and innovation. Third, the assumption of a conflict of interest within PAA seems to imply either the presence of egoistic or, as Williamson prefers, opportunistic motivation. Conflicting interests matter and threaten entrepreneurial efficiency because individuals can be expected to act upon these interests: the 'core' assumption of rational action.

PARs and PAA are pervasive features of life and are to be found between many different categories of economic actor (Arrow, 1984, 37). It is important to note that PARs can take many different forms and that individuals can simultaneously be both principals and agents. A number of PARs have already been encountered in earlier chapters. The PAR between junior employees (agent) and managers (principal) is mediated in capitalist firms by mechanisms of vertical control, in MIS by horizontal control and in LMFs by both vertical and horizontal control. In some capitalist firms, additional PARs are found between directors

(agent) and shareholders (principal) and here interests are (supposedly) reconciled through capital markets and takeovers. Within the LMF, the board of directors (agent) - in the case of Mondragon, the Junta Rectora - is ultimately responsible to its owners who are also its workers (principal). The owners of a public bureaucracy are government. In Chapter Nine, the PAR between government (agent) and the electorate (principal) is considered. In this chapter, attention is focused on the PAR between government (principal) and entrepreneurs (agent).

Before proceeding to a discussion of the various ways in which this relationship can be managed, it first needs to be established whether this PAR also constitutes a PAP. First and given the definition of entrepreneurship employed, it is reasonable to assume that the relationship between government and bureaucracy will at least initially be characterised by some uncertainty. Second, it is assumed that sole interest of the government is to maximise the volume of efficient entrepreneurial action. In Chapter Nine the validity of this assumption is challenged but for now it can be justified as a necessary feature of feasible socialist entrepreneurship. Given the division between government ownership and entrepreneurial control of resources, it cannot necessarily be assumed that entrepreneurs will share this interest. Within much of the principal-agent literature, the agent is assumed to have a preference for 'shirking' (Bendor, 1990, 390). This may simply manifest itself in reduced effort or it may imply the maximisation of budgets (Niskanen, 1971), discretionary resources (Williamson, 1964,

Niskanen, 1991), or total sales (Baumol, 1959). As none of these will necessarily realise the government's interests, the relationship can be assumed to be disjoint.<sup>1</sup>

George Stiglitz (1975, 966) argues that the solution to any PAP is to 'design a compensation scheme which motivates the agent ... to act in the principal's interests'. The responsibility and challenge for government is to design an incentive scheme that can motivate entrepreneurial action and discourage shirking or budget-maximising. Stiglitz's suggestion is valuable because it emphasises the hierarchical nature of PARs. Principals are frustrated by a lack of information about agent's actions but can compensate for this with their greater power. By using their authority to manipulate the terms of the contract offered to entrepreneurs, government can hope to 'achieve an outcome different from that which would have occurred in the absence of [its] intervention' (Barry, 1983, 341). Through a combination of threats and offers, government can deny to entrepreneurs the opportunity to realise those parts of their preference schedule which conflict with the government's interests.

The government's success in transforming a disjoint into a cojoint relationship offers the most obvious criterion by which the merits of any incentive scheme can be assessed. In addition, it is possible to identify four further conditions which must be met if any proposal is to be deemed viable. First, solutions

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<sup>1</sup> It is said 'necessarily' because and as argued in Chapter Three, budget-maximising can lead to efficient volumes of entrepreneurial innovation in particular circumstances.

should not exacerbate problems of adverse selection or, more generally, have the effect of reducing the quality of new entrepreneurs. Second, solutions should not be prohibitively expensive to implement. Third, solutions should not impede the realisation of socialist values. A scheme which induces entrepreneurial efficiency but which threatens either equality, democracy or liberty is not desirable. Finally and given the reservations expressed about the Mondragon scheme, any solution should be capable of implementation at a global as well as a local level.

Theorists have identified a number of ways in which the interests of principals and agents can be reconciled (see Milgrom and Roberts, 1992 for a general survey). In the next section it will be argued that two of the more common, monitoring and buy-outs, are of little value for socialist entrepreneurship. A third, risk-sharing, is preferable but raises particular technical difficulties.



### 7.3 False Starts

#### 7.3.1 Principals, Agents and Monitoring

Monitoring by a principal of an agent's actions is perhaps the most frequently practised solution to PAPs; its general nature having already been encountered within both the capitalist firm and MIS. In this case, government agrees to pay a bureaucratic entrepreneur a fixed wage but withholds some proportion if monitoring reveals entrepreneurial shirking. Knowing the penalties, entrepreneurs will adopt the government's goals and maximise effort. If a 'forcing contract' (Miller, 1992, 104) can be devised which ensures that the entrepreneur is paid just enough to secure maximum effort, the solution can be used to secure not only efficiency but greater equality. Entrepreneurs will not have to be paid spectacular prizes and profits from successful entrepreneurial action can be redistributed by the state. Barry Weingest (1983) has argued - contrary to Niskanen's claims - that monitoring can effectively regulate the relationship between government and bureaucracy but entrepreneurial activity raises particular difficulties for monitoring. Drawing upon the analysis in Chapter Five, a distinction can be drawn between (i) the monitoring of outputs, and (ii) the monitoring of inputs.

#### (i) The Monitoring of Output

Monitoring is most effective and entails only minimal

implementation costs when there is a predictable relationship between entrepreneurial input and output. In such circumstances, government can simply extrapolate from their performance an entrepreneur's effort and reward or punish her accordingly. In these circumstances it is not even clear whether the PAR constitutes a PAP as uncertainty has been eliminated. Such a solution is not viable here. Entrepreneurship, as Joseph Schumpeter (1943, 73-4) suggests, is an activity in which luck partly determines outcomes, in which 'failure ... threatens or actually overtakes many an able man'. Government will struggle to discern any clear relationship between entrepreneurial effort and outcome and risks rewarding shirkers whilst punishing those who have been unfortunate.

Bengt Holmstrom (1979) and Roy Radner (1981) argue that these difficulties can be surmounted through the long-term monitoring of performance. If output - most obviously profit - is observed over a indefinitely long period, the principal can be relatively sure that moments of good luck will have compensated for bad luck, leaving for each entrepreneur a precise relationship between input and output. However, if entrepreneurs heavily discount the value of future income, shirking may remain the optimal strategy and monitoring in the long-term may simply encourage entrepreneurs to shirk in the meantime. Second, monitoring in the long-term also means that individuals who lack the ability to be successful entrepreneurs are sheltered from the consequences of their actions in the short-term. In the case of entrepreneurial activity this is important because the costs of

failure are likely to be high. Government may be able to bear the costs of employing a large number of poor typists but will be crippled by employing large numbers of poor entrepreneurs for whose losses they are responsible.

#### (ii) The Monitoring of Input

In situations where there is no predictable relationship between outputs and inputs, the obvious alternative is for the government to monitor inputs directly. Such a strategy is, for example, used within the kibbutz to regulate behaviour. In many respects, the method is inferior. First, it creates additional transaction costs as the principal will normally have to hire another individual to undertake the monitoring. Second, this creates an additional PAR which government may have to monitor. Finally and as suggested by Anthony Downs' 'Law of Counter-Control' (1967, 147), monitoring may encourage entrepreneurs to invest resources in attempts to mislead the monitor.

In the case of entrepreneurship, further problems can be identified. First, if entrepreneurs are budget-maximising rather than shirking, simple forms of input monitoring will be ineffective. Descending on the enterprise, a monitor may well find a hive of activity but will be in danger of drawing the wrong conclusion from it. Second, monitoring will be frustrated by the particular nature of entrepreneurial activity which is frequently cognitive rather than mechanical and dependent upon the application of tacit knowledge and the occasional flash of

genius. Confronted by new circumstances and ideas, the monitor will struggle (ex ante) to judge the worth of a particular project. Monitoring may well reveal the entrepreneur sat at their desk contemplating new innovations but the monitor will not, for example, know whether every option has been explored because this will require an entrepreneurial judgement, the accuracy of which can only be revealed ex poste.

In emphasising the difficulties of monitoring, discussion has been pulled toward the elite theory of entrepreneurship. Within the modern corporation, entrepreneurial activity may be more predictable, allowing, as Schumpeter (1943, 132) envisages, 'things [to be] strictly calculated that had of old to be visualised in a flash'. As has already been argued in Chapter Two, the problems of socialist entrepreneurship are not general but depend upon the particular form of entrepreneurial activity under consideration. As with the LMF, the suggestion here is that effective monitoring may be possible for neo-pluralist but not elite entrepreneurship. Monitoring, it can be concluded, represents at best only a partial solution to the PAP between government and bureaucracy.

### 7.3.2 Principals, Agents and Buy-Outs

A second possibility is to place the risk of any venture with the agent, to allow the entrepreneur to 'buy-out' government ownership. Steven Shavell (1979) argues that in conditions of pervasive uncertainty, the optimal course of action is frequently

for the agent to give the principal a fee in return for the claim to any residual profit. Being both owner and manager, the agent will then bear the full costs of their actions and have no more incentive to shirk or budget-maximise than the capitalist entrepreneur. Whereas monitoring institutionalises the PAR and emphasises the presence of hierarchy, buy-outs dissolve the PAR and eliminate hierarchy.

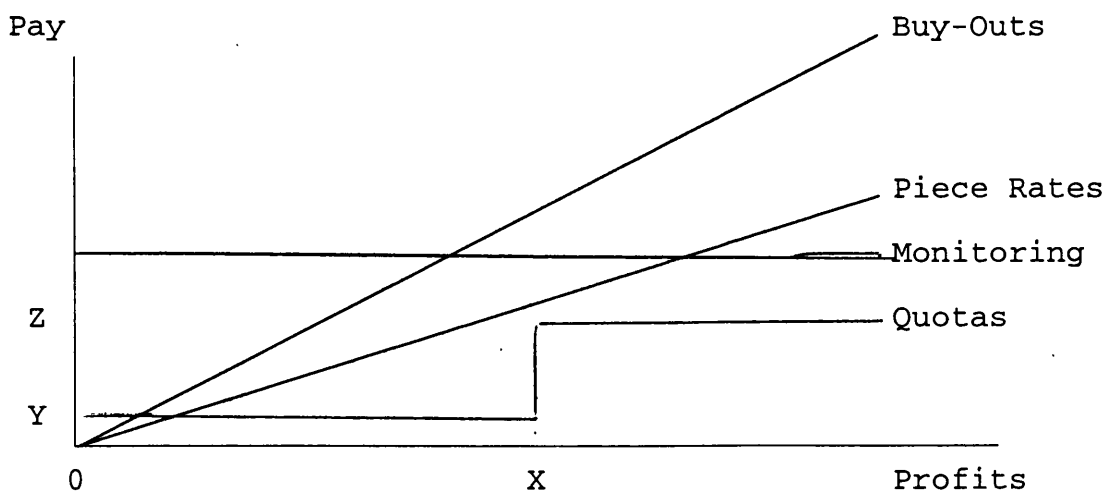
Objections to buy-outs, already rehearsed, are political. By placing the burden of risk upon the entrepreneur, buy-outs generate inequality. Entrepreneurs who are both talented and lucky will receive considerable rewards. Buy-outs, it should be noted, will not simply replicate capitalist inequality and are for this reason preferable. The fees paid by the entrepreneur for the right to use public assets and claim residual income from them will be a source of income which can be redistributed by government. But considerable inequality will remain. Buy-outs are not a method to be employed by a socialist bureaucracy but are an alternative to it.

### 7.3.3 Principals, Agents and Risk-Sharing

Given the difficulties involved in monitoring entrepreneurial action, it nonetheless appears desirable that bureaucratic entrepreneurs bear some of the risk of any venture: that their remuneration be tied to performance in some direct way. Figure 7.1 illustrates two possible ways in which this can be done; through quotas and piece rates. Here, the horizontal axis depicts

profits made for the government by an entrepreneur and the vertical axis payments made by the government to the entrepreneur. In a quota system, the government dictates some minimum level of performance,  $X$ , which the entrepreneur must satisfy, paying individuals  $Y$  if they fail to reach this level and a fixed amount,  $Z$ , if they reach or exceed it. Piece rates allow the government to gear pay to performance more subtly. Wages can be made proportionate to profit at some specified rate. One obvious possibility is that entrepreneurs be made to bear a certain proportion of profits or losses, for example ten percent. Both quotas and piece rates can be easily distinguished from monitoring and buy-outs. In the latter there is an exactly equal relationship between pay and profit. In the former and subject only to a favourable monitor's report there is no relationship between pay and performance. It is this and not the absolute level of payment which distinguishes piece rates and quotas.

Figure 7.1. Gearing Pay to Performance



The use of quotas or piece rates as a way of linking pay to performance does raise a number of largely technical difficulties. First and with respect to quotas, there is an obvious danger that the entrepreneur having satisfied the minimum requirement,  $X$ , will begin to shirk. By imposing a number of different quota levels each of which carries a different payment, such problems can be alleviated. But unless the number of payment levels is exactly the same as the number of possible profit levels - transforming a quota system into a piece rate one - opportunities for shirking remain. Second, in the case of both quotas and piece rates, obvious disputes will arise over the appropriate level at which the quota or proportionate rate should be set. Entrepreneurs will attempt to convince the government that the quota should be set at a low level and the piece rate at a high one. Given the uncertainty that surrounds entrepreneurial action and the impossibility of judging (ex ante) the likely (ex poste) result of a course of action, it will be unlikely that either party will discover a 'right' answer and time and effort devoted to bargaining constitutes a considerable transaction cost.

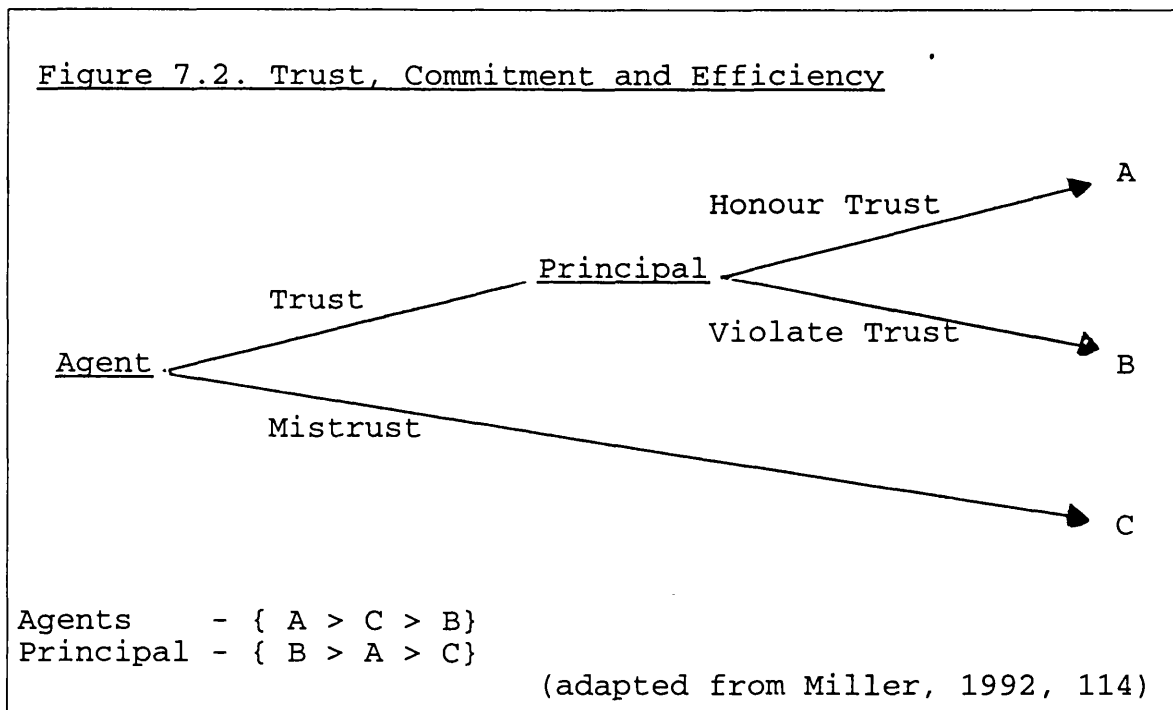
Even having agreed upon a rate, disputes may continue. Entrepreneurs will fear that if they maximise their effort and return significant profits government will respond by raising the necessary quotas and lowering the piece rate. Knowing this, agents might find it rational to continue shirking in the expectation that by doing so they can convince the government of the difficulty of entrepreneurial action and secure a lower quota

and higher piece rate. This strategic behaviour is likely to retard efficient entrepreneurial action and plagued incentive systems adopted in the Soviet Union (Ekern, 1979).

At the same time and as Gary Miller (1992) argues, many private sector firms appear to have resolved such difficulties. To see why, the relationship between principal and agent should be seen in terms of commitment, trust and honesty. In Figure 7.2 it is assumed both parties are considering the introduction of a specific piece rate or quota. The agent has the choice of either trusting or not trusting the principal. If she does not trust the principal she will continue to shirk, perhaps in the expectation of subsequently altering the terms of the agreement. If the agent trusts the principal she will work to the best of her ability within the terms of the agreement. If the agent trusts the principal, the principal in turn faces the choice of whether to honour or violate that trust. If he honours the trust he will retain the agreement even if the agent performs well and significantly exceeds the minimum quota requirement. If he violates the trust he will alter the terms of the agreement if the agent performs well, setting far tougher standards of performance. There are three possible outcomes (A-C). The agent most prefers an outcome in which she trusts the principal and the principal subsequently honours that trust (A). Here, the agent is rewarded for her effort. The agent will least prefer an outcome in which she trusts the principal and the principal subsequent violates that trust (B). Here, the agent is punished for their initial effort. Cooperation is uncertain because this



is precisely the outcome which will maximise the principal's profits. Having used the initial agreement to see how agents are capable of performing, he can subsequently impose a forcing contract. Fearing that if they bestow trust upon the principal that the principal will have every reason to abuse that trust, the agent may find it necessary to withdraw trust from the start (C). This outcome is pareto-inferior ( $B > A$ ) and will reduce the volume of entrepreneurial action.



Within the private sector, two mechanisms exist to facilitate cooperation. First, courts may be used to enforce agreements made between principals and agents. If the principal can be made to bind himself to a particular agreement, the agent will have a reason to bestow trust. The value of external parties who can act as a 'leviathan' has already been noted with respect to

capitalist exchange relationships. Second and as Miller (1992) emphasises, competitive forces can be used to secure cooperation. If a principal violates the agent's trust, it is likely that cooperation will subsequently be withdrawn and performance deteriorate. Knowing this the principal may have no choice but to honour trust if he is to stay in business. In an interesting twist to the discussion of markets and hierarchies in Chapter Six, market forces here play the role of the leviathan. Success is not certain. At any one time, competitive pressures may be so intense as to force the principal to renege upon a agreement and risk the consequences of doing so but the logic of Miller's argument is clear and similar to that employed during the discussion of iterated game theory in Chapter Five.<sup>2</sup>

These mechanisms are not open to participants in the PAR between government and bureaucracy and for this reason Miller's argument does not hold in the case of socialist entrepreneurship. Because in this case the principal is a sovereign power, it may choose but does not have to submit to the authority of the court. Retrospective legislation can always be used to secure legal immunity and knowing this, the agent may be wary of entering into any agreement. Second and again because of its unique political position, the government is insulated from the pressures of competition. Unless emigration is assumed to be costless, agents

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<sup>2</sup> Half a solution is better than no solution but Miller ignores the position of the agent. Why will they not shirk when they know that the principal will honour an agreement? Outcome A is assured only if it is assumed that in the event of (consequent) bankruptcy the agent will struggle to find another job.

will not be able to choose between rival governments to work for and the budget-constraint deterring capitalist defection is softened by government's power to raise additional taxes. It should not be assumed that separation of ownership and control between government and bureaucratic entrepreneurs is equivalent to the separation of ownership and control within capitalist organisations.

One final problem with the use of quotas and piece rates can be identified. Risk-sharing cushions the impact of bad luck on entrepreneurs but does little to reduce its general salience. In times of economic boom, quotas and piece rates - set, perhaps, years before - are unlikely to prove demanding. Even entrepreneurs of below average ability will find that they are able to satisfy minimum quota levels without having to exert themselves. Conversely, in times of recession even the most able and hardest working of entrepreneurs will struggle. Knowing that they are doomed to fail regardless of their efforts, entrepreneurs may simply prefer to shirk.

## 7.4 Tournaments and Bureaucratic Competition

### 7.4.1 Ordinal Tournaments: Characteristics and Advantages

The incentive schemes considered so far have two attributes in common. First, they judge performance absolutely in that pay is tied to individual achievement independently of the achievement of others. Second, performance is judged relative to some externally imposed standard: a particular quota or piece rate. These characteristics contribute to the inefficiencies documented in the last section. An alternative is to judge performance relative only to the achievement of others and on the basis of an internal standard of reference. Such incentive schemes are called tournaments. Here, the entrepreneur who returns the highest level of profit will receive the highest payment. Conversely, the entrepreneur who returns the lowest profit or the highest losses will receive the lowest remuneration or highest penalties. Between these extremes, all other entrepreneurs are ranked ordinally in terms of their relative performance.

With reference to the earlier discussion, several advantages of tournaments can be distinguished. First, they entail minimal policing costs. Government has to do no more than measure, compare and rank performance at the end of competition. Second and unless a particular entrepreneur is convinced that they are certain to win a particular tournament, there is no incentive to shirk once a certain performance level has been reached. Third, tournaments will ease problems of adverse selection. If an

entrepreneur fears that they will do badly in a tournament they will have no incentive to enter it. Fourth and as recognised by Edward Lazear and Sherwin Rosen (1981), Bengt Holmstrom (1982), and Barry Nalebuff and George Stiglitz (1983), tournaments work whatever the degree of uncertainty faced by agents. It does not matter if (ex ante) the principal has little information about likely (ex poste) performance. Fifth, tournaments can partly compensate for the impact of luck. If all entrepreneurs are hampered by a severe recession, relative performance will remain unaffected: all compete on a level playing field. As the same will apply during periods of economic boom, entrepreneurs are given no reason to shirk as a result of particular economic circumstances.

#### 7.4.2 Ordinal Tournaments: Problems and Solutions

A number of potential problems with the use of tournaments can be identified. First, government must decide the reference group against which individual firms are to be judged. One possibility is for government to place entrepreneurs in competition against other enterprises created at the same time. But whilst all participants in a tournament will face the same general economic conditions of boom and bust they may face different specific circumstances. It is entirely possible that the light engineering industry enters a recession at precisely the moment that software design enters a period of rapid growth. In this case, luck still partly determines outcomes and distorts incentives.

Alternatively, entrepreneurs can be placed in competition against others engaged in the same kind of functional activity, software programmers competing against other software programmers. Here, one problem is solved only for a whole series of others to emerge. First, in certain industries there will simply not be enough entrepreneurs for meaningful comparison to be possible. The more innovative bureaucratic entrepreneurs are - the greater the number of new industries that emerge - the greater the problem becomes. Second, precise classification of some industries will prove difficult and generate conflict between entrepreneurs and the government. One of the primary advantages of tournaments - that they allow government to withdraw from the competitive fray - is sacrificed. Finally, such a system encourages inefficiency. Companies producing products for which there is little consumer demand will find themselves able to enjoy the same rewards as others producing in a profitable but crowded market. There is little incentive for firms to coordinate demand and supply by moving from one industry to another. In such cases, government can intervene by denying entry to new firms in certain areas or ordering others to relocate but this will require them to make entrepreneurial decisions which they are not necessarily well equipped to take.

The default solution, then, is to place all entrepreneurs in one giant and inclusive ordinal tournament. There are two possible (and related) problems. First, will inclusive tournaments discriminate against small firms employing only a handful of people who could never hope to make the same kind of profits as

a larger organisation? Second, will inclusive tournaments discriminate against newly formed firms whose products and techniques of production are not yet fully established?

The first argument is unconvincing as discrimination against certain kinds of firms - those that make lower profits - is the very intention of tournaments. If only large firms are able to make large profits then it is a desirable feature of inclusive tournaments that they will eliminate smaller firms. Furthermore, the assumption that smaller firms will be more likely to be eliminated can also be challenged. Precisely because their revenue is larger, large firms have a capacity to make greater losses as well as greater profits. If smaller firms are likely to be clustered around the centre of the ordinal rankings and therefore unlikely to be eliminated will this soften their budget-constraint? Uncertainty about their final position should reduce this possibility but there will still be incentives to remain alert as relative position determines remuneration as well as elimination.

The argument that inclusive tournaments will discriminate against newly formed firms and that this will retard eventual efficiency is more persuasive. It was argued in Chapter Six that capitalism also discriminates against new firms but this offers only a limited defence for socialism. One possibility here would be to run separate tournaments for newly created firms of all kinds. Alternatively, a subsidy could be offered to new firms in their

first few years.<sup>3</sup> Whilst government will then have to specify the relevant time period over which this subsidy will be offered, it will otherwise not have to become engaged in entrepreneurial decision-making.

A second problem with tournaments - emphasised by Paul Milgrom and John Roberts (1992, 404) - is that they appear vulnerable to strategic manipulation. If all entrepreneurs agree to shirk at the start of a tournament, the relative position of each will remain unaffected. Entrepreneurs can receive the same reward for both good and deliberately poor performance. In some respects, the argument is similar to that already levelled against quotas and piece rates; through coordinated action, entrepreneurs can deceive government. Agents face a collective action problem the circumstances of which can be manipulated by government to reduce the probability of deception. In the case of quotas or piece rates, agents have to shirk in order to convince the principal of the severity of the existing system. In the case of tournaments, agents have to shirk for all to secure an unchanged reward. But each agent in a tournament will be tempted by the prospect of unilateral defection and the hope that they can push themselves to the top of ordinal rankings. Universal cooperation (shirking) is Pareto-optimal for the entrepreneurs but will not necessarily be attained as the structure of interaction is that of a prisoners dilemma. As in the case of MIS, cooperation is possible in certain conditions but government can make

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<sup>3</sup> In Chapter Two it was seen that the Conservative Party adopted a similar strategy in the 1980's.



cooperation less likely by favouring tournaments across different industries in which the number of participants is large, interaction infrequent and networks relatively open.

Third, there is a danger that in particular circumstances, tournaments encourage decision-making inconsistent with the requirements of entrepreneurial efficiency. Most obviously, entrepreneurs who are ahead and believe that they will remain so may have an incentive to shirk. Alternatively, individuals in this position may come to simply adopt more conservative entrepreneurial strategies. Conversely, entrepreneurs who are nearing the end of a tournament and who have suffered a series of failures may decide that they have little to lose and take excessive risks.

Care has to be taken before condemning such behaviour. The elite theory of entrepreneurship may be taken to suggest that seemingly excessive (ex ante) risks are precisely those that sometimes bring the greatest rewards and LMFs have been criticised for their aversion to risk. Tournaments should not be condemned simply because entrepreneurs will take risks they would not take under capitalism as capitalist competition is not optimal and cannot serve as a benchmark for judging efficiency. Capitalism may indeed experience a similar problem. In Chapter Five it was noted that because income is subject to diminishing marginal returns, entrepreneurs who acquire spectacular prizes may eschew further risks. The advantage of tournaments is that all will start from an equal position at the start of each tournament. The

problem with tournaments is that it is precisely the individuals whose past records suggest that they are least equipped to deal with risks who are the most likely to take them.

Again, the solution lies in the size of the tournament. The argument that entrepreneurs will take poor decisions rests upon the assumption that they will be aware of how well they are currently performing and in large tournaments it will be difficult for entrepreneurs to accurately assess performance. They may suspect that they are doing poorly but will not know how precarious a position they are in until the tournament ends and results are revealed. The deterrent to excessive risk-taking is the fear that it might make an already poor performance worse. In this respect, tournaments are superior to capitalist competition where entrepreneurs are more likely to be aware of the immanent approach of bankruptcy as profits turn to losses.

Fourth, it is uncertain over what time period a tournament is best run. Over a relatively short period, for example three years, the problem, again, is that results will be contaminated by luck. Alternatively, if performance is judged over a longer period, individuals not suited to entrepreneurial activity will be left to squander public resources. It has already been noted that monitoring experiences the same problems. Compromise and the acceptance of a trade-off appear necessary. But it should not be assumed that in this respect tournaments are inferior to capitalist competition. Most new capitalist enterprises fail and the chances of failure are increased by deficiencies in capital

markets: new businesses are starved of resources and otherwise viable enterprises are frequently bankrupted. The advantage of tournaments is that all entrepreneurs are given a sufficient period in which to establish their credentials.

A related problem surrounds the possibility that entrepreneurs will be unduly influenced in their decision-making by the period of time left in the tournament. With, for example, only one year remaining to the end of a tournament an entrepreneur might be tempted to forego an extremely profitable investment opportunity with a pay-back period of five years in favour of a more modest one which will show a more immediate return. Again, capitalist competition is not immune to such difficulties. The more efficient the monitoring of performance undertaken by capital markets is, the less likely a firm will be to make long-term investments. In the case of tournaments, such difficulties can be minimised through the use of roll-over accounts. Instead of starting each tournament from an equal position, profits and liabilities stemming from decisions taken in previous tournaments can simply be included in new tournaments.

One final deficiency of tournaments should be noted. Holmstrom (1982) demands of any incentive scheme that it be 'budget balancing'. This can be interpreted to mean that no scheme should leave the principal having to pay out to agents more than agents earn for the principal. Buy-outs satisfy this requirement. Having paid a certain fee, the agent bears the entire risk of any subsequent profits or losses. So long as the fee is positive,

government will benefit from the exchange. None of the other incentive schemes considered satisfy this requirement. In the case of piece rates where the entrepreneur receives a certain proportion of earnings, the budget will be balanced so long as profits are positive. This remains the case if the entrepreneur is made to bear the entire cost of any failure. But such a condition results in an asymmetry between the costs and benefits of entrepreneurial action and will frustrate efficient entrepreneurial action. If relaxed, government may be left to carry the responsibility for a large part of any entrepreneurial loss.

With quotas the same difficulty arises. If all fail to satisfy minimal requirements then no wages need be paid to entrepreneurs. If the quota is set at a level of positive profit and if all fall just short of satisfying its requirements then a surplus may be generated for the government. But whilst if losses are sustained wages will not have to be paid, there is no guarantee government will not lose on any venture. The same logic applies to tournament competition. Depending upon entrepreneurial performance, tournaments can generate profits or losses for government. For this reason, tournaments require the government itself to become an entrepreneur: carrying the risk of the action of others.

### 7.5 Efficiency and Equality: Return of a Trade-Off

In outlining the advantages of tournament competition, the issue postponed until now has been that of the appropriate gearing between pay and performance. Bureaucratic entrepreneurs will be paid wages and the level of their wages will depend upon their relative performance. Whether the winners of a tournament will be paid millions or thousands of pounds and how much money, if any, losers of a tournament will have to pay to government has not been discussed. It is here the trade-off between efficiency and equality most obviously bites. Sensitive tournaments in which successful entrepreneurs are rewarded with spectacular prizes are likely to elicit maximum effort but result in greater inequality. Insensitive tournaments in which successful entrepreneurs are rewarded with only slightly more than the average wage will secure greater equality but are less likely to motivate entrepreneurs.

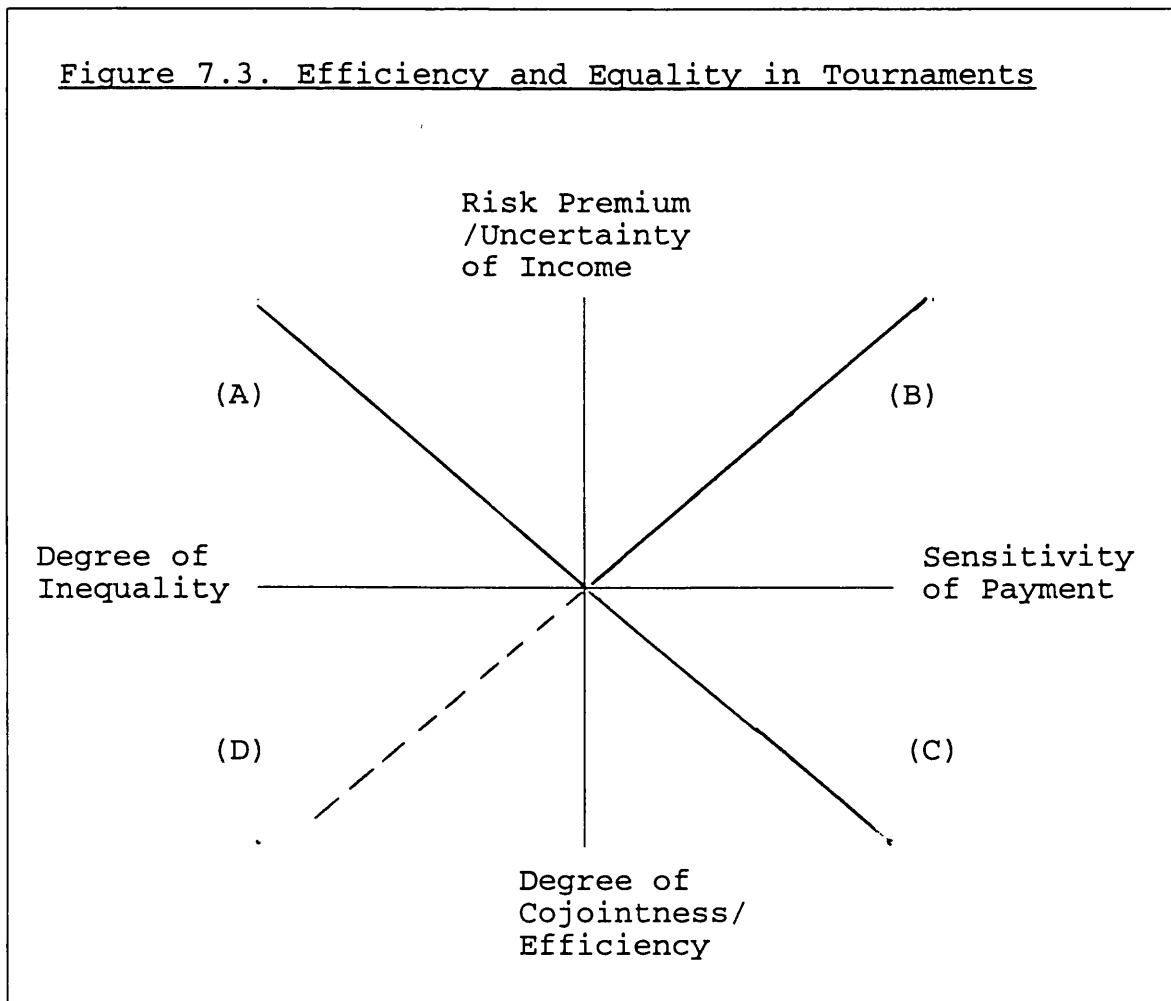
How sensitive must a scheme be before it can induce maximum effort? This is an empirical question and one which rational choice theory is poorly equipped to answer. At certain times and for certain individuals, relatively insensitive payments may suffice. Much will depend on cultural and individual attributes. No definitive answer such as 'X is required to motivate entrepreneurs' can be given. But this does not mean that nothing can be said about the nature and severity of the trade-off between efficiency and equality.

Insensitive tournaments make it more likely that entrepreneurs will shirk and as shirking reduces the volume of entrepreneurial action, insensitive payments threaten efficiency. On the assumption that the relationship between the two is linear, the trade-off is illustrated in quadrant C, Figure 7.3. With reference to the rest of this diagram, it can also be seen that entrepreneurs will have to bear more risk in sensitive tournaments. Tournaments reduce but do not eliminate the salience of luck and entrepreneurs will continue to endure significant variations in their income. For individual entrepreneurs, uncertainty is costly. Government is more able to cope with risk as it is able to draw on reserve funds and compensate for the bad luck of some entrepreneurs with the good luck of others but individuals are unable to do this and are likely to demand a risk premium of higher wages. Entrepreneurs are unlikely to be excessively risk-averse individuals but a premium will still be required and the resulting trade-off is shown in quadrant B.

The relationship between sensitivity and uncertainty can be extended to an additional variable, equality. The more sensitive a scheme, the greater will be the levels of inequality both between entrepreneurs and between entrepreneurs and other groups in society. The latter is due to the effects of the risk premium entrepreneurs will demand and the former to the sensitivity of payment combined with the effects of luck and differential ability. Unless and as in MIS, payments are exactly equal, untalented and unlucky entrepreneurs will always receive a lower income than talented and lucky ones. Sensitive tournaments will

emphasise such differences, the trade-off being illustrated in quadrant A.

On the assumption that any system must remain in or return to equilibrium, it is possible to extrapolate from these relationships a fourth trade-off between efficiency and equality. This is mediated through the others and depicted with a dotted line in quadrant D. Tournaments reduce but cannot eliminate this trade-off, the existence of which can be discerned independently of any assumptions about the specific levels of pay that will be necessary to motivate action.



## 7.6 Conclusion

Theorists are frequently drawn to the conclusion that there is no perfect solution to PAPs, that it is 'impossible for managers to create incentives that completely realign individual self-interest and organizational efficiency' (Miller, 1992, 136). Given the foundations upon which PAA is built, this is not surprising. The initial assumptions of conflicting interests and uncertainty mean that all solutions are likely to be 'second best'. The argument of this chapter has been that the nature of entrepreneurial activity is such as to recommend the use of tournaments and that through careful design the problems associated with their use can be minimised.

In his discussion of the PAR between bureaucracy and government, Terry Moe (1984) identifies two structural weaknesses in government's position. First, he argues that government will be unable to offer incentives that directly reward entrepreneurs for good performance because 'in public bureaucracies ... there is no residual in the ordinary sense of the term' (Moe, 1984, 763). Second, he suggests that PARs between government and bureaucracy are characterised and complicated by the presence of multiple principals. The implication is that the public sector will be less able to deal with PAPs than the private sector. Neither of these conditions have been assumed to apply in this discussion. Agents are made responsible to only one principal and more radically, bureaucracy has been pictured as engaging in profit-making activity. This has taken us far from the picture offered



by Niskanen in his critique of bureaucratic entrepreneurship. Having outlined the contours of a viable incentive scheme, it is now necessary to discuss the ways in which bureaucracy can be made to seek profits, the more general relationship between bureaucracy and the market and the specific ways in which tournaments can be used to animate both.

## Chapter Eight

### **Bureaucratic Entrepreneurship: Structure**

- 8.1 Introduction
- 8.2. Bureaucracy and Markets: The Theory
  - 8.2.1 Bureaucracy and Markets: Opposites and Alternatives
  - 8.2.2 Bureaucracy, Markets and New Public Management
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  - 8.2.4 Bureaucracy: External and Internal Markets
- 8.3 Bureaucracy and Markets: The Practise
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- 8.5 Conclusion

## 8.1 Introduction

Bureaucracy is a term of 'strong emotive overtones and elusive connotations' (Albrow, 1970, 13). Portraits of public sector bureaucrats are frequently unflattering. Those who attempt to define this breed with reference to their behavioral characteristics point to their lack of initiative (Schumpeter, 1943, 207), conservatism (Downs, 1967, 96) and hatred of enterprise (Mises, 1944, 9). In a summary of such criticisms, Owen Hughes (1994, 44) concludes that whilst

formal bureaucracy may have had its advantages it is also argued to breed timeservers not innovators, it encourages administrators to be risk-averse rather than risk-taking and to waste resources rather than use them efficiently.

Discussion in Chapter Three sought to confirm these prejudices. Bureaucrats will only innovate if innovation increases budget size and bureaucrats have no incentive to efficiently coordinate resource use. Market socialists seem largely to accept this argument. Public bureaucracy is associated with the failings of 'classical' socialism and alternative ownership arrangements are sought.

This chapter defends public bureaucracy. Market socialists should embrace and not eschew public bureaucracy. Much depends on the perceived relationship between publicly owned bureaucracy and the

market and section 8.2 argues that this relationship has frequently been misunderstood. Drawing upon competing theories of public administration and with specific reference to recent reforms in the British civil service, it is argued that bureaucracy can be reconciled with markets. This conclusion establishes the possibility of bureaucratic entrepreneurship. Section 8.3 pulls together the threads of previous analysis and introduces a specific model of bureaucratic entrepreneurship that makes use of ordinal tournaments between bureaucrats. Difficulties encountered in the construction of this model are identified and resolved. Finally, the advantages, both economic and political, of bureaucratic entrepreneurial socialism over MIS and the LMF are emphasised. The discussion is relatively uncritical. The limitations of bureaucratic entrepreneurship are examined in Chapter Nine.

## 8.2 Bureaucracy and Markets

### 8.2.1 Bureaucracy and Markets: Opposites and Alternatives

It has been repeatedly argued that markets are a necessary condition for entrepreneurial efficiency and budget-maximising has been seen as the inevitable consequence of abandoning market disciplines. Having relinquished the Weberian definition of bureaucracy when confronted with the activities of public entrepreneurs like Hyman Rickover, this argument can be used to provide the foundation of an alternative definition of public bureaucracy. Bureaucracy is a form of governance characterised by suppression of the market. The definition is not exhaustive. Relationships within families and between friends are not governed by market principles but cannot reasonably be described as bureaucratic. The definition is valuable in this particular context to the extent that it (i) contains within it the basis for a critique of bureaucracy, and (ii) echoes more general beliefs about the relationship between markets and bureaucracy. Hughes (1994, 20) writes that 'provision by markets is the main avenue pursued as an alternative to bureaucracy'. Similarly, Ludwig von Mises asserts that

there are only two methods for the conduct of human affairs within the frame of human society, that is peaceful cooperation among individuals. One is bureaucratic management, the other is profit management (quoted Lane, 1993, 16).

Going beyond the limited definition of markets offered in Chapter Two, the claim that markets are incompatible with bureaucracy can be substantiated with reference to six specific facets of markets: competition, voluntary exchange, private ownership, profit-maximising, hard budget constraints and decentralisation.

(i) Competition Markets are competitive and competition promotes efficiency, provides a mechanism for the communication of entrepreneurial knowledge and incentives for its discovery. The presence of competition underpins Israel Kirzner's account of capitalist entrepreneurship. Bureaucracy is monopolistic (Niskanen, 1971, 30) and retards efficiency. It may be objected that for Joseph Schumpeter monopoly is inexorably linked to innovation but monopolies in his account are only a temporary phenomenon: a by-product of the moment of creative destruction. Public bureaucracy is given a legal and therefore 'non-contestable' monopoly (Baumol, 1982, Spence, 1983). Rickover faced no rivals once given the authority to proceed with the construction of the Nautilus. Bureaucratic monopolies, it can be expected, sap incentives for entrepreneurial discovery and deny entrepreneurs the chance to learn from the mistakes and triumphs of others.

(ii) Voluntary Exchange The exchange of resources within a market is voluntary. This requirement ensures that all market transactions are Pareto improvements and secures consumer sovereignty. Public bureaucracy is coercive. As Christopher Pollitt (1993, 126) emphasises, public bureaucracies are

frequently called upon to provide services - prisons, education, mental health care - to unwilling consumers. The Nautilus was paid for by compulsory taxation. The use of coercion may occasionally be necessary to secure efficiency; facilitating, for example, the provision of non-excludable public goods like defence. At the same time, coercion allows public bureaucracy to discount consumer preferences and to pursue unpopular and unprofitable ventures.

(iii) Private Ownership The presence of private ownership and markets define capitalism and the further claim that efficient markets require private ownership is a salient part of the critique of socialist entrepreneurship. That individuals own resources and can exclude others from using them creates both the possibility of non-coercive exchange and gives entrepreneurs the incentive to remain alert to perviously unrecognised and mutually beneficial trades. Public bureaucracy means state ownership. It was, in some sense, the people of the United States and not Hyman Rickover who owned the Nautilus. Three immediate consequences of denying private ownership can be identified.

(iv) Profit-maximising Private ownership allows entrepreneurs to claim the residual difference between the costs and revenues of any entrepreneurial venture: profit (Alchian and Demsetz, 1972). Entrepreneurs have an incentive to maximise profit and profit assists coordination by sending signals to other entrepreneurs about the efficacy of particular courses of action. Within a public bureaucracy, no such incentives exist.

Entrepreneurs cannot appropriate profits as they do not have any rights of ownership. Instead, bureaucrats will find it in their interests to maximise budget size.

(v) Hard Budget-Constraint Private ownership requires that entrepreneurs be responsible for the losses as well as the profits of any venture. If losses are sufficiently high, enterprises fail. Other firms or individuals may choose to finance losses but are under no obligation to do so. Capitalist entrepreneurs face a 'hard budget-constraint' (Kornai, 1986) and this motivates entrepreneurial discovery and encourages the communication of entrepreneurial knowledge because bankruptcy sends a powerful message to others in the market. As ownership of a public bureaucracy resides with the government rather than individual bureaucrats, budget-constraints are softer. Whilst government can be bankrupted, its coercive powers to raise taxation and print money allow it to sustain unprofitable ventures almost indefinitely.

(vi) Decentralisation Private property facilitates the decentralisation of decision-making. The entrepreneur who owns an enterprise has sovereign decision-making powers within it. If an entrepreneur chooses to make product X, no one can make them produce product Y. Private property when combined with competition ensures entrepreneurial pluralism. Entrepreneurs are not only free but are likely to pursue conflicting entrepreneurial projects. Failures are likely but success possible as entrepreneurial eggs are not placed in one basket.



Bureaucracy, as Weber emphasises, is subservient. Decision-making power within the bureaucracy is centralised and external to it. This was precisely the feature of bureaucracy which recommended its use within Oskar Lange's and Friedrich Taylor's models of socialism but it is also the feature which frustrates entrepreneurial efficiency.

There is little new in this account. The intention has been to both clarify and develop the argument of Chapter Three by more completely specifying the characteristics of the market and emphasising the tensions between market and bureaucracy. To establish the efficiency of bureaucracy it is necessary either to challenge the assumption of market efficiency or to reassert the compatibility of markets and bureaucracy. The former has been rejected and the second will be pursued in this chapter. In defence of the economics of socialism it is possible to call in assistance the politics of the New Right.

### 8.2.2 Bureaucracy, Markets and New Public Management

Until recently, the dominant tradition within public bureaucracy has been that of 'progressive public administration' (PPA) (Ostrom, 1974, Hood, 1994, 125-41, Hughes, 1994, 23-57). These practises which emphasise the values of monopoly and permanence of position provide a 'soft' target for critics like Ludwig von Mises and William Niskanen. The criticisms levelled against public bureaucracy are criticisms of PPA. Since then and, in part, as a result of their arguments (Hood, 1994, 134, Hughes,

1994, 74) an alternative method of governance within public bureaucracy has emerged and gradually displaced PPA (Aucoin, 1990): new public management (NPM). Although, like bureaucracy, a precise definition of NPM has proven elusive, general characteristics can be discerned. Rod Rhodes (1991, 1-2) describes NPM in the following terms.

A focus on management, not policy, and on performance appraisal and efficiency; the disaggregation of public bureaucracies into agencies which deal with each other on a user-pay basis; the use of quasi-markets and contracting out to foster competition; cost-cutting; a style of management which emphasises, amongst other things, output targets, limited-term contracts, monetary incentives and freedom to manage.

NPM is a broad philosophy with many different components the most important of which is perhaps the desire to use markets to enhance the efficiency of public bureaucracy. So pervasive is this association that some commentators have discarded the phrase new public management in favour of 'market-based public administration' (Lan and Rosenbloom, 1992): encouraging critics to speak of 'government by the market' (Self, 1993). Three particular elements of the NPM reform package are important in this context, their implementation and impact illustrated with reference to recent reforms in the British Civil Service.

First, NPM requires the development within public bureaucracy of

competition (Dunleavy, 1994, 38, Dunleavy and Hood, 1994, 9, Hood, 1991, Hood, 1994, 131, Hood, 1995, 5). In Britain, the 'Next Steps' and 'Competing for Quality' initiatives seek to promote competition both between public bureaucracies and between public bureaucracies and private firms. One of the first Next Steps agencies, the Queen Elizabeth II Conference Centre, whose remit is to 'provide secure conference facilities for national and international government and private sector use' (Cabinet Office, 1995, 31) competes with a large number of other venues in central London. Under the 'Competing for Quality' programme, government activities are costed and through tendering offered to other private or public service bodies to provide. The intention, as expressed in the original White Paper, is to 'open up to competition ... areas close to the heart of government' (quoted Fry, 1995, 121).

Second, NPM discourages coercion and encourages the development of user-chargers (Osborne and Gaebler, 1992, 12). Although perhaps practised more frequently now, there is nothing revolutionary in this. Public Bureaucracy does not always rely upon coercion. Her Majesty's Stationary Office (HMSO), (re)launched as an agency in 1988, has for many years sold copies of government reports and parliamentary debates to members of a general public none of whom are forced to purchase material. Finally and as part of these reforms, NPM seeks to encourage profit rather than budget-maximising. Various government agencies - HMSO, the Patent Office, the Royal Mint and Vehicle Inspectorate - have been given 'trading fund' status and required

to operate independently of Treasury constraints and to show a positive return on investment.

In assessing the impact of reforms not only in Britain but in America, Australia and New Zealand, commentators argue that NPM has led to the 'bankruptcy of bureaucracy', (Osborne and Gaebler, 1992) and to the emergence of a 'post-bureaucratic paradigm' (Barzelay, 1992, 116). If bureaucracy is to be defined by its deficiencies the claim has some appeal but in other respects it is simply rhetorical. Our response to inconsistencies between the Weberian definition of bureaucracy and the actions of Hyman Rickover was to not to deny Rickover bureaucratic status but to abandon the definition of bureaucracy. The individuals who work for HMSO are still employed and paid by the state. They continue to perform the same functions. Any definition of bureaucracy which refuses to acknowledge the possibility of a change in the ways that these functions are undertaken is inadequate. In recommending the use of competition to prevent budget-maximising, Niskanen (1971, 195) was seeking the reform not the replacement of public bureaucracy.

### 8.2.3 Bureaucracy and Markets: Institutions and Organisations

Douglass North (1990, 3) defines institutions as 'the humanly devised constraints that shape human interaction [and which] ... structure incentives in human exchange'. The market is an institution. Competition, hard budget-constraints and private ownership create incentives for entrepreneurs to maximise profits

and these characteristics are artificial and humanly devised. Markets depend on laws of contract, free trade and bankruptcy. Voluntary exchange, for example, demands the presence of a 'leviathan' to enforce agreements. North (1990, 5) defines an organisation as 'a group of individuals bound by some common purpose to achieve objectives'. Bureaucracy is a form of organisation (Perrow, 1972, 3, Jackson, 1982, 5). In the terminology employed by Friedrich Hayek, markets are 'nomos' and bureaucracy is 'taxis'.

Bureaucracy and markets are not, as Hughes and Mises suggest, alternatives to each other because they are not, in this sense, comparable. Kinship, voting, bidding, bargaining, custom and lotteries are institutional alternatives to the market (Shubik, 1970) as are moral incentives, economic democracy and ordinal tournaments. Pressure groups, capitalist enterprises, kibbutzim and the labour-managed firm are organisational alternatives to bureaucracy. As Figure 8.1 suggests, choice is not between an institution (the market) and an organisation (bureaucracy) but between types of institution and types of organisation. Markets cannot be operated independently of organisations or more precisely, efficient markets cannot be run independently of organisations. If economies of scale are to be realised or transaction costs minimised, individuals must join together to pursue joint ventures. Public bureaucracy can, as with the case of PPA, co-exist with the use of non-market institutions (II). Alternatively and as with NPM, markets can be used with public bureaucracy (I). Finally, non-bureaucratic organisations

(families) can be used with non-market institutions (reciprocity) (IV), whilst non-bureaucratic organisations (LMFs) can be used with market institutions (III). The claim that markets and public bureaucracy are incompatible is inconsistent with actual bureaucratic practice and confuses two very different theoretical issues.

Figure 8.1. Bureaucracy and Markets

		<u>Institution</u>	
		Market	Non-Market
<u>Organisation</u>	Bureaucratic	I	II
	Non-Bureaucratic	III	IV

#### 8.2.4 Bureaucracy: External and Internal Markets

Once consequence of asserting the compatibility of markets and public bureaucracy is the need to offer an alternative definition of public bureaucracy. In this case, the particular requirement is for a definition that can distinguish public bureaucracy from other organisational forms. From the wreckage of earlier attempts, one characteristic emerges unscathed. As Weber emphasises, bureaucracy is an organisational form which is created to pursue externally determined objectives. As Vincent Ostrom (1974, 3) comments, bureaucracy is marked by a

reliance upon hierarchy where subordinates are required to defer to the commands of superiors in the selection of appropriate action and are subject to sanctions or discipline for failure to do so.

Iconoclastic in many respects, Hyman Rickover nonetheless remained formally accountable to the government of the United States. The construction of a nuclear powered submarine may have been Rickover's own idea but to pursue it he had to receive the permission of first bureaucratic and ultimately political superiors. Bureaucrats are subservient because they are not owners. Subject to the 'prohibition of harmful use' (Honore, 1961, 113), the capitalist entrepreneur is free to use the resources of her firm in any way they want. Unlike the bureaucratic entrepreneur, she has sovereign decision-making powers. Public bureaucracy is that organisational form in which ownership resides with the state. The technocratic entrepreneurs who work within the giant corporation are bureaucrats but because ownership is dispersed among large number of individual shareholders, they are not public bureaucrats.

This feature of public bureaucracy has implications for entrepreneurial efficiency. Because it has coercive taxation powers, government can, if it desires, eliminate bureaucratic budget-constraints. Equally, government can - as in the mathematical model - deny public bureaucrats any discretion and centralize decision-making. Alternatively, government can decentralize decision-making but encourage bureaucrats to

maximise budgets. Finally and in the absence of a private sector, government can eliminate competition by giving to one bureaucratic organisation responsibility for the production of all goods and services. In short, government can run public bureaucracy so as to retard entrepreneurial efficiency.

It may be objected that the sovereignty of ownership gives capitalist entrepreneurs a similar choice. Shareholders, like government, can order the managers of capitalist firms to maximise sales, employment or budgets rather than profits. There remain important differences between the two environments which suggest both that (i) private firms are less likely to undertake such action, and (ii) that such choices are unlikely to subvert efficiency to the same extent. First, it is unlikely that private owners will have any incentive to encourage such behaviour but the same cannot be assumed of politicians (9.2.1). Second, if a private firm adopted such practises it would go out of business. Public bureaucracy can resist such pressures because of the owner's unique position within the economy. Finally and perhaps most importantly, whilst shareholders or managers can adopt practises that will stifle efficiency within their firm they cannot affect the choices of other firms. They can ignore but cannot eliminate the market. Competition will remain even if the private firm chooses not to compete and even if all the firms in an economy adopt inefficient practises they will remain vulnerable to the entry of new firms. Again because of its legislative and coercive monopoly, the state can simply suppress all competition.



Public bureaucracy offers an uncertain platform for attaining entrepreneurial efficiency. The market can but need not be reconciled with public bureaucracy. Bureaucratic efficiency is threatened not by the nature of bureaucrats but by the nature of bureaucratic ownership. It has already been argued that the successful separation of ownership and control within the private sector cannot be assumed to imply the possibility of successfully separating ownership and control in the public sector. To this can now be added the additional - and in many respects equivalent - conclusion that the successful use of bureaucracy within the private sector cannot necessarily be assumed to imply the possibility of successfully using bureaucracy within the public sector.

To assert that public bureaucracies can be inefficient is not to claim that they necessarily will be. As owners, politicians, have a choice and their likely response to this choice will be examined in Chapter Nine. In this chapter it is assumed that efficiency is prized.

It should not be assumed that once this choice is made, differences between the public and private sector evaporate. Private sector firms inherit a market structure but government must create it. NPM should be seen as more than a programme of 'external' reform through which bureaucratic organisations are integrated into the market by increasing competition, reliance on user-charges and profit-maximisation. It is also a set of 'internal' reforms designed to create a market.

First, decision-making within the bureaucracy must be decentralised. The government must resist the temptation to intervene in the decision-making process once the goal of the organisation has been determined. Within the British Civil Service, framework agreements between parent departments and agencies have been used to separate 'operational' from 'policy' decision-making. The Fraser Report although critical of progress, reaffirmed the goal of moving

to a position where agency Framework Documents establish that, within the overall disciplines of the cash limits and targets set, managers are free to make their own decisions on the management of staff and resources (quoted in Greer, 1994, 47).

Second, NPM seeks to create conditions where competition becomes possible through the disaggregation of bureaucratic structures. Monolithic organisations are separated into a number of smaller units.

The aim is to divide the public sector into separately managed or 'corporatized' units with their own designer logos and corporate identity, operating with 'one-line' budgets, mission statements, business plans and managerial autonomy. The new disaggregated structure replaces the PPA style of providing public services ... within a single aggregated unit (Hood, 1994, 129).

Finally, NPM attempts to foster efficiency through providing stronger incentives (Dunleavy, 1994, 38, Dunleavy and Hood, 1994, 9). Agency chief executives are selected following intense and open competition (Fry, 1995, 114) and are subsequently encouraged to renounce tenure in return for the opportunity to receive bonuses for exceptional performance.<sup>1</sup> The market mechanism which ties reward to performance for the capitalist owner is here reproduced in the public sector. The use of incentives is not, as Christopher Hood and Michael Jackson (1991) claim more generally for NPM itself, a new phenomenon. Within the ancient Chinese bureaucracy, official's rewards were determined by the accuracy of their budget forecasts and capacity to control expenditure (Kamenka, 1989, 30) and in Britain, the use of performance related pay was recommended by the Fulton Committee in the 1960's (Fry, 1995, 78). What has changed has is not the nature of public bureaucracy or even the tasks it is called upon to perform but the political will to implement particular strategies.

There are other elements of continuity between PPA and NPM. Public bureaucracy continues to be bound by rules. Within the Weberian bureaucracy these are used to specify, potentially in

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<sup>1</sup> This at least is the theory. In practise, appointments are often political. In April 1993, for example, the then Home Secretary, Kenneth Clarke, appointed Derek Lewis of the Granada group as Chief Executive of the Prisons Service in preference to Joe Billing, the Home Office civil servant who had been running the prisons for two years and who had been the selection panels first choice. William Plowden (1994, 94) concludes that the appointment was a political one but simply because appointments are now frequently political does not mean that appointments have to be political.

great detail, the ways in which particular tasks are to be performed. Within a NPM bureaucracy, rules are instead used to set goals and to provide the parameters within which the market is employed. The result is a hybrid mixture of hierarchy and markets. Within the capitalist firm, it has been suggested, efficiency is often promoted and transaction costs minimised through suspending markets and promoting hierarchy. Within a public bureaucracy, the hierarchical powers of politicians are used to create and then impose upon bureaucrats a market framework.

### 8.3 Bureaucracy and Markets: The Practise

#### 8.3.1 Bureaucratic Entrepreneurial Socialism: A Model

There are three principal economic actors within BES: government, consumers and agencies. The functions and powers of each are specified. In addition, there are three general principles of organisation which determine the relationships between the actors: state ownership, markets and tournaments.

All productive assets within BES are owned by government. Because the government owns resources and is ultimately responsible for the residual between revenues and costs, it is, in the sense of the term employed by Armen Alchian and Joel Demsetz (1972), an entrepreneur. But for BES to function efficiently, government must eschew entrepreneurial activity and resist the temptation to engage in detailed decision-making about innovation and coordination. Government's role is not simply one of benign neglect. First, it must specify the goal - profit-maximisation - subservient bureaucrats pursue. Second, it must devise and enforce a set of rules to govern interaction between bureaucrats and between bureaucracy and consumers. A socialist government does not have to play a qualitatively different role from capitalist governments which must also devise and enforce legal rules to sustain markets. The difference with BES is quantitative as rules are more numerous and complex.

The role of consumers within BES is unchanged. Exchange is

voluntary and consumer preferences are sovereign. No restrictions are placed upon the kind or volume of products that can be purchased. Responsibility for the production and provision of goods and services is given to bureaucratic agencies managed by a designated individual or set of individuals: the bureaucratic entrepreneurs. Agencies will be autonomous and bureaucratic entrepreneurs given extensive decision-making powers. Each will be left to decide what products to produce and how to produce and market them. Each will be left to determine the optimal size for their organisation and subject to legally enforceable standards on, for example, health and safety and minimum wages each will be responsible for internal management. Agencies will be free to centralise or decentralise decision-making and to decide what use, if any, is to be made of mechanisms of 'vertical control' within the organisation.

Entrepreneurial efficiency is secured through the use of the market. The relationship between BES and the market can be clarified with reference to the six characteristics of the market identified in the previous section.

First, relationships between consumers and agencies are ones of voluntary exchange. Additionally, the relationship between agencies and government is non-coercive in that no individual is under an obligation to become a bureaucratic entrepreneur. Second, the autonomy granted to each agency encourages decentralized decision-making. Markets are a necessary but not sufficient condition for entrepreneurial efficiency and the

autonomy given to agencies gives bureaucratic entrepreneurs the opportunity to suspend the use of markets within their organisation when this will enhance efficiency. One further implication of decentralization is that bureaucratic entrepreneurs, like their capitalist counterparts, are free to pursue conflicting projects. Third, decentralization and consumer sovereignty creates the possibility of competition.

Relationships within BES are mediated by a second institutional mechanism, ordinal tournaments, the terms of which are determined by government. Performance within tournaments is assessed by profit. Bureaucratic entrepreneurs' remuneration is determined by their position within tournaments and at the end of each tournament, a number of the lowest placed agencies are eliminated. If decentralisation and consumer sovereignty create the possibility of competition, tournaments give bureaucratic entrepreneurs an incentive to compete. Elimination from future tournaments imposes a hard budget-constraint. The difference between BES and capitalism is that the budget-constraint is not absolute but relative, depending not upon the size of any one agency's losses but the size of those losses relative to others. Finally, tournaments give entrepreneurs an incentive to profit-maximise.

It is part of the capitalist case not only that markets are a necessary framework for efficiency but that markets require private ownership if their potential efficiency is to be realised. Tournaments are an institutional mechanism imposing

upon entrepreneurs incentives to remain alert in the absence of private ownership.

### 8.3.2 Bureaucratic Entrepreneurial Socialism: Specific Issues

Much in this description has been left unspecified. The sensitivity and length of tournaments and the numbers to be eliminated from each tournament can be left to government to determine through a process of trial and error.<sup>2</sup> It is not the intention of this chapter to give a detailed blueprint of BES. In terms of organisational design, three features require explication and discussion as all raise difficult technical and political problems. These are, first, the capacity of BES to operate alongside a capitalist sector; second, the precise mechanism for the entry of new agencies and, third, the financing of agencies.

#### 8.3.2.1 Public and Private Sectors

The advantages of co-existence between a socialist and capitalist sector have already been addressed in Chapter Six. LMFs like Mondragon benefit from co-existence because they are unable to generate sufficient innovation. On the assumption that BES is better able to generate such activity, a case can be made for the

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<sup>2</sup> In assessing the competitive solution, Hayek's (1935c, 214) principle objection to the trial-and-error method is that the number of variables involved is too large and that a mistake in the calculation of one will necessitate 'changes of hundreds of other prices'. Within BES, no attempt is being made to use the trail-and-error method to fix prices and the number of variables involved is far smaller.



elimination of capitalist firms. Nonetheless, reasons for retaining, at least initially, a capitalist sector can be found.

First and even assuming the goodwill of capitalist owners, it is likely that the transformation of capitalist firms into bureaucratic organisations will entail substantial transition costs. Entrepreneurs used to judging performance in terms of absolute profit and loss will have to adapt to the requirements of ordinal competition. The implementation of BES will be marked by a 'valley of transition' (Przeworski, 1985, 177). By only gradually introducing BES and allowing a socialist and capitalist sector to initially co-exist, these costs will be minimised and diffused over a longer period of time.

Second, if economic costs do not prove transitory - if BES is shown in practise to be inferior to capitalist entrepreneurship - damage will be proportionate to the economy's dependence upon BES. Third and for this reason, the electorate is less likely to endorse a party committed to the immediate and total suppression of capitalism. Electoral pragmatism, it will be recalled, formed an important part of the minimalist's case in Chapter Six. Fourth, the economic performance of BES may be improved by its having to co-exist with a capitalist sector. As competition between agencies improves individual agency performance, competition between different forms of organisation can be expected to be equally beneficial. Government has a choice of whether or not to run BES efficiently. Anticipating the arguments of Chapter Nine, government has a choice of whether to abide by

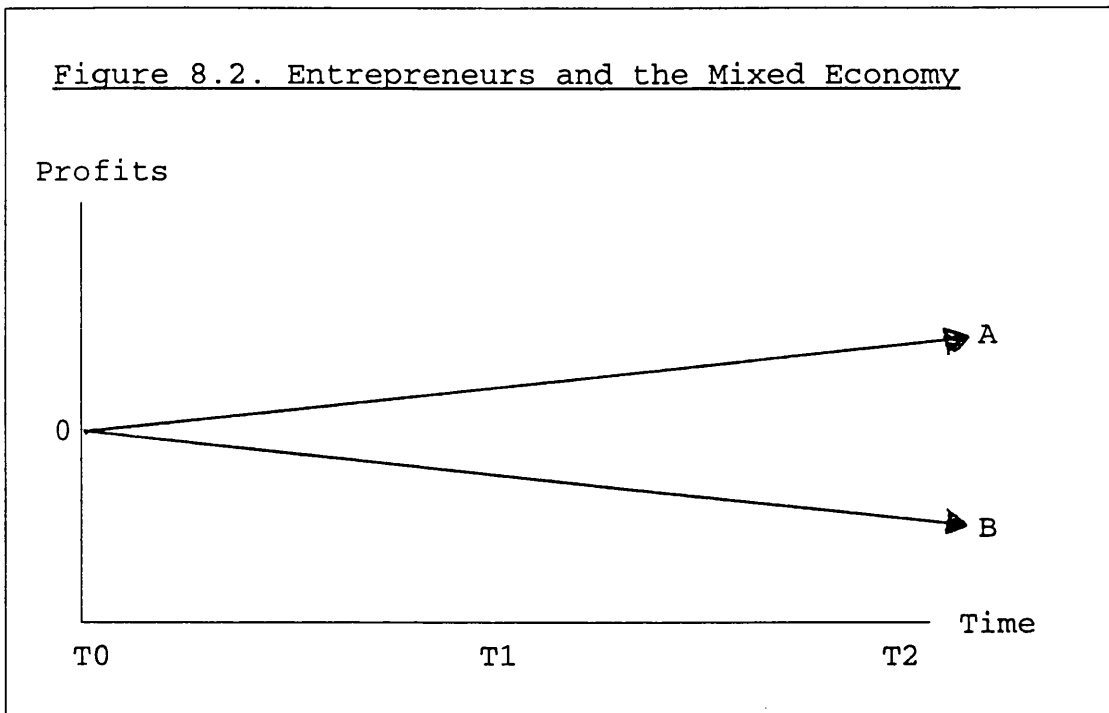
its own rules. In part, government's capacity to tolerate inefficiency is due to its monopoly of ownership. If BES competes with a capitalist sector, the inefficiencies of BES will be exposed to the higher profits of capitalism. Competition imposes upon government a hard budget-constraint and this makes it less likely that government will initially choose to run BES inefficiently.

Finally, a more principled objection to the elimination of a capitalist sector can be made. One of the political objectives of socialism is liberty and elimination of the capitalist sector is a coercive act that reduces the range of individual choice. Milton Friedman (1962, 15) argues that the elimination of a capitalist sector threatens political freedom as the existence of a capitalist sector limits government's capacity to discriminate against individuals whose political or moral views it does not approve of.

Political freedom means the absence of coercion of a man by his fellow men. The fundamental threat to freedom is power to coerce, be it in the hands of a monarch, a dictator, an oligarchy, or a momentary majority. The preservation of freedom requires the elimination of such concentration of power to the fullest possible extent ... by removing the organization of economic activity from the control of political authority, the [capitalist] market eliminates this source of coercive power.

Will competition with a capitalist sector fatally undermine BES? If so, the pragmatic argument for co-existence appears weaker. In Figure 8.2, the financial performance of two entrepreneurs is shown over a period of time (T0-T2) equivalent to the length of a tournament. One entrepreneur, A, is either consistently lucky or consistently alert and secures high profits. The second, B, is either consistently unlucky or inert and records repeated losses. Consider the likely impact of allowing A and B the choice of being either bureaucratic or capitalist entrepreneurs. On the assumption that she knows her performance will be impressive, A will be a capitalist entrepreneur as this will allow her to secure the spectacular prizes of capitalist success. On the assumption that he knows that his performance will be inferior, B will be a bureaucratic entrepreneur as this will allow him to avoid the spectacular losses of capitalist failure. Capitalist performance will be artificially inflated, bureaucratic performance artificially deflated and the survival of BES threatened by the exercise of choice. Whilst it appears that one system is performing better than the other, the elimination of either will leave performance unchanged. An electorate can be given the choice between which system it prefers but individual entrepreneurs cannot be given the opportunity to choose between two actually existing systems without undermining the possibility of that choice being made in the future.

Figure 8.2. Entrepreneurs and the Mixed Economy



The obvious objection to this argument is that it rests upon erroneous assumptions about entrepreneur's knowledge of the future. The uncertainty of entrepreneurial action is such that individuals will not know whether they are likely to be entrepreneur A or B and therefore have no incentive to defect. The complaint is exaggerated, requiring qualification rather than surrender. At time  $T_0$  entrepreneurs may be genuinely uncertain about their future performance. Once a tournament has started ( $T_1$ ), some of this uncertainty will have been eliminated. Entrepreneur A will be aware that her performance might deteriorate but will have been exposed to information upon which some judgement about future performance can be made. She may, for example, know whether her good results were due to outrageous good fortune. The difficulty in controlling entrepreneurial performance is for any monitor to know this. For this reason, BES

should be seen as an alternative to and not a complement for capitalist entrepreneurship.

#### 8.3.2.2 Entrepreneurial Entry and Exit

Designing mechanisms which generate efficient entry and exit of bureaucratic entrepreneurs provides BES with its most significant challenge. At the end of a tournament, a particular number of entrepreneurs will be eliminated and replaced by new ones. At one level, the difficulty for government is specifying the correct number to eliminate. Efficiency is threatened if either too many or too few are eliminated. Suppose a tournament consists of one hundred agencies. If only one is to be eliminated, large numbers of potentially successful entrepreneurs will be excluded and the incentives for bureaucratic entrepreneurs to remain alert reduced. If ninety nine entrepreneurs are to be eliminated, a different set of problems emerge. The danger then is of excluding too many entrepreneurs and of replacing them with less talented ones. Again, the incentives for entrepreneurs to perform efficiently are reduced as all might calculate at the start of the tournament that no matter how alert they remain elimination will be almost certain.

It appears that government must search, perhaps through a process of trial and error, for an optimal solution. Its capacity to do so in rapidly changing economic circumstances can be doubted as optimal solutions in one tournament may soon become obsolete. In one sense, the problem does not appear so different from that

faced by government in trying to determine the appropriate length of tournaments and the sensitivity of entrepreneurial reward but this is to underestimate the difficulties BES will face.

The fundamental difference between socialism and capitalism is the centralization of decision-making within the former. This is revealed in the search within socialism for a definite answer, for a particular number of agencies to eliminate. Within capitalism, decision-making about entry is decentralized. Individuals decide whether to enter the market and there are no formal restrictions upon the numbers that can decide to do so. Limitations on entry may mean that potentially successful entrepreneurial ventures will never be given the chance to prove themselves in the market. An additional complication arises for BES. If the number of applicants to become entrepreneurs is greater than the number of places available, government must choose between candidates. Government cannot remain above the process of entrepreneurial decision-making but will have to make important economic judgements. Given the (ex ante) difficulty of judging an entrepreneur's likely (ex poste) performance, it is difficult to see that any efficient selection mechanism can be devised. Rigidly specifying the number of agencies that will be eliminated also creates problems of exit. If average profit is high, agencies which record substantial profits might still be eliminated whilst if average profit is negative, tournaments might ensure the survival of entrepreneurs who would be bankrupted in a capitalist system.

A defence of BES can be constructed out of criticisms of capitalist entrepreneurship. First, restrictions upon entry might enhance efficiency. Capitalist competition leads to the almost immediate closure of many new firms. In part this reflects the inherent difficulty of entrepreneurial action and the failure of capital markets but many entrepreneurs fail because they are simply inadequate and lack sufficient entrepreneurial judgement. That capitalism places no restrictions on the entry of such individuals is not a source of strength. Trying to judge likely performance is difficult but will exclude many who obviously lack the ability to become entrepreneurs.

Second, whilst in theory capitalism allows for unlimited freedom of entry, in practise this negative right is not translated into a positive freedom. Most capitalist entrepreneurs cannot afford to finance their own entry and must borrow money from banks or venture capitalists. As funds for lending are limited, entrepreneurs compete for limited resources. Third, capitalism can be condemned for sustaining firms that make only negligible profits as the capture of profit does not itself suggest an optimal allocation of resources. What matters is whether resources currently consumed by firms can be redeployed more effectively elsewhere. Precisely because it eliminates agencies on the margins of survival, BES enhances entrepreneurial efficiency. Finally, whilst survival within BES is arbitrary and dependent on the profits of others, capitalism is also capricious. Viable firms can be driven into bankruptcy by the whims of capital markets and by temporary recessions.

Alternatively, a defence of BES can be constructed around the claim that criticisms of it are exaggerated. BES places a limit upon the creation of new agencies not on the entry of entrepreneurs. Any individual who fails to be selected to manage an agency will still be able to approach existing agencies with their ideas. If an agency believes the individual capable of being a successful entrepreneur, they can employ them within their organisation and grant them, if appropriate, considerable discretion. Equally, a recently eliminated entrepreneur whose profit record is generally satisfactory can approach an existing agency. Decision-making is in this way decentralised; there is no single moment when entrepreneurial entry is determined and no limit upon the number of entrepreneurs within the system.

Finally, it is possible to design BES in ways that further decentralise decision-making. Two possibilities are considered. First, faced with an excessive number of applicants wanting to form agencies, government can encourage each to bid for the limited number of places. With, for example, ten places available, the ten entrepreneurs who bid the largest sums can be allowed to enter. This is undesirable in so far as it discriminates in favour of those with greater initial assets. Alternatively and having been informed of the existing sensitivity of payments, entrepreneurs can say what additional 'tax' they will be prepared to pay on profits. If, to use another example, bureaucratic entrepreneurs are rewarded with five per cent of all profits, individuals can bid to receive only three per cent. Three distinct advantages of such a scheme can be



identified. First, it frees government from part of its decision-making burden. Government's role can be restricted to the collection and collation of information. Second, it increases equality. With a smaller proportion of profits given to entrepreneurs, more becomes available for the purposes of redistribution. Finally, it ameliorates problems of adverse selection. Those individuals who believe they have excellent entrepreneurial judgement and who therefore expect to make the most profit have an incentive to put in the lowest bids.

Second and more radically, government can resolve many difficulties by simply lifting any restrictions upon the volume of entry. Here, government announces that ten per cent of all agencies will be eliminated and that those eliminated will have to pay a forfeit of, for example, £2000. Subject to their being able to offer collateral on this amount, any individual is then allowed to form an agency at the start of a tournament. The total number of agencies will vary according to individual's assessment of market conditions. Decision-making is decentralised and barriers to entry removed. The difficulty with this proposal is that it exposes government to large risks. As was noted in Chapter Seven, ordinal tournaments are not budget-balancing. It is unlikely that £2000 will cover the losses of the least successful entrepreneurs and whilst this sum can be increased, to do so reduces the ability of entrepreneurs to enter the market.

### 8.3.2.3 Capital and Finance

No mention of how investment capital is to be allocated between agencies has so far been made. One obvious possibility here is to make use of ordinal tournaments and give to the most profitable agencies the most capital, others receiving an amount proportionate to their ranking. Intuitively, such a system is both simple and appealing and is certainly preferable to a mechanism that allocates the most money to agencies that record the lowest profits. Critics might accept that ordinal tournaments can be used to provide sufficient incentives for bureaucratic entrepreneurs to remain alert but still object that the same system allocates investment capital inefficiently. Three problems can be identified.

First, it leads, once again, to the centralisation of decision-making. Government will have to decide how much to allocate to the agency that performs best, how to divide up the rest and, by extension, the total amount of capital to be allocated. Second, ordinal tournaments will not allocate capital in absolute proportion to profit and this might be thought to lead to perverse results. Imagine a tournament between four agencies in which one is to be eliminated. The first agency makes £1001 profit, the second £1000, the third £10 and the fourth no profit. If there is some relationship between the profit agencies make in current and future tournaments, ordinal allocation appears to give too little to the second and too much to the third agency. In a tournament between a large number of agencies such

difficulties will be reduced but, third, the assumption that capital allocation should be made proportionate to profit can itself be challenged. Consider the position of a modestly placed entrepreneur who at the very end of a tournament discovers a revolutionary means of producing an existing product for far less money. Tests confirm the potential of the scheme but implementation requires large initial amounts of capital investment. Tournaments will starve the entrepreneur of the necessary finance. Equally, the capture of large profits by an entrepreneur in one tournament need not mean that they can make the best use of additional resources.

Again and because capitalism is also unable to allocate investment funds efficiently, one form of defence for BES is attack. Alternatively, it may be objected that an entrepreneur will be able to approach another agency with their ideas. Finally, it is possible to devise alternative methods of finance in which decision-making is also decentralised. Rather than allocate capital ordinally, government can do so cardinally. At the end of a tournament, government can award to each agency some proportion - perhaps exceeding unity - of profit for future investment. This resolves two of the problems of ordinal finance as government not need become actively involved in investment decisions and allocation is made proportional to profit. Bureaucratic entrepreneurs can then be told that whilst they are free to spend the amount allocated to them, they are under no obligation to do so. Imagine that a bureaucratic entrepreneur calculates that from a infusion of, for example, £100 they can

derive an eventual return of £300. They will then have an incentive to lend the money to any entrepreneur who offers a return of more than £200. Entrepreneurs who lack initial capital but who are certain of their capacity to secure high returns have an additional source of funding. Through a series of decentralized side payments, capital can be allocated efficiently.

The transaction costs of this solution are likely to be high. Entrepreneurs will have to discover others with capital available, bargaining will have to take place and difficulties will arise over the terms on which security can be offered. As bureaucratic entrepreneurs do not own their agencies, they cannot offer existing capital as collateral. One solution to the existence of transaction costs is hierarchy. The autonomy given to agencies includes the right of merger and this can be used to minimise transaction costs. Alternatively, a market solution may be found in which bureaucratic organisations dealing exclusively in the allocation of capital in return for either a fee or a share of subsequent profits emerge. These agencies will compete in tournaments alongside others and be subject to competition from new entrants.

## 8.4 The Virtues of Bureaucratic Entrepreneurial Socialism

The trade-off between entrepreneurial efficiency and equality cannot be eliminated. But relative to both capitalism and other forms of market socialism, BES is more able to reduce the salience and extent of this trade-off.

### 8.4.1 The Politics of Bureaucratic Entrepreneurial Socialism

Socialism has been characterised as requiring the pursuit of equality, democracy and liberty. The closer these goals come to being realised, the more socialist a system can be described as being. The level of equality within BES will depend upon the sensitivity of the tournaments used to judge entrepreneurial performance and to this extent it cannot be said how equal BES will be. Because risk is shared and a risk premium paid, BES, unlike MIS, is incapable of attaining absolute equality but for two reasons, BES will be capable of sustaining a greater degree of equality than capitalism.

First and as an institutional device, ordinal tournaments minimise the necessary trade-off between equality and efficiency. For any given level of efficiency, BES sustains a greater level of equality than capitalism. First and when compared to the undiluted profit incentives offered by capitalism, tournaments are relatively insensitive. Entrepreneurs are not rewarded with spectacular prizes and are not punished with spectacular losses. Tournaments also reduce the salience of certain forms of luck,

further reducing inequality between entrepreneurs.

Second, state ownership also promotes equality. Entrepreneurs are only rewarded for their judgement and unavoidably and to some reduced extent, their luck. Capital is not rewarded as a separate asset as individuals own no capital. Bureaucratic entrepreneurs will be able to borrow capital but no residual can be earned from the simple ownership of capital. The profit generated by bureaucratic agencies can be used for the purposes of redistribution or reinvestment. In this respect, BES is superior to the LMF. Here, ownership although diffused is still exclusive. Mondragon's profits are distributed among their workers and owners and not the broader Spanish population.

Can BES secure greater democracy? At the 'micro' level of the individual agency, bureaucratic entrepreneurs are free to implement systems of economic democracy and in agencies engaged in non-elite entrepreneurial activity this may result in greater efficiency. But because agencies are not owned by the individuals who work in them, economic democracy cannot be embedded in the same way it can in the LMF. BES does allow for the extension of democracy at the 'macro' or system level. Although much decision-making is decentralized within BES, government must still determine the sensitivity and length of tournaments, the level of subsidy to be given to new agencies and the amount of profit to be used to finance investment. Many of these choices involve making a trade-off between efficiency and equality. By voting for particular parties, the electorate can influence the decisions

eventually made, expressing their preference for either greater efficiency or equality. Does capitalism give voters the same control? Adam Przeworski (1985) and Charles Lindblom (1977, 172-84) argue that it does not. Whilst governments can theoretically respond to electoral preferences for greater equality by raising taxes on capitalist firms, the fear of disinvestment and capital flight will prevent them from doing so. Capitalists are systematically lucky (Dowding, 1991, 137-8). State ownership prevents capital flight and disinvestment and allows for greater collective control.

#### 8.4.2 The Economics of Bureaucratic Entrepreneurial Socialism

Markets are a necessary condition for entrepreneurial efficiency and the use of markets ensures that BES will be more efficient than those forms of socialism which rely upon the suppression of markets and the centralization of decision-making. It has also been argued that markets are an insufficient condition for entrepreneurial efficiency and that the replacement of markets by hierarchy can sometimes reduce transaction costs. The autonomy given to bureaucratic entrepreneurs allows them to suspend the market within their agency.

BES is more efficient than capitalism. First, tournaments reduce the salience of luck and the chances of otherwise viable agencies being eliminated by temporary recessions. Second, tournaments increase entrepreneur's uncertainty about their performance. None will be able to eschew risks in the belief that survival is

assured through the capture of only a small profit. Third, tournaments guarantee entrepreneurial survival over the length of one tournament, giving new agencies a chance to establish themselves. In Chapter Two it was argued that capitalist markets systematically under-supply entrepreneurial activity and in Chapter Six it was suggested that this deficiency is exacerbated by the instability, short-termism and risk-aversion of capital markets. State control over investment decisions and the removal of all barriers to entry allows BES to take account of the positive externalities of entrepreneurial action when determining investment levels.

BES is also more efficient than either of the other forms of market socialism considered. If the behaviour of individuals under MIS remains unchanged, positive externalities will continue to be ignored.<sup>3</sup> LMFs are compromised for the same reason. Whilst ownership is extended to workers in individual firms, ownership is still exclusive and for this reason is inefficient. Second and unlike its rivals, BES is able to sustain diverse forms of entrepreneurial activity. MIS struggles to deal with the requirements of neo-pluralist entrepreneurship. Because BES does not depend on reciprocal monitoring of performance and, for example, the presence of small groups with rigidly knit patterns of social interaction, this limitation does not apply. If bureaucratic entrepreneurs discover a profitable opportunity for expansion they will have an incentive to take it. Finance for

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<sup>3</sup> It will be recalled that the value of this (Carens') assumption was challenged in section 5.2.2.



expansion is adequately provided for through (i) capital allowances from government at the end of a tournament, (ii) borrowing from other agencies capital allowances, and (iii) merger with other agencies. Unlike LMFs, the structure of BES does not discourage entrepreneurs from pursuing more innovative or hazardous (elite) projects. Whether bureaucratic entrepreneurs will choose to do so depends on their aversion to risk but there is no organisational or institutional impediment to the exercise of such a choice.

### 8.5 Conclusion

The major changes in the present character of bureaucracy that are suggested .. involve changes in the structure of bureaucracy and changes in the incentives of bureaucrats (Niskanen, 1971, 195)

Niskanen argues that traditional bureaucracy is inefficient and in the concluding chapter of Bureaucracy and Representative Government recommends a number of policy reforms. Competition within bureaucracy should be increased (Niskanen, 1971, 195) and older bureaus be 'permitted to expire gracefully' (Niskanen, 1971, 200). Despite recognising the 'inherent' difficulties of 'defining, contracting for, and monitoring the output of a public service' (Niskanen, 1971, 199) he also recommends the increased use of centralised oversight. More powers should be given to the executive office (Niskanen, 1971, 196), whilst the legislative control process should be reformed so as to ensure more representative committee membership (Niskanen, 1971, 219). It is also considered necessary to alter bureaucratic incentives more directly. Bureaucrats are to be rewarded for reducing the size of their budgets; rewards taking the form of either promotion (Niskanen, 1971, 202), bonus payments upon retirement (Niskanen, 1971, 204) or additional resources for 'perks' like research and development (Niskanen, 1971, 205).

BES also advocates changes in the structure of bureaucracy and the incentives given to bureaucrats. The proposals though are far

more radical than those offered by Niskanen. Tournaments are used to structure competition and agencies that perform inadequately will be eliminated. Decision-making will be decentralized, allowing government to be absolved of the responsibility for closely monitoring entrepreneurial action. In its place, bureaucrats are given incentives to profit-maximise and to remain alert to the possibilities of entrepreneurial discovery.

In many respects, BES is a development of and represents a logical conclusion to current NPM reforms within public bureaucracies. Whilst the most vigorous NPM reforms have been undertaken by New Right governments in America and Britain (Pollitt, 1993), the intention of this chapter has been to show that the philosophy of management embedded in NPM is of more general value. Through the retention of public ownership, BES can be used to promote the political values of socialism. Like rational choice theory, NPM is a tool: one which has been employed by the New Right but from which socialist's can and should learn.

## Chapter Nine

### **Bureaucratic Entrepreneurial Socialism: Politics**

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### 9.1 Introduction

Public choice theory has been the avenue through which a romantic and illusory set of notions about the workings of governments and the behaviour of persons who govern has been replaced by a set of notions that embody more scepticism about what government can do and what governors will do (Buchanan, 1984, 11).

MIS demonstrates that once altruism is assumed, the difficulties of socialist entrepreneurship can be easily disposed of. Presented in its crude form, Joseph Carens' argument was rejected. Feasible socialism must be built on egoism and it is a comparative advantage of BES that ordinal tournaments can harness the self-interest of entrepreneurs. Paraphrasing Adam Smith, it is not from the benevolence of the bureaucratic entrepreneur that we expect economic growth but from their regard to their own interest. There are three principal actors within BES: consumers, politicians and entrepreneurs. If egoism is assumed of entrepreneurs and consumers, consistency requires that the same be required of politicians (Brennan and Buchanan, 1985, 48). A belief that politicians will be inspired by a concern for the general welfare of their community is no more defensible than the assumption that entrepreneurs will be motivated by 'Social Duty Satisfaction'. Can BES cope with this additional requirement?

Using both rational choice theory and the example of Britain's

nationalised industries, section 9.2 argues that politicians have little intrinsic interest in devising and enforcing efficient rules of competition between entrepreneurs. In previous chapters, attention has been pulled toward institutional design. In this chapter, the focus is on organisations and the construction of a political system which gives politicians no incentive to subvert efficiency. Returning to the distinction between hierarchical and market solutions drawn in Chapter Six, section 9.3 assesses and finds wanting two possible arrangements: decentralisation and constitutionalism. Finally, the foundations of a more acceptable solution are found in the Japanese political system and the work of Friedrich Hayek.

## 9.2 Political Self-Interest and Entrepreneurial Efficiency

### 9.2.1 Rational Choice and the Theory of Inefficiency

Geoffrey Brennan and James Buchanan (1985, 2) define rules as 'institutional arrangements governing ... interactions'. Rules structure incentives and suggest behaviour. BES is characterised by a set of rules governing ordinal competition between bureaucrats. Rules determine the sensitivity of entrepreneurial payment, entry into and elimination from tournaments and levels of investment. Rules can most obviously be evaluated in terms of their capacity to achieve desired goals. Effective rules of language facilitate communication and effective rules of commerce facilitate exchange. Ideally, BES's rules should generate entrepreneurial activity without sacrificing equality, democracy and liberty. If the economic and political advantages of BES identified in Chapter Eight are to be realised, effective rules must be both devised and consistently applied. It will be assumed that through a process of trial and error effective rules can be discovered. The question addressed in this chapter is whether they will be applied.

In spheres of activity where interests do not conflict, rules of behaviour can evolve in the absence of a dictator. In Figure 9.1, individuals have the choice of whether to drive on the left or right hand side of the road. The game is one of coordination as utility is maximised if individuals make the same decision. There is no need for government or some other third party to enforce

a decision: a convention will naturally emerge and will be respected by drivers.

Figure 9.1. A Pure Coordination Game

		<u>Individual B</u>	
		Left	Right
<u>Individual A</u>	Left	5,5	0,0
	Right	0,0	5,5

Within BES, preferences conflict. Bureaucrats, for example, have an interest in budget-maximisation that consumers do not share. If efficiency is to be realised, rules will have to be imposed. In itself this presents no problem as bureaucracy has been defined in terms of its organisational subservience. But will elected politicians any more than bureaucrats find it in their interest to devise and enforce effective rules?

To answer this question, politician's maximand must be specified. Anthony Downs (1957, 28) famously suggests that politicians pursue office and that 'parties formulate policies in order to win elections, rather than win elections to formulate policies'. This assumption is now firmly embedded within the rational choice literature (Stevens, 1993, 210) and will be utilised in this chapter.<sup>1</sup> Initially, this assumption appears promising. If

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<sup>1</sup> A alternative assumption is that politicians are intrinsically concerned with policy (De Swann, 1973, 88). Whilst Michael Laver and Kenneth Shepsle employ this assumption in their



consumers prefer effective rules to ineffective ones and if there are more consumers than bureaucratic entrepreneurs, politicians will maximise their vote by imposing effective rules. There is a principal-agent relationship between politicians and voters but no principal-agent problem as interests converge. For five reasons, this conclusion can be challenged: politicians will neither devise or consistently apply effective rules.

First, politicians will not devise effective rules because voters themselves may prefer ineffective ones. It was noted in Chapter Six that individuals discount the future value of income and for this reason, rules that undermine long-term efficiency may be still be preferred if they generate short-term growth. In the long-term, voters may come to regret the choice of ineffective rules but will be immediately tempted by the prospect of the short-term gains that come, for example, from softening the budget-constraint on agencies that are felt to have failed because of bad luck.

Second, territorial representation encourages politicians to pursue the possibly sectional interests of their constituents. Assume that there are three agencies and it is known that efficiency will be maximised if the agency finishing last in the tournament is eliminated, the one finishing second given no extra capital and the one finishing first given all of its own profits back to invest. The three agencies are located in three different

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study of coalition formation they convincingly argue (1996, 20) that differences between the two can be exaggerated.

constituencies. Politician A in whose constituency the agency finishing last is located will find it in their electoral interest to propose (X) that the rules be amended in such a way as to allow their agency to remain open. Politician B in whose constituency the agency finishing second is located will find it in their electoral interest to propose (Y) that the rules be amended in such a way as to allow investment for their agency to be increased. Politician C in whose constituency the agency finishing first is located will also find it in their electoral interest to propose (Z) that the rules be amended in such a way as to allow investment for their agency to be increased.

As Figure 9.1 indicates, whilst each politician will benefit from a change in the rules affecting their agency, overall efficiency is lowered if any concessions are made. Nonetheless, logrolling can be used to secure the passage of inefficient amendments (Fioriana and Noll, 1978, Shepsle and Noll, 1981). Politicians A and B can, for example, form a coalition supporting amendments X and Y. Although in this example one politician, C, is excluded from the trade, given the additional assumption of asymmetric costs and benefits William Riker (1982, 163-7) demonstrates that through a series of mutually beneficial trades from which none are excluded all can lose.

Figure 9.1 Logrolling and the Supply of Concessions

		<u>Policy Demand</u>		
		X	Y	Z
<u>Politician</u>	A	+6	-5	-5
	B	-5	+6	-5
	C	-5	-5	+6
Total		-4	-4	-4

Third, voter's discount the value not only of future but of past events and place, for example, disproportionate emphasis on economic performance at the time of an election (Fair, 1978, Fiorina, 1981). Political Business Cycle theory suggests that politicians can exploit this attribute to manipulate the economy and ensure that

within an incumbent's term in office there is a predictable pattern of policy, starting with relative austerity and ending with the potlatch right before the election (Nordhaus, 1975, 172).

The incentive to behave in this way is unaffected by any long-term damage to the economy. For BES, one implication of this is that politicians will abandon effective rules requiring closure of agencies if tournaments are scheduled to end immediately before an election. Decisions about investment and the sensitivity of payment will be influenced by their immediate electoral rather than long-term efficiency implications.

Fourth, as well as accommodating their policies to the preferences of voters, politicians can attempt to shape preferences through partisan social engineering, adjusting social relativities, context management, organisational manipulation (Dunleavy, 1991, 119-25) and advertising. As John Kenneth Galbraith (1983, 151) emphasises, individual preferences are not fixed: business leaders and politicians can 'create the wants [they] seek to satisfy'. Advertising campaigns are expensive and must be financed through either individual or corporate contributions. Whilst political scientists have found 'no simple and predictable connection between contributors and the desire for political privilege' (Heard, 1960, 69), contributions can be used to purchase 'protection from punitive legislation or sanctions, political patronage ... access to decision-makers and [entry] into desirable circles' (Fischer, 1995, 4). To secure finance, politicians may be tempted to undermine effective rules by softening agency budget-constraints and increasing payments to successful entrepreneurs in return for campaign contributions.

Donald Wittman (1995) argues that politicians' capacity to deceive voters in these ways is limited as opposition parties have an incentive to publicise and deter such behaviour. But the presence of a strident opposition may further discourage the formulation and implementation of effective rules. Neither socialism or capitalism can eliminate entrepreneurial risk and it is both inevitable and desirable that particular projects will fail. For two reasons, failure will often appear avoidable and unnecessary. First, as entrepreneurs operate in conditions of

uncertainty but contribute to the reduction of uncertainty through their actions, ventures will fail for what will seem (ex poste) to have been predictable reasons. Second, failure will frequently overtake a venture that is itself intrinsically sound. As Joseph Schumpeter (1943, 73-4) observes, whilst 'incompetent men and the obsolete methods are in fact eliminated .... failure also threatens or actually overtakes many an able man'.

Within a capitalist system, the costs of failure are largely internalised and borne by employees, shareholders and managers. Failure rarely induces political disquiet. Consumers did not write to MP's to complain about Sir Clive Sinclair's lack of judgement in launching the C5 electric car. The costs of failure within BES are externalised and ultimately met by the taxpayer. As ordinal tournaments are not budget-balancing (7.4.2), costs may be considerable. Opposition parties will have an incentive to publicise and exaggerate failure, attacking government for not intervening to close agencies run by incompetent entrepreneurs or saving agencies run by competent ones that experience bad luck. For reasons of political expediency, government will either set ineffective rules that give it considerable discretion to intervene or abandon effective rules once they become politically costly. Economists argue that it is not monopoly but non-contestable monopoly that threatens economic efficiency (Baumol, 1982, Spence, 1983). In this case, it is the (democratic) contestability of government that threatens efficiency.

### 9.2.2 Nationalised Industries and the Practise of Inefficiency

Public ownership gives government the power to determine rules of economic behaviour. Rational choice theory suggests that for this reason rules will be inefficient and the conclusion is strengthened by an examination of the British Government's post-war record in managing nationalised industries. When devising the rules by which these industries were run, little attention was given to economic efficiency. Industries were constituted as monopolies and whilst encouraged to adopt a 'business-like attitude' (Coombes, 1971, 58) were given few explicit financial targets. Firms were not subject to a hard budget-constraint and closure required an act of Parliament (Swann, 1988, 196).

So far as rules were set that might have been used to promote efficiency, government consistently undermined them. The initial intention when nationalising ownership was, for example, to respect managerial autonomy. Ministers were given the power to appoint industry Chairmen but were not meant to interfere in day-to-day decision-making (Morrisson, 1944, 173). In practise and over a period of several years, political control was extended to include specific pricing policy (Prosser, 1986, 24), borrowing limits (Curwen, 1988, 90) and investment planning. Less formally, ministers controlled policy formulation by secretly threatening to reduce future investment or increase taxes (Coombes, 1971, 42, Prosser, 1985, 25, Ashworth, 1991, 85).

By subverting its own rules, government could pursue its

electoral interests. Occasionally these were narrowly partisan. The Conservative Party prevented British Coal from raising its prices shortly before the 1955 election whilst the Labour Party vetoed electricity price increases just before the 1950 one (Ashworth, 1991, 56-60). David Coombes (1971, 103) suggests that government also devised policies to reward valued political allies who contributed to party funds. Labour protected the interests of the National Union of Mineworkers against British Coal and the Conservatives helped private air operators break the monopoly of the state airline, BOAC.

To protect itself from electoral punishment, successive governments refused to impose a hard budget-constraint on industries: a strategy that would have necessitated redundancies and adverse publicity. The Conservatives withdrew plans to close a large number of local post offices in the early 1980's (Ponting, 1986, 215) whilst Tony Benn, the then Secretary-of-State for Trade and Industry, threatened to dismiss the Chairman of British Steel unless he withdrew plans to close a large number of plants (Abromeit, 1986, 197). For the same reason, governments discouraged industries from undertaking innovative action in which the risks of failure were high. In a critical review of nationalised industry performance, William Robson (1962, 196) emphasises the costs of a managerial culture that discouraged innovation.

It is impossible to conduct even the most successful business enterprises without a considerable amount of money which turns out to be wasted. If the management is over-fearful of spending money unless it is absolutely certain to obtain a safe return on the outlay, the result is bound to be a highly conservative, excessively prudent, and technically backward undertaking.



### 9.3 Controlling Leviathan: Markets and Hierarchies

In Chapter Five it was argued that exchange in a capitalist system depends on the presence of a third party who is able to enforce agreements. If the requirements for entrepreneurial action are to be reconciled with the achievement of socialism, BES also requires a third party to devise and enforce rules of ordinal competition between bureaucratic entrepreneurs. The state is the one organisation that has the sovereign power to impose rules on bureaucrats but because it also has the power to finance losses through compulsory taxation, the state is the one organisation that has the capacity to implement inefficient rules of behaviour. Democracy requires that the state be composed of elected politicians but elections give politicians an incentive to favour ineffective over effective rules.

The problem of socialist entrepreneurship has so far been treated as an economic one, prompting careful consideration of the nature of entrepreneurial incentives, markets and ownership. It now appears that the problem is not economic but political. There is a need for a leviathan to devise and enforce rules but leviathan itself cannot be controlled. As Douglass North (1990, 58) concludes,

therein lies the fundamental dilemma ... if we cannot do without the state, we cannot do with it either. How does one get the state to behave like an impartial third party?

Drawing initially upon the distinction between markets and hierarchies first introduced in Chapter Six, three possible answers to North's question will be considered.

### 9.3.1 Controlling Leviathan: Markets

Opportunistic budget-maximising by bureaucrats can be controlled through the imposition of hierarchy but government cannot be controlled in this way as it stands at the apex of the hierarchy. A similar problem has already been encountered in Chapter Seven where it was noted that employers power to renege upon wage agreements made with employees can frustrate mutually beneficial cooperation. Gary Miller (1992, 162) argues that in the absence of hierarchy, markets can serve as an alternative and 'credible commitment mechanism for resolving the tension between undisciplined managerial self-interest and organizational efficiency'. In a competitive market, employees trust employers because they know that the consequence of employers abusing that trust will be bankruptcy. Can the market also be used as a mechanism through which the government leviathan can be controlled? Charles Tiebout's arguments are instructive.

Economists expect markets to undersupply non-excludable public goods. When asked how much of a good they are willing to pay for, individuals have an incentive to misrepresent their preferences: to free ride. For this reason, Paul Samuelson (1954) concludes that the state must provide and pay for public goods through compulsory taxation. Tiebout (1956) demonstrates that if (i)

individuals are fully mobile, (ii) have perfect information, (iii) can choose between a large number of communities in which to live, (iv) face no restrictions upon employment and if communities are (v) unaffected by positive and negative externalities, (vi) experience decreasing returns to scale, and (vii) wish to attract new members so as to be able to produce at the lowest cost that consumers can efficiently reveal their preferences for public goods through moving to a community that offers the optimal tax-service package for them. Because the fifth assumption makes non-excludable public goods into excludable private ones, individuals will not need to choose between different supply schedules at the ballot box but through migration can ensure that 'each locality has a revenue and expenditure pattern that reflects the desires of its residents' (Tiebout, 1956, 420). One further and important implication of Tiebout's model is that competition between communities to attract residents will also ensure that each will produce goods at the lowest possible cost. Bureaucrats will not be able to maximise budgets because such behaviour will result in emigration and the erosion of the tax base. Decentralisation and pluralism secures both choice and efficiency.

Tiebout's solution suggests a means by which the leviathan of BES government can be controlled. In the previous section it was argued that government can adopt ineffective rules because its power to raise taxation allows it to sustain losses. If individuals can respond to this strategy by exiting to another community then government can be deterred from adopting

inefficient rules. Migration and competition impose a hard budget-constraint on leviathan and eliminate monopoly. Furthermore and as in Tiebout's argument, markets secure democracy as individuals can move to that community that comes closest to reflecting their preferred trade-off between efficiency and equality. Government by the market appears an efficient and logical extension of the principles underlying market socialism.

Because its assumptions are so severe, it can be argued that the Tiebout model is of little practical relevance. Surely because information is imperfect, externalities do occur and employment is restricted, individuals cannot easily move between communities and so cannot discipline politicians that pursue inefficient policies. This objection can be challenged in three ways. First, in an examination of the impact of the Community Charge on residential movements in London, Keith Dowding, Peter John and Stephen Biggs (1996) demonstrate that Tiebout's assumptions are surprisingly robust: individuals do respond to changes in local community tax and expenditure policy through migration. Second, Austrian economic theory shows that a defence of the market need not depend on the kind of assumptions about perfect competition embodied in Tiebout's model. Third, whilst pareto optimal allocation of public goods depends on the applicability of Tiebout's assumptions to all individuals, efficiency in production does not. If, for example, only one fifth of a community exit in response to organisational failure, the resulting shortfall in revenue may be sufficient to deter

government from adopting ineffective rules. Two more serious objections can, however, be levelled against market solutions to government failure.

First, competition between communities is unlikely to be restricted to the pursuit of effective rules. In Chapter Eight it was argued that BES cannot co-exist with a capitalist sector in which ownership is private and prizes for entrepreneurial success spectacular. Because they are free to vary the trade-off between efficiency and equality, governments will have an incentive to compete for the attentions of the most successful entrepreneurs by offering more sensitive payments. Competition will not only push governments to adopt effective rules but to adopt rules that secure efficiency at the expense of equality. It is for a similar reason that Peter Self (1993, 63) objects to the principle of government by the market: arguing that 'the unequal distribution of market wealth [will be] not modified but compounded in the allocation of public costs and services'. Even if ownership remains public and all communities remain faithful to the basic principles of BES, competition makes entrepreneurs 'structurally lucky' (Dowding, 1991, 137-8). All may favour a balanced trade-off between efficiency and equality but each will be tempted to alter the rules to attract entrepreneurs most able to stimulate growth.

The second objection to the market solution is that it misrepresents the nature of the electoral problem. Ineffective rules are pursued not because government is able to deceive

voters but precisely because electoral competition ensures that government faithfully reflects electoral preferences. It is because the electorate discounts the value of future pay-offs and is susceptible to opposition attacks on government that effective rules are not implemented. Decentralisation and pluralism will simply recreate national inefficiency at the local level. Furthermore, the government market will be extremely unstable. Having encouraged governments to sacrifice future efficiency, voter's will have an incentive to move to those communities - if there are any - which risked initial electoral unpopularity by implementing effective rules. Knowing that the future benefits of restraint will be shared with immigrants, communities will have even less reason to pursue effective rules. It is open to either local communities or central government to prevent free riding by individuals wishing to escape from the consequences of their own votes but to do so will undermine the efficacy of the exit mechanism on which the market solution rests.

### 9.3.2 Controlling Leviathan: Hierarchy

The power of elected politicians need not be unlimited. Constitutions can be used to limit the powers of politicians, to prevent them from pursuing particular courses of action (Elster, 1988, 2). A distinction can be drawn between constitutional prohibitions on (i) outcomes, and (ii) processes. Constitutional restrictions on outcomes are frequently negative in intent and prevent particular policies being adopted: slavery or arbitrary arrest. Constitutional process requirements are frequently

positive and require policies to pass certain political hurdles before being implemented: consideration by both houses in a bicameral legislature and judicial review. In capitalist states, both can be used to limit the power of leviathan. In the United States, a proposed balance budget amendment (Buchanan and Wagner, 1977, 180) will, for example, make it difficult for government to manipulate the economy for electoral purposes through the creation of budget-deficits. Process requirements that constitutional amendments require more than simple majority support also make it more difficult for American governments to vote-maximise by disenfranchising certain sections of the population. Can constitutional restrictions of either sort be used to prevent the adoption of ineffective rules of ordinal competition?

Using the example of rules of the road, the first section of this chapter argued that conventions can emerge in the absence of formal promulgation. A second feature of this rule should be noted: its potential stability. Once a convention has emerged there will be little reason to change it. Only if rules of ordinal competition share this feature will constitutional restrictions on outcomes be effective. Prior to elections, a constitutional convention could then determine rules of payment, investment, entry and elimination. These rules could be fixed in the same way that constitutional prohibitions against slavery are. If voters can be made sufficiently aware of the importance of this initial choice, future income might not be so heavily

discounted and effective rules chosen.<sup>2</sup>

The rules that govern interaction within BES cannot be so stable if efficiency is to be maximised. Even if the 'right' set of rules is initially chosen, preferences about the appropriate trade-off between efficiency and equality may change and this will necessitate revision to the rules. Right rules can become wrong rules and constitutional restrictions on outcomes make it impossible to respond to changing circumstances. The same argument can be levelled against process restrictions that make it more difficult to change rules by, for example, imposing a two-thirds majority requirement. This may allow the opposition to veto undesirable changes but it will also allow them to veto necessary ones. James Buchanan and Gordon Tullock's (1962, 65) claim that the 'external cost' of binding decisions is inversely proportional to the number of individuals required to take collective action is incorrect once a particular set of rules is already in operation.

The costs of constitutional inflexibility should not be exaggerated as stability itself enhances efficiency. Brennan and Buchanan (1985, 10) argue that because change destroys

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<sup>2</sup> Brennan and Buchanan (1985, 75) argue that systematic uncertainty in the electoral process leads voters to heavily discount the future. Because it is not known whether politicians will remain faithful to their rules, little attention is paid to the long-term implications of adopting a specific rule. If rules are fixed and uncertainty reduced, voters will have less incentive to discount the future. Analogous reasoning explains Friedrich Hayek's (1993c, 112) faith in constitutional conventions.



information, transition costs have to be calculated.

The mere demonstration that state A would be 'better' than the status quo, once state A were achieved, is not sufficient to demonstrate that a move from the status quo is justified.

North (1990, 78) emphasises that rules create incentives for individuals to invest in particular skills. If, for example, tournaments eliminate only one agency in each tournament entrepreneurs will learn to adopt risk adverse strategies. If preferences about the appropriate trade-off between efficiency and equality change then more agencies may need to be eliminated. Entrepreneurs will have to learn new skills and it will take time for them to do so. Transition costs are finite and if preferences change dramatically it may still be rational to change the rules of competition. For this reason outcome restrictions are inappropriate.

In chapter Seven it was argued that (input) monitoring of entrepreneurial performance will be ineffective because entrepreneurship resists simple measurement. Constitutional restrictions are ineffective for the same reason. It cannot be specified in advance what kind of amendments are undesirable. Process restriction might demand that amendments be submitted to a constitutional court for consideration but judges will be unable to know what politician's motives are in changing policy. Judges can be given discretion and allowed to block changes that

they suspect are motivated by electoral considerations but this might lead to changes motivated by a genuine concern for effectiveness being blocked as well. A constitutional prohibition on slavery is possible because it is slavery itself that is opposed. Constitutional prohibitions on certain policies are ineffective because it is not the policy but the motives for certain kinds of policy that are opposed.

#### 9.4 Incentives and the Location of Discretion

Brian Barry (1990, 7) argues that 'it is a bad idea to set things up so there is a ... incentive to do wrong' and it is this advice that has animated the discussion of incentives. Shirking, budget and vote maximisation threaten efficiency. MIS was condemned because it gives individuals an incentive to shirk, PPA because it gives bureaucrats an incentive to maximise budgets and BES because it gives politicians an incentive to maximise votes. It has not been argued that individuals will do 'wrong' no matter what their position; only that they will do 'wrong' when they have an incentive to do so. An organisational arrangement that gives politicians no incentive to do wrong secures the feasibility of BES.

In his discussion of constitutionalism, Jon Elster (1989, 9) argues that choice in designing political systems is between 'rules and discretion'. This is to obscure a further and significant distinction. What matters is not only whether there is discretion but who is given discretion and what their incentives are in exercising this discretion. Through a detailed examination of Japanese economic policy it will be shown that discretion can be given to individuals who have no incentive to subvert efficiency.

#### 9.4.1 Computers, MITI and Economic Miracles

At the end of the Second World War, Japanese gross domestic product had fallen by twenty five per cent, its merchant marine had been destroyed and two major cities razed to the ground. Only by 1952 did industrial production recover to its pre-war levels. Yet within the space of a generation, Japan was being offered to the world as a model of economic success. Erza Vogel's (1979) Japan as Number One rode the crest of a new wave of literature extolling Japanese virtues. Talk of a 'Japanese miracle' is by now somewhat stale. As a term it is also misleading as it implies that the causes of Japanese growth are inexplicable. Drawing on Marie Anchooguy's (1989) study of Japan's computer industry a familiar explanation of growth is offered: one that emphasises the role played by the Ministry of International Trade and Industry (MITI).

Economic growth has been actively promoted by the Japanese state. Ownership remains in private hands but the state regularly intervenes to guide entrepreneurial decisions. The most important government agency in promoting growth is MITI. Formed in 1949 and always the smallest of the economic Ministries, MITI holds two formal sources of power. First, it is responsible for screening private sector applications for loans from publicly-owned funding organisations like the Japan Development Bank, The Export-Import Bank and the Small Business Finance Corporation. Second, MITI is encouraged to influence market structure by regulating competition, controlling imports and proposing price changes.

This is not achieved through formal commands but administrative guidance: 'warnings, suggestions and encouragement to individual firms' (Johnson, 1982, 265).

In 1960 and following extensive consultation, MITI took the decision to designate computing a 'strategic industry' and promote its growth. Although sales of computers were growing rapidly, Japan was almost entirely dependent on imports. Japanese firms accounted for only seven per cent of sales (Anchordoguy, 1989, 34). Over the next twenty years, Japanese market share grew by over sixty per cent and Japan became the only country outside of the Iron Curtain in which IBM was displaced as market leader. MITI was instrumental in encouraging the growth of the industry and three main strands to its policy can be discerned: protectionism, financial support and structural control.

(i) Protectionism MITI's first priority in 1960 was to provide a 'breathing space' within which a domestic industry could be developed. Tariff barriers were immediately raised and any company wishing to import a computer was told that it first had to apply for an import licence; giving MITI the opportunity to 'persuade' the company to reconsider its decision. IBM was allowed to open a firm in Japan but only on the condition that it employ Japanese citizens, accept a voluntary market ceiling and provide full access to its patents after a specified period of time.

Having later joined the OECD and signed the GATT accords, Japan

came under intense pressure to liberalise its trade arrangements. Eventually and after much delay, some tariff barriers were eliminated in 1975 but MITI had no intention of abandoning domestic producers to international competition. Import licences were still required and sometimes took years to process. The publicly owned Japan Electronic Computer Company (JECC) - whose role will be examined presently - refused to deal with firms that bought computers overseas and government continued to purchase only Japanese models.

(ii) Financial Support During the period computing was designated a strategic industry, government met the entire cost of 'pure' research and shared with individual firms the cost of any work that resulted in the acquisition of a patent. During the 1960's, government spent nearly twice as much on computer research as all private firms combined. The 'New Series' project - designed to combat IBM's 'third generation' computers - received \$235m of support and later largely unsuccessful research into artificial intelligence \$350m (Suzuki, 1988, 38):

MITI also secured the Finance Ministry's support for favourable changes to the taxation system. Corporation tax for computer firms was cut from forty per cent in 1950 to less than twenty per cent in 1968 and further tax concessions were announced for research work. If, to take one example, firm's research expenditure in any one year was greater than that in the previous, one quarter of the difference was refunded. Anchordoguy (1989, 243) calculates that \$713m of tax was saved in this way

alone. Subsidies were also made available through the JECC. Created in 1960, this organisation 'played a critical role in the development of a modern Japanese computer industry' (Anchordoguy, 1989, 59). JECC bought computers and leased them to private firms relieving manufacturers of the need to market their own products. Additionally, JECC operated a 'buy-back' policy for firms wanting to upgrade their capacity. By allaying fears that any computer bought might become obsolete, demand was sustained at a time of rapid technological development.

Finally and by exercising informal pressure and staking its own reputation on the success of the industry, MITI ensured that other organisations matched its own funding commitments. The publicly owned Japan Development Bank was, for example, encouraged to lend to firms at zero or at least negligible interest rates. The participation of MITI and the Japan Development Bank encouraged the participation of private lending organisations. Anchordoguy (1989, 36) quotes one senior executive as stating that

if the Japan Development Bank lends money to an industry, that means the government is backing it. Other banks will also lend money because they feel that MITI will rescue them ... if things get into a pinch.

(iii) Structural Control MITI not only subsidised but guided the actions of private firms. JECC was used to control the prices at which computers were sold and fearing the dangers of 'Kato Kyoso' (excessive competition) MITI controlled the number of firms within the industry. In the early 1970's and prompted by (misplaced) fears about the impact of foreign competition, MITI announced that

six companies in Japan is definitely too many ... we should use administrative guidance to make two or three firms, not six, to unify and to effectively use our engineers and thereby contribute to the development of the Japanese computers (quoted Anchordoguy, 1989, 105).

Having threatened to withdraw funding from existing projects, MITI succeeded in prompting the merger of NEC with Toshiba, Fujitsu with Hitachi and Mitsibushi with Oki. But whilst competition was controlled by MITI it was not eliminated (Johnson, 1982, 318). JECC was told to only purchase those computers for which there was a buoyant demand and following the failure of several of its projects, one firm, Matsushita, was forced to withdraw from the market. MITI encouraged firms to compete for research contracts and demanded that each firm have its own capital staked on the success of any project for which there was government funding. As Anchordoguy (1989, 167) concludes,



the overall effort [to develop the industry] has been successful because the government has generally structured its policies in ways that did not squelch the initiative of each company.

It is misleading to imply that MITI alone was responsible for the successful development of the computing industry. The state facilitated entrepreneurial action but did not itself act as an entrepreneur. The state provided funds for innovation but it was private firms that conducted the research and in whose names patents were registered. JECC marketed computers but it was privately owned firms that manufactured them. Risk was minimised but it was not eliminated. Furthermore and as Jon Wornoff (1990, 152-3) emphasises, MITI's record was not perfect. A number of expensive mistakes were made most notably in financing expensive research into artificial intelligence and in providing large subsidies for the eventually bankrupted Japan Software company.

A number of other factors contributing to the success of the industry can be identified and their relevance understood in terms of the arguments of previous chapters. First, corporate structure in Japan encourages investment as firms are financed by debt rather than equity. This allows managers to forego the pursuit of short-term profits designed to appease shareholders. Second, the organisation of firms within 'Keiretsu's' - large conglomerates made up of many individual components - facilitates growth. The size of these combines allows them to channel large amounts of capital into investment and to sustain initial losses.

This element of Japanese entrepreneurship is clearly neo-pluralist. Finally, Japanese firm's commitment to the practise of lifelong employment allows companies to invest in human as well as physical capital.

To argue that MITI is not solely responsible for the economic 'miracle' is not, however, to suggest that it is irrelevant. The growth of the industry indicates the difference the intervention of one powerful ministry can make.

#### 9.4.2 Bureaucracy, Democracy and Discretion

Two important similarities between BES and the mechanisms used to encourage Japanese growth can be identified. First, both recognise the need to control the environment within which entrepreneurs act: BES through ordinal tournaments and MITI through administrative guidance. Second, both recognise the need to grant considerable autonomy to entrepreneurs. An important difference can also be observed. Whilst Japanese ownership is private, intervention in the market is in many ways more extensive. It has not, for example, been suggested that the socialist state should set the prices at which agencies market their products.

Points of divergence and convergence although worth noting are in themselves immaterial. MITI and administrative guidance are not being offered as alternatives to or rivals for BES. The example has been introduced because although the states act

differently, both take decisions regularly affecting the welfare of entrepreneurs. A change in the level of research support will have as great an impact on the profits of a Japanese firm as a change in the levels of investment will have on a bureaucratic agency. Why did politicians not subvert MITI's rules for their own electoral purposes? Because whilst government is neither decentralised or constrained by constitutional requirements it nonetheless lacks sufficient policy capacity.

In the aftermath of the Second World War, the primary objective of the American occupying forces was the 'democratisation' of the Japanese political system. The powers of the military and the emperor were reduced and a new constitution stating that 'sovereign power resides with the people' (quoted Herzog, 1993, 265) passed. Nonetheless and despite the intentions of the constitutional settlement, power was transferred not to the legislature but to the bureaucracy. The rule of law has been replaced by the rule of bureaucrats (Henderson, 1975, 195). In his assault on Japanese political culture, Peter Herzog (1993, 262) suggests that 'bureaucrats reign supreme in most government agencies while ministers behave like simple robots': a description endorsed by numerous other academics (Kunio, 1986, Maheswari, 1987, Ito 1992, 318).<sup>3</sup>

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<sup>3</sup> In recent years a revisionist literature stressing the interdependency of the bureaucracy and the Liberal Democratic Party has emerged (Parks, 1986, Koh, 1989, Haley, 1991). Even then it is still acknowledged that 'in comparative terms, Japan's administrative elite may be among the most powerful in industrialized democracies' (Koh, 1989, 256).

MITI does consult with other bodies before taking decisions. Japan has at least four powerful groups representing the interests of industry and individual computer firms are encouraged to voice their concerns directly to MITI through deliberation councils. But not only does MITI control access to these meetings - excluding interests opposed to the dominant growth coalition - it retains the authority to impose unwelcome decisions upon firms. MITI's decision to launch JECC and to merge the six computer firms was, for example, taken despite strong opposition (Anchordoguy, 1989, 61). The organisational autonomy of MITI from elected politicians more susceptible to the demands of interest groups, makes the subversion of effective rules less likely.

Rules are discretionary and MITI is in a position to change them in response to mistakes and volatile international conditions but there is no incentive to abuse this discretion. In his discussion of the lessons that can be learnt from the Japanese model, Chalmers Johnson (1982, 315) comments that there is a need for a political system in which

the bureaucracy is given sufficient scope to take initiative and operate effectively. This means, concretely, that the legislature and judicial branches of government must be restricted to 'safety valve' functions.

In Chapter Eight, the necessary actors within BES were identified as being consumers, agencies and government. The success of the Japanese system suggests that a fourth actor must be added to this list: a small number of elite and vigorously independent bureaucratic guardians responsible for setting and, when necessary, changing the rules of ordinal competition. These officials will have no incentive to vote-maximise as they will not be elected and no incentive to budget-maximise as they will be given no budget beyond that necessary for administrative needs. Will officials shirk? If promotion and perhaps salaries within the organisation are made dependent on the performance of agencies this incentive can also be nullified through organisation design.

There is both an irony and a cost in positing the need for such a body. Whilst in Chapter Three the 'instrumental efficiency' of bureaucracy was challenged, Max Weber himself expresses a very different concern: that the very efficiency of bureaucracy leads bureaucrats to usurp politician's functions. Bureaucrats, Weber argues, make poor politicians being too conservative and unwilling to compromise. Bureaucratic power threatens efficiency and will lead to the creation of a 'politically stultified nation, with the vigour of the non-bureaucratic classes unable to express itself' (Albrow, 1970, 48). But whilst bureaucracy has been defined in terms of its subservience, the feasibility of BES appears to depend on bureaucrats acting in non-bureaucratic ways.

The cost of the solution is evident. Socialism requires democracy

and bureaucratic control of the rules of ordinal competition is undemocratic. When considering changes to the rules, unelected and unaccountable bureaucrats may but need not take account of public opinion. If the trade-off between efficiency and equality is to be minimised, it appears necessary to accept a further trade-off between efficiency and democracy. Herzog (1993) describes Japan as a 'pseudo-democracy'. Does the same label need to be attached to BES?

#### 9.4.3. Saving Democracy: The Political Order of a Free People

The distinction between 'nomos' - spontaneous orders - and 'taxis' - organisations designed to achieve particular purposes - has already been noted in Chapter Three. In The Political Order of a Free People, Friedrich Hayek (1982d) recognises that for spontaneous orders like the market to operate effectively it will be necessary for an organisation, the state, to construct rules governing behaviour. But the market, Hayek claims, has been undermined by governments using their unlimited powers to subvert rules for political purposes.

The very omnipotence conferred on democratic representative assemblies exposes them to irresistible pressure to use their power for the benefit of special interests, a pressure a majority with unlimited powers cannot resist if it is to remain a majority (Hayek, 1982d, 128).

Because existing organisational structure gives politicians an incentive to undermine efficiency, the survival of liberal democracy depends not on the election of a more prudent class of representatives but on the reconstruction of the political system. Hayek (1982d, 106) proposes a functional division of labour between Governmental and Legislative Assemblies in which the Government Assembly is made responsible for the direction of government activity designed to achieve particular goals like the provision of public goods (taxis) and the Legislative Assembly is made responsible for rules of universal conduct, for providing a framework within which individuals can pursue disparate projects and goals (nomos). The Legislative Assembly will be charged with tasks that

include not only the principles of taxation but also all those regulations of safety and health, including regulations of production or construction, that have to be enforced in the general interest and should be stated in the form of general rules. These compromise not only what used to be called safety legislation but also all the difficult problems of creating an adequate framework for a functioning competitive market and the law of corporations (Hayek, 1982d, 114-5).

The problem Hayek addresses is the same one that afflicts BES. The proposed solution is applicable to BES as rules of ordinal competition are 'nomos': they provide an arena in which

innovation and coordination can take place but do not require bureaucratic entrepreneurs to act in particular ways. Will the members of the Legislative Assembly not subvert the rules for their own purposes? Hayek suggests that elections should take place in age cohorts when individuals are forty five and that elected members should remain in the assembly until compulsory retirement at sixty. Liberated from the need to seek reelection, incentives to use changes to the rules as a form of vote-maximising are eliminated. As salaries and pensions are high but fixed, incentives to use changes to the rules as a form of personal income-maximising are also satiated and as the attendance of members is monitored, incentives to shirk are minimal.

Four advantages of this functional division of labour can be identified. First and unlike constitutional outcome prohibitions, discretion is retained. Second and unlike bureaucratic control, discretion is democratic. Collective control over economic outcomes can be achieved as members of the Legislative Assembly act not only on behalf of but are elected by the people. Will changing preferences about the appropriate trade-off between efficiency and equality be reflected in policy amendments? The absence of reelection retards the process of change but will not eliminate it as it will take only a maximum of eight years for a majority to be built around a new position. Furthermore, the transition costs of changing rules of competition mean that this delay need not be seen as a cost. Third and unlike market solutions, centralisation of power allows equality to be retained



as competition is restrained. Finally and unlike many democratic systems, elected politicians do not have an incentive to subvert rules for their own purposes.

### 9.5 Conclusion

Rational choice offers a new and more vigorous means by which to study politics but there is little that is new under the sun. Plato's Republic addressed many of the arguments raised in this chapter over two thousand years ago. Plato (1979, 145) takes harmony to be the hallmark of a healthy society: 'the greatest good for a city is what binds it together and makes it one, and the greatest evil is what pulls it apart and turns it into many'.<sup>4</sup> As a method of governance, democracy is rejected because it engenders violence, selfishness, instability and faction. Democracy leads politicians like Alcibiades - who plotted with Sparta and Persia against Athens - to put their interests above those of the common good. Justice can only be attained through the rule of 'guardians' and only then if guardians are given absolute power. Why should these select individuals act in the interests of all? Part of Plato's answer is that through rigorous education, guardians can be trained to rise above the pursuit of self-interest. 'They will be compelled to take their turns ruling, for the sake of the city ... and [will] regard ruling not as something fine and splendid but as something necessary' (Plato, 1979, 202).

In his discussion of the guardian's broader social position, Plato also shows an awareness of the importance of incentives. Guardians are selected rather than elected because elections

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<sup>4</sup> This and all subsequent references are taken from Nicholas White's (1979) A Companion to Plato's Republic.

threaten unity. Furthermore, whilst the guardians are not expected to live in abject poverty, they will not be allowed to accumulate income because the competitive pursuit of wealth encourages greed. 'We must keep wealth from our guardians, because wealth makes any practitioner of a task worse at it' (Plato, 1979, 108-9). Finally and to ensure their selfless devotion, guardians are denied private property and a personal family life. Plato does not use government as an instrument of socialism designed to equalize wealth but equalizes wealth in order to remove a potentially disturbing influence on government.

What shall we answer if someone objects that we have not allowed the guardians to have much happiness? We shall answer that it would not be surprising if they are indeed happy, but in any case our aim is to make the whole city as happy as possible, rather than any particular group in it. Moreover, we do not wish the guardians to have any sort of happiness that will make them other than guardians, because if they do the city will be ruined (Plato, 1979, 106).

The guardians of BES are given the same absolute power to control the rules of ordinal competition between bureaucratic agencies. Their impartiality is ensured not through positive incentives like, for example, performance related pay or through positive appeals to duty, sacrifice and altruism but through the elimination of incentives that encourage inefficiency.

Plato's guardians resemble those found within the Japanese bureaucracy in that they are unelected and unaccountable. Karl Popper attacks Plato for sowing the seeds of totalitarianism, accuses him of placing too great a faith in the capacities of a small number of individuals and argues that the real question is not 'who should rule' but 'how can we so organize political institutions that bad or incompetent rulers can be prevented from doing too much damage' (Popper, 1945, 121). If there is no one to guard the guardians there is nothing to stop abuses of power occurring. For this reason, Popper despairs of Plato's elitism and champions the cause of democracy. The case against democracy in the first section of this chapter was that it makes rulers more likely to do damage even if it can prevent them from doing too much damage. Democracy may be the risk adverse strategy but it is not necessarily the one that will maximise expected gains.

Hayek's Legislative Assembly treads the middle ground between Plato's sovereign and noble guardians and Popper's democracy. The Political Order of a Free People envisages a political system in which the abuse of power is controlled through elections but in which the chances of an abuse of power occurring are reduced by careful consideration of the incentives organisational structure creates for members. This proposal can best minimise the trade-off between efficiency and equality and between efficiency and democracy in BES. The arguments of socialists like Karl Marx, Gerry Cohen, Anthony Crosland and John Roemer are not irrelevant to the study of socialist entrepreneurship but it is in the economic work of the most strident critic of socialism, Friedrich

Hayek, that the real problem for socialism is found and it is in his political work that an eventual and satisfactory answer to the problem of socialist entrepreneurship is found.

**Chapter Ten**

**Conclusion**

- 10.1 The Economics of Entrepreneurial Socialism
- 10.2 The Politics of Entrepreneurial Socialism
- 10.3 The Compatibility of Socialism and Entrepreneurship

The compatibility of socialism and entrepreneurship can be evaluated in two ways: economic and political. First and other than capitalism, what system (if any) generates sufficient entrepreneurial activity? Second, which of these systems qualifies as socialist? The exactness with which the terms socialism, entrepreneurship and compatibility have been defined in earlier chapters facilitates discussion of both questions. Answers need not be prefaced by the qualification 'it depends what you mean by ...'. Socialism is a political programme distinguished by the pursuit of equality, democracy and liberty. The closer these goals come to being realised, the more socialist a system can be described as being. Entrepreneurship is a economic function involving innovation and coordination and requiring the bearing of uncertainty. In Chapter Two, six criterion were introduced by which the compatibility of socialism and entrepreneurship can be judged.

Requirement 1. The compatibility of socialism and entrepreneurship demands that socialism offer a mechanism through which information about consumer's preferences for goods can be judged and translated into entrepreneurial action. If this mechanism is to be profit-driven markets, their compatibility with socialism must be established. If this mechanism is not to be profit-driven markets the efficacy of an alternative mechanism must be established.

Requirement 2. The compatibility of socialism and entrepreneurship demands that socialism offer a mechanism through

which the success of any particular entrepreneurial venture can be judged. If this mechanism is to be profit-driven markets, their compatibility with socialism must be established. If this mechanism is not to be profit-driven markets the efficacy of an alternative mechanism must be established.

Requirement 3. The compatibility of socialism and entrepreneurship demands that socialism must provide reasons for a sufficient number of individuals to remain 'alert' to the possibility of entrepreneurial discovery.

Requirement 4. The compatibility of socialism and entrepreneurship demands that socialism must offer a 'balanced' cost-benefit schedule. For Schumpeter, entrepreneurial activity is risky but promises large rewards. For Galbraith, entrepreneurial activity is safe but promises only minor rewards. If socialist entrepreneurial activity is costly and/or risky possible rewards must be spectacular.

Requirement 5. The compatibility of socialism and entrepreneurship demands that socialism must offer a mechanism through which new entrepreneurs can be drawn into economic activity and through which unsuccessful ones can be removed.

Requirement 6. The compatibility of socialism and entrepreneurship demands that socialism be capable of generating the kind of activity described in neo-pluralist, elitist and new right theories of capitalist entrepreneurship



## 10.1 The Economics of Entrepreneurial Socialism

In the concluding chapter of Collectivist Economic Planning (1935a) and having questioned the efficacy of the mathematical solution, Friedrich Hayek briefly evaluates the iconoclastic but unpublished arguments of a younger generation of socialist economists. The argument here is presumably directed against Oskar Lange's competitive solution, the details of which were published a year later.<sup>1</sup> Hayek's description of what we will call the 'radical' solution appears curious because the competitive solution is actually far less radical than he appears to have believed; being based on an overt commitment to (i) centralized decision-making, and (ii) neo-classical images of the state as auctioneer in a perfectly competitive market. At least superficially, the radical solution appears to offer a more accurate description of BES and for this reason, Hayek's argument is worth examining.

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<sup>1</sup> Hayek (1935c, 217) states that in Germany, similar proposals 'have been published and discussed' but no references are provided and in his commentary on the calculation debate, Don Lavoie (1985) provides no further clues.

The common [and] fundamental idea [of the radical solution] is that there should be markets and competition between independent entrepreneurs or managers of individual firms, and that in consequence there should be money prices, as in the present society, for all goods, intermediate or finished, but that these entrepreneurs should not be owners of the means of production used by them but salaried officials of the State (Hayek, 1935c, 218).

Will the radical solution work? Hayek suggests that it will not because in the absence of private ownership, decision-making will remain centralized and politicised. The argument is presented in a series of what he takes to be unanswerable questions, two of which will be mentioned. First, 'how [is the entrepreneur's] success or failure ... to be tested' (Hayek, 1935c, 232)?

If the penalty for loss is the surrender of the position of 'entrepreneur' will it not be almost inevitable that the possible chance of making a loss will operate as so strong a deterrent that it will outbalance the chance of the greatest profit? (Hayek, 1935c, 235).

Fear of personal bankruptcy gives capitalist entrepreneurs reason to exercise caution when making decisions but the prospect of acquiring 'spectacular prizes' (Schumpeter, 1943, 73) encourages them to take (calculated) risks. The costs and benefits of

entrepreneurial action are balanced (requirement 4) and entrepreneurs have an incentive to remain alert to the possibility of new discoveries (requirement 3). State ownership means that entrepreneurs will be 'salaried officials of the state' (Hayek, 1935c, 218) and entrepreneurs will be aware that whilst they may lose their position if mistakes are made, successful innovation and coordination will not improve their position. The costs and benefits of entrepreneurial action are not balanced and there are insufficient incentives for entrepreneurs to remain alert to discoveries.

Second, 'there remains the very serious question of how to decide ... whether a going concern is making the best use of its resources' (Hayek, 1935c, 235).

In a capitalist society the transfer of capital from the less to the more efficient entrepreneur is brought about by the former making losses and the latter making profits. The question of who is to be entitled to risk resources and with how much he is to be trusted is here decided by the man who has succeeded in acquiring and maintaining them (Hayek, 1935c, 236).

Hayek asks whether allocation in the socialist system is to be determined by the same principle and answers his question with the assertion that it cannot. State ownership means that

it will rest with the central authority to decide whether one plant located at one place should expand rather than another plant situated elsewhere. All this involves planning on the part of the central authority on much the same scale as if it were actually running the enterprise (Hayek, 1935c, 236-7).

Hayek (1935c, 238) concludes that the radical solution is no more feasible than its mathematical predecessor and argues that whilst socialist economists have conceded some ideological ground, they have not fully understood the logic of the Austrian position.

To assume that it is possible to create conditions of full competition without making those who are responsible for the decisions pay for their mistakes seems to be pure illusion. It will at best be a system of quasi-competition where the person really responsible will not be the entrepreneur but the official who approves his decisions and where in consequence all the difficulties will arise in connection with freedom of initiative and the assessment of responsibility which are usually associated with bureaucracy (Hayek, 1935c, 237).

Hayek argues and Chapter Four accepted that markets are a necessary condition for entrepreneurial efficiency not least because they allow for consumer sovereignty (requirement 1), decentralization and the utilization of tacit knowledge. With

reference to Figure 10.1, Hayek's argument can then be summarised in the claim that whilst markets can be combined with private ownership (I) and planning with state ownership (IV), markets cannot be combined with state ownership (III).<sup>2</sup> If Hayek is right it would appear that socialism is incompatible with entrepreneurship but must this argument be accepted?

Figure 10.1 Ownership and Allocation

		<u>Allocation</u>	
		Market	Planning
<u>Ownership</u>	Private	I	II
	State	III	IV

Whilst it has been argued that the market is in principle an efficient mechanism for discovering knowledge and allocating resources, acceptance of the need for markets by itself means very little. Whether and to what extent markets will generate entrepreneurial activity depends on the way that the market is constituted and the organisational and institutional structures that are used to animate it and it is for this reason that it is misleading to speak of market socialism as if it is itself a solution to socialism's problems. In his discussion of the impact of new institutionalism on the study of political science, Robert Goodin (1996, 13) writes that what

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<sup>2</sup> The relationship between planning and private ownership (II) has already been discussed (3.2.5).

people want to do, and what they can do, depends importantly upon what organizational technology is available or can be made readily available to them for giving effect to their individual and collective volitions. This presents itself to individual citizens as a constraint, to managers of the state apparatus as an opportunity.

The organizational technology available to socialist economists in the course of the calculation debate was extremely crude and compromised by a misplaced attachment to neo-classical theories of economics. The organisational technologies available to the economist, politician and doctoral student have not, however, remained fixed and a very different answer can now be given to the question 'are socialism and entrepreneurship compatible'?

Three types of market socialism have been examined. Chapter Five examined a form distinguished by an institutional commitment to moral incentives and an organisational one to kibbutzim. It was argued that the possibility of successfully using moral incentives depends on the presence of specific environmental factors but that these same factors discourage neo-pluralist entrepreneurship, violating requirement six. Chapter Six examined a form of market socialism distinguished by an institutional commitment to economic democracy and an organisational one to LMFs. It was argued that whilst this system is in many respects more efficient than capitalism, it is unable to (i) sustain elite entrepreneurship, again violating requirement six, and (ii) offer

a balanced cost-benefit schedule to entrepreneurs entering the market, violating requirements four and five.

BES is distinguished by an organisational commitment to state ownership - of which more will be said presently - and an institutional one to the use of tournaments between bureaucratic entrepreneurs. Goodin suggests that institutions shape behaviour, constrain options and present opportunities. In his terms and when combined with a functional division of labour between Legislative and Governmental assemblies, tournaments encourage innovation and coordination, deny entrepreneurs the opportunity of acquiring spectacular prizes and so present (socialist) politicians with an opportunity to minimise the trade-off between efficiency and equality and between efficiency and democracy.

Tournaments allow markets to be combined with state ownership and offer a mechanism through which the success of particular ventures can be judged (requirement 2). Agencies finishing at or near the top of the ordinal ranking are judged to have undertaken successful ventures and those finishing at or near the bottom of the ordinal ranking are judged to have undertaken unsuccessful ventures. With specific reference to Hayek's argument, it should be noted that the allocation of resources in BES is undertaken by a different but similar principle to that found in a capitalist society. Those that make the most profits not only retain but are given more resources whilst those that make the lowest profits lose what they already have. There is no need for government to intervene in specific decisions about who is to get

what resources, only for it to establish the general framework within which such decisions are made.

Because relative position determines both remuneration and future survival, tournaments provide bureaucratic entrepreneurs with incentives to remain alert to new discoveries (requirement 3). The penalty for failure within tournaments is, as Hayek suggests it will be in his discussion of the radical solution, elimination and loss of entrepreneurial status but because wages are sensitive to performance, entrepreneurs will still have reason to take risks.<sup>3</sup> It has also been argued that tournaments can be designed in such a way as to maximise the entry of new entrepreneurs (requirement 5). On the condition that they offer some collateral, all will be given one chance to form an agency (8.3.2.2). Finally and because they offer a flexible cost-benefit schedule (requirement 4), tournaments are capable of sustaining new right, elite and neo-pluralist entrepreneurship (requirement 6). As decision-making within BES is decentralised, it will be the responsibility of bureaucratic entrepreneurs to decide what kind of project their agency should pursue and this decision will be made in the knowledge that rewards will vary accordingly. Elite entrepreneurship is, for example, more risky but, if successful, is more likely to propel the entrepreneur to the top of the ordinal rankings and result in a greater reward.

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<sup>3</sup> It will be recalled that Hayek (1935c, 218) suggests that entrepreneurs will be 'salaried officials of the state'. Bureaucratic entrepreneurs will be salaried in the sense that they are paid by the state but the term salary is otherwise misleading as it is defined by the Concise Oxford Dictionary to mean a fixed payment.



## 10.2 The Politics of Entrepreneurial Socialism

The second question to be addressed in this chapter is political: does BES qualify as socialist? It is frequently argued that market socialism represents too great a ideological concession to the right (Elison, 1988, Mandel, 1988) and John Roemer (1994, 35) acknowledges that it is possible to view the evolution of market socialist theory in these terms. The transition between different stages of the market socialist debate has been marked by recognition of (i) the dynamic efficiency of capitalism, (ii) the need to price scarce resources, (iii) the need for rivalry between firms, and (iv) for incentives to motivate entrepreneurial action. At best, market socialists are seen as offering a 'second best' theory of socialism (Cohen, 1991, 14) and at worst, critics accuse market socialists of abandoning socialism.

This interpretation of market socialism can be challenged. First, the argument in previous chapters has been based on a firm commitment to equality of income: a criterion that would satisfy the most zealous of socialists. Second and whilst recognising its achievements relative to 'actually existing' forms of socialism, it has been argued that capitalism discourages long-term investment and systematically undersupplies efficient levels of entrepreneurial activity (2.4). Market socialism need not pander to capitalism. Third, the form of market socialism considered most able to generate entrepreneurial activity, BES, unambiguously requires the nationalization of the means of

production.

Social democrats like Anthony Crosland (1964, 34) believe the location of ownership to be an irrelevance and in Chapter Four social democracy was defined as a system that seeks to realise greater equality within the confines of capitalist ownership. Market socialists recognise the need to constrain private ownership (4.6.1) but frequently argue that state ownership will retard efficiency and so favour 'softer' forms of 'social' ownership. Roemer (1994, 23), for example, now views ownership as 'an entirely instrumental matter' and argues (1994, 20) that 'the link between [state] ownership and socialism is tenuous'.

Critics leap on this concession and accuse market socialists of intellectual confusion (De Jasay, 1990, Gray, 1993, 98). If, they argue, social ownership gives individuals sovereign decision-making powers then market socialism will simply recreate patterns of capitalist inequality and if, as they suspect, social ownership is simply a linguistic cloak for state ownership then the inefficiencies of central planning will be preserved. Their argument overreaches itself in both respects. First, whilst social ownership in the kibbutz and the LMF does generate inequalities between organisations, it reduces inequality within them. Second and as already argued, state ownership need not degenerate into central planning.

Within BES, state ownership is the foundation on which not only entrepreneurial efficiency but socialism is built. First, state

ownership allows government to set the terms of ordinal competition between bureaucratic entrepreneurs and to minimise the trade-off between efficiency and equality. Second, state ownership allows the electorate to influence the choice of trade-off made. Third, state ownership also promotes equality by rewarding entrepreneurs only for their entrepreneurial ability and not for their possession of capital. Fourth, state ownership eliminates the source of capitalist entrepreneurs 'structural luck' (Dowding, 1991, 137-8) and prevents them from holding the state to ransom. Fifth, state ownership allows government to set investment levels in ways that reflect the positive externalities of entrepreneurial action. Finally, state ownership and tournaments allow government to shield new enterprises from premature closure. BES is not only a efficient but a radical form of market socialism.

The standard defence for market socialists when faced with the charge of ideological impurity is to respond that theirs is the more feasible form of socialism. Market socialists can present themselves as pragmatic socialists, willing to learn from economic theory, electoral realities and failed utopian theorising. As Christopher Pierson (1995, 190-1) suggests, market socialism is

not for starry-eyed dreamers, but for hard-headed and practical politicians in an era of historic reverses [for socialism]. In this sense, market socialism ... presents the possibility of prosecuting a socialist political project under existing and seemingly rather unpromising circumstances.

How is the criterion of feasibility to be judged? Alec Nove (1991, 209) suggests that a model of socialism is feasible if it describes

a state of affairs which could exist ... within the lifetime of a child already conceived without our having to make or accept implausible or far-fetched assumptions about society, human beings and the economy.

Defined in this narrow way, BES satisfies the requirement of feasibility as it does not assume the emergence of either altruism or economic abundance. But it should be recognised that what will be seen as feasible to the electorate also depends on the circumstances of particular countries and the size of the political gulf between the status quo and the proposal under discussion. This is not simply a matter of the costs of transition but of political imagination. A form of socialism that requires the nationalisation of the means of production will appear less feasible than one that, for example, seeks to realise socialist values within a capitalist system. Furthermore and

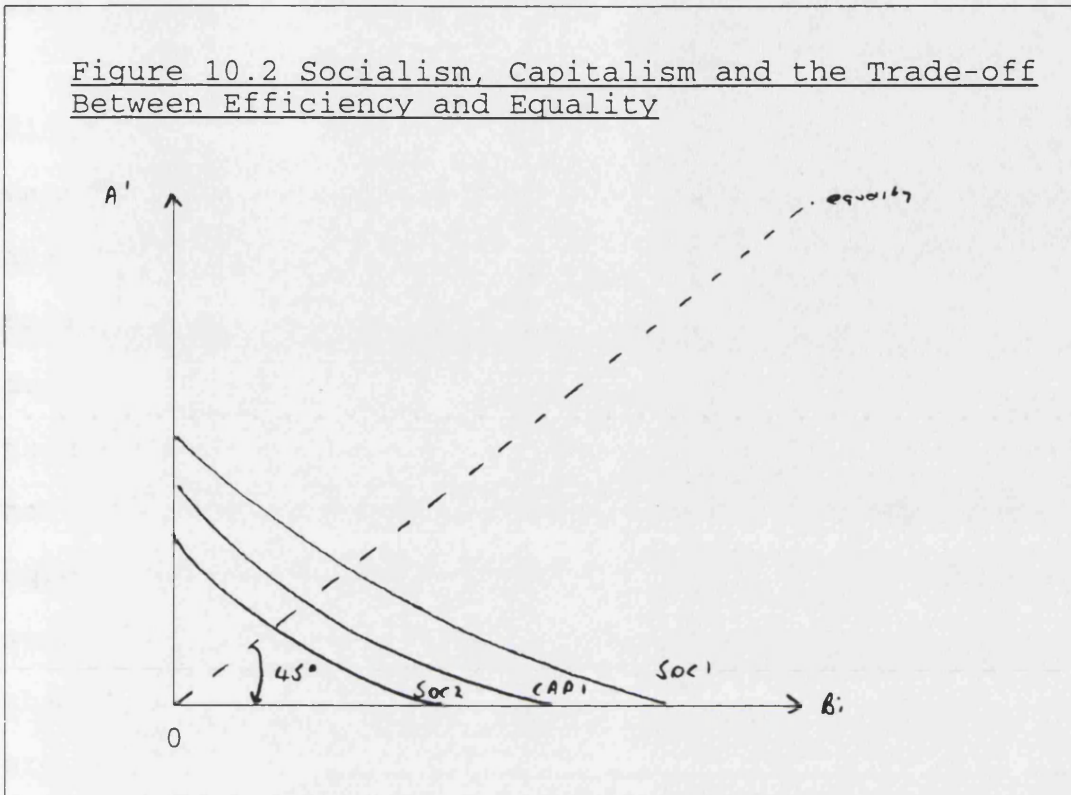
because BES cannot co-exist with a capitalist sector (8.3.2.1), nationalisation will have to be immediate and total. For the same reason that reservations were expressed about the 'maximalist' strategy in Chapter Six, a political question mark has to be placed over the feasibility of BES. The commitment to state ownership represents a political weakness as well as a source of strength.

### 10.3 The Compatibility of Socialism and Entrepreneurship

In so far as it has been hoped to achieve ... a distribution of income independent of private property in the means of production and a volume of output ... at least approximately the same or even greater than that procured under free competition it was more and more generally admitted that this was not ... practicable (Hayek, 1935a, 37).

In Chapter Four, a framework within which the trade-off between efficiency and equality can be understood was introduced and is reproduced in Figure 10.2. Austrian economists argue that the trade-off is necessarily severe and that this should be reflected in both the shape of the socialist production possibility frontier (SOC) and in the distance between it and the capitalist (CAP) one.

Figure 10.2 Socialism, Capitalism and the Trade-off Between Efficiency and Equality



The notion that we can draw precise lines on a diagram to indicate the productive capacities of different politico-economic systems is ultimately a fiction. Not only will the precise shape of production frontiers be affected by the particular geographical, historical and cultural circumstances of each country but at the level of abstraction in which theories of feasible socialism deal, it is difficult to see how, for example, a claim that the capitalist production frontier lies above the socialist one can ever be falsified. As Clifford Hooker (quoted Lane, 1996, 368) argues, theories are rarely 'reducible to finitely, observationally verifiable assertions' and because accepted observationally based facts are themselves 'theory laden and subject to theoretical criticism', falsification is

problematic.

Ultimately it is not the compatibility of socialism and entrepreneurship but only the quality of the arguments used to assert the compatibility or incompatibility of socialism and entrepreneurship that can be judged. Whilst accepting Hayek's denunciation of the mathematical and competitive solutions, this thesis has argued that one form of market socialism, BES, is able to (i) better manage the trade-off between efficiency and equality relative to both classical and other forms of market socialism, and (ii) reduce if not eliminate the distance between the socialist and capitalist production frontiers. If these arguments are accepted then it can be concluded that socialism is not incompatible with entrepreneurship.

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