

# **What Economic Structure for Socialism?**

by David M. Kotz

Economics Department  
Thompson Hall  
University of Massachusetts Amherst  
Amherst, MA 01003  
U.S.A.

Telephone 413-545-0739  
Fax 413-545-2921  
E-mail [dmkotz@econs.umass.edu](mailto:dmkotz@econs.umass.edu)

March, 2008

This paper was written for the Fourth International Conference "Karl Marx and the Challenges of the XXI Century," Havana, May 5-8, 2008.

## **1. Introduction**

Popular support for socialism has rebounded from the low point reached in the early 1990s following the sudden demise of Communist Party rule in the former Soviet Union and in Central and Eastern Europe. Since then the intensifying problems generated by neoliberal capitalism have spurred renewed interest in an alternative. New efforts to build socialism have recently emerged in several countries in South America.

However, it is not yet clear what "a new socialism for the twenty-first century" might be. There is general agreement that the mistakes of twentieth century socialism should not be repeated. In particular, most socialists believe that the economic structure of twentieth century socialism had serious flaws. There is little agreement, however, about what kind of economic institutions should form the basis for a new socialism.

Some have advocated the harnessing of market forces as the route to a viable socialism. It is claimed that market socialism can combine the efficiency, innovativeness, and individual choice which competitive markets are supposed to assure with the social justice and economic security promised by socialism. Some point to the rapid economic growth in China since its shift to a market economy as evidence for the potential success of market socialism.

This paper argues that a market economy is not a suitable basis for building socialism. Section 2 considers why markets may seem appealing as a basis for socialism. Section 3 offers a critique of market socialism. Section 4 discusses participatory planning as an alternative economic basis for socialism.

## **2. The Lure of Market Socialism**

The view that socialism should be built on the basis of a market economy has emerged in recent times in several different historical contexts. Since 1978 China has sought to build socialism based on market forces, achieving a high rate of economic growth that has impressed many

observers. Toward the end of Soviet period in the USSR, many intellectuals were drawn to the idea of market socialism.<sup>1</sup> Since the late 1980s some Western socialist theorists have argued that a viable socialism must be based on a market economy (Nove, 1983; Roemer, 1994).

The attraction to market forces as the basis for socialism ultimately stems from a recognition of the economic problems of central planning as it has actually been practiced. Central planning can claim credit for bringing rapid economic development and a rising living standard for the majority in a number of countries from the late 1940s through the mid 1970s. However, it is important not to understate the problems of central planning as it has actually been practiced.

The slowdown in economic growth in the Soviet Union and Eastern Europe after 1975 was only a symptom of the problems of their system of central planning. These problems include low quality goods in some (although not all) sectors, failure to provide the particular types of goods and services desired by customers, a variety of wasteful practices in production, persistent shortages, lack of consumer services, environmental destruction, and technical progress that was uneven and ultimately lagged relative to that of capitalism.

Opponents of socialism claim that the economic problems of actually existing socialism are inherent in socialism. When the collapse came in 1989-91, many socialists concluded that the institution of economic planning must be fundamentally flawed.<sup>2</sup> The idea that the problems of central planning could be easily resolved by introducing a market system was very appealing. For those living in socialist countries, with no experience of the problems of actually existing market systems in the capitalist world, this appeal became very great. If markets could guarantee economic efficiency and progress, while a socialist state assured economic justice and individual economic security, perhaps socialism could be rescued.

### **3. Contradictions of Market Socialism**

The hope that market forces can serve as the economic basis for a socialist society is

misplaced. The problems with market socialism fall into two categories. First, the economic virtues that are usually claimed for markets exist only in the unrealistic models of neoclassical economic theory, not in actually existing market systems. Second, if the economy of a socialist society is built on market forces, the working of a market economy will eventually purge the society of any socialist features. These two problems will be considered in turn, although we will have to consider the first problem more briefly than the second due to space constraints.

A competitive market system is supposed to bring about what neoclassical economists call an "optimally efficient allocation of resources." That means that such a system will use available resources of labor-power, land, and capital goods to yield the greatest possible satisfaction for consumers. Although each individual pursues only self-interest, the invisible hand of the market, operating through market prices, produces an economic optimum from such self-seeking behavior. Producers, while seeking only their own profit, are compelled to cater to the wishes of individual consumers.

In neoclassical economics textbooks, one finds that a series of unrealistic assumptions must be made to "demonstrate" the efficiency of a competitive market economy.<sup>3</sup> These assumptions include no economies of large-scale production; complete and accurate information on the part of everyone about every good available in the economy; no external effects of production or consumption such as pollution; and no public goods such as education, fire protection, or parks. Thus, the claim that individual pursuit of self-interest in markets results in a social optimum depends on assuming away any kind of interrelation among economic actors which might conflict with such a conclusion!

Actually existing market systems do have a kind of rough efficiency. That is, the pressure of competition forces producers to find ways to reduce the costs they have to pay to the lowest possible level, and producers must produce something that consumers are willing to purchase. However, costs

can be reduced by better organization of the work process -- or by cutting workers' wages, forcing workers to work harder or faster, dumping waste products into rivers or the air, or moving production to a place where wages are lower. The latter examples are not genuine cost savings but rather are redistributions of welfare from workers or others to the owners of the firm. Similarly, producing something that consumers are willing to purchase can be attained by seeking to satisfy existing consumer wants or by seeking to mold consumer wants through advertising into a form that is most profitable for the firm.

While actual market systems do have the above kind of rough efficiency, they also have characteristic forms of waste and inefficiency. These include the following: 1) the existence of major externalities in a modern, interdependent society; 2) the waste that results from producers' inevitable wrong guesses concerning the demand for their product; 3) a market economy's requirement for large sales and financial/insurance sectors; 4) the underproduction of such public goods as education, health care, public transportation, and parks (which implies a misallocation of resources); 5) the existence of involuntary unemployment, which periodically grows worse during business cycle recessions.<sup>4</sup>

The claim that markets are technologically progressive is a distinct theoretical claim from that of efficiency. The efficiency claim takes production processes and products as given, while technological progress involves the creation of new processes and products. Neoclassical theory has never produced a carefully argued theory of the superiority of a market system for technological progress. Instead, the rough argument is made that the possibility of gaining profit from innovation will lead profit-seeking firms to discover and rapidly introduce new processes and products.

However, this claim immediately encounters the problem that little profit can be gained from innovation in a competitive industry, since any innovation will quickly be copied by rivals. A market economy can produce a strong profit incentive to innovate only if patents -- a temporary monopoly --

are granted by the state, or if monopolies develop through private actions. However, monopolies, including patents, also hold back innovation and limit its benefits, as is seen in the high monopolistic prices of many life-saving medicines produced by profit-seeking firms. It is not obvious that a market system should have an overall advantage at innovation compared to a planned economy, in which innovation is publicly funded and does not depend on the profit motive, and in which the benefits of innovation can be readily provided to all. Cuba's pharmaceutical industry provides a good example of the advantages of innovation within a system of economic planning.

While the theoretical claims of optimal efficiency and technological progressivity for a market economy are unfounded, there is an even more serious problem with the market socialist case. That case assumes that market forces are a neutral institution, which can be harnessed by any social system. It is true that markets are not equivalent to capitalism. As Marx defined it, capitalism is a system of commodity production (market economy) in which the producers own no means of production and must sell their labor-power for a wage to the minority that does own the means of production.

However, history has shown that granting market forces a major role in a socialist system ultimately leads away from socialism and back to capitalism. This is not a historical accident. It emerges from the interaction between market forces and socialism.

Market forces can do their job of allocating resources only by activating the profit motive as the driving force of productive activity. For markets to work, economic actors who are successful must be allowed to gain the financial rewards of their success. That is why Deng Xiaoping eventually realized he had to proclaim "it is glorious to get rich" if China's introduction of a market economy was to succeed.

A market economy within a socialist system will inevitably, over time, give birth to a new wealthy class. If private ownership of firms is not permitted at first, the economically successful will

hold their wealth initially in other forms. However, wealth brings political power. The new wealthy class will inevitably press for the right to own productive property, which would enable them to rapidly multiply their wealth and also make it more secure. They will have the financial means to persuade government officials to support their aims. The contradiction between a small class of increasingly wealthy individuals, who are playing a central role in the economy, and a socialist state dedicated to economic justice for working people, cannot be indefinitely contained. Eventually either the new wealthy class will get its way and obtain the right to own productive property, becoming a capitalist class -- or the market system would have to be abolished and replaced by another economic structure. Once a capitalist class fully emerges, it will move toward becoming the new ruling class, either directly or through alliances with state officials. At some point public enterprise will be condemned as inefficient, and the demand that it be privatized will be raised.

The course of developments in China since 1978 approximates the analysis given above. The market was introduced to accelerate the development of the forces of production, expected to lead ultimately to communism. The market was viewed as neither capitalist nor socialist, as Chinese theorists still argue today. At first there was no significant role for private enterprise apart from foreign joint ventures. By the 1990s a class of wealthy individuals had arisen, and political pressure to legalize private enterprise accompanied that development. During the course of the 1990s private business was gradually accepted in official Communist Party policy statements. In 1999 the Chinese constitution was amended to guarantee the rights of private property owners. In 2002 "entrepreneurs" -- that is, capitalists -- were allowed to join the Communist Party.

Many of China's wealthy capitalists are reported to have close connections with party officials, in some cases family connections. This is not surprising, given the continuing powerful role of the party and state in the economy. Thus, China's evolution toward capitalism is no accident, regardless of the original intention behind introduction of the market. What is regarded as

"corruption" in China is not due to an unfortunate failure of character on the part of party and state officials, or to a lack of vigilance by party organs. It is an inevitable result of the unleashing of market forces in a socialist system. Both theory and history show that, while a market economy regulated by a strong and interventionist state can bring rapid economic growth -- as in Japan and South Korea as well China -- it inevitably becomes capitalist economic growth.

#### **4. The Alternative: Participatory Planning**

The economic problems of actually existing socialism were not inherent in socialism, or in economic planning. They were structural problems of the particular form of planning that first arose in the Soviet Union and later appeared in other Communist Party ruled states. All of the economic problems listed in section 2 above were due to a key feature of that form of socialism: an absence of popular participation in decision-making in the economy and the state. There were various problematic policies, but the foregoing structural feature was the underlying source of the economic problems.<sup>5</sup>

Economic activity in any system will serve the needs of those who have power within that system. In a market economy ordinary consumers have a limited power -- they can decide not to purchase something. Hence, producers have to be concerned with what ordinary consumers want to buy, since that is something they cannot fully control, try though they may.

In Soviet-type planning, those actors with power were able to get high quality goods produced for them. No one ever claimed that Soviet weapons were of low quality, yet they were produced via the system of central planning. Soviet military leaders, and the ministers in charge of production of military equipment, were powerful and could demand high quality products. Similarly, some of the industrial ministers in civilian sectors had the power to demand high quality products, and some Soviet industrial products were world class.<sup>6</sup> Special enterprises produced housing for high officials, and the quality of such housing was excellent.<sup>7</sup>



Powerful Soviet officials exercised their power by their ability to discipline or demote top enterprise officials if product quality was deemed unsatisfactory. It was an effective incentive. By contrast, ordinary households had almost no power in the Soviet planning system. Enterprise managers were not rewarded and punished based on how well they satisfied household consumers. The environmental damage from Soviet-type central planning resulted from an unaccountable leadership's focus on economic growth. The absence of democratic rights for the population prevented the emergence of a strong environmental movement that could have insisted on changed priorities.

For economic planning to work effectively, power must be dispersed among all of the relevant groups in the economy, not monopolized by unaccountable high officials. Models of participatory planning have been elaborated by a number of authors (Devine, 1988, 2002; Albert and Hahnel, 1991). They involve democratic participation both in the economy and the state, which must be closely intertwined in a socialist system. These models share the following four principles: 1) wide participation in decision-making by those affected by a decision; 2) representation of the population as workers, community members, and consumers on decision-making bodies; 3) a decision-making process based on negotiation and compromise, to handle the inevitable existence of opposing interests among different groups; and 4) an equitable sharing of the benefits and burdens of economic and political life.

If consumer representatives sat on enterprise boards and on regional and national level planning bodies, they could insist that enterprises produce high quality consumer goods that people would like to purchase, with the power to set rewards and penalties to back up their demands. If the top political leaders are dependent on popular support for staying in office, they would be under pressure to make the system work to meet the needs of ordinary people. Democratic institutions, which in a capitalist system are always limited by the enormous political power of the rich, would

work far better in a socialist system that has no class of wealthy property owners.

The promise of getting rich is not necessary to build an efficient, innovative economy. "Innovation Institutes" could fund the testing out of new ideas, new products, and new services. Someone with a proposal for a new restaurant or service establishment could apply for funds and leasing rights to carry out their proposal, without departing from the principle of public ownership of productive property. Modest material rewards should be sufficient to encourage innovation and new and varied services, given the presence in any population of many individuals who are personally inclined to launch new projects.

By providing representation for all constituencies in the making of allocation decisions, participatory planning would provide channels for all groups to see that their needs are addressed. It also recognizes the existence of conflicting interests even in a socialist society and provides institutions in which groups can negotiate and reach compromises. For example, enterprise boards having representatives of workers, consumers, and the community could strike a reasonable balance among workers' interest in not being overworked, consumers' interest in affordable and well-made products, and the community's interest in avoiding pollution of air and water. In a country having a relatively low living standard, a system of participatory planning would allow the population to demand a high rate of economic growth though democratic decisions about the resources to be devoted to investment and improved technologies.

For participatory planning to work effectively, economic decisions should be as decentralized as possible to facilitate maximum participation by affected parties. Old-style central planning was overly centralized. Some economic decisions must be made at the center, but many can be made at a regional or local level.

The claim that a system based on free markets is superior to any other in efficiency, innovation, and growth has no foundation. While a capitalist market economy can develop the forces

of production and bring a rising level of material consumption for part of the population, history shows that it has been unable to build a society that meets the needs of the entire population. Only socialism can assure everyone material comfort, security, and a guaranteed opportunity to participate in productive labor, without some exploiting others. Only socialism can build a society based upon the better aspects of human nature, rather than its baser aspects, and finally enable people to become the real masters of their fate. But socialism can carry out this historic mission only if it embraces democracy and popular participation as the basis of its institutions.

### References

- Ackerman, Frank, and Nadal, Alejandro. 2004. *The Flawed Foundations of General Equilibrium: Critical Essays on Economic Theory*. London and New York: Routledge.
- Albert, Michael, and Hahnel, Robin. 1991. *The Political Economy of Participatory Economics*. Princeton: Princeton University Press.
- Barnett, Vincent. 1991. "Conceptions of the Market among Russian Economists: A Survey," *Soviet Studies* 44(6), 1087-98.
- Devine, Pat (ed.). 2002. *Building Socialism Theoretically: Alternatives to Capitalism and the Invisible Hand*, special issue of *Science and Society* 66(1), spring.
- \_\_\_\_\_. 1988. *Democracy and Economic Planning*. Boulder, CO: Westview Press.
- Kotz, David M., and Weir, Fred. 2007. *Russia's Path from Gorbachev to Putin: The Demise of the Soviet System and the New Russia*. London and New York: Routledge.
- Nove, Alec. 1983. *The Economics of Feasible Socialism*. London and Boston: G. Allen and Unwin.
- Roemer, John E. 1994. *A Future for Socialism*. Cambridge, MA: Harvard University Press.

### Notes

- 
1. A survey of Russian economists in 1991, the last year of the Soviet Union, found that 95 per cent agreed with the statement "the market is the best mechanism to regulate economic life" (Barnett, 1991).
  2. Kotz and Weir (2007) argue that the demise of the Soviet system was not a result of economic problems but rather stemmed from the drive on the part of a decisive section of Soviet officialdom to become the new owners of the valuable assets of the system.
  3. As Ackerman and Nadal (2004) point out, the most sophisticated attempts by neoclassical theorists to prove the optimal efficiency of competitive markets based on reasonable assumptions ultimately failed.
  4. We are considering here only features inherent in a market economy. Features of the capitalist form of a market economy, such as exploitation of labor, are not included in this list.
  5. A problematic policy in the Soviet case was the policy of taut planning, under which the planners did not aim for either excess productive capacity or stocks of goods to deal with unforeseen developments. The absence of slack in the economy caused many problems, such as shortages of key goods and waste of inputs when complementary inputs were unavailable.
  6. Western transnational corporations paid to license technologies from Soviet metallurgical enterprises. Soviet eye surgery equipment and seamless rail laying machines were among the world's best.
  7. The author directly observed the quality of housing of high officials when conducting interviews of former Soviet officials who still occupied the same residence as when they been high officials of the Soviet party or state.