IS CAPITALISM OBSOLETE?

A Journey through Alternative Economic Systems

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We are now at the halfway point of our journey. Let us take a short look back at the path we have traveled so far.

We were looking for a promising alternative to capitalism, defined as a system that combines market exchanges and private property. What we demand of such an alternative is that it passes the cooperation test and the allocation test. Along the way, we visited systems of common ownership and planned economies, both of which eschew markets and private property, but we reached the conclusion that these do not amount to promising alternatives to today's system. We could not rule out that they would be incapable of solving the problem of cooperation, and it is certain they would fail to solve the allocation problem.

Where do we head next?

One thing appears incontrovertible: We must retain one of the two components of capitalism—namely, the market. The market is the only institution we have that is able to solve the allocation problem in complex economies. If an alternative to capitalism is to solve the allocation problem, then the market is, at present at least, indispensable.

Our onward journey will therefore lead us to economic systems that combine the market with noncapitalist institutions. The indispensability of the market does not say anything yet about the role of private property within the economic system, and it also leaves open the question of how large a share of the resources is to be distributed via markets. In other words, the concepts of the market and of capitalism are distinct: To concede the indispensability of the market is not to give up on our search for a better economic system.

Before moving on, it will be useful to identify the economic advantages of markets explicitly. These advantages are often overlooked, and not only by the critics of capitalism.

Why Markets?

Markets can encourage economic efficiency and frugality, and they can bring about valuable innovations and coherence within complex economies. They are therefore extremely helpful in solving the cooperation and allocation problems that economic systems face. How do markets manage to do all this?

Markets reveal what individuals really want, and they motivate individuals to be careful with their resources. In a market context, prices migrate toward the level at which supply and demand are in equilibrium. Because prices reflect the overall behavior of all sellers and buyers, they are a reliable signal of the social value of the various goods and services. They guide the decisions of producers, who try to produce more of those goods with rising prices, and hence rising value contributions to society. Producers also try to save on any production factors that are becoming more expensive. This is a good thing, because production factors become more expensive when demand is high for them from other producers; and this high demand, in turn, derives from the increase in profits these producers can achieve with the use of these factors. At the same time, market prices guide the decisions of consumers. People consume less of what becomes more expensive, which means lower consumption of goods which require more resources to produce. Conversely, they consume more of a good if its price drops— that is, if society is able to produce it at a lower cost.

The information on the relative scarcity of resources, which a central planner must try to extract from individual producers and consumers, flows out all by itself from a market, in the form of prices. This easily accessible information guides the production and consumption decisions of all economic agents. The result is that resources are made
available to those producers who can make the most productive use of them, and to those consumers who are prepared to pay the highest price for them. Thus, a relatively efficient allocation of resources emerges from innumerable independent decisions.

The market system also serves to promote useful innovation, because it provides incentives for individuals and enterprises to earn money by innovating. Such innovations always entail costs and their results are always unpredictable. The market mainly rewards individuals and enterprises whose innovations respond to real needs in society. There is thus an incentive to think very carefully about which innovations are really worthwhile. This applies just as much to the opening of a snack bar as it does to the launch of a revolutionary technological product. A supplier can be successful only if it manages to produce something that is valuable to others. In effect, buyers collectively select, through the things they purchase, who gets to be a producer and who does not. Established enterprises can be voted out and new enterprises with better ideas can prevail. The market rewards useful innovations and punishes useless ones; it thus dispenses with the latter and allows society to benefit from the former.

The beauty of markets—if they function properly—is their pluralism, and the fact that they do not involve concentrations of economic power. The challenge for the design of a promising economic system in the twenty-first century is to find an institutional arrangement that allows the full effects of these key advantages to be felt, but that keeps the negative effects of markets—wastefulness, inequality, the stultifying effects on personal development—to a minimum.

THE SYSTEM OF SELF-MANAGEMENT

The market can be combined with public ownership of firms, democracy in the workplace, and the central planning of strategic investment. Thus, we can imagine a mixed system in which infrastructure and the structural development of the economy, education, and the health system are subject to national planning, while the majority of goods and services are provided through self-managed enterprises and cooperatives operating in free markets. Let us call this a system of self-management. Such a system promises to combine the advantages of the market when it comes to specialization, flexibility, and diversity with the social advantages of planning and collective property. The system of self-management is the subject of this chapter.

Since the beginnings of the labor movement in the nineteenth century, the idea of producers managing themselves has informed visions of future socialist societies. The idea of self-management competed with the idea of planning, and managed to win over those socialists who were skeptical of authority and bureaucracy and had some sympathy for moderate versions of anarchism. Today, self-management is still an important point of reference for some left-wing intellectuals considering alternatives to capitalism. It is also a widespread idea among those who are partial to cooperatives. These people are by no means all socialists; there is a strong Catholic tradition, for instance, of supporting cooperatives. Some grassroots trade union organizations are also sympathetic to the idea of self-management.

Economists, especially some working during the 1970s and 1980s, have suggested various designs for economic systems based on self-management. Rather than focus on the design of one particular economist, however, we will consider here a model that integrates the most interesting elements of various designs. This is an economic system consisting of four fundamental elements. First, the means of production are, formally, the property of the state—but in contrast to planned economies, a considerable part of these property rights are transferred to the workforce that makes use of the means of production. Second, the decision-making process within enterprises is based on self-management by those employed in them. Third, the supply of goods and services to households and enterprises is mainly provided by markets. Fourth, a central plan determines the volume of overall investment within the economy, as well as the distribution of the overall investment among economic sectors and regions.

Under this economic system, the impact of the central plan is much more attenuated than in a planned economy, because at the micro level of individuals and single enterprises, the coordination of economic activity is fundamentally organized through myriad decentralized market
transactions. In the system of self-management, the planner is responsible for only the macroeconomic steering and long-term development of the economy. This frees the planner from the nitty-gritty work of determining production processes in detail, and so avoids the complex procedures that raised so many problems and questions in the previous chapter.

Since the planner is responsible to citizens, the investment rate for the overall economy and its structural development is subject to the will of the electorate, whereas individuals and enterprises retain control over concrete decisions about consumption and production. In this respect, this system clearly offers more individual freedom than a planned economy. Freedom of work and freedom of consumption are enshrined, at least formally, in capitalist democracies; but self-management turns out to be superior to capitalism in this regard, insofar as it avoids concentrating wealth in the hands of a few and offers workers more opportunity to make autonomous decisions about their own activities within firms.

In short, the system of self-management promises to combine the collective rationality of planning with the flexibility of markets and the autonomy of works councils. This makes it a potentially attractive alternative to capitalism, including to the social market economy—arguably the most successful version of capitalism so far.

Self-management is not only a possible economic system for the future; it is also an empirical reality of which people have had experience. Shortly after the end of the Second World War, the former Yugoslavia initially introduced a Soviet-style planned economy. Because the desired economic effects of this system failed to materialize, the Yugoslavian government under Marshal Tito introduced a new system in January 1953 that corresponded in its essential aspects to the economic system just sketched. It was based on collective ownership, planning, markets, and self-management. The fundamental traits of this system remained in place relatively unchanged until the early 1960s. The results it yielded were disappointing, however. When far-reaching reforms became necessary, Yugoslavia continued to experiment with new forms of self-management, but never managed to find a satisfactory solution.

The former Yugoslavia was not a democratic country and was seriously handicapped by a history of violent political conflict. With enormous economic and cultural discrepancies between its regions, it was not entirely well-suited for experiments with new kinds of economic systems. Thus, the fact that self-management failed there and then does not mean it could not be successful today. As we did with the idea of a planned economy, we will need to identify the fundamental characteristics of self-management as a system to develop an opinion about its capacity to function under today’s conditions.

THE CENTRAL PLANNING OF INVESTMENTS

In a system of self-management, the planner determines the annual volume of investment for the whole economy, and decides on the distribution of this investment across all sectors and regions. This plan should be the output of a process of democratic will formation. The central planning of investments may have three important advantages compared to the determination of investment under capitalism. First, the polity may be able to get a grip on macroeconomic stability, or at least bring about a better management of the general economic cycle. Under capitalism, private investment is mainly responsible for cycles of boom and bust. Investment behavior is highly volatile because it depends on capitalists’ profit expectations. Keynes memorably described the psychology behind capitalist investments, calling the decisions "the result of animal spirits." If the overall level of investment was instead under government control, it might stabilize macroeconomic activity.

Second, central management of investment would allow for a wide range of consequences of such investment—beyond the simple expectation of profitability—to be taken into consideration. This is economically warranted especially if the social value of an investment diverges significantly from the expected private profit of an investor. Unlike a capitalist investor, a central planner might, for instance, take the long-term effects of investments on the environment and on global climate change into account. The planner could also take into consideration that large investment projects have an influence on the population’s
preferences regarding their place of residence, and thus select investments that support a sustainable geographical distribution of the population.

Third, the central planning of investment could avoid the kinds of structural impasses that arise from the coordination problems inherent in developing two or more business sectors simultaneously. Such structural impasses are well-known from the history of industrialization. For instance, no heavy industry enterprise will invest in a country in which the supply of electricity may be insufficient, because such industries depend on large quantities of it. But if there is no heavy industry, then the electricity suppliers have no reason to create the required capacities, because they have to calculate their investment decisions on the basis of a relatively low level of demand. The country becomes stuck in a development trap, because the two types of investors are unable to coordinate their actions. Such interdependence between two or more business sectors is by no means only a phenomenon of past industrialization. New technologies frequently raise questions of coordination, as for instance in the case of personal computers and the provision of broadband connections. Central management of investment by a planner would take such mutual dependencies into account and avoid structural impasses.

A core question for the economic system of self-management concerns how, exactly, the central investment plan is to be implemented. How can the common will of the polity embodied in the plan be reconciled with the independence of the self-managed firms?

The most convincing suggestion for a solution to this problem comes again from the Polish economist Oskar Lange, whom we met in the previous chapter as one of the pioneers of iterative planning procedures. According to Lange, the government should regulate the volume of investment made by enterprises by granting credit. The overall economy is divided up by the planner into \( S \) number of sectors and \( R \) number of regions. Each enterprise belongs only to one sector and one region. Thus, there are altogether \( S \times R \) possible combinations of sectors and regions, and to each such combination belongs a group of enterprises. The task of the planner is to make sure that over a particular period of time there is a certain democratically decided volume of credit available for each group of enterprises. To achieve this, the planner makes use of the connection between the enterprises’ propensity to invest and the rate of interest. Enterprises invest more when the cost of financing investment drops—that is, when the interest rate decreases.

Lange suggests a setup by which credit can be granted to enterprises only by a state bank, or by a number of state banks. For each group of enterprises, the planner decides on a specific rate of interest at which they may borrow money from the banks to finance investments.

At the micro level, the enterprises devise their own investment projects, while the state banks decide on the credit to be granted and control the finance that is made available. Leaving aside the unlikely case in which the enterprises are financially powerful enough to fund all their investments exclusively through retained profits, their investment volume will be determined by the credit they are granted.

The rate of interest at which an enterprise borrows money from the bank influences its willingness to invest. The lower the rate of interest, the more attractive an investment is for the enterprise. The planner alters the rate of interest for each group of enterprises until the overall demand for credit from all enterprises in the group corresponds to the level at which the planner’s intended volume of investment is likely to be realized. As part of this process, the planner has to estimate the proportion of investment that will be financed by the enterprises’ retained profits. Given the state’s control over the banking sector, and assuming mandatory financial disclosure on the part of the enterprises, this should not be difficult to estimate. In this way, the planner can realize its aims relatively easily without having to undermine the autonomy of the enterprises.

**Economic Democracy**

After central management of investment, the second characteristic element of this economic system is the democratization of the workplace. Self-management means that authority within enterprises rests with the entire workforce. The workers are subordinated neither to a
capitalist nor to a bureaucrat, but decide for themselves about the details of their productive activities and about how the output of their production should be used.

The workers of a self-administered enterprise form a long-lasting community, with all members enjoying equal rights in directing the enterprise. There are different ways in which the workers' collective might make decisions. In smaller enterprises, it could be that many of them are made at general meetings and thus according to principles of basic democracy. In larger enterprises, perhaps only important strategic questions would be taken up in general meetings. As a rule, the workforce elects a workers' council and delegates to it far-reaching decision-making powers.

The election of the workers' council is of central importance for self-management because the council possesses powers that are similar to those of a capitalist joint-stock company's supervisory board. However, the election of a workers' council is, for the most part at least, based on the principle of "one man, one vote." (Voters' rights could be made dependent on level of employment: a part-time worker, for instance, could be given one vote, but full-time workers two.) The workers' council in turn elects an executive board whose members are charged with managing the enterprise.

A self-administered enterprise makes autonomous decisions on all market transactions, including new investments, the use of new production methods, and the marketing of new products. It decides on redundancies and on new recruitment, on the speed of assembly lines, and on the organization of labor. The enterprise determines the level of specialization for each job. Its members can either specialize in one task to be performed, or decide in favor of a rotational principle that has each member alternately performing manual and intellectual labor.

A self-managed enterprise autonomously decides how its post-tax income is to be used. In particular, this means it determines the income of its members. The income of the enterprise may also be used for funding social projects, such as a canteen or childcare facilities for the workers and their families. Part of the income is retained by the enterprise and used for productive investment.

How does a self-managed enterprise determine how much to pay its members? This is an important question, because the rules for such payments influence income distribution across the whole society. It is possible to conceive of a wide range of rules. One possibility is for each worker of an enterprise to receive the same income. In this case, there are no hourly wages and pay does not depend on either the quantity or the quality of the work performed. Alternatively, an enterprise might measure individual members' working hours and pay them accordingly. Another option is to establish hourly wages corresponding to workers' qualification levels and to the tasks required. It is also conceivable that an enterprise might refer to market rates for labor, perhaps in neighboring capitalist countries, to set its hourly wages. This would result in payments to workers that combined individual market-based wages with shares of profits. The profit shares might be the same for every worker. Alternatively, an enterprise might use different criteria for distributing profits, perhaps based on the merits and needs of individual workers, as established in public discussions at regular general meetings.

In any case, payments are an internal affair to be decided collectively by the members of an enterprise. Typically, the larger part of an enterprise's workforce is made up of workers with relatively low qualifications. Workforces deciding on the basis of majority voting therefore tend to be in favor of an equalization of incomes. In effect, this means that workers with different qualifications receive roughly the same remuneration for working the same hours.

Enterprises are in competition with each other, however, for the recruitment of the most productive laborers. A perfectly egalitarian enterprise therefore finds it difficult to employ and retain highly qualified workers if other enterprises adopt a system of differential payments according to workers' qualifications. Self-administered enterprises in that case have to pay unequal incomes to remain competitive.

Because all enterprises' products ultimately have to be sold in competitive markets, and because more productive workers have stronger bargaining positions, it is reasonable to expect that workers' payments will be based on their productivity. The better qualified among them will receive higher incomes, which means some income inequality. But
compared to income gaps under capitalism, these inequalities are likely narrower. Some evidence for this can be drawn from actual experiences of cooperatives and firms with some worker representation or strong union influence over wage policy. Such institutions undeniably lead to flatter wage structures in companies—and presumably the institution of self-management only strengthens this tendency. Further, the members of a self-managed business enjoy shares of its profits, and these can be expected to be distributed in relatively equal fashion. This also contributes to a relatively small income gap among members of the company.

The value this economic system places on the democratization of the workplace stems from a central criticism commonly leveled against capitalism. Self-management allows everyone involved in the production process to articulate their ideas and suggestions about the organization of work, the distribution of profits, and the strategic development of the business, and it allows them to influence decision making on equal footing with all other workers. Ideally, this framework affords individuals a better understanding of their work and leads to more independent behavior and a more consciously controlled life.

Nevertheless, the democratization of enterprises also has its downsides. There is a trade-off between democratic participation in decision making and an enterprise's capacity to react quickly and flexibly on the basis of decisions taken by its board. The more perfectly democratic the business, the more difficulty it will have reaching decisions. Too much democracy at the workplace can also have negative effects on workers: Individuals may become frustrated and weary having to participate in frequent, lengthy processes of collective decision making.

To introduce a system of self-management, we would need to answer difficult questions: Should the legislator be entitled to impose a certain type of democratic decision making on all enterprises? Would having such uniformity be a good idea? Should the legislator prescribe a detailed charter for all self-managed firms, perhaps depending on the size of their workforce? Or should the firms independently draw up their own assignments of participation rights and duties? Allowing the free stipulation of those rights and duties, and thus of the extent to which the workplace is democratized, has the advantage of allowing experi-
forces thus tend to equalize the twins’ wages. In a system of self-management, by contrast, there are three reasons to worry that the income distribution among similar workers in different enterprises will be unfair.

The first problem concerns the capital stock of the enterprises. Imagine that all capitalist enterprises become self-managing enterprises overnight. Naturally, there are huge differences in value between their facilities, machines, and administrative buildings. Some workers therefore become members of enterprises with a great deal of capital, others of enterprises with a great deal less. To avoid a situation where the former workers simply pocket their windfalls in the form of higher remuneration, the state asks all self-managed enterprises to pay a price for their inherited capital goods, as well as for patents and brand names.

In principle, each enterprise makes a payment to the government that corresponds to the value of the inherited capital assets. Instead of a one-off payment, this can also be arranged in the form of annual payments, much like interest payments. The problem is that, upon the introduction of self-management, it is likely very difficult to determine the value of the inherited assets correctly. There are often no market prices for equipment, because they are goods that are specific to the enterprise. If recent market prices can be identified, it is necessary to take into account that these were formed under capitalist conditions, and the value of the same asset might be dramatically higher or lower in the system of self-management. The value of a luxury brand, for instance, might turn out to be much lower if, under the new system, luxury is so derided that luxury articles have to be sold much more cheaply.

It is likely, then, that the state is not able to identify the initial capital value of an enterprise. The price for the inherited capital stock therefore has to be determined jointly by a government agency and the workers’ council. The result depends on the latter’s negotiation skills and political contacts. In the overwhelming majority of cases, therefore, the prices paid by enterprises diverge from the real value of their initial capital assets; and this might establish enduring differences in the incomes of different enterprises’ members.

The workers of an enterprise whose initial capital stock has been undervalued receive a higher income for the same labor than the workers of an enterprise whose initial capital stock has been overvalued, because the former do not pay enough to the government. It is difficult, however, to correct for this unfair treatment retrospectively, because the government is unable to determine whether differences in income were caused by mistakes in the evaluation of the initial assets or by later intervening factors, such as differing efforts exerted by the workers to make their firm more profitable.

The second factor leading to unequal pay for the same work has to do with how investment is managed under this system, as described above. Because interest rates are made to vary according to regions and economic sectors, the workers of enterprises that can borrow from state banks at low interest rates receive a higher net income than workers of enterprises that face higher borrowing costs. This follows from the fact that workers share in the profits of their own enterprises, and these profits rise when the interest on debt falls. In this case, too, a violation of horizontal justice is the consequence.

Finally, undeserved differences in income result from random fluctuations in enterprises’ profits. That is, these profits are dependent upon uncertain sales and price conditions. While in the case of capitalism the owner of an enterprise absorbs most of these fluctuations, in the system of self-management the whole workforce bears this risk. Under capitalism, the remuneration of the workers takes the form of a fixed wage that is agreed ex ante, while the owner’s profit is uncertain. In a system of self-management, by contrast, workers’ pay contains an element that depends on the profits, which depend in turn on the vicissitudes of the market. Workers who happen to be members of enterprises that strike it lucky on the market therefore earn more than workers whose enterprises lose out through sheer bad luck.

SECOND CRITICISM: UNCERTAIN INCOMES

Tying personal income to profits not only leads to inequality. It also means that workers bear a great deal of risk, since their disposable income is directly affected by profit fluctuations. This constitutes a further deficiency of the system of self-management.
The allocation of risk in a capitalist market economy is more efficient than in a self-management system, because individuals can choose whether they want to be self-employed or work as regular employees. If they have access to sufficient capital, those more willing to take risks can start businesses. Their income will therefore be less certain than those more risk-averse individuals who opt for regular employment and fixed incomes. Individuals who have accrued some savings can also invest their money in portfolios made up of stocks from enterprises across diverse economic sectors and regions. If a portfolio is carefully assembled, the investment risk is diminished. In a self-managed economy, by contrast, a worker-saver implicitly puts all his money into one "stock"—namely, the share of the profits generated by the enterprise where he works. Thus, far from being well diversified, investment risk is dangerously concentrated. An individual who loses her job loses her labor income and capital income—that is, her right to a share of the profits. Within a self-managed economy, therefore, individuals are subject to maximum income risk.

Inevitably, given the dependence of workers' incomes on all the chance factors that affect a company's profits, there are sometimes calls for the government to step in and intervene—especially as the state formally owns all the enterprises. To the extent the government heed these calls, however, it imperils the entire economic system. The threat here is the complete erosion of market discipline, as happened in Hungary after the reforms of 1968. The prospect of explicit subsidies and hidden aid causes enterprises to concentrate their efforts on establishing privileged relationships with politicians and bureaucrats instead of focusing on cost-cutting or raising the quality of their products.

THIRD CRITICISM: MISDIRECTED STRUCTURAL TRANSFORMATIONS

A capitalist enterprise has an incentive to produce more if the market price for the good it supplies goes up, because by doing so it can increase its profits. And if the enterprise expects the price rise to continue for some time, it recruits additional employees. The opposite is the case if the price sinks over a certain period of time: it is then no longer profitable to maintain the previous level of employment. The redistribution of the workforce within the economy that results from overall product price changes corresponds to the changing needs of society. If the market price of a product rises, this is a sign that this product has become more valuable for society. Consumers are willing to pay more money for it. A falling price, by contrast, indicates that the need for a product is diminishing. In sum, this means that the redistribution of labor from products with falling prices to products with rising prices corresponds to the changing desires of consumers.

Under conditions of self-management, by contrast, price changes may be followed by paradoxical reactions from the enterprises: price rises may lead a self-managed enterprise to reduce the level of employment, while price drops may lead it to increase employment! In 1958, the U.S. economist Ben Ward was the first to point out this surprising flaw in self-management, having discovered it through mathematical simulations. The clear implication is that a market consisting exclusively of self-managed enterprises does not respond in the right way to changes in social needs. This defect essentially results from the rational self-interest of the self-managed enterprise's workforce.

The core of Ward's analysis can be stated simply. A self-managed enterprise acts in the interest of the individuals who are its members at a certain point in time. Its decisions, including decisions about hiring, are therefore guided mainly by expectations about how alternative moves would affect members' incomes. New members are recruited only if their joining will improve the incumbent members' financial position.

If the enterprise is able to sell its products at higher prices, its existing members stand to profit; assuming their number is held constant, their per-capita income will rise. Taking the same logic a step further, members' incomes also grow if their numbers are reduced, so that each has a bigger slice of the extra profits from rising prices. Thus, there may be an inclination towards reducing the membership, perhaps by opting not to replace workers who leave the enterprise for age-related or other reasons. Rising prices could in this way be followed by a reduction of the employment level in the enterprise.
If prices fall, however, there is less profit to distribute, and the disincentive to recruit new members therefore loses force. Given the lower amounts involved, existing members are less reluctant to share profits with new colleagues. In a situation of falling prices, it is more important to have new colleagues helping to bear the fixed costs of the enterprise. Each enterprise must cover the costs of the capital goods it uses, such as interest on credit and payments to the state for inherited capital equipment. These costs are the same regardless of the number of members in the enterprise. If the number of members rises, the costs are distributed more widely and, other things being equal, the old members’ per-capita income rises. A fall in prices can thus lead to recruitment of additional members.

Ward’s discovery revealed a remarkable defect in the system of self-management—namely, a behavioral pattern that is rational from the perspective of an individual firm’s workforce, but absurd when viewed from the perspective of the overall economy. In the system of self-management, if the social value of a good drops (as indicated by its price), the level of employment in that sector and the volume of production of that good rises—and if there is an increase in social value, by contrast, production drops. This is paradoxical and, as a consequence, the distribution of resources in such an economy would be inefficient.

Interestingly, symptoms of the very kind of group egoism Ward highlights can be detected in successful cooperatives in our own economic system. Instead of raising the number of members, they show a tendency to bring additional workers on as wage laborers. Further growth often precipitates a legal transformation from a cooperative into a corporation, and thus an abandonment of the principles of self-management.

The Basque conglomerate Mondragón, which comprises several cooperatives, some of which date back to the 1950s, provides a good example of the uneasy relationship cooperatives have with market success. Its cooperatives’ market success led to a remarkable expansion in the mid-1990s, but the new branches were, at the base of things, barely distinguishable from capitalist enterprises. Recent figures show that less than half the workers at Mondragón are actually members of a cooperative. The majority are regular wage laborers without significant chances ever to become cooperative members.

FOURTH CRITICISM: INSTABILITY AND UNEMPLOYMENT

These peculiar reactions to price changes can lead to instability in markets and increased unemployment—phenomena which were, indeed, typical of the Yugoslavian economy.

As an illustration of this problem, imagine an economy with only two economic sectors, and made up wholly of self-managed enterprises. Each enterprise is active in just one of the sectors. Now imagine that demand for one sector’s products is decreasing, while demand for the other sector’s products is increasing.

The enterprises in the sector with sinking prices try to increase their membership, to shift part of their fixed costs onto the new members. Although they offer lower incomes than the enterprises in the other sector, they are able to recruit new members, because people without a job prefer employment to unemployment. As the volume of manpower expands in all the enterprises in this sector, the sector’s output rises. For this increased output to be sold, the price of the product has to fall further.

There is thus a cumulative reduction of the price and an expansion of employment that, ultimately, some enterprises are not able to survive. With falling prices, enterprise members also see their per-capita income fall, and beyond a certain point they no longer see a reason to continue working there. Some enterprises therefore close, and the whole sector abruptly shrinks. This adaptive process plays out through unnecessarily costly fluctuations: first, employment rises, then it suddenly falls.

Meanwhile, in the other economic sector, which is experiencing growing demand, the adaptive process is also unnecessarily costly. Here, enterprise members have no incentive to take on people looking for work and let them profit from rising prices. To the contrary, members even try, wherever possible, to do without replacing any workers who happen to depart. These enterprises have an interest in increasing their
output only if this can be done with the existing workforce—perhaps by having people put in overtime, or by replacing old machines with new ones to increase labor productivity. The enterprises of this sector have no incentive to create new production facilities, even if these could produce a surplus, since the surplus would need to be shared with the new members. Say, for example, an enterprise with a hundred members has optimized its facility and generates a financial surplus. It could replicate that facility elsewhere and take on a hundred new members to operate it. While the enterprise's surplus would double, the per-capita income of the old members would remain unchanged. For the members of the already existing enterprise, the investments would therefore not be worth the effort.

The behavior of these individual enterprises raises the question of how a high rate of unemployment could be avoided under a system of self-management. One obvious notion is to declare a right to labor, so that enterprises were forced to accept anyone who wanted to become a member. This idea finds expression in works by Eugen Dühring and Theodor Hertzka, two nineteenth-century intellectuals who demanded a universal right to free access to the means of production. Their thinking was that, if self-managed enterprises were not allowed to exclude anyone who wanted to become a member, there would be no involuntary unemployment. Workers' freedom of movement would also lead to the abolition of income differences between enterprises, as workers would flow to those that were doing well, participate in their profits, and thus bring about an equalization of incomes across all enterprises.

Unfortunately, such a right to labor would have catastrophic consequences for productivity. Enterprises would have no incentive to become more profitable, because each improvement in income level would be absorbed by the arrival of new members. Further, the permanently changing workforce would make the daily organization of the production process much more difficult, a problem similar to that facing Kropotkin's associations for the production of luxury goods.

A promising strategy might be the creation of new self-managed enterprises by citizens, civil society organizations and—most importantly—the government. There could be a public office for the statistical identifica-

tion of sectors in which incomes were high and rising, which would then lead to the foundation of new enterprises in these sectors (while taking into account variations in the supply of workers' qualifications and regional specificities). The government could, in this way, promote structural developments that fit better the evolution of social needs. This selective creation of new enterprises would reduce unemployment and income inequality. If the government were at the same time to implement active employment policies that supported the professional and regional mobility of the people, the problem of unemployment could be moderated even further.

On paper, this looks promising. In practice, the project of the targeted creation of new enterprises would probably ask too much of the state and other actors involved. To decide what exactly these new enterprises are meant to produce, they would need to have precise knowledge of market conditions and of the available production factors. It is unlikely that government officials and normal citizens would possess such knowledge. Civil servants would, at the very least, need to work very closely with the banks, which are in a privileged position to oversee the evolution of economic conditions. And, indeed, it is the banks that, upon closer scrutiny, turn out to be the hidden protagonists in the system of self-management. They would end up exerting far more power than one might expect at first. The next—and final—criticism will highlight the central role played by banks within this economic system.

FIFTH CRITICISM: MISGUIDED INVESTMENT DECISIONS

In this economic system, efficient investments are expected to result when central planning of the investment structure is combined with enterprise-level determination of investment projects. A closer look at this system, however, reveals various problems that could be tackled only by exceptional regulatory efforts and with the help of banks that were loyal to the state.

The central plan is supposed to be executed by setting different interest rates for different enterprises' borrowing, according to their varying economic sectors and regions. Note, however, that different
interest rates create possibilities for arbitrage. Two enterprises facing different interest rates have the incentive to devise an arrangement whereby the enterprise whose rate is lower takes out a loan with a state bank that covers the credit needs of both. By providing cheaper credit to the enterprise whose rate is higher, the two enterprises undermine the central planning of investment. Lending between enterprises must therefore be categorically prohibited, or must only be permissible to the extent that it is necessary for trade between suppliers and their customers.

To avoid other possibilities for arbitrage that would undermine the central plan, any loan from an enterprise to a private person, especially to a member of the enterprise, must also be prohibited. Robust state control of self-managed enterprises would be necessary to enforce these prohibitions. This control function could be delegated to the banks that lend money to enterprises, but this raises the question of whether the banks would actually perform this function, or whether they in turn would rather collaborate furtively with the self-managed enterprises.

This same mechanism of using different interest rates to direct investment also threatens to pervert selection principles within a group of enterprises—meaning, among enterprises that fall into the same category based on their economic branch and geographical region. Imagine such a group that, according to the planner, intends to invest too much. The planner raises the interest rate for this group. This reduces its demand for credit, and credit is eventually granted at a higher interest rate that would achieve the planning target. The increase of the interest rate, in fact, brings about a self-selection among the investment projects. Some are shelved because they are no longer worthwhile from the viewpoint of their proposer. Unfortunately, though, it may happen that the projects that make it through are not the ones with highest economic returns, but those with the highest risk. Given a high rate of interest, enterprises may embark on projects that present high likelihood of incurring losses and low likelihood of making very large profits. In the unlikely event of success, the enterprise repays the credit and its members earn a lot of money. If, however, the project fails, the members of the enterprise can expect that the government will bail it out or that they will be able to join another enterprise, keeping their personal situation more or less as it is. Thus, the interest rate mechanism may lead to the selection of the wrong investment projects: Comparatively safe projects promising an average profit are not financed, while resources flow toward high-risk ventures that produce, on average, meager returns. Avoiding such selections would, again, imply banks’ strict control over investment projects.

Self-management may contain an even greater danger for enterprises’ investment behavior. The members of an enterprise profit from an investment only as long as they work there. Investments that mostly raise profits in the distant future are of little interest to them, because they may no longer be members of the enterprise when such profits materialize. Enterprises therefore have a strong inclination toward short-term investments—and the older the workforce, the stronger this inclination is. If members close to retirement constitute a large proportion and dominate the workers’ council, the incentive for investment is particularly weak. The workers’ council may decide to cut expenditures for servicing facilities and machinery. It might even sell off part of the enterprise’s equipment, to achieve higher payouts for members before they leave. Such decisions can spell the collapse of otherwise healthy enterprises.

The state therefore needs to introduce special regulations to try to prevent these developments. But this is easier said than done. Enterprises might, for instance, be obligated to maintain a balanced age structure within their workforce. If an enterprise is in decline, however, it makes little sense to compel it to take on new, young members. The age structure of enterprises further depends on general demographic developments. And if the population overall is aging, then the proportion of older employees will generally grow in all enterprises.

Another stipulation of the state might be that enterprises must maintain reserves that can be used only for investment. But how large should these reserves be? Surely the answer must take into account the financial situation of the particular enterprise, as it cannot build up reserves if it makes losses. Yet it is also true that an enterprise can misrepresent its financial situation. The state could also prohibit any part of an enterprise’s physical capital from being sold without explicit authorization.
But this is costly and probably ineffectual, because the authority lacks the knowledge to make well-founded decisions.

All of these suggestions imply drastic interferences in the autonomy of enterprises, are associated with substantial bureaucratic efforts, and offer little hope of dealing justly with every individual case. It seems obvious that a government would opt for the simplest solution—namely, delegating control to the state banks.

State-owned banks would therefore play a central role in this alternative economic system. It is likely that the polity would ultimately allow for an exception to the principle of self-management and install representatives of the banks, endowed with special authority, on every workers' council, to control the use of publicly owned productive capital. The number of enterprises would be kept relatively low so as to render control easier. This, however, would increase the danger of monopolies and intensify the problem of unemployment, leading in turn to yet more need for regulation.

The representatives of the state-owned banks would thus participate in the strategic management of the production enterprises, but would—in contravention of the spirit of self-management—not be fully democratically controlled. And as a part of the state, they would be burdened with tasks that go far beyond the usual business of a bank. The vague definition of the scope of their responsibility, the lack of transparency in their dealings, and most importantly their power to distribute cash on a large scale would quickly pique the interest of politicians. The upshot would surely be the formation of personal ties between politicians and the directors of the state-owned banks whom they appoint, and therefore a great concentration of power in the hands of a small elite. Examples of corruption in publicly owned banks in our own capitalist economies give us little reason for optimism in this regard.

**MOVING ON FROM SELF-MANAGEMENT**

The economic system of self-management is characterized by four elements: public ownership of the means of production, central planning of investments, markets for goods, and self-management by workers.

We embarked on this chapter hoping that this system would avoid the defects of capitalism and of Soviet-style planned economies. But self-management turns out to have its own serious defects. It entails an unfair distribution of workers' income, and makes income subject to large, unpredictable fluctuations. Involuntary unemployment cannot be avoided. The allocation of production factors is not responsive to changing social needs, and the investments made by enterprises are inefficient. There are simply too many defects here for us to hope that a self-managed economy can function smoothly.

It seems clear that it would not take long before a government overseeing such a malfunctioning system would be forced to intervene with ad hoc measures to counteract the consequences of these defects. There is therefore a serious risk that the system of self-management would ultimately degenerate into a kind of cronyism, in which the personal relationships among politicians, bankers, and the leaders of a few large-scale firms' works councils become decisive in the workings of the economy.

Yet surely we do not want to abolish the social market economy only to end up with a new kind of feudal system. In the following two chapters, our search for an alternative economic system will therefore do away with two elements: the central planning of investment and the self-management of enterprises. These institutions are, after all, only means to achieving greater ends. The central planning of investment aims at macroeconomic stabilization and the management of structural developments. The self-management of enterprises is intended to allow workers to control their own activity. Both are important ends, but they can also be achieved by different means—the first, by monetary and fiscal policy and industrial and regional policy, and the second, by instituting codetermination and the manifold legislation that protects workers against employer abuses.

All these instruments are at the disposal of market socialism as an alternative economic system.