

**A STATUE OF LANGE:
How the Socialist Calculation Debate was a Boon to Austrians**

Heidi C. Lange

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I. Introduction/Thesis

Austrian Economists are set apart by their realistic approach to the economic process. Foremost among the schools of economics, the Austrian school shies away from mathematical calculations and abstract models, basing its theory on the actions of real people in the real market; for good reason is the “Bible” of Austrians called *Human Action*. Hence, it is not surprising that the Austrians came into their own in a debate against some of the least realistic thinkers in the short history of economic thought - the socialists. As Israel Kirzner tells us in his paper “The Economic Calculation Debate: Lessons for Austrians,” the Socialist Calculation Debate “... was... important as a catalyst in the development and articulation of the modern Austrian view of the market as a competitive-entrepreneurial process of discovery.” (Kirzner 1) The famed Socialist Calculation Debate is what set the Austrians apart from other economists; it was the turning point that made Ludwig von Mises and his followers realize that they did not view things in the same light as other free-market friendly economists.

II. The Socialist Calculation Debate

The Socialist Calculation Debate spanned several decades, beginning in 1920 with Ludwig von Mises’ famous paper “Economic Calculation in the Socialist Commonwealth.” Over the next quarter century or so, Mises and Friedrich A. Hayek developed Austrian theory by trading economic journal articles back and forth with the proponents of socialism. The substance of Mises’ original challenge to socialism was this: he argued that under a socialist economy, it was impossible to rationally allocate goods, since, by definition, in a socialist economy there are

no freely determined market prices. Mises believed that without real market prices, it was impossible to undertake an enterprise in an organized and intelligent manner. This idea was a novel challenge to socialism. Before Mises, the most popular argument against socialism was that since people are not altruistic, whatever “socialist planner” was put in charge of the economy would take advantage of the rest of the country. To this, the socialists replied that in a socialist economy, there would be a new and selfless type of man, who would of course carry out his duties as planner in a way which would lead to the best situation for every citizen (Murphy 1). The debate over socialism remained at this stalemate until Mises came along with this idea that socialism would not work because the socialist economy lacked real prices.

To demonstrate why prices are necessary, Mises uses the example of a railroad engineer attempting to lay track across a mountainous area. Let us grant that the engineer is perfectly altruistic and has as his goal only the “best” for society. Still, the engineer faces problems which he cannot solve without prices. Imagine that he comes to a large mountain. Will he blast a tunnel through the mountain and lay track there, or will he lay track over the mountain? Blasting a tunnel is costly and dangerous, but so is the alternative course. In the world of the free market, the engineer can solve the problem very simply; he compares the cost of the tunnel to the cost of running track over (or around) the mountain. Whichever brings him the most revenue, or imposes the least cost, is the one he chooses. Many things may play into his decision - it may be cheaper to lay track through the mountain, for instance, but he will have to pay his workers higher hazard pay. So it may be more expensive to lay track through the mountain, but perhaps he will later gain additional revenue from passengers and shippers since he can reach his destination faster. Under a system without prices, how can the engineer, however brilliant and

however altruistic, decide which way to go? He cannot. Perhaps the socialist engineer will follow a rule such as “human life is more important than anything else.” This would most likely lead him to lay track around the mountain, since if he blasts a tunnel through the center of it, he risks losing the lives of his workers. Yet if he follows this rule of the importance of human life, he would be led to avoid building the railroad in the first place, since laying track at all risks human life. If the engineer is determining his actions based on market prices, then he can take into account the preferences of everyone concerned with the operation. He can weigh the cost of building the railroad against the benefit of having the railroad, both costs and benefits as they concern every person involved. As Mises says, “In an exchange economy the objective exchange-value of commodities enters as the unit of economic calculation. This renders a three-fold advantage... it renders it possible to base the calculation upon the valuations of all participants in trade... [it] furnishes a control over the appropriate employment of goods... [and it] makes it possible to refer values back to a unit” (“Economic Calculation” 98). Mises’ point here is that in order to weigh one alternative against another, we must have a common unit of value. There is no way to compare Railroad Worker Bob’s value of his safety against Passenger Jill’s value of getting to her destination quickly - to use a cliché; it is like comparing apples and oranges. In order for the railroad engineer to make decisions based on the relative importance of his railroad, he must have a common unit of value to compare it with alternatives. That common unit is market prices.

III. The Response to Mises

Socialism proponent H. D. Dickinson was one of the economists who, by challenging Mises’ arguments and forcing him to defend himself, strengthened the Austrian position.

Dickinson believed that while prices were helpful in planning and allocating resources, not all of those prices had to be “real” - some could be set by the government. In his 1933 response to Mises, “Price Formation in a Socialist Community,” he says that “...a rational pricing of instrumental goods is at least theoretically possible in a socialistic economy” (Dickinson 238). He suggests that there be two types of goods in the socialist economy - production goods, publicly owned, and consumption goods, privately owned. The private goods will be priced on consumer preferences, as determined in a system similar to the free market. The production goods, however, will be assigned prices by the socialist planners. The producers of higher-order production goods will base their production on signals they receive from lower-order distributors. For instance, if a fruit stand runs out of fruit before the day is over, the owner of the fruit stand will signal the fruit growers to grow more fruit. (There one problem with this which we will ignore for the purposes of this paper, although we will acknowledge its existence: in a normal market system, if the fruit stand runs out of fruit, there are actually *two* responses the owner can make. He can either get more fruit, or raise his prices. For the sake of simplification, we will assume that in Dickinson’s socialistic model, fruit growers always ask for more fruit and never raise their prices in response to excess demand.) Higher-order producers, however, may find the need to trade among themselves for some reason. For this purpose, the “production goods” have been assigned what Dickinson refers to as “accounting prices.” For instance, the socialist planners may decide that a ton of iron is worth two tons of steel. This sort of false “pricing” allows the producers of higher-order goods to trade among themselves should the need arise. So: in Dickinson’s model, higher-order producers determine how much of what to produce based on signals they receive from lower-order producers, who receive their signals

from the actions of consumers. Consumption goods are priced in a free market fashion, and production goods are given “accounting prices” by the socialist planners.

IV. Two problems with Dickinson’s model.

The first and most obvious (although rarely pointed out) problem with Dickinson’s model is his assumption that production and consumption goods are indeed different. To quote Austrian economist Robert Murphy, “the theoretical distinction between production and consumption goods is in practice spurious” (Murphy 4). In the real world, there are many goods which serve as both production and consumption goods. Consider a good as simple as an apple. Under Dickinson’s system the apple would have two different prices - one as a “consumption apple,” and one as a “production apple.” The difference depends solely on the purpose intended for the apple. When it sits on the shelf of a grocery store, the apple is presumably intended for a customer to buy and eat, and is a consumption good. However, if that same apple had ended up on a truck to an apple juice factory, it would be a production good, since it is intended for the production of apple juice. (In this case, apple juice would be the final consumption good.) But what if a customer came into the store, bought the “consumption apple,” and went home and made apple juice with it? Then would the apple sitting on the store shelf not be a “production apple”? Alternatively, let us imagine that consumers buy up all the apples in the store, and do in fact intend to eat them immediately. The owner of the store sends a message up the line to the apple growers, letting them know he needs more apples. Pretty soon, all the apples have been bought by consumers and no “production apples” remain. The apple juice factory has no apples! Since the consumers have not yet eaten their apples, they are quite happy to sell them to the apple juice factory (which, because of the scarcity of apples, offers the owners of the apples a

higher price than they originally paid for them). Now the “consumption apples” have become “production apples” again. It is obvious that attempting to make a distinction between “production apples” and “consumption apples” is, at the least, unhelpful (example - Murphy 6-5). Dickinson’s model appears to overlook the fact that the same good can be either a consumption or a production good.

The second problem with Dickinson’s approach, as Hayek points out in his 1935 paper, “Collectivist Economic Planning,” is this: it is impossible to name a price for each and every good in existence, from the viewpoint of the socialist planner. “In order to do so it will be necessary to treat every machine, tool, or building not just as one of a class of physically similar objects, but as an individual whose usefulness is determined by its particular state of wear and tear, its location, and so on.” (Hayek 209) In other words, the socialist planner, no matter how clever or how omniscient, cannot simply say, “A hammer is worth two dollars.” He must determine the price of *each and every* hammer. What is the price of the hammer owned by John Worth in Texas, taking into account its age and wear? What is the price of the hammer owned by Terry Franklin in Nevada, again taking into account age and wear? What is the price of a perfectly new hammer in Alaska, sitting on top of a deserted mountain, as compared the price of an exactly similar hammer in San Francisco, where they need the hammer for building a house? The problem is simply too huge, Hayek argues, for any central planning board to solve.

IV. Hayek’s Concession

Hayek did grant Dickinson the possibility of centrally planned prices. “It must be admitted that this is not an impossibility in the sense that it is logically contradictory”(Hayek 207). Many Austrian economists believe that Hayek should not have made this concession, and

many historians of economic thought believe that because Hayek made this concession, the Austrians lost the debate. In 1935, when Hayek wrote his article, it was enough of a stumbling block for the socialists to say that it would be impossible to run the necessary equations, but seventy years later, it is at least conceivable that a computer might be invented which could serve the purpose of the central planners in determining prices for each and every good, based on whatever set of equations the planners determined were necessary. Still, as Gene Callahan tells us in his book *Economics For Real People*, “Hayek highlights the *reason* that market prices enable rational calculation: market prices for the factors of production reflect the best estimates of their role in fulfilling consumers’ needs” (Callahan 164). Hayek reminds us of the Austrian doctrine that since individuals’ preferences are very subjective, and prices reflect preferences, real prices are subjective and are determined by free dealings between producer and consumer. Since in a socialist economy, at least some prices are not found by the subjective interactions of the free market, it is impossible to have rational allocation of goods in a socialist economy. As Hayek’s article says, “...the changes in tastes are by no means the only, and perhaps not even the most important, changes that cannot be foreseen.” (Hayek 217) Although Hayek did make a perhaps uncalled-for concession in granting the logical possibility of Dickinson’s model, he stayed faithful to the Austrian doctrine that says that in economics, everything is subjective to the individual’s preferences, and everything is changeable.

V. The Austrians/ Unrealistic Models

The main tenet of Austrian economics is that nothing is certain. Austrian economists are possibly the most “practical” of the economic schools, because theirs is first and foremost an economics about the real world, and the actions of real people in that world. Ludwig von Mises

tells us that “...economics is a living thing - and to live implies both imperfection and change.”

(Human Action 7) The contrast between the Austrians and the socialists was strong in this respect - too often, the socialists based their arguments on theoretical constructs which did not allow for the changeability of the world and humans in the world.

One thing which continually caused the Austrians to clash with the socialists was the latter’s use of unrealistic models and thought experiments. To quote Nicolai J. Foss, “...what really annoyed the Austrians was their socialist opponents’ use of unrealistic and unattainable social ideals... as standards of comparison.” In particular, Oskar Lange “...does not hesitate to jump from abstract propositions about a model... to claiming [that] this model [is] of direct applicability.” (Foss 258) Certainly the socialist economists made some outrageous claims along these lines. Consider this quote from Oskar Lange’s 1935 article: “The administrators of a socialist economy will have exactly the same knowledge... of the production functions as the capitalist entrepreneurs have” (Lange 55). Dickinson, too, has pipe dreams; he believes that in a socialist economy there will be “...fullest publication of all relevant statistical data...” (Dickinson 239). Both Lange and Dickinson make the mistake of believing that a socialist economy would somehow solve the problem the market economy experiences of not having perfect information. They confuse “equilibrium models” with realistic stories about the economy.

The first thing an economist learns is the basic model of supply and demand. The idea is that there exists a certain price for each good, at which supply will exactly equal demand. This is the “equilibrium price,” which is the most efficient outcome of a situation. However, this is only a model - in the real world, no states of economic equilibrium can occur. How do we know equilibrium does not occur? When we go to the grocery store, there are goods on the shelves. In

a perfect equilibrium world, the supplier would put the goods on the grocery store shelf moments before we walk in to buy those goods. In a perfect state of equilibrium, there would be no overstocking, no shortages, and no clearance sales. The equilibrium model is merely a tool which some economists find to be a useful mechanism for thinking about the world.

Why is it that there can be no such state of perfection? Because there is an “information problem,” and because the world changes constantly. The suppliers at the grocery store cannot know what you want to buy (think about it - you don’t even know half the time!). The way the grocery store solves this information problem is to overstock (which sometimes leads to excess stock being thrown away, after a certain time). Every member of the economy solves the information problem a different way. In addition, the equilibrium models are not applicable to real life because such models are like a “snapshot” of the economy at a frozen moment in time. As Hayek says, “We should not expect equilibrium to exist unless all external change had ceased” (Hayek 212). Looking at the market in equilibrium is looking at a market without change, and while such a picture may be useful, it is not realistic and should not be used as a basis for action or planning. Using static equilibrium models and rigid equations to plan the economy “...eliminates from view real human choices, the very phenomena that differentiate economics from other disciplines” (Callahan 318). The socialists were naive in believing that they could plan an economy in a world without choice and change. In a way, the fact that the world is constantly changing is a part of the information problem; if we had perfect information, we would know how the world will change tomorrow. The point is that outside of theoretical models, which may or may not be useful to economists, there is *no such thing* as economic equilibrium.

For this reason, Lange and Dickinson's claims that the socialist economy would have perfect information seem absurd to the Austrian. This naivete of his opponents' frustrated Mises, who "...criticized the socialist writers for confusing the necessary tool of *static* equilibrium [used as a model or thought experiment] with proposals for a blueprint on which to plan the socialist economy" (Moss 159). Hayek, in his 1935 paper, "The Present State of the Debate," found it necessary to state the obvious: "We should not expect equilibrium to exist unless all external change had ceased" (Hayek 212) - a situation which even the novice economist knows is impossible. The socialists committed what, to the Austrian, is the greatest sin - they forgot that economics deals with real human beings and their unpredictable choices.

V. Conclusion: A Statue of Lange

Despite the obvious wreckage caused by their doctrines, there is this to be said for the socialists: they brought the Austrians out of the woodwork. Although the Austrians certainly existed before the Socialist Calculation Debate, had it not been for the debate, they might have remained an obscure offshoot of the Classical Economists. Perhaps Oskar Lange had it backwards when he said that there should be a statue of Mises in the central planning board of the socialists - it would appear that, on the contrary, there should be a statue of Lange in the Hillsdale Mises library. But I don't think Dr. Arnn would approve.

(3345 words)

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