The Microeconomic Efficiency Argument for Socialism Revisited

In a recent article, James A. Yunker presented a challenging new argument on the relative efficiencies of capitalism and socialism.[1] It is based on the widespread existence of the separation of ownership and control in modern capitalism. With such separation, Yunker claims that managers will not be oriented toward the maximization of profits, and therefore substantial inefficiencies will exist. To remove these, he advocates "pragmatic market socialism," in which all nonhuman factors of production are publicly owned.

In a pragmatic market socialist economy, managers would be free to make all enterprise decisions except for the determination of their own bonuses. These would be proportional to profits, with the factor of proportionality fixed by a Bureau of Public Ownership (BPO). Yunker

(p. 89) states that "in all probability" managerial bonuses would not amount to more than 5 percent of profits and interests. The remaining 95 percent would be collected by the BPO and distributed equally among the population as a social dividend. Two main advantages are claimed for pragmatic market socialism. First, microeconomic efficiency would be raised because "the institutional flexibility available under socialism with respect to ownership rights over large corporations would permit the concentration of these rights for the purpose of enforcing a much stronger profit motivation than exists under modern capitalism" (pp. 87–88). Second, there would be the "abrogation of unequal distribution of unearned property return" (p. 88).

Yunker's argument is important for two main reasons: (1) because it is claimed that the change to socialism would enhance both efficiency and equality, and (2) because a pervasive feature of modern capitalism, separation of ownership and control, is central to his argument. This often is ignored in discussions of the relative advantages of capitalism and socialism. Given the importance of the argument, it must be subjected to careful scrutiny. It is the intention of this note to begin that process.

I first will identify the assumptions crucial to Yunker's analysis and suggest some alternatives. In particular, I question whether the separation of ownership and control necessarily leads to a weak motivational structure and whether all property income can be correctly identified as "unearned income." The alternative assumptions are then used to examine whether the introduction of pragmatic market socialism necessarily increases efficiency and reduces inequality. It is assumed that all economic agents within a pragmatic market socialist system will behave as is envisaged by the designers of that system. However, this assumption is then shown to be incorrect unless the policies of the BPO are reviewed by public authorities. The need for that review leads one to question whether public ownership actually implies a concentration of property rights.

Assumptions

The most important assumption of Yunker's article is that the separation of ownership and control inevitably entails "mushy motivation" (p. 89) for corporate managers. This leads immediately to the conclusion that the separation of ownership and control causes capitalism to be inefficient. Yunker offers only one piece of evidence that can be construed as directly supporting this assumption. He points out that owner-controlled firms have been shown to have higher profit rates than manager-controlled firms (p. 86). However, that evidence indicates only that managers may have a weak incentive to maximize reported profits. It does not prove that managers have no incentive to ensure that the firm is efficiently run. Thus, it is crucial to distinguish between the motivation to maximize reported profits and the motivation to promote efficiency within the firm. The absence of the former does not necessarily imply absence of the latter.

In order to substantiate the argument of the previous paragraph, it is useful to examine a simple case. Let us suppose that there is total separation of ownership and control in a particular firm. The manager can control the allocation of enterprise funds. Every dollar saved due to increased efficiency could be used to increase the manager's salary. Thus, the manager would have the same motivation to promote efficiency that any owner-manager would. In this case, separation of ownership and control certainly does not lead to "mushy motivation" to promote efficiency.

Yunker uses the concept of "unearned property income," which he defines in the following manner: "We can say that a certain type of income is 'unearned' if it can be taken away from those who originally received it and distributed evenly among the general population, without this having an adverse effect on the total output available to society for consumption" (p. 108, note 44). Thus, unearned income is that which does not have an incentive effect, for if it did, nonpayment of the income would cause a withdrawal of the services of some factor. This definition of unearned income is identical to that of economic rent in marginal analysis: payment over and above the minimum necessary to call forth the services of a factor.[2]

Yunker assumes that all property income is unearned.[3] This is incompatible with his definition of unearned income if one accepts a marginal value theory. That theory shows that payment of a competitive rate of return on property is necessary for efficiency in a market economy. Thus, in the rest of this note, in contrast to Yunker, I assume that a competitive return is paid on all assets.

In order to analyze how the distribution of income changes when the economic system is changed, one must make assumptions about how property owners are compensated for nationalization of assets. I will assume, in contrast to Yunker, that all property owners are fully compensated at market values. In comparing the relative advantages of two systems, one should ensure that the *ceteris paribus* condition is fully satisfied. Application of this condition implies that one should compare two systems in which the distribution of wealth is identical.

Efficiency and Distribution

When pragmatic market socialism is instituted, I assume that the BPO faithfully follows the policies set for it. I then shall examine whether instituting pragmatic market socialism leads to an increase in efficiency and a decrease in inequality, as claimed by Yunker. In conducting such an examination, it is difficult to construct a very general argument because the degree of separation of ownership and control can vary continuously. No simple argument would be applicable to all cases. Thus, I have chosen to examine two extremes: no separation and complete separation. Given that the actual degree of separation must lie between these two limits, it seems likely that the conclusions from these two analyses will bound the set of possible conclusions.

No Separation

In the case of no separation of ownership and control, the analysis is simple and the conclusions familiar. The argument is included for completeness. A necessary condition for microeconomic efficiency is that the marginal rate of substitution between income and effort for managers must equal the value of the marginal product of effort for the firm.[4] This condition will be satisfiied when the people who are contributing extra effort in making decisions are able to appropriate all the extra returns due to that effort. When there is no separation of ownership and control, the owners are also the decision makers, and the necessary condition will be satisfied. If pragmatic market socialism were instituted and managers were paid only a small fraction of profits, the necessary condition would be violated, and there would be a consequent loss of efficiency. However, assuming that property owners have higher incomes than the average citizen, the change to pragmatic market socialism would bring about a more egalitarian distribution of income. Therefore, one obtains the familiar result: a trade-off between equality and efficiency.

Complete Separation

When there is complete separation of ownership and control, stock ownership is so diffuse that management cannot be ousted by stockholders. Hence, assuming that, from time to time, managers may want to raise equity funds, they would only need to pay dividends large enough to give stockholders a competitive return on their equity. Subject to this restriction, managers will have as much control over corporate funds as corporate policies.[5] If there are no constraints on the size of managerial salaries, managers could then pay a competitive return on equity and maximize their salaries. As was shown earlier, it will then be in the manager's interest to ensure that the firm is run efficiently. Enterprise decisions would be identical to those which would be made if profits were being maximized, except that reported profits would be lower and managerial salaries higher. Such managerial motivation would be fully consistent with the conditions necessary for microeconomic efficiency: Those making decisions would receive all extra returns resultant from their decisions. Managers would have the appropriate incentive to ensure that their enterprises operate efficiently. One cannot say that it is separation of ownership and control *per se* that causes inefficiencies.

To find a possible source of inefficiency, one must relax the assumption that there are no constraints on managerial salaries. In such a case, it is useful to define the notion of "potential surplus," here meaning that quantity, measured in monetary units, which managers maximize when they have complete control over all enterprise policies.[6] Managers can benefit from increases in potential surplus in two ways: through increases in salary or through increases in nonsalary benefits, such as expense accounts, prestige, or a comfortable life. (For terminological ease, I shall use "perquisites" to indicate the second category of benefits.) When there are restrictions on the size of salaries, resources will be used for perquisites. For example, managers may use retained earnings for growth solely to increase prestige and power. With restrictions on salaries, inefficiencies will arise for two reasons: (1) the value of the marginal product of managerial effort will differ from the manager's marginal rate of substitution between income and effort, and (2) managers may devote large amounts of resources to increasing their welfare through perquisites when a much smaller amount of resources paid in salary would produce an equivalent increase in welfare.[7] Hence, separation of ownership and control *with* restrictions on salaries can lead to inefficiencies.

In order to examine whether pragmatic market socialism can be more efficient than capitalism when the latter has both separation of ownership and control and restrictions on managerial salaries, let us construct an exceedingly simple model.[8] Assume that managerial salaries are constrained in some manner to be a constant proportion, A, of potential surplus and that perquisites are a proportion, B, of potential surplus ($A + B = 1$). One unit of perquisites is assumed to be worth $1/D$ units of salary to the manager ($D > 1$).[9] Thus, if the manager received the proportion $A + (B/D)$ of potential surplus in salary, he would make the same production decisions as when the proportion A is received in salary and B in perquisites. Yunker assumes that if market socialist managers were to receive 5 percent of profits, efficiency would rise. However, unless the 5 percent of profits is worth as much as the proportion $A + (B/D)$ of potential surplus, efficiency will not necessarily rise.[10] Thus, the broad conclusion emanating from this simple model is that it is an empirical question whether the changeover to pragmatic market socialism will increase efficiency. Under the assumption that managerial salaries under capitalism are constrained, an increase in efficiency is possible if pragmatic market socialism is instituted and the socialist managers are paid a large enough share of profits. However, Yunker provides no evidence on parameters A, B, or D, on their equivalent in a different model, so that his 5 percent figure has no basis.

The change to pragmatic market socialism could certainly generate an increase in efficiency if the share of profits given to managers were worth as much as the proportion $A + (B/D)$ of potential surplus under capitalism. In such a case, managers would no longer have the incentive to use resources in order to generate welfare in the form of perquisites. Thus, the increase in efficiency would be due entirely to the loosening of the constraints on managerial salaries.

Let us examine the changes in distribution of income that would occur if pragmatic market socialism were introduced in such a way that its efficiency would be higher than the capitalist system (with constraints on managerial salary) it replaced. Because managers no longer would receive perquisites, their monetary incomes would have to increase (but not necessarily their welfare). A share of profits would now be available for a social dividend because the rise in managerial incomes could be less than the value of the forgone perquisites. The income of wealth holders would remain the same because, as has already been assumed, equity holders would be compensated at fair market value, and a competitive rate of return on savings would be paid. The direction of change in the distribution of income would be indeterminate, as this depends upon the relative size of the change in managerial salaries and the social dividend. However, there is no doubt that, as managerial welfare could remain constant, the distribution of welfare might become more equal.

It should be noted that it is not the public ownership aspect of pragmatic market socialism that would be responsible for any rise in efficiency. Rather, the efficiency increase would be due solely to the removal of constraints on managerial salaries. Such a policy would also be available under capitalism.

The Possibility of Implementation

Yunker assumes that the introduction of pragmatic market socialism will lead to the concentration of property rights. Stated starkly, his thesis is that stock ownership is so diffuse that one remedy is to give ownership to everyone. The assumption that public ownership leads to concentration is based on viewing the body politic as a single entity. This view will only be appropriate if the institutions of pragmatic market socialism, especially the BPO, do not need to be controlled within the democratic process. If the BPO needs to be supervised by the owners of property (that is, all citizens), then pragmatic market socialism faces the same dilemma as modern capitalism: the lack of incentive for owners to participate in management decisions. Thus, in deciding whether a pragmatic market socialist economy will behave as envisaged by Yunker, one must examine whether the BPO's actions need to be supervised. Only if no supervision is necessary can one say that pragmatic market socialism leads to the concentration of property rights.

One basic assumption guiding most economic analysis is that economic agents act in their own self-interest. Yunker makes this assumption (see p. 81). Thus, if there is no supervision of the BPO's policies, and no relation between the rewards of the officials of the BPO and its actions, those officials will not necessarily act as envisaged in the theory of pragmatic market socialism. In fact, standard theoretical and empirical works on the behavior of large organizations lead us to conclude that, unless the BPO is supervised, its behavior may be very detrimental to efficiency in the economy. W. A. Niskanen, for example, points out that a bureaucracy will have an incentive to maximize its own budget.[11] Peter Blau and Marshall Meyer give practical examples of how specific bureaucracies differ radically from what may be expected due to the self-interested behavior of their members.[12]

Given that the BPO will not necessarily follow the policies set for it, the BPO must be supervised. The hiring and firing of the top personnel, and possibly their rewards, must be related in some way to their performance. Democratic institutions will need to obtain information about the BPO and make judgments on its performance. The BPO's policies must come under review, directly or indirectly, within the electoral process. Voters will have the same incentive (or lack thereof) to take an active part in this process as do small stockholders in large capitalist corporations.

Yunker acknowledges that the determination of BPO policies in pragmatic market socialism will be problematic. However, he takes comfort in the fact that "the social decisions would be made in the absence of an influential capitalist class" (p. 89). Nevertheless, one group still can profit from the policies of the BPO: enterprise managers. They would have every incentive to exaggerate the extent to which efficiency is dependent on large bonus payments. They are likely to participate eagerly in the political process through which BPO policies are reviewed and personnel chosen. Thus, pragmatic market socialism would face the central dilemma of any public choice mechanism: A narrow interest (the managers) would have much more incentive to influence the political process than would a much broader interest (those who receive the social dividend).

Conclusions

The assumption that the separation of ownership and control necessarily implies inefficiency has been shown to be incorrect. From the standpoint of efficiency, pragmatic market socialism will not necessarily have any advantage over a capitalist economy with either no separation or complete separation of ownership and control. However, it has been shown that when separation of ownership and control and constraints on managers' salaries exist, there may be inefficiencies. If pragmatic market socialism were to remove these constraints, then efficiency could increase, and funds for a social dividend would be available. However, one cannot be certain that such a result would occur if the bonuses of socialist managers were arbitrarily restricted to 5 percent of profits.

A change to pragmatic market socialism would radically alter the supervisory structure of industry. Inevitably, this change would entail supervision of industry through the political process. Given that the benefits of pragmatic market socialism would be available if, in a capitalist economy, constraints on managerial salaries were removed and a tax on profits instituted, one may wonder whether the change to Yunker's scheme would be worthwhile. Yunker accepts the view that "proposals for drastic revisions of the system must obviously be viewed with great caution" (p. 87). Accepting this premise, and noting that the claimed increase in efficiency under pragmatic market socialism is also obtainable through mild reforms of the existing system, the microeconomic efficiency argument for socialism is, as yet, unproven.

Peter Murrell

The author is Assistant Professor of Economics, University of Maryland, College Park. *He would like to thank Jeff Miller for helpful comments.*

Notes

1. James A. Yunker, "The Microeconomic Efficiency Argument for Socialism Revisited," *Journal of Economic Issues* 13 (March 1979): 73–112.
2. For a definition of *economic rent* applied to a market-socialist environment, see A. P. Lerner, *The Economics of Control* (New York: Macmillan, 1944), pp. 218–19.
3. See, for example, note 12, p. 105. That note does contain a justification for this assumption, but it is based on circular logic. Yunker uses the assumption in his article, concludes that there can be a rise in efficiency even if property income is not paid, and then uses the conclusion to justify the assumption.
4. This condition is solely a reworded version of the condition that marginal rates of substitution must equal marginal rates of transformation, obtained when one views effort as a product that imposes disutility on the manager. A competitive economy is assumed.
5. Indeed, one of the most important pieces of evidence for the separation of ownership and control is the fact that managers do not use corporate funds to promote stockholder welfare. See, for example, Dennis C. Mueller, "A Life Cycle Theory of the Firm," *Journal of Industrial Economics* 20 (July 1972): 211–15.
6. Potential surplus will essentially be a measure of managerial welfare. I do not pretend that there will not be difficulties in identifying and measuring potential surplus in the real world. In particular, there would obviously be index number problems of measurement. However, use of this concept does allow a simple argument in the present context.
7. Therefore, perhaps some authors have used X-inefficiency to describe a situation in which managers are receiving a large share of the potential surplus in perquisites (which may imply that, for example, managers devote little effort to cost reduction).
8. I emphasize that the assumptions of the model are formulated in order to make analysis easy rather than intended to be realistic. Nevertheless, I believe that the model's characteristics are such that its broadest conclusions are relevant to more realistic situations.
9. The assumptions that *A*, *B*, and *D* are constant and that salary will be proportional to potential profits are adopted for ease of analysis rather than realism. The basic assumption that drives the analysis is the assumption that managers would like to pay themselves higher salaries than they are presently allowed. Use of a more realistic form of the salary constraint would only complicate the analysis without changing the conclusions.
10. Although the theory of second best warns us to be wary of such assumptions, I assume, with Yunker, that an increase in the share of the marginal return on effort that goes to the one making the effort increases efficiency.
11. W. A. Niskanen, Jr., *Bureaucracy and Representative Government* (Chicago: Aldine-Atherton, 1971).
12. Peter M. Blau and Marshall W. Meyer, *Bureaucracy in Modern Society* (New York: Random House, 1971).