

UNDERSTANDING PRICE MECHANISM IN A SOCIALIST ECONOMY

¹Park O. Idisi, ²Ibukun Joyce Ogwu, ³Wofai Onen Obeten

Department of Agricultural Economics and Farm Management, University of Abuja, PMB 117, Abuja, FCT.

Abstract: Price mechanism allows the determination of ways to allocate resources among different goods and services as a result of the interaction of consumers and business outfits. It is the process by which changes in prices guide and shape changes in the value and types of the goods and services that are produced. This however may be a complex situation since pricing is dynamic. Also, since consumers and business outfits strive to maximize their benefits, it is important to establish price mechanism in a socialist economy. This study, hereby presents how price mechanism works in a socialist economy, the merits and limitations comparatively with other market economies. The paper concluded that the existence of price mechanism has little or no relevance in a socialist economy. This implies that the situation may not be operative in a socialist economy where all decision making lies within the government forces. Price mechanism is a distinguishing feature of a free market economy which does not pertain to a socialist economy.

Keywords: Price mechanism, consumers, businesses, producers, socialism, socialist economy.

I. INTRODUCTION

Price mechanism refers to the system where the forces of demand and supply determine the prices of commodities and the changes therein. It is the buyers and sellers who actually determine the price of a commodity [1]. It is the intension of this study to present how price mechanism works in a socialist economy, the merits and limitations comparatively with other market economies.

The price mechanism is the means by which decisions of consumers and businesses interact to determine the allocation of resources between different goods and services. It operates in a free market situation where forces of demand and supply dictate prices. It is the process by which changes in prices guide and shape changes in the value and types of the goods and services that are produced. The price mechanism will determine: "what is produced, how much is produced and for whom a good or service is produced for." The forces of demand and supply interact to bring about an equilibrium price. According to Koutsoyiannis [2], an equilibrium exists when at a certain positive price, the quantity demanded is equal to the quantity supplied. The price at which $Q_D = Q_S$ is the equilibrium price. At such price, there is neither excess demand nor excess supply. Koutsoyiannis [2] referred to equilibrium price as the price at which the excess demand is zero and the market is cleared. Fig.1 shows the interaction between demand and supply and the equilibrium price, P_e .

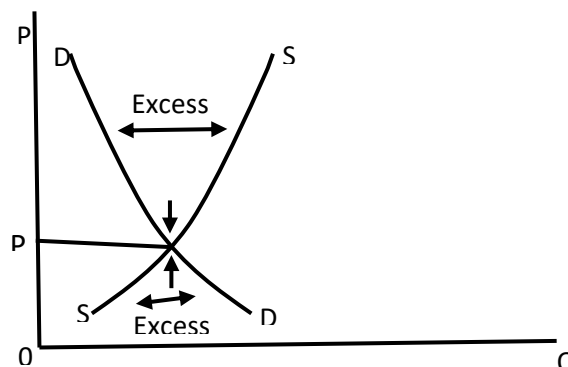


Fig 1: Interaction between demand and supply

Socialism is a phenomenon which refers to the practice in a socialist economy and according to Hoppe [3], socialism is a social system in which the means of production, that is, the scarce resources used to produce consumption goods, are “nationalized” or “socialized.” Hoppe [3] further described socialism as an economic theory of social organization that believes that the means of making, moving, and trading wealth should be owned or controlled by the community as a whole.

II. FUNDAMENTAL POSTULATES OF SOCIALISM

According to Salman [4], some of the pioneers and well known social thinkers include Robert Owen, Charles Fourier, Pierre-Joseph Proudhon, Louis Blanc, Charles Hall and Saint-Simon. Socialism was to act as a pre-cursor to Communism. Karl Marx [5] described socialism as a specific historical phase that will displace capitalism as a precursor to communism. Socialism does not promise to make everyone equal and pay everyone the same wages and replace market economy in a complete sense. However, communism does promise income and social equality [4]. Some of the well known social leaders include Vladimir Lenin and Joseph Stalin. Some of the important countries that tried Socialism include former Soviet Union, Hungary, Poland, Romania, Vietnam, Yugoslavia etc.

III. FEATURES OF SOCIALISM

Some vital characteristic of socialism according to Salman [4] are stated thus;

1. **Collective property:** In a socialist economy, there is no right to own private property. All the property collectively is in the ownership of the socialist government in the country. This means that all the business enterprises are in the collective ownership, management and control of the government.
2. **Planned Economy:** the government in its own wisdom solves the central problems of the economy. Decisions like: What to produce? How to produce? When to produce? For whom to produce? and How much to produce? are all taken by the government. All the economic planning and policy making rests with the government.
3. **Decisions in Collective Interest:** all the decisions are made by the government in the collective interest of a socialist country. People are directed to follow the instructions of the government and are not allowed to object to any decision or policy of the socialist government.
4. **Reduced Income Inequality:** government makes the decisions about the wages arbitrarily. The wages are forced to remain in parity in all fields. Government tries to keep income equality through setting the wages and disallowing any objection or bargaining.
5. **Restriction on Market forces:** market forces of demand and supply are not consulted by the government in a socialist economy. Market mechanism does not prevail and all the decisions are made by the government in its own wisdom.
6. **Centralized Economy:** all the decision-making authority rests with the government. No one else is given the authority to make the economic decisions even for oneself. Everyone has to follow the commands of the government and everyone is treated like an employee of the government.
7. **Non-existence of Private sector:** private sector is non-existent in a socialist economy. No private economic activity is allowed. Every person has to work for the government and earn wages that are set arbitrarily.

All these features of price mechanism, according to Kwat [6], has little relevance in a socialist economy because price mechanism is regarded as a distinguishing feature of a free market economy. In a socialist economy, the various elements of the price mechanism—costs, prices and profits—are all planned and calculated by the planning authority in accordance with the targets of the plan. Thus, rational economic calculation is impossible in a planned economy because unlike a free market economy the price mechanism is regulated and controlled.

For Kwat [6], the various assumptions under which the price system works in a free market economy do not hold well in a socialist economy. In a socialist economy, it is the central planning authority that performs the functions of the market. Since all the material means of production are owned, controlled and directed by the government, the decisions about what to produce are taken within the framework of a central plan. The decisions, as to the nature of goods to be produced and their quantities, depend upon the objectives, targets and priorities laid down by the central planning authority. The prices of the various commodities are also fixed by this authority. Prices reflect the social preferences of the common man. Consumers’ choice is limited only to the commodities that the planners decide to produce and offer.

Kwat [6] further stated that the problem of how to produce is also decided by the central planning authority. "It establishes the rules for combining factors of production and choosing the scale of output of a plant, for determining the output of an industry, for the allocation of resources, and for the parametric use of prices in accounting." The central planning authority lays down two rules for the guidance of plant managers. One, that each manager should combine productive goods and services in such a manner that the average cost of producing a given output is the minimum. Two, that each manager should choose that scale of output which equalises marginal cost to price [6]. Since all resources in the economy are owned and regulated by the government, the raw materials, machines and other inputs are also sold at prices which are equal to their marginal cost of production.

According to Kwat [6], if the price of a commodity is above its average cost, the plant managers will earn profits and if it is below the average cost of production, they will incur losses. In the former case, the industry would expand and in the latter case it would cut down production, and ultimately a position of equilibrium will be reached where price equals both the average cost and the marginal cost of production. According to Kwat [6], in case where costs differ with plants, the plant managers produce up to the point where long-run marginal cost (LMC) is equal to price ($P=AR=MR$), in such a situation, it is only in the marginal plant that $LAC=LMC=MR=AR=P$ at point E_1 , as shown in Figure 2(B). All other plants would earn extra revenue (profit) equal to PA BE , as shown in Figure 2(A) which would go to the government. The low cost units will subsidize the high cost units and in equilibrium total revenue and total cost would be the same for the industry as a whole.

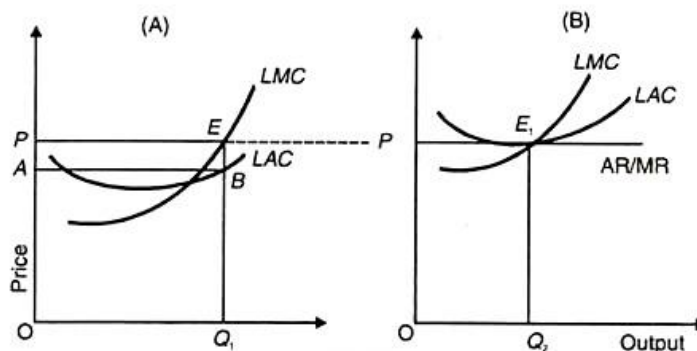


Fig 2: Long-run Production Determination at a given Price

IV. PRICING IN SOCIALIST ECONOMY

But how can the central planning authority find out the equilibrium market and accounting prices? According to Kwat [6], starting from historically given prices, it can instruct the plant managers to regard them as correct prices. If they are wrong, surpluses or shortages will emerge. Prices will be readjusted. This process will continue until the equilibrium position is reached by trial and error. The process of trial and error would, however, proceed on the basis of historically given prices which would necessitate relatively small adjustments in prices from time to time.

Thus, according to Kwat [6], "all decisions of the managers of production and of the productive resources in public ownership and also all decisions of individuals as consumers and as suppliers of labour are made on the basis of these prices. As a result of these decisions the quantity demanded and supplied of each commodity is determined. If the quantity demanded of a commodity is not equal to the quantity supplied, the price of that commodity has to be changed. It has to be raised if demand exceeds supply and lowered if the reverse is the case. Thus the central planning board fixes a new set of prices which serves as a basis for new decisions, and which results in a new set of quantities demanded and supplied [6].

Also, Kwat [6] stated that the problem for whom to produce is also solved by the state in a socialist economy. The central planning authority takes this decision at the time of deciding what and how much to produce in accordance with the overall objectives of the plan. In making this decision, social preferences are given weightage. In other words, higher weightage is given to the production of those goods and services which are needed by the majority of the people over luxury items. They are based on the minimum needs of the people, and are sold at fixed prices through government stores. Since goods are produced in anticipation of demand, an increase in demand brings about shortages and this leads to rationing. Thus, the problem of income distribution is automatically solved in a socialist economy because all resources are owned and regulated by the state. All interest, rent and profit are fixed by the state and go to the state treasury.

V. MERITS OF PRICE MECHANISM IN A SOCIALIST ECONOMY

As regard wages, according to Kwat [6], they are also fixed by the state according to the amount and quality of work done by an individual. Each individual is paid according to his ability and work. Economic surpluses are deliberately created and invested for capital formation and economic growth. Thus, according to Kwat [6], the price mechanism is not incompatible with a socialist economy, rather, it helps the socialist economy in two ways:

First, it serves as a basis for accounting—a means to evaluate and compare cost of production and output based on accounting prices and costs. Second, it acts as an incentive to the people to do things in accordance with plan targets [6]. Thus, in a socialist state, according to Kwat [6], it is the central planning authority that performs the functions of the market. Since all the material means of production are owned, controlled and directed by the government, the decisions about what to produce, how to produce, and for whom to produce are taken within the framework of a central plan. The prices are fixed by the central planning authority. Prices reflect the social preferences. Even in producing goods, social preferences are given weightage. So the price mechanism does not operate in a collectivist economy the way it operates in a free market economy because the state owns controls and regulates the means of production and distribution within the economy. But this does not mean that prices do not play any part in such an economy. In fact, they are used to solve the problem of how to produce.

VI. LIMITATIONS OF PRICE MECHANISM IN A SOCIALIST ECONOMY

The following points, according to Kwat [6], highlight major limitations of the Price Mechanism in a Socialist Economy:

1. The government issues directives to producers to manufacture goods of different types and in fixed quantities which are required to meet the social wants.
2. The imposition of administrative controls, regulating the supplies of goods, rationing of commodities, issuing of licences, fixation of quotas, etc. are some of the devices which tend to modify the working of an automatic price system.
3. Even the resource owners are not allowed to act freely. If the government wants the private sector to produce more for the future, then resources will be reallocated towards the capital goods sector. People may also be asked to save more and consume less in the present.
4. When the government fixes prices of goods and services of say sugar, cloth, steel, etc., and wages of workers, these act as constraints on the working of the free market mechanism.
5. Such measures as progressive income and wealth taxes, provision for social security, price support programme, giving of subsidies, credit facilities, etc., also interfere with the working of the price system.
6. Measures aimed at nationalisation of social services also tend to modify the price system in favour of mixed economy.
7. The price mechanism functions under the assumptions of perfect competition. But in the real world, competition is nowhere perfect. Producers are not fully aware of the tastes of consumers. So they overproduce some goods and under produce in the case of other goods. They are, therefore, unable to maximise their profits. Moreover, the failure of demand and supply of goods to reach equality often leads to recession or inflation.
8. The imperfections of competition also lead to the emergence of monopolies which result in wrong pricing, incorrect and wasteful resource allocation and monopoly profits. They have weakened free competition and reduced consumers' sovereignty.
9. The price mechanism has increased income inequalities instead of reducing them. This is because supply and demand does not work properly. Production is guided by the demand of the elite and not by the needs of the poor. Resources are, therefore, directed towards producing luxury goods for the rich who can pay the most. This further leads to misdistribution of income.

VII. CRITICAL ANALYSIS OF SOCIALISM

On the economic criticism of Socialism, Maududi [1] analyzed that socialism in its quest to tame capitalists brought one big capitalist in the form of government which is the communist party accredited with the responsibility to operate, manage and administer the overall economy without giving society and individuals any recourse to challenge the

government. In such a case, no government, consisting of human after all can keep itself judiciously pursuing common goals than individual goals. Usmani [7] reasoned that socialism kills the self-motive which drives individuals to excel and be efficient.

On the political criticism of communism, Fukuyama [8] argued that following the collapse of the Soviet Union, liberal democracy no longer faced any serious ideological challenges and thus had proved itself to be the only sustainable and successful form of government. Fukuyama [8] claimed that capitalist liberal democracy would ultimately extend to all nations and this would be 'the end of history'.

More important, though, than motivation and promises is what a socialization of means of production really amounts to [9]. The property rules that are adopted under a socialization policy and which constitute the basic legal principles of countries like Russia are characterized by two complementary features. First, nobody owns the socialized means of production; they are "socially" owned, which is to say precisely: no person, or no group of persons, or all taken together is allowed to either acquire them or sell them and keep the receipts from their sale privately. Their use is determined by people not in the role of an owner but of a caretaker of things. And secondly, no person or group of persons or all taken together is allowed to engage newly in private investment and create new private means of production. They can neither invest by transforming the existing, non-productively used resources into productive ones, by original saving, by pooling resources with other people, nor by a mixture of these techniques. Investment can only be done by caretakers of things, never for private profit, always on behalf of the community of caretakers with whom the possible profits from investments would have to be shared [10].

What does it mean to have such a caretaker economy? What, in particular, does it imply to change from an economy built on the natural theory of property to a socialized one? In passing, two observations should be made, which will already throw some light on the above-mentioned socialist promises of equality and efficiency. Declaring everybody a co-owner of everything solves the problem of differences in ownership only nominally. It does not solve the real underlying problem: differences in the power to control [10].

In an economy based on private ownership, the owner determines what should be done with the means of production. In a socialized economy this can no longer happen, as there is no such owner. Nonetheless, the problem of determining what should be done with the means of production still exists and must be solved somehow, provided there is no pre-stabilized and pre-synchronized harmony of interests among all of the people (in which case no problems whatsoever would exist anymore), but rather some degree of disagreement. Only one view as to what should be done can in fact prevail and others must be excluded. But then again there must be inequalities between people: someone's or some groups' opinion must win over that of others [10].

The difference between a private property economy and a socialized one is only how whose will prevails in cases of disagreement is to be determined. In capitalism there must be somebody who controls, and others who do not, and hence real differences among people exist, but the issue of whose opinion prevails is resolved by original appropriation and contract. In socialism, too, real differences between controllers and non-controllers must, of necessity, exist; only in the case of socialism, the position of those whose opinion wins is not determined by previous usership or contract, but by political means [10].

The second observation is intimately connected with the first and concerns socialism's allegedly superior coordinating capabilities. Again closer inspection reveals that the difference is merely illusory, created only by semantics: to say that an economy of private owners is supplanted by a nationalized one creates the impression that instead of a multitude of decision-making units, all of a sudden there is only one such unit. In fact, nothing has changed at all. There are as many individuals with as many different interests as before. Just as much as capitalism then, socialism has to find a solution to the problem of determining how to coordinate the uses of different means of production, given the fact of differing views among people on how this should be accomplished. The difference between capitalism and socialism is again one of how coordination is achieved, and not between chaos and coordination, as the socialist semantic insinuates. Instead of simply letting individuals do what they want, capitalism coordinates actions by constraining people to respect previous usership. Socialism, on the other hand, instead of letting people do whatever pleases them, coordinates individual plans by superimposing on one person's or group of persons' plan that of another disagreeing person or group regardless of prior ownership and mutual exchange agreements [10]. It hardly deserves comment that this difference, too, is of the utmost importance. But it is not, as Marxist socialism would like us to believe, a difference between social planning and

no planning at all; on the contrary, as soon as the coordinating mechanisms of socialism and capitalism are brought into the open and reconstructed, socialism's claim to greater efficiency immediately begins to lose much of its credibility, and the opposite thesis appears to be more convincing [10].

VIII. THE EQUATIONS OF MATHEMATICAL ECONOMICS AND THE PROBLEM OF ECONOMIC CALCULATION IN A SOCIALIST STATE

In the capitalistic economy, according to Mises [11], it is possible to make economic calculations on the basis of present-day knowledge. And economic calculation can only take place by means of money prices established in the market for production goods in a society resting on private property in the means of production. That is to say, there must exist money prices of land, raw materials, semi-manufactures [11]. It may be that mistakes will occasionally be made because unexpected events interfere with expectations. In the socialist state, however, it would not even be possible to calculate on the basis of our present knowledge. Those who think that it would be possible to apply the equations of mathematical economics for making the calculations fail to see that included among the items of which these equations are composed are unknown preference scales belonging to a situation which is unreal and can never be realized in practice. The circumstance that they are unknown frustrates all attempts to use the equations for purposes of economic calculation [11].

If there are no money prices for means of production, Mises says, all "capitalistic production would be groping in the dark" [11]. Since no such markets exist under socialism, and hence no prices could be established for capital goods, the fundamental economic problem facing socialism would be how to rationally, economically calculate without such prices. This led Mises to conclude that in a socialist state, "economic calculation is impossible" and that "socialism is the abolition of rational economy" [11].

IX. CONCLUSION

Price mechanism has little relevance in a socialist economy because it is regarded as a distinguishing feature of a free market economy. In a socialist economy, the various elements of the price mechanism—costs, prices and profits—are all planned and calculated by the planning authority in accordance with the targets of the plan. Thus, rational economic calculation is impossible in a planned economy because unlike a free market economy, the price mechanism is regulated and controlled. The various assumptions under which the price system works in a free market economy do not hold well in a socialist economy. The decisions about what to produce, how to produce, and for whom to produce are taken within the framework of a central plan and not determined by price mechanism. This is also determined by the planning authority. Furthermore, while it is possible to make economic calculations by means of money prices on the basis of present-day knowledge in a capitalist economy, it would not even be possible to make this calculation in the socialist state.

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