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# Economic Calculation in the Corporate Commonwealth

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by the point at which the benefits of size cease to outweigh the costs of such calculation problems. The inefficiencies of large size and hierarchy may be a matter of degree, but, as Ronald Coase said, the market would determine whether the inefficiencies are worth it.

The problem is that the state, by artificially reducing the costs of large size and restraining the competitive ill effects of calculation problems, promotes larger size than would be the case in a free market—and with it calculation problems to a pathological extent. The state promotes inefficiencies of large size and hierarchy past the point at which they cease to be worth it, from a standpoint of net social efficiency, because those receiving the benefits of large size are not the same parties who pay the costs of inefficiency.

The solution is to eliminate the state policies that have created the situation, and allow the market to punish inefficiency. To get there, though, some libertarians need to reexamine their unquestioned sympathies for big business as an “oppressed minority” and remember that they’re supposed to be defending free markets—not the winners under the current statist economy.

The general lines of Ludwig von Mises’s rational-calculation argument are well known. A market in factors of production is necessary for pricing production inputs so that a planner may allocate them rationally. The problem has nothing to do either with the volume of data or with agency problems. The question, rather, as Peter Klein put it, is “[h]ow does the principal know what to tell the agent to do?”

This calculation argument can be applied not only to a state-planned economy, but also to the internal planning of the large corporation under interventionism, or state capitalism. (By state capitalism, I refer to the means by which, as Murray Rothbard said, “our corporate state uses the coercive taxing power either to accumulate corporate capital or to lower corporate costs,” in addition to cartelizing markets through regulations, enforcing artificial property rights like “intellectual property,” and otherwise protecting privilege against competition.)

Rothbard developed the economic calculation argument in just this way. He argued that the further removed the internal transfer pricing of a corporation became from real market prices, the more internal allocation of resources was characterized by calculational chaos.

Mises’s calculation argument can be applied to the large corporation—both under state capitalism and to some extent in the free market—in another way not considered by Rothbard. The basic cause of calculational chaos, as Mises understood it, was the separation of entrepreneurial from technical knowledge and the attempt to make production decisions based on technical considerations alone, without regard to such entrepreneurial considerations as factor pricing. But the principle also works the other way: production decisions based solely on input and product prices, without regard to the details of production (the typical MBA practice of considering only finance and marketing, while treating the production process as a black box), also result in calculational chaos.

The chief focus of this article, however, is Mises's calculation argument in the light of distributed information. F. A. Hayek, in "The Uses of Knowledge in Society," raised a new problem: not the generation or source of data, but the sheer volume of data to be processed. In so doing, he is commonly understood to have opened a second front in Mises's war against state planning. But in fact his argument was almost as damaging to Mises as to the collectivists.

Mises minimized the importance of distributed information in his own criticisms of state planning. He denied any correlation between bureaucratization and large size in themselves. Bureaucracy as such was a particular rules-based approach to policy-making, in contrast to the profit-driven behavior of the entrepreneur. The private firm, therefore, was by definition exempt from the problem of bureaucracy.

In so arguing, he ignored the information and coordination problems inherent in large size. The large corporation necessarily distributes the knowledge relevant to informed entrepreneurial decisions among many departments and sub-departments until the cost of aggregating that knowledge outweighs the benefits of doing so.

Try as he might, Mises could not exempt the capitalist corporation from the problem of bureaucracy. One cannot define bureaucracy out of existence, or overcome the problem of distributed knowledge, simply by using the word "entrepreneur." Mises tried to make the bureaucratic or non-bureaucratic character of an organization a simple matter of its organizational goals rather than its functioning. The motivation of the corporate employee, from the CEO down to the production worker, by definition, will be profit-seeking; his will is in harmony with that of the stockholder because he belongs to the stockholder's organization.

By defining organizational goals as "profit-seeking," Mises—like the neoclassicals—treated the internal workings of the organization as a black box. In treating the internal policies of

## Pervasive Irrationality

It also describes quite well the environment of pervasive irrationality within the large corporation: management featherbedding and self-dealing; "cost-cutting" measures that decimate productive resources while leaving management's petty empires intact; and the tendency to extend bureaucratic domain while cutting maintenance and support for existing obligations. Management's allocation of resources no doubt creates use value of a sort—but with no reliable way to assess opportunity cost or determine whether the benefit was worth it.

A good example is a hospital, part of a corporate chain, that I've had occasion to observe first-hand. Management justifies repeated downsizings of nurses and technicians as "cost-cutting" measures despite increased costs from errors, falls, and MRSA (Methicillin-resistant *Staphylococcus aureus*) infections that exceed the alleged savings. Of course the "cost-cutting" justification for downsizing direct caregivers doesn't extend to the patronage network of staff RNs attached to the Nursing Office. Meanwhile, management pours money into ill-considered capital projects (like remodeling jobs that actually make wards less functional, or the extremely expensive new ACE unit that never opened because it was so badly designed); an expensive surgical robot, purchased mainly for prestige value, does nothing that couldn't be accomplished by scrubbing in an extra nurse. But the management team is hardly likely to face any negative consequences, when the region's three other large hospitals are run exactly the same way.

Such pathologies, obviously, are not the result of the free market. That is not to say, of course, that bigness as such would not produce inefficiency costs in some firms that might exist under *laissez faire*. The calculation problem (in the broad sense that includes Hayekian information problems) may or may not exist to some extent in the private corporation in a free market. But the boundary between market and hierarchy would be set

that output would be permanently lower than it had been before planning started . . . . [We should expect] the excessive development of some lines of production at the expense of others and the use of methods which are inappropriate under the circumstances. We should expect to find overdevelopment of some industries at a cost which was not justified by the importance of their increased output and see unchecked the ambition of the engineer to apply the latest development elsewhere, without considering whether they were economically suited in the situation. In many cases the use of the latest methods of production, which could not have been applied without central planning, would then be a symptom of a misuse of resources rather than a proof of success.

As an example he cited “the excellence, from a technological point of view, of some parts of the Russian industrial equipment, which often strikes the casual observer and which is commonly regarded as evidence of success.”

To anyone observing the uneven development of the corporate economy under state capitalism, this should inspire a sense of *déjà vu*. Entire categories of goods and production methods have been developed at enormous expense, either within military industry or by state-subsidized R&D in the civilian economy, without regard to cost. Subsidies to capital accumulation, R&D, and technical education radically distort the forms taken by production. (On these points see David Noble’s works, *Forces of Production* and *America by Design*.) Blockbuster factories and economic centralization become artificially profitable, thanks to the Interstate Highway system and other means of externalizing distribution costs.

the capitalist corporation as inherently profit-driven, Mises simultaneously treated the entrepreneur as an indivisible actor whose will and perception permeate the entire organization. Mises’s entrepreneur was a brooding omnipresence, guiding the actions of every employee from CEO to janitor.

He viewed the separation of ownership from control, and the knowledge and agency problems resulting from it, as largely nonexistent. The invention of double-entry bookkeeping, which made possible the separate calculation of profit and loss in each division of an enterprise, has “reliev[ed] the entrepreneur of involvement in too much detail,” Mises writes in *Human Action*. The only thing necessary to transform every single employee of a corporation, from CEO on down, into a perfect instrument of his will was the ability to monitor the balance sheet of any division or office and fire the functionary responsible for red ink. Mises continues:

It is the system of double-entry bookkeeping that makes the functioning of the managerial system possible. Thanks to it, the entrepreneur is in a position to separate the calculation of each part of his total enterprise in such a way that he can determine the role it plays within his whole enterprise. . . . Within this system of business calculation each section of a firm represents an integral entity, a hypothetical independent business, as it were. It is assumed that this section “owns” a definite part of the whole capital employed in the enterprise, that it buys from other sections and sells to them, that it has its own expenses and its own revenues, that its dealings result either in a profit or in a loss which is imputed to its own conduct of affairs as distinguished from the result of the other sections. Thus the entrepreneur can assign to each section’s management a great deal of in-

dependence. The only directive he gives to a man whom he entrusts with the management of a circumscribed job is to make as much profit as possible. An examination of the accounts shows how successful or unsuccessful the managers were in executing this directive. Every manager and sub-manager is responsible for the working of his section or subsection. . . . His own interests impel him toward the utmost care and exertion in the conduct of his section's affairs. If he incurs losses, he will be replaced by a man whom the entrepreneur expects to be more successful, or the whole section will be discontinued.

## Capital Markets as Control Mechanism

Mises also identified outside capital markets as a control mechanism limiting managerial discretion. Of the popular conception of stockholders as passive rentiers in the face of managerial control, he wrote:

This doctrine disregards entirely the role that the capital and money market, the stock and bond exchange, which a pertinent idiom simply calls the “market,” plays in the direction of corporate business. . . . In fact, the changes in the prices of . . . stock and of corporate bonds are the means applied by the capitalists for the supreme control of the flow of capital. The price structure as determined by the speculations on the capital and money markets and on the big commodity exchanges not only decides how much capital is available for the conduct of each corporation's business; it creates a state of affairs to which the managers must adjust their operations in detail.

I have since learned that Nardelli, in the last months before he walked, took the entire purchasing function out of Atlanta and moved it to . . . India —Of all the things to pick for foreign outsourcing.

I am told that “out of touch” doesn't even begin to describe how bad it is now between HD stores and Purchasing, and between HD Purchasing and suppliers.

Not only is there a language dialect barrier, but the purchasing people in India don't know the “language” of American hardware—or even what half the stuff the stores and suppliers are describing even is.

I am told that an incredible amount of time, money, and energy is being wasted—all in the name of what was in all likelihood a bonus-driven goal for cutting headcount and making G&A [general and administrative] expenses look low (“look” low because the expenses have been pushed down to the stores and suppliers).

More than one observer has remarked on the similarity, in their distorting effects, of the incentives within the Soviet state-planning system and the Western corporate economy. We already noted the systemic pressure to create the illusion of short-term profit by undermining long-term productivity.

Consider Hayek's prediction of the uneven development, irrationality, and misallocation of resources within a planned economy (“Socialist Calculation II: The State of the Debate”):

There is no reason to expect that production would stop, or that the authorities would find difficulty in using all the available resources somehow, or even



On the other hand, management may be handsomely rewarded for running a corporation into the ground, so long as it is perceived to be doing everything right according to the norms of corporate culture. In a New York Times story that Digg aptly titled “Home Depot CEO Gets \$210M Severance for Sucking at Job,” it was reported that departing Home Depot CEO Robert Nardelli received an enormous severance package despite abysmal performance. It’s a good thing he didn’t raise employee wages too high, though, or he’d be eating in a soup kitchen.

As you might expect, the usual suspects stepped in to defend Nardelli’s honor. An Allan Murray article at the Wall Street Journal noted that he had “more than doubled . . . earnings.”

But Tom Blumer of BizzyBlog, whose sources for obvious reasons prefer to remain anonymous, pointed out some inconvenient facts about how Nardelli achieved those increased earnings:

- His consolidation of purchasing and many other functions to Atlanta from several regions caused buyers to lose touch with their vendors . . . .
- Firing knowledgeable and experienced people in favor of uninformed newbies and part-timers greatly reduced payroll and benefits costs, but has eventually driven customers away, and given the company a richly-deserved reputation for mediocre service . . . .
- Nardelli and his minions played every accounting, acquisition, and quick-fix angle they could to keep the numbers looking good, while letting the business deteriorate.

In a follow-up comment directed to me personally, Blumer provided this additional bit of information:

One can hardly imagine the most hubristic of state socialist central planners taking a more optimistic view of the utopian potential of numbers-crunching.

Peter Klein argued that this foreshadowed Henry Manne’s treatment of the mechanism by which entrepreneurs maintain control of corporate management. So long as there is a market for control of corporations, the discretion of management will be limited by the threat of hostile takeover. Although management possesses a fair degree of administrative autonomy, any significant deviation from profit-maximization will lower stock prices and bring the corporation into danger of outside takeover.

The question, though, is whether those making investment decisions—whether senior management allocating capital among divisions of a corporation or outside finance capitalists—even possess the information needed to assess the internal workings of firms and make appropriate decisions.

How far the real-world, state capitalist allocation of finance differs from Mises’s picture is suggested by Robert Jackall’s account in *Moral Mazes* of the internal workings of a corporation (especially the notorious practices of “starving,” or “milk-ing,” an organization in order to inflate its apparent short-term profit). Whether an apparent profit is sustainable, or an illusory side effect of eating the seed corn, is often a judgment best made by those directly involved in production. The purely money calculations of those at the top do not suffice for a valid assessment of such questions.

One big problem with Mises’s model of entrepreneurial central planning by double-entry bookkeeping is this: it is often the irrational constraints imposed from above that result in red ink at lower levels. But those at the top of the hierarchy refuse to acknowledge the double bind they put their subordinates in. “Plausible deniability,” the downward flow of responsibility and upward flow of credit, and the practice of shooting the

messenger for bad news, are what lubricate the wheels of any large organization.

As for outside investors, participants in the capital markets are even further removed than management from the data needed to evaluate the efficiency of factor use within the “black box.” In practice, hostile takeovers tend to gravitate toward firms with low debt loads and apparently low short-term profit margins. The corporate raiders are more likely to smell blood when there is the possibility of loading up an acquisition with new debt and stripping it of assets for short-term returns. The best way to avoid a hostile takeover, on the other hand, is to load an organization with debt and inflate the short-term returns by milking.

Another problem, from the perspective of those at the top, is determining the significance of red or black ink. How does the large-scale investor distinguish losses caused by senior management’s gaming of the system in its own interest at the expense of the productivity of the organization from losses occurring as normal effects of the business cycle? Mises of all people, who rejected the neoclassicals’ econometric approach precisely because the variables were too complex to control for, should have anticipated such difficulties.

Management’s “gaming” might well be a purely defensive response to structural incentives, a way of deflecting pressure from those above whose only concern is to maximize apparent profits without regard to how short-term savings might result in long-term loss. The practices of “starving” and “milking” organizations that Jackall made so much of—deferring needed maintenance costs, letting plant and equipment run down, and the like, in order to inflate the quarterly balance sheet—resulted from just such pressure, as irrational as the pressures Soviet enterprise managers faced from Gosplan.

## Shared Culture

The problem is complicated when the same organizational culture—determined by the needs of the managerial system itself—is shared by all the corporations in a state-induced oligopoly industry, so that the same pattern of red ink appears industry-wide. It’s complicated still further when the general atmosphere of state capitalism enables the corporations in a cartelized industry to operate in the black despite excessive size and dysfunctional internal culture. It becomes impossible to make a valid assessment of why the corporation is profitable at all: does the black ink result from efficiency or from some degree of protection against the competitive penalty for inefficiency? If the decisions of MBA types to engage in asset-stripping and milking, in the interest of short-term profitability, result in long-term harm to the health of the enterprise, they are more apt to be reinforced than censured by investors and higher-ups. After all, they acted according to the conventional wisdom in the Big MBA Handbook, so it couldn’t have been that that caused them to go in the tank. Must’ve been sunspots or something.

In fact, the financial community sometimes censures transgressions against the norms of corporate culture even when they are quite successful by conventional measures. Costco’s stock fell in value, despite the company’s having outperformed Wal-Mart in profit, in response to adverse publicity in the business community about its above-average wages. Deutsche Bank analyst Bill Dreher snidely remarked, “At Costco, it’s better to be an employee or a customer than a shareholder.” Nevertheless, in the world of faith-based investment, Wal-Mart “remains the darling of the Street, which, like Wal-Mart and many other companies, believes that shareholders are best served if employers do all they can to hold down costs, including the cost of labor” (Business Week Online, April 12, 2004).