

Brivers, Ivars

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Market or Government – Is There a Third Way?

Ivars Brīvers

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Ivars Brīvers
E-mail: *abrivere@td.lv*
BA School of Business and Finance,
Riga, Latvia
K.Valdemara iela 161, LV-1013

Market or Government – Is There a Third Way?

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Abstract: The paper deals with the discussion on the possible models of economy – market economy, which is usually associated with capitalism, and planned economy, which is usually associated with socialism. The experience of the 20th century has shown that efforts to choose the model of socialism have failed. Is it sufficient to make a conclusion, that capitalism is preferred to socialism not depending on conditions? Even if so, that the events of the 21st century show, that model of capitalism also has faced serious contra versions, and thus should be significantly modified. The great economists from Smith to Keynes have made forecasts about the new model of economy in the future – neither socialism, nor capitalism in a common sense. To solve the global problems, we need to think outside the box, revising critically the conventional wisdoms, thus creating a new model of economy. A possible way in that direction may be the localization of economy in a global scale.

Introduction

The aim of this paper is to discuss the benefits and shortcomings of the two economic systems – capitalism and socialism, and to look for a possible third form of economic model. Certainly market could not be contrasted with socialism and even more government with capitalism. Government is an integral part of any organized society. However the functions of government, at least theoretically, differ in the two discussed models of economy. The historical discussion mostly has generally led to conclusions, that any of the two systems has its benefits and shortcomings, and the historical process of development needs to adjust the existing economic model to the actual circumstances, and to look for improvements. The present world situation proves the necessity for that.

The first chapter deals with the historical development of understanding the concepts of capitalism and socialism, the phases of capitalist development, and the forecasts for the future development of the great economic thinkers Walras, Keynes, Schumpeter and others.

The second chapter recalls the historical discussion during the 20th century about the main theoretical problem of socialism – the possibility to set adequate prices for capital goods otherwise than in market.

The third chapter marks a new alternative, that may be considered either as an improvement of the existing capitalist model, or as a new, third economic model – local economies. The huge pressing problems of the present capitalist system in such a model should be several times smaller and therefore it will be much easier to accustom with them.

Methodology of the research

The methodology of the conclusion making is based on qualitative historical analysis and empirical evaluation of the standpoints of the scientific discussion. The paper is mainly library-based. The ideas of world famous economists are taken from their own books in a printed form or that can be found in Internet.

The analysis and conclusions have been approbated in several scientific conferences – annual European Society for the History of Economic Thought conferences in Prague, 2008, Amsterdam, 2010, annual Latvian Economic association conferences in Riga, 2010 and 2013, in the International conference of the Latvian Institute of Social Market Economy in Riga, 2012 and in the 7th International symposium of Warsaw University of Life Sciences in Jachranka, 2014. The main ideas have been discussed in the contents of study courses in BA School of Business and Finance in Riga, and have been developed in some previous publications, mentioned in the References. Author expresses special thanks to Professor Dzintra Atstaja (BA School of Business and Finance) for close and lasting cooperation discussing and developing the ideas and the results.

The Roots and Development of Two Modern Economic Systems

Since the XIX century mankind deals with two alternative models of economy – capitalism and socialism. Both these terms appeared in the middle of the XIX century. The term “capitalism” has its roots in Latin, based on “*caput*” – head, from which the term “*chattel*” was derived in a sense of a movable property. Such economists as David Ricardo and Pierre-Joseph Proudhon used term “*capitalist*” in their works; Karl Marx and Friedrich Engels were using term “*capitalistic system*”. The term “*capitalism*” in a modern sense came into our conversation language in the end of the XIX century, mainly due to German economists Werner Sombart, Max Weber and others.

The term “socialism” also has its roots in Latin – “*sociare*”, which means “*to share*”. The use of the word “socialism” in a modern sense is associated with the French philosophers and economists Pierre Leroux, Henri de Saint-Simon and others.

During the last two centuries there have been different definitions and interpretations of “capitalism” and “socialism”, thus creating the possibility of different interpretations of political and economical systems of various countries. Certainly, the ideological aspects constantly have led to confusion with the definitions of the two systems. In this paper the distinctions between capitalism and socialism are viewed in economic dimension. In that sense the main feature, that distinguish one model from the other is: in capitalism there is a private property on capital goods, in socialism capital goods are public domain. It follows that capital goods are not subject to the market, and thus the adequate price setting problem appears. Therefore it is necessary to have a centralized price setting institution, as well as a centralized institution, which will organize the process of resource distribution. From the point of view of economics, a public property of capital goods and centralized planning are the two main features of the socialism.

The roots of discussion about benefits and shortcomings of the both systems go back to ancient Greeks. Plato’s and Aristotle’s dissonant opinions may be interpreted as early roots of opposing these two systems, contrasting the fairness to utility, usefulness to efficiency, cooperation to competition. An exciting discussion about both systems, is given in the fundamental book of Leon Walras, where author associates these opinions with Plato and Aristotle.

“From the very beginning of human society and from the first appearance of social wealth, the problem of the distribution of this wealth has been subject to debate. ... Of all the systems of distribution which have ever been devised, the two most prominent are communism and individualism, which have had as their respective champions the two greatest minds of antiquity, Plato and Aristotle. ... Communism says, “Goods ought to be appropriated collectively. Nature has given them to all men, not only to men living today but to posterity as well.” ... In reply individualism argues. “Goods ought to be appropriated individually. Nature has made men unequal in virtue and talent.” ... Which is right, communism or individualism? Are not both of them both right and wrong in the same time?” (Walras, 1874).

Except the fact that Walras uses term “communism” instead of “socialism” and “individualism” instead of “capitalism” the text of Walras seems very live issue in modern world. Indeed, the “communist” ideas, which Walras associates with Plato, are both right and wrong in the same time, as well as ideas of “individualism”, which are associated with Aristotle. Walras is not judging who is right and who is wrong, but points out: “the theory of property must be in essence a moral science. ... If, therefore, any science espouses justice as its guiding principle, surely it must be the science of the distribution of social wealth, or, as we shall designate it, *social economics*.”(Walras, 1874)

Socialist ideas have been likable to many people at all times and countries. The principle, that a person can acquire wealth not only by work, but also from interest on capital has been considered unjust. From the other hand such a possibility has been acting as powerful motivating factor. The idea that the most talented, clever and diligent members of society should be remunerated for that, also seems to be fair.

Up to the XVIII century the existing economic model was neither capitalistic nor socialistic in a modern sense, as there was private property on capital goods, but as it was mainly physical capital, there did not existed significant flows of capital in a global and even national level. The Industrial revolution with its retinues – capital concentration, financial markets, economic growth and globalization (the latter with a delay of hundred years) created the economic model, which we know as capitalism, and the theoretical basis of which is the fundamental work of Adam Smith “An Inquiry into the Nature and Causes of the Wealth of Nations”, published in 1776, and being one of the signals of the new-coming era of capitalism.

The problem of globalization – why it was not a close satellite of development of capitalism in its first phase, but took its place only later - in the second phase, is thoroughly discussed in the paper of the famous Brazilian economist Celso Monteiro Furtado: “It is known that during a first period, enterprises in the nations that headed the Industrial Revolution forced the opening of external markets, which explains the imperialist offensive that occurred throughout the 19th century. Nevertheless, the true motor of that economic growth was not so much the dynamism of exports, but instead the amplification of internal markets, derived from the increased buying power of the wage earning population. ...The explanation for this historical picture is found in the advance of new social forces, which appear at the same time as the process of urbanization generated by industrialization itself. The evolution of the system of power, a consequence of the action of organized workers, carried with it the elevation of real salaries and obliged governments to adopt protectionist policies to defend their respective internal markets. In this fashion, and starting at that moment, the motor for growth was the amplification of the internal market, with a subsidiary contribution from exports.” (Furtado, 1999)

None of the serious thinkers, including Marxians and Marx himself, deny the qualitative changes in the existence of mankind, brought by the new economic system. It created a new basis for human development, scientific discoveries, improvements in people everyday lives, changing the world beyond recognition. Though nothing in this world is only positive and negative, and the new economic system, with all its benefits, brought also new problems, at first increasing social inequality, which encouraged people to seek improvements to the existing system, or a new, better system. Therefore the forward-looking ideas of Walras about social economics as a science, which is investigating the principles of providence and usefulness in distribution of goods, are very up-to-date and will be even more important in the future.

The events of the 20th century seem to have proved the socialist system to be less efficient than the economy driven by the market forces, and put the discussion to an end. But the example of the Soviet Union shows, that capitalism is better than a bad socialism. From this one it cannot be concluded that a good capitalism is certainly better than a good socialism. The events of the 21st century both in a global and local scale show that existing capitalism system has a lot of heavy problems. Cambridge professor Ha-Joon Chang discusses them in his book “23 Things They Don’t Tell You about Capitalism”, among which one can mention the growing inequality both

among nations and individuals inside the country, unjust principles of remuneration for different kinds of labor (laborers vs. managers, production vs. services, public sector vs. private sector), the problem of “impatient capital” as a result of too high efficiency of financial markets. (Chang, 2010) This goes hand in hand with the sensational speech of Nicolas Sarkozy in the World Economic Forum, where he mentioned: “The crisis we are experiencing is not a crisis of capitalism. It is a crisis of the denaturing of capitalism – a crisis linked to loss of the values and references that have always been the foundation of capitalism. Capitalism has always been inseparable from a system of values, a conception of civilization, an idea of mankind. Purely financial capitalism is a distortion, and we have seen the risks it involves for the world economy. But anti-capitalism is a dead end that is even worse. We can only save capitalism by rebuilding it, by restoring its moral dimension. I know that this expression will call forth many questions.” (Sarkozy, 2010)

Perhaps, that is the reason for the necessity to reconsider the basic principles of the possible models of economy. Almost of the great economists – Smith, Ricardo, Mill, Walras (previously quoted), Keynes, Schumpeter have pointed the necessity to reconsider the economic paradigm in the future. For our generation it may turn out to be not future, but present. To justify this, let us quote the last public speech of Schumpeter: “Marx was wrong in his diagnosis of the manner in which capitalist society would break down; he was not wrong in the prediction that it would break down eventually. The Stagnationists are wrong in their diagnosis of the reasons why the capitalist process should stagnate; they may still turn out to be right in their prognosis that it will stagnate - with sufficient help from the public sector.”(Schumpeter, 1950)

Keynes is less pessimistic as Schumpeter, when he says: “I see us free, therefore, to return to some of the most sure and certain principles of religion and traditional virtue-that avarice is a vice, that the exaction of usury is a misdemeanour, and the love of money is detestable, that those walk most truly in the paths of virtue and sane wisdom who take least thought for the morrow. We shall once more value ends above means and prefer the good to the useful. We shall honour those who can teach us how to pluck the hour and the day virtuously and well, the delightful people who are capable of taking direct enjoyment in things, the lilies of the field who toil not, neither do they spin. But beware! The time for all this is not yet. For at least another hundred years we must pretend to ourselves and to every one that fair is foul and foul is fair; for foul is useful and fair is not. Avarice and usury and precaution must be our gods for a little longer still.” (Keynes, 1930)

Anyway one can make a conclusion, that the possible escape route is the restoring of the moral dimension. Is it possible in the global world, and what are the alternatives? These are questions that are waiting for immediate answers.

Socialist Calculation Debate

One of the fundamental discussions about the theoretical possibility of a socialist model of economy is the problem of price setting for capital goods. As calculations in the capitalist system are based on market prices, the impossibility of calculations is not a threat in this case. But what about socialism, where capital goods belong to the society and are not subjected to market? Indeed, is it possible to use successfully in decision making plans, containing measurements in a monetary form, if they are based on prices, that are not set in the market and thus not adequate?

The discussion about the possibilities and efficiency of price setting in capitalism and socialism started in the beginning of the 20th century. The Italian economist, the successor of the school of Lausanne and ideas of Leon Walras – Enrico Barone claimed that the setting of adequate system price in socialism can be done at least as successfully as in capitalism, because prices can be considered as the solution of the equation set of the Walrasian general equilibrium theory. (Barone, 1908)

The discussion was continued by the Austrian economist, a follower of Marxian ideas, Otto Neurath. He mentioned that during the World War I governments of many European countries were carrying out “war economy”, providing high employment and avoiding business cycles. The goal of the governments was not to maximize aggregate monetary indicators of volume, but to satisfy the needs of state and society. Therefore Neurath made a conclusion that such an economy operates more efficiently than a market economy, at least in wartime conditions. Can it be the same in a peace-time? Even before the war Neurath considered possibility to create an economic system, which could successfully function without money. After the war Neurath considered a model of economy, which would provide objective needs of the society according the “war economy” model, but that “additional benefits”, i.e. goods and services, which are outside the necessities, should be produced in another sector of economy, where money will be on the basis of exchange. (Neurath, 1919)

These ideas of Neurath correspond with the approach of the Latvian economist Karl Ballod, mentioned in his „Ein Blick in Der Zukunftsstaat”. (Ballod, 1898) Ballod considered that the main goal of economy is to satisfy the basic needs of the people, which can not be identified with people’s desires. These needs can be calculated statistically. The economy of the country shall consist of two institutional sectors – public sector, which is not driven by the market forces, but acts as in the planned economy. The other – private sector deals with people’s desires, and is driven by the market forces.

The ideas of Neurath were taken with enthusiasm by German socialists Otto Bauer and Emil Lederer, who did not support the opinion of Neurath about getting rid of money, but agreed with Neurath, that the decision making in socialism is more efficient than in capitalism. The discussion was developed by American economists Fred M.Taylor, Abba P.Lerner, Polish economist Oskar Lange and British economists Maurice H.Dobb and Henry Douglas Dickinson.

The most prominent opposite point of view, containing a fundamental criticism of socialism, is expressed by Austrian economist Ludwig von Mises. He attacked the basic concept, arguing, that any indicator, that is measured in monetary terms is baseless, because it is impossible to determine the price of any commodity without the market based price system. “Without calculation, economic activity is impossible. Since under Socialism economic calculation is impossible, under Socialism there can be no economic activity in our sense of the word.” (Mises, 1920)

Oscar Lange offered a model for adequate price setting (Lange, 1938), later the model of adequate price setting was developed in the works of Leonid Kantorovich, “father” of Linear Programming, the only one of the Soviet Economists, who has received the Nobel Prize in Economics. The basic concept of Kantorovich was the notion of shadow prices, which show the price of a given resource at given prices of final products, i.e. marginal efficiencies of resources, and allows evaluating the costs of natural resources. In the end of the 30-ies orthodox Marxists considered the ideas of Kantorovich as an attack on the labor theory of value; therefore Kantorovich could publish his ideas only twenty years later, after the end of the Stalinism era. (Kantorovich, 1959) His disciple, Ivan Siroyezhin, developed these ideas. (Siroyezhin, 1980)

The response to the defenders of possibility to calculate adequate prices in socialism was given by the ideological successor of Mises, Friedrich Hayek, who argued, that the economic planner would need a terribly large amount of information to perform adequate calculations. Furthermore, there is no guarantee that individuals, who will take the decisions, will not be influenced by selfish interests, and even if not, their motivation will be less, than it would be if they were making decisions about their own property. This was strengthened by American economist James Buchanan: “The more significant criticism of socialist economic organization lies in the difficulties of choice-making. Even if the socialist state should somehow discover an oracle that would allow all calculations to be made perfectly, even if all preference functions are revealed, and even if all production functions are known with certainty, efficiency in allocation will emerge only if the effective decision-makers are converted into economic eunuchs. Only if

such men can be motivated to behave, to make decisions in accordance with cost criteria that are different from *their own*, can this decision-structure become workable.” (Buchanan, 1969)

Still, as one can see from the quote from Buchanan, in principle he does not deny the possibility of such calculations. The two problems, that for Hayek and Buchanan seem to be insolvable, are: 1) the problem of the terribly gigantic size of the model, 2) the problem of “economic eunuchs”, which hardly exist in the modern society. If these problems hypothetically could be solved in the future, there it may turn out a necessity to return to the socialist calculation debate. (Brivers, 2009)

Localization of Economy – is this a Third Way?

In present it becomes obvious, that the forecasts of the great economists are true, and more and more facts indicate the necessity to upgrade the capitalist model significantly or even to search for a new model. Financial innovations have spoiled the market mechanism. The innovative ideas in the speculative economy have destroyed the function of market economy, which equalizes the profitability of different businesses in a long run. Since the collapse of the Bretton Woods system, speculative economy has become more and more profitable, and the innovative ideas there have kept this profitability for more than 30 years, inhibiting investors and entrepreneurs from the real economy. Finally, the profitability of the speculative economy has collapsed with a blast. A possible alternate solution is to consider non-financial and financial capital separately. Non-financial capital is a private property, but financial capital – just the opposite, is only a public property. This item has been discussed in another paper of the author. (Brivers, 2014)

The way to find a new economic model, which is mainly based on a private property, being above all capitalistic, is the way of localization of economy. The basic idea of small economies versus big economies may be based on the concept of Ernest Schumacher. “When we move from small-scale to medium-scale, the connection between ownership and work already becomes attenuated; private enterprise tends to become impersonal and also a significant social factor in the locality; it may even assume more than local significance. ... In small-scale enterprise, private ownership is natural, fruitful, and just. ... In large-scale enterprise, private ownership is a fiction for the purpose of enabling functionless owners to live parasitically on the labor of others. It is not only unjust but also an irrational element which distorts all relationships within the enterprise.” (Schumacher, 1973) In this quotation Schumacher considers mainly the micro level, but the same idea, contained in the title of the book – “Small is beautiful: Economics as if People Mattered”, is applicable to the macro level as well. Indeed, as it has been broadly discussed, the present form of economy is such, that people matter less and less giving preference to figures and money.

Every nation must be able to develop on its own, without help from outside. All vital products must be produced within its own country. Only in this case the state can be truly independent. Any country whose economy is dependent on other countries is not only vulnerable to crises, but also can become a victim of various types of extortion. And vice versa - a truly independent country can build healthy trade relations with other countries by exchanging the surplus of production and specific products, but maintaining economic independence and without being under the yoke of debt.

The main benefit of such independent national states will be the possibility to strengthen the society by re-establishing the virtues, which will be based on true human values.

Localization does not mean elimination of international trade. On no account it means any restrictions for people travelling and cooperation; just the opposite – it requires more and more cooperation in a global scale. In local economics the present problems of capitalistic model will take place, but in a far much lesser extent. As it has been said in the film of the English author – economist Helena Norberg-Hodge “The Economics of Happiness” – there is only one economy

that has sense: it is local economy. We should localize our economic activities, our minds, our spirits. Not only “Buy local”, but also “Sell local” and “Act local” should be the basic principles of economy. At first we should stop the discrimination of the producers, who produce for the local market, avoiding direct and hidden subsidies for the exporters.

The decision making in a local level in most cases will be more effective, as it moves closer to the performer. Local food, local energies, local banking – these are the routes for the movement to local economies. These ideas become more and more popular in the world. Perhaps it may be the basis of the new capitalist economic model, where people matter, and money, economic growth, innovations, etc. are means, not the ends.

Conclusions

The discussion about two possible economic models – capitalism, associated mainly with the power of market, and socialism, associated mainly with power of government, has been the item of discussions between philosophers, economists and politicians since ancient times. The events of the 20th century have shown that the capitalistic model of economy has turned out to be victorious over the socialistic model. From the main distinction between the two models - the private or public property of the capital there turns out the problem of adequate price setting for capital goods in socialism. The discussion about possibility to set adequate prices otherwise as in market continued for more than half a century, and came to a conclusion, that it is not realistic. Still from the point of view of future and, if the problem is considered in a small economy, as in local economies, the insurmountable obstacles may turn out to be much smaller, and it may be useful to return to that discussion.

One of the most influential economists of the 19th century Leon Walras, when discussing the shortcomings and benefits of each economic model, did not make a final judgment, which one is the best. His suggestion was to develop the social economics as one of the main branches of economic science. In modern world social economics should take much more important place in economic science, research and study programs in the universities.

The present problems of the capitalism have increased significantly and need an immediate solution. The possible alternative, that may be considered either the way, how to upgrade the existing capitalist model, or the way, how to create a new, third economic model, is localization – creating small, self-sufficient economies, that should widely cooperate, but keep their independence. Local needs should come first, and people activities, minds and spirits should be closer to home. Both in micro and macro levels, and even in a household level, true friendship requires that both sides are not dependant each from other. The best economic model is, where economy no longer appears as an end itself, but as a means to an end, and the main goal of it is the happiness of the people – the economics of happiness.

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