

Siebert, Horst

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# Kieler Arbeitspapiere Kiel Working Papers

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**Principles of the Economic System  
in the Federal Republic -  
An Economist's View**

by

Horst Siebert

Weltwirtschaft  
Kiel

Institut für Weltwirtschaft an der Universität Kiel

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Kiel Institute of World Economics  
Düsternbrooker Weg 120  
2300 Kiel 1  
Federal Republic of Germany

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**Principles of the Economic System in the Federal Republic -  
An Economist's View\***

Horst Siebert  
Kiel Institute of World Economics

Germany's "social market economy" has its roots both in historical experience and in a value orientation centered around the individual. The immediate historical background is to be found in the years of an Orwellian dictatorship repressing individual tastes and individual behavior. Another aspect of the German experience was the interventionism of the state and the central planning mechanism that slowly developed in the late 19th century and became dominant in the war economies and in the thirties. The inflation of 1923, the repressed inflation of 1936-1948, the problem of the alienation of the worker in the 19th century and the endogenous erosion of competition through large firms also formed part of the historical background. The consensus of the founding fathers of the Grundgesetz was a value orientation stressing individual freedom, human dignity and the subsidiarity of societal organization.

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I appreciate comments from Klaus-Werner Schatz, Karl-Heinz Paqué and Holger Schmieding.

## 1. The Basic Principles

In this paper, we shall not study in detail the concept of the founding fathers of the social market economy (Müller-Armack 1966, 1978; Röpke 1958, 1963; Giersch 1960; Watrin 1979) and the system introduced in 1948. Instead, we shall mainly look at the social market economy in actual practice ("Verfassungswirklichkeit"); moreover, we are interested in the challenges the future holds.

### Individual Liberty

Due to the experience of having been under a dictatorship rule and in accordance with the constitutional history in Europe, the first articles of the Grundgesetz define the rights of the individual. The "dignity of man" (Art. 1), "inviolable and inalienable human rights" (Art. 1), "the right to the free development of one's personality" (Art. 2), "the right freely to express and to publish one's opinion by speech" (Art. 5), the "freedom of movement" (Art. 11), the "rights of ownership and inheritance" (Art. 14) and many other provisions show that the corner stone of the Grundgesetz is to respect the decisions of the individual. In terms of economics, the basic presumption of the Grundgesetz is that individual preferences should count, that it is for the individual to decide. One is free to choose what to consume, whether to consume or save, whether to work or enjoy leisure, which job to take, where to live, where to travel, and what to produce for someone else.

Basing the decisions on individual preferences implies confidence in the sovereignty of the individual. The individual is the best judge of his own affairs; he or she will weigh the benefits and costs of a decision, evaluate the risk associated with it and will have a strong incentive to obtain the relevant information for his or her choice.

mechanisms are not well understood? To see what is meant by  
The Competitive Order (1981) (pp. 11-12) to see what is meant

A system that is ultimately geared towards the preferences of the individual must have an institutional mechanism by which the individual can voice his preferences. The institutional vehicle is the market or a set of markets: the competitive order. If a market economy is established by an adequate institutional framework, the individual can vote with his purse and with his feet. By giving up income and by spending money on a specific product and not on alternative products, the individual clearly signals his opportunity costs and his marginal willingness to pay. By choosing one place to live and not another one, he indicates his willingness to pay for a specific location. By deciding how many hours to work or not to work, he indicates his evaluation of work and leisure. When these individual evaluations are summed up by the market, the value of a good from the point of view of the demand side is specified.

Economic decentralization not only refers to revealing the marginal willingness to pay. Markets also allow a decentralized autonomy of decisions on production and investment; they signal the incentives to produce. By expressing opportunity costs, i.e. the costs of an opportunity foregone, the market economy prevents inefficiency. Firms making a loss have to exit because their opportunity costs are too high: the resources could be used better elsewhere.

Information on economic and technical conditions is not ubiquitous in an economy but is distributed asymmetrically among the subsystems. Decentralization allows the utilization of comparative advantages in the generation and processing of information; it is an incentive to collect and reveal information.

The competitive order not only satisfies the conditions for static efficiency, it also provides for dynamic efficiency. Firms search for new technical knowledge and look for new possibilities for investments. Thus, markets are not only a mechanism to

disseminate a given set of information, they are an exploratory device in the sense of Hayek (1968) generating new knowledge.

The competitive order is not explicitly written down in the constitution. It may be questioned whether it is a principle<sup>1</sup> in its own right as stated by Eucken (1952, p. 254) who regards it as the only basic principle, or one may take the view that the competitive order is instrumental in allowing individual liberties. Decentralization allows personal choice and provides options. Thus, decentralization is part of an open society (Popper 1944). Still, other writers may link the competitive order to the overall target of efficiency (the economic principle).

### Equity

Besides giving freedom to the individual, the constitution also protects the individual. Thus, no one is allowed to violate the right of others (Art. 2); property imposes duties (Art. 14); and the Federal Republic is a "social federal state" ("Sozialer Bundesstaat", Art. 20). Equity enters other stipulations in the constitution such as preventing regional disparities in living conditions (Art. 72). De facto, there is a strong material protection of the individual, especially through a net of mandatory social insurance systems including unemployment, disability and old age insurance. The market as an allocation mechanism is corrected in order to attain results which are socially acceptable.

## 2. The Social Market Economy as an Economic Order

The principles of individual liberty, competitive order and equity do not yet fully specify the economic system of the Federal Republic. The "social market economy" must be understood as an institutional arrangement defining the rules for the decision making of households, firms, and the politicians, including the restraints as well as the incentives.

The Concept of Economic Order

Soziale Marktwirtschaft has to be interpreted as a specific form of a "Wirtschaftsordnung". It is an "ensemble", a frame of reference, a self-regulating system with the targets of individual freedom and choice, efficiency through decentralized autonomy in a competitive order and equity.

A "social market economy may be described as a permanent search for an economic and social framework, designed to encourage both an efficient production of the means of material well-being and personal freedom in a socially-balanced order" (Watrin 1979, p. 419).

An important strand has developed in the literature of institutional economics - that of the principal-agent paradigm, where the principal sets rules that influence the behavior of the agent, where the principal cannot fully observe the behavior of the agent, yet where the behavior of the agent determines the result of the activities. In a way, Wirtschaftsordnung is a super principal-agent contract. The principals are (i) the fathers of the constitution and (ii) the legislature when it has the appropriate majority for constitutional changes and the normal majority for other legislative alterations. To some extent, the judiciary plays the role of the principal when the rules are interpreted anew. The individuals (the households and the firms) are the agents that can behave according to the incentive structure and the institutional framework developed by the principal. The principal wants to reach its maximum in its targets of freedom, efficiency and equity, for instance by maximizing one target subject to restraints from the other targets. In an optimal solution, the principal will devise rules so that the optimality conditions of the agent are satisfied.

The description of the Wirtschaftsordnung as a super principal-agent problem is not yet complete. To some extent, the voter becomes the principal when he is discontent with the institutional conditions prevailing and when he wants a change. However, in contrast to specific policy areas, the rules of the



game require constancy and ought to change only under rare conditions. This is especially true for constitutional change.

"Denken in Ordnungen"

"Denken in Ordnungen" - to think in terms of an order was a central demand of the founding fathers of West Germany's social market economy. They were concerned with the question of how a small institutional change affects the overall system after all the households, all the firms and other agents such as the policy makers have reacted. In a cybernetic context, it is the question of how the system changes if the rules are slightly altered. This is analogous to the general equilibrium analysis for an institutional arrangement (see the concept of "market conformity" below). It seems to me that this concept of "Denken in Ordnungen" is not understood by many economists in the United States.

Hutchison (1981, p. 162) may come closest to the concept of *Wirtschaftsordnung* by distinguishing between a Ricardian and Smithian mode of the competitive market economy (Vanberg 1988, pp. 16 f.). The Ricardian concept stresses

"an abstract, purely economic model of competitive equilibrium presented as achieving some kind of Utopian <maximum> or <optimum>",

while the Smithian concept is

"formulated in much broader terms, comprehending the political and social order" (Hutchison 1979, p.433).

Economic policy in a social market economy has two distinct roles which are crucially different: to establish and preserve the economic order (*Ordnungspolitik*) and to influence economic processes (*Prozeßpolitik*). Prozeßpolitik attempts to modify the business cycle, growth and allocation in day-to-day or year-to-year or even longer-term operations, for instance in providing social overhead capital. Ordnungspolitik refers to the

establishment of property rights, of the incentive system, of the institutional arrangements and of the rules including the constitutional conditions. The Ordoliberalists who laid down the intellectual foundations of West Germany's economic order also argue that the main policy task is Ordnungspolitik, i.e. to establish the institutional arrangements for a market economy. Prozeßpolitik should be limited to special cases.

Eucken (1952) had developed the constituting principles of the competitive order. Open markets, nowadays the most important ingredient of the concept of contestable markets (Baumol et al. 1982), are a prerequisite for competition. Private ownership is both a guarantee of individual liberty and an incentive to minimize costs and to reveal truly economic information. Freedom of contract is conducive to competition. Liability ensures that social costs are internalized. The constancy of economic policy helps to prevent the intertemporal misallocation of resources, and price level stability (see below) is a sine qua non for the price mechanism to operate.

An economic order for the economy as a whole may be interpreted as consisting of separate partial orders for specific functional areas (order for the competitive process, monetary system, social order and labor market) or for specific policy areas (trade policy, business-cycle policy, agricultural policy). A basic issue is how these partial orders can be made consistent with each other (Eucken 1952, p. 304; Klotten 1989, p. 11). A related problem is how macro policies can be integrated into the order of a social market economy.<sup>2</sup>

The Social Market Economy as an institutional framework has a set of important requirements that have to be satisfied for the institutional framework to function. These conditions<sup>3</sup> are the system (market) conformity of policy measures, the defense of competition, price-level stability and the social order. These elements can only be understood with the historical experience of Germany prior to 1945.

Interventionism, Market Conformity and the Role of State

The German population in general and the intellectual fathers of the social market economy in particular had experienced an interventionist state, especially in the thirties and during the war. It was clear to the majority that a controlled economy - "une économie dirigée" -

"had produced an appalling amount of inefficiency" (Watrin 1979, p. 411).

Therefore, decentralization and a competitive order was called for.<sup>4</sup>

The interventionist experience of the twenties and the thirties had shown that one intervention would quickly lead to the next. This is especially true for price regulation, for example regulating the price of a standard loaf of bread would quickly spread like a cancer to all types of bread, including bagels and croissants, to the labor costs of the baker, to flour, to the milling process, to wheat, and all other inputs as well as substitutes for the product.<sup>5</sup> As we know from the present European agricultural policy, intervention cannot be partially confined to one specific product, but tends to have side effects which are seldom recognized *prima vista*.

A specific intervention may not only affect other markets (via the interdependence of markets by the potential for substitution and by complementarity), but intervention may also have an impact on the market system itself, changing the basic properties of the allocation mechanism. Therefore, the intellectual founding fathers of the Soziale Marktwirtschaft (Eucken, 1952; Müller-Armack, 1944, 1946; Röpke, 1942) demanded that policy actions should be compatible with the market economy ("marktkonform"): in a narrow interpretation, a policy decision should not induce such a change or disequilibrium in another market that a new intervention becomes necessary. In a broader sense, a policy measure should not change the property of the overall system.

It has proven extremely difficult to pinpoint the concept of market conformity. In a static view, one can quickly see how the regulation of one market shifts demand or supply to another market; but in intertemporal decisions such as the choice of a location, capital accumulation and the depletion of resources it takes a long time to see impacts. Moreover, the concept of market conformity is extremely difficult to define with respect to the impact on the system as a whole (system conformity). Finally, the concept

"does not provide a conclusive answer to the question as to what activities the state should fulfill in a free society and what decisions are reserved to the market" (Watrin 1979 p. 421).

A specific aspect of interventionism is the issue of the nationalization of basic industries. This was a prominent topic in the early days of West Germany, and although it occasionally flares up, it is not an issue any longer, partly due to the severe inefficiencies of those German firms which are supposed to have been oriented towards the common weal (Gemeinwirtschaft) in the last twenty years, and partly due to the experience in Eastern Europe.

Apart from the issue of interventionism, the state as a "Rechtsstaat" is restrained in its activities by a set of rules and procedures. It has been assigned the role of protecting individual liberty and of guaranteeing the institutional arrangement of the competitive order, for instance by competition policy (see below). Eucken (1952) and Miksch (1937) required a strong government that could defend the competitive order and suppress specific interests.<sup>6</sup> The state

"is assigned a crucial role in monitoring the proper functioning of the competitive process, which, if left alone, is believed to degenerate due to monopolistic tendencies and growing disproportions of private power" (Vanberg 1988, p. 19).

The state has the producing role according to Buchanan (1975, p. 68) of providing public goods (or rules for public goods as in environmental quality management). Moreover, the West German state has taken over a dominant role with respect to the equity targets, i.e. in the attempt to produce fairness.

With respect to the proper productive role of the state such as with public goods, the aggregation of individual preferences by the market is not possible (free rider), and a political aggregation mechanism has to substitute for the market process through voting. Voting is also applied when merit goods, for instance policy targets, are involved. In deciding on public and merit goods, a federal structure being based on the subsidiary principle allows the expression of regional preferences. Thus, economic decentralization is to some extent accompanied by political decentralization.

#### Endogenous Tendencies to Monopolies and a Framework for Competition

Competition is a necessary condition for an effective decentralization, but the spontaneity of the market may be endangered endogenously by the behavior of firms. Profit-maximizing firms can improve their position by reducing competition. They can form cartels and engage in other forms of cooperation in order to reduce competition; they can strive for a monopoly position by internal growth or can attain a monopolistic position by mergers. This was the experience in Germany in the three decades preceding World War I and at the time of the Weimar republic, reflected in the debate in the late 1920s and early 1930s (Mises 1926; Rüstow 1932; Hayek 1944). These potential endogenous tendencies would severely affect the institutional setting of a market economy; at the same time, firms could engage in rent seeking and attempts to influence the institutional arrangements under which they operated. Historically, the result was an industrial complex interlinked with the state ("Vermachtung" der Wirtschaft, Kloten 1989, p. 11).<sup>7</sup>

An important framework of the institutional arrangement of a social market economy is therefore competition policy. Its role is to guarantee that competition is not eroded endogenously by principally ruling out cartels, by controlling mergers and by surveilling the abuse of a monopolistic position. But other important aspects include free market entry to keep markets contestable and an open economy to allow competition from abroad.

### Inflationary Experience and the Independence of the Bundesbank

Germany has gone through two big inflations: the hyperinflation of 1923 and the repressed inflation from 1936-1948. Inflation generates severe repercussions from distorting allocation and especially from hurting those individuals with a fixed nominal income, for instance wage earners. Inflation can therefore be a danger to an economic system, it can lead to a political destabilization of society, and it violates the condition of constancy of economic policy. For these reasons, price-level stability is an important target of economic policy; the Bundesbank was institutionalized as an independent central bank. The government cannot monetize its budget deficit by taking recourse to the central bank.

These provisions are not part of the constitution, but of the Bundesbankgesetz. It is interesting to note that the actual position of the Bundesbank is not only defined by the legal rules but by a consensus in the population. This more or less holds for other aspects of the institutional system as well. If the consensus changes, the institutional setting may vary.

### The "Social Question" and the Social Order

The late 19th and the early 20th centuries in Europe were dominated by the social question. Industrialization, new forms of production, the migration from the countryside to the industrial locations gave rise to social problems. Socialist movements claimed to have found an answer to how economic efficiency and

progress and personal freedom could be obtained by the public ownership of means of production and central planning. The social ethics of the Catholic church centered on improving the conditions of human life. From this historical perspective, any economic system has to provide an answer to the social question, both from an ethical point of view and from a practical one. There must be some consensus on the economic system.

The experience with a central collectivist planning system in Europe was that such a system did not deliver the promises made: it did not protect the worker as an individual but rather it required an Orwellian-type control of the individual worker, for instance in limiting his choice of work place or controlling what type of work he did in order to allocate food stamps in a rationing system. Thus, introducing the market economy in 1948 was in itself a social reform. The system provided economic opportunities and choices.

Besides stressing this positive property of the market economy, the attribute "social" market economy refers to the basic position of at least some of the Ordoliberalists that the allocation process by markets may lead to an income and wealth distribution that warrants correction (Vanberg 1988, p. 20). An important aspect of this can be found in the social insurance schemes which were started in the 1880s and have been further developed in the 40 years of the Federal Republic. The "productive state" (Buchanan 1975, p. 68) has gained a more important role; moreover, the worker participated in economic growth - to wit the wage drift in the fifties and sixties - and he was integrated in economic terms by acquiring real (houses) and financial wealth. Finally, the issue of the position of the workman of the last century had changed. With 54.9 percent of the work force in service activities (including 20.1 percent in government) and only 40.1 in industry (Statistisches Bundesamt 1989), the social question of the 19th century has disappeared from the center of the stage.

### 3. Trends and Challenges: How do the Principles Work?

How has the social market economy performed in its 40 years? Can we recognize trends? Is there a slow erosion of the "social market order" (Bernholz 1979; Klump 1985; Tuchtfeldt 1973; Vanberg 1988?; Willgerodt 1988). Is the German economy still a social market economy (Kloten 1989, p. 14)? And what will be the challenges of the future?

#### Policy Targets

From a historical perspective, the social market economy has done well in generating products, in stimulating technical change and providing high rates of economic growth. At 8 percent, the growth rate of real GNP was high in the early fifties; it has come down to 3 percent in the late eighties (4 percent in the sixties, 3,5 percent in the seventies and a slump in the early eighties). The unemployment rate was originally high, but it was reduced quickly in the fifties and remained very low up to 1974, rising steadily thereafter to a high level of nearly 9 percent. Inflation was nonexistent in the fifties (except in 1951) and sixties, but it increased in the seventies and the early eighties.



**Table 1 - Macroeconomic Variables, Federal Republic of Germany  
(five-year average)**

	Real growth rate (GNP)	Unemployment rate	Inflation rate
1950-1954 <sup>a</sup>	8.7	8.5	2.0
1955-1959 <sup>a</sup>	6.0	3.8	1.9
1960-1964	4.6	0.9	2.7
1965-1969	4.0	1.2	2.1
1970-1974	3.0	1.3	6.1
1975-1979	3.9	4.4	3.7
1980-1984	1.0	7.0	4.3
1985-1989 <sup>b</sup>	2.8	8.8	1.0

<sup>a</sup>Excluding the Saar. - <sup>b</sup>Partly estimated.

Source: Deutsche Bundesbank (1975); Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (1988).

### External Shocks

A tremendous initial challenge was the inflow of 12 million refugees. Employment and housing had to be provided; infrastructure had to be supplied, and the refugees had to be integrated into society. Overall, the system fared pretty well. Another shock was provided by the two oil crises of the seventies, and though there were some voices not trusting the market, the market mechanism did pretty well in adjusting to this scarcity shock.

All in all, the Federal Republic underwent a stark change in its sectoral structure by strongly reducing employment in agriculture, by a continuous rise of the service activities and, since 1970, by a relative decline in manufacturing (Siebert 1989a). There is an overall consensus that the German economy, being heavily dependent on foreign trade, has to adjust to the changes in the world economy.

### The Conflict between the Principles

There is a broad range of problems where the basic principles of personal liberty, the competitive order and equity are in harmony. Thus, the competitive order is instrumental in allowing personal freedom and in contributing towards a solution to the social question. But there are problems where the basic principles are in conflict and where a balance between efficiency and equity has to be found. This problem of finding a balance is a continuous process, and the opportunity costs of solutions will become only apparent over time. Since it is an important issue, the overall features of the social market economy should not be destroyed. There are five areas where these overall features are challenged, namely through subsidies and distortions, the size of the government, regulation, rent seeking and specifically through social regulation.

Subsidies and Distortions. Sectorial adjustments have been dampened by subsidies for ailing industries like coal, shipbuilding, and steel. Subsidized sectors are typically characterized by a small number of firms, low growth, strong import penetration and a historically high level of protection. Most subsidized or protected sectors used to have a large number of employees (and voters), but today they are in fact quite capital intensive (mining, steel, shipbuilding, and even parts of textiles and clothing). Shielding workers from too strong structural adjustments is a specific motive, and rent-seeking is a good explanation.

In the coal industry, a work place is subsidized by 35,000 DM per annum (1986) which amounts to 57 percent of the average total labor costs per person employed in this industry (Kiel Institute of World Economics, own calculations). Subsidies have severely changed the position of individual firms, for instance subsidizing Arbed has severely affected the private producer Korf. They have distorted the sectoral structure and they have retarded the adjustment of sectors and whole regions. Their most detrimental impact has been to ward off the location of new industries, for instance by preventing lower wages in regions with ailing industries and by their impact on the planning of land use (Siebert 1989a). Politicians have not been courageous at all in reducing subsidies, and a sunset law for subsidies has never been tried.

A defensive sectoral policy for ailing sectors is not the only case of distortion. Industrial targeting may become the more relevant area. Politicians do not trust the market to develop new sectors, and they claim to know better in which sectors to place capital, including public funds. This appeal of strategic trade policy extends beyond subsidies. In the eyes of the European Commission, competition policy can be more generous vis-à-vis larger units if they fit into the strategic trade policy concepts.

Experience with promoting new sectors in Germany artificially, for instance subsidizing the development of nuclear plants and

larger computers, is disappointing. Cycles of interventionism have been observed in government activities, for instance in town planning (Siebert 1980, p. 368). There is no doubt that strategic trade policy is a threat to the market economy, because decentralized private decisions are substituted by a political process. Strategic trade theory seems to be so fascinating for the political area that the concept of "Wirtschaftsordnung" tends to move into the background.

The experience with subsidies is disillusioning. The amount of subsidies is high, being estimated at 133 bill DM for 1989, that is 5.9 percent of GNP (Kiel Institute of World Economics, own calculations) and not too far from the wage income tax receipts (182 bill DM, 1989), the most important single tax in Germany. The risk of the system as a whole is that specific interest groups may be able to dominate the state. An institutional check on subsidies and distortions would consist of clearly defining the role of government in a market economy, especially its allocative function to provide social overhead capital (technical infrastructure) and other public goods (basic research) as well as financing (taxation schemes). A compulsory depreciation rule for subsidies may be a powerful tool.

Privatization and the Role of Government. The share of government expenditures in GNP may be considered to be an indicator of the role of the government in a market economy. For the Federal Republic, it has moved around 48 percent in the last 15 years with a peak in 1982 (50 percent). In the late 1980s, there was a small decline. A large part (18.5 percentage points) is made up of the social security system with an increasing upwards trend.

Public enterprises are mainly engaged in electricities, gas, water, local and urban transportation services, railways, communication, residential construction and some areas of manufacturing. They account for 7 percent of employment and roughly 15 percent of gross investment in the Federal Republic of Germany (Europäischer Zentralverband der öffentlichen Wirtschaft 1987, pp. 35, 37). The privatization of public firms has been rather timid.

Constitutional checks on the size of government, on governmental expenditures or on financing may be the appropriate answer to the tendency of the government to take over a larger role in a market economy.

Regulation. Regulation of industry and services has occurred in many areas, namely in all sectors that have received exemptions from the German antitrust law (Gesetz gegen Wettbewerbsbeschränkungen), agriculture, the coal and the iron industry, banking and insurance, transportation and communication (including the postal service and public electricity, gas and water utilities). Moreover, regulations apply to environmental protection and to many other aspects such as the health system and information media (Donges and Schatz 1986).

The basic feature of regulation is to exclude competition and to limit market access. It has been estimated that, measured in terms of value added, roughly 50 percent of the German economy is severely regulated (Donges and Schatz 1986, pp. 26 f). In order to prevent excessive profits from being gained out of the monopolistic position created by regulation, in some important cases the setting of prices is also controlled. In many cases, however, the right of a restricted market entry is given away for free, for instance when limited emission rights are de facto granted at a zero price.

Arguments for regulation are natural monopolies, protection of the consumer and the internalization of externalities. The basic question is to what extent these arguments are valid and to what extent regulation really is in the interest of the individual. Besides the primary effects of higher prices due to reduced competition, regulation tends to have side effects that may not be apparent at a first glance. For instance, the German regulation of trucking has increased the comparative advantage of Dutch truckers and has shifted locational advantage away from the North German ports. Moreover, regulation of trucking, for instance forbidding market entry to the trucking division of producing firms or cabotage rules for foreign truckers, generates

excess traffic which is not consistent with energy conservation or environmental protection.

One way out would be to auction off access rights whenever these rights can be linked to quantities, for instance auctioning off emission rights, the right to participate in a stock exchange, and the right to provide a transportation service. The other way out is explicitly to allow market access. This is especially important in the light of new concepts of competition such as contestable markets. Europe '92 may be a way to improve market access.

A challenge for the market economy will be to revise the exemptions from the German antitrust law. In banking and insurance, the protection of the customer (Anlegerschutz, Gläubigerschutz) should not be attained by limiting market access. Stock exchanges should be opened to more competition. In the case of the postal service we see a modest structural change including a more open market in final products. In electricity, new property rights for common carriers will have to be developed to allow competition. Finally, in the transportation sector, deregulation is possible in trucking and in airlines (Donges and Schatz 1986; Soltwedel et al. 1986). In all these areas and in other regulated fields (coal, steel, crafts) a huge potential for deregulation exists.

Rent-seeking. Subsidies may be controlled by sunset laws, and excessive government expenditures may be checked by rules of financing. Competition policy is the answer to an endogenous tendency to encroach upon competition by establishing noncompetitive market positions. What is the institutional response to rent-seeking by which the frame of reference for private decisions is altered and by which partial orders are politicized? Linked to this issue of rent-seeking is the problem of economic power and of vested interests (Kloten 1989, p. 15). Apparently, a systematic institutional check on rent-seeking does not exist. Competition policy of the traditional type, relating to positions in the relevant market, is not the adequate answer. Guaranteeing free market access in order to keep markets contestable is an important step against rent-seeking. But it

does not seem to be a sufficient institutional safeguard because rents are determined by many factors including favorable institutional (legal) conditions of operation. To think in terms of an economic order - "Denken in Ordnungen" - may be a guarantee against special interests of subgroups of society and against rent-seeking - but there may be some indications that this philosophy is losing ground (Kloten 1989, p. 15).

Protection of the Individual versus Flexibility. The regulation of the labor market has its roots in the intention to protect the individual. Labor market regulation consists of three basic aspects: (i) governmental insurance schemes if people are unemployed (ill, disabled and retired), (ii) lay-off restraints, and (iii) the delegation of bargaining for the wage contract to the employer's and employee's organizations with the bargaining solution de facto becoming law and being mandatory for all employees, including trade union non-members ("Allgemeinverbindlichkeit").

This system of regulation implicitly defines the incentives to supply and demand labor. The incentives work in the direction of reducing the demand for labor and uncoupling employment and growth as well as investment and employment. This is a deficiency of the system.<sup>8</sup> As is the case for any insurance, social insurance gives rise to moral hazard behavior of those insured. Lay-off restraints explicitly define exit conditions and implicitly stipulate entry conditions by influencing the demand for labor (Siebert 1989b). Generalized wage bargaining allowing an organizational integration of the employees prevents a differentiation of wages according to occupation, sectors and regions. Moreover, the three types of regulation interact with each other. For instance, social security and lay-off regulations define the bargaining position of the trade unions.

Besides problems of moral hazard behavior, a regulating system protecting the individual may also give rise to a different attitude of individuals: they expect individual protection from the government and the regulatory system, and they tend to think

in terms of aspirations against the government. There is a trade-off between the insider and the outsider, but much more important, there is a trade-off between individual protection and the open society characterized by Popper (1944, p. 174) as

"competition for status among its members".

Definitely, there is a conflict between individual protection and the efficiency or flexibility of the system. This is possibly best documented in the discussion on the closing hours of stores (Ladenschlußgesetz). On the whole, politicians have not been courageous in allowing or initiating more flexibility.

Erosion of the Market Mechanism. Subsidies for ailing and new industries, some forms of regulation, rent-seeking and the reduced flexibility in the labor market point out that the market mechanism is being endogenously eroded in a slow process. From hindsight such a process may have been checked better if the market economy had been explicitly laid down in the Basic Law. Not having such a constitutional anchor, the legal system has been indifferent to the problem of "Marktkonformität" with respect to the system as a whole. Here is an open question: "Denken in Ordnungen" may not be sufficient as a defense.<sup>9</sup>

#### Institutional Competition versus European Centralization

The institutional framework of Germany's social market economy will be affected by European integration, especially by the Single Market. There is a consensus to enter the Single market, but there is also some awareness that European integration may change the rules of the game. A little bit reminiscent of the discussion in the 1960s on the role of "planification", there is a debate on whether the institutional setting for Europe has to be defined centrally in Brussels or whether it can be delegated to a process of institutional competition.



Institutional competition means that different national institutional arrangements can exist simultaneously in a single market and that the rules of the country of origin (for a product or a service) are mutually recognized. The implication of institutional competition is the arbitrage of consumers and firms. Consumers vote with their purses and their feet and firms take advantage of differentials in national regulations. Countries compete for the mobile factors of production, and the emerging institutional setting is the result of an open-ended process. The most important impact of institutional competition will be to open up markets that so far have been closed due to national regulation.

The conflict between the strategies of institutional competition versus prior harmonization is an expression of a more deeper conflict of orientation: on a constitutional level, it is the conflict of federalism versus centralization. On a philosophical level, it is the conflict between liberalism in the classical or British sense versus a more planning-oriented approach. We here have diverging views on such issues as confidence in the functioning of markets or any type of interventionism, sovereignty of the consumer or the need for his or her "protection", the role and the size of the government, spontaneity of autonomous decision making and decentralized processes versus constructivism, or the English case law versus the logic of the Roman law. Europe is in a search of its institutions, and the showdown between the British and the French concept of Europe is still to come.

### Nature and Environment

A fascinating issue is how the institutional system has dealt with the challenge of environmental disruption which was not recognized until the early 1970s. In terms of the economist, the environment became to be perceived as a scarce good being used for the competitive uses of consumption and of receiving wastes. For our analysis it does not matter whether preferences for environmental quality have changed or whether the demand for the assimilative services of the environment has increased. There was

a shock to the system, not exogenous as in the oil crisis, but endogenous.

Institutionally, the system reacted by attempting to create new property rights for the use of the environment as a waste receptacle and by signalling environmental scarcity to the subsystems of the economy. New laws for air quality management (Bundesimmissionsschutzgesetz, TA Luft, Abwasserabgabengesetz etc.) were introduced in the early 1970s and revised in the mid-1980s. Admittedly, these laws predominantly used the regulatory (licencing) approach to the environmental issue, but a debate has been going on in 1989 on institutional arrangements for environmental incentives. A new institutional arrangement has to be developed which puts a greater emphasis on price instruments. There is also the issue of a constitutional amendment with respect to the environment. I think one can be confident that the institutional arrangement can be changed to accommodate the environmental problem.

A challenge for an institutional setting is how it accommodates the vital interest of future generations (Siebert 1980). In the case of capital accumulation this issue can be left to private decisions. The value of a capital good can be sold by the generation retiring from production to the next generation. For the environment, new property rights have to be found that take the interest of future generations into account. The accumulation of pollutants over a time period of ten or twenty years in the environmental system has to be reflected in the price system. It will be a special challenge to the social market economy how strict irreversibilities will be incorporated into an institutional framework allowing a preventive environmental policy.

#### 4. Conclusions

Looking back over forty years of Soziale Marktwirtschaft, the system has fared pretty well. It has allowed economic well-being, individual autonomy and an ample net of social security. It was

not questioned by public opinion in Germany after having been accepted by the major parties. In a time of an Orwellian crisis of socialist planning in Eastern Europe, the relative merit of the social market economy is all but too apparent. As a matter of fact, the concept of social market economy with its principles may provide an orientation for the east European countries in their search for a better institutional setting for their economies. Institutional competition in Europe, if it is allowed to come into being, will be an invigorating stimulus for the system.

The social market economy has reacted as well to external shocks as to the inflow of refugees and the energy crises, and one can be confident that the environmental issue can be integrated into the system. What is now of concern is that the system will be slowly eroded endogenously by subsidies for ailing industries and by strategic trade and industry policy, by regulations favoring specific interests, by rent-seeking, by the inflexibilities in the labor market and by the conflict between a political demand to be secured by government and the overall necessity to have an open society allowing individual liberty.

Footnotes

- <sup>1</sup>Germans tend to become very "grundsätzlich" on terms. For Eucken (1952, p. 252) a principle was a basic demand as a guide to action, not the goal itself.
- <sup>2</sup>See the discussion in the 1960s (Kloten 1989, pp. 12, 13).
- <sup>3</sup>I do not quite follow Eucken's four regulating principles. His fourth problem, namely inverse supply reaction, is not a major issue. His third problem that prices correctly reflect scarcity is a dominating issue (see section on Nature and Environment, p. 22).
- <sup>4</sup>In the early years of the Federal Republic strong political forces favored a centralization and some type of central planning.
- <sup>5</sup>If you do not like the old-fashioned example, look for natural gas price regulations in the United States in the 1970s and 1980s and some phenomena in trade policy such as upgrading or local content rules as a consequence of quantitative restrictions.
- <sup>6</sup>"Es erwies sich, daß die Gewährung von Freiheit eine Gefahr für die Freiheit werden kann, wenn sie die Bildung privater Macht ermöglicht, daß zwar außerordentliche Energien durch sie geweckt werden, aber daß diese Energien auch freiheitszerstörend wirken können" (Eucken 1952, p. 53).
- <sup>7</sup>The problem of political power (Macht) was a central issue to the Ordoliberalists (Eucken 1952, p. 169).
- <sup>8</sup>"In der Sozialordnung gibt es zahlreiche, damals unterschätzte, sich später als schwerwiegend erweisende konstruktive Mängel" (Kloten 1989, p. 12).
- <sup>9</sup>Possibly, fiscal federalism both in a spatial and a functional interpretation is an answer. By linking taxation and government financing to the supply of public goods the voter can see what the government is providing. This relates to the regional dimension of public goods (and financing) where regions decide on their public goods and the financing. It refers to the splitting up of some government services (railroads, postal services) into an infrastructure company owning the tracks or telephone lines and operating companies which can be private. And it also implies a financing through user charges wherever possible.

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