Walter Eucken`s Principles of Economic Policy Today

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Abstract

Walter Eucken was the head of the Freiburg school of economics, a circle of German ordoliberal scholars of the interwar period, whose thoughts were highly influential in the immediate post war period. Being disillusioned by what he called the "age of experiments"- the failure of both classical liberalism and socialism - he formulated eleven principles for what he called a market economy, in which competition would not only limit the extent of private economic power, but also lead to an efficient allocation of resources and hence to economic prosperity. Although the principles never received much international attention, in light of recent economic research on both institutions and welfare economics, the essence of Eucken's work appears to be very modern indeed. This paper highlights these parallels and proposes a reformulation of Eucken`s principles against the background of modern economic theory. We thus attempt to make a contribution to the current debate on the efficient design of those institutions that shape economic activity.

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Introduction

After being named the sick man of Europe at the turn of the millennium (Sinn, 2003, p. 13), Germany seems to have become the economic powerhouse of Europe. Unlike most other developed economies, its unemployment rate only increased by a relatively small margin during the recent financial turmoil. Given the high export share exceeding 30 percent in Germany and, hence, the strong adverse impact of the decline in world trade on GDP, this German "*Jobwunder*" was rather astounding. Miracles are however comparably rare in economics, so it makes sense to search for some better explanation for this outstanding success. The IMF (2011a, p. 6) attributes the German labor market performance to several factors; among them are not only the "Hartz IV" reforms, but also the flexibility incorporated into collective labor agreements, e. g. work-time accounts, and the subsidy for reduced work-time hours (Kurzarbeit). Moreover, the IMF (2011a) estimates that German GDP will rise by three percent in 2011. Against the background of the problems in Greece, Ireland and the United States, German policy-makers might feel less inclined to continue with structural reforms. The long-term growth prospects are, however, much less impressive, with potential output growth estimated at between 1¼ and 1½ percent (IMF, 2011a, p. 5). Hence, Ashok Mody of the IMF's European Department concludes that Germany is experiencing a robust cyclical recovery, but not yet evidently much more than that (IMF 2011b). Therefore, Germany needs to continue on its path of structural reform if it wants to boost growth and economic prosperity in the years to come.

But what kind of reforms should one envision? Given the controversy about the previous labor market reforms, any fundamental reshaping of the institutions that make up the German economic system will most likely meet strong resistance if it is perceived to be unfair. If faced with a perceived choice between economic equality and efficiency, the majority of Germans appear to be willing to sacrifice the latter for the former. This is not a new dilemma. After the Second World War, the German neoliberals – with Ludwig Erhard being their most prominent and powerful figure – were faced with a similar choice, albeit with the threat of Marxism looming large. Their solution – generally speaking – was a concept called the Social Market Economy (SME) which strove to combine core elements of market competition with a considerable degree of social policy and hence public consensus. Historically in its theoretical conception, it was closely related to the political and economic philosophy of Ordoliberalism as developed by a group of protestant economists and lawyers in the 1930s, the so-called Freiburg school with Walter Eucken acting as the intellectual leader (Goldschmidt and Wohlgemuth, 2008).

However, no widely-accepted ideological body of ordoliberal thought such as in the case of Marxism ever existed, but rather a collection of scholarly and political writings that were loosely connected to each other in their attempt to find a middle way between a 'laissez-faire' market economy and planned economy (Goldschmidt and Wohlgemuth, 2008, p. 264). Still, one unifying element of all SME writings is the emphasis on competition as a public good that needs to be safeguarded against private economic power. In its practical implementation after the Second World War, the distributive and corporative elements within the German economy played a much larger role than originally intended by Germany´s first minister of economics, Ludwig Erhard (Wehler, 2008, p. 75 and 133). For example, he opposed Konrad Adenauer's pension reform that raised retirement benefits by a considerable margin. Other labor market institutions specific to Germany, like worker's participation in both operational management and in the boards of management, originated from the powerful role of unions, which were thus integrated in the new economic and social order. Consequently, a mixed system prevailed, more accurately described as Rhenish Capitalism. This system lacked a consistent theoretical background and incorporated various strands of thought – such as those of the catholic social school or those of social democrats – and existing institutions. Nevertheless, despite its shortcomings and the lack of a consistent theoretical foundation, the SME proved extremely successful in the years from 1948 to the mid-1960s, thereby founding the myth of the "*Wirtschaftswunder*" (Wehler, 2008, p. 74).

Beginning in the early 1970s, the degree of regulation in Germany's SME continually increased with rising public expenditure shares and state intervention. However, in the early 1980s, the liberal idea was reestablished by substantial deregulation and liberalization, e.g. in the telecommunication, energy and transport sector. However, many of these were half-heartedly implemented with serious unintended consequences. For example, the transformation of the German railway authorities into a publicly-owned joint stock company did little to improve quality and punctuality. Moreover, given its political influence as one of Germany's biggest corporations, it has so far been successful at keeping the legal barriers to competition intact, as for example the ban on national bus lines. Most importantly, it has succeeded in keeping the operation of the network under its control, which allows the Deutsche Bahn to effectively restrain competition. Similar things could be said about the energy sector. Thus, the so called 'neo liberal' policies of the 1980s and beyond failed to deliver results and created in many cases privately owned monopolies.

After reunification, when the recovery of the former Eastern Germany from socialism required much more time than originally anticipated, various liberalizations in capital markets in the mid-2000s were implemented – with disastrous consequences as prudent regulation and oversight were abandoned in favor of a doctrine of regulation via 'market discipline', which failed utterly in the aftermath of Lehman. This liberalization was accompanied with a substantial deregulation of labor markets. In addition, the system of unemployment insurance was reformed substantially by the so-called Hartz-reforms, named after the head of the relevant round-table commission at that time.[1] Particularly for those unemployed who need not to care for children, the incentives to work rose substantially, and new forms of part time labor and temporary employment emerged. Large parts of the German job miracle were certainly due to these reforms, although the larger part of the

[1] See Wurzel (2006) who investigated the German labour market reform. Atkinson and Micklewright (1991) show, that higher transfer to unemployed increase duration of unemployment. A general survey of labour market intervention delivers Heckman et al (1999).

population paid for them with stagnating real incomes. Worse, while real incomes at the top rose substantially, the real wage of unskilled labor even decreased. Thus, it is no wonder that many Germans express massive doubts about the legitimacy and effectiveness of the SME at the beginning of the 21st century.

Hence, the German version of the SME inevitably requires further adjustment to meet challenges that became apparent only decades after the model came into existence: globalization, ecological overstressing, demographic change and evolving social values and expectations to name a few. Probably driven by the prospect of reelection, postwar German governments of any color have increased social security and tried to redistribute income via taxation, while neglecting the institutional design of the economy as outlined above. Hence, while the state played an ever more active role in economic activity, a growing inequality in income and social participation persisted. Much of this inequality was due to serious defects in institutional design, such as the widespread lack of liability, the continued existence of monopolies and the continuous pressure of private lobby groups on political decision-making. Such an economic order is not only unjust from a liberal perspective, it is also grossly inefficient. Therefore, the key task for policy makers in the 21st century is to redesign those parts of the economic, legal and political institutions which have given rise to economic and political rent seeking and thus have contributed to the growing perception of social inequality.

Of course, a simple ´back to the roots` approach based on a faithful exegesis of the existing ordoliberal thought is not enough to tackle today’s problems. For example, the goal of economic policy in the 21st century cannot lie in achieving more material welfare alone. While the founding fathers of the SME emphasized the importance of non-material goods such as political stability and public consensus, current debates increasingly revolve around fostering well-being and enabling broad political participation as well as social mobility and inclusion. Despite the fact that the Freiburg School emerged out of the German context, many other countries, particularly the Nordic states, have developed characteristics of a modern SME through their own historical developments and therefore have further experience to contribute to the debate. Therefore, in order to assess the merits of the idea of the SME in the world of today, one has to broaden the scope in several respects. Consequently we try to determine how the original concepts from the 1930s can be translated and transformed in light of modern economic and political science. These are the key questions which we tackle in the following.

The rest of the paper is organized as follows. In Section (2), the fundamental ordoliberal concept according to the Freiburger school and its modifications by Alfred Müller Armack and others are briefly described. Section (3) attempts to translate the concept of SME into modern economic terms and suggests some deficiencies and modifications from the view of both modern economics and the current beyond GDP debate. Section (4) discusses possible measures of the main principles of a modern version of the SME and comments on their assessment from the normative view of ordoliberalism. Section (6) is devoted to concluding remarks.

Historical Background: SME and the Ordoliberal School

The German ordoliberals of the interwar period were an informal group of academic economists and lawyers who tried to find a “third way” between pure liberalism and socialism. Intellectually headed by Walter Eucken, other prominent members were Franz Böhm, Leonhard Miksch, Wilhelm Röpke and Alexander Rüstow at that time. Although no official program existed and their views differed in some respects, Eucken`s writings undoubtedly stand out as the most comprehensive and from an economic standpoint the best founded basis of ordoliberal thought (Müller, 2007, p. 101). His research question, which all ordoliberal authors of the time shared, albeit with different answers, was: ‘How can modern industrialized economy and society be organized in a human and efficient way?’ (Eucken, 1951, p. 27). His principles, which will be discussed below, constitute his comprehensive answer. However, the solution to the problem of what needs to be done automatically led him to a second problem. Who was to implement and safe-guard such an ‘order’ against organized group interest? This is the question Eucken struggles with in his principles and which even he fails to answer satisfactorily.

Walter Eucken, son of Nobel Price-winner in Literature Rudolf Eucken, grew up in an extraordinarily literate social background and studied history, public sciences, economics and law. His main works, “The foundations of political economy” (1939) and “Principles of economic policy” (1952, posthumously),[2] were originally published exclusively in German and only became available in English in 1950 and 1952, respectively. Unfortunately, having been invited by Hayek to give three lectures at the London School of Economics in 1950, he died of a heart attack before having finished the last lecture (which was then given by A. Peacock the next day).[3] Another obstacle for a better acknowledgement of his thought in modern economics is his informal methodology together with his broad scope and philosophical approach, which renders his work difficult to formalize. This is all the more regrettable, because unlike other members of the school, Eucken was an exceptionally clear economic thinker who explicitly abhorred what he called ´pure word economists’ (“Begriffsnationalökonomen”, see Grossekettler 2010, p. 296).

All ordoliberals in a wider sense agreed on the notion that a truly liberal economy was not given per se, but required careful institutional design. With reference to the political sphere, the need for a constitutional system of checks and balances in democratic society had been widely accepted since the time of Montesquieu. They argued in favor of a fixed set of rules for economic activity that would limit private economic power. Indeed, they argued that

[2]

[3] The Lectures were then published posthumously (Eucken, 1951).

political freedom would prove impossible as long as economic order would grant some individuals power over others (Yeager, 2005, p. 508). Thus, scholars of the History of Economic Thought have classified ordoliberal thought as the German idiosyncratic strand of the wider neo-liberal movement of the time, the Freiburg school being it's most prominent and comprehensive body of thought. Interestingly, and contrary to public perception, in many respects close links exist to the Austrian school of economics, in particular to Hayek, who directly followed Eucken as the department chair in Freiburg. However, essentially, Eucken´s concept was less evolutionary than Hayek's and put much more emphasis on a strong, although liberally-oriented state. The ordo-label stems from the identically named German journal which was founded by Eucken and Böhm 1948 and is still the house magazine of their modern successors. Because articles in ORDO are published in German only, the school's recognition abroad was substantially lower than it was in Germany, where it has also significantly declined in recent years.[4] At the time being, there is an intense debate in Germany about the future of ordoliberal thinking in the light of its insignificance in international mainstream economics.

Given that many members of the school were either actively involved in the resistance against the Nazis or went into exile, they were politically unsuspicious in the immediate post war period when the Allies were looking for German economists. Hence, they became sought-after advisors and played a big role in shaping the postwar economic order in Germany. For example, Eucken and Mikitsch were both working in what was to become the Ministry of Economic Affairs, and were close advisors to Ludwig Ehrhard (1897-1977), Germany's first Minister of Economic Affairs and Adenauer's successor as chancellor. Moreover, Alfred Müller-Armack (1901-1978), professor of economics and later State Secretary in the Ministry of Economic Affairs who coined the term SME in 1946, referred extensively to ordoliberal scholars. Above all, he embraced their key notion that competition and hence a market economy required careful institutional design. However, Müller-Armack disagreed with Eucken in one important aspect. While Eucken argued that a truly competitive market economy would automatically lead to social justice because income would be distributed according to merit,[5] Müller-Armack emphasized the need for a much stronger policy of income redistribution and social security. Thus, Eucken's work is only a part, although an important one, of the original theoretical concept of SME as advocated by Müller-Armack and Erhard. Moreover, there are considerable differences between the theoretical concept and the implemented economic system of the postwar years (Goldschmidt and Wohlgemuth, 2008). Finally, the slogan of SME has been used widely in the political and public sphere as to give legitimacy to political parties and decisions. Interestingly, nearly all political parties, but also private interest groups, have used the slogan in their favor, which testifies to its integrating power in the public arena and also to

[4] A comprehensive review of the ordoliberal school in English can be found in the articles by H. Peukert (2000), C. Watrin (2000) and K.W. Nörr (2000) in P. Koslowski (2000)

[5] This is not to say that Eucken argued against social security as such. For example, he saw the need to care for the elderly and disabled who are not able to earn their living on the labour market. His emphasis however was on establishing a competitive order, the outcome of which he saw as efficient.

its lack of intellectual consistency. Thus, we believe that Eucken's principles depicting the core of the market element of the SME offer the only consistent and comprehensive starting point for an articulation of a modern SME today. Given the current turmoil on financial markets, this acutely needed reformulation finds relevance not only in Germany, but among an international audience as well.

The Ordoliberal Freiburg Concept of a Market Economy

The essence of the Freiburg strand of ordoliberalism lies in what Eucken deemed the constitutive (K) and regulative (R) principles of a market economy in his work of 1952 (see Table I).[6]

Table I: Eucken`s Original Set of Principles

K1	Functioning price system
K2	Primacy of the monetary order
K3	Open markets
K4	Private property
K5	Freedom of contract
K6	Liability
K7	Continuity of Economic Policy
R1	Antitrust Policy
R2	Income Policy
R3	Correction of Externalities
R4	Correction of anomalous labor supply

The seven constitutive principles can be briefly described as follows:

(1) A *functioning price system* of perfect competition. This presents the fundamental principle according to Eucken. He regarded a decentralized market structure a prerequisite of a well-functioning price system in contrast to Austrian dynamic concepts of competition advanced by Hayek and Schumpeter.

(2) By *primacy of the monetary order* Eucken has mainly the stability of the value of currency in mind. Eucken`s idea on this issue was a commodity-bundle standard instead of the gold-standard and a 100% reserve requirement for banks, i.e. a combination of the plans by Graham (1937) and Simons (1948).

[6] The English translation is borrowed from Peukert (2000, p. 122).

(3) *Open markets* mean the absence of prohibitive tariffs and other restrictions on free trade, and also any form of anticompetitive measures to protect “the home market, e.g. by predatory pricing against outsiders or even by suggestive advertisement.

(4) *Private property* is meant by Eucken mainly as a means of power distribution which must, however, be bound by competition.

(5) *Freedom of contract* is proposed only to the extent that it is compatible with perfect competition, e.g. as long as it does not support cartels or any other abusive practice.

(6) The principle of *liability* addresses in particular corporate law. Eucken´s radical view on this issue was that the majority stockholders should be fully liable.

(7) *Continuity of economic policy* means that the latter should be both reliable and predictable for market participants (Grossekettler 2010, 324).

The constitutional principles are complemented by four regulative principles (Peukert 2000, p. 124):

(1) *Antitrust policy* according to Eucken should be conducted by a public agency which should ideally dissolve monopolies or at least control their market behavior. This proposal led to the German law against barriers to competition in 1957.

(2) Eucken explicitly associated *Income policy* with a progressive income tax which he favored both for distributional and efficiency reasons (the latter because it dampens the production of luxury goods and thus gives room for more investment).

(3) *Correction of externalities* is mainly discussed by Eucken in ecological terms, pointing among others to the destruction of North American woods.

(4) *Correction of anomalous labor supply* means regulations on the length of the working day and other protective measures of workers, in particular of children and women.

Eucken`s work remained unique in spite of many valuable contributions of later ordoliberal writers. The concept was modified substantially after World War II by Müller-Armack and Erhard, who implemented it in German economic policy against vigorous opposition, namely by the unions. They modified the concept of a social market economy to allow for both “market conform” interventions and active business cycle policy, and to place a much stronger weight on welfare policy including, *inter alia*, social housing policy, pension and health policy and family aid policy. It was now widely acknowledged that welfare policy should go beyond simple income redistribution, including, for example, substantial labor protection.

However, the further development of the social market economy was more eclectic and policy-driven rather than following a well-defined conception. By contrast, in the light of modern economic theory, Eucken`s original contribution turns out to be particularly attractive. It not only anticipates important ideas like the concept of time inconsistency and the principal agent problem, but also forms a consistent set of interdependent institutions, without any of which the entire concept would become invalid; only the interplay of the entire set of principles comprises his model of an ideal market economy.

Sixty years have passed since Eucken`s Principles from 1952 were published. The world has changed a great deal since then, and so have individual behavior and social values. Therefore, in order to fairly assess Eucken`s ideas in a modern setting, one has to vet their fundamental content and verify whether they remain relevant and appropriate today.

Elements of a Responsible Market Economy

To begin with, for a modern interpretation, it does not make much sense to maintain Eucken´s distinction between constitutive and regulative principles. By contrast, contemporary institutional economics covers both general rules and procedures. Moreover, some of Eucken´s principles are quite closely related to each other, so their number can be reduced.

Moreover, many things have changed substantially since Eucken and the other proponents of ordoliberalism wrote. First, economic theory has made some progress, not least due to rigorous empirical and experimental testing methods which were not available at Eucken`s time. Second, while many economic and social problems of Eucken's time persist until today, new challenges like globalization and scarceness of non-renewable resources have emerged. Last but not least, social values have changed substantially, in particular with respect to the importance assigned to economic growth and both the definition and relative weight of social justice. Some of the principles have also to be modified or broadened substantially in scope.

In particular, we suggest rearranging them in the following way:

(1) Open markets, competition, and market prices all refer to decentralized allocation decisions in a competitive system. Thus they can be summarized as the general principle of *competitive market allocation*. Unlike Eucken`s narrow yardstick of perfect competition, the concept should now refer to modern competition theory.[7]

(2) Analogously, the principles of private property, freedom of contract, and liability can be headed by the general principle of a *framework for efficient property rights*. Here the results of both welfare economics and modern institutional economics, concerning e.g. the principal agent problem, are taken into consideration. The internalization of externalities can also partly be subsumed under this heading since, in general, internalization works through generating property rights in order to create a price for the externality.

[7] See, for example, Tirole (1988) and Carlton and Perloff (2005).

(3) There is also a close link between consistency of policy, primacy of currency policy, and the ecological issue (the latter being tackled by Eucken under the heading of externalities). All of these principles refer to *sustainability* in the sense of long term oriented behavior. This problem is also discussed under the heading of time consistency in contemporary economics.

(4) Finally, Eucken`s regulative principles of income policy and correction for "anomalous labor supply" are both special causes of the large field of welfare policy, including the legal constitution of the labor market. In contrast to Eucken`s time, these issues are no longer discussed in terms of mere income support measures today, but in the much broader context of *social inclusion*.

Hence we are left with only four instead of the original eleven principles of ordoliberalism for what now may best be called a Responsible Market Economy (see Table II).

Table II: Eucken`s Principles Rearranged and Consolidated

<table>
<tr><td>K1</td><td>Efficient Price System</td><td rowspan="3">1) Competitive Market Allocation</td></tr>
<tr><td>K3</td><td>Open Markets</td></tr>
<tr><td>R1</td><td>Competition</td></tr>
<tr><td>K4</td><td>Private Property</td><td rowspan="3">2) Framework for Efficient Property Rights</td></tr>
<tr><td>K5</td><td>Freedom of contract</td></tr>
<tr><td>K6</td><td>Liability</td></tr>
<tr><td>R3</td><td>Correction of Externalities</td><td rowspan="3">3) Economic and Ecological Sustainability</td></tr>
<tr><td>K7</td><td>Sustainable Rules</td></tr>
<tr><td>K2</td><td>Financial Stability</td></tr>
<tr><td>R2</td><td>Social Inclusion</td><td rowspan="2">4) Social Inclusion</td></tr>
<tr><td>R4</td><td>Effective Labor Markets</td></tr>
</table>

Before going into detail, it must be stressed that neither economic theory nor social values are undisputed issues. On the contrary, divergence concerning these matters is hardly less today than it was at Eucken`s time, even among economists. So any statement of fundamental economic principles requires a clear focus, which must be normative by definition. It makes sense to assess the principles stated above from the point of view of those whose ideas they refer to, i.e. from the viewpoint of a modern, ordoliberal economist. This does not mean, of course, that they could not be disputed or even be principally dismissed from proponents of divergent economic perspectives. The more important issue is, however, that these principles are consistent both with each other and with the state of contemporary economic theory.

Competitive market allocation

To start with, what are the core elements and the merits of the first principle, called *competitive market allocation* above? For an economist, this may be more or less self-evident. Vast literature, both theoretical and empirical, treats this question.[8] Leaving apart specific problems like externalities and asymmetrical information, economists widely agree on the general application of the so-called first theorem of welfare economics. According to this theorem, the competitive market solution generally ensures a Paretian solution of the allocation problem, i.e. within given endowments, the welfare of one cannot be improved without reducing the welfare of someone else.[9] Although the theorem is only derived from mainly static, abstract economic models, it is also supported, in principle, by more dynamic concepts of competition theory.[10] Admittedly, there are a lot of different views on particular problems like natural and morphological monopolies, the efficiency of oligopolies, or the relevance of market structure versus market behavior. In essence, however, there is widespread agreement that decentralized units with a minimum of market power should make allocation decisions, and that public interventions should generally favor more rather than less competition. Hayek[11] famously made the even more fundamental point that the core problem of allocation is the aggregation of vast amounts of information, dispersed among millions of decentralized market participants, which can never be elicited by any public agency.

What practical implications can be derived from this discussion? In general, one has to define a set of rules that would ensure that competition prevails over any form of concentrated market power, whether private or public. To achieve this, the ordoliberal concept covers three requirements, namely open markets, a competitive price system, and effective legislation against monopolies, cartels and abuse of market power. The last element distinguishes the concept of ordoliberalism from simple laissez faire liberalism (Peukert 2000).

A competitive price system does not only rule out private market power and price-agreements, but also price controls and related interventions except in the presence of market failures e.g. externalities. In particular, this notion rejects minimum and maximum

[8] See Mas-Colell (1995) and the literature cited there in.
[9] See, for example, Mas-Colell et al. (1995), chapter 10.
[10] The gap between theory and reality, especially the issue of imperfect information, is discussed by Stiglitz (2002).
[11] Although Hayek was not a member of the original ordoliberal school and proposed a more fundamentally liberal view, he was quite close to Eucken in many respects. Hayek held two times a chair in Freiburg and was even appointed as a president emeritus of the Eucken Institute in 1978. For more on their relations see Pies (2001).

prices in order to pursue distributional goals. The reason for this rejection is twofold: First, such interventions would destroy the informational content of prices and, hence, the efficiency of allocation. Second, price interventions are not carefully targeted with respect to the social problem, because they benefit also those who are not really in need. Consequently, the preferred ordoliberal instrument for social targets consists of income policy rather than price intervention.

Open markets, in particular free trade and international factor mobility, present another component of competition. In light of economic theory, the former can be a substitute for the latter, although an imperfect one. The problem with competition from abroad lies in the fact that its restriction in many cases carries advantages for the home country, or at least for some pressure groups there. On the other hand, from a global and long-run point of view, open markets are the much better option in most cases. In other words, open markets have a public good character, and can therefore only be preserved by international agreements like GATT and WTO.

Concerning monopoly and cartel legislation, there are quite different approaches in practice, depending on the underlying concept of competition. For the same reason, it is not easy to measure the degree of competitiveness in most markets. A natural monopoly under substantial pressure from substitute goods may act more competitively than a firm within a stable oligopoly, for example. Moreover, prices need not be competitive or even low when they equal unit costs, because the latter may be artificially inflated. So the relevant information concerning competition is less the market structure or market results than the prevailing market power, which can be measured by various concepts.

Efficient Property Rights

The second principle, called *Framework for efficient property rights* above, is also at the very heart of ordoliberal thought. In particular, private property is seen as an essential for both efficiency and liberty. In contrast to Aristotle and the catholic social school, it is not derived from natural rights, but mainly established because of division of power and the positive incentives generated thereby (Peukert 2000, 123). Without private property all firms would finally belong to the state ruling out genuine competition. Moreover, common property generates externalities which would interfere with both an efficient allocation and social freedom. With common property, the natural incentives for investment, maintenance, and careful use must be substituted by law, thereby creating both bureaucracy and permanent quarrel about personal rights and obligations. In the 1930s, a famous debate took place, with mainly Ludwig von Mises opposing Oskar Lange and Abba P. Lerner, concerning the option of competitive socialism. Both theoretical arguments and empirical evidence in former Yugoslavia finally demonstrated that the combination of decentralized allocation decisions and common property (with centralized investment and public price control) does not really work.[12]

However, private property is only a necessary, but not a sufficient requirement for efficient property rights. Efficient property rights also call for a minimum degree of freedom of contract, in line with the notion of liability. As a striking example, the recent financial crisis arose not least because liberalization of financial markets had not been backed by a respective tightening of liability rules, in particular for managers and consultants. In this respect, Eucken was even skeptical of private limited companies, because of the principal agent problem as it is called in modern institutional economics today.[13] Admittedly, it is not easy at all to design a set of rules that balance the need for liability against the willingness to take risk, which is also essential for a market economy. Presumably, the huge investments which are needed in a modern industrial economy would have never been made by small and medium enterprises without limitation of liability. On the other hand, many misguided investments and spectacular crashes could also have been avoided.

Concerning modern economics, broad literature exists on this issue, both in terms of (game)-theory and empirical evidence. Among others, this research has resulted in both practical rules for good governance and the design of principal-agent relations.[14] From a modern economic point of view, the question is no longer if but under which conditions to allow for decision-making by people who do not directly bear the respective risks and costs. One should note that this problem is at least as much of an issue in the public sector as it is in private firms.

Another important element of property rights is legal certainty. Without protection of investors (including intellectual property) and the rule of law even properly defined property rights cannot work because of lacking enforceability. This also applies in the case of corruption, because the latter implies a violation of existing property rights by definition. Legal certainty is also a precondition for economic confidence, in particular concerning foreign direct investment and savings.

The problem of externalities is their separation of the power of decision from liability, which is a core requirement of efficiency.[15] Thus, in general, the existence of externalities – regardless of whether negative or positive - leads to a failure of the first theorem of welfare economics. Important examples are environment pollution and the free use of limited natural resources. While in politics the common answer to these problems is civil and regulatory law, economists generally prefer market instruments in order to internalize the externalities. The reason is that the optimal level of consumption of resources is generally above zero, but depends on the opportunity costs of prevention or substitution respectively. However, these opportunity costs cannot be known by any political institution but could be

[12] A modern view on all aspects surrounding property rights can be found in Segal and Whinston (forthcoming).
[13] A very comprehensive overview of principal agent problems within firms is provided by Prendergast (1999).
[14] The literature on Corporate Governance is extensively covered in Shleifer and Vishny (1997).
[15] The classic reference on externalities is Coase (1937). See also Laffont (2008).

better detected by market mechanism.[16] Thus the natural solution would be installing appropriate instruments like CO2 emission certificates or green taxes in order to make market players take into account the true costs generated by their decisions.[17]

Although well-founded in the theory of welfare, market instruments in environmental policy are often opposed in politics. The reasons include both the difficulty of measuring, in particular, potential and future, long-term externality costs as well as distributive arguments, as the internalization of external costs would imply higher prices of the respective goods. As a result, in reality direct interventions like prohibitions and regulations are frequently preferred above market instruments.

The ordoliberal criticism of this tendency is threefold: First, it is a threat of individual freedom. Second, this policy is unfair because it tend to discriminate between activities which involve the same amount of externalities. Third, market instruments along with direct distributional measures could achieve the same degree of environment protection at lower opportunity costs and voluntary degrees of redistribution.

Externalities do not only occur in the use of environment and free resources, but are also identified in many other fields of modern economic theory. For example, the too-big-to-fail problem with financial institutions can be seen as a negative externality in analogy to a fire hazard, as it was already recognized by Adam Smith. Positive externalities may arise from education and R&D (e.g. knowledge spillovers to the rest of the economy), which is frequently taken as an argument for subsidizing these activities. While this is a valid argument in theory, ordoliberals are mostly skeptical about the practical feasibility, because the respective externalities are neither easy to quantify nor can substantial bandwagon effects be ruled out. This does not mean that respective subsidies could not pay off, but there are good arguments that they should, in principle, be restricted to obvious cases where private incentives are clearly too weak.

It should also be noted on this occasion that even in theoretical welfare economics, not all externalities need internalization. In particular, when internalization does not change behavior substantially (like e.g. in the case of cigarette taxes), the externalities are not Pareto-relevant but have distributional effects. Thus, taking into account the resulting transaction costs, bandwagon effects and bureaucracy, in many cases internalization would not improve but even damage welfare. This theoretical argument corresponds with the general ordoliberal concern that a too high degree of public intervention could undermine individual freedom to an inappropriate degree.

[16] This problem is discussed in the basic paper of Baumol and Oates (1971).
[17] Endres and Finus (2002) illustrate in their paper, that quotas may be superior to tax agreements.

Economic and Ecological Sustainability

Continuity and reliability of economic policy is a precondition for confidence of both investors and foreign trading partners. Without confidence in turn, there will be less investment, less gains from trade and, hence, less welfare and growth than would be otherwise possible. To a certain degree, there is an overlap with the efficient property rights principle, because investor protection, rule of law and absence of corruption are also core elements of economic reliability and sustainability. However, economic reliability would imply much more than efficient property rights. First and foremost, legislation should give investors and taxpayers a reliable basis for their decisions and, therefore, must not be changed substantially within a too short period of time. This is not easy to achieve, because it is often in governmental interest to change incentives ex post when benefits have already been reaped and the costs in terms of loss of reputation and confidence can be rolled over to future generations of politicians.[18] [19] In other words, problems of time-inconsistent policies are lastly the result of an intergenerational externality which can only be overcome by long-term rules or meta-rules which a simple majority cannot easily alter. This also applies to the ecological issue, which is a key matter of sustainability. Generally, sustainability does not result from good will but requires appropriate institutional incentive arrangements like pollution taxes, the independence of central banks or constitutional brakes to public expenses or debt taking.

Other important elements of economic sustainability are the stability of both financial and political institutions, steady savings and education levels and a balanced foreign account, the latter meaning that it also forms a long-run equilibrium. However, there are neither undisputed definitions nor obvious measures for these quite sophisticated requirements. Therefore, in order to make them operational, one has to rely on more or less arbitrary considerations and figures that, in themselves, are of only secondary importance and related to that which one actually seeks to measure

For example, it seems natural that a relatively high level of equity of both industrial and financial firms is more sustainable with respect to financial stability than excessive debt taking. Again, there is an overlap with the property rights issue because equity is also preferable in terms of liability. Furthermore the share of both real investment and human capital investment should ensure at least the current standard of living in the future. Concerning the current account, there is no simple sustainability rule, because a deficit can either reflect lacking competitiveness or attractive investment opportunities or both. However, high volatility of the current account and/or the exchange rate could point to non-sustainable international relations of the respective economy.

[18] A prime example of this kind of government behavior is the area of capital taxation. Governments have incentives to set low capital tax rates to attract firms ex ante. Ex post, i.e. after they have made their investment decision firms are (partly) locked in if it is costly to relocate their business, which could give governments an incentive to raise taxes.

[19] The problem of time inconsistencies was first formulated by Nobel Prize winners Kydland and Prescott (1977). Their insight and the subsequent literature are summarized in Klein (2009).

Social Inclusion

Among all ordoliberal principles, the social issue is undoubtedly the one which has changed the most since the days of Eucken. Being more or less a concession to hardships at that time, social inclusion and participation are now defined much more broadly, including cultural participation and substantial legal entitlements instead of mere existential relief. In a way, this tendency is self-enforcing, because the more people gain a substantial part of their income from non-market sources, the stronger their potential as a pressure group becomes. This may present one reason why Ludwig Erhard`s prediction that the importance of the social question would decline with inclining wealth turned out to be completely false.

On the other hand, it is also true that pure alleviation of economic hardships proves insufficient for reducing inequality and achieving equal opportunities in society. In particular, social mobility can only be improved if all children have a fair chance to develop their abilities, independently from the social status and ethnic background of their family. Although the ordoliberals of the Freiburg school did not particularly stress this point, they would undoubtedly agree to it today, not least because better education generally goes along with positive externalities in favor of more growth and higher welfare for the economy as a whole.[20]

A much trickier point is the level of income inequality which a modern society is willing to tolerate. Neither economic theory nor empirical research can provide a clear recommendation on this issue. Nevertheless, from an ordoliberal point of view, the more crucial question concerns the appropriate instruments for distributional goals. As was argued above, interventions into the market mechanism are generally assessed as suboptimal. Ordoliberals would generally prefer indirect measures, in particular those that improve the ability of recipients to improve their own situation and overcome the necessity of relying on the state for subsistence. Indeed, Eucken explicitly mentioned self-help and the subsidiary principle as complements to his main principles (Grossekettler 2010, 324). Apart from education, important examples are policies that impose work requirements on recipients as e.g. the EITC in the US or the German "Kombilohn" or other workfare measures instead of unconditional benefits. The goal to promote self-help naturally limits the extent of redistribution, as sufficient incentives for self-help must be preserved. On this point, ordoliberals and the catholic social school fully agree.

Concerning labor market constitution, again no simple formula exists. In principle, ordoliberal economists are skeptical about wage cartels and all the more about minimum wages by law, because in both cases the competitive equilibrium wage is suspended. On the other hand, even Eucken recognized the possibility of exceptions to this rule, for instance if

[20] See Lange and Topel (2006) and the literature cited there in.

anomalous labor supply would result in an unstable equilibrium or unacceptably low wages from a social point of view.

In modern labor market analysis, many more reasons are discussed for market interventions, including monopsonistic labor demand, discrimination, informational asymmetries and efficiency wages. There is also widespread political consensus that unions should be allowed to monopolize wage bargaining on the labor supply side, and that strikes ought to be allowed to enforce their claims. Moreover, workers' respective. union representatives participate substantially in both economic and political decisions in many countries, up to codetermination on equal terms, as for example in German supervisory boards. Despite often considerable economic costs that such regulations generate, it would hardly be possible to eliminate codetermination arrangements due purely to political considerations.

Again, the ordoliberal view emphasizes balanced institutional design. For example, given the union privileges, it is important that there a countervailing power exists on the labor demand side and that a certain bargaining culture ensures fair and amicably achieved agreements. Concerning labor market policy, the activation of the unemployed is certainly preferable to purely passive measures like early retirement or generous benefits. Analogously, labor protection legislation should be fair and give no incentives for abuse or saturation. Possible indications of inappropriate rules could be excessive strikes or pervasive lawsuits. One also has to consider that trade unions represent mainly the interests of those who are employed. In tendency, they are less interested in reducing the unemployment rate, because this could come at the cost of lower wage increases. Thus, a permanently high unemployment rate could also suggest some misalignment of either labor market legislation or the wage bargaining process.

Summary

A common feature of the principles discussed above is the strong preference for general rules, both in the market and for the public sector. The ultimate reason can be interpreted in terms of game theory: Without binding rules, time inconsistent decisions and lack of reliability would lead to myopic behavior which would damage efficiency and hence welfare in the long run. A second general concern of ordoliberalism is the unity of decision power and liability. This concern also underlies the deep skepticism of public interventions, because politicians and bureaucrats neither bear personal responsibility for what they decide nor do they have a particularly long-term perspective.

Similar concerns apply to salaried managers, in particular in companies with limited liability. These concerns are indeed strongly supported by modern institutional economics, including the theories of bureaucracy and political economy.[21] In a way, every political market

[21] For an economic perspective on bureaucracy, see Dixit (2002).

intervention converts private in public goods, to a certain degree at least. This not only weakens the power of market incentives, but is also likely to result in political quarrel where, in the end, the maximization of votes will prevail over the maximization of common welfare. In particular, minorities suffer the risk of being completely ignored or even exploited, while in the market process they can pursue their interests in the same way as everyone else, within the limits of their endowment at least. In this way, a political element innately exists in ordoliberalism, which ultimately cannot be separated from economic reasoning.

It is also important to note that the ordoliberal principles are seen as an entity, which cannot be broken off in order to select only those elements which seem convenient. For example, the market mechanism cannot work properly in order to reduce unemployment if wages are fixed at too high of a level or if welfare policy weakens the incentives of the unemployed to find a new job. Analogously, competition between firms fails to guarantee efficiency if within the firms' decision-making power, authority and liability are separated. At the same time, the market mechanism cannot survive if a fair chance does not exist for anyone who is willing to participate in the market place to reap the benefits of his effort. Last but not least, in the ordoliberal view, a free society requires a liberal economy and vice versa. Eucken himself called this the interdependency of constitution.

In this light, the appropriate question is not whether some elements of the ordoliberal concept are good or bad in one respect or the other, but if the concept as a whole can keep its promise to foster a wealthy, responsible and free society. This is what is to be investigated in subsequent research.

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