

## ***Freedom and Order for more Justice***

*"Self-responsibility, personal initiative, and private property are some of the essential traits of social market economy. This social order reconciles personal freedom, equal opportunities, and growing wealth with the social progress generated by employment. Practising social market economy may be defined as the effort to link freedom and order, and consequently achieve a greater degree of justice".*

**Ludwig Erhard**

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## **Introduction**

Social market economy is not a clear-cut, utopian design of a society. It is rather a concept that is open to innovative thoughts and changes. In Germany, the past 50 years of economic policy have been characterised by social market economy and its principles have been taken up by numerous other European countries.

Under the intellectual influence of the Freiburg School (school of economic thought, founded at the University of Freiburg in the 1930s) Konrad Adenauer (1876-1967), the first German Federal Chancellor, and Ludwig Erhard, his Federal Economics Minister introduced social market economy into the post war society of Germany. Indebted to the legacy and tradition of this great chancellor, Konrad-Adenauer-Stiftung has made social market economy a cornerstone of its endeavours.

The present introduction is meant to serve as a basis for the further education of both internal employees and external partners of Konrad-Adenauer-Stiftung. Its aim is to give a better comprehension of the conception of social market economy, particularly to persons with a non-economic background. The publication, therefore, will also be a useful supplement to the "Lexikon Soziale Marktwirtschaft von A bis Z" (Encyclopaedia of Social Market Economy from A to Z).

## Table of Contents

### **Foreword by Kristina Köhler, Member of the German Bundestag (Federal Assembly)**

Freedom and Responsibility – Economic Governance in Social Market Economy.....p.5

### **Part I**

#### **Social Market Economy:**

**How does it influence the International Work of Konrad-Adenauer-Stiftung.....p.9**

### **Part II**

**Economic Governance in Social Market Economy.....p.11**

1. Historic Foundations.....p.11
2. Principles of Social Market Economy.....p.14
  - a. Human Being / Individual
  - b. Freedom
  - c. Responsibility
  - d. Performance
  - e. Order
  - f. Public Welfare
  - g. Subsidiarity
  - h. Solidarity
  - i. Justice
3. Social and Economic Prerequisites for a Social Market Economy.....p.17
  - a. Competitive Order
  - b. Market System and Free Access to the Markets
  - c. Private Property
  - d. Freedom of Contract
  - e. Rule of Law
  - f. Regular and Steady Economic Policy
  - g. Monetary Stability
  - h. State Intervention in Case of Market Failure
  - i. Social Balance
4. Roles of the Individual Agents and Areas of Responsibility of Economic Policy.....p.22

### **Part III**

#### **Issues from the Arab World and Approaches of How to Solve Them**

**According to the Rules of Social Market Economy** .....p.25

1. Values in Economic and Social Systems: An Arab View
2. Germany's Social Market Economy: A Development Model for the Arab world?
3. Regulatory Policy: Indispensable tool for the Developing Economies of the Arab World
4. Social Partnership: How to combine Freedom and Security?
5. Performance and Reward in the Arab World
6. Monetary Policy and Economic Stability
7. Competition Laws: Distortion of Competition in the Arab Economies and Consequences on Economic Development
8. Solidarity and Subsidiarity: A Basis for Social Peace in the Arab World?
9. Exchange Rate Policy in Arab Countries: Walking a Tightrope between Free Play of Exchange Rates and Monetary Stability

### **Bibliography**

**Foreword by Kristina Köhler, Member of the German Bundestag**

**Freedom and Responsibility**

**Economic Governance in Social Market Economy**

*Speech held at the presentation of the French translation of the encyclopaedia "Soziale Marktwirtschaft", in Tunis, Tunisia, July 12 2007*

Imagine somebody wanted to sell you a book explaining how you can become a millionaire overnight. You would reasonably expect this to be a sham. You might be interested, though, if the book told the story of the vendor himself who did make a fortune from next to nothing - and who left it to you to draw the proper conclusions.

The "Lexikon Soziale Marktwirtschaft" (Encyclopaedia of Social Market Economy from A to Z), whose French and Arabic versions have recently been published, does not contain any entertaining rags-to-riches stories: it is not about stories at all, it is about information and analysis. Yet, the very matter-of-fact essays on "Economic Policy from A to Z" also stand for a success story: the success story of a country that, after the Second World War, virtually lay in ruins and managed to become one of the richest countries in the world.

Those looking for an instant recipe for a successful economic policy will not find one in this encyclopaedia. However, the undiminished interest in the book goes to prove that the "Lexikon Soziale Marktwirtschaft" may well serve as the basis for a dialogue on economic governance.

It therefore makes sense to acquaint you with this economic and social order which is structured along market economic principles. After all, in the post war years, the Christian Democratic Party CDU contributed significantly to the establishment of an overall economic order.

Our topic is "Freedom and Responsibility - Economic Governance in Social Market Economy". These terms constitute two values which, taken by

themselves, would provide for a whole evening's discussion.

"Freedom" and "Responsibility" can never be taken out of their cultural context.

Let me therefore begin with the concept of the human being which is placed at the centre of social market economy and which I as a Christian democrat (along with many other Germans) feel committed to. As might be expected, social market economy may also be approved of or legitimised by other concepts of the human being or other attitudes towards life.

**I.**

Our decision for social market economy is based on the conviction that each individual person has a right to develop his/her own personality and at the same time be responsible for fellow humans and for the community. This concept of the human being is the source of our basic values of freedom, solidarity, and justice.

One of the founding fathers of social market economy, Ludwig Erhard, then economics minister of CDU, gave a reason for his support of social market economy. This reason has not lost its validity until today. According to Erhard, the inherent meaning of social market economy is to combine the principle of freedom on the market with the principle of social balance and the individual's ethic responsibility for the common good.

Have we really achieved this goal with the help of social market economy?

Let's look at the facts. Firstly, Germany is not only one of the richest countries in the world, it is also one of the most caring. Those unable to care for themselves due to age, illness or unemployment are entitled to the basic goods of daily life.

These include food and shelter as well as excellent medical care. Surprisingly enough, they also include items that, at the time of the introduction of social market economy, were considered luxury goods for

the privileged such as television sets or refrigerators.

Secondly, the growing wealth in Germany benefited all social classes not just the rich and influential. In Eastern Germany, where social market economy was rejected in favour of a state-run planned economy, only the mighty were granted such perquisites as a great variety of food or a car of their own. Things that in the market economy of Western Germany were available for the average worker or employee soon after the war.

Is that an economic miracle? I wouldn't think so!

The growing prosperity for all and the stable social net were the result of the West Germans' decision for the market and competition in a system where the individual, either as a customer or as an entrepreneur, has one goal: to pursue his/her own interest.

## **II.**

Culture and concrete aims in economic policy may vary in our countries, but there is one point we all agree upon: an economic system can only be efficient, if it serves the needs of the humans in general, not only the strong and the proficient but also the needy and the weak.

However, market economy means competition. Offering something that somebody else wants and is prepared to pay for will lead to success in competition.

The precondition for the functioning of this principle is a regulatory framework. We have to define rules for competition. They are the cornerstones upon which market economy is built. The principle of supply and demand does not work without the right of property, a reliable legal system, and the freedom of trade.

Economic policy has to establish conditions and procure the frame within which suppliers and demanders of goods and services may realise their potential and take their own decisions.

Under the relevant conditions those persons are rewarded who supply the better product, the better service, in other words, who comply best with the demand. This principle of supply and demand works mercilessly:

The supplier who offers bad quality, lacks innovation, or is simply too expensive, will lose his customers to his competitors or, in the worst case, will go bankrupt and have to dismiss his employees. This is one side of the coin.

The competition which exerts pressure on the supply side offers great freedom on the demand side. That's the other side of the coin. Customers have a great freedom of options thanks to the competitive environment of businesses. They can select from a wide range of choice and pick whatever is most suitable for their needs. It's up to the customers to decide what they want to spend their money on.

Freedom of choice thus becomes the driving force behind the economic order. This driving force generates high performance.

It also acts as a catalyst for businesses to outsource jobs to other countries, to replace men by machines in order to produce more efficiently and at cheaper costs. The same freedom people appreciate as customers may threaten them as workers or employees.

Let's take agriculture as an example: in the past century, Germany lost 90% of its jobs in agriculture because more and more often the farmers' hard physical labour was replaced by modern machines. A tough blow fate had dealt the people concerned:

Suddenly, they had become redundant. They were not able to make a living to support their families with. As a result, many had to move to the cities in the hope of finding work there.

Looking back, we realise that life expectancy, income, and living standard have greatly improved since so many people stopped doing hard physical work. We are aware of the fact that machines have raised productivity. We know that job destruction in

agriculture has freed energy for success in other areas that otherwise would not have been possible.

The Austrian economist Joseph Schumpeter described the ambivalence toward this steady change of structures in a market economy as a "process of creative destruction". The term highlights that both – emergence and disappearance – cannot be separated from each other, particularly in times when businesses have to withstand global competition. The "creative destruction" will always entail adaptation pains but is mandatory in the efforts to remain competitive on an international level.

This is as far as principles go. In practice, governments tend to interfere with market economy in times of structural change and transformation by beginning to subsidise and regulate sectors and industries which are not competitive anymore. They do so in order to prevent these industries from collapsing and thus, supposedly, to secure jobs.

The same happened in Germany. The Germans too, willingly accept the advantages of a market society but call for the helping hand of the state, if competition becomes rough. We all wish to buy at favourable prices, but we complain about the loss of jobs, when companies move their factories to Asia in order to lower production costs.

Both these facts are connected. You cannot want one thing and reject the other, but this is something that has to be explained repeatedly. Even in Germany. Even after 60 years of market economy.

### **III.**

Some may think that freedom is all very well but wonder, whether it is worth to have a freedom that exposes humans to so many risks, threatens jobs, and calls for adaptations to the requirements of the markets. What kind of freedom is it that rewards the performers and increases their wealth? What use is the freedom to be able to choose from 50 different types of mobile phones, if you have just lost your job? Could it be that this freedom is just the freedom of the strong, of those who know how to profit from the market and competition? Didn't we

agree upon the fact that an economic system has to serve the needs of the weak and the poor as well?

In Germany too, this question is discussed over and over again and nobody seriously denies that competition promotes disparity and distributes wealth unequally.

However, the alternative is not equal distribution of wealth. The alternative is equal distribution of hardship. That is exactly the reason why the market economy particularly benefits the weak and the poor because an unequal society where everybody, also the poor are slightly better off is better than a society where everybody is equally underprivileged.

What exactly is the use of a system of market economy for the disadvantaged?

First of all, there is the chance to participate. The market does not know any discrimination on the grounds of social background. The guiding principle is that the better may win. So, everyone has the chance to make his way up and acquire prosperity by using his own resources. Globalisation is a convincing example of how competition and participation are related: all those countries which gained access to world markets were able to increase their wealth and thus have more people participate in it.

The precondition for this improvement is education. Education is crucial for those who want to profit from the chances of competition and want to become free, independent, and responsible for their own life.

It goes without saying that there will always be those who, for whatever reasons, are not able to fend for themselves. They too, will profit from a system of market economy because only this system guarantees the economic success, necessary in the first place, to finance the social benefits to the deprived of a society.

Social benefits include the redistribution of income by means of taxes, subsidies, and wage-determined contributions to social security, as well as pension schemes and protection from unemployment or disability.

In a society where the strong are supposed to support the weak, circumstances have to provide the strong with the freedom to become as successful as possible. This is only feasible with a regulatory framework. The state itself doesn't have anything to give, let's be very straight about that. It is the high-income persons who finance the living of the disadvantaged.

Competition is the better proof of solidarity than charity could ever be: where this principle was dismissed over an extended period of time such as in Eastern Germany or Eastern Europe during the times of the Cold War, the countries went bankrupt. Those who suffered were the average citizens, not the ruling elite.

There is a clear message in that: we need the market economy in order to take responsibility for the weak.

We have to be careful, though, not to misinterpret the social aspect of market economy. It is not meant to be a kind of compensation for the losers of a society, but an investment in a functioning competition. The system of market economy, in turn, profits from the institutions of social security.

One reason is the safety net which alleviates the fears of people. With the backup of a social safety net individuals may be more willing to incur risks and more confident to invest their personal assets (such as financial resources, qualifications, time) into the economy. These investments may lead to a quicker pace in structural change.

Another reason may be found in the social benefits which may contribute to the reintegration of the weak and deprived into the working life and society.

Social benefits are designed to open up new opportunities in competition. They should smooth the path for the unlucky ones to a future they can shape themselves and be responsible for. The ideal welfare state would be one that motivates and invigorates latent energies. This is currently a major topic in Germany, and in my opinion this is one of the great challenges German social policy has to face.

#### IV.

As we see, there are the most diverse motivations for supporting social market economy - hoping that our own children will stand better chances or, as an entrepreneur, that investments will bring the hoped-for return.

The Christian Democrats in Germany support social market economy based on the conviction that human beings should be responsible for themselves but also for their next. They encourage social market economy because it safeguards the freedom of individuals and at the same time constitutes the most efficient form of care and social balance we know of.

In any case, social market economy does not develop in law books but in the minds of people and becomes visible in their actions. This is a position Richard von Weizsäcker, former German Federal President, was adamant on. He wanted to communicate to the German people the thought that it is not enough to make political changes towards a regulatory framework of the market economy. What is needed is the acceptance by the population.

Particular responsibility is attributed to the decision makers and the economic elite of any market economy:

They have to arouse conscious interest in the economic contexts thereby taking up existing convictions which are marked by culture and life's experience.

A necessary consequence is the dialogue with those concerned. Only if people find their basic convictions and their self-perception well guarded in an overall political order, are they willing to support and adhere to it. Konrad-Adenauer-Stiftung will continue to be a reliable partner in this process. In the same way, the foundation is supporting societal discussions on necessary reforms in Germany.



## **Part I**

### **Social Market Economy: How does it influence the International Work of Konrad-Adenauer-Stiftung?**

*Issue: Why does Konrad-Adenauer-Stiftung concern itself with social market economy?*

“Social Market Economy” next to “Ethics of a Modern Civil Society” and “Future of Europe” are focal points in the work of Konrad-Adenauer-Stiftung.

After 50 years of economic and social stability and peace the social market economy has proved to be a valuable instrument of economic governance in Germany. Social market economy is a model that puts the human being at the centre of its attention and sets out from there, from the individuals, their capacities, needs, and motivations. This is a clear distinction from socialist approaches which centre on the collective and claim the right to direct and intervene rather than adhere to economic governance. In this way, social market economy is more than just an economic success story, it has become a cornerstone of the German community. Konrad-Adenauer-Stiftung has always advocated Konrad Adenauer and Ludwig Erhard’s economic and socio-political concept that they have introduced with great political foresight and against many obstacles.<sup>1</sup>

Social market economy continues to be of topical interest and given the future challenges this system of order will gain in importance. The work of Konrad-Adenauer-Stiftung therefore puts a lot of emphasis on this key issue. Applying the rules of social market economy will help to defy today’s menacing realities of fiercer competition on an international level and crumbling social safety systems on a national level.

Global competition, technological progress, demographic outlook both in industrialised and developing countries are but a few of the challenges in

store for social market economy. Konrad-Adenauer-Stiftung engages in the task of maintaining an equilibrium between freedom on the market and social balance and of developing concrete solutions for political decision makers in Germany and abroad. Complying with the legacy of Konrad Adenauer, the foundation is convinced that social market economy is not only a suitable overall system of order for national development but also one of the most precious export articles of Germany.

The debate on globalisation will exacerbate due to the ever-widening gap between rich and poor, and the urgency to take the growing anxieties seriously will rise. Developing countries mustn’t be kept on the losing side forever. It does not mean we are dismissing the ideas of opening up markets and liberalising capital markets. Globalisation, however, needs an international overall system of order reflecting the principles of social market economy. Consequently, Konrad-Adenauer-Stiftung is trying to introduce the concept of social market economy into the international and inter-societal dialogue on economic governance. Developing countries must be involved in global communication processes to a much greater extent. Their voices must be heard and Konrad-Adenauer-Stiftung intends to lend support to their cause.<sup>2</sup>

In over 40 years of work, an international network took shape which makes Konrad-Adenauer-Stiftung a global player, familiar with the world’s problems and chances of development. Konrad-Adenauer-Stiftung is a value-driven foundation with a shrewd understanding of economic governance and so has become an esteemed partner for those who uphold democracy, rule of law, justice, and a sustainable economic development at home and abroad.

In their international work, Konrad-Adenauer-Stiftung is active in over 120 countries lending quality advice to governments, unions, parties, NGOs, journalists, religious leaders, and politicians with the aim of achieving stable democratic and economic conditions.

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<sup>1</sup> See „Soziale Marktwirtschaft“ Leitthemen der Konrad-Adenauer-Stiftung : [http://www.kas.de/stiftung/leitprojekte/soz\\_marktwirtschaft/285\\_webseite.html](http://www.kas.de/stiftung/leitprojekte/soz_marktwirtschaft/285_webseite.html)

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<sup>2</sup> See Zukunftsthemen internationaler Arbeit, I. Umgang mit den Folgen der Globalisierung: [http://www.kas.de/international/348\\_webseite.html](http://www.kas.de/international/348_webseite.html)

The foreign offices of Konrad-Adenauer-Stiftung have had the "Lexikon Soziale Marktwirtschaft - Wirtschaftspolitik von A bis Z" translated. So far into Arabic, French, Chinese, Vietnamese, Spanish, and Serbian. Preparatory work has already been undertaken for the translation into further languages. Moreover, with the help of their external bodies Konrad-Adenauer-Stiftung promotes the dissemination of the ideas of social market economy by offering seminars and expert conferences.<sup>3</sup>

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<sup>3</sup> See Die Soziale Marktwirtschaft in der Arbeit der Konrad-Adenauer-Stiftung:  
[http://www.kas.de/stiftung/leitprojekte/soz\\_marktwirtschaft/1969\\_webseite.html](http://www.kas.de/stiftung/leitprojekte/soz_marktwirtschaft/1969_webseite.html)

## **Part II**

### **Economic Governance in Social Market Economy**

#### 1. Historic Foundations

*Issue: What is the context social market economy emerged from?*

Social market economy can trace its roots back to Christian ethics and a Christian concept of man. Modern catholic social studies developed when the church started addressing the conditions of the working classes, and debating the solutions that had been offered by competing liberalist and socialist theories on economic order. (...) In 1891, Pope Leo XIII, wrote the first social encyclical (open letter), "Rerum Novarum" to sharply criticise the early capitalist class society (RN, section 1, 2). Even so, the liberal theory of order is not rejected as a principle, but the programme of the socialists does not find approval.<sup>4</sup> Pope Leo XIII saw a chance of combining the idea of social justice with freedom as a basic right and its closely linked institution of the market. His idea was to establish a solid equilibrium which supports the economic order and withstands the tensions between freedom and social balance.

"Standing firm in the contrasting context of freedom and social balance".

This is the basic principle postulated by the intellectual fathers of social market economy. Among those who paved the way are Alfred Müller-Armack, several representatives of the Freiburg School notably Walter Eucken, Leonhard Miksch, and Franz Böhm, as well as Wilhelm Röpke and Alexander Rüstow who were representatives of the so-called economic and social humanism.

Major preliminary work in shaping the German postwar order had been done by the Freiburger and

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<sup>4</sup> See Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, S. 279

Kreisauer circles engaging in intellectual resistance against the national socialist system.<sup>5</sup> Social market economy was conceived as an answer to the interventionist economic policy after the First World War and the war economy of the Nazi regime which was marked by a comprehensive system of state-imposed price-control and management regulation.

Ludwig Erhard is credited with the economic and currency reform of 1948 which initiated the implementation of a realistic concept of a market economy based on social issues. In the public, he is perceived as a great pragmatist and the father of social market economy which he pursued first in his position as Federal Economics Minister and later as Federal Chancellor.<sup>6</sup>

After the era of national socialism and their directed economic reforms, visionaries like Ludwig Erhard and Konrad Adenauer set up a counter-draft based on freedom and social awareness and succeeded in implementing it into the German postwar economic policy. With the election of Konrad Adenauer as Federal Chancellor in 1949, the German people also voted for the social market economy which was supported by CDU/CSU and FDP.

*Issue: What does social market economy signify in Germany and elsewhere, today?*

Alfred Müller-Armack saw the economic concept of social market economy as an open notion rather than a preconceived theory thus making room for potential adjustments of the concept in an ever-changing social environment. It also shows clearly that dynamisms in the economic ways and manners of social market economy are explicitly open to societal change.<sup>7</sup>

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<sup>5</sup> The Freiburger and Kreisauer circles were civil resistance groups against the Nazi regime who planned an economic and socio-political reorganisation for the time after the Hitler dictatorship.

<sup>6</sup> See Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p. 361

<sup>7</sup> See Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p. 362

In the 1960s, economic governance in Germany showed its first departures from the original guidelines of social market economy. The government started to indulge the desires of the most diverse interest groups by granting them transfer payments and privileges instead of creating incentives for performance and thus advancing the creativity of the individual. The resulting economic governance was not consistent anymore and lacked a clear direction. It was more of a governance of processes than of economy.<sup>8</sup> For several years now, the German public and politicians have discussed the return to the founding principles of social market economy or rather the newly defined priorities of economic governance.

Other European countries developed similar systems in order to guarantee public welfare in the form of public goods within a free economic order.

The French model of an "etatist capitalism", following in the footsteps of Jacobean tradition, coordinates its economic order mainly through the agency of the centralised state and the circulation of elites between state, economic and financial system.<sup>9</sup> In such a centrally organised system economic policy is much more subject to state intervention than is possible in the German system.

Sweden's economic policy follows a model of "social democratic capitalism" (...). The name already hints at the domineering role the long years of hegemonic rule by the social democratic party played in that country. The model, similar to the French one, is marked by the strong position of the state and the public sector using the high tax revenue to organise their active redistribution policy.<sup>10</sup>

Both examples state very clearly that the historic backgrounds of individual countries also lead to dif-

ferent patterns of socio-liberal economic orders. It is also evident that the competition of different forms of economy in Europe has a positive effect. Competition of systems may be highly fruitful and benefiting to the different economies.

*Issue: What role does the social market economy play in the European Union?*

The ideas of social market economy are the foundations on which the European Union builds its European market integration and their common economic and social policies. The Treaty of Rome integrated, as early as 1958, principles of social market economy into the European economic policy. The Treaty of Maastricht elaborated on these fundamentals for the economic union and extended it to the monetary union.<sup>11</sup> Principles such as a unified internal market, free movement of goods, capital and persons, regulated competition, solidarity, subsidiarity, freedom, order, and public welfare are today's foundations of a common, European economic policy.

Many of the principles of social market economy found expression in the European Union. On June 23 2007, the heads of state and governments of the European Union agreed on the draft of the Reform Treaty which is to be ratified by 2009. This draft confirms Europe's decision for a social market economy. It further states that the Union strives for a sustainable development of Europe on the basis of a balanced economic growth and a high measure of competitive social market economy aiming at full employment and social progress.

The European social model, although revealing slight differences of character in the individual member states, has often been called Europe's trade mark. It is clearly distinguishable from the US American liberal economic model because Europe puts more emphasis on the social aspect than Northern America. Participation and co-determination of workers, protection from short-

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<sup>8</sup> Working paper of Konrad-Adenauer-Stiftung, N. 165/2006, Jürgen Löwe (ext.), Die Verantwortung der Ordnungspolitik, Der Wandel der Sozialen Marktwirtschaft in der Zeit und Ansätze zu Ihrer Revitalisierung, p. 6

<sup>9</sup> Kulturelle Voraussetzungen für die Entwicklung von Demokratie und sozialer Marktwirtschaft, GTZ und Goethe-Institut, Dezember 2005, p. 81

<sup>10</sup> Ibidem, p. 82

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<sup>11</sup> Neue Aspekte der Wirtschaftspolitik in der EU: Deutsche Beiträge zur Verunsicherung, Rolf Hasse, Universität Leipzig, 2003; [http://www-1.mtk.ut.ee/varaska/2003/3\\_Majanduskasvupol/Hasse.pdf](http://www-1.mtk.ut.ee/varaska/2003/3_Majanduskasvupol/Hasse.pdf)

term dismissals, social cushioning for unemployment are achievements of the unionised workers and are part and parcel of the European social model. They are not to be found in the laissez-faire systems of Northern America.

In comparison to the economic systems of America or Asia we find that the European Union managed to develop a genuine common market which contributes considerably to the economic development of new member states and to an economic stabilisation and long-term prosperity of all member states. The principles of mutual responsibility, subsidiarity, and competition of systems have kept their validity across borders and have proved their usefulness.

"Social market economy is a progressive notion waiting to be shaped".

*Alfred Müller-Armack*

When social market economy developed, it was very closely linked to the German history. Yet, its fundamental ideas may as well be applied to other economic, social, and cultural environments. It is a concept drawing on human rights as they are stated in the international human rights convention and may therefore be applied in any society.

## 2. Principles of Social Market Economy

*Question: Which values are at the basis of social market economy?*

Human dignity shall be inviolable (Art. 1 of the German Constitution). Any economic activity is therefore supposed to serve man, not vice versa. Economic activity is not an end in itself, but a mechanism with the purpose to serve.

Economic activity, according to the rules of social market economy, has to be value-driven. Economic players always have to be viewed as part of a society. The individual takes on responsibility for himself and the community. On the other hand, the community has to take responsibility for the individual, should s/he be in need. In this contrasting context social market economy seeks a balance between freedom and responsibility, individual gain and public welfare.

The state bears the role of the provider of order. It has to create a framework of governance, a system of preconditions which enables the economic players to act with as much freedom as possible and as much solidarity as necessary. The state is a firm referee who supervises the compliance with the rules, but who is not a player in the game itself.

The following is an outline of some basic principles of social market economy. In a way, they represent the central values of social market economy which are at the root of economic governance. Consequently, they lead to recommendations on how to conduct developmental work.

In Germany, fundamental features such as the human dignity, the freedom to act, or the social rule of law are anchored in the German Constitution (the basic law). In this way, social market economy is set on a solid legal basis any citizen may refer to. On an international level, there are similar agreements on values such as the general declaration of human rights or other international agreements of the UN.

*Task: Participants engage in a brainstorming on how the nine principles may be reflected in an economic order and on how or whether these principles have been implemented in their respective working country.*

### **a. Human being / Individual**

Humans and their right to a dignified existence are the core of social market economy. Each individual has the right to get a chance of developing his/her potential, as well as the obligation to make good use of it.

The thinking in systems of order puts the individual at the centre of its attention. At the same time, it implies that economy and the production of wealth are not goods in themselves, but mechanisms to improve living conditions for each member of the society. Putting so much emphasis on the central position of the human in social market economy clearly sets it off against any collectivistic approaches.

### **b. Freedom**

In the area of economic activities freedom for the individuals means the freedom of purchase, freedom of contract, of action, and the freedom to choose employment, pursue their own goals in order to develop their own personality by using all their faculties of creative competitiveness.

The freedom of the individuals to pursue their own goals generates the required diversity and adaptability of a healthy economy. Experience with the planned economies of socialist countries made it very clear that individual freedom is essential to satisfy the needs of a society. As long as humans are able to act freely in the economy, they will try to optimise their gains which in turn generates more wealth for the whole society.

### **c. Order**

The state provides a structured order for economic processes to accomplish economic aims of the society in the best possible ways. A society without any economic governance is like a game without rules.

In the economy, order or governance is identical to the rules of a game. Order is represented by the public law and civil law. These regulations, in public law for example, encompass tax law and social law, in civil law they include contract law and labour law.

Without any overall economic governance the economy and society would deteriorate to a place of anarchy and injustice. The way economic order is shaped or rather how the body of rules and regulations is developed depends on the specific culture and needs of the respective society but also on the quality of the national economy.

Economic governance has to be distinguished from process governance. The state has the duty to set an economic and social frame without interfering in the market's self-control ( $\Leftrightarrow$  interventionism). Economic governance has to be developed in a context of transparency and good governance so as to guarantee a continuing communication and control between state and public.

"Citizens charge the state with laying down the rules of the game. But it is the citizens who play the game".

*Horst Köhler, President of the Federal Republic of Germany*

(The Order of Freedom, speech held at the Employers' Forum "Business and Society" March 15 2005 in Berlin)

#### **d. Justice**

Justice in conformity with social market economy signifies the balance of different types of justice. They may be summed up as a concept seeking to achieve justice, equality, or fairness in every aspect of society: for example just payment for performance, just satisfaction of human needs, equal opportunities, just allocation of goods and services, fair exchange of goods and services, fairness on the market, equal participation in the rights and duties of public welfare, inter-generational justice, commutative justice. Justice is a very complex matter, so much more difficult to grasp because some aspects of justice have conflicting targets. The

achievement of one may rule out the fulfilment of the other: just payment for performance may not always be compatible with just allocation of goods and services.<sup>12</sup>

The aim of social justice is to develop a peaceful way of living together, to minimise the differences to the greatest possible extent without levelling out the results of different performances, though.

#### **e. Responsibility**

Responsibility is a social value which is essential for a healthy community. In an open society freedom and responsibility are two inseparable terms. Without responsibility freedom will degenerate to a state of non-commitment and undermine its own fundamentals.

##### Autonomy

Each individual is responsible for his/her own actions and may be called to account for them. Only those who are able to care for themselves will also be able to care for others.

##### Social responsibility

Those who are able to care for themselves cannot withdraw from the solidarity to assume responsibility for others thus extending responsibility to the society as a whole. Weak members of the society like children, the diseased and the old have to be cared for and important institutions like the family have to be given support.

Environmental protection is another urgent topic. It becomes more and more vital to deal responsibly with nature's resources in order to preserve them for future generations. In the same way, every individual has the responsibility to promote peace and a sustainable development both in their own country and abroad.

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<sup>12</sup> For a detailed explanation of different types of justice consult the encyclopedia: Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p. 355 ff

### **f. Performance**

Thanks to the freedom of action every human being has the chance to develop his/her personal performance and to attain maximum results in the market. Personal work is the basis of any economic success – both for the individual or the society as a whole. Therefore, the one decisive factor for the income has to be the individual performance (just payment). Disrespect of the principle of performance will very likely cause the performers to emigrate, a black market to develop, and productivity to decline. In the long run, no society can afford to rely on an economy which is based on unproductive pensions and hostility towards performance.

To help matters, the principle of performance is supplemented by values such as solidarity and subsidiarity. There will always be those who are not able to reach a sufficient income due to illness or exclusion from the labour market through no fault of their own.

“Since each individual’s ownership of his/her labour is the basis of any resulting ownership it is more than anything else holy and inviolable”.

*Adam Smith*

An Inquiry into the Nature and Causes of the Wealth of Nations (German translation by Streissler, M., edited by Streissler, E. W., Düsseldorf, 1999)

### **g. Solidarity**

Solidarity is based on human communion. It is the ethic precondition required for the pursuit of common welfare. Putting a common interest before one’s personal interest is motivated by the knowledge that common challenges can only be mastered through common effort.

A society which has integrated the principle of solidarity into its ethic system can give its members social peace and consequently enjoy stability and long-term success. The principle of solidarity is not a one-way street. It relies on a system of mutuality in which people contribute as much as they can,

because otherwise they would lose their moral right to claim solidarity from others.

### **h. Subsidiarity**

Humans are requested to take their fate into their own hands and rely on self-help rather than help from others. The principle of subsidiarity postulates that no social body should perform functions that the individual or a subordinate social body can perform effectively from their own responsibility and resources. First, there is the individual, then the family who cares for their members, then the community etc. This system ensures that help can be offered effectively, adapted to the situation and with the appropriate measure of burden for the individual.

### **i. Common welfare**

The need to belong to a group and be dependent from social ties is a fundamental disposition of human nature. As a social being humans have rights and duties in order to participate in the public welfare.

Public welfare means the wellbeing of a society as a whole. The criteria for measuring public welfare have been consensually established in our system of norms and values. In an economic environment, public welfare means the responsibility of each individual for the creation of societal wealth but also the right to participate in this wealth.

In social market economy, taxes and other levies are essential to the financing of public services such as infrastructure, promotion of the economy, or social benefits. Art. 14 of the German Constitution explicitly states that ownership comes with an obligation.

States or societies can thus direct their efforts at their individual goals of what to reach on an economic and social level. This process is left to the states and the respective public debates.



### 3. Societal and Economic Preconditions for Social Market Economy

*Issue: Which institutional and political elements are being advanced by social market economy?*

The principles of social market economy can only be implemented, if we create certain economic and institutional preconditions. Being a societal line of approach, social market economy has a positive influence on the shaping of states and the development of transparency standards and good governance. An economic model, in accordance with the ideas of social market economy, needs a legal framework and legal security. This has to be provided by the state and results in an efficient, well functioning administrative body, a government which is able to fulfil its duties, and an independent judiciary. Social market economy also needs responsible and high-performing citizens pursuing their economic goals independently.

This is the reason why social market economy tries to further entrepreneurial spirit and a solid middle class – two cornerstones of a sustainable and economic development.

Societal and economic preconditions guarantee the principle of competition, a functioning market system with free access to the market, the right of private ownership, freedom of contract, rule of law, a regular and steady economic policy, monetary stability, basic supply of collective goods by the government and the legally secured asset of social justice.

*Economic Governance instead of Process Governance*

#### **a. Competitive Order**

Competition is a method of innovation. It enables good solutions (products, ideas, parties) to defeat bad solutions in a fair way.

Accordingly, in a competition there are two or more parties vying for something. Economic competition consists of the rivalry for business. In order to be successful in the market, suppliers and demanders have to give their business partners favourable conditions.<sup>13</sup> Free competition means that, as a matter of principle, there are no barriers as to entry or exit of the market nor to duration and number of instances any individual wishes to participate in the market.

Competition has some important functions in a market society. It limits state power towards private persons but also checks private economic power because it continually forces any market participant to offer favourable business conditions. A competitive order grants people a high measure of freedom by curbing both state and private power.

In the conception of social market economy competition is the method of choice to achieve economic and societal progress and satisfy the needs of the society in an optimal way. Walter Eucken, one of the founding fathers of social market economy, defined the competitive order as being the third type of economic order besides the centrally managed economy and the monopolistic economy order. Yet, economic order does not automatically come about by a laissez-faire policy. Continuous conflicts of interest have to be channelled, individuals or groups of persons have to be prevented from forming unilateral positions of power. All this is greatly helped by a well-oiled competitive order because it decentralises the authority to take decisions.<sup>14</sup> The controlling influence lies with the consumer. They control the economic process with their decisions.

The state, however, has to assume a function of supervision. Monopolistic tendencies have to be prevented in order not to distort competition. The

<sup>13</sup> See Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p. 455

<sup>14</sup> See. H. Joerg Thieme: Soziale Marktwirtschaft – Ordnungskonzeption und wirtschaftspolitische Gestaltung, C.H. Beck, 1991, p. 16f and Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p. 35f

state has to create the framework that permits to maintain the guiding principles of competition.

Monopolies and cartels generally lead to unfair competition and have to be avoided. But unlike the US American principle of destroying any monopoly, social market economy does not hold the view that natural monopolies should be destroyed.

Instead, they should be put under state supervision so as to prevent any profit-taking from persons or groups in power positions.<sup>15</sup> It may also make sense to exempt developing national economies from the prohibition of monopoly, at least for a limited period of time.

#### Duties of competition in the market economy

##### *Classic political functions of competition*

- limitation of state power towards private persons
- control of private economic power

##### *Static functions of competition*

- choice of goods made up according to the needs of the consumers
- optimal use of production factors
- distribution of income according to market performance

##### *Dynamic functions of competition*

- Innovation in products and production procedures
- Imitation and generally high ability to adapt

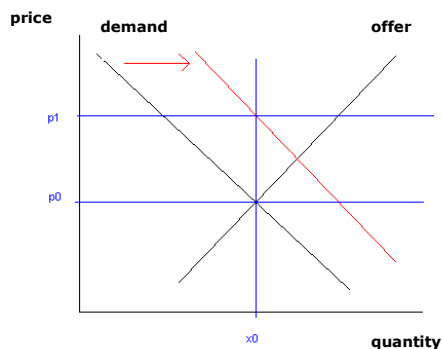
Source: Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p.457

Restriction and prevention of cartels and monopolies greatly advance entrepreneurship which is the backbone of economy. If the state establishes an economic framework that is favourable to compa-

nies, many individuals will jump at the chance to found a business of their own and realise their potential. Flexibility, adaptability, and creativity are intrinsically linked to the small and medium enterprises constituting the middle class. A strong middle class guarantees for innovation and renewal of the economy.

#### b. Market system and free access to the market

In market economy, prices have a fundamental controlling effect because they are indicators of scarcity and thus implement the decisions of economic agents. A well-functioning economic system is therefore imperative for any social market economy.



In a free market, the price of goods is determined by the system of supply and demand on the condition that market participants have enough information at their disposal, the country's markets are sufficiently integrated, and all market participants have the same chances, rights and duties.<sup>16</sup> The most important step is to create free access to the market for any prospective market participant by eliminating barriers to market entry such as corruption, monopolies, or nepotism. Neither supply-side nor demand-side must be able to influence the market price in their favour. All transactions are based on mutual agreements (freedom of contract) without any interference by the state or other bodies of society ( $\Leftrightarrow$  interventionism).

<sup>15</sup> Jörg M. Winterberg: Soziale Marktwirtschaft in Deutschland: Geschichte, Gegenwart und Zukunft, p.5

<sup>16</sup> See Winfried Jung (Hrsg.), Social Market Economy, An Economic System for Developing Countries, Internationales Institut Konrad-Adenauer-Stiftung, 1990, p. 114ff

### c. Private property

One of the basic traits of a functioning social market economy is that not only labour and knowledge, but also houses, real estate, furniture, factories, machines, money, securities, pension claims, etc. are owned by individuals, and they decide what is going to happen to these assets. They may be let, leased, mortgaged, sold, given away, or bequeathed. They may be used to establish jobs, they may be modified, or reduced.

The right of disposal of money and items which comes with private ownership helps to advance the development of one's own personality as well as to start and sustain a family.<sup>17</sup>

Nevertheless, property entails obligation, its use should also serve the public good.

### d. Freedom of contract

The freedom of contract is as essential to competition as private property. Market participants have to be able to conclude contracts free of any external restrictions. The freedom of contract is an indispensable element of the competitive order because individual economic decisions have to be contractually secured in a decentralised manner.

Freedom of contract is not without limitations, though. It must not be improperly used to undermine or eliminate the order of competition. Likewise, contracts must not offend common decency, otherwise they will lose their validity. Moreover, in these cases the principle of liability will be applied. Those market participants who may be called to account for their actions will indeed be the ones who act responsibly.

### e. Rule of law

In a state under the rule of law, public power is bound by law to adhere to an objective order of value and law which is unchangeable in its basics and designed for permanence. Contrary to an abso-

<sup>17</sup> See Rolf H. Hasse, Herrmann Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p. 156 f.

lutistic state, the power of a rule of law state is largely determined by laws in order to protect the citizens from arbitrariness (formal concept of a constitutional or rule of law state). For a functioning and flourishing market society it is imperative to accomplish in practice what the principles of a high-quality institutional infrastructure advocate such as the legal system and an independent judiciary, or principles like private property, competition, or economic legislation. The principle of liability is indispensable in order to guarantee the security of planning for the market participants. Each person, each business must enjoy legal security to be able to plan their activities.

"Without legal rules there is no competition, no contract security, no reliable payment, no punctual delivery, no international trade, no direct trade with other countries".

*Roman Herzog, former President of the Federal Republic of Germany*<sup>18</sup>

### f. Regular and steady economic policy

Another basis for planning security besides the rule of law is the regularity and steadiness of economic policy. Competition in itself is a highly dynamic process forever modifying the relevant risks, key figures, and conditions of action for any economic agent.

In order not to further aggravate this complexity and insecurity by economic interventions, it is necessary for politicians and the state to maintain a constant and consistent economic policy.<sup>19</sup> Developing countries are particularly susceptible to arbi-

<sup>18</sup> Introductory speech on the topic: "Europäisches Erbe, Europas Zukunft" when an honorary doctoral degree was conferred on him by „Nationale Juristische Akademie Charkow“, 06.02.1998; <http://www.bundespraesident.de/Reden-und-Interviews/Reden-Roman-Herzog-11072.12091/Ansprache-von-Bundespraesident.htm>

<sup>19</sup> See. H. Joerg Thieme: Soziale Marktwirtschaft – Ordnungskonzeption und wirtschaftspolitische Gestaltung, C.H. Beck, 1991, p. 19

rary political initiatives or interventions in the economic life which may introduce a factor of uncertainty in the decisions of entrepreneurs and consumers alike who may then abandon investments or long-term projects.

#### **g. Monetary stability**

National economies where money is legal tender and value-preserving mean distinguish themselves by higher economic efficiency and a higher welfare (lower transaction costs) from national economies which do not use money for the exchange of goods (payment in kind). The economic advantages of money can only be completely realised when the money value remains stable. Inflation or even hyperinflation destroy these advantages partially or completely.<sup>20</sup>

Keeping the price level stable is vital to the monetary policy of the institutions trusted with this task (Germany: Deutsche Bundesbank, Europe: European Central Bank).

A currency is stable in its internal economy, as long as its purchasing power remains stable. Purchasing power depends on the price development. If prices rise, people receive fewer goods per currency unit. Price changes of individual goods are compensated by an opposite price development of other goods. That's why we only speak of changes of purchasing power, if the average price level changes over an extended period of time. We speak of internal currency stability or internal stability of monetary value, if the domestic price level or the price level of the currency block remains constant.

#### **h. State intervention in case of market failure**

There are certain economic and business areas where market failure may happen, if external effects are neglected in individual economic considerations. Thus, the society may incur costs the causer does not have to pay for, such as environ-

mental pollution. These costs have to be passed on by means of governmental measures. The use of environmental goods like water, air or landscapes, which do not have a price in the market, may be taxed and may thereby express actual scarcities.

In order to internalise these external effects individual economic calculations have to be enlarged by suitable measures to include costs arising from society. The supply of collective goods which cannot be covered by the market does not necessarily have to be provided by the government. These services may just as well be supplied by private providers. The state then ensures that the demand is covered (the state bears the guarantee but is not responsible for the action itself).

Should the labour market show any anomalous supply behaviour, economic measures have to be taken to counter the declining wage rate. At the beginning of industrialisation in the 19<sup>th</sup> century, workers in Germany had to offer more work at declining wages just to be able to reach a salary that guaranteed the existence of the family: a fact that in turn made wages decrease even more. With the help of social market economy, the economic policy has created tariff autonomy which is secured by the constitution. This autonomy explicitly permits the labour market to close unions – actually the cartels of workers – who are negotiating wage rates with employers' representatives.<sup>21</sup>

#### **i. Social balance**

"Self-responsibility, personal initiative, and private property are some of the essential traits of social market economy. This social order reconciles personal freedom, equal opportunities, and growing wealth with the social progress generated by employment. Practising social market economy may be defined as the effort to link freedom and order, and consequently achieve a greater degree of justice".

*Ludwig Erhard*

<sup>20</sup> See Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p. 235

<sup>21</sup> Jörg M. Winterberg: Soziale Marktwirtschaft in Deutschland: Geschichte, Gegenwart und Zukunft, p.6

Social market economy is a market economy combining competition with social balance.

Social balance is to a large extent reached by a government policy of re-distribution financed by public revenue. That in turn, consists largely of taxes and other charges levied on the performers of a society. The state more or less coerces solidarity of the strong with the weak and has to take care its policy of balance is carried out in a differentiated, moderate and efficient way in order not to be counterproductive.<sup>22</sup>

Just satisfaction of human needs has to be financed in a way that does not affect competition ie. taxed services must not have a direct negative effect on competition.

The primary distribution of income has to be corrected. For this purpose the government has to set up an income policy which is structured along social aspects.

One of the means used in social market economy is a progressive income tax supplemented by a system of compensation for loss of income due to illness, unemployment, or old age.<sup>23</sup> This compensation is based on collective social security.

The thin line separating the social state from the welfare state is crossed when the individual is relieved from the worry of securing his existence and future. In this case, the principle of subsidiarity is disrespected and the principle of solidarity overly stretched which furthers the spread of an attitude of claiming rights and possessions. National and international performance of an economy would be seriously endangered by the excessive tax burden on citizens.<sup>24</sup>

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<sup>22</sup> See Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p. 357

<sup>23</sup> Jörg M. Winterberg: Soziale Marktwirtschaft in Deutschland: Geschichte, Gegenwart und Zukunft, p.6

<sup>24</sup> See Rolf H. Hasse, Herrman Schneider, Klaus Weigelt (Hrsg.): Lexikon Soziale Marktwirtschaft, Wirtschaftspolitik von A bis Z, Schöningh, 2002, p. 399

#### 4. Roles of individual players and areas of responsibility in economic policy

*Issue: What kind of decision makers are there in a society? What are their duties? Who makes social and economic policy?*

Economic decisions become evident in contracts between two individual partners. Each act of acquisition is the result of such a conclusion of contract.

Now, economic policy is represented by numerous individual players and groups trying to influence, control, and shape these contracts. By influencing economic activities they are trying to transform an unsatisfactory situation into a desired one. In short, they are practicing economic policy. In order to accomplish their wishes, these players get organised in interest groups which may be classified as follows:

1. Interests of the entrepreneurs – eg. profit, stable economic situation
2. Interests of the private households (employees) – eg. durably high living standard, job security
3. economic interests of the state or rather public decision makers to reach superior social goals <sup>25</sup>

These players may again be divided into the group of decision makers (parliament, government, central bank, regional, local, and supranational bodies) and the group of influence takers (chambers, unions, business syndicates).

The decision makers are all governmental or government commissioned institutions which, by their activities, contribute to shaping the economic order. A body may be deemed governmental, if it has the legal power to coerce compliance with measures it has taken on its own authority. In other words, it has the sovereignty to command or prohibit.

This group of persons or bodies is clearly defined and set apart from the group of influence takers who do not have the privilege of sovereign actions. Yet, the latter are unquestionably in a position to bring about or at least influence political decisions. To be more precise, they can criticise or advise the decision makers, those bodies legitimised to conduct legally binding business. They can also publicly state their position on sensitive economic issues and in this way promote public debate. In general, they are not subject to any political restraint.<sup>26</sup>

However, the group of influence takers is of major importance to any vigorous economic policy. The so-called influence takers act as sensors for the policy and the decision makers, since all the groups participating in the economy pursue their own interest and therefore closely follow economic developments and policy. It is very important for a mature system of entrepreneurs to fulfil their economic and societal duties in a responsible way and contribute to shaping the economic policy. Thus, it is only the self-assured and mature citizens who will join ranks to form active interest groups.

It is crucial to build an open and fair system of advice between the groups of decision makers and influence takers in order to develop economic decisions in an atmosphere of public debate. Some structural requirements have to be met:

- the legal opportunity and personal capability of the economic participants (entrepreneurs, employees, consumers etc.) to organise themselves and to express their positions on certain issues
- a culture of discussion and advice within the governmental organisations (government, parliament etc.), provision of communication channels to the influence takers (advisory boards, hearings etc.)
- ability of the decision makers to carry through their decisions on a legal level, meaning that an efficient administrative

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<sup>25</sup> Günther Rüter (Hrsg.), *Ökologische und Soziale Marktwirtschaft, Entstehungen, Grundlagen, Instrumente*, Reihe: Grundlagen politischer Bildung, Band 1, Konrad-Adenauer-Stiftung, 1997, p.86

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<sup>26</sup> See Günther Rüter (Hrsg.), *Ökologische und Soziale Marktwirtschaft, Entstehungen, Grundlagen, Instrumente*, Reihe: Grundlagen politischer Bildung, Band 1, Konrad-Adenauer-Stiftung, 1997, p.110

body and an independent judiciary have to be available

Social market economy positively influences and strengthens democratic and pluralistic structures, contributes to the development of a public debate, and furthers society building.





### **Part III**

#### **Examples of issues from the Arab World and Approaches of How to Solve Them According to the Rules of Social Market Economy**

#### **Authors**

##### **(in order of appearance)**

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# Values in Economic and Social systems

## An Arab view

BY TALAL ABU-GHAZALEH

**In my own time at University in the sixties one of the basic issues we dealt with was macro-economic theories and their applicability to state policy for managing the economy. What were the pros and cons of each and how did theory compare to practice. This was the time of the cold war between the East and the West and when the theories really could be seen in force, especially in Europe. Communism and Capitalism were the political paradigms with their economic equivalents, at opposite ends of the economic spectrum, the central planned economy and the free market economy. Even if neither end of the spectrum was ever totally found in practice the difference was sufficient to stimulate academic and political debate as to which was the superior.**

Times have changed. The different theories might still be taught and discussed in universities as part of teaching students about economic analysis and its interpretation and how to assess its application as part of learning how to exercise their own judgment and make their own economic and political decisions and not blindly follow the "Pied Pipers" of the day. In the political world, however, there is little doubt that governments have swung away from central planning in favour of the market economy. The market economy is seen as one which gives more efficiency and better incentives to develop new goods (competition) and governments are there, not necessarily as providers but more as enablers and regulators. And this is true not only so in respect of the macro-economic view, i.e. that of the states and governments, but also of the micro-economic view, i.e. that of the people, be it that of consumers, be it that of business. The current classic example is China where the rejection of strict central economic planning in favour of the market economy has resulted in phenomenal growth – an example which is rapidly being followed by many other countries in the Arab Region, Europe and elsewhere.

Of course no system is perfect and the market economy does have disadvantages but where it is

superior is its inherent recognition of the fundamental aspirations of the individual – self determination, free-will and the pursuit of individual goals.

It is this strong desire for individuality which is the most important barrier to any kind of centrally planned economic approach. No state economy can foresee, plan and accordingly act to the individual wants of their people. Each CEO of a firm knows that he has to be very, very close to the market and its rapid changes. Markets consist of individuals with their own ambitions, wishes, needs and demands and unless these are satisfied business will be rapidly lost to competitors.

This, which is so easy to understand in respect of business, is the same when we examine the view of the individual towards the state and the services it provides. Government is an institution that is wanted and needed because it renders services that the individual needs and wants and reacts accordingly when these change.

Recognition of the role of the individual as such is very difficult to accomplish in a centralist approach with its absence of competitive markets. There are and always will be different, individual wishes and demands. In order to fulfill these, there will have to be different, individual suppliers. In total there will have to be a market. A market that brings together these people with their individual, different demands and those that supply them whether what is demanded and supplied, is a product or a service. The essence of the market economy is that "consumer sovereignty" is best served where there are many suppliers competing with each other.

In early micro-economic writings and teachings individuals, and businesses are themselves groups of individuals, were regarded as economic men with a sole objective of maximizing profit. We now recognize that this was a simplistic view and that very often it is a bundle of demands that are combined: price, quality, service, maintenance, warranty, reliability, responsibility etc. Those companies in the

market that offer the best combination of all this will be the favourites and the winners.

A simplistic assessment might assume that the best companies can be depicted quite easily: these are those who show the highest profit or more precisely those with the highest return on capital invested. Therefore these companies must respond better to demand than their competitors. However a more sophisticated assessment will raise doubt that companies nowadays really can be or should be looked at only from the viewpoint of how much profit or return on capital has been generated. In the modern world "Economic man" has been replaced by "Social man". Success cannot and should not be from the view of owners /shareholders only. He will claim that other stakeholders are participants in the economic game and are affected by what the business does. This view recognizes that business is playing not only a part as market partner in offering the best product but also as society partner in caring and serving the society in a broader sense. He might even bring forward the argument that the companies that show the highest profit might be those that show a very bad performance when looked at through the eyes of other stakeholders. Monopoly, environmental damages, employee-exploitation, gender questions, tax evasion, etc. might be his keywords. And it might and sometimes, is argued very passionately that these excesses are the result of "free market economy". The verdict might conclude that Free market economy is a market without any value or only with a value from the viewpoint of business people. While it can be argued that centrally controlled economies were no better in this respect and were similarly anti-social, this is no defense against the historical development of business in different parts of the world where one has to state quite honestly that this harsh argument can not be laid aside. It describes situations that happened and obviously still do happen in some parts of the world. The "free market" has to be regulated either by itself or by the state.

There are states where obviously virtues and values existed or still exist that demonstrate the characteristics of a caring society i.e. communities where people live together, share similar basic beliefs and values, people who are bound to more than just money and, people who basically care for each other and share similar views about human rights and obligations. These communities are "societies" in the true sense of the word, and consequently the

use of the words "socio" and "social" in the sense of the Latin word which means "together" is very appropriate. It is evident that "Social" in this sense has no necessary direct relationship with the political terms "socialist" or "socialistic".

States should be societies in this easy, clear sense that they predominantly care for the people. States of this type will not allow companies to engage in excessive abuses and will set frameworks for business activities. States of this type will try to combine the inherent advantages of the "free market economy" with the values of society. They will establish a structure for the development of a "Social Market Economy", an economy that encourages both economic growth and also the values of society.

I am currently Deputy Chairman of the UN Global Compact of which the UN Secretary General is Chairman. This body was established in 2000 and works towards advancing ten universal principles in the areas of human rights, labour, the environment and anti-corruption (Appendix 1). The adoption of these principles by all businesses provides core values upon which a market economy should be based.

The paradigm of "Social Market Economy" fits directly to the heritage of the virtues and values of our Arab Society.

I am confident that we will follow this path vigorously so that our states in this macro view and our companies in this micro view will be regarded lighthouses of good social citizenships. That this sometimes needs considerable encouragement and effort is what I had to learn and still do learn whenever I work in my capacity as Deputy Chairman of the Global Compact. However as all Arabs know the more difficult the task the greater the satisfaction when it has been accomplished.

TAG.

The UN Global Compact

The Ten Principles

Human Rights

Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights;

Principle 2: make sure they are not complicit in human rights abuses.

Labour Standards

Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;

Principle 4: the elimination of all forms of forced and compulsory labour;

Principle 5: the effective abolition of child labour: and

Principle 6: the elimination of discrimination in respect of employment and occupation.

Environment

Principle 7: Businesses should support a precautionary approach to environmental challenges;

Principle 8: undertake initiatives to promote greater environmental responsibility;

Principle 9: encourage the development and diffusion of environmentally friendly technologies.

Anti-Corruption

Principle 10: Businesses should work against corruption in all its forms including extortion and bribery.

# Germany's Social Market Economy

## A Development Model for the Arab world?

BY MARCUS MARKTANNER

**West Germany developed the social market economy (also: managed capitalism) as its political-economic model after World War II. In its heart is the harmonization of economic freedoms with social justice. The fact that the social market economy has a social consciousness was the result of three factors.**

First, it was necessary to overcome the hardship that Germans experienced on the ground. Second, it was necessary to spread confidence in the new political-economic system. Third, it reflected the paradigm shift in economics that set in with the Great Depression when economists began to advocate stronger states and to question the universal blessings of markets. Germany's social market economy is often described as a third way between capitalism and socialism. As it defines a social and economic order, it is far more complex than a macroeconomic policy framework. The commitment to a normative social and economic order had not only helped Germany realizing its economic miracle after World War II, it is also a viable option for the Arab world. Why?

The Arab world suffers from three problems that Germany was fortunate to avoid by subscribing to a social market economy: Lack of private sector competition, inward-orientation, and unequal economic opportunities. In Germany, competition has led to rising incomes, widening tax bases, and economic modernization. Outward orientation has additionally led to peaceful relationships with its European neighbours. Equal economic opportunities and income redistribution have furthermore strengthened social cohesion, dismantled regional income imbalances, and promoted vertical mobility within the society. The spirit of the social market economy is also tangible in the European Union. The Arab world, on the other hand, embarked on a socialist flavoured inward-orientation strategy that led to the bureaucratization of economic activity, capital flight, the melting of the private sector middle class, political authoritarianism, and nepotism.

Of course, making the right political decisions was extremely difficult after World War II. Similar to Germany, the Arab world was caught in the battle of ideologies. The combination of a colonial past with the evolution of the Cold War and the initial economic and technological success of the former Soviet Union had made inward-orientation and socialism a serious alternative. Moreover, many developing countries raised concerns about the opening of their economies to global competition, fearing that without protection they never would be able to catch up to the industrialized world. It turned out that they were wrong. The most successful developing countries were those that embarked on an outward-orientation strategy.

This apology in favour of early Arab leaders after World War II notwithstanding, most Arab countries are today in need of a new political-economic paradigm. The social market economy is a serious alternative in this regard, especially as opposed to its main competitor, the so-called Washington Consensus.

The main difference between the social market economy and the Washington Consensus lays not so much in the choice of successful policy and development instruments rather than the assessment of their interaction with social development goals. Both camps agree that competition, private property rights, price liberalization, control of inflation and fiscal austerity are main forces behind successful economic development. Specifically, they agree that these are favourable policies to allocate a country's scarce resources more efficiently and to free economic growth. Yet, there is substantial disagreement with regards to whether these benefits also promote social stability and cohesion. Social market economists question that this is the case and therefore additionally demand for taking into account the social order under which economic reforms and policies take place.

The compatibility of social order and economic reforms is so essential to the social market economy that there is even a unique German policy term for

it, the so-called "Ordnungspolitik", which is best translated as order policy (regulatory or managed policy). The goal of order policy is to promote both market competition and balanced social development. In doing so, the state will step in with corrective actions only such that they minimize market distortions. This means, for example, that instead of giving subsidies to declining industries, the state will help laid off workers to acquire new skills. Moreover, the state is a last resort and demands individual self-responsibility first. Nevertheless, order policy in practice is responsive when economies slide into a recession and pro-active in empowering citizens when they are deprived of access to economic opportunities. It also anticipates market failures in the areas of education, social security, public infrastructure, and the environment.

It is eventually the awareness of the relationship between social and economic orders that cause social market economists to be critical of the Washington Consensus. From their perspective, the available experiences with the Washington Consensus suggest that economic and political reforms have been rushed into countries under the illusion that they would also bring about social development when in fact a complementary social stabilization concept should have been in place as well. Economic and political reforms in Latin America and the Arab world may have improved allocation efficiency but failed to dismantle existing economic inequali-

ties of income and economic opportunities. Even worse, in the former Soviet Union once low levels of inequality have been lifted to Latin American and Arab standards. Accordingly, the fact that the benefits of economic reforms have left out the poorest of the society accounts substantially for current political instabilities in terms of a resurgence of left-wing populisms in Latin America, Islamic fundamentalism in the Arab world, and nationalism in Russia.

The only real world experience with the transformation of a society in the spirit of the social market economy has been the German unification. Germany has often been criticized for its handling of the unification, especially from the Washington Consensus camp. This critique was generally that West Germany's transfers to the East were too generous and the East's exposure to competition too little. Indeed, Germany has paid a high price for its reunification for many years and different aspects of the unification could have been handled differently, but Germany never drifted into social chaos. Germany's current generation made a sacrifice into equal economic opportunities for all Germans, whose fruits will be reaped by future generations. The Washington Consensus, on the other hand, fell to the illusion that getting the prices right alone would also get societies right. No, it also requires investments into the social order. Learning from Germany and Europe may therefore be a serious alternative for the Arab world.

# Regulatory Policy

## Indispensable Tool for the Developing Economies of the Arab World

BY GHANIE GHAUSSY

**The theory of economic order is hardly developed in Arab economic literature. At best, it is addressed in politics to compare the various economic systems and to derive there from the implications for economic policy. This situation may be ascribed mainly to the fact that Arab States—despite the unifying element constituted by Islam as a religion encompassing all aspects of life—did not have, historically speaking, a homogeneous development, except for the classical era of the Muslim empire which, even itself, was not free from regional and geographical differences. During that era, there developed almost everywhere, an economic system based on the free choice of economic actors, though directed, in almost all Arab territorial States, towards trade (bazaar capitalism).**

The economic and social development which followed upon the Industrial Revolution had contributed, in European countries, to the advent of a fairly homogeneous economy based on freedom and the division of labour. It had, on the other hand, required the introduction of a regulatory policy (managed policy), since any freedom that does not have limits turns into a destructive freedom. At that time, the economic dependence of the Arab world vis-à-vis Europe was determined by the European colonial powers which had continued to exercise their influence until the end of the colonial period. Colonisation had also contributed in distorting the ancient structures in Arab countries.

The new concepts of the economic order introduced by the colonial powers have marked all those who, in the Arab countries, had been, for political or economic reasons, in contact with them. It was not until the late 1950s and during the 1960s that the Arab States, which had just obtained their independence, started to conceive of the orders according to their own political and economic visions. Discussions about "Arab socialism" and the "socialism of the Ba'th party" are but a few instances. As men-

tioned above, this debate was more focused on the political system, and less determined by criteria belonging in a regulatory policy (managed policy) in matter of economy.

Yet, in the conception of economic orders, the issue is to know how and based on what criteria the various economic actors—enterprises, households, etc—establish their plans and how they coordinate them among themselves. The issue is also to know if and under what form the State intervenes in this process. In a market economy, the various enterprises design their production plans, and the households design their consumption plans according to the individual and free decisions. The State creates the legal and economic framework conditions and does not intervene in the individual decisions of the economic actors. Coordination of the plans is governed by the market, i.e. by the price mechanisms on the various markets. An economic order which governs the economy via the market and in which the process of adaptation is also effected by the market is that of "free economy". The sine qua non condition for such an economic order is the existence of private property and freedom of action of the economic actors as regards their individual economic activities. By contrast, a "centrally managed economy" admits neither a private property of the means of production nor of consumption goods. State planning bodies take decisions on behalf of businessmen and consumers. The coordination process is not effected by the formation of prices on the market but by State planning bodies (socialism).

Neither in Western States, nor in Arab States do these various types of economic order exist in the pure state. The needs of the economic actors (individual needs) and those of the community (collective needs) require State intervention. Absolute freedom granted to businessmen and the possibility of their merging, if not the creation of monopolies or oligopolies which determine prices on the mar-

ket, may jeopardise, in a considerable way, the meeting of individual needs. Combines between producers and the formation of cartels or groups, as well as “gentlemen’s agreements” are the consequences of a free market economy without State intervention. Enterprises which focus on maximising profit are hardly interested in investments in areas that relate to collective needs and do not promise substantial profits. Several areas of national economy—be it European or Arab—which are vital for proper operating of a given society, such as investments in infrastructure, security, education, law and social security, make it necessary for the State to intervene directly or indirectly.

For this reason, the German Federal Republic has combined, since the conception of its economic order of 1948, the principle of free competition with that of “social harmony”. That was how the notion of “social market economy” came into being. Social market economy is, therefore, “advisedly conceived for market economy”; it rests on a deep-seated conviction that “the social exigencies of a modern society” must be mainstreamed “in a system of free competition” (A. Müller-Armack).

As regards developing economies—such as those we find today in almost all Arab countries—State intervention is crucial; and this, not only in favour of collective needs, but also in all economic sectors

that are essential for economic development but which do not attract private investors.

In order to create an optimal economic order, it is necessary—particularly in emerging Arab economies—to target an optimal balance between a free conception of private interests and private enterprises, on the one hand, and ensuring collective interests via State investments, on the other hand. There should be created a “mixed economy” or, as we call it today, a “managed capitalism”, a system in which the State—by adopting proper legislation—creates the necessary framework conditions for private economic activities and allows at the same time—via direct interventions—the meeting of collective needs. This optimal balance varies from one country to another, from one case to another. On the whole, it may be said that an economic order is optimal when, within a framework established by the legislation, private activities may be conducted freely and “as much as possible” and State interventions and activities are limited “as much as need be”. The managed framework for such a “mixed economy” with an overriding social dimension must be guaranteed in the long term. A managed policy in the field of economy which changes from day to day according to political interests is a political economy that is prejudicial to development and to the growth of any national economy.



# Social Partnership

## How to Combine Freedom and Security?

BY GHANIE GHAUSSY

**One of the major achievements of “social market economy” is the creation of a responsible “social partnership” within a liberal economic order. It is, first and foremost, a freedom under which the “social partners”—both organised workers (trade unions) and responsible enterprises (employers)—design, without direct intervention by the State, the social conditions of labour.**

In the field of labour policy, the wages policy is managed exclusively by the social partners, without direct intervention either by politics or by the State. In this way, social partnership is also the implementation of the principle of subsidiarity which grants priority to private entities (individuals, institutions) to handle their own affairs by themselves. The social partners agree together on collective agreements which comprise—besides the provisions related to wages—rules concerning the labour code. This system has been implemented in certain Western countries, such as Germany which, for purposes of this article, will serve as an illustrative example.

The system of a voluntary social partnership, such as defined above, has not been implemented yet in the Arab world. The various Arab States have opted for a regulation policy; in other words, they have created the conditions necessary for a more or less social organisation of economic life by adopting several direct State measures for the production market and the labour market. The employers, not less than the workers, must abide—inasmuch as they are concerned—by this policy. These measures determine—for instance, under the form of decrees—, in States with a socialist tendency (Syria, Libya, Algeria and, to a lesser extent, Egypt), as direct interventions of the State in the whole business policy. If in other States more oriented to market economy (Jordan, Saudi Arabia, Lebanon, Gulf States), the regulatory policy equally plays a certain role, its importance seems to be more limited than in the former set of States mentioned above. It is worth pointing out, here, that the extent of influence that the regulatory policy exerts on the labour and capital markets, as well as on train-

ing and innovation, also determines “good governance”; or, in other words, the quality of the economic order is more or less reduced by the number of bureaucratic obstacles put in place by the different governments.

While the ideal social partnership is a utopia difficult to achieve, certain German-speaking countries, such as Germany, Switzerland and Austria—but also Benelux and France—, have approached the ideal of an “optimal social partnership”.

Social partnership in Germany is composed of trade unions as representatives of workers, and of employers’ organisations. The umbrella trade union organisation—the 6.6 million-member strong Federation of German Trade Unions (Deutscher Gewerkschaftsbund – DGB) is composed of: IG-Metall (with 2.3 million), Ver.di (with 2.2 million), Christlicher Gewerkschaftsbund (with 0.7 million), IG Bau (with 0.4 million) and several other small unions whose total number is about 1 million affiliates. The power of trade unions in Germany is not exclusively a quantitative matter; it also obtains from the fact that these organisations are represented not only in the economic bodies, social security institutions, vocational training and broadcasting institutions, but also in politics and justice. This association which sees to the interests of workers is checked by the employers’ organisations (Bund der deutschen Industrie – BDI and other corporate interest groups) which are also represented on the political and State levels.

As social partners, the two groups—employers and trade unions—play a special role in the wages policy and labour policy. The former policy belongs within the exclusive purview of the social partners, without any State intervention. The social partners negotiate the collective agreements, which comprise aspects related to wages as well as aspects related to the labour code. These agreements are, in most cases, laid out as mandatory. While in the “social security” field, the State sets—in agreement with the social partners—the terms related to the vari-

ous mandatory insurances, such as pensions, health, dependants, accident, unemployment, sick-leave wage payments, paid annual holidays and paid public holidays—while determining the minimum threshold—, the measures provided by the social partners may extend beyond this in favour of workers. Such regulations relate to agreements on working time which bind enterprises and works councils by dedicated individual agreements, flexi-time, the acceptability threshold for professional mobility, protection of jobs and health at the workplace, special payments on certain occasions—Christmas bonus, special monthly bonuses, additional month's salary and company retirement provident fund—, as well as structures for in-house training and retraining. This "social safety net" that the enterprises have to bear in terms of payroll costs amounts in West Germany to 70% and in East Germany to about 63% of the wage costs. These costs constitute a major disadvantage for German enterprises in terms of national and international competitiveness. For the workers, these costs constitute at once disadvantages—social security contributions reduce the net salary amount—and considerable advantages insofar as they benefit from the agreements on wages.

In this context, it is worth also mentioning that the implementation of the measures outlined above is not an easy thing. It differs considerably from one sector to another and, even within the same sector, from one enterprise to another, according to the relevant collective agreements. Fairly low growth rates and rising unemployment rate have weakened, over the past ten years, the position of the social partners, and more particularly that of trade unions. The employers are less inclined to make concessions in matter of wages, and the trade unions can no longer force acceptance of their wage claims. For this reason, the number of affiliated workers has been slashed by about a half over the past fifteen years (1991-2006). Globalisation and the integration of labour from Eastern Europe and overseas, as well as off-shore processing, have also contributed in weakening the position of trade unions. And yet, according to a report released by the "Institut der Deutschen Wirtschaft" (IWD), their importance as a social partner and counter-weight to the power of the employers and of capital is not questioned in Germany.

# Performance and Reward in the Arab World

BY YUSUF MANSUR

**Few will recall that the greatest challenge facing the Arab world is development. Fewer still would see a link between development, social justice and democracy. Especially since several economies in the region have achieved tremendous economic growth rates recently with little to no advances in development. Rentierism, nepotism, corruption, and Wasta, (the use of personal influence or position to derail an otherwise competitive and transparent selection process) are primary deterrents to Arab development, which underscores the need for creating greater social justice and democracy.**

Economics defines development as a state of sustainable economic growth, whereby an economy grows at sustainable rates for several years. For the growth to be sustainable, it must be based on the enhanced competitiveness of its economic agents. Competitiveness, in its core, means being more productive than other producers; thus, increased competitiveness is enhanced productivity of the economic inputs or factors. In other words, in order for an economy to become competitive, it must improve the conditions that affect the productivity of its economic agents, including workers and capital.

For people to become more productive, their rewards must match their efforts. In other words, the economic system must reward workers for producing goods and services. However, this reward can not be equitable or fair if the system itself is based on social injustices. Especially when rewards are given to non-producers (rentierism); nepotism is not simply an aberration but a flagrant common practice. Wasta, becomes the necessary and acceptable mode for interaction among economic agents.

On the other hand, rent seeking is a behaviour whereby someone extracts rent, benefit or value from others without contributing to productivity. Examples of rent seeking include gaining control of land and other pre-existing natural resources through government decrees, or by imposing bur-

densome regulations or other government decisions that may affect consumers or businesses.

Manifestations of rent seeking include "Wasta" and using non-public information to further one's personal gains. Capturing special monopoly privileges or benefiting from a yet to be disclosed government regulation causes an inefficient redistribution of wealth, whereby those that do not produce become wealthier while being unproductive. Owning large tracts of land and benefiting from the increases in demand by seeking monopoly rent, whereby the seller offers small portions of land at exorbitant prices, is another form of rent-seeking.

In the aggregate, rent seeking, when propagated, condoned and practiced, is damaging to the economy as a whole and results in substantial damage to society as efficient and effective resources, faced with the dearth of compensatory rewards, either reduce their economic contribution or flee the economy into others that appreciate in terms of opportunity and reward the productivity of the individual.

From a macroeconomic standpoint, the cost of rent seeking can be considerable. By simply paying for a favourable regulatory environment instead of competing through the more costly option, such as efficient production and competitiveness through increased R&D, employee training, business processes upgrading, etc., enterprises will seek the bribery option and reap benefits that are completely unrelated to their contribution to the wealth of society.

Furthermore, in such societies where social injustice is rampantly practiced, the result is inequitable distribution of the gains from economic growth and the collapse of the underpinnings of development. Societies that witness large disparities in income are either subject to windfall profits, which do not repeat and are, therefore, not sustainable or are economies that witness brain drain, social unrest, lack of empowerment of economic agents such a

labor--particularly women--, and are, consequently, susceptible to setbacks and internal shocks.

The moral hazard in the Arab world is that people have come to condone such practices, accepting and encouraging them, which is probably the primary reason why the Arab world is by no means developed. This is not an assertion but a statement of fact. Even economies that have benefited from the oil boom are not only susceptible to oil price fluctuations which deter long range planning but also face the same challenges of the underdeveloped. According to the third Arab Human development Report, more than half the women in the Arab world are unable to read or write. Literacy rates vary from 28.5 per cent in Yemen to 85.9 per cent in Jordan. Many Arab countries failed to provide primary school education for all children, and enrolments in secondary school are worse. Child mortality for children under five is also high, about 60 per 1000 births, compared with six in industrialized countries.

Nowhere is the message of social justice combined with a market economy more clearly stated and underscored than in the paradigm of the social market economy, where justice, in addition to freedom, presents one of the most important principles of socially responsible democratic systems. Within the social market economy, the individual is viewed as

a rational economic agent and, thus, a utility maximizer. Whether this utility arises from income, wealth or profit, maximizing it is the principle that forms the basis of the market economy. However, in a social market economy, this economic rational is combined with a deep sense that all members of society must partake, based on social justice, in the building of the welfare of the society. This is achieved through a balanced relationship between different types of corresponding types of justice including fair results for fair opportunities.

The worst that can happen to a nation is to lose the desire to invent its own future, which is even worse than losing the will to build it. Corruption is the enemy of performance and meritocracy; the logic and underpinnings of the social market economy paradigm as a relevant model for the region are, thus, unquestionably eminent.

# Monetary Policy and Economic Stability

BY GHANIE GHAUSSY

**The mission of monetary policy is to manage the policy related to money and to credit within a national economy. It relates more particularly to regulation by the Central Bank of the money stock, its primary objective being to guarantee monetary stability.**

The State, too, influences monetary policy, either directly or indirectly, via financial policy, exchange rates and foreign trade. In most Arab countries, this influence is often direct and considerable. The State does not only influence Central Bank decisions, but also intervenes directly—often for stability reasons—, and via the financial and monetary policy, in the economic process. This intervention may also be justified by the fact that, within a national economy, the various economic objectives—growth, price stability and equilibrium of the balance of payments—cannot be achieved simultaneously but are partially opposed. Accordingly, while an increase in the money stock may stimulate growth, it is at the same a threat to price stability and the equilibrium of the balance of payments. Economists talk in this context of the “magic triangle” of monetary policy and stability.

Economic growth in Arab countries is subject to strong periodic variations. Between 1975 and 1982 and between 1985 and 1990, these countries reported high growth rates. Subsequently, and until 1995, the growth rates had been steadily on the decrease. As from 1996, the rates have once again stabilised at a fairly high level (around 5.6% on average). However, this growth did not benefit all Arab countries due to existing differences in terms of natural resources and monetary and tax policy in these different countries.

As regards monetary policy, it would be relevant to analyse the relationship between the money stock (M1)<sup>27</sup> the quasi-money stock (M2)<sup>28</sup> and the price

level (here: consumer price index – CPI), for it reflects the close relationship between the policy related to the money stock and the inflation rate. According to World Bank and IMF indications, relatively poor Arab countries, such as Egypt, Jordan, Lebanon Morocco, Syria and Yemen, have reported, for rather long periods, not only high growth rates of their M1 and M2 money stocks, but also relatively high prices. By contrast, oil-producing countries, such as Kuwait, Libya, Oman and Saudi Arabia, have reported fairly low growth rates of their M1 and M2 money stocks, together with fairly moderate price rises. These examples illustrate the direct relationship between monetary policy and inflation.

Central banks (banks of issue) are the main actors of national monetary policy. These institutions may, therefore, see to stability in matter of prices in Arab countries. They have multiple tools at their disposal. Among classical monetary policy measures, one may mention discount or refunding policy, minimum reserve policy and open market policy.

To these, one would add the currency-related policy which the State contributes in devising, and the direct credit restriction policy of the bank of issue.

The discount or refunding policy relates to variation of the discount rates by which commercial banks may, in case of need, obtain short-term credits from the Central Bank. The banks submit to the Central Bank discountable commercial paper (discount policy) or mortgage certificates of deposit (Lombard rate policy) in order to obtain short-term loans from the Central Bank. Based on variation of the discount or Lombard rates, the Central Bank may influence credit demand by banks and by the private sector. Conditions for such credits in the Arab world differ from one country to another. It is worth emphasizing that the policy related to the money stock, in this way, can only obtain in the presence of a well-developed capital market. Unlike Western industrialised countries, most Arab countries do not meet this requirement. Consequently,

<sup>27</sup> Money stock (M1): component currency, notes, demand deposits (subject to no term, means of payment always available).

<sup>28</sup> Money stock (M2): M1 + time deposits with a term of 4 years or less.

such monetary policy measures are less efficient in them.

The minimum reserve policy relates to variation of the deposits reserve rates (demand deposits and time deposits) which commercial banks must constitute with the Central Bank. An increase of the reserve rate narrows the room for manoeuvre of private banks, while a reduction of this rate increases the possibility of granting credit. This instrument, which is often used in industrialised countries, steers directly the money stock and, thus, influences demand for credit by the private sector. In Arab countries, this tool is hardly used due to lack of proper legislation.

In the case of an open market policy, the Central Bank buys or sells treasury notes or bonds, as well as local government treasury bonds, directly on the market and, thus, influences the money stock held by the private sector. This policy of steering the money supply, commonly used in the West, is limited to the Arab countries which resort to treasury notes and bonds negotiated via the banking system. It also requires private sector confidence in the State financial policy which, with very rare exceptions, does not obtain in the Arab world.

Finally, concerning the policy related to exchange rates; the Central Bank is not autonomous but operates in close cooperation with the State. Indeed, the purchase and sale of currencies on the spot market and the forward market do not only have direct effects on the money stock, but also influence foreign currency prices on the exchange market and national currency exchange rates. This measure is

widely used in almost all Arab countries. However, we do not have precise statistical data as to the volume of these transactions in the various countries.

Now, there is yet one measure that is non-market-compliant, i.e. the direct credit policy of the bank of emission or of the State. In an inflationist economy where the measures outlined above do not have the expected effect, not only the State is led, in its deficit management policy, not to use up the credits allocated to it, but also the Central Bank and State-owned and private banks are forced not to exceed a certain credit ceiling. This highly constraining measure is very rarely used. The IMF recommends this measure only when trying to curb a rampant inflation rate of the kind Algeria experienced during the 1990s.

While resorting to these various monetary policy measures, it is important to take into consideration the fact that their impacts always obtain with a certain time lag. This is all the more true in Arab countries where the monetary market and the capital market are not quite developed yet. In the case of the smaller Arab countries, whose markets strongly depend on international markets (the Gulf countries, or Lebanon, for instance), the effects of the monetary policy of the bank of issue and of the stability policy of the State can, furthermore, be neutralised by external elements, of which financial flows to or from overseas, for instance. Besides, the success of monetary policy also depends on other measures of economic policy and, particularly, financial policy and foreign trade.

# Competition Laws

## Distortion of Competition in the Arab Economies and Consequences on Economic Development

BY YUSUF MANSUR

**The introduction of well-defined legislation governing the rules of monopoly and competition, touted by economists as a necessary underpinning for development, is a new advent in most Arab economies. In many cases, the legislation, when introduced, is supported by weak, non-independent implementation structures and mechanisms, or hurdled by lack of expertise and awareness. Consequently, monopolistic practices, which create inefficiencies and market distortions, continue to plague many of the Arab economies. One remedy is found in the application of the principles of the social market economy in relation to competition.**

Economics defines development as a state of sustainable economic growth, whereby an economy grows at sustainable rates for several years. For the growth to be sustainable, it must be based on the enhanced competitiveness of its economic agents. Competitiveness, in its core, means being more productive than other producers; thus, increased competitiveness is enhanced productivity of the economic inputs or factors. In other words, in order for an economy to become competitive, it must improve the conditions that affect the productivity of its economic agents, including workers and capital.

As per the European Union and United States, two leaders in antitrust legislation, and the UNCTAD model competition law, and the Anti Competition Restraint Law of Germany, which was introduced as early as 1958, an antitrust law typically includes three broad elements: anti cartel or collusion mechanisms; restrictions against abuse of dominance or monopoly power; and regulations controlling mergers, acquisitions and amalgamations, which would concentrate market power in fewer companies. Such a law would entail penalties associated with infringements upon the law that vary from one country to the other and are usually levied in addition to existing penal codes, not in lieu thereof.

Best practice, especially in developing countries, requires that the body in charge of the implementation of a competition law should be independent, an issue which takes greater prominence where governments are not elected. The judiciary should be trained on the technical aspects of competition in order to competently handle competition issues. The public in the Arab world, who have, for decades, been used to handling anticompetitive practices through bribery or silent forbearance, should be made fully aware of its precepts and stipulations in order to avoid such practices and their consequent penalties.

A pressing need for proper and fully implemented competition legislation has emerged with the start of the privatization process, which commenced in the Arab world in the 1990s. The Middle East and North Africa region generated, so far, over \$19 billion (5 percent of total developing country proceeds generated from privatization) through 310 transactions. Privatization, defined as the full or partial transfer of ownership or management of an entity from the public to the private sector, can also mean the transfer of a public monopoly into a private monopoly, which would operate unchecked without a properly implemented antitrust law. The economy, thus, loses efficiency as the private monopoly would cause little efficiency gains in terms of reducing production costs or improving quality; and the consumer continues to suffer from higher prices, restrictive practices to entry and the lack of development of competition in the domestic market.

While development economists emphasize the importance of having competition legislation, few countries in the Arab region have introduced such legislation into their economies even after implementing aggressive and wide-reaching privatization programs. The Arab countries that have competition laws are Jordan, Lebanon, Oman, Saudi Arabia, Algeria, Egypt, Morocco, and Tunisia. The majority of these countries only introduced such legislation af-

ter having signed Association Agreements with the EU under the 1995 Barcelona Declaration, which stipulated that the signatory to the agreement should make their competition legislation compatible with that of the EU. Other countries, which have not signed such agreements with the EU but are seeking membership in the World Trade Organization (WTO), have had their competition legislation scrutinized and were encouraged, as a precondition for accession, to become compliant with the standard rules of competition by introducing such legislation, as it affected trade practices.

The countries that do not have competition laws are Bahrain, Kuwait, the Palestinian Authority, Qatar, Syria, the United Arab Emirates, Yemen, and Libya. With the exception of the Palestinian Authority, which is a special case in many respects, all the countries that do not have competition laws are also oil producers.

Moreover, the introduction of competition laws into Arab economies has been slow and weakened by ineffective implementation mechanisms. In Jordan, the first draft of a competition law was first introduced in 1996; however, it was not until 2004 that a competition law was formally introduced. Similarly to Tunisia, the first Arab country to introduce such a piece of legislation in 1991, the implementation of the competition law in Jordan still suffers due to a lack of independence of the body tasked with its administration; a lack of adequate knowledge of lawyers, judges and prosecutors of the technicalities of such laws; and infringements upon the scope of the Competition Directorate at the Ministry of Industry and Trade by the regulatory commissions which had sprung up with the start of the privatization drive. In Egypt and Saudi Arabia, recent newcomers into competition legislation, judgment upon implementation is still pending.

Arab countries, in general, have been reluctant to introduce this legislation. Part of the reason for the delay in introducing and implementing such laws is the focus by rulers on the maintenance of the status quo instead of creating development through enhanced productivity and competitiveness. Another reason is that special interest groups, usually close to the rulers and recipients of monopoly rights as a reward for allegiance or kinship in countries where economic and political decisions are unilaterally taken, can monkey wrench the process of introducing such legislation. A third reason is lack of expertise, which can be easily acquired given the plethora of technical aid packages that the poorer countries enjoy and the enhanced revenues among the oil producers due to increased oil prices.

It is not surprising, hence, that the First Arab Human Development Report, published by UNDP in 2002, cited many deficiencies in the development of the Arab economies amidst shock and uproar by observers in and out of the region. Even the oil rich economies have shown, over a span of 20 years, less development than the world average and some of the world's poorest regions. The upshot is that dictatorships suffocate competition and breed inefficiencies. Development experts and policy makers would do well to look into the principles of the social economy, and learn some of the benefits generated in economies where enlightened reforms combined the free market principle with the equitable social distribution of gains within a society. Thus as Konrad Adenauer once said, "Freedom is the basis of success of humanity's work and its aspiration", However, "The freedom of the individual, imposes upon one that he or she benefits from it without forgetting his responsibility toward those around him and society as a whole." This should be the starting point of any antitrust legislation—a free market is, therefore, not an unregulated market.



# Solidarity and Subsidiarity

## A Basis for Social Peace in the Arab World?

BY GHANIE GHAUSSY

**In the debate around regulatory policy (managed policy), the “principle of social State”—that is the harmonisation of social differences (“social question”)—plays a key role. In several Western countries, and a fortiori in Germany, the principle of social State is even enshrined in the Constitution (foundation law, Articles 20 and 21). A hundred and twenty years ago, and after heated discussions and claims to resolve the social question, the principle of social State was incorporated, in an exemplary way, in the social legislation established by Bismarck. Since then, the legitimacy and functionality of the principle of social State have formed the subject of several political and public debates and have had their implementation methods refined.**

Claims for the establishment of a social State are also heard in almost all Arab States—though under a form different from that applied in the West. It derives its origins from an “Islamic vision of the State” since Islam is not only a monotheistic religious doctrine, but also a State ideology which, by enjoining mandatory norms, values and codes of conduct, marks the State with its special imprint. According to the precepts of the Islamic faith, the socio-ethical principles of “solidarity” and of “subsidiarity” should be in the foreground in all Muslim countries.

What do these principles mean? Solidarity is a socio-ethical principle which derives its roots from the notion of “fraternity”, so dear to the French Revolution. It conceives the individual as part and parcel of society and requires him not to limit himself to his own well-being, but to also see to the well-being of the weaker ones in society. So defined, the principle of solidarity rests above all on the solidarity attitude of high-performance citizens, that is, on sympathy, helpfulness and reaching out to under-performing citizens. It is not the individual interests of each that have precedence, but rather the will of each individual to contribute—by his services—to the well-being of society, i.e. to show solidarity to those around him. Besides, the citizen has to be ready to accept the principle of social

State as part of his performance system. Seeing that the State has also to act according to the principle of equality, it must—inasmuch as it observes the criteria of equality and the rule of law—to see to the well-being of the whole population.

As an organiser principle, “subsidiarity” addresses the relationship between State and individual/society. The State brings assistance and support to the members of society who are incapable of resolving their problems by their own means. More practically, this means that State activity must be organised in conformity with the principle of social State. At the same time, it does not have to turn into a threat to the freedom of the individual and of social groups. The subsidiarity principle sustains the social State and its system based on performance and merit, but it equally underscores the gaps and limitations of State intervention inasmuch as the latter restricts the freedom of the citizens. Freedom is a fundamental value and its protection appeals to the responsibility of each. The challenge consists, once again, in striking an optimal balance in State action.

Here, we come to the second question: “What is it that legitimises the principle of ‘social State’?”

To begin with, one needs to mention “social security”. This concept comprises the creation of framework conditions likely to ensure an existence that is socially acceptable to each citizen. These conditions may be achieved, for instance, by means of social insurance measures, creation of educational facilities, health care infrastructures and, finally, structures ensuring a minimum of security to the citizens who are incapable, by their own means, to access social services. Thus, the State ensures a decent existence to the citizens who, for various reasons, are incapable of providing against the hazards of life by a proper provision.

Next to “social security”, the second pillar of the social State is “social justice”. The latter requires the social State, in accordance with the subsidiarity principle, to support the economically vulnerable

members of society, to prevent any too wide gaps between the various social groups and to protect the more vulnerable members of society against the many risks that threaten their existence, without however removing or excessively curtailing fundamental freedoms. Indeed, the social State must also observe "individual freedom" as a "fundamental right".

What about "solidarity" and "subsidiarity" in the Arab world? The fact that solidarity does not derive exclusively from an individual voluntary decision, insofar as it extends beyond the ethical obligations prescribed by the Koran—"sadaqa" (charity) and "zakat" (alms tax)—is attested by the existence of private foundations (awqaf), of a religious and ethical character, created most often by rich citizens. These foundations are quite common in Arab States. It is this solidarity which actually explains the creation, in 1928, of the "Muslim Brotherhood" association whose initial objective was to renew society according to the precepts of the Koran. Rapidly accepted by the citizens of other Arab and Islamic countries, despite temporary bans, this association created several sister organisations in other Arab countries. Since then, this organisation has reported a strong politicisation which goes beyond the mere principle of solidarity. Another supranational organisation, the "Islamic Solidarity Fund",

created by Saudi Arabia, disseminates Islamic solidarity on national and international level based, in particular, on a strict Wahabi interpretation of Islam.

As for "subsidiarity" as it exists in Germany, it is rare in Arab countries. However, in these countries, the State is a major actor in the social field. Most often, the military, civil servants and those in power have created a "State fund" which controls the means of production and the distribution of income. Socialist ideologies and social reforms related to development objectives which rest on social justice and participation by the masses in the means of production are quite common: "Ba'th party socialism" in Syria and in former Iraq, "Arab socialism" of Nasser, "Algerian socialism" of Boumédiène, "Third Universal Theory" of Kaddafi, to mention but a few. They all promise to their respective countries both social justice and security guaranteed by the State. That these systems should question the fundamental right to "freedom" is a logical consequence of this economic and social policy. The social and distribution policy practiced by Saudi Arabia is of a completely different nature which, in view of the huge wealth accumulated thanks to the oil godsend, has led to the creation of various "rentier classes" of which some are privileged, indeed.

# Exchange Rate Policy in Arab Countries

## Walking a Tightrope between Free Play of Exchange Rates and Monetary Stability

BY GHANIE GHAUSSY

**Being a major tool of monetary policy, the exchange rate policy serves to influence the price of foreign currency, denominated in national currency, on the national exchange market, particularly if the latter is subject to strong variations. Within the free exchange rate system adopted by the IMF member States, exchange rates vary according to currency offer and demand on exchange markets.**

When exchange rates vary quite strongly, central banks intervene by buying or selling currencies in order to stabilise the exchange rates on the market. Being IMF members, Arab countries have also committed to accepting market-driven free exchange rates. However, for monetary or balance of payments reasons, they intervene on the exchange market to avoid too strong fluctuations of currency prices (exchange rates). On the whole, States intervene on the exchange market only in either of two cases: either because a deficit of the balance of payments would induce strong devaluations, that is a drop in exchange rates, or else because a surplus of the balance of payments would induce strong revaluations, that is a rise in exchange rates on exchange markets. Excessive devaluation, as much as high revaluation, constitutes a serious threat to international trade, to the evolution of global income and to the situation of employment in the countries concerned and, consequently, to the stability of national economy as a whole. It must be added that these active interventions in matter of exchange rates do not always generate the effects desired. Indeed, the current balance of payments may react in an "abnormal" way to currency devaluation and revaluation. This case in point often occurs in developing and emerging countries—in which most Arab countries belong. This abnormal reaction induced in particular by a devaluation may be explained economically by the elasticity of the demand on currency.

The listing of exchange rates on the markets of Arab countries differs from one country to another. On the whole, rich countries—such as Kuwait, Libya, Saudi Arabia and the United Arab Emirates—have quite significant currency incomes thanks to exports of oil whose prices have been constantly on the rise on the global market over the past few years. This situation generates significant surpluses of the current balance of payments and keeps foreign debt within a quasi-negligible rate. These countries export their capital and invest their currencies on the short or medium term on international markets. In the past, fear of foreign takeover or domination of markets swayed in industrialised countries due to the considerable flow of petrodollars. The Mexican crisis and the long-term decrease in oil prices on the global market during the 1990s have left such fears unfounded. Rich Arab countries have always used part of their surpluses for imports of goods, so much so that their balance of payments has ended up posting a deficit again, and this, even in Saudi Arabia, the top oil exporter during the 1990s. Besides, petrodollar surpluses have served for long-term foreign investments, particularly in the USA and in Western Europe. According to data released by the IMF, the foreign currency reserves of these countries have increased significantly since 2001 due to the rise in oil prices following the war in Irak. On the other hand, such countries as Egypt, Jordan, Lebanon, Syria, Morocco, Tunisia and Yemen experience heavy indebtedness. Some of them depend on capital imports in view of their negative current balance of payments. In order to illustrate the problem of these countries, it would be interesting to propose a few figures: in 2003, a year for which we have statistics for Arab countries issued by the IMF, the foreign debt, denominated in percentage of GDP, amounted to 111% for Syria, 110% for Lebanon, 84% for Jordan and 75% for Tunisia. For Egypt, this rate posted 31%, while for Algeria, Morocco and Yemen, it was respectively as follows: 40%, 47% and 40%. In order to assist these highly-indebted countries to

wards overcoming the balance of payments difficulties which constitute major risks for economic stability, the IMF grants transition loans in accordance with the "stand-by arrangement" (SBA).

Apart for the chronic surpluses and deficits mentioned above, one notes—even in rich Arab countries—short term currency fluctuations. These fluctuations often have a negative impact on global income, as well as on domestic balance. The increase in the money stock due to rising currency incomes is a special case. If this increase is not accompanied by a greater offer in goods, the country runs the risk of an "inflationist" price rise. It is for this reason that, even in this case, exchange rates are modified; in other words, the State intervenes actively on the exchange market.

As a general rule, Arab countries—which are also member-States of the League of Arab States—wish to manage themselves their exchange rates systems. Given the fact that free fluctuation of exchange rates comprises, in particular when the fluctuations are significant, several economic risks, Arab countries have also opted—inasmuch as they

have pegged their currency to the dollar, SDRs or the Euro—for the "managed floating" policy, that is, controlled flexibility. This implies that the formation of exchange rates is left, generally speaking, to the market. However, the relevant authorities on national level may intervene, periodically and according to the economic situation, on the exchange markets by buying or selling currencies. The chief objective remains achieving the "long-term balanced exchange rate", that is the "right trend" which, from the point of view of the proper authorities, serves as a reference. Such interventions avoid too strong fluctuations of exchange rates. They become necessary in the face of the globalisation of capital markets and the short and medium term capital flows on international exchange markets. Such interventions also help facilitate the process of adaptation of national macroeconomic monetary aggregates. The efficiency of these interventions depends on the time of intervention, the amount of foreign currencies or of national currency sold or bought on the market and on the continuity of the economic and monetary policy of the relevant monetary authorities.

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