Selamat datang Bapak-Bapak dan Ibu-Ibu,

Konrad-Adenauer-Stiftung Indonesia and Timor-Leste (www.kas.de/indonesien/id/) is pleased to welcome you on this year's postgraduate course "The Social and Ecological Market Economy", which will take place in Bandung (November 19-23) and Belitung (November 25-29). Moreover, we would like to congratulate you as you have been chosen out of a vast array of applications to attend this programme. With such talented, skilful and promising people on the course, we are very much looking forward to meeting you soon in one of the two places.

For Konrad-Adenauer-Stiftung (www.kas.de/wf/en/), a German political foundation with offices in more than 80 countries worldwide, the principle of Social Market Economy is one of its core beliefs both domestically as well as regarding our international cooperation. We are convinced that the teachings of the Social Market Economy lay the groundwork for a relationship between economy and society that allow for personal freedom and economic success while guaranteeing protection from radical economic influences. The overwhelming success story of Germany's economic, social and political development over the last 60 years only proves us right. Globally, too, the Social Market Economy may be a guiding principle for how to combine economic growth and success with social balance. With growth rates rising in more and more countries worldwide, the question of how to distribute wealth in a just way may only get more pressing.

Hence this course is designed to make you familiar with the principles and core beliefs of Social Market Economy. For this aim, we proudly announce that we were lucky to have Professor Marcus Marktanner from Kennesaw State University (USA). He has been a renowned expert on Social Market Economy for many years and has widely published on development economics. He has been so kind to provide a basic reading that you can find below. We ask you to have a look at it **prior to your participation in the course**. In order to discuss the Indonesian economic model and potential ways of how it could benefit from Social Market Economy, we have an excellent team of lecturers from Paramadina University, our cooperation partner for this course.

We would like to cordially thank Dr. Anies Baswedan and the team of Paramadina University without whose support this programme could not have been realised. It has been our utmost pleasure to work with such a prestigious institution and we are sure that the inspiring und trustful cooperation in the run-up to this programme will lead to its success in the end.

For now, we would like to wish you an interesting read of Marcus Marktanner's summary and many fruitful discussions and new insights during the course later this month. We are looking forward to meeting you in Bandung or Belitung, respectively.

Yours sincerely

Dr. Jan Woischnik
(Head of Office, Konrad-Adenauer-Stiftung Indonesia and Timor-Leste)

The Social and Ecological Market Economy

A Primer

By

Professor Marcus Marktanner, Kennesaw State University

1. Introduction

This course introduces the concept of the Social and Ecological Market Economy (SEME). The normative objective of the SEME is to combine the freedom on the market with equitable social development (Mueller-Armack, 1956, p. 390). In order to accomplish this objective through economic policy, the SEME is concerned with five questions:

1. What value system guides the SEME?
2. How is the state supposed to be organized?
3. How is the market supposed to be organized?
4. What socioeconomic developments must government correct?
5. What principles shall guide government interventions?

In answering these questions, Social Market Economists rely on two sources: Economic history and economic theory. This is despite the fact that since the late 19th century there has been a methodological dispute ("Methodenstreit") about the right approach to economic research.

The "Methodenstreit" is essentially about the missing micro foundation of macroeconomics. The historical school around Gustav von Schmoller (1838-1917) argued that economic theories should be derived from the descriptive study of real world events. This was opposed to the deductive approach of the Austrian School, founded by Carl Menger (1840-1921). The Austrian school argues that economic findings must be deduced from microeconomic models, which rest on plausible assumptions about individuals and their interaction (see, for example, Ekelund and Hebert, 1997, pp. 246 ff.).

Social and Ecological Market Economists have always looked at the Methodenstreit as a non-productive intellectual battle. Eventually, every modern economist should not only be well trained in theory, but also in economic history and empirical research. Rather than seeing deductive and inductive economic research as mutually exclusive approaches, both have their legitimacy, and both have a strong legacy in the SEME.

In light of this, this course begins with a short journey through global economic history from its earliest days until the development of Social and Ecological Market Economic thought in the

first half of the 20th century. This historical contextualization illustrates why Social and Ecological Market Economists have developed certain policy preferences the way they have. Moreover, a historical contextualization breathes exciting life into otherwise boring economic theory. It also shows that the intention of Social and Ecological Market Economists was never to only provide an economic vision statement for post WWII Germany. In contrary, because the SEME draws on political and economic lessons from different places at different times, it always has been engaged in dialogue with other intellectual schools. Social and Ecological Market Economists also comment on economic policy outside Germany and Europe from their own perspective. The SEME must be accordingly understood as an independent economic school of thought that often offers alternative points of view to neoclassical, Keynesian, and socialist economics. Sometimes it also offers complementary positions.

2. A Brief Journey through Comparative Economic History and Economic Thought

2.1 From Ancient and Medieval Political and Economic Thought to Enlightenment

Much of ancient and medieval political philosophy rested on the idea that the individual is subordinate to the state. This was the case during Athens' democracy, the Roman Empire, medieval times, and the spread of mercantilist empires.

The collapse of mercantilist empires encouraged a new political philosophy. This new philosophy was enlightenment. It championed the value of individualism and the subordination of the state to citizens' needs. This period naturally coincided with the emergence of modern nation states, with Great Britain becoming the first of them.

Adam Smith (1723-1790), the father of modern economics, saw himself as a moral philosopher. His moral philosophy was an attack on the medieval church's beliefs about individual responsibilities. In its early days, the church struggled with accepting private property as compatible with Christian values and held that the pursuit of self-interest is sin. Feudal land ownership, the collection of taxes, and the restriction of individual citizens' economic opportunities were justified by the church's alleged position as the earthly arm of divine law (compare Frost (1989), pp. 175-206). Others may argue that the medieval church abused this role.

Things began to change with Gutenberg's (1398-1468) invention of the printing press around 1440 and the availability of the bible to the common man, ending the Church's interpretation monopoly of the Bible. As more and more people had begun to read the Bible, disagreement with the church's reading rose. Popular discontent eventually culminated in several peasants'

uprisings across Europe. Europe's struggle for private land ownership had begun, but it was not before the 1789 French Revolution when it started to turn in peasants' favor.

As opposed to the church, Adam Smith explicitly accepted the idea that all individuals are driven by self-interest. But does that mean that a society which gives free reign to self-interest turns into a sin city governed by waste, gluttony, and immorality? The answer is no, at least as long as the society's scarce resources are allocated through a competitive market system.

Modern economics motivated by Adam Smith's ideas has shown that market competition forces all economic actors to use scarce resources wisely. No economic actor can afford to waste them for the purpose of personal vanity. The market place will punish such behavior immediately. Under competition, the wasteful loses against the frugal and the vane against the humble. Vanity, immodesty, and waste will ultimately increase the cost of production and reduce investment capacities. Competition teaches individuals the same values that the church preached, too. But people's right to pursue their own interest has led to a much greater supply of basic needs than what would have been ever possible under the rule of the medieval church. This was the moral philosophy of Adam Smith and this moral philosophy is fully adopted by the SEME.

2.2 The Industrial Revolution, the Social Question, and Socialist Economic Thought

The 1688/89 Glorious Revolution in England, which introduced a parliamentary monarchy, provided the country with political and economic freedoms that were unmatched in Europe at the time. These freedoms interacted with other advantageous pre-conditions for development. These conditions were a favorable climate, navigable rivers, and a strong naval fleet to protect against invasions. The combination of political and economic freedoms helped England develop financial markets and entrepreneurship, which triggered the industrial revolution (for more on England's exceptionalism, compare Landes (1998), Chapter 15).

As the industrial revolution proceeded, however, it also produced socioeconomic hardship, whose dimensions Adam Smith had not foreseen. The development of industrialized urban centers led to fast rural-urban migration. The number of workers rushing into cities in hope for a better life and economic opportunities grew much faster than what could be absorbed by the newly established manufacturing industries. As a result, wages kept on falling and people started to work ever longer hours in order to make up for lower wages. Some families became so desperate that they even had to send their children to work. And many factories had not scruples to hire them. These dynamics have become known as the social question of the 19th and early 20th century.

How had the social question eventually been resolved and how did Europe turn into a welfare state, for which it is known today? One important factor was land abundance and labor scarcity in the United States of America of the 19th century. The United States provided the opportunity for many disenfranchised Europeans and landless peasants to migrate. Driven by the opportunity to own land and to leave economic hardship and political uncertainty behind themselves, Irish and Germans became the biggest emigration populations to the United States in the mid-19th century. The drain of people in Europe increased the political bargaining power of those who stayed. Since emigration was a credible threat, governments needed to respond with sincere social and economic reforms. One could therefore date the origin of Europe's welfare state to the mid-19th century and credit Europe's emigrants and the United States' open door policy for it (compare World Bank (2002), pp. 24 ff.).

An important by-product of the social question was the development of socialist economic thought. Karl Marx (1818-1883) blamed the social question on an unequal primary distribution of productive resources. Owners of factor capital hire factor labor, which, although they generate the value added in the production process, is paid only a subsistence wage. Socialists then concluded that capital should be socialized in order to prevent the exploitation of workers.

The idea of Marx's exploitation mechanism is not novel. Already in the 18th century, there was an intellectual movement in France called Physiocracy, which explained the exploitation of landless peasants by the landed aristocracy. The land owning class hires tenant farmers, who add value to agricultural production, but the peasants never leave the minimum subsistence income level.

Therefore, if one substitutes the Physiocrats' landowners and peasants by Marx's capitalists and workers, respectively, one obtains the same mechanics at play. But the policy conclusions were very different. The Physiocrats saw the solution to the exploitation of peasant by the landed aristocracy in land reforms that will give peasants private ownership of land. Physiocracy was a powerful intellectual movement prior to the 1789 French Revolution. Marx, for whatever reason, saw the solution not in the empowerment of workers, but in the disempowerment of the owners of factor capital. In his famous words: "In this sense, the theory of the Communists may be summed up in the single sentence: Abolition of private property" (Marx and Engels (1848), p. 22).

There is obviously a relationship between private land ownership and capital accumulation, which is that private land titles can be used as collateral to gain access to credit. In order to resolve unequal access to capital, therefore, Social and Ecological Market Economists advocate as a first best solution that economic development starts with a land reform. A land reform would give individuals land titles that can be traded and used as collateral. If the land reform is accompanied by the expansion of a competitive banking sector, the outlook for equitable social

development is favorable. In places where land reforms are not possible and people do not have resources that can be used as collateral, private banks will not cater to them and the government needs to develop second best solutions. Such second best solutions could be public banks that step in where private banking markets fail. Cooperatives are other second best solutions.

While Marx may have correctly identified capitalist exploitation mechanisms underlying the social question, his policy recommendations were short-sighted. He was oblivious of the importance of access to education and the accumulation of human capital. Marx was also ignorant about the problem of incentive-incompatibility of socialist production. Last but not least, Marx predicted falsely that England would see a workers' revolution. Instead, Bolshevist party apparatchiks took the revolution to Russia after its Czarist regime began to falter during WWI.

2.3. The First Globalization Wave, the Stock Market Crash, and the Great Depression

The period between 1870 and 1914 is often referred to as the first wave of globalization. It was characterized by North-South trade flows, in which North America and Europe specialized in capital-intensive manufactures and Latin America in land-intensive agricultural production. During this first globalization wave, much of Europe and the United States had already established relatively equal primary distributions of land. In addition, political structures were comparatively responsive to citizens' needs. The same holds for the so-called Western offshoots of Europe, which are Canada, New Zealand, and Australia. As trade with the South increased and Europe and North America began to specialize in manufactures, the labor force benefitted equally from the economic expansion.

The situation was very different in Latin America where much of the political and economic life was controlled by European colonists. European colonization already began in the 15th century and the legacy of colonialism dates back much further in Latin America than in any other place. The blood toll of Latin America's colonization was also much greater than that of North America (which is not to trivialize the death toll of Native Americans in the North). European settlers have annihilated large shares of indigenous populations and brought huge holdings of fertile land under their control. Compared to North America, a highly unequal primary distribution of land and economic opportunities emerged. With South America specializing in land-intensive production, the already high initial levels of income inequality were now further enhanced by the asymmetric gains from trade, which exclusively favored the landed aristocracy. One of the reasons why Latin America has today among the highest levels of income inequality is rooted in these historical events.

The first globalization wave came to an end with World War I. The end of WWI had very different consequences for Germany and the United States. After WWI, the United States enjoyed the roaring 1920s. This period was characterized by bursting consumer confidence. The USA emerged as the new political and economic powerhouse and the Pax Americana slowly replaced the Pax Britannica. At the end of the 19th and early 20th century, the USA also pioneered the introduction of anti-trust laws. Its firm commitment to competition fully unleashed the US economy's productive potential. Much of the economic expansion was financed by stock markets. And stock prices had been rising quickly. As stock prices kept on going up, an economic bubble developed. As people felt richer because of higher stock prices, they used their stocks as collateral for loans to buy even more stocks, fueling stock prices even more. But at some point of time, markets had become saturated and new innovations slowed down. Once this saturation point had been reached and stock holders realized that their expectations about continuously rising stock prices have no real economic basis anymore, the big sale began and prices came down faster than people were able to sell. A huge number of savers lost their wealth. Similar dynamics are at play in most other financial crises.

Most financial crises can be linked to what 18th century political philosopher David Hume (1711-1776) called the price-specie flow mechanism. This mechanism showed the logical inconsistency of mercantilism, which was the economic development model of imperialism. Mercantilist philosophies dominated Europe between the 16th and 18th century. Free trade was seen as a zero-sum game: Exports are good, imports are bad. But because continuous trade surpluses will not be tolerated by trading partners on equal footing, mercantilism also required military conquest and oppression. As opposed to the liberal peace hypothesis, which states that freely trading partners do not go at war with each other, mercantilism was a formula for war and conflict.

The price-specie flow mechanism says that continuous trade surpluses lead to an inflow of gold and silver ("species"), which drive up the price level. But as inflation increases, it would make more sense to import the same good cheaper from other countries with lower prices. If countries resist balancing their trade accounts by switching to imports, then they must use ever more resources towards coerced trade and their empires will likely collapse under "imperial overstretch" (Kennedy, 1987).

In modern days, the price-specie flow mechanism works more subtle. It is generally linked to a sudden expansion of the monetary supply, which may or may not be the result of a trade surplus. What matters is inflation. Because prices are not checked by international competition, inflation affects the non-tradable sector like real estate and services more than the tradable sector, where international competition keeps inflation low. Then, when prices for real estate go up, people feel richer and consume more, which is known as the Pigou-effect, or in Marxist

terms, fictitious wealth. Then, lured by the wealth illusion, many people will expand overly optimistically their borrowing by using their existing non-tradable assets as collateral, thus inflating the bubble even more. Investors who redirect productive resources from the tradable to the non-tradable sector in expectation of higher prices and profits also add fuel to the fire. And as long as money is relatively cheap, the bubble will continue to grow. Only when the supply of non-tradables overshoots demand, prices will collapse. And prices collapse faster than they have been climbing up, just as a bubble bursts faster than it was inflated (for a comprehensive discussion of the 1929 Stock Market Crash, see Galbraith, 1961).

Another factor contributing to the stock market crash was at play too, especially towards the end of the 1920s. This factor was the Gold Standard. The Gold Standard is a monetary system in which the central bank backs each coin and bill in circulation by an equivalent of gold. The problem during the end of the roaring 1920s became that not enough gold could be secured in order to make sure that the money supply kept pace with the growth of the economy's real output. And just as inflation is the result of a money supply that grows faster than the real output, deflation follows when the money supply falls short of real output. And this is what happened during the late 1920s.

Deflation is a dangerous development that decreases aggregate demand through a self-fulfilling prophecy. Once consumers observe that prices come down, they postpone their spending, hoping that prices keep on falling even more. And because consumers do not choose to buy, demand decreases, and producers need to respond by lowering prices. Under the Gold Standard, deflation, which began in 1928, can only be stopped when demand for money goes down again, which only happens as a byproduct of a decline of economic output. Thus, under a pure gold standard, monetary policy cannot react before a recession takes place. This, however, did not happen after 1929, which, according to monetarist economists, is the main reason for the transformation of the bubble of the 1920s into a Great Depression, which was at its height in 1933. This is even more puzzling if one takes into account that when the USA went into a recession, imports from England decreased faster than exports, as a result of which Gold Reserves in the US even increased. But the Federal Reserve simply refused to make credit available (For a monetarist view of the Great Depression, see Friedman and Schwartz, 2008).

In retrospect, when taking the two developments of a stock market bubble and deflation together, their interaction resembles a bomb with an explosive and a fuse. The explosive was the stock market bubble and the fuse was deflation.

The situation was very different in Germany. After World War I, the Treaty of Versailles mandated reparation payments from Germany. With a destroyed economic base, the reparation payment burden left the German government with no fiscal space to rebuild the economy and to finance public services. The government was forced to finance its expenditures

by the money printing press, which inevitably led to inflation. In 1923, the economy collapsed under hyperinflation. The 1923 experience with hyperinflation is still in the collective memory of Germany and explains Germany's rigorous commitment to price stability ever since.

Still in 1923, Germany introduced a currency reform. It also received help from the United States, which provided much needed loans to Germany's banks and industries. It followed a short period of economic recovery, which has become known as the Golden 1920s. During this time, consumer confidence spread, economic activity increased, and cultural life returned to the cities. But the 1929 stock market crash and subsequent global economic crisis put an abrupt end to this era.

The economic downturn initiated by the 1929 stock market crash was made worse by two economic policies aimed at restoring full employment. These two policies were competitive tariff and currency depreciation races. The policies have become known as "beggar-thy-neighbor" policies because all countries were trying to recover at the expense of all other countries. And as all countries had the same idea of escaping their own economic malaise at the expense of others, all countries eventually needed to learn that no country could gain, but that they all lose. International policy cooperation became victim to a collective rationality trap. What happened precisely?

As the world economy fell into a recession, each country thought that the imposition of tariffs would create jobs, because what used to be imported would now have to be produced domestically. The problem with this idea was that all countries were hoping that all other country would not have the same idea. Yet, all countries were equally "smart." Consequently, all countries started now to create jobs to replace imports but they lost jobs in industries that used to export. And because under free trade countries import goods that it could produce under autarky only at higher costs, and exports goods that it can produce at lower costs than other countries under autarky, all countries lost their specialization gains from free trade without creating more jobs.

Similarly, most countries abandoned the Gold Standard and tried to depreciate their currencies against other countries through an expansion of the money supply. Then, if one currency depreciates against the other, exports of the depreciating country would be stimulated. But the problem of the currency depreciation policy was again that it only made sense if all other countries would not have the same idea. But they also had. Widespread currency depreciation led therefore to no nominal currency depreciations and no employment gains, but all countries ended up with more inflation.

Germany was hit by the Great Depression at an extremely vulnerable point in its history. The late Golden 1920s just seemed to leave the memory of the hardship following WWI and

hyperinflation behind Germany when the specter of an economic downturn suddenly returned. As the US entered the Great Depression, aid to Germany receded again. As Germany felt again isolated and vulnerable, it eventually became receptive to radical political ideas, something which the brilliant British Economist John Maynard Keynes (1883-1946) already warned of in his 1919 book "The Economic Consequences of the Peace" (p. 251): "But who can say how much is endurable, or in what direction men will seek at last to escape from their misfortunes?"

One important factor contributing to Germany's political radicalization was its economic structure. As opposed to the United States, which introduced anti-trust laws and competition policy already at the end of the 19th century, Germany still had tolerated a highly cartelized industrial and financial sector. The financial and industrial sectors were seen as partners of the government in pursuing political goals of the still young German nation state, especially in its pursuit to outcompete France, England, and Russia in the late 19th and early 20th century for imperial hegemony. Similar political constraints did not exist in the United States. At the end of the 19th and early 20th century, the priority of the United States' economic policy was much more on domestic economic development than on foreign policy. In Germany, these priorities were reversed.

The Great Depression also led to a paradigm shift in economic theory. In the public opinion, the 1929 Stock Market crash and subsequent Great Depression were seen as a failure of markets. They were not seen as a failure of the regulatory framework of these markets and the counter-productive economic policies of the 1930s.

The Great Depression gave rise to two new branches of economics. One was Keynesian, the other monetarist economics. In a nutshell, Keynesian economics, which developed in the midst of the Great Depression, focuses on how to stabilize an economy after a crisis has occurred. On the other hand, monetarist economics, which established itself after WWII, is more concerned with the prevention of a crisis in the first place.

As far as practical economic policy is concerned, Keynesian economics quickly won the upper hand. The philosophy of Keynesian economics is similar to the role of a crank lever to re-start a stalled engine. Specifically, Keynes has argued that if in a recession government increases public spending, public expenditures stimulate aggregate demand, which would be followed by an increase in aggregate supply. Keynes also showed that each dollar spent by the government increases aggregate demand by much more than one dollar because of multiplier effects. Therefore, once those multiplier effects take over, the government can withdraw itself again. The economy runs again on its own. Keynesian economics encouraged Roosevelt's "New Deal."

In Germany, Keynesian economics was also at work. When the Nazis came to power in 1933, they immediately began to invest in their military capacity. Because Germany's industries were

highly cartelized, it was easy for the Nazis to co-opt them. And because Germany's industries were looking forward to economic expansion, they also happily cooperated with the Nazis. This way, fascism eventually won control over Germany. And just as Keynes had predicted, Germany's public expenditures, even though motivated by a perverse and insane political ideology, were an economic success. Employment, consumer confidence, and national pride were again on the rise. And so was people's self-denial, which helped Hitler continue to work on his delusions of German grandeur until they collapsed under Germany's capitulation in WWII. Keynes was also right here.

To Social and Ecological Market economists, the period between the two World Wars provided many important lessons. The first one was the importance of the role of the money supply for business cycles. Social and Ecological Market economists argue in line with the so-called Austrian school of economics that most financial and economic crises can be explained by easy credit. From this angle, the 1929 stock-market crisis was only made possible by reckless credit expansion in the early 1920s, during which borrowers had become increasingly leveraged on fictitious stock market wealth. A central bank that had monitored the total money supply could have prevented a bubble. This is also the belief of the monetarist school. For an overview of different experts views on making assets prices subject to inflation targeting see The International Economy Magazine (2009) publication "Should, or Can, Central Banks Target Asset Prices?"

The second lesson was that the state and the economic sector need to be strictly separated. Fascism terminates the freedom in the market and prevents equitable social development. The experience of Germany has shown that fascism undermines competition, consumer sovereignty, and the efficiency of the market. It also has illustrated that fascism ultimately leads to political instability and chaos.

2.4. Social and Ecological Market Economy since WWII – A Brief Overview

With the social question of the 19th century and the Great Depression of the 20th century still casting their shadows over Germany's collective memory, markets were seen as inherently unstable and unjust, thus giving rise to socialism as an alternative model with a moral superiority. Wilhelm Roepke (1899-1966) was one of the first to attack this popular interpretation of history. He argued that it was exactly not the market, which is to blame for economic crises, but the non-separation of government from the economic sector. With a long history of medieval gilds, associations, syndicates and cartels, this problem was already put into Germany's cradle in 1871 (Roepke, 1946). After WWI, Germany increasingly knotted tight relationships between the political and economic sector. These ties were no longer meant to

give Germany's industries room to grow, but to serve political interests. The deal was simple: Government needed Germany's big industries to finance government spending and Germany's big industries needed the government to make more than normal profits. It was a win-win situation for government and the industries at the expense of consumer sovereignty.

In the eyes of the public, the analysis of an economic crisis is often naive. Prices go up, standards of living go down, and jobs are not being created – Conclusion: Markets are bad. Ironically, this public naivety then helps government to cover up the very own economic policy failure. And while policy makers know that it is their own bad economic policy that is to blame and not the market, political vanity keeps politicians from coming clean, because coming clean puts re-election at high risk. Policy makers have therefore a strong incentive to make sure that the idea that it is the vague and anonymous market that is at the root of all evil is constantly being reinforced. Blaming the market instead of economic policy has remained a popular and effective policy strategy until today.

A particularly effective and popular strategy to cover up for bad economic policy has become to blame "the speculator." Economic actors who make available their savings in good times are typically called "investors," but "speculators" in bad times, even though they are the same person. In good times, policy makers use those investors to praise their good economic policy and favorable business climate that they have created. But when economic policy is bad, the business climate deteriorates, and the same investors face now more risks so that they demand higher interest rates, then the formerly good investor becomes the bad speculator. Politicians are just not shy to take credit for good policy, but very reluctant to admit own policy mistakes. The speculator is then the perfect scapegoat.

The Social and Ecological Market Economy is a blend of two economic schools. One was the Cologne school, the other the Freiburg school. The Cologne School was mostly concerned with questions related to the value system of the Social Market Economy. It borrowed from political philosophy, sociology, and Catholic social ethics. Two questions were asked by the Cologne School: What value system shall guide the political economy? And how is the state supposed to be organized to meet this value system?

The legacy of the Cologne School in Social and Ecological Market Economic thought has been to separate it from purely liberal and socialist economic thought. As opposed to classical liberalism, it argues that individuals are not only driven by motives of self-interest, but that they are also endowed with a social impulse. Social and Ecological Market Economists have explained this with reference to the Christian heritage of Europe and the Social Ethical Teachings of the Catholic Church. Sally (2002, Part III) reviews the influence of the various schools on the Social Market Economy.

The reference to Christianity in Social and Ecological Market Economics has always been a source of confusion and irritation. Does it mean that the SEME is a Christian or even Catholic Political Economy? The answer is a clear no. Although many SEME economists were devout Christians, the reference to Christianity and Catholic Social ethics served primarily political tactics against the alleged moral superiority of socialism. Christian religion, just like any other religion, shows that acts of solidarity have their origin in individuals' love and generosity. They are never mandated by a state. Socialism, however, takes away this Christian legacy. By imposing solidarity on people, socialism technically puts itself above God's bottom-up solidarity design. This anti-Biblical design then, of course, also explains why all socialist states have banned religion. The reference to Christian religion in the SEME must therefore be seen as a powerful political tactic to rightly discredit socialism with the prevailing religious geography in Germany at the time, not as a religious affiliation. The same argument can be made for other religions. For example, also Arab socialist states have emphasized their secular orientation, because neither is Islam a religion that calls for coerced redistribution. Even Zakat, a form of alms-giving that the Holy Al-Quran defines as one of the five essential pillars of Islam (in addition to the testimony of faith, prayer, fasting, and the pilgrimage to Mecca), is expected to grow from within the Muslim: "If you give alms openly, it is well, and if you hide it and give it to the poor, it is better for you; and this will do away with some of your evil deeds; and Allah is aware of what you do" [Al-Quran 2:271].

The Freiburg School is more pragmatic than the Cologne School. It is mostly concerned with questions related to the minimization of market distortions and the appropriate conduct of economic policy. Mainly three questions are asked by the Freiburg School: Which institutional framework shall prevail on markets? When is the state supposed to interfere into the economy? And, if government needs to interfere into the economy, then according to which principles shall it do so? Because of its preoccupation with giving the economy an order, the Freiburg School is also known as Ordoliberalism. Whereas the Cologne School defined a normative value system and a vision statement for the SEME, the Freiburg School was much more concerned with developing actual principles of economic policy towards the realization of this goal.

While the roots of SEME thought date back to the late 19th and early 20th century, it was not before 1947 before the term Social Market Economy was first introduced by Alfred Mueller-Armack (1901-1978). He defined the Social Market Economy later as a political economy that seeks to combine the freedom in the market with equitable social development (in German "… das Prinzip der Freiheit auf dem Markt mit dem Prinzip des sozialen Ausgleichs zu verbinden", Mueller-Armack (1956), p. 390). The term Social Market Economy is chosen as a commitment to individual freedoms on the one hand, and a commitment to equitable social development for all on the other. Given the historical context at the time, the term Social Market Economy was

indeed extremely powerful. It appeased those who feared that Germany might drift into socialism, and also gave hope to those who were afraid that a return to market economic liberalism could lead to another social question.

The Social Market Economy is unique in the sense that it also became an official political program, not for Germany, but for the European Union. In Article 3 of the Lisbon Treaty it says: "The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance." Not even communism managed to become a true political program, because it was considered too unrealistic. Socialism should pave the way towards communism someday, but the path literally ended at the Berlin wall separating East Germany's socialism from West Germany's SEME. Similarly, while classical liberalism, monetarism, and Keynesianism have alternated in influencing politicians, there are no countries that commit themselves explicitly to any of these branches of economic thought. The fact that the political and economic thought, which originated largely on the territory of Europe's aggressor during WWII, eventually has become the economic vision statement for a united and peaceful Europe after the war is probably the greatest recognition that the intellectual founding fathers of the SEME could have dreamt of.

The political spearhead of the Social Market Economy was Ludwig Erhard (1897-1977). Ludwig Erhard was the economic advisor to the administration of the United States' post-WWII occupation of Germany, and became later minister of the economy, and chancellor. His understanding of a Social Market Economy was founded in the firm belief that equitable social development is foremost the result of equal opportunities under a free market system. The welfare of a state depends less on a welfare state than on the presence of market-constituting principles.

Ludwig Erhard gave the starting signal to the Social Market Economy in 1948 with the currency reform and liberalization of prices. Many prices were still fixed in order to contain post WWII inflation. By liberalizing prices, Erhard stepped out of his area of authority and took the US administration by surprise. Lucius Clay (1897-1978), the military governor of the United States in Germany, ordered Erhard to have him explain his single-handed decision. In this meeting, Erhard was asked "Herr Erhard, my advisers tell me that what you have done is a terrible mistake. What do you say to that?" to which Erhard replied "Herr General, pay no attention to them! My own advisers tell me the same thing." (Yergin and Stanislaw (2008), p. 18). The response of the market, fortunately, left no doubt that Erhard was right. It was the starting

signal to Germany’s economic miracle. Formerly empty shells in the stores filled quickly, inflation receded rapidly, and economic activity accelerated fast.

The Social Market Economy in theory and practice are two different things. It is important to understand that Germany is not a role model of a Social Market Economy. Even though Social and Ecological Market Economic thought is still well represented in public political discourse, short-term political interests and international policy cooperation constraints have often led to the pursuit of policies that were against Social Market Economic principles. Since 1948, different phases can be identified.

The first phase of the Social Market Economy covered the period between 1948 and 1967. One could call this first phase the “Ordoliberal Founding Years of the Social Market Economy.” It laid the foundation for Germany’s post WWII economic miracle through the strengthening of markets. The state only played a role in giving markets a competitive order and by assuring everyone equal economic opportunities. In 1967, Germany’s post WWII reconstruction boom, however, came to an end and Germany had its first post WWII mini recession. After 1967, and in particular during the oil crises of the 1970s, a second phase began. It was during this phase when ecological concerns were given greater attention. It was also during this time when the Social Market Economy became an Ecological Market Economy. From an economic philosophy perspective, this second phase was nevertheless a Keynesian macro-management phase, during which the state tried to stabilize the economy through fiscal and monetary policies. The experiment failed. A third phase, which can be labeled “The Return to Ordoliberal Principles” began in the 1980s. A return to core ordoliberal principles was almost a global phenomenon. As far as Germany is concerned, the German unification of 1990 introduced another phase, namely one of building a Social and Ecological Market Economy from scratch in the new five countries in reunified Germany. During the 1990s, the influence of the Social and Ecological Market Economy also reached the process of European Integration, at least in rhetoric. Since the global economic and financial crises in 2008, a fifth phase has begun, which is characterized by a “Return to Keynesian Economic Principles.” With the above historical and contextual overview in mind, the next sections discuss the SEME’s specific value system, political organization ideas, and principles of economic policy.

3. The Value System and the Role of the State in the Social Market Economy

3.1 Individualism, Solidarity, and Subsidiarity

Social and Ecological Market Economists have adopted the moral philosophy of Adam Smith, which is that the pursuit of self-interest is a legitimate individual right. Social and Ecological

Market Economists, however, go further. According to the human image of Social Market Economists, the individual is not only preoccupied with the pursuit of its self-interest, but also with the well-being of the other members of society.

So-called ultimatum games in experimental economics have verified that while there may be differences in the extent to which societies have a preference for equality, no society is perfectly egalitarian. A typical ultimatum game is played like this: Player A is given $10. Player A must then offer Player B a share of this $10. If Player B accepts what Player A has offered, both players get to keep what they agreed upon. Economic theory purely motivated by self-interest would predict that Player A offers Player B only one cent, the minimum. One cent is better than nothing and should not be rejected by a rational individual person. The experiments with ultimatum games show, however, that most players offer more than the minimum and most players would not accept the minimum (For an overview see, for example, Bearden, 2001).

The principle of subsidiarity defines the interaction between individuality and solidarity. Subsidiarity is a state-constituting principle. It mandates the size of the group that provides a solution to a certain problem. Such a problem could be an externality, which is simply the fact that the action of one individual or group of individuals affects the action of another individual or group of individuals. An example of an externality is the degradation of the natural environment. At other times, the problem may simply be about collective decisions. Industrial relations between workers and employers would be a case in point here. Whatever the problem, subsidiarity means that those involved in developing a solution to a problem should grow in concentric circles from the origin of the problem.

Three examples shall illustrate subsidiarity at work further. Assume there is a lake that is used by a boat rental company and fishermen. Both generate income from the lake. But boat rentals and fishing conflict with each other. The touristic activities on the lake chase away the fish, and angry fishermen chase away the tourists. Subsidiarity now simply demands that the issue should be tried to be resolved first by the fishermen and the boat rental companies. For example, they may merge into one company that tries to maximize the economic potential of the lake, so that the fishermen become stakeholders in the boat rental company and vice versa. Only if the fishermen and the boat rental companies cannot agree on a solution among themselves, then a larger community may begin to mediate in this conflict. This larger community may be a chamber of commerce or a court system.

The second example is collective bargaining about the wage rate in industrial relations. The stakeholders are employers and unions. The subsidiarity principle mandates then that no one else but the representatives of factor labor and factor capital should be involved in the wage negotiation process. Only if both parties fail to reach a consensus, they may resort again to mediation by reaching out to the larger community. Laws that explicitly grant the two sides of

industrial relations the right for collective bargaining are a direct commitment to the subsidiarity principle.

A third example of the application of the subsidiarity principle is central bank independence. History has regularly shown that politicians cannot handle money very well. This is because elected politicians pursue short term goals without being really accountable for the long term damage that they cause with inflation. Elected officials who issue today a 30 year bond do not really care about whether in 30 years the tax base really allows for the repayment of today's debt, or whether the government needs to avert bankruptcy through the money printing press. Modern states have therefore independent central banks. Because inflation originates in a money supply that is faster than the output growth of the goods and services produced, history has shown that the concentric circles around the decision of the money supply should be as small as possible.

In line with the principle of subsidiarity are therefore developments that lead to an expansion of central authority around a given problem, as well as the curtailment of existing authorities. As a rule of thumb, subsidiarity tends to call for an expansion of central authority whenever the problem originates in conflicting decentralized decision-making processes. This is typically the case with environmental problems. A curtailment of centrality is necessary, on the other hand, whenever centralized decisions conflict with decentralized needs. The difficulties of the European Monetary Union that began to unfold in 2008 are another case in point for problems associated with too much centralization.

Compared to socialism and classical liberalism, which see all problem-solving power in either decentralized or centralized decisions, subsidiarity calls for a more flexible state. Subsidiarity calls for a state, which is not biased toward laissez-faire as is the case with classical liberalism, or the central planning extreme as is the case with socialism. The principle of subsidiarity does not know any universal truth about the role of the state. It simply postulates a political organization principle. This principle may sometimes lead to more, sometimes to less political centralization.

Solidarity is a particular form to internalize an externality. Living in a country with extreme inequality can cause negative externalities in the form of urban crime, risks to public health (drugs, diseases), and political instability. Rural poverty may lead to urban migration, which may bring hardship to urban centers. Urban centers have therefore an interest to transfer some of their wealth into rural areas for the purpose of development. Similarly public schools and public health programs are foremost expressions of solidarity from those who have access to economic opportunities with those who have not.

The application of the principle of subsidiarity is in theory easier than in practice. Many questions are important: Which urban center pays how much for rural development? What is the optimum provision with public education and public health? What self-help contribution does the solidarity community expect from the solidarity receiver? It is clear that such questions can only be answered through political dialogue and cooperation. Different countries will answer these various questions differently. Differences in geography, demography, and culture will substantially influence how the various questions will be answered.

The principle of subsidiarity is not an invention of German political philosophy. In fact, although the term does not appear as such, it was already addressed by the Federalist Papers. Alexander Hamilton (1788), for example, wrote "that acts of the large society which are not pursuant to its constitutional powers, but which are invasions of the residuary authorities of the smaller societies" will not be part of the "supreme law of the land." Later, Abraham Lincoln wrote: "The legitimate object of government is to do for a community of people whatever they need to have done but cannot do at all, or cannot so well do for themselves in their separate and individual capacities. In all that people can do individually well for themselves, government ought not to interfere" (quoted in Nicolay and Hay, 1907, pp. 180).

Although the origin of the political debate about subsidiarity goes at least back to the 18th century and was part of the political enlightenment process, it has also influenced Catholic Social Teachings. In fact, the development of the subsidiarity principle is even often falsely attributed to the Catholic Church. The Catholic Church's interest in subsidiarity was mainly a response to the alleged moral superiority of socialism, which began to spread in the second half of the 19th century.

For much of the Church's history during medieval times, Church leaders denied peasants the right to pursue their self-interest, or to own land. Technically, the Catholic Church claimed the interpretation monopoly of what constitutes Christian deeds, without being too Christian at all, of course. After the invention of the printing press made the Bible available to the common man and the Catholic Church lost members to the Protestant movement, the Catholic Church began to come under pressure to read and interpret the Bible correctly. This pressure was further increased in the second half of the 19th century in the context of the social question of the industrial revolution and the emergence of socialist thought that demanded that the individual is subordinate to the common good. Socialism promised that social misery could only be avoided if the state ranks solidarity above individuality. But this belief is not in line with the reading of the New Testament, which shows regularly that solidarity originates in individual freedoms and choices, not centralized decisions. And as the Church came under pressure from the rise of the Protestant Church and Socialism, the Catholic Church needed to come clean by

accepting the Biblical facts, among which there is that the principle of individuality ranks before solidarity.

But this then raises the question, how individuality and solidarity are supposed to be integrated. For liberal economists, this question was not even asked. For socialists, the answer was simple in theory: Nationalization of the means of production and central planning. In practice, socialism also meant a police state, atheism, and “cultural revolutions.” The Catholic Church’s answer to combining individuality with solidarity, on the other hand, was subsidiarity: No larger group must lend a helping hand to a smaller group before the smaller group has not exhausted or provided all means to help itself.

3.2. The Separation of the State from Special Interest Groups

Besides subsidiarity, the state is supposed to be insulated from special interest groups. This idea is closely related to the idea of justice. Social Market Economic Thought is committed to equal opportunity justice, which incorporates efficiency justice but rejects distributive justice. A state that is built around equal opportunities shall reward the individual choice of exercising greater effort for greater personal gains. It shall not, however, aim at redistributive justice in the sense that all consumption shares are equal.

The very idea of a special interest group is to advocate for special treatment of some groups over others. History has shown that government may reach out to special interest groups in order to have them serve a certain purpose. This was the case in Germany after WWII when government sought the help of big industries to help the country meet its reparation payment and other public obligations. Later, in the 1930s, the Nazis called on Germany’s industries to support government in its war preparation. Fascism and state corporatism are the ultimate forms of uniting government and special interest groups.

In modern democracies, empowering special interest groups has become an almost epidemic practice. Very often swing voters are organized in special interest groups like, for example, employees in the agricultural sector. And even though the agricultural sector employs only three to five percent of the labor force, it is exactly these three to five percent of the votes that matter. This is because in politics most voters seem to be genetically pre-programmed and vote either right or left, no matter what the political agenda looks like. Then, if 48 percent always vote left and 48 percent always right, all that matters to win an election is to promise certain perks to the four percent of well-organized swing voters. This is the basic idea of Downs’ (1957) median voter theory.

Giving perks to small special interest groups does normally not generate a huge public outcry. A subsidy to farmers may make a big difference to the farmers, but the net burden for the average tax payer is rather negligible. It is at least small enough not to outweigh any individual's cost of organizing a campaign for the separation of the government from special interest groups.

It is a collective action problem. Collective action problems have their own laws. It is typically the small group that can organize its interest much better than the large group. In large groups, the free rider problem is much greater than in a small group. Lobbying efforts in small groups are much closer to being private gains than in large groups, which increases individual incentives to participate in a lobbying campaign. This is the central essence of Olson's (1965) "Theory of Collective Action."

The problem of undermining the state by special interest groups is almost as old as political philosophy. The ancient Greek historian Polybius (~200-118 BC) already noted in his theory of anacyclosis (evolution of political regimes) that the state alternates between good and bad governance. According to Polybius, bad tyrants follow wise kings, good aristocrats bad tyrants, bad oligarchs good aristocrats, good democrats bad oligarchs, and the mob of the streets good democrats. As far as the democrats are concerned, Polybius describes them as endowed with a "foolish thirst for reputation" and "appetite for gifts and the habit of receiving them" (Polybius, 2009, P. 238).

Also Confucian and Taoist political philosophy emphasizes the importance of leadership by virtue. Good governance is perceived as calm governance that does not interfere with individual economic activities, often summarized by the saying that the less the king does, the more gets done.

Similar to Polybius, the famous Islamic thinker Ibn Khaldun (1332-1406) noticed that political regimes are subject to a virtue-and-vice cycle. This cycle begins with the rise of regimes in which the leaders expose "desert qualities, desert toughness, and desert savagery." This regime then deteriorates into a second stage, in which the next generation moves "from privation to luxury and plenty." In a final and third stage, the political leadership becomes corrupted and "takes many clients and followers. They help the dynasty to some degree, until God permits it to be destroyed, and it goes with everything it stands for" (Ibn Khaldun (1958), p. 311 f.).

It is often not immediately clear that the nature of a certain problem is the non-independence of special interest groups from the government. Roepke, for example, lamented that many intellectuals have blamed market economics for the Great Depression of the inter-war period, when Germany was indeed a fascist or state-corporatist economic model. Roepke (1969, p. 31) concluded: "And in order to refloat the economy whose functioning has been so largely

impaired by past interventions, those same critics of capitalism clamor for more interventions, more planning, and hence a further emasculation of our economy. It is as though one poured sand into an engine and then hoped to start it up again by pouring in more sand."

Of course, acknowledging the importance of separating the state from special interest groups is much easier than implementing it in practice. Political constraints often prevent that major constitutional reforms are initiated from within a given political regime. As the teaching of Polybius, Ibn Khaldun, and also many others suggest, major constitutional reforms are only possible after regimes collapse. In Germany, this was the case with the capitulation in World War II, May 8, 1945.

As Germany rebuild its economy after WWII, it made great efforts to prevent that state corporatism and fascism would infiltrate again the state. The most important step was to eliminate any provision in the new constitution that would give any government an opportunity to rule by emergency decrees and to bypass the parliament. In other words, checks and balances between the executive, legislature, and judiciary should never be suspended again. This was not the case in Germany during the Republic of Weimar, when many governments evoked and provoked the use of Article 48, which provided for the opportunity to “govern” based on emergency decrees. The last government to evoke this article was the one of Hitler in 1933.

A second, more economic policy oriented approach to address the issue of insulating government from special interest groups is competition policy. Besides welfare and efficiency criterions, competition policy is also meant to prevent certain businesses from becoming too big to fail, and therefore from becoming too big to manipulate politics. In developing an effective competition law, Germany’s US occupation played an important role. The US pursued two objectives in Germany. The first was to break up industries with market power to isolate government from access to economic power, which made Germany less of a political threat. The second goal was to introduce more competition in Germany, thus helping American firms gaining access to the German market.

Lastly, competition policy is meant to prevent Joseph Schumpeter’s (1883-1950) gloomy prediction of democracies eventually succumbing to monopolistic market power and rising income inequality from becoming reality. Schumpeter argued that capitalism destroys capitalism. Through a process of creative destruction, certain industries will ultimately gain monopoly power. To Schumpeter, monopolies are the result of serving consumers more efficiently than perfectly competitive markets. Yet, this market success nevertheless creates inequalities, which cannot be sustained in a democracy. The poor will therefore vote for redistribution, which will pave the way to some kind of distributive justice as in socialism. (Schumpeter, 1976). But if we assume that the process of creative destruction does not stop

before monopolies, there is always a threat that market power does not only lead to income inequality and redistribution, but also rent-seeking and lobbyism.

Keeping markets competitive is also social policy. Competition policy must accordingly monitor market power accurately. By doing so, it is important to distinguish between market power based on market efficiency and market power based on government protection. Holding everything else constant, rising income inequality from market power in contestable markets is less problematic than rising inequality from monopolies protected by the government.

4. The Order of The Market: Market Constituting Principles

Social Market Economists argue that economic activity requires a certain order. The ideal order of the market requires the state to provide at least seven attributes that economic actors can and must rely on. These order attributes are 1.) Free prices, 2.) Free Trade, 3.) Free Contracts, 4.) Private Property Rights, 5.) Private Liability, 6.) Price Stability, and 7.) Predictability of Economic Policy. A closer look at these seven market order attributes reveals that they all serve one purpose. This purpose is to minimize any exogenous distortions to market prices. This section is largely based on the work of the famous ordoliberal economist Walter Eucken (1891-1950) and in particular his book "Grundsaetze der Wirtschaftspolitik" (principles of economic policy).

4.1. Free Prices

Free prices mean that the government abstains from the imposition of any price controls, subsidies, tariffs, and quotas. Social Market Economists therefore fully acknowledge, in line with mainstream economics, that market prices, which are the result of individual economic actors' free interaction, are the best scarcity indicator for the efficient allocation of scarce resources.

Price controls like price floors, price ceilings, or tariffs lead to a deadweight loss of society's aggregate welfare. In the case of a price ceiling, producers are coerced to redistribute welfare to consumers. In the case of a price floor, consumers redistribute welfare to producers. And in the case of tariffs, welfare is redistributed from importers to domestic producers. Yet, while every manipulation of market prices creates winners and losers, economic theory and history have regularly shown that the winners win less than what the losers lose. Consequently, the society as a whole always loses.

Comparative economic research has identified the absence of a free price mechanism to be one of the major factors of the collapse of central planning. There is simply no substitute to a market price to guide the allocation of scarce resources. Economists accordingly like to compare the price system to a light house that guides ships safely into the harbor. Centrally planned economies were simply sailing without any orientation guide.

4.2. Free Trade

Free trade expands economic choice and the opportunities for finding the best use for scarce resources. Trade is also an aggregate positive sum game, which means that trade is good for exporting and importing countries. While this finding may sound obvious today, for much of mankind's history, trade was considered to be a zero sum game. Exports are good, imports are bad. For much of economic history, the objective was to generate trade surpluses.

This misconception had terrible political consequences. It gave rise to mercantilism, colonialism, and imperialism. Because exports are considered good and imports bad, all countries wanted to export, but no one wanted to import. The result was coerced trade with colonial territories during the 16th and 20th century. Between the 16th and 19th century, trade coercion led to slave trade between Africa and North America, several Dutch Anglo wars for supremacy in naval transportation, rampant smuggling, and eventually colonial independence wars.

Although already great thinkers like David Hume and Adam Smith identified mercantilism as non-sustainable in the 18th century, it was not before the first half of the 19th century when the brilliant English economist David Ricardo (1772-1823) proved that trade and specialization allows for all countries to consume more than each could produce for itself. His theory has become the corner stone of modern trade theory. By specializing in goods that countries are best at producing and trading them for goods that other countries are better at producing, welfare gains that no country can realize without trade are freed. Ricardo's theory of comparative advantage has shown that political borders make very little economic sense. It can also be used to defend the liberal peace hypothesis, which states that countries trading with each other do not go at war.

Similar to price manipulations, restrictions to free trade through tariffs, export bans, export subsidies, import bans, import subsidies, or quotas constitute an exogenously imposed redistribution of welfare between economic actors in two countries. Specifically, protectionism leads to an imposed redistribution of welfare from domestic consumers and importers to inefficient domestic producers. And again, the winners from protectionism win less than what the losers lose. Any deviation from free trade generates a dead weight loss to the society as a

whole.

4.3. Free Contracts

Prices are the result of countless transactions and contracts between economic actors. The embedded information about the use of scarce resources and their productivities can never be matched by a central planner. Any restrictions to free contracts therefore imply that the information content embedded in prices becomes distorted.

The prime examples of restrictions to free contracts are state corporatism and fascism. Under the pretext of nationalism and patriotism, companies are expected to serve the interest of the state and consumers should subordinate themselves to some higher common objective. Therefore, whenever the government interferes into the market by suspending consumer sovereignty and dictating companies and consumers with whom they are supposed to make contracts, individual freedom is no longer guaranteed and market prices become less efficient scarcity indicators.

But not only government may limit the scope of free contracts between economic actors, but also economic actors themselves. The most common prerequisite for the limitation of economic actors' free contract choice is market power. Examples for restricting free contracts are tie-in sales, exclusive distribution channels, and territorial demarcation agreements.

4.4. Private Property Rights

The design of ownership has always been controversial in the history of political economic thought. St. Augustine (354-430) already lamented in his "The City of God" that private property in the earthly world is not conducive to living a life in line with God's ideal (Augustine, 2003).

St. Thomas Aquinas (1225-1274) also already realized that ownership of resources generates positive incentives for their efficient use. He distinguishes between relative and absolute property (St. Aquinas, p. 1968 f.). While he advocates private property rights for production purposes, the production objectives must not be private. Given the fact that for much of its history, the Church was a huge landowner and not much of an advocate of land reforms, Aquinas' philosophy makes sense, of course.

Political philosophy turned more and more in favor of absolute ownership beginning with the emergence of Protestantism and the Renaissance. For Luther (1483-1546), for example, the eighth commandment "You shall not steal" was evidence that the natural order should be built

around absolute private property. He also noted that private property obliges the proprietor to use resources with a sense of social responsibility (Luther, M. (online), p. 46). Usury, for example, would be contradictory to this social responsibility, just as it is in Islam.

Physiocracy in the 18th century also called for absolute private land ownership, which the famous French Physiocrat Francois Quesnay also justified with incentives, namely the fact that "without that sense of security which property gives, the land would still be uncultivated" (original: "Sans la certitude de la propriété, le territoire resterait inculte, " Quesnay (1888), p. 331).

The fact that private property rights encourage efficient production was not even contested by Marx. His concern was rather that "the production of too many useful things results in too many useless people" (Marx (1844), online). Of course, this is only plausible if the primary distribution of productive resources is already highly unequal, which gives rise to market power. Under an equal primary distribution of land and economic opportunities and rigorous competition policy, there is no reason to assume that factor labor would be marginalized. In contrary, factor labor will give way to human capital.

For private property rights to serve economic efficiency the most, several conditions need to be met. Property rights must be absolute, secure, tradable, and collateralizable. They also must be efficiently specified. It turns out, for example, that inheritance law can undermine the efficient use of private property rights. Specifically, under partible inheritance customs, the size of farmland can become too small for efficient use. Or alternatively, if many heirs decide to farm the inherited land together, the problem may be that too many cooks spoil the soup. Impartible inheritance, in which typically the eldest child inherits the land while other children are compensated with other assets, is often more efficient.

4.5. Private Liability

The pursuit of self-interest is the major force behind the efficient use of scarce resources. And the major driver of self-interest is the chance to make a private profit or gain. A private profit is a legitimate reward for entrepreneurial risk-taking and inventive economic activity. Because excessive risk-taking is naturally checked by possible losses, private liability is the natural flip side of private profits. In a Social Market Economy, insurance markets are the only acceptable solutions to insure against potential losses.

What is inefficient because it encourages beyond-optimal risk-taking is the nationalization of private losses. Bail-outs from the tax payer to individual companies technically imply that the government rejects the verdict of consumers and the selection test of the market.

Of course, in political practice, governments are concerned with the loss of jobs and the welfare of workers in certain industries or regions, which are legitimate concerns from a Social Market Economic perspective. However, social assistance to vulnerable people must be market conform, which means that it must not contradict the selection test of the market. Moreover, social assistance programs must be cost-minimizing to the tax payer. This is only the case if solidarity is between human beings, but not between human beings and factor capital. Bailing out a-loss making company imposes de facto solidarity between tax payers and workers with their inefficient capital.

Bail-outs are often justified by the argument of systemic risk. Systemic risk means that a company or sector of the economy has so many backward and forward linkages with the rest of the economy that a bankruptcy would wreak havoc over the rest of the economy. Because another word for systemic risk industries is too-big-to fail, economic policy has a clear responsibility to prevent that certain companies become too big to fail. Competition policy needs to play an important role and balance the trade-off between efficiency gains from economies of scale and systemic risk.

4.6. Price Stability

Social Market Economists are committed to a monetary policy of price stability. Because Germany experienced one of the worst hyperinflations in monetary history in 1923, the hardship of inflation is still deeply burned into the collective memory of Germans. During hyperinflation, first real savings were eradicated, borrowers rewarded, and lenders punished. Then, the financial transmission mechanism collapsed and lastly the economy came to an absolute standstill.

Inflation is typically triggered by either cost-push inflation or monetary expansion, with the latter a more common phenomenon. Examples of cost push inflation were the oil crises of the 1970s and the so-called Triple F crisis (Food, Fuel, and Finance) after 2007. Cost-push inflation is triggered by real events such as a political crisis, natural disasters, or climate change. Monetary expansion on the other hand is often linked to public budget deficits that government can no longer anymore finance through taxation or new debt because it lost its credibility and interest rates rise to ever higher levels.

The political temptation to spend more than what government collects in taxes and what it can borrow at reasonable interest rates is obviously lower whenever the central bank is independent. One of the biggest lessons of economic history has regularly been that politicians are simply not the best agents to handle taxpayers' money. This is a particular problem in democracies where elected politicians think in four year election cycles but issue bonds with

thirty-year maturities. Therefore, the incentive to borrow from future generations is extremely high, at least when the central bank is independent.

The basic idea of central bank independence is that government cannot borrow directly from the central bank. This intention was also clearly incorporated into the European constitution. But when the sovereign debt crisis began to unfold in 2009, Europe began to change its constitution in favor of tolerating de facto bail-outs of governments for the alleged sake of monetary stability.

There are two competing opinions. One camp, which can be called the austerity advocacy camp, argues that once government debt spins out of control, only austerity measures help while bail-outs will only lead to inflation. If government spends more than what its tax base and borrowing capacity on financial markets allow for, the solution must consequently be to broaden the tax base by making the economy more competitive and to restore government's credit worthiness through expenditure cuts. This is obviously a painful procedure, forcing government to pass laws that require workers to retire later, to work longer hours, and to accept less social benefits. But ultimately, such painful measures are necessary in order to set the economy back on track.

The other camp, which can be called the bail-out advocacy camp, argues that austerity only deepens the recession. Instead, helping the government to ease its financial constraints allows government to initiate competitiveness-enhancing public investments. These investments would then grow the tax base by so much that future generations can easily repay their parents' debt.

Social Market Economists argue that while bail-outs may work, what happens if they do dot. Then, inflation is inevitable because government has to repay even more debt, which the central bank has to finance with the printing press. In this case, we only have postponed structural adjustments and rolled over their cost on our children. Social Market Economists are not willing to take this risk and argue that austerity today is the lesser evil.

But in order to avoid that government needs to ever choose between austerity and bailouts, a policy is necessary that avoids the unfolding of an economic crisis in the first place. In the case of Europe, this would have been possible by postponing monetary integration until after the political union has become more deepened and advanced. Eventually, a common currency contradicts the subsidiarity principle. Given the heterogeneity of Europe's economies, the common currency of the Euro could not serve the individual countries better than competing currencies.

4.7. Predictability of Economic Policy

The predictability of economic policy provides certainty for the future and encourages long term planning. If economic policies change quickly and unexpectedly, often real prices change. This is the case for trade policy that affects prices of imported goods, social policy that can change the price of labor, and monetary policy that manipulates the cost for capital.

Erratic economic policy changes the prices on which planning and investment decisions were based and may render many economic plans that were first deemed profitable now non-profitable. Examples in history were the introduction of price controls after the Great Depression and the back and forth between employment stimulating policies on the one hand and the fight against inflation on the other during the oil price crises. A final example is the uncertainty regarding economic policy's response to the financial and economic crisis beginning in 2008.

The first to identify the importance of the predictability of economic policy was David Ricardo. David Ricardo, in essence, argued, that it should not matter whether government finances public expenditures through higher taxes or through government bonds. Citizens should know that when government finances expenditures through bonds, citizens will be taxed later, which should cause them to already save today and cut down consumption. Because citizens cut down consumption today because they expect higher taxation in the future to repay government debt, the government may as well tax citizens today. This has become known as the Ricardian equivalence between tax-financed and capital-market financed public expenditures. It suggests that it is in the nature of economic actors to operate in an environment that is characterized by the predictability of economic policy (Ricardo, 1846).

So why then do governments use a combination of taxes, bonds, fees, and even the inflation-tax to finance its expenditures and not only taxes, which would be the most transparent? The answer is simply that it is not in the best interest of a politician to operate under full transparency. The Italian economist Puviani (1854-1907) already noted at the end of the 19th century that non-transparent government finances create a so-called fiscal illusion (Puviani, A., 1897). Fiscal illusion is essentially the result of asymmetric information between government and tax payers and a collective action problem. It is simply much easier for government to pretend to its citizens that its public expenditures benefits citizens in various ways than it is for citizens to prove that they do not. This information advantage increases with the non-predictability of economic policy.

As the non-predictability of economic policy increases economic actors' planning uncertainty, economic actors try to develop counter-veiling measures. These counteractive measures typically occur on the political and economic level. On the political level, economic actors try to

increase predictability through lobbyism and rent-seeking and on the economic level through legal mergers and acquisitions, but also illegal anti-competitive behavior. The non-predictability of economic policy therefore invites political clienteles and undermines consumer sovereignty.

5. When Government is Supposed to Interfere – Regulatory Areas

5.1. Abnormal Labor Supply Functions

An abnormal labor supply function is one that is not, as expected, positively related to the wage rate, but negatively. In other words, as wages fall, workers are willing to work longer and longer hours. The negative income effect then reverses the positive substitution effect, which would make leisure relatively more attractive.

Abnormal labor supply functions were known since the era of mercantilism when government interfered into the labor market with price ceilings on wages. The motivation behind this was the right economic conclusion that lower wages force people to work more and longer hours and even motivate child labor. This was, of course, in the interest of mercantilism where the individual was asked to subordinate itself to the state.

Besides political totalitarianism, other factors may create abnormal labor supply functions. Among these other factors, especially rural-urban migration at the beginning of a transition from a predominantly agrarian to an industrializing country needs to be mentioned. Development is often associated with high unemployment in rural communities. This rural excess labor has then the greatest incentive to migrate into urban areas as soon as new industrial job opportunities emerge. But the rush into the industrial labor market often resembles an uncontrolled labor avalanche and the labor supply exceeds demand. Competition for scarce jobs then becomes ruinous in the sense that workers are offering to work more and longer hours just to have some income. Eventually, some income is still better than none.

An abnormal labor supply function can occur moreover when factor capital has a demand monopoly (monopsony) for labor. It can then push wages down and drive workers into ruinous and impoverishing competition. When Hitler banned unions in 1933, his objective was to keep wages low and to maximize labor supply.

In a world of perfect competition without market power and direct political influence into economic processes as well as rights for collective bargaining between workers and employers, many causes for the development of abnormal labor supply functions can already be eliminated by the economic order. What cannot be eliminated by the economic order though, are

exogenous shocks that cause sudden excess labor supplies that may develop into abnormal labor supply functions.

The development of an abnormal labor supply function was also feared after WWII in Germany. The industrial heart of Germany was the Rhineland and in particular the city of Cologne. During WWII, the Rhineland and Cologne had repeatedly been bombed by the British Royal and United States Air Forces, razing the Rhineland to the ground. After WWII, it was therefore feared that an influx of people into the Rhineland could generate an abnormal labor supply function. Labor concerns were accordingly particularly important for post WWII Germany. Social Market Economists accept that in order to avoid an abnormal labor supply function, minimum wages may be legitimate as a result of extreme economic shocks. Minimum wages may then protect those who are employed but leave those without a job vulnerable. Targeted social assistance programs to those vulnerable segments of the labor market would then have to be delivered.

In Social Market Economic thinking and in line with the principle of subsidiarity, minimum wages should be negotiated between unions and employers and not by the government. This process is called collective bargaining. The efficiency of collective bargaining is derived from the idea of the bilateral monopoly in which the demand monopoly for labor (employers) negotiates on equal footing with the supply monopoly of labor (unions). Then, if both labor and capital have the same bargaining power, the negotiated wage rate would be equivalent to the one resulting on perfectly competitive markets.

The fears of abnormal labor supply functions never materialized in post WWII Germany. Instead of ruinous competition on the labor market, Germany's post WWII economic miracle led to a labor shortage that was filled by guest workers from countries like Turkey, Greece, Italy, and Spain. This import of labor was extremely important to Germany's post WWII recovery as it prevented wages from growing too fast, which in turn would have undermined Germany's export competitiveness.

5.2. Unequal Social Development

Functioning markets' strength is the efficient allocation of scarce resources. Yet, it says nothing about the distribution of income. Economists like Marx and Schumpeter argue that competition will inevitably lead to great income inequality. According to Marx, this is because factor capital is monopolized and will exploit factor labor. For Schumpeter, it is innovation and creative destruction that will ultimately lead to market concentration and rising income inequalities. There seems to be an unavoidable force at play that drives market economies towards greater inequality.

Clearly, today's economists know a lot about how markets allocate scarce resources, but they know very little about the dynamics behind rising income inequality. The only exception is the second welfare theorem of economics, which essentially states that any final income distribution can be generated from the primary distribution of production factors. The primary distribution of resources is therefore important. Obviously, it is much easier to generate a market driven equitable final distribution of income from an equitable primary distribution of productive resources and economic opportunities than from an unequal one.

This seems to be indeed a powerful explanation that also has a lot of economic historical support. In the case of Europe, landless peasants have fought over several centuries for the redistribution of land and therefore a new primary distribution. In Europe, this fight had become increasingly successful after the French revolution. Land redistributions also occurred in East Asian economies like Japan, South Korea, and Taiwan after WWII under the directive of the United States. Latin America and Sub Saharan Africa have never seen comparable initiatives and high inequalities of land holdings, which date back to era of colonization, were never fundamentally changed.

An unequal primary distribution of land also creates unequal access to economic opportunities. Landless peasants rely on tenant farming where they are vulnerable to exploitation. Without land titles, citizens cannot offer collateral and remain without access to credit. At the same time, the larger is the primary inequality of land, the more unequal will be the process of industrial modernization. Rural poverty is exported into urban poverty.

Once a country has already developed a strong manufacturing and service industry, existing inequalities are more difficult to correct. Very often, high income inequalities also translate into political regimes that are co-opted by economic elites. Lasting public investments into social mobility like public education, public health, technological infrastructure, but also a competitive economic order that encourages market entry and investment are less likely to be introduced when inequality is high. History has shown that major political transitions only take place after regimes collapse, not before.

A public policy towards social upward mobility is therefore important for a country's political stability. But what are social mobility facilitators? What can government do to make sure that the gap between the poor and the rich does not widen too much? While income redistribution seems to be the most intuitive answer, it is not the most powerful facilitator of social mobility. Lasting vertical mobility can only be the result of a strong competitive and economic base and a government that is insulated from special interest groups. Public programs to facilitate access to credit, education, and health must be complementary to market economic reforms.

The problem with the redistribution of income is often tax evasion. This is particularly true in countries where capital is highly mobile. The more mobile capital is, the more likely it flees from high taxation. Moreover, while high redistributive taxation may encourage consumption, it discourages investment.

5.3. Environmental Problems

Environmental problems are typically a form of so-called negative externalities. A negative externality occurs when two economic activities conflict. For example, a plant pollutes a water resource with toxic waste that reduces the fisheries' incomes. A negative externality is negative because at least one economic actor is adversely affected by at least one other economic actor's activities.

There are also positive externalities. Positive externalities are given whenever one economic activity supports favorably another one. For example, a water mill at a river increases the oxygen level in the water, which in turn supports fish growth. Another famous example is the mutually beneficial externalities between an apple orchard and a neighboring beekeeper. The bees pollinate the farmer's apples and the farmer's apple trees serve as a nectar reservoir for the bees.

Today, Social Market Economics is typically called Social and Ecological Market Economics. Social Market Economists always perceived themselves as open to the incorporation to new developments. The first objective was to combine the freedom in the market with equitable social development. The social question of industrialization and rising inequality were the pressing concerns of the late 19th and early 20th century. A second major concern emerged in the 1970s in the context of the publication of the Club of Rome's (1972) report "The Limits to Growth" and oil crises (Meadows et al,1972). The report warned that mankind will inevitably outgrow its natural resources and called for action towards a better balancing of economic activity with ecological sustainability.

Negative and positive externalities are different from each other in the sense that positive externalities are more of a luxury problem and do not need governmental intervention. The invisible hand of the market will likely bring together the apple farmer and the beekeeper. Eventually, it is a win-win situation. And if they are not matched by the market, there is no reason to assume that government would be any better in matching apple farmers and beekeepers. It would be a violation of the two state constituting principles of subsidiarity and the insulation of government from special interest groups. The same holds for unidirectional externalities as in the case of the water mill that enhances fish growth, but fisheries having no

advantage to the miller. As long as no one gets hurt and at least one may benefit from an externality, markets should be trusted in identifying such opportunities.

The situation is completely different in the case of negative externalities. Here the government is needed in the form of courts. Eventually, while neither the apple farmer, nor the beekeeper, nor the fisherman, and nor the miller in the case of the positive externality would have an incentive to sew anyone for anything, it is likely that in the case of the negative externality the fisher will want to sew the polluter. Therefore, under negative externalities, government institutions are essential.

The importance of a balance between the ecological environment and the economic system is often interpreted from the perspective of evolutionary biology and thermodynamics. Economies are by nature open systems. In the language of thermodynamics, an open system separates itself from its environment by a higher level of order (or negentropy in thermodynamic terms). A higher level of order means that a system only allows several states, actions, and behaviors. The number of states, actions, and behaviors in the environment, on the other hand, is infinite. For example, human bodies as a biological system only tolerate certain body temperatures, while the environment could take any temperature. Thus, human bodies are characterized by the ability to maintain a temperature difference to their environment. Only when a human system's ability to maintain a temperature difference to its environment is no longer given, the human system ceases to exist and it becomes absorbed by the environment. Similarly, social systems that are based on law and order are designed to eliminate possible behaviors that can be found in the environment. For example, social and economic systems do not tolerate criminal behavior, anti-competitive actions, or a power monopoly outside the government as safeguards against anarchy. Anarchy is essentially the acceptance of any possible action, behavior, or state in a society and is equivalent to the death of a social system (for an overview of the relevance of General Systems Theory to Economics, see Boulding, 1974).

Technically, externalities are conflicts at the frontier between the economic system and its natural environment. Any externality uses air, water, or land as a means of production without these resources having a scarcity price. The result is an overuse of these environmental resources, which jeopardizes the survivability of the economic system. The economic system can only survive in the long run if it is able to internalize the source that transmits the externality. This means in economic terms that it must be assigned a scarcity indicator and made subject to efficient use. Often this requires the specification of new property rights.

The idea that environmental problems can be addressed by the specification of new property rights and subsequent market allocation was first shown by Ronald Coase (1960) in his famous article the "Problem to Social Cost." The importance of Coase's article with regards to

environmental economics, but also comparative economics, cannot be overstated. Prior to Coase's article, the standard prescription to environmental problems was Pigou's tax solution, which trusted a central authority with enough wisdom to measure the actual cost of the environmental damage and price it accordingly through a tax. The presence of environmental problems and the seeming inability to correct market failures gave central planning accordingly an apparent advantage over decentralized market economies. Coase proved this conclusion wrong.

Just as environmental problems are a public bad, so is their internalization a public good. In providing these public goods, government must play an important role. This role, however, is not to micromanage the economic activities linked to the externality but to force economic actors to solve this new scarcity problem. Market based economic solutions to solve environmental problems are typically markets for emission rights. Then, if certain economic actors want to use a shared air, land, or water resource that serves as a transmitter for an externality, they now need to pay a price. Of course, the role of the government is then to define the maximum tolerable level of emissions into a natural resource that serves as a transmitter of a natural resource. Since this is a political process, it needs to be guided by the state-constituting principles of subsidiarity and non-governmental partisanship with all stakeholders.

Through the internalization of externalities into the economic system, the economic system gains system complexity and reduces environmental complexity. In thermodynamic language, this is called the import of negentropy and means that the system has reached a higher level of order. General System theorists also speak of the law of requisite variety (Ashby, 1957). It says for systems to maintain an equilibrium order difference to its environment, the variety to respond to external shocks must be as high as the variety of shocks. If environmental shocks are not internalized by the economic system, the system will inevitably collapse.

Evolutionary biologists and scholars of cybernetics have also studied which system design is best suited to sustain itself in a turbulent environment. Important concepts are ultrastability and multistability. An ultrastable system maintains its order difference to its environment through feedback mechanisms. A thermostat would be a an example for a mechanical, human beings shivering as a response to cold or sweating as a response to heat a biological, and market prices going up when a certain resource becomes scarce to enforce better resource management an economic illustration of ultrastability. A multistable system is composed of various ultrastable subsystems. The brain is the ultimate biological multistable system that coordinates millions of ultrastable feedback mechanisms from the human organism (compare Ashby, W.,1960). And the marketplace is the ultimate design for a multistable economic system to solve a society's scarcity problem. Interconnected markets, independent entrepreneurs, and

innovators are all ultrastable systems that are interconnected through markets and whose problem-solving activities are essential for economic stability in the sense of maintaining standards of living and quality of life.

The findings of General Systems Theory have been particularly important as a tool to the understanding of comparative economics. The concept of multistability is naturally found in the concept of markets. For example, whenever the economic system receives an exogenous shock from its environment like, for example, a drought or a natural disaster, the shock translates automatically into shifts in demand and supply, as a result of which new relative prices emerge. These new prices then serve independent entrepreneurs, firms, and inventors as a guide to find new ways to solve the scarcity problem of society, the ultimate purpose of the economic system. A centrally planned economy, on the other hand, lacks the ability to translate environmental shock signals into new prices to guide independent problem seekers. Central planning is an ultrastable system. There are no prices and no independent problem seekers. Instead, a central plan needs to be redrafted every time a shock occurs. Which plan ultimately succeeds is a tedious trial and error process. And if the economic environment becomes too turbulent, an optimum central plan may never be found and the system eventually collapses.

5.4. Market Power

Market power is the fourth area that calls for the government to interfere into the market process. Market power is given when a firm can dictate market prices, or, in other words, when the firm is a so-called price maker. A firm with no market power, on the other hand, is a price taker. For a price-taking firm, there is so much competition that charging a lower price than everyone else would generate so much demand that the firm could not meet it. It would be simply too small. Similarly, if a price-taking firm charged a price that is above the market price, no consumer would buy from it. There are simply too many other firms from which consumers can buy at a lower price. The market form that makes firms price-takers is called perfect competition. It is the guiding model of the Social Market Economy's competition philosophy.

On markets that are controlled by price-making economic actors, the price is higher and the quantity supplied of goods and services is lower than in perfectly competitive markets where all firms are price takers. This then creates a welfare deadweight loss, which is the result of the fact that the firms could serve more consumers at extra costs which are lower than what extra consumers would be willing to pay. Price-making firms are allocation inefficient in the sense that they do not allocate more resources into the production of goods that consumers value highly.

This is because for price-making firms there is a relationship between the market price and quantity demanded. A market demand can be thought of as a line-up of consumers according to their willingness to pay. Those with the highest willingness to pay stand at the beginning of the demand line, those with a lower willingness to pay at the end. Then, if the market is controlled by a single firm, a monopoly, it is one firm that needs to supply many consumers. And if the firm wants to serve, for example, ten additional consumers, it must lower the price to a level below what the tenth extra consumer is willing to pay. This then means that consumers one to nine have a willingness to pay which exceeds the marginal revenue of the price-making firm. In other words, unless a price maker is unable to charge every individual a separate price, the marginal revenue of a price maker will have to fall faster than consumer's willingness to pay. And because a profit maximizing price-making firm will expand its production as long as the extra cost of production are less than the extra revenue, a price maker will maximize profit at a point where consumers' willingness to pay is higher than the price-making firm's extra production costs. However, if the market price is higher than the incumbent price-making firms' extra production costs, another firm with the same production cost structure could enter the market and charge a price which is lower what the incumbent firms charge and still cover its production costs. Accordingly, whenever there is market power, there also must be market entry barriers.

Several sources of market power and market entry barriers are known, among which the most important is protection by government. Others are product differentiation and the so-called natural monopoly. Product differentiation is related to marketing. For example, many car manufacturers produce more or less identical cars but give them different feels like sporty, fashionable, fancy or family-practical. Then, depending on people's lifestyle preferences, they develop certain preferences for one brand over the other, which gives these companies some market power over consumers that is similar to a monopoly, except for the fact that market entry is possible. Markets with firms that compete through product differentiation are therefore called monopolistic competition. Although monopolistically competitive markets are less efficient than perfectly competitive markets, they generally do not give rise to a regulatory need. As long as consumers are willing to pay for product differentiation a higher price, even though it has very little practical value, monopolistic competition per se is no violation against the primacy of consumer sovereignty.

A particular interesting case is the so-called natural monopoly. A natural monopoly is one where one firm has lower and lower average total costs as it expands production. This is often the case when start-up or fixed costs are very high. This is for example the case for railway tracks. It barely makes sense to build two parallel railway tracks between two distant cities in order to increase competition. The railway company that first built a railway track then can always offer more connections between the two cities whenever a competitor threatens to

enter the market. The incumbent firm can then always offer extra connections at a lower price than the market entering firm. And because the market entering firm knows that, it will not enter the market. But because a natural monopoly abuses its market power just as any other firm with market power and settles at a price that is much higher and a quantity that is much lower than what the social optimum would be, government is called upon to regulate such industries in favor of consumers. This could be done, for example, by forcing the monopolist to let other companies use its tracks at a "fair rate of return." Many natural monopolies can be found in fact in industries who distribute their products through highly specified networks like electricity grids or pipelines, where in turn much of the high fixed cost are bound. High fixed costs of capital that has a high product-specificity, like a gas pipeline, is also said to have a high sunk cost share. It is a sunk cost because of the relative immobility much of the capital's productive value would be lost in any alternative use. If a gas pipeline is no longer anymore used, its second best use may be simply its scrap metal value. More mobile capital like trucks, cranes, and printing presses have lower sunk cost shares.

Among the biggest challenges for competition policy is anti-competitive behavior in the form of cartels, price-fixing agreements, tie-in sales, and market demarcations. Cartels have a long tradition in Germany, which goes back to medieval times when Europe was politically and economically fragmented. City states allowed their industries to organize themselves in guilds. Guilds were associations of craftsmen which on the one hand promoted high standards of excellence in craftsmanship, but on the other hand, also regulated market entry. Because the markets were highly scattered, guilds helped to generate high quality products that were able to conquer other markets despite the political obstacles stemming from political state fragmentation.

Later, guilds turned into legitimate cartels. As Germany united in 1871 and domestic markets grew in size, Germany experienced first a founding boom. Stocks of highly concentrated industries were rising, which in turn led to the buildup of fictitious wealth that worked like adding fuel to the fire. In 1873, however, the first speculators began to question the sustainability of Germany's economy and began selling their stocks, causing a landslide on stock markets. Aggregate demand collapsed and the founding boom turned into a founding crisis. In order to protect Germany's industries, protectionist measures were introduced in Europe. Responding to the increasing rise of socialist political ideas, Bismarck (1815-1898), Germany's first chancellor introduced the first social safety nets, comprising rudimentary retirement plans, health and unemployment insurance. No one though questioned yet Germany's cartels, which kept on growing in economic and political power.

After WWI, their economic power became essential in managing Germany's reparation payments. Germany's industries were no longer seen as economic actors that are supposed to

solve the scarcity problem and to serve the needs of consumers, but as a political ally of the German government that has been humiliated by the defeat of WWI and the imposition of reparation payments. State corporatism was born and grew in importance under the Nazis (For a review of competition policy in Germany see Feldenkirchen, 1992).

It is probably safe to say that while economists know a lot about the welfare losses associated with the exercise of market power vis-à-vis consumers, the true concern with market power has always been that economic market power is being coopted for non-democratic political objectives. This, at least, seems to be the important lesson of Germany's history. This history has shown that yes, market power and cartelization is to the disadvantage of consumers and they will not solve the scarcity problem, but the ultimate threat is that market power facilitates fascism, undermines democracy, and puts peace at risk. Competition policy is not only necessary to allocate scarce resources efficiently; it is also a peace building formula.

6. Principles of Governmental Market Interference

6.1 Minimize Sectoral Interventions

Social Market and Ordoliberal economists acknowledge that all economic subsystems are interconnected. They accordingly speak of an interdependence of orders. No governmental intervention in any subsystem of the economy will remain within the borders of this subsystem. The idea that it is possible to develop a policy that would benefit one sector of the economy without harming another one is therefore often impossible (Eucken (2004), pp. 304-308).

From a partial equilibrium perspective, no subsidy, price control, or tariff comes without any adverse redistributive welfare consequences between consumers and producers. They all lead to a dead weight loss, too. And if one adopts a general equilibrium perspective, sector interventions become even more harmful. Favoritism to domestic producers hurts importers and a bail-out for a non-competitive economic actor harms the competitive one. Similarly, an expansionary fiscal policy to stabilize the economy that is financed through borrowing on capital markets may lead to higher interest rates and crowding out of private investment. It also may lead to currency appreciation and therefore reduce exports and stimulate imports. Sectoral interventions in economic policy should therefore be avoided and replaced by a thinking in terms of the interdependence of orders.

Early development economic theories were also concerned with the interdependence of various sectors. So-called balanced growth, like Nurske (1907-1959) theorists wanted to make sure that the state develops an investment strategy that would allow all sectors of the economy to grow at the same rate (Nurske, 1961). This was mostly to make sure that industrialization

does not zoom ahead of food production. Yet the problem with this approach was that instead of avoiding the adverse effects from punctual interventions, the government now created problems of universal intervention and bureaucratization of the economic process. India's "License Raj" between 1947 and economic reforms in 1990 was a prime example for this mistake.

Balanced growth strategist need to be distinguished from unbalanced growth strategists, like Hirschman (1958). Unbalanced growth strategists believe that sector interventions can have a positive development effect. This is in particular true for public investments into the so-called commanding heights of an economy: energy, steel, telecommunication, and transportation. As far as unbalanced growth strategies are concerned, many East Asian Tigers made good experience with public investments into these areas. So can sector interventions be still successful? The answer is yes, if the sector intervention corrects a market failure, which is often the case with commanding heights of an economy. The interdependence of orders and the whole picture are again important. Interventions in functioning markets are more likely to have adverse effects than sectoral interventions to correct market failure.

6.1. Minimize Stabilization Policy

Keynesian stabilization economics boils down to anticyclical fiscal and monetary policy. Whenever there is unemployment despite excess capacity, as was the case during the Great Depression, expansionary fiscal policy is recommended. Government spending, similar to starting a stalled engine with a crank lever, would then jump-start economic recovery and job creation. On the other hand, if the problem is unemployment because companies do not have access to capital in order to finance necessary investments, then an expansionary monetary policy with lower interest rates would do the job. In other words, if the problem comes from the demand side, fiscal policy shall stimulate the economy, does the problem come from the supply side, then monetary policy should be applied.

While Keynesian stabilization economics is today often expressed in sophisticated mathematical and graphical models, the basic idea of anti-cyclical fiscal policy can already be found in the Old Testament. In Genesis 41:1-40, Egypt's Pharao had a dream in which he saw "seven heads of grain, full and good, growing on a single stalk," but "after them, seven other heads sprouted - withered and thin and scorched by the east wind." Joseph explained to the Pharao that his dream means that "seven years of great abundance are coming throughout the land of Egypt, but seven years of famine will follow them." Joseph advised the Pharao that Egypt "should collect all the food of these good years that are coming and store up the grain under the authority of Pharaoh, to be kept in the cities for food. This food should be held in

reserve for the country, to be used during the seven years of famine that will come upon Egypt, so that the country may not be ruined by the famine."

This Old Testament reference is insightful to the extent that it refers to natural disasters like droughts. It is thus a fully exogenous event. And in fact, for stabilization policy to make the most intuitive sense, the nature of the shock must be exogenous. If, for example, a natural disaster destroys the capital stock of an economy, post disaster economic policy should be directed towards a monetary expansion to facilitate the financing of the reconstruction. Similarly, if, for example, climate change leads to the deterioration of livelihoods that reduces aggregate demand and forces people to enter into a transitional phase, government expenditure programs in public infrastructure may help to stabilize aggregate demand until the private sector of the economy is able to absorb again the excess labor.

As history has shown, however, the prelude to extreme boom and bust cycles has often been easy access to credit and monetary expansion. Bubbles in real estate or stock markets are therefore endogenous. This, at least, is the basic idea of the Austrian Business Cycle Theory, which, although always controversial, regularly proves itself difficult to be knocked out (for an overview of the Austrian Business Cycle Theory see, for example, Ebeling, 1996).

From the perspective of Social Market Economists, Keynesian economists spent too much thought on stabilizing an economy that went into a slump and too little thought into avoiding a slump in the first place. Social Market Economists argue that because most boom and bust cycles are manmade, a commitment to the state and market constituting principles will prevent extreme business cycles in the first place.

Moreover, a Social Market Economy that has invested into sustainable social safety nets like health, invalidity and most importantly unemployment insurance function as automatic stabilizers that reflect the spirit of anti-cyclical fiscal policy. But in line with the principle of subsidiarity, these social safety nets should be financed by employers and employees with the intention of preparing for a potentially uncertain future. What should be avoided by economic policy at all cost is that government is overwhelmed by an economic downturn and then sees itself forced to resort to hectic interventions. Because politicians' primary interest is to be re-elected, there is a danger that politicians overbid each other with policy activism. Good economic policy is such that it prevents economic crises as much as possible and responds to them as little as necessary. This is the spirit of stabilization policy in Social Market Economics.

6.2. Market Conform Social and Environmental Policy

If government interferes into the market, then it should be market conform, meaning that it must not affect relative prices. In terms of social policy, non-market conform policies are

typically universal subsidies, price ceilings, and price floors. The problem with universal social policies is that they have the highest inclusion error. A price ceiling on bread or fuel, for example, also subsidizes those who could afford market prices.

From a welfare perspective, the incidence of a subsidy is often inefficient. There are two kinds of subsidy incidences, absolute and relative. The absolute subsidy incidence measures how much of a subsidy is consumed by the needy versus the non-needy. In the case of a food subsidy, for example, if we assume that the poor eat more bread than the rich, the absolute subsidy incidence is greater for the poor. The relative subsidy incidence looks also at the value of subsidized commodities in the poor's expenditures relative to overall expenditures. In the case of food subsidies, the relative incidence of the subsidy is also greater for the poor. In the case of fuel subsidies, however, which are often intended to keep taxi services and public transportation affordable, the absolute subsidy incidence may well be greater for a rich individual with great automotive mobility. It is also possible that even the relative subsidy incidence is greater for the wealthy.

Effective and market conform social assistance programs are only targeted social assistance programs in the form of cash transfers. A governmental fixed price or a subsidy to influence market prices does always create a dead weight loss and socially costly inclusion errors. Whenever government changes relative prices through market interventions, they also create more costly adjustment processes to the vulnerable consumers. Imagine that consumers substitute in their diet between rice and bread. If government then lowers the price for bread, individual consumers buy now more bread. However, they do not buy more rice. This is because consumers respond to a change in relative prices through two adjustment mechanisms. The first is a substitution effect; the second is the income effect. The substitution effect says that because bread is now becoming cheaper, individuals get more extra utility per dollar spent on bread than extra utility per dollar spent on rice. As a result of this substitution effect, individual consumers will therefore buy more bread and less rice. The income effect, on the other hand, says that because the real income of the individuals has risen, they can afford now to buy more of both bread and rice. This positive income effect allows the consumers to offset the reduction in rice consumption due to lower bread prices, so that the consumer ends up with the same amount of rice, but more bread. A cash transfer, on the other hand, would avoid the substitution effect and provide individuals with the opportunity to reach a higher consumption level of both bread and rice. Targeted social assistance programs in the form of cash transfers are therefore generally superior.

What about in-kind transfers? Generally, in-kind transfers work similarly to a cash transfer, unless the government makes available mostly bread when people actually preferred rice. In

this case, an in-kind transfer could be less efficient than a cash-transfer. In-kind transfers should therefore be ideally reflecting the traditional dietary composition of the target group.

What about market-conform environmental policy? Environmental economics and policy was long considered a field in which market economic thought would have no place. In fact, the presence of externalities was long seen as a major reason for the superiority of command based economies. The argument was that if market economies operate in a turbulent environment, in which more and more land, water and air resources are used by conflicting economic activities, an increasing role of the state and economic centralization would become inevitable.

This interpretation only began to change after property rights and markets were increasingly identified as the key to the resolution of environmental problems, as opposed to the central taxation or management of economic activities. The difference between a centralized taxation of land, water, and air emissions that lead to negative externalities and a market solution through an emissions market is that the tax solution defines a scarcity price for the use of the respective resource while the market solution defines an emissions quantity. Assuming that natural scientists are more likely to identify an optimum emissions quantity that is ecologically sustainable and to which politicians can respond by establishing an emissions market than politicians being able to identify a tax or technological process that generates a sustainable environmental equilibrium that is also understood by natural scientists, emission markets are more likely to be ecologically effective.

The biggest problem with sustainable environmental solutions is not the existence of solutions in the spirit Social Market Economic principles, but the political process. In order to be able to define optimum emissions, the political decisions making process must be free of special interest group interference. Environmental problems are complicated because there are often many stakeholders. Any solution to an environmental problem must therefore involve a comprehensive political dialogue. The complexity of this process is even more challenging if one considers global environmental problems. Market-conform emission markets would also work here, but what does not work is the international political market, whose political decision-making capabilities often lag behind the problem-solving needs.

6.3. Primacy of Rules-Based over Discretionary Economic Policy

The discussion of rules-based versus discretionary economic policy is also rooted in the Social Market Economy's anti-Keynesian stance. Keynes developed his framework for economic stabilization as a short-term remedy to short-term problems. Keynes' disciples also argue that Keynes' contribution was to save capitalism from capitalism, not to destroy it. But when Keynes died in 1946, not many of his disciples still saw a reason to stop in the long run what seemed to

have worked in the short run. Many economic historians would though argue that Keynes himself would have disagreed with using his economic tools for too long. It is therefore very important to understand why Keynesian economics, which may work in the short run, does not work in the long run.

Let's begin by illustrating how Keynesian economics ideally works in the short run. Assume that an economy is confronted with unemployment that the central bank believes is due to too little investment. In order to stimulate investment and therefore aggregate spending into machines and more workers to operate them, the central bank increases the money supply through open market operations. As a result of these, capital becomes less scarce and the interest rate falls, to which firms respond as expected. The shift in aggregate demand then pushes up the aggregate price level, which in turn stimulates an increase in the aggregate quantity supplied. Because price levels go up but nominal wages are assumed to be sticky in the short-run, real wages go down. Lower real wages then increase quantity demanded for labor and unemployment is being dismantled. This short-term inverse relationship between unemployment and inflation is known as the Philips Curve, named after the empirical work of the economist Phillips (1958) on the British labor market.

While any inflationary policy to create jobs reflects a quite sophisticated transmission mechanism from monetary expansion to more employment, it is in essence nothing more but a coerced redistribution from the employed to the non-employed workers. And that is where the problems begin, because workers will feel betrayed by the Central Bank. The next time workers begin to negotiate their wage rate, they will argue that they want not only a higher wage rate to compensate for an increase in productivity, but they will also form inflationary expectations and try to insure themselves against them. Therefore, after a Central Bank has used an inflationary policy to meet employment objectives, it will be reversed again during the next round of wage negotiations. These negotiation rounds will become more complicated because employers and employees will not only have to discuss productivity gains, which can be easily verified, but also expectations about the future policy of the central bank, which is highly uncertain. Therefore, policies that may work once because they caught people by surprise will not work anymore once the same people expect a surprise. Such policies are said to be time inconsistent. Although in a different context, Abraham Lincoln is attributed with describing similar phenomena as follows: "You can fool some of the people all of the time, and all of the people some of the time, but you cannot fool all of the people all of the time."

Of course, every central bank has some discretionary decision-making room. If a central bank has the primary objective to maintain price stability, then it has some discretionary power as regards to judging the effectiveness of certain monetary policy interventions. Before the introduction of the Euro, the German central bank, the Bundesbank, had only one primary

objective, which was to maintain price stability (Germany's Central Bank Bill, Bundesbankgestz, Article 3). The European Central Bank (ECB), which was established in 1992, defines its objectives already slightly wider. Although it also acknowledges "the primary objective of price stability," it also states that "without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union" (Lisbon Treaty, Article 127 (1)), including employment and balanced growth objectives. A widening of the objectives necessarily increases the discretionary power of the European Central Bank. Whereas the German Bundesbank only needed to make discretionary decisions as regards to how to accomplish one goal, the European Central Bank now also needs to make a discretionary decision as regards to whether it can maintain the primary objective of price stability "without prejudice" when also pursuing other objectives. The likelihood of making policy mistakes must increase.

The first Nobel Laureate in Economics, Jan Tinbergen (1903-1994), was the first to show that there must be at least one policy instrument for each policy objective (Tinbergen, 1952). In other words, in economic policy there is no one rock that can kill two birds. Moreover, Tinbergen's economic policy principle of one instrument for each policy shows a close resemblance to the law of requisite variety discussed under environmental problems.

7. Conclusions

This course booklet has attempted to introduce the historical context of the development of Social and Ecological Market Economic thought and to show its relevance for actual economic problems of today. It also tried to illustrate that economic policy in line with Social and Ecological Market Economic principles sometimes distinguishes itself from other political and economic paradigms, at other times it has strong similarities to other philosophies. It is also important to state that while Social Market Economic thought originated among German speaking social scientists and creates strong connotations with German and European economic policy, there are no intellectual property right claims to Social and Ecological Market Economic thought. If anything, Germany wants to stimulate and encourage intellectual and political dialogue with all social scientists, NGOs, and think tanks that are committed to the objective of combining economic freedom with equitable social development, which is not a German or European normative vision, but a universal one.
The world is increasingly facing economic, political, ecological, and human challenges, which require increased political cooperation among countries. I strongly believe that Social and Ecological Market Economic principles provide the biggest least common denominator for tackling these challenges. Trusting unfettered market liberalism or socialist planning with mastering these challenges is much more unlikely to win the necessary international political support than Social Market Economic Principles.

8. Personal Afterword

I would like to thank Dr. Jan Woischnik and his team at the Konrad Adenauer Foundation in Jakarta, Indonesia for the opportunity to discuss the principles of the Social and Ecological Market Economy with colleagues and students in Indonesia. Discussing the Social and Ecological Market Economy in seminars and workshops outside Germany is a unique honor and privilege. My own personal experience with such forms of intellectual exchange has regularly been extremely useful to my own understanding of what Social and Ecological Market Economics really means. Among the most important insights for me is that the Social and Ecological Market Economic thought as it was developed in Germany has many communalities with political and economic thought in other regions, cultures, and religions, which regularly makes me as much of a student as a lecturer.

9. Review Questions

This section contains review questions, which I hope are not only entertaining, but also help to summarize again some of the most important characteristics of Social Market Economics.

1. The dispute between those who say that actual historical lessons matter for understanding economics and those who say that they don't, is known as
    a. The Battle of Economics
    b. Star Wars
    c. Methodenstreit
    d. Conflictnomics

2. The age when governments began to subordinate themselves to individuals is known as
    a. Enlightenment
    b. The Copernican age
    c. Globalization
    d. The East Asian Miracle

3. Why did Gutenberg's invention of the printing press put pressure on the Catholic Church?
    a. Now everyone was reading, no one was working anymore
    b. The price for paper went up
    c. An abnormal labor supply function developed in the media sector
    d. People began to disagree with the Church's interpretation of the Bible

4. Ancient Greek philosophers emphasized the subordination of _________ to ________.
    a. the state; the individual
    b. the individual; the state
    c. the church; the state
    d. the state; the church

5. The philosophy of economic liberalism emphasizes the subordination of _______ to _________.
    a. the state; the individual
    b. the individual; the state
    c. the church; the state
    d. the state; the church

6. The logical inconsistency of mercantilism was first articulated by
    a. David Copperfield
    b. David Bowie
    c. David Beckham
    d. David Hume

7. The first globalization wave occurred between
    a. 16th and 18th century
    b. 1870 and 1914
    c. 1945 and 1980 (era of Bretton Woods)
    d. 1980 and 2008 (the neoliberal counterrevolution)

8. The first globalization wave was triggered by
    a. The industrial revolution
    b. Political liberalization
    c. Both a. and b. are correct
    d. Mercantilism

9. What was the _____ for the Physiocrats, was the _____ for Karl Marx.
    a. landowner, industrialist
    b. King, President
    c. French fry, freedom fry
    d. apple, orange

10. The following quote comes from which famous philosopher? “The production of too many useful things results in too many useless people.”
    a. Adam Smith
    b. Jean Jacques Rousseau
    c. David Hume
    d. Karl Marx

11. Which of the following was a trade-off that was of particular concern to Karl Marx?
    a. Efficiency vs. Equity
    b. Investment vs. Consumption
    c. Inflation vs. Unemployment
    d. Consumption vs. Growth

12. Adam Smith's moral philosophy was directed against
    a. the Church, which held that the pursuit of self-interest would be harmful to economic development
    b. the government, which held that private property rights would be harmful to economic development
    c. the Federal Reserve, which held that the Gold Standard is the best monetary system.
    d. the English brewers, which tempted consumers into alcoholism.

13. The period of enlightenment is called as such because of
    a. The discovery of the light bulb
    b. The heavy use of candles at the time
    c. The spread of modern science
    d. People getting happier and lightening up

14. The first globalization wave led especially to
    a. North-South trade
    b. Arms trade
    c. Slave trade
    d. Rice trade

15. During the first wave of globalization, which group benefited mostly in Latin America?
    a. Peasants
    b. Industrial workers
    c. Landowners
    d. Elementary school teachers

16. During the first wave of globalization, emigration from Europe
    a. Led to a more equal distribution of income
    b. Led to political change that focused more on social justice
    c. Both answers a. and b. are correct.
    d. Led to a destabilization of the Gold Standard

17. The first wave of globalization ended because
    a. of World War I
    b. of World War II
    c. trade was not a win-win situation
    d. of the collapse of trade due to global inflation

18. During the first globalization wave, Latin America and West Africa specialized in what production?
    a. agriculture
    b. manufacturing
    c. services
    d. oil

19. The first wave of globalization led to _____ in Europe, the US, Australia, and New Zealand, and _____ in Latin America and West Africa.
    a. less equality; more equality
    b. more equality; less equality
    c. less wealth; greater wealth
    d. less power; greater power

20. The period between WWI and the 1929 stock market crash is known as:
    a. Highway to hell
    b. The end of the world as we know it
    c. The big bubble trouble
    d. The roaring 1920s

21. What event began the period known as the Great Depression?
    a. World War I
    b. World War II
    c. The stock market crash
    d. Severe shortage of Zoloft

22. The post WWI period was characterized in the US by
    a. A reorientation to puritan values and a life in moderation
    b. High taxes and government regulation
    c. Problems to transform the economy from a war to a peace economy
    d. Great consumer and producer confidence

23. Marx coined the term fictitious wealth. What did he mean? The idea that
    a. money cannot buy happiness
    b. material wealth is a divine award
    c. the accumulation of wealth requires hard work
    d. people get richer when the value of people's stock holdings increase

24. In a world of deflation, consumers
    a. Buy more, because prices come down
    b. Buy less, because prices go up
    c. Buy more, because people get richer in real terms
    d. Buy less, because they wait for prices to come down even more

25. Which of the following is a self-fulfilling prophecy?
    a. Consumers expect prices to go up and therefore buy less
    b. Consumers expect prices to go down and therefore buy less
    c. Producers expect prices to go down and therefore produce less
    d. All of the above.

26. Policies such as tariffs and currency depreciation, which benefit the home country at the expense of other countries are known as:
    a. Pardon-my-French policy
    b. Hide-and-seek policy
    c. Hit-and-run policy
    d. Beggar-thy-neighbor policy

27. Which theorist(s) shifted the focus of traditional economics from the supply to the demand side?
    a. John Maynard Keynes
    b. John Watt
    c. Jack Daniels
    d. Theodore Roosevelt

28. During the Great Depression, what policy did countries NOT resort to?
    a. Competitive depreciation races
    b. Competitive appreciation races
    c. Competitive tariff races
    d. Public investment programs to stabilize demand

29. Why did Germany have hyperinflation in 1923? Because Germany tried
    a. to finance its reparation payments and public expenditures by printing money
    b. to finance its reparation payments and public expenditures by increasing taxes
    c. to finance its reparation payments and public expenditures by selling gold
    d. to finance its reparation payments and public expenditures by borrowing money from the League of Nations.

30. Under inflation, which of the following is NOT true?
    a. Borrowers win, lenders lose
    b. Retired people lose
    c. Nominal interest rates go up
    d. People get richer in real terms

31. When the Nazis build roads and highways and financed military industry projects as part of their preparation for war, the consequences were all EXCEPT which one?
    a. Employment rose
    b. The Nazi philosophy gained popular legitimacy
    c. The German economy began to grow
    d. Germany needed to deal again with hyperinflation

32. Economics is defined as the science of
    a. Producing the most output with the least input
    b. Distributing income fairly
    c. Allocating scarce resources efficiently
    d. Controlling as much of the market as possible

33. The Social Market Economy is defined as a model that
    a. Combines socialism with capitalism
    b. Combines central planning with price regulation
    c. Is purely theoretical, with no reference to historical lessons
    d. Seeks to combine the freedom in the market with equitable social development

34. The term Ordoliberalism refers to
    a. Principles of economic policy
    b. Principles of production
    c. Principles of distribution
    d. Principles of social ethics

35. The relationship between the Social Market Economy and Ordoliberalism can be described best as follows: The Social Market Economy is a _____, Ordoliberalism a _____.
    a. prerequisite for growth, a prerequisite for development
    b. normative vision, means to it
    c. conservative model, liberal model
    d. socialist model, welfare model

36. Which statement describes best the difference between economic thought in the German and Anglo-Saxon tradition?
    a. The German tradition is only concerned with inflation.
    b. The German tradition believes that prices should be set by the government.
    c. The German tradition is more historically contextualized.
    d. The German tradition holds that the individual must subordinate itself to the state.

37. The concept of the Social Market Economy rests on which two values?
    a. Individuality and solidarity
    b. Self-restraint and hard work
    c. Patriotism and conservatism
    d. Love and peace

38. A political organization principle that combines individuality and solidarity is called
    a. Social gluing
    b. Subsidiarity
    c. Socializing
    d. Social Networking

39. The following quote is attributed to? “Without that sense of security which property gives, the land would still be uncultivated.”
    a. Karl Marx
    b. Francois Quesnay
    c. Confucius
    d. Ibn Khaldun

40. What term did Karl Marx use to describe the wealth associated with rising stocks?
    a. Gambler's wealth
    b. Fictitious wealth
    c. True wealth
    d. Proletariat wealth

41. The state-constituting principle of “insulating government from special interest groups” has its origin in the negative experience with
    a. Mercantilism
    b. The first globalization wave
    c. The New Deal

   d. The increased cooperation between government and industries after WWI in Germany.

42. The theory which shows that mercantilism creates inflation is known as:
    a. Price-Is-Right Flow Frenzy
    b. Price-Specie Flow Mechanism
    c. Price-Specie Glow Conundrum
    d. The Prices-are-Vices Morality

43. Which theorist shifted the focus of traditional economics from the supply side to the demand side?
    a. Kenny Manfred Johnson
    b. John Maynard Keynes
    c. Maynard James Keenan
    d. Conan Davenport Hyman

44. In their normative orientation, Social Market Economist were particularly influenced by
    a. Islamic finance
    b. Confucian teachings
    c. Astana yoga
    d. Catholic Social Ethics

45. Abraham Lincoln once wrote: "The legitimate object of government is to do for a community of people whatever they need to have done, but cannot do at all or cannot so well do, for themselves — in their separate and individual capacities." This describes the principle of
    a. Individuality
    b. Solidarity
    c. Subsidiarity
    d. Subsidiary

46. The concept of the Social Market Economy seeks to combine
    a. Market anarchy with government totalitarianism
    b. Market laissez-faire with high taxation
    c. Market freedom with equitable social development
    d. Market waka-waka with social happy-pappy

47. The concept of the Social Market Economy was designed as an economic vision for Germany
    a. Under the Holy Roman Empire
    b. During the first globalization wave
    c. Under the Nazis
    d. After World War II

48. During World War II, allied aerial bombardments destroyed the industrial heart of Germany in the so-called Rhineland. Many economists were afraid that after WWII, so many people would migrate into the Rhineland in search for employment that
    a. The Rhineland would develop an “industrial bubble”
    b. The Rhineland would develop “too strong labor unions”
    c. The Rhineland would develop a “housing bubble”
    d. Wages would fall so that people choose to work longer and longer hours

49. Which are not market-constituting principles?
    a. Free prices, free trade, and free contracts
    b. Private liability and price stability
    c. Predictability of economic policy and private property rights
    d. Printing money during recessions and raising interest rated during booms

50. Which of the following is NOT explicitly one of the market constituting principles that safeguards the individuality principle?
    a. Free trade
    b. Private liability
    c. Free prices
    d. Free speech

51. Social Market Economists acknowledge how many market constituting principles?
    a. 3
    b. 5
    c. 7
    d. 9

52. In SEME thought, which statement is true about market-constituting principles?
    a. They should be always in place
    b. They are instruments that government can “play around with”
    c. They show why socialism does not work
    d. They were the laws governing St. Augustine’s “City of God”

53. Why is price stability important to Social Market Economists?
    a. Because it prevents distortions to the exchange of monetary funds between savers and borrowers and therefore increases market efficiency.
    b. Because it protects savings.
    c. Because it promotes long term planning.
    d. All of the above.

54. Why is the predictability of economic policy important to Social Market Economists?
    a. It is not important. In contrary, the less predictable government is, the better it is.
    b. Because it protects against business cycles.
    c. Because it promotes good beggar-thy-neighbor policies.
    d. Because it promotes long term planning.

55. In the SEME, when is the state entitled to interfere into the market process?
    a. Whenever it feels like it
    b. Whenever it will look good during elections
    c. Whenever the market causes harmful externalities
    d. Whenever the country has a trade deficit

56. When a large influx of new workers enters a community, and there are more workers than jobs so that wages go down and workers work longer and longer hours, then this is an example of _____.
    a. A good economy
    b. An abnormal labor supply function
    c. An externality
    d. A great time to apply for a job

57. Social Market Economists acknowledge how many regulatory cases when government shall interfere?
    a. 1
    b. 2
    c. 3
    d. 4

58. Which of the following is an example of a negative externality?
    a. My neighbor plays the stereo so loud so that I cannot fall asleep.
    b. A chemical plant pollutes the river so that the fisherman cannot make a living.

c. Both a. and b. are examples of a negative externality.
d. The price for milk goes up.

59. Social Market Economists recommend that the government should interfere in the market when ______?
    a. Fertility rates go down.
    b. The price for apple juice goes up.
    c. Life expectancy goes up.
    d. An industry develops market power.

60. Social Market Economists recommend that the government should interfere in the market when ______?
    a. Income inequality decreases.
    b. Competition leads to less market power of a dominant firm.
    c. Wages go up and people choose to work more.
    d. Pollution leads to more children being born with birth defects.

61. Social Market Economists acknowledge how many principles according to which government shall interfere in the market?
    a. 1
    b. 2
    c. 4
    d. 8

62. Which of the following is not a SEME principle according to which government shall interfere in the market process?
    a. Limit stabilization policy
    b. Primacy of rules over discretion
    c. Avoid sectoral intervention
    d. Limit the free movement of capital

63. Which of the following is an example of a stabilization policy?
    a. The New Deal
    b. The General Agreement on Tariffs and Trade
    c. The Asia Pacific Economic Cooperation Agreement
    d. None of the above.

64. Which of the following is an example of an economic policy rule?
    a. No stabilization policy under any circumstances.
    b. No bail-out to anyone under any circumstances.
    c. No trade restrictions under any circumstances.
    d. All of the above.

65. Which of the following is an example for discretionary economic policy?
    a. An increase in the money supply that leads to lower real wages and therefore more hires.
    b. And increase in governmental spending to stimulate employment.
    c. Both a. and b. are correct.
    d. A rule that government cannot spend more than what it collects in tax revenues.

66. Which of the following is an example of a sectoral intervention?
    a. Governmental subsidies for ethanol.
    b. A policy of price stability.
    c. The Asia Pacific Economic Cooperation Agreement
    d. Bankruptcy laws.

67. Which statement is true? The SEME is rather
    a. Anti-American
    b. Anti-Market
    c. Anti-Innovation
    d. Anti-Keynesian

68. The _____ is the term used to describe what happens when prices go up leading to the need for wages to go up in a continuing pattern.
    a. Downward Spiral
    b. Price-Wage Black hole
    c. Price-Wage Spiral
    d. Price-Wage Cycle

69. Generally speaking, the SEME is more grounded is what academic field, other than economics?
    a. Fine arts
    b. History
    c. Music
    d. Rocket science

70. Private corporations contribute billions of dollars to political campaigns in the United States. This could be considered an example of _____.
    a. True democracy
    b. Socially responsible business
    c. Market power
    d. Game theory

71. The idea that an increase of inflation can create more employment only works because wages are assumed to be
    a. stinky
    b. sweaty
    c. sticky
    d. silly

72. Why can an increase in the money supply not solve employment problems in the long run?
    a. It will trigger a price-wage spiral.
    b. The economy will run out of workers.
    c. Workers get so rich that they don’t want to work anymore.
    d. All of the above is correct.

73. The theory that many economic crises are linked to credit expansion is called
    a. The French School
    b. The Swiss School
    c. The Russian School
    d. The Austrian school

74. The East Asian Crisis of 1997 shows parallels to which theory?
    a. Adam Smith’s invisible hand
    b. Karl Marx’s exploitation theory
    c. Keynes’ General Theory
    d. David Hume’s Price Specie Flow Mechanism

75. The Austrian School of Economics attributes the Greece crisis largely to
    a. The country’s non-favorable climate for production
    b. Protectionist policies by Germany, Austria, and Switzerland
    c. High transportation costs for exports
    d. Credit expansion after the introduction of the Euro

76. Competitive markets are
    a. Ultrastable systems
    b. Super stable systems
    c. Parastable systems
    d. Multistanble Systems

77. Ricardian equivalence means that
    a. Exports equal capital imports
    b. Demand equals supply
    c. Debt-financed public expenditures have the same effect as bond-financed expenditures
    d. Investment equals saving

78. Fiscal illusion refers to the fact that public expenditures
    a. Are always bad
    b. Never meet their objectives
    c. cause the illusion that the expenditures are paid by the state, not the taxpayer
    d. are seen more likely justified when the tax system is complicated

79. Jan Tinbergen's rule of economic policy is most closely related to
    a. The law of requisite variety
    b. The law of demand
    c. The law of supply
    d. The law of the market

80. Jan Tinbergen, the first Nobel Laureate in economics, argued that for each policy objective there must be
    a. One policy instrument
    b. Two policy instruments
    c. Three policy instruments
    d. Four policy instruments

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