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Content

Germany's Social Market economy:
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by

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1. Introduction

Institutions matter! Starting in the 1960s, the idea that institutions influence human behavior – not only within the economy – came back into the focus of economics and other social sciences (cf. Sauerland 2015). Institutions, since then, are broadly defined as "the rules of the game", i.e. as "humanly devised constraints that structure political, economic and social interactions" (North 1991, p. 97). Such rules are important to shape the game within the economy (economic institutions) and also within policy making (political institutions). Institutional economics does not only analyze the influence of different institutions on human behavior in a positive perspective but also looks for adequately designed institutions to influence human behavior in order to realize outcomes that are for the benefit of all people affected. Looking at the different branches within the institutional economics, some of them have a focus on organizational aspects whereas others focus on the impact of institutions on the development of a whole economy.

Today, institutional economics is an important and still growing part in economic theory and it has become an important source for policy recommendations. As empirical analyses indicate adequately designed economic and political institutions have positive effects on growth and wealth (cf. Acemoglu/Johnson/Robinson 2005, p. 402ff). Whereas the debate about capitalism vs. socialism seems to have come to an end, the current discussion is more about which kind of market economy ensures a positive economic and social development in a country. The ongoing economic and financial crisis fueled this discussion about successful economic systems, especially in Europe.

In the light of the above discussion two different kinds of liberal institutional concepts have regained attention. Modern institutional concepts on the one hand focus primarily on the

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workability of competition based market economies. Particularly economic freedom, measured in different areas, plays an important role in these liberal market concepts (e.g. Gwartne/Lawson/Hall 2013, p. 2): They share a lot of elements with the Washington consensus, being for a long time the common basis for policy advice, e.g., by the International Monetary Fund and the World Bank (cf. Birdsall/de la Torre/Caicedo 2010). On the other hand also an old institutional concept has regained attention. It is the German ordoliberal social market concept which – presumably – helped Germany (and also Austria) to cope with the current crisis in an effective and humane way. Not surprisingly, the German economy is taken as a benchmark for successfully dealing with short-term crisis and long-term development.

Facing two different liberal institutional concepts two questions arise: Firstly, what are the differences and similarities of the two concepts? Secondly, can the ordoliberal social market economy concept become an alternative to the prevailing liberal market economy concepts put forward by international organizations like the OECD? Can it become a blueprint for Latin American countries looking for reform options to improve the economic situation of their citizens?

This paper tries to answer these questions taking five steps of argumentation. Firstly, the paper briefly sketches the theoretical and empirical background of the modern liberal market economy concept. Secondly, it outlines in more detail the basic ideas of the ordoliberal social market economy concept and some modern amendments to this concept based on institutional economics' ideas. Thirdly, the paper compares the two concepts and it uses institutional data to describe two prototypes of economies based on those concepts of the United States and Germany. Fourthly, the same databases are used to describe the institutional status quo in five Latin American countries. The fifth and last step of the argumentation discusses the limitations of a simple blueprint idea with regards to economic orders. The paper ends with conclusions on options and limits of taking the liberal or the social market economy concept as a blueprint for Latin American countries.

2. The modern liberal market economy concept

2.1. Historical background

Why have institutional economics' approaches become so successful in economics over the last 30 years? The success was and is basically grounded on the relevance of the empirical results provided by institutional economics analyses.

In economic growth theory for example, the neoclassical approaches used capital per capita, technical progress and human capital as determinants to explain growth. Other theories saw geography as an important determinant for growth. However elaborated these theories became, there were still noteworthy differences in growth rates between countries that could not be explained by those determinants. With the growing influence of theoretical institutional economics the institutional framework of a country (or region) was incorporated into growth theoretical approaches (cf. Acemoglu/Johnson/Robinson 2005). One of the founders of this research was Douglass C. North (1990), with his book on "Institutions, Institutional Change and Economic Performance".

Although there is a widespread acceptance in economics concerning the importance of institutions the most interesting question in theory and empirical analyses still is: Which institutions are really relevant for a positive economic development? Before trying to answer this question, we are going to sketch the theoretical concept of institutional economics briefly.

2.2. The theoretical concept

According to the institutional economics' literature the modern liberal market economy distinguish between economic institutions and political institutions. Both kinds of institutions are described in more detail in the following section.

2.2.1. Institutions

The institutional economics' literature stresses three *economic institutions* as being very important for the positive development of an economy (e.g. Gwartney/Lawson/Hall 2014, p. 3). Those are (i) well-defined and insured property rights, (ii) stable money ensuring low inflation rates, and (iii) open access to national and international markets. These institutions are the foundations of modern liberal market economies. Especially institutions (ii) and (iii) represent a key part of the above mentioned Washington consensus (Williamson 2004, 3f.).

All three institutions help markets to work efficiently: Well-defined property rights are the basic prerequisite for exchange of private goods and services in markets (Demsetz 1967). Stable money and low inflation rates help the price mechanism within markets to coordinate economic activity efficiently. High inflation, in contrast, distorts the relative prices and therewith hinders the price mechanism to send to both, producers and consumers. Open access to national markets ensures the workability of a competitive economic order, because new producers can enter into the market and therewith increased the competition pressure on the established producers. In addition, open access to international markets is necessary to realize

the advantages of free trade, e.g. a larger range of products available for the consumers and a larger market volume accessible for the producers.

The logic behind these three institutions is clearly microeconomic; it explicitly refers to the necessary framework for a competition based economy. Setting up such an economy will, as microeconomic theory tells us, ensure an efficient allocation, i.e. a provision of goods and services according to the preferences of the consumers. In addition, the companies in such an economy create jobs, therewith enabling the workforce to participate in the economic development. Relating to that the establishment of a competition based economic order represents also a social policy in itself: it enables people being included in the labor market, it provides jobs and therewith income.

The institutional economics' literature also stresses the idea that the economic institutions framing a competition based economy need to be complemented by some *political institutions* that support the workability of the competitive economy. Generally speaking, such an economic system needs a functioning (i) protective state and (ii) productive state to work properly (Buchanan 1975).

One of the basic functions of the protective state is to ensure defined property rights. In a wider sense, this state should also set up competition rules and act as a supervisor for these rules. In addition, one of the important duties assigned to the productive state is to overcome potential market failure, e.g. within the provision of public goods.

With this briefly outlined *set of economic and political institutions* the North American liberal concept for a competition based economy is described. Within this liberal concept the idea of "freedom to choose" is central. Consequently, the state or the government respectively has just very basic duties assigned. Compared to the activities of the private actors within the economy, which are highly valued in this concept, activities of government are seen more skeptical and should be therefore kept to a basic, necessary level.

2.2.2. Legitimation

Before such a concept can be implemented in reality, the question of legitimation has to be discussed. Following the arguments developed in constitutional economics, especially by J.M. Buchanan, the consensus of the people affected is the only source of legitimation for the respective order (Buchanan/Tullock 1962).

Consensus means that the people, who are affected, can agree upon such an order and to the rules framing this order. According to the core element of economics – methodological

individualism –, this consensus is the only way to legitimize any order. Following this logic, consensus can only be realized if all people, who are affected, expect mutual benefits from the implementation of the institutions as the rules of the game they have to play afterwards. Constitutional economics – similar to J. Rawls “Theory of Justice” – uses the idea of a veil of uncertainty to develop arguments for an at least hypothetical consensus on the rules for a competition based economy (Rawls 1971, 1999).

In short, people can agree upon the rules of a competition based economy, because this economy provides benefits for all: it ensures on the goods markets the provision of goods and services according to the preferences of the people; on the labor market it creates jobs and income, which are necessary prerequisites for being included in the social interaction within society.

3. The ordoliberal social market economy concept

Concepts, such as the social market economy concept, being developed to create an economic or political order for a society, cannot be understood without some knowledge about the historical and cultural background of those scholars that developed it (for a detailed background analysis cf. Hasse/Schneider/Weigelt 2008). Obviously an economic system is embedded into other social systems within a country. Following the work of Acemoglu and Robinson (2012) economics institutions are at least embedded into (and supplemented by) political institutions. Both are influenced by the prevailing culture of the country/region if economic and political institutions evolve within an evolutionary process. If economic or political orders are consciously designed (mechanism design) to be implemented in a structured way, the design and implementation process must also take this cultural and historical embededdness into account.

3.1. Historical background

The basic ideas of the Social Market Economy framework were developed in the 1930s and 1940s in Freiburg, Germany (cf. Vanberg 1988). At Freiburg University, a group of the law scholars and economics scholars established an interdisciplinary cooperation to develop birth framing rules for a post-war economic order in Germany. The so called Ordoliberals had a strong catholic background and were social liberal by experience. The most important proponents of the Ordoliberal School became the economist Walter Eucken and the law scholar Franz Böhm (cf. van Suntum et al. 2011). The Ordoliberals were trying to develop the framework for a “humane and workable economic order”, in their perspective, the “natural order” (Greek "ordo").

Their research and conceptual work was strongly influenced by their historical experiences (cf. Zweynert 2013). The Ordoliberals had experienced two different kind of economic systems: firstly, a mere capitalistic system with unrestricted free markets and secondly the centrally planned (war) economy in Germany.

Taking the model terms of institutional economics with its characteristic distinction between the "choice within rules" and the "choice among rules", the Ordoliberals had a clear focus on the latter. They were looking for the rules of the economic game ("Wirtschaftsordnung") that would produce beneficial results for all people within this economy.

Characteristic for the Ordo-approach was also a clear division of responsibilities between the state (and government respectively) and the private players in the economy. While the government should act as a strong rule setter and as a supervisor for the compliance, e.g. in completion policy (cf. Möschel 2001)) private players should be responsible for the movements within the given Social Market Economy framework. This division of responsibilities was, in short, built upon the before mentioned, historical experiences.

In the unrestricted free market economy, the private players (namely the powerful companies) used their economic power to usurp the political process. As a result, they did not only choose the movements within the economic game but – due to their political influence – they also set the rules of their own economic game. The government itself was either too weak or – in the logic of the modern public choice theory – the political decision-makers were willing to take up the demand for intervention by strong and well-organized economic interest groups to increase their own probability of being re-elected. The result of this economic power in combination with the reluctant political power was, in ordoliberal terms, a workable economy, but not necessarily conforms to human dignity.

Even more negative experiences came up within the centrally planned war economy. Here, the Nazi government not only set the rules of the economic game. It also directly determined the activities of the war-relevant companies. As all resources were allocated in the strategic industries, Germany experienced a not workable and inhumane economic system during World War II.

In conclusion, the ordoliberal approach tried to avoid massive economic power to protect political decision-makers and to enable the government to be a strong rule setter and supervisor. The economic order that should ensure the humanity and workability was competition based („Wettbewerbsordnung").

3.2. The theoretical concept

According to the ordoliberal ideas, the competition based economic order had to be implemented and protected by the government setting adequately designed economic institutions. These economic institutions were labelled as "principles" by the Ordoliberals. Eucken (1952, 1990, p. 254ff.) distinguished two kinds of principles: while the constitutive principles should ensure a workable competition based economic order, the complementary regulating principals were meant to support the humane aspect of the economic order.

3.2.1. Institutions

3.2.1.1. Constitutive principles

The ordoliberal Social Market Economy framework incorporates six constitutive principles aiming to establish a workable price system within the competition based economy (Kasper/Streit/Boettke 2013, p. 348). Those are (i) the privacy of monetary policy, (ii) open markets, (iii) private property, (iv) freedom of contracts, (v) liability, and (vi) the consistency and stability of economic policy. In addition, the necessary togetherness of all constitutive principles was seen as a necessary prerequisite for establishing the workable price system with perfect competition, i.e. the "Wettbewerbsordnung". Figure 2 gives an overview about the constitutive principles.

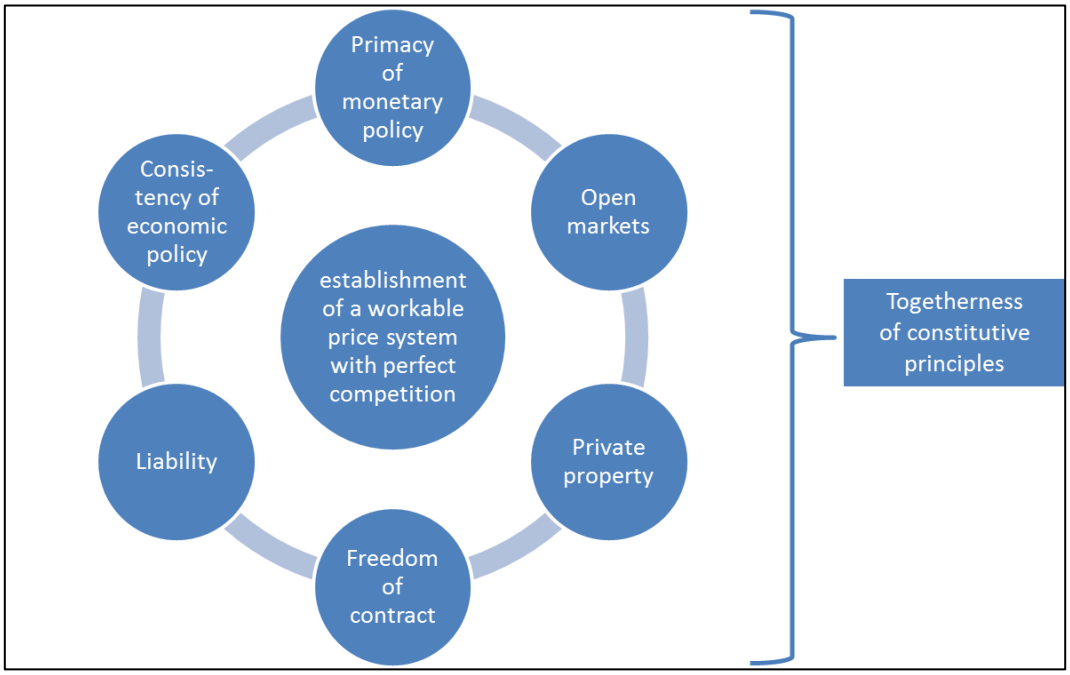

Figure 2: Constitutive ordoliberal principles

Having a look at these principles, the ideas behind most of them are very familiar to modern liberal economists. The *primacy of monetary policy* can easily be translated into price stability, i.e. low inflation rates. *Open markets* mean open access to national and international

markets. *Private property* represents the idea of well-defined and ensured private property rights. The *freedom of contract* principle is necessary for a workable competition based economy. The reference to *liability* means that there should not be a separation of chances and risks in economic activities; i.e. liability limitations should be avoided. Looking at the *economic policy* in general, this should not only be *consistent* over time, but also stable to enable private decision-makers building reliable expectations.

The Ordoliberals developed their principles based on theoretical reasoning (keep in mind the state-of-the-art in economics at the time when the principles were developed). In addition, the empirical experiences with the two economic systems mentioned before (unrestricted free markets and centrally planned war economy) served as a knowledge base for the principles. This empirical basis is obviously different from the empirical insights we have today on the influence of different institutional designs on growth, wealth and economic development.

However, the Ordoliberals also realized that a competition based economic order will not only produce positive outcomes but also some negative ones. Therefore, they did not only develop the constitutive principles to make the economic order workable, but also tried to develop additional principles to prevent some unwanted effects.

3.2.1.2. Regulating principles

To ensure not only the workability of the system, but also the humanity Eucken (1952, 1990, p 291ff.) supplemented the constitutive principles by with four regulating principles (see figure 3). The first regulating principle refers to the monopoly problem, the second to the necessary income policy, the third to cost accounting problems, and the fourth to anomalous supply situations. Here again, the ideas behind most of them are very familiar to modern liberal economists.

Under the headline of "*the monopoly problem*" the Ordoliberals wanted to prevent market power. From their perspective (and because of their historical experiences) the limitation of market power was necessary for two reasons. Firstly, market power from a microeconomic perspective, very often results in a provision of goods and services that is worse than the situation resulting from perfect competition. Therefore, from a mere economic perspective, it is necessary to have, for example, competition laws and a cartel ban implement. As mentioned before, the proper function of these institutions needs some organization supervising the keeping of the rules.

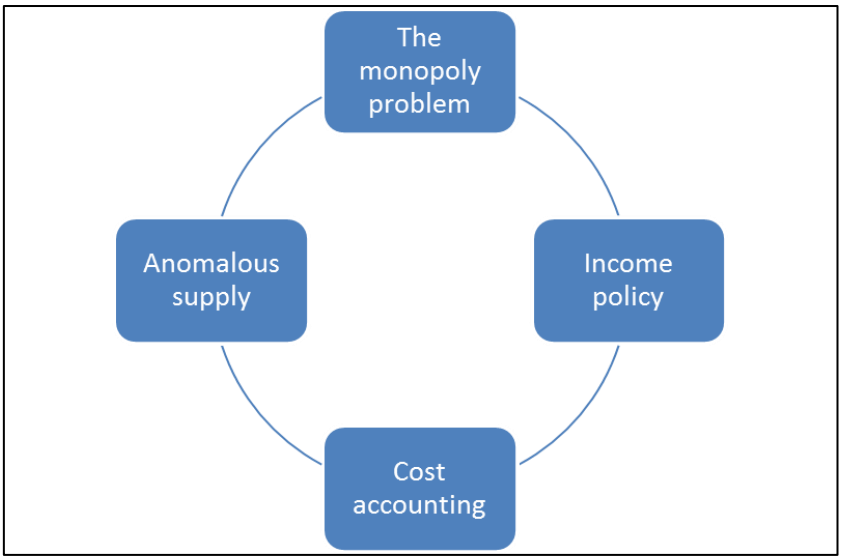

Figure 3: Regulating ordoliberal principles

Having this in mind, market (or more general: economic) power might also have a second negative effect: it can influence the political rule setting: If companies are strong (and big), they will not only have market power, but also political influence due to their economic strength. Although the public choice theory was not invented at the time of the Ordoliberals, their analyses already incorporated this politico-economic perspective.

The second regulating principle, "*income policy*", takes a different perspective. Even (or especially) if the competition based economy produces outcomes as predicted in the microeconomic perfect competition model, there will be unwanted effects for people in the respective country. These effects do not refer to the efficient provision of goods and services, but to the resulting distribution of income. To protect the weak (or potential losers of the market game respectively) the Ordoliberals suggest a redistribution of income via progressive income taxes. This redistribution clearing refers to the idea of the humanity of the economic system. It is further developed within the modern enhancement of the ordoliberal principles, i.e. the supporting principles to be presented in the next section.

Also with the third regulating principle, the Ordoliberal were ahead of the time. The "*cost accounting*"-principle refers to the externality problem. Externalities, such as environmental pollution, are not adequately covered within the accounting system of the economic actors. Therefore, as we know today, the price system does not send correct information and quantities provided are accordingly too small (in case of positive externalities) or too big (in case of negative externalities). Keep again in mind that externalities and potential ways to internalize them came onto the economic and political agenda with Ronald Coase's seminal paper on "The problem of social cost" (Coase 1960).

The Ordoliberals, however, were in the 1940s aware of the fact that markets do not always produce efficient (or socially wanted) outcomes. Facing externalities as a potential reason for market failure they asked for the necessary internalization of such effects. As potential instruments for internalization Eucken (1952, 1990, p. 302) discussed legal obligations. From today's perspective, this might be a point of criticism on the ordoliberal framework. If we however distinguish between the principle, saying externalities should be internalized, and the instruments suggested for internalization, this criticism must be qualified. Whereas the principle is still topical, environmental economics knows today – of course – more and better instruments than legal obligations.

The regulating principle on "*anomalous supply"* situations referred us to potential unwanted (and inhumane) effects on the labor market. Again, based on the current state of the arts in theory, Eucken describes a situation where labor supply increases. This increase in supply results c.p. in lower wages. If families wanted to realize a given income, they are forced to offer more labor in times of lower wages. As a result, there would be an inverse supply function for labor. Eucken sees the competition based economy as a major solution to this problem. In cases, where an inverse labor supply function is still found, he sees a minimum wage, set by the government, as a feasible instruments to prevent unwanted outcomes (Eucken 1952, 1990, p. 304).

To sum up, the regulating principals refer to allocative market failure situations as well as to the unequal distribution of income that results from a competition based economy. The regulating principles are first attempts to make the workable competitive order more humane.

In the original ordoliberal concept it is the government's duty to set the institutional framework for an economic order, i.e. the rules of the game (Ordnungspolitik). The private actors are within these rules free to choose their economic activities (moves). In addition to constitutive and regulating principles Eucken described some policy recommendations. Those are direct measures to influence the economic activities. Eucken refers to two fields of policy: (i) economic stabilization policy and (ii) social policy. In a modern interpretation the intention of these policies is to support the workability of the competitive market order (van Suntum et al. 2011, p. 16). Social policy in this respect is not just social policy – it is social policy supporting the workability of the market economy. It therewith helps to gain acceptance for the social market economy.

3.2.2. Legitimation

Eucken (1952, 1990, p. 314) stressed the fact that implementing a workable system to coordinate economic activities is the necessary prerequisite to solve social problems. Like with the modern liberal market economy concept, the competition based economic system is in itself a social policy, because it ensures a *provision of goods and services* according to the preferences of the people. This is, as we mentioned before, a source of legitimation. In addition, a higher GDP – following the logic of the old and new institutional economics concepts – will be realized if the institutions for a market-based economy are adequately set. As governments can only redistribute the available GDP, a higher GDP – caused by adequately designed institutions – creates more options for redistribution activities (Eucken 1952, 1990, p. 315). And if a social policy is a social policy for the market, it has exactly this positive effect.

Apart from the social function of the competition based order itself, Eucken explicitly discusses the question of social justice and social security.

His view on *social justice* is similar to that of F.A. von Hayek (1978), who stressed the point, that taking the characteristics of competition seriously, social justice referring to a certain result does not make sense. Eucken (1952, 1990, p. 315f.) sees social justice being realized if the distribution of income happens according to the principles of the competitive market, risk and liability. Justice, from this perspective, can just be a measure for the process of competition (which needs rules for fair and non-discriminatory behavior). Modern philosophers, e.g. Wolfgang Kersting (2012, p. 224), add that also the starting chances to enter into the "market game" can and should be subject to justice or fairness concerns. This argument refers especially to the educational sector, meaning that the government's duty is to provide *access to education* for every citizen.

The *social security* argument developed by Eucken (1952, 1990, p. 317ff.) refers to the potential losers of the market game. Although the arguments developed in section 2.2 indicate that the competition based economy creates benefits for all people and is therewith acceptable for all, there are limits of this argument. Participating in the market game does not necessarily mean, as we discussed above, that everybody wins.

The potential losers of the market game are for example, the old, the ill, and the unemployed. They are at risk of generating just a low income or no income, e.g. in case of unemployment. Age, illness and unemployment are risks for a secure existence and inclusion into social interactions. And exclusion can have a lot of negative effects for the individual and for the

society. Therefore, the ordoliberal social market concept includes also mechanisms to secure existence, e.g. insurance against the risks connected with age, illness and unemployment.

How does this affect the idea of a consensus about the rules of the game? It is exactly the idea of providing social security systems within the social market economy that makes this economic system a consensus generating mechanism. Taking the example above, the characteristic of any insurance is that all members of the insurance pay for those who are a "liability case". That means within insurance systems for health, age and unemployment related risks, there is redistribution from the healthy to the sick, from the young to the old, and from the employed to the unemployed. Taking again the consensus of the people affected as a measure for legitimation of a competition based economic system that is supported by these kinds of insurances the question is why should people agree upon implementing such a redistribution system?

Obviously, those who will receive payments out of the distribution system will be in favor of implementing such mechanisms. But it is also for the benefit of the potential payers to voluntarily agree to the implementation. The reason is based on two arguments.

The first argument for their acceptance is a typical insurance argument. Even if they are sure at the time of implementation that they belong to the winners of the market game, they cannot be sure that they will have this position forever. To prevent the worst case, i.e. becoming a potential loser, they will accept to introduce an insurance against the risks connected with the worst case. This argument is similar to that developed by John Rawls (1971, 1999) to justify fair rules within a society. The second argument is a more economic one. It is built on the benefits for the potential winners of the market game. One of the basic prerequisites for being a potential winner and keeping the benefits is assurance of property rights and the absence of social riots. Looking at the potential losers they might feel the pressure to engage in social riots if there existence is in danger. Therefore it is in the best interest of the potential winners to compensate the positive potential losers to ensure the situation of social peace which directly provides benefits for those winners. Both arguments deliver rational reasons to accept the social market economy, including social security systems.

It was exactly this argument of keeping social tensions low that motivated Bismarck to implement social security systems in Germany. The implementation of social security systems is, in a modern interpretation, a social policy for the market. It supports the workability of the competition based market economy which creates mutual benefits from cooperation. With this regard, Bruni and Sugden (2013, p. 160) come to the following conclusion: "To recognize this

feature of markets is not to oppose all redistributive policies. Indeed, one might argue that a market economy is politically sustainable only if everyone can expect to benefit in the long run from the wealth that markets create, and that might require some collective commitment to redistribution." Social security systems have in the course of time become a major pillar of the social market economy in Germany. Some experts claim that especially the flexibility offered by the social unemployment insurance helped Germany to cope with the current crisis without high frictions on the labor market (e.g. Rinne/Zimmermann 2011).

Now that we have characterized the modern liberal market economy concept and the ordoliberal social market economy concept within the overall framework of institutional economics, the next step is to compare these two concepts: what are the differences and similarities of the two concepts?

4. Liberal vs. social market economy: the concepts compared

Comparing the modern liberal market economy concept with the old ordoliberal constitutive principles the overlap is obvious – and might be astonishing. Both, the old and the new concept clearly focus on the institutional framework necessary to establish a competition based economic system.

Both emphasize the advantages of such an economic system: Firstly, workable markets as instruments to realize mutual gains from cooperation. Following the "invisible hand"-narrative introduced by Adam Smith, both concepts stress the fact that consumers as well as producers benefit. Secondly, workable competitive markets create employment. Operating within flexible labor markets private companies provide jobs and therewith income which is necessary for the social inclusion of people in societies with market economies.

Both concepts also emphasize the necessity of adequately designed institutions to implement and preserve a competition based economy. Both stress the importance of stable prices (price stability/access to sound money), the importance of well-defined and secured property rights (private property/security of property rights) and the relevance of adequately designed regulations (freedom of contract/regulation of credits, labor and business). In addition, access to national and international markets (open markets/freedom to trade internationally) is important in both approaches.

Differences between those concepts can be found in the deeper level of the practical realization of the necessary institutional framework. For example, whereas the modern approach puts more emphasis on the independence of central banks to achieve stable prices, the ordoliberal approach focuses more on a buffer stock-based currency as an instrument to

reach this goal. These differences on the instrumental level are caused by the differences in the relevant state-of-the-art knowledge in the 1940s and today.

Apart from this more technical aspect, there is one major difference between the old and the modern institutional concept: The ordoliberal concept is much more comprehensive than the modern liberal approach.

Whereas the ordoliberal approach explicitly refers to the aspect of the humanity of the economic system, the focus of the modern liberal approach is clearly on its workability. With its explicit reference to necessary social policy measures, the ordoliberal concept needs a stronger state and assigns more duties to the government. The government is not only responsible for setting the adequate institutional frame but also for taking the right measures in applying the respective policies. From a financial perspective, the ordoliberal government needs a higher budget, i.e. it is probably bigger than the liberal "minimal" government.

Looking at the potential arguments to legitimize the implementation of a liberal or social market system, both concepts refer (explicitly or implicitly) to the acceptance of the people affected. Using the consensus criterion for legitimation the arguments provided for the ordoliberal concept seem to be more convincing. It does not only refer to the general idea of mutual benefits of a workable economic system. With its explicit reference to a necessary social policy the ordoliberal concept provides good reason for the potential losers of the market game to approve the comprehensive institutional setting of the social market economy.

However convincing these theoretical arguments may seem, empirical data on the acceptance of the German social market economy indicates that a reasonable share of the Germans were not really convinced by their economic system until 2007. The approval of the social market economy has increased again since 2008. One reason for this growing acceptance might be the fact that German people receiving information from the media about the bad economic and social situation in the southern European countries perceive the situation in Germany as far better. And as the perceived advantages are a major reason for acceptance, this acceptance has grown since the beginning of the crisis – and its coverage in the media (cf. Sauerland 2013).

Now that we have described the differences and similarities between the theoretical concepts, we are going to outline some empirical data on institutions in different countries. Before we describe the institutional footprints of the United States and Germany – as the two prototypes for the implemented concepts – we have a look at the data available on institutions today.

5. The empirical data: economic freedom, competitiveness and wealth

> "The cornerstones of economic freedom are (1) personal choice, (2) voluntary exchange coordinated by markets, (3) freedom to enter and compete in markets, and (4) protection of persons and their property from aggression by others. Economic freedom is present when individuals are permitted to choose for themselves and engage in voluntary transactions as long as they do not harm the person or property of others."
>
> Gwartney/Lawson/Hall (2014, p. 1)

Apart from the theoretical literature, the empirical research on institutions has become an important part of institutional economics. A major focus of empirical analysis is on the institutional determinants of long-term growth in different countries. From the perspective of state of the art growth theory, the institutional framework is – in addition e.g. to technical progress, human capital, and capital per capita – an important determinant of growth rates (Acemoglu/Johnson/Robinson 2005). But which institutions are now then really relevant for growth?

To answer this question, empirical institutional economics analyses try to find the most relevant economic and political institutions for a positive economic development. In the context of these empirical analyses, a lot of data on the quality of economic institutions in different countries has been collected. Nowadays researchers can use several well established databases on institutional quality for empirical analyses.

5.1. Some databases

The empirical results indicate that the above-mentioned set of institutions ensuring freedom of choice and workability of market processes has indeed a huge impact on economic development. Consequently there are at least two major databases collecting data on the economic freedom within different countries. The Index of Economic Freedom (IEW) is provided by the Heritage Foundation (Miller/Kim 2015) whereas the Economic Freedom of the World-Index (EFW) is collected and provided by the Fraser Institute and other international liberal think tanks (Gwartney/Lawson/Hall 2014). In addition, the Global Competitiveness Index (GCI), published by the World Economic Forum collects data on the workability of market processes (Schwab 2014).

The EFW-index collects data on five areas of relevant institutions. Those are (i) the size of government, (ii) the legal structure and the security of property rights, (iii) access to sound money, (iv) freedom to trade internationally, and (v) regulation of credits, labor and business (cf. Gwartney/Lawson/Hall 2014, p. 3-6).

Quite similar, the IEW-index covers four ideas (cf. Miller/Kim 2015, p. 13-16): (i) the rule of law (property rights, freedom from corruption), (ii) the limitation of government (fiscal freedom, government spending), (iii) regulatory efficiency (business freedom, labor freedom, monetary freedom), and (iv) open markets (trade freedom, investment freedom, financial freedom).

Obviously, these two indices basically cover *economic institutions*. The few *political institutions* to be found in the indices refer to the protective state, i.e. legal structure, property rights and rule of law. Political institutions for the productive state are not covered. If there are references to productive functions of the government, they are defined in a negative way: the size of government (should not be too big) and regulations (should not be too strict; should not prevent freedom to do business, flexibility of labor markets; should not restrict access to capital). Therefore measures for productive state functions could be supplemented by data collected within the GCI, because this index takes more measures into account.

The GCI-index is based on 12 pillars referring to three stages of economic development (cf. Schwab 2015, p. 4-9). Data is collected on well-functioning public and private institutions (pillar 1), a well-developed infrastructure (pillar 2), a stable macroeconomic environment (pillar 3), and a healthy workforce that has received at least a basic education (pillar 4). These pillars represent the basic prerequisites for a factor-driven economic development. The next level of development is described by efficiency-enhancing factor, i.e. higher education and training (pillar 5), efficient goods markets (pillar 6), well-functioning labor markets (pillar 7), developed financial markets (pillar 8), the ability to harness the benefits of existing technologies (pillar 9), and a large domestic or foreign market (pillar 10). Finally, the last stage of development is innovation-driven and characterized by business sophistication (pillar 11) and innovation (pillar 12).

Obviously the measures taken for pillars 2 (infrastructure), 4 (health and primary education) and 5 (higher education and training) refer to functions of the productive state not being covered within the freedom indices.

All three datasets are used in the empirical analyses to measure the influence of the theory-based derived indicators on economic development or wealth respectively, typically measured as GDP per capita. In the following section, we will focus on the EFW-index and supplement this data by the GCI-data.

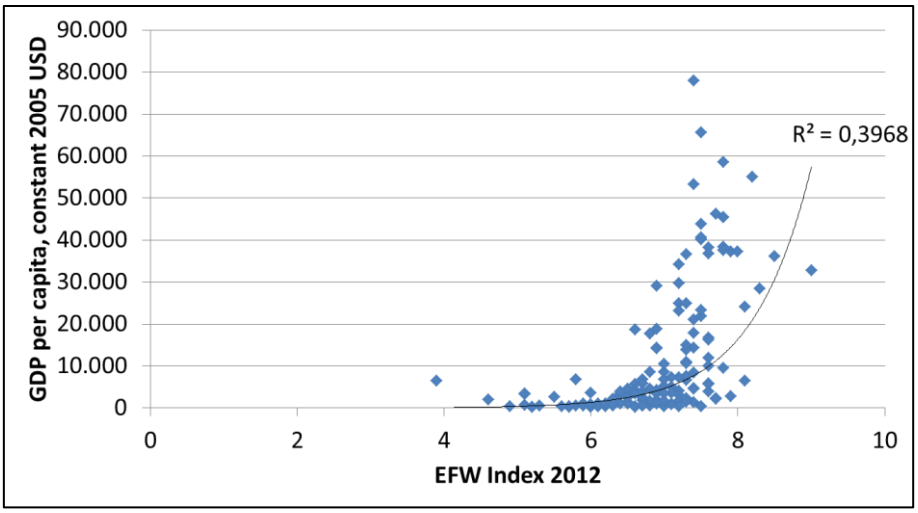

Figure 1: Economic freedom and GDP per capita

Analyzing EFW-data, we find a correlation between economic freedom and wealth (see figure 1): thus defined better institutions correlate with a higher GDP per capita. The policy implication drawn from these analyses is simple: improve the quality of institutions to improve living conditions. Not surprisingly – and as mentioned before – a lot of policy recommendations, e.g. by the OECD (2014, p.65ff.) are referring to institutional reforms.

5.2. Countries (and concepts) compared: the institutional footprints of the United States and Germany

Discussing the idea of institutional blueprints as a source for institutional change in Latin American countries, the mere correlation of economic freedom and wealth is not sufficient. Therefore, we will now have a closer look at the institutional settings of two countries, which can be labeled as prototypes for the implementation of the liberal and the social market economy concept: The United States and Germany. We try to characterize both countries by their "institutional footprint".

The data presented in table 1 is taken from the latest available EFW ranking and GCI report. Both were published in 2014. The EFW data refers to the year 2012 and uses a scale from 0 to 10, the GCI data to 2014-2015 and uses a scale from 1 to 7. While the EFW ranking reports data for 152 countries, the GCI covers 144 countries. The GDP per capita (based on purchasing-power-parity) is taken from the World Economic Outlook (IMF 2015).

	EFW 2012		**GCI 2014**			**GDP 2012**
Country	**Total score**	**Rank**	**Score**	**Rank**	**Classification**	**Per capita PPP**
Germany	7.55	28	5.49	4	stage 3	$ 42.756
United States	7.81	12	5.54	3	stage 3	$ 51.450

Table 1: Institutional data – Germany and the United States

Having a first look at this data, the United States is characterized by greater economic freedom than Germany, however the competitiveness of both countries is almost identical. The development of the EFW-scores (in figure 4) since 1970 shows some convergence: Whereas the German score went up from 1975 to 2003 and has been rather stable since then the US score went slowly down since 2000 and especially in the aftermath of the financial crisis since 2008. In addition, the gap in GDP per capita has become smaller since 2005 (see also figure 4).

Looking at the institutional footprint of both countries in 2012 (see figure 5), there are some differences and some similarities in the five areas analyzed. Firstly, the scores for access to sound money and freedom to trade internationally are almost identical in the US in Germany. Secondly, Germany shows greater freedom in the score for the legal structure. Thirdly, in contrast to that the US scores are better for regulation and size of government.

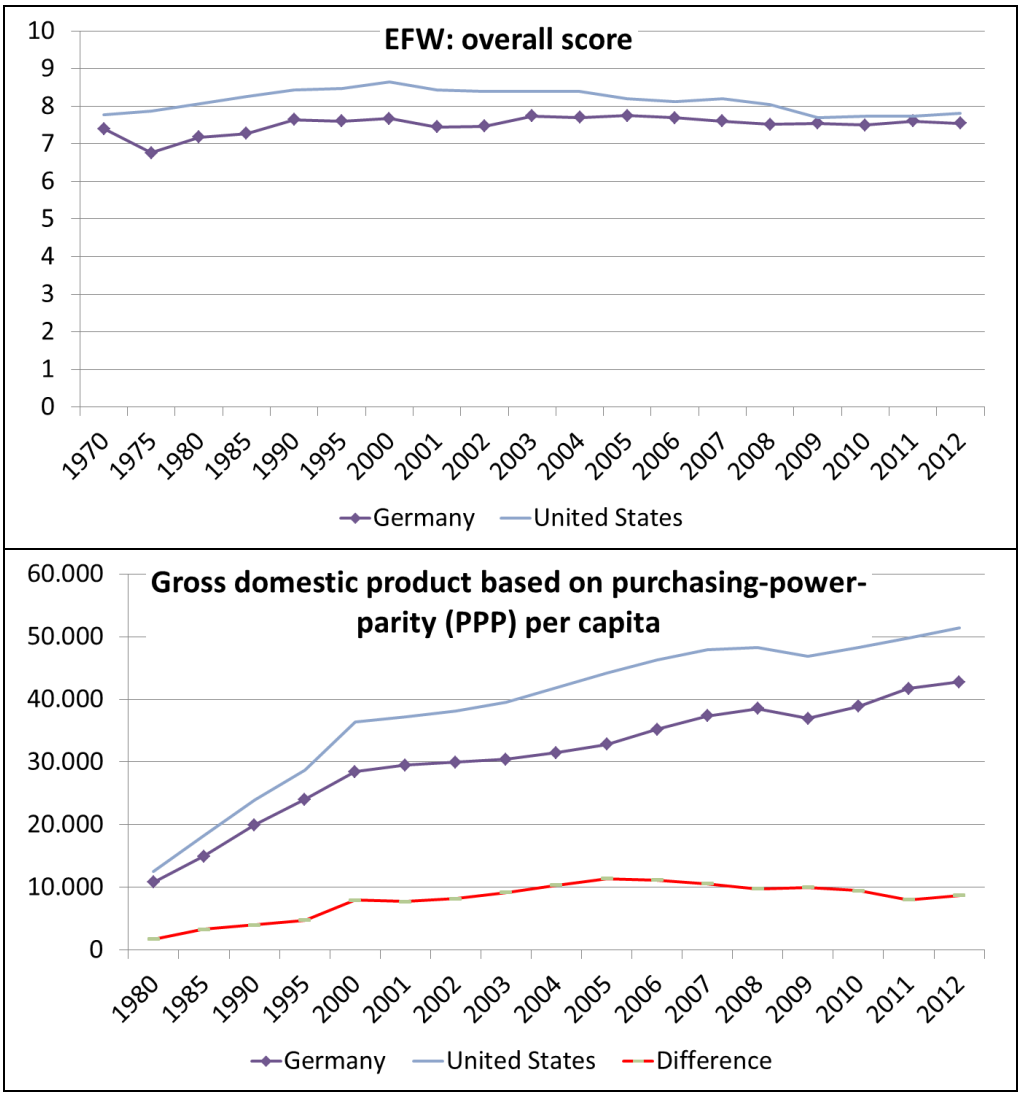

Figure 4: Institutional data and GDP per Capita – Germany and the United States

Especially the last result is not surprising in the light of the two different concepts implemented in the two countries. As mentioned before, a social market economy with an active social policy for the market means c.p. in larger share of government on GDP. In addition, a social security system to cover the risks connected with being unemployed means higher regulation, especially of the labor markets.

Consequently, the scores for Germany (see figure 5) in both the dimensions according to the logic of the EFW-measures must be worse than those for the US with its still liberal market economy (Gwartney/Lawson/Hall 2014, p. 78, 172). Germany's low score in size of government is predominantly caused by transfers and subsidies paid by the government (score 2.15 from 10). In the area of regulation, hiring and firing regulations (3.84), centralized collective bargaining (3.90) and especially bureaucracy costs (1.45) are decisive for the low score. Looking at the situation in Germany and the performance of the labor market, one might question the correlation between low regulation and good labor market performance.

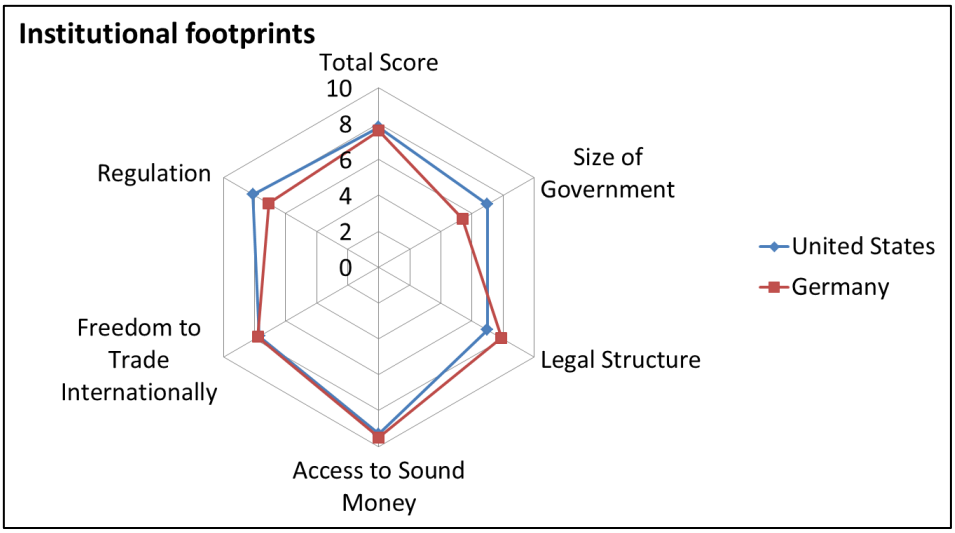

Figure 5: Institutional footprint – EFW data for Germany and the United States

In general, the United States and Germany are both highly developed and highly competitive countries and can serve as a benchmark for other countries. If their economic systems can even serve as blueprints for institutional reforms will be discussed in section 6. Before we do that, let us have a look at the institutional footprints of some Latin American countries.

5.3. Institutions in Latin American countries

> "The need to boost competitiveness by undertaking the necessary investments and by fully and efficiently implementing structural reforms has become not only important but also urgent if the region is to be able to consolidate the economic and social gains that many countries have

experienced in past years. Becoming more resilient and less affected by external fluctuations will depend on this."

Schwab (2014, p.32)

As in section 5.2, the following table presents the latest available data about five Latin American countries and Turkey. Turkey is taken here as an example for a successful economic development over the last 30 years. The data presented in table 2 is again taken from the EFW ranking 2012, the 2014-2015 GCI report and the April 2015 World Economic Outlook.

	EFW 2012		GCI 2014			GDP 2012
Country	**Total score**	**Rank**	**Score**	**Rank**	**Classification**	**per capita PPP**
Argentina	4.92	149	3.79	104	Transition: stage 2 to 3	$ 21.647
Brazil	6.61	103	4.34	57	Transition: stage 2 to 3	$ 14.537
Chile	7.84	10	4.60	33	Transition: stage 2 to 3	$ 21.503
Mexico	6.75	91	4.27	61	Transition: stage 2 to 3	$ 17.147
Turkey	7.03	71	4.46	45	Transition: stage 2 to 3	$ 18.254
Venezuela	3.89	152	3.32	131	Transition: stage 1 to 2	$ 18.226

Table 2: Institutional data – Latin American countries plus Turkey

5.3.1. Institutional Development since 1970

Looking at the institutional development since 1970 (figure 6), three trends become obvious. Firstly, the scores of economic freedom in Chile, Brazil and Mexico (and Turkey) converged since 2001.

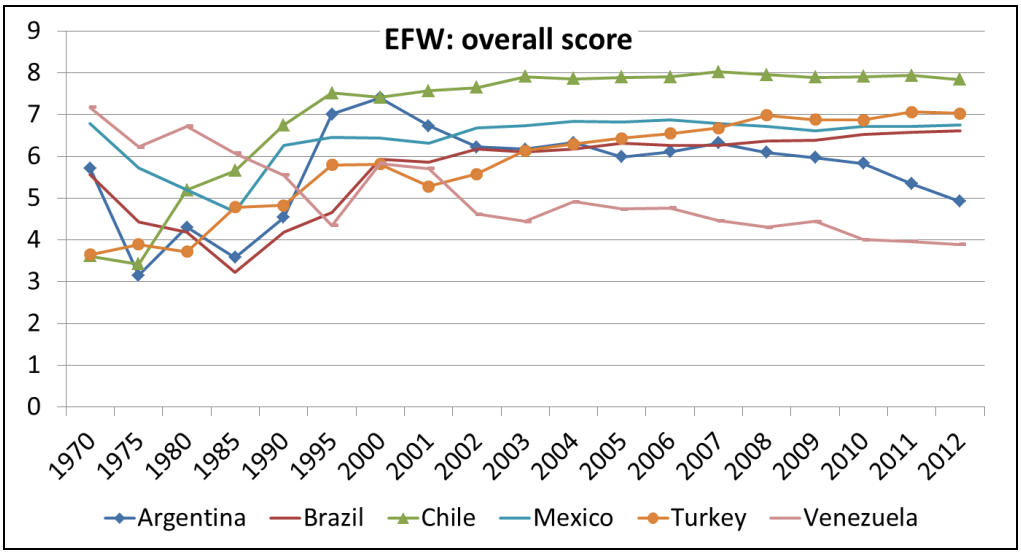

Figure 6: Institutional data and GDP per Capita – Latin American countries plus Turkey

Whereas Chile's and Mexico's score remained stable, the scores of Brazil and Turkey slightly increased. Secondly, the freedom scores in Argentina and Venezuela went down since

2006/2007. Thirdly, whereas Venezuela in 1970 had, according to the EFW measures, the top position of the sampled countries regarding economic freedom, in 2012 it had the worst score. Chile's and Turkey's institutional developments were just the opposite; they caught up and are now at the top of the sample.

Looking at the GDP per capital data since 1980 in figure 7, Chile and Turkey also had a positive development, coming from the worst situation and moving to places 2 and 3. Despite of its fall in institutional quality, Venezuela still has a relatively high GDP per capita, but now just in a midfield position.

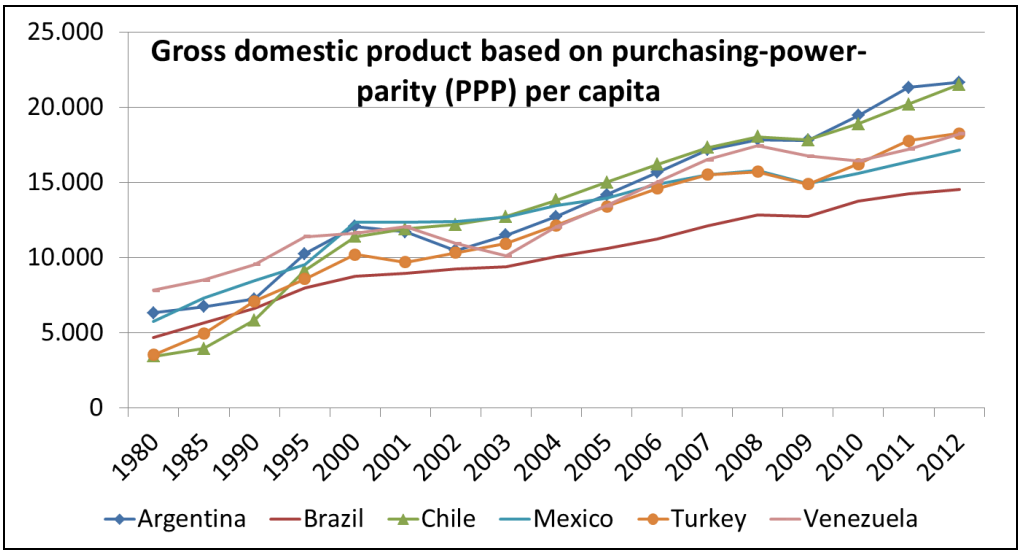

Figure 7: GDP per Capita – Latin American countries plus Turkey

Taking the extremely different development in the economic freedom scores between Chile and Venezuela figure 8 shows the differences in GDP per capita values (left vertical axis) and in the EFW-score (right of vertical axis) between both countries since 1980.

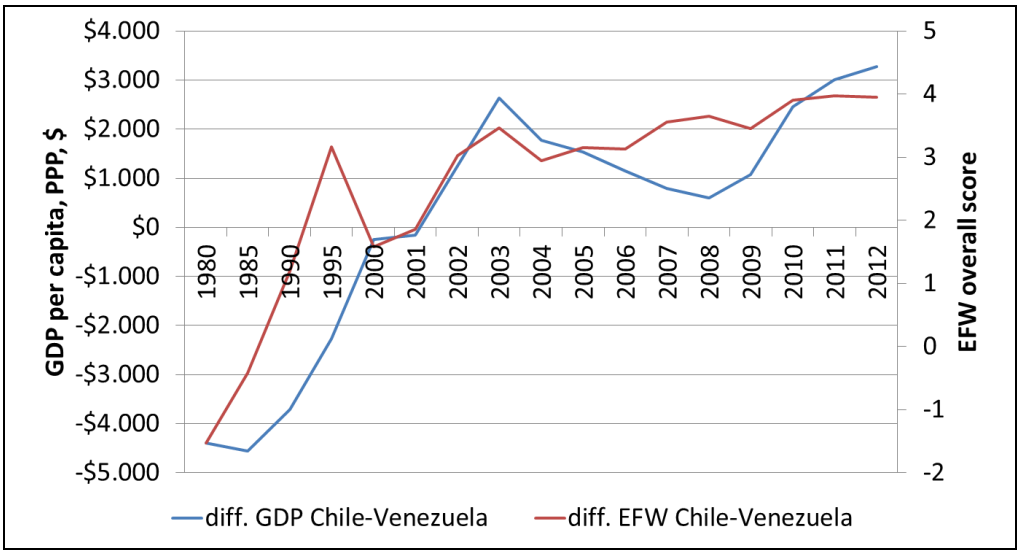

Figure 8: Institutional data and GDP per Capita – differences between Chile and Venezuela

On first sight, the development between both values seems to be very similar: A negative value of the EFW overall score, indicating that the economic freedom in Chile is lower than in Venezuela, corresponds with a negative value in GDP, meaning that Venezuela has a higher GDP per capita than Chile. Similarly, positive value is of the difference in EFW scores correspond with positive values in GDP differences; that means a higher economic freedom in Chile than in Venezuela correlates with a higher GDP per capita in Chile than in Venezuela.

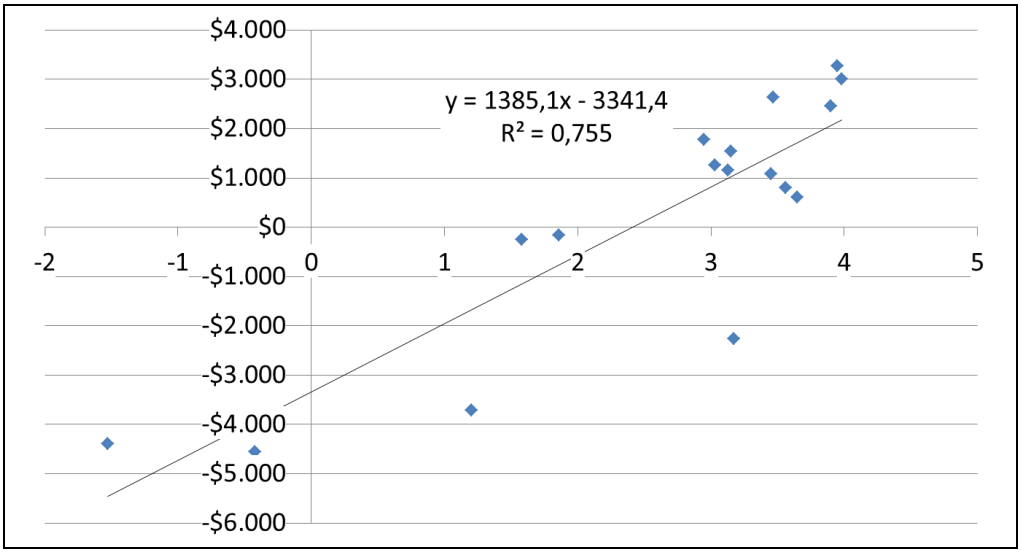

Figure 9: Institutional data and GDP per Capita in Chile and Venezuela – simple regression

To test for the empirical validity of this optical impression figure 9 shows a simple correlation between differences in EFW-scores (horizontal axis) and differences in GDP per capita (vertical axis). The linear regression model indicates that differences in GDP highly correlate with differences in institutional quality in the two countries.

5.3.2. Institutional status quo

Looking at the institutional status quo in 2012 as depicted in figure 10, the footprints of the countries in the sample show great differences, not only within the sample but also in comparing the sample countries with the two prototypes Germany and the US.

The biggest differences compared to the prototypes show Argentina and Venezuela. Measured in the dimensions of the EFW-index both countries show a much lower quality of institutions than Germany and the US.

In contrast to that, the institutional footprint of Chile in 2012 was very similar to the US and Germany. In the distinguishing size of government-measure, Chile was closer to the US score than to the German score; in fact, in terms of EFW-scores, Chile did even better than the US with regards to the size of government.

Mexico in general also shows similar patterns as the two reference countries. However, it has much lower scores for the quality of its legal structure. The score for size of government is close to that of the US and, like with Chile, higher than for Germany. Brazil's institutional footprint is similar to that of Mexico but with lower scores in regulation. Again, the size of government is close to the US scores – and higher than for Germany. Finally, Turkey's scores are similar to those of Mexico. The legal structure in Turkey is worse than in the two prototype countries; the size of government is similar to the US, i.e. different from Germany.

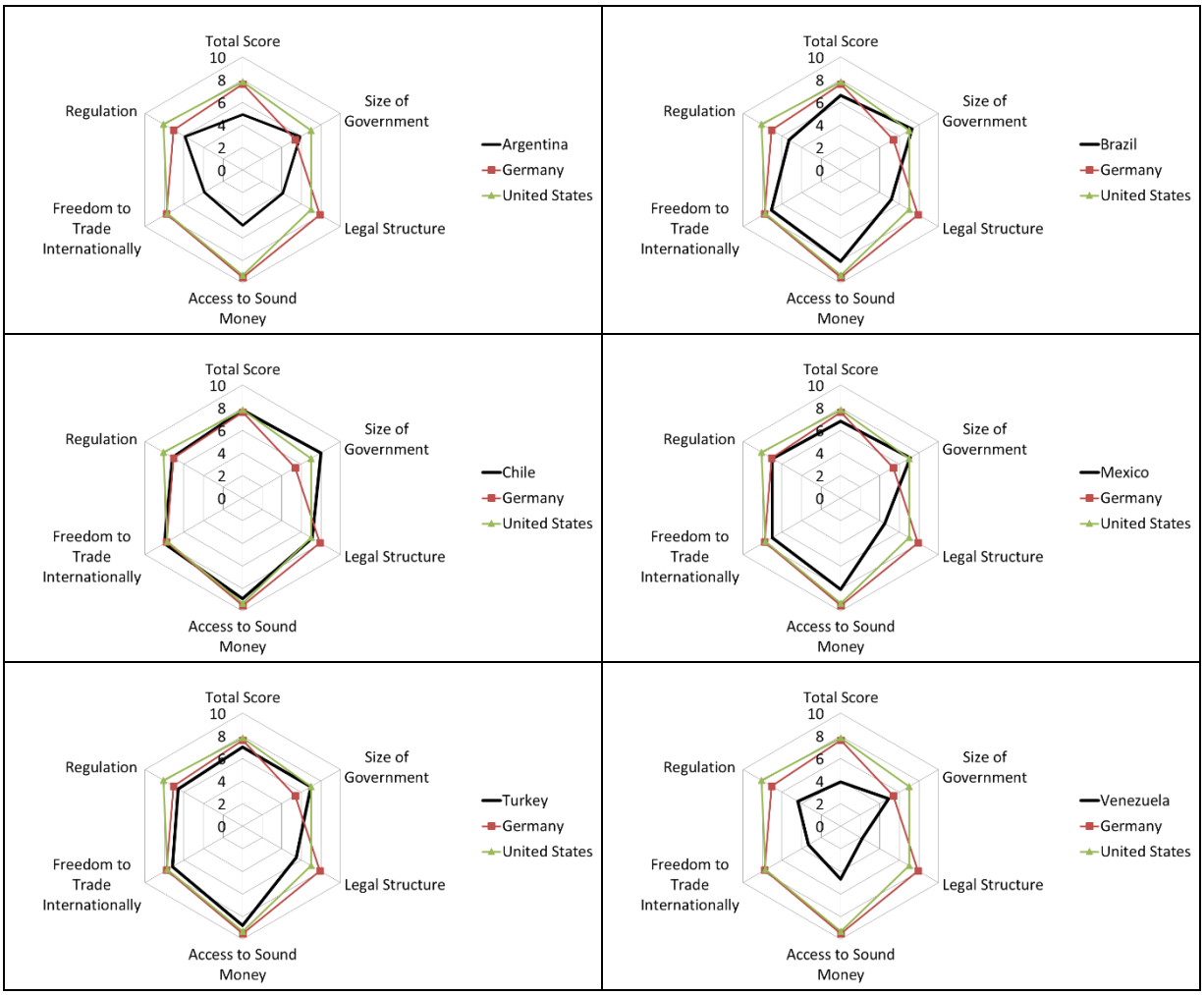

Figure 9: Institutional footprints 2012 – EFW data for Latin American countries plus Turkey

Summarizing this, Argentina and Venezuela could improve the quality of their institutions in almost every dimension measured by the EFW-index. With reference to the two prototypes taken as references in figure 10, Chile, Mexico and Turkey seem to follow the modern liberal market concept. Chile does implement this concept even better than the US in terms of government size, whereas Mexico and Turkey have room for improvement especially with regards to the quality of their legal structure.

Compared to Germany, the size of government, representing the strong social security systems, is lower in Chile, Mexico and Turkey. If those countries wanted to follow the ordoliberal social market concept they would have to go for reforms in this policy area.

6. The blueprint-caveat: on the relevance of acceptance, informal institutions and behavioral patterns

Changes of economic systems, following one of the two market economy concepts outlined above, are extremely important political decisions in a country's history. In terms of institutional economics, it is a choice among formal economic rules that influence human behavior in setting guidelines to foster socially wanted results. Choosing formal economic rules is often based on the idea of institutional learning. And although institutional learning in general is a good approach to develop ideas for reforms in the learning county, this concept has its limits because it basically refers to the knowledge about formal economic and political institutions. To realize the full potential of changing formal institutions, three relevant points must be kept in mind in addition to the mere institutional learning. Firstly, new rules must be accepted by the people affected, secondly, behavioral patterns are important to "work" with the formal institutions – and behavioral patterns change slowly – and thirdly, formal institutions are embedded into a larger set of informal institutions, social ties and networks.

Therefore, the conscious choice and implementations of new formal economic institutions to improve the performance of a country's economic system is not a simple task. In order to realize the full potential of performance improvements, reforms – or the new institutions respectively – do not only need theoretical acceptance, as we have discussed in section 2, but also practical acceptance and support. As all of the countries described in the sample have a democratic political system, it needs at least political majorities to change the formal rules of the economic game.

As we have learned especially from the analyses of transforming post-socialist countries in Middle and Eastern Europe into market-based economies (cf. Zweynert/Goldschmidt 2006) the changing of formal rules is confronted with obstacles, at least the obstacle of path dependency in institutional development. These path dependencies of institutions became well known with the work of Douglass C. North on institutional change (1990). It still plays a major role in recent publications such as Daron Acemoglu and James Robinson's book "Why nations fail" (Acemoglu/Robinson 2012).

The idea behind the path dependency is simple: Once formal (economic and/or political) institutions are in force for some time, people invest (at least time) in learning to operate

successfully within the given set of formal institutions. As a result of these learning processes in the course of time they develop a set of behavioral patterns, including all types of activities that have proven to be successful within the formal institutional restrictions. Every change in the existing set of institutions therefore means a devaluation of human capital for the people affected, because their institutional knowledge and their behavioral patterns do no longer produce benefits. The idea of learning to develop successful behavioral patterns indicates, that those patterns change slowly, whereas formal rules can be changed quickly.

But those people who have invested a lot in institutional knowledge and behavioral patterns are often very unwilling to accept institutional changes. If they have, in terms of Acemoglu/Robinson, high de facto political power, they will use this power to preserve the existing formal economic institutions or to develop them further just gradually. This path dependency is obviously a major obstacle for substantial changes of formal economic rules.

Beside these path dependencies in formal economic institutions, another obstacle for institutional change arises when looking at a broader set of institutions within a society. Formal economic institutions are embedded within the institutional framework of the larger societal system and that means also within a set of informal institutions. Informal institutions are not formally fixed within laws but are – for example – orally transmitted and accepted within different groups of people. Like formal institutions, informal institutions play an important role in framing individuals' behavior. To give an example: The behavioral norms of a reputable businessman are typically not fixed in a written way. Scrupulous merchants know how to behave in a correct way. The tendency nowadays to fix additional corporate governance codices is a good example that formal and informal institutions are often complements. That means, changing the formal institutions has to keep in mind the corresponding informal rules of the game. Changing just the formal rules will, again, not produce the potential benefits. Again, the experiences with the transformation processes in Middle and Eastern Europe have shown, that the adaption of behavioral patterns and informal rules to formal institutional changes takes time. It has to be "managed" carefully to avoid frustration of the citizens resulting from a gap between the expected (potential) benefits of the new institutions and their actual performance. Frustration about the situation under new formal institutions may result in backlashes in institutional change.

These arguments sketch some important restrictions for institutional learning or copying institutions respectively. A new set of formal economic institutions is not a guarantee for successful reforms of the economic system, even if this set of institutions is the proven basis

for growth and wealth in another country. As formal institutions are embedded in a broader context, the historical and cultural tradition in a country either supports or restricts the workability of newly implemented formal economic institutions. With this respect, institutional reforms should be cautiously prepared and acceptance has to be gained e.g. by transparent political processes shaping the economic reforms – if policy makers want to avoid blockades of reforms.

7. Conclusion

Institutions matter – as they have a proven empirical impact on growth and wealth. Referring to the questions which institutions matter, two different institutions for a market-based economy can be distinguished: firstly, the modern liberal market economy concept and secondly, the ordoliberal social market economy concept. Prototype countries for the implementation of these concepts are the US and Germany.

Both concepts are trying to establish a competition based economy by implementing adequately designed institutions for its workability. Therefore they are very similar in stressing the importance of property rights, stable money, free access to national and international markets and adequate regulations of markets for capital, labor and goods and services.

However, there are huge differences between both concepts regarding their view on social security systems. Whereas the modern concepts more or less neglects aspects of social security, the ordoliberal concept stresses its importance for the workability and acceptance of the social market economy. Accordingly, the theoretical legitimation for the ordoliberal social market economy is stronger than that for the liberal market economy concept.

With the comeback of institutions in social sciences, a lot of the empirical data on institutions has been collected. Therefore today we have empirical data to analyze institutional footprints of different countries and to distinguish the two different concepts. Looking at the institutional footprints of Latin American countries compared to the US and the German footprint, Latin American countries have potential for improvements, especially with regards to the quality of their legal structure. Looking at the institutional framework in 2012, the successful Latin American countries, i.e. Chile, Brazil and Mexico seem to be more on the "liberal concept-track". Compared to Germany all of them show smaller governments or public sectors respectively. However, as politicians and the citizens are still looking for ways to improve the situation within the country, the ordoliberal concept could be an option to be chosen.

In the process of institutional reforms (or institutional change), choosing and implementing new formal institutions is not an easy task. Informal institutions and established behavioral patterns are very important for the design of reform measures. Compared to formal institutions informal institutions and behavioral patterns change very slowly. Therefore reforms in institutional structure must be implemented cautiously – if disruptive changes should be avoided.

From this perspective, the idea of simply taking the blueprint of a liberal or a social market economy and to implement all necessary formal rules will not produce the wanted outcome in the short run. The blueprint-idea does not work because of the embededdness of the economic system into other social systems.

However, countries looking for ways to improve the economic situation of their citizens by changing formal economic institutions should be aware of the different types of market-based economies. The German ordoliberal social market economy concept is a well-established alternative to the modern North American liberal market economy concept. Unfortunately, it is not very well-known outside of Germany. To broaden the perspective of institutional reforms, articles like this might be helpful to learn about different styles of market based economies and therewith about different options for reforms.

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