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Transition towards a Social Market Economy? Limits and Opportunities

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Abstract

The quest for an appropriate development and transition strategy in less developed countries (LDCs) and post-socialist countries (PSCs) has been studied for a long time, and it has been subject to numerous controversies among academics and development practitioners alike. Disputes have existed with respect to sequencing, timing, and pacing reforms, regarding the components of stabilization-cum-adjustment programs, and also relating to the question which actors can become effective drivers of transition and development. Today, a widespread consensus exists that institutions and governance matter for making market-oriented policy reform succeed and that governments, despite the general need for less state interventionism, remain central actors for institution building and rule enforcement. The following considerations focus on the question whether or not the concept of the *Social Market Economy*, as it was originally developed and designed by German academics and policymakers more than fifty years ago, will be appropriate to guide policy and institutional reform in LDCs and PSCs and to make market-oriented reforms a viable policy choice in such countries regardless of their political regime.

Keywords:
Less developed countries, post-socialist countries, transition, social market economy

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Transition towards a Social Market Economy? Limits and Opportunities

1. Introduction

The quest for an appropriate development and transition strategy in less developed countries (LDCs) and post-socialist countries (PSCs) has been studied for a long time, and it has been subject to numerous controversies among academics and development practitioners alike. Disputes have existed with respect to sequencing, timing, and pacing reforms, regarding the components of stabilization-cum-adjustment programs, and also relating to the question which actors can become effective drivers of transition and development. Today, a widespread consensus exists that institutions and governance matter for making market-oriented policy reform succeed and that governments, despite the general need for less state interventionism, remain central actors for institution building and rule enforcement.

The search for a suitable strategy has been aggravated because a general theory of development and transition does not exist. Several historical role models, however, can be identified which may provide general guidance for policymakers. Besides the model of a liberal market economy, as it has been applied, e.g., in the United States, other market-based models can be identified such as the Scandinavian model of the welfare state or the German model of a Social Market Economy. The latter could be of particular relevance for LDCs and PSCs because it appears to combine the advantages of a liberal market economy in terms of economic efficiency with the advantages of a welfare state in terms of social justice.

The following considerations focus on the question whether or not the concept of the *Social Market Economy*, as it was originally developed and designed by German academics and policymakers more than fifty years ago, will be appropriate to guide policy and institutional reform in LDCs and PSCs and to make market-oriented reforms a viable policy choice in such countries regardless of their political regime.

It will be argued that whether or not the transition towards a market economy is successful, i.e. whether it leads to large-scale efficiency gains and sustained economic growth-cum-change, ultimately depends on the implementation of the new rules of the game and their impartial, transparent, and predictable enforcement and, related to that, the societal acceptability and hence political feasibility of the envisaged economic reform and transformation steps. This implies that the concept of a Social Market Economy can be applied in diverse environments, but that the institutional characteristics of the Social Market Economy will be contingent on the stage of socio-economic development, existing political constraints as well as the historical development trajectory of the respective country.

The paper is organized as follows: The next chapter introduces the original ideas and characteristics of the Social Market Economy as it had been conceived by its founding fathers. Chapter 3 discusses the applicability of the concept to LDCs and PSCs. It is argued that a gradual and non-orthodox implementation strategy will be superior to a big-bang approach and that governments need to assume new responsibilities, and therefore must develop novel capabilities and stronger capacities. Furthermore, the notion of best-practice institutions is being rejected. Instead, it is argued that economic governance is a dynamic process during which transitional institutions may prove to be economically efficient and politically feasible in certain periods of time. In the course of socio-economic development, these institutions may become inappropriate due to changing political, economic, social, and international constraints, and hence they will be replaced by other transitional institutions. This suggests that pragmatic flexibility and policy adaptability are key characteristics of successful policymaking. Institutional frameworks which allow for these characteristics will be best suited to foster economic development. Chapter 4 concludes.

2. The idea of the Social Market Economy

By its founding fathers, the *Social Market Economy* was conceived as a liberal market economy, based on ordoliberal reasoning, which was social by itself. The original conception of the Social Market Economy was developed in Germany before and during World War II as a potential post-war economic order. After the war, it was politically and visibly represented by Ludwig Erhard, among others. The concept did not allow for the substitution or elimination of market processes through state interventions or the active correction of market outcomes. The idea implied the realization of a market order based on individual self-responsibility with no or only very limited government redistribution. An indicator of the success of the Social Market Economy was said to be the fact that public social transfer payments became redundant due to continuously improving economic performance and all economic actors' participation therein (Wünsche 1994: 36). Thus, the original *Social Market Economy* does not develop its social characteristics through artificially imposing apparently social elements (favoring particular groups in society) onto an otherwise free market system. Rather, the attribute *social* is to be justified through the functions of economic competition and technological progress leading to economic growth processes, which allow a socially just distribution of income increases.

This is what Müller-Armack (1956: 390), who coined the term *Social Market Economy*, may have had in mind. He defined the concept as "an idea of order policy (..) pursuing the objective, on the basis of a competitive market economy, to link free initiative with social progress which is being assured exactly through market economic performance"[1] According to Ludwig Erhard, this, in fact, was supposed to be the driving force to unfold and ensure individual freedom. However, the basic principles underlying the concept of the Social Market Economy do not only include individual freedom and functioning competition. Subsidiarity, solidarity, and responsibility complete the set of basic principles. In order to ensure an efficient functioning of the economic order, to maintain social peace, and to enhance the societal acceptance of this particular capitalist system, solidarity mechanisms need to be in place which support the disadvantaged who cannot sufficiently participate in market processes and earn a living or who are handicapped in another way. Basically, citizens are supposed to be self-responsible. Hence, in order to make incentives compatible, any public support should be organized in a subsidiary way (Schlecht 2001).

Körner (2007: 19) argues, that, besides the principle of individual freedom, the commandment of social justice equally serves as a foundation of the economic and societal order. This would, however, not allow a onesided interpretation favoring either radical market liberalism or an encompassing, egalitarian social-policy approach. Both principles together constitute a framework for developing and securing a humane economic and social order. Eventually, this concept may help to

[1] Author's translation; the original reads "eine ordnungstheoretische Idee (..), deren Ziel es ist, auf der Basis der Wettbewerbswirtschaft die freie Initiative mit einem gerade durch die marktwirtschaftliche Leistung gesicherten sozialen Fortschritt zu verbinden."

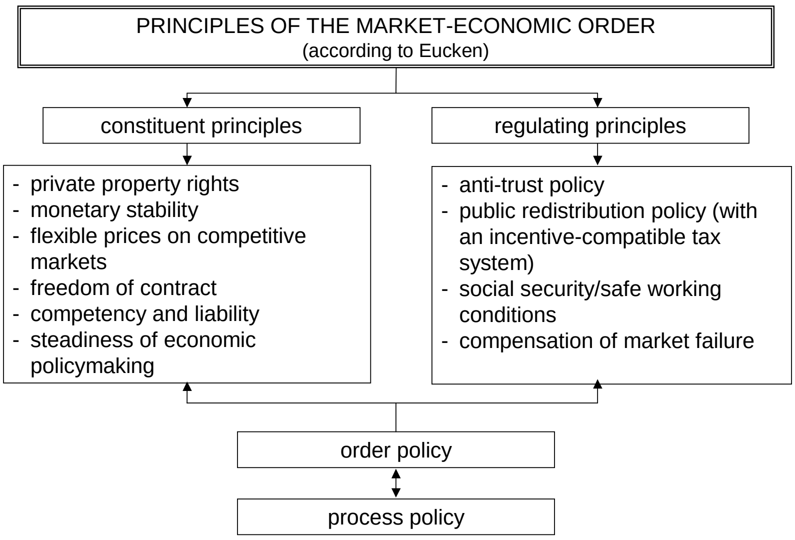
bundle vested interests, to amalgamate diverse ideologies, and to harmonize different moral concepts.

In order to protect the Social Market Economy, a concentration of economic power has to be avoided. Neither the economic order nor economic policies should be subject to the influence of powerful interest groups or business cartels. Therefore, Eucken (1990/1952) postulated that politics and public policies ought to dissolve powerful economic groups or, at least, limit their functions. Moreover, public policymaking should focus on crafting and impartially enforcing the economic order and should not seek to steer economic processes.

Time and again, the attribute *social* has been the cause for conflicting political disputes. On the one hand, this attribute helped to gain societal acceptance for implementing the new economic order. On the other hand, the meaning of *social* remained unclear or was subject to opportunistic (political) interpretations. In the course of post World War II German economic history, the Social Market Economy has undergone a remarkable evolution with substantial reforms, additions, and modifications. These include, e.g., the introduction of a pay-as-you-go pension system, comprehensive worker co-determination rights, substantial social protection, and a generous social transfer system. As a consequence, an affluent welfare state has emerged the financing of which is getting ever more difficult, the incentives of which counteract market principles, and the survival of which is being challenged by globalization forces, demographic trends, and politically opportunistic behavior. The remainder of this paper does not explicitly focus on the actual design and evolution of the Social Market Economy in contemporary Germany.[2] Instead, Müller-Armack's definition serves as a point of departure and reference for addressing the question whether or not the concept of the Social Market Economy can be usefully applied to transition countries.

[2] With respect to this aspect and regarding the need for Germany to re-model its approach to a Social Market Economy in order to address the challenges from globalization and European integration, see, e.g., Vanberg (2007), Streit (2005), and Hass (2007).

Figure 1: Principles of the Market-Economic Order



Source: Eucken (1990/1952); author

A market economy is an order which ensures the autonomy of economic actors and coordinates – through the system of flexible relative prices – economic activities which take place within a given market-oriented institutional framework.[3] The basic understanding underlying the concept of the Social Market Economy is that a society consists of different orders, the political, economic, and social orders, and that each of these consists of various sub-orders, e.g., the monetary order and the legal order. Each order is made up of institutions, conceived as formal and informal rules of the game including their enforcement characteristics. These economic, political, and social institutions provide the incentive structure within a society and determine the behavior and actions of individuals. The main task of the government is to establish and enforce this order whithout intervening into economic processes. Thus institution building, or more generally order policy, is the key to bring about a functioning, efficient, and politically feasible market system. Order policy concerns the entirety of rules, which are relevant for the organizational structure of an economy and for economic processes as well as the entirety of mechanisms which are responsible for administering and steering the economy.

Today, it is widely recognized that macroeconomic stabilization, privatization, and price liberalization, though necessary components of economic transition and policy

3 A large part of the following considerations heavily draw from Ahrens (2002a).

reform, are insufficient and that adequate economic rules and regulations must be in place to make incentives work and markets perform well, to reduce transaction uncertainties between private actors, and hence to support private sector development and coordination. In the 1990s, three disparate developments helped reinforce the efforts to put institutions on the reform agenda of policymakers. The first one was the failure of price liberalization and privatization in the Russian Federation and other successor states of the USSR due to a lack of a market-oriented regulatory, legal, and political framework. Another one was the dissatisfaction with economic reforms in Latin American countries and the insight that these policy reforms neglected the importance of safety nets and social insurance. The third one was the Asian crisis in 1997/98 which revealed that financial liberalization without prudent regulation can have disastrous consequences (Rodrik 1999).

The *constituent principles* of a Social Market Economy elaborated by the German *ordo* liberal school and, in particular, by Walter Eucken (1990/1952) serve as a useful starting point for identifying key economic institutions which matter for market performance and the evolution of a private sector. *Ordo* liberals derive their prescriptions for public policymaking from the notion of *order* which is a fundamental precondition to make governance structures effective.

> Order means that repetitive events or actions fit into a discernible pattern which allows people to have confidence that the pattern of future actions, on which they may depend, can be predicted reasonably well. If the world is ordered, complexity, and hence the knowledge problem, is reduced and economic agents are better able to specialise. Institutions serve to facilitate the emergence of order.[4]

Adherents to the *ordo* liberal school favor order policy (i.e., supporting and enhancing the economic and social order of society) over process intervention. This maxim is essentially based on three axioms including that (1) cognitive abilities of individuals are limited so that an order, that allows recognizable patterns to be uncovered, will improve living standards through an enhanced division of labor and give citizens distinctive realms of freedom; (2) individual freedom is an unalterable prerequisite of competition; and (3) order is required to make binding commitments possible and to enforce formal rules in order to overcome problems of asymmetric information and the temptations of opportunistic behavior (Kasper and Streit 1998).

Public policymaking that is based on the commitment to consistently conduct order policy will not only ensure that individual freedoms are more secure but that

[4]. Kasper and Streit (1998: 151; emphasis omitted).

economic coordination is more effective and rent-seeking and discrimination are limited. Arbitrary ad hoc interventions and conscious discretionary policymaking (e.g., to smooth cyclical economic swings with respect to aggregate demand), it is argued, will attenuate market signals, create economic disturbances and destabilize private actors' expectations (Eucken 1990/1952). Government interventions into economic processes should be only undertaken if they are market compatible, i.e. if they "do not interfere with the price mechanism and with the automatism of the market derived from it" (Röpke 1950: 160).

The primary focus of *ordo* liberals is on competition, because competitive structures display basic control and knowledge-generating functions that serve to efficiently operate a complex market system. This implies that all policy measures ought to be market conforming. By the same token, redistribution policies should be rejected unless they aimed at ensuring the opportunity of equality for individuals and firms in a way which would not erode competitive signals. Thus, universal institutional arrangements which equally apply to all economic actors are more desirable than discriminatory interventions and specific directives (Kasper and Streit 1998).

The constituent principles of order policy that promise to enhance and maintain competitive markets include a flexible system of market prices, monetary stability, private property rights, open markets (i.e., freedom of both entry as well as exit), the liability of all economic actors for their actions and commitments, freedom of contract, and the steadiness of economic policymaking (see Figure 1). Since the proper functioning of a competitive order is based on the decentralized *ex post* coordination of individual plans and actions through market transactions, establishing a system of flexible market prices will be the focal point of creating and maintaining a market economy. Only a price system that reflects the scarcities of goods, services, and the factors of production can efficiently fulfill the functions of a competitive system. This is why Eucken postulates a primacy of monetary stability. But basically all constituent principles are interdependent. Therefore, ordo liberals argue that they need to be realized simultaneously in order to effectively promote private sector development and to establish a functioning market economy. In addition, these principles need to be complemented by so-called *regulating principles*, because actual market-oriented economies may contain weaknesses and deficits which require correction. Eucken thus emphasizes the need for anti-trust policies in order to prevent the emergence of monopolistic power, the need to correct income distribution (e.g., though a progressive income tax) in order to enhance social justice, the need for social safety nets and the protection of employees, and the need for institutions that help internalize external effects.[5]

3. A Social Market Economy for transition countries?

As regards its justification, the idea of the Social Market Economy rests on ethical norms such as solidarity and social protection in order to generate social peace and hence a secure societal foundation of sustained economic growth and development. Moreover, one may argue that social aspects in economic lifes and economic policymaking help to ensure the political feasibility of economic reforms in times of major policy and institutional reforms and particulary in times of systemic transformation in which (potential) losers from economic restucturing and institutional change may threaten to object or even block reforms. Finding a social balance or compensation for individual losses may help to enhance the acceptance of policymaking, the credibility and hence the legitimacy of policymakers.

Taking this as a point of departure, the following discussion seeks to develop arguments on how to introduce and secure the concept of the Social Market Economy in times of economic transition from a state-led towards a market based system. It will be argued that blueprints or best-practice approaches are not available, that the transition will be time-consuming, and that country-specific transitional institutions may become crucial determinants of success.

3.1 An argument in favor of a non-orthodox, gradual approach

However important the constituent and regulatory principles may be for the proper functioning of market economies, the *ordo* liberal school shows two basic weaknesses, especially if the concept of the Social Market Economy is to be applied

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[5]. See Eucken (1990/1952). Notice in this connection that our references to *ordo* liberal ideas are restricted to the policy prescriptions concerning the economic order. Actually, the *ordo* liberal approach is much broader in that it not only emphasizes the interrelations of institutional frameworks of various product and factor markets but also the interdependence of all sub-orders of society comprising the economic, the political and the social order. This implies that economic, social, legal, and other policies need to be compatible so that the institutions of different sub-orders mutually support each other; see, e.g., Böhm (1950) and Leipold (1994).

in the context of systemic transition. On the one hand, this school of thought has not answered the question of how to acquire those institutions which are required to fulfill these principles and how policymakers can credibly commit themselves to conduct order policy instead of relying on interventionist measures which may serve narrow interests. On the other hand, the *ordo* liberals have somewhat neglected the dynamic aspects of a growing developing or transition country, the economy of which may be subject to widespread market and coordination failures.

Regarding the second qualifier, it is to be noted that markets not only fail due to anti-competitive behavior but also due to relatively high transaction costs preventing privately induced technological change and due to adverse selection and moral hazard resulting from incomplete information. More modern economic theories including those of imperfect competition and principle-agents relations have recognized these failures and developed regulatory instruments to cope with them. In reality, all successful market economies rely on a set of regulatory organizations and institutions which oversee product and factor markets. With respect to less developed countries (LDCs) and also previously socialists countries (PSCs), where market failures are more pervasive than in industrialized countries, it is essential to understand that regulation may go beyond issues such as securities regulation, financial supervision, and anti-trust. Rodrik (1995 and 1999), Hellmann et al. (1997), and Lau (1997), among others, convincingly argue that especially coordination failures and imperfect capital markets require strategic government interventions in order to trigger socially desirable private investment. By referring to the experiences in East Asia and notably in Taiwan and South Korea in the 1960s and 1970s, they show that governments effectively coordinated private investment decisions, provided targeted subsidization and thus helped initiate a process of sustained growth. However, while institutional arrangements such as financial restraint, staggered entry procedures regulating market access, and the provision of contingent rents worked well in these countries, similar arrangements failed in others.[6] This fact does not call into question the usefulness of specific policy interventions *per se*, but indicates the need to better understand the institutional, economic, and political factors which determine the effectiveness of government interventions in a given country setting.[7]

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[6]. With respect to the use of the mentioned policy instruments and institutions and the role of governments in East Asia in overcoming coordination failures, see Section VI.2 in Ahrens (2002a).

[7]. To foster this understanding, case studies are required which help explain the success and failure of various types of government intervention. With respect to selective government policies in East Asia, see, e.g., Ahrens (2002a).

Moreover, with respect to industrial policy and more specifically technology policy, which may be of particular importance for catching-up economies, analysts argued that less developed or transition countries do not simply select and costlessly apply technological innovations which had been introduced in more advanced industrial countries and which are regarded as appropriate for domestic use. Certainly, relatively backward economies can, as Gershenkron (1962) observed, take advantage of the technological knowledge of advanced countries. But they can only do so if they have acquired sufficient technological capabilities and institutional capacities to identify suitable technologies and to adapt, absorb, and improve the technologies imported from abroad. Since such a competence has numerous externalities, government activism in facilitating and encouraging the process of technological change is critical. Moreover, circumstantial sensitivity and tacitness in applying technologies make it extremely difficult, if not impossible, for PSCs and LDCs to rely on a best-practice approach or to formulate a blueprint for national technological policies and their implementation. To a large extent, technological progress and economic performance depend on the organizational and institutional environment in which the industrial sector operates. Besides the macroeconomic policy framework, a country's technological infrastructure is of critical importance, i.e. its education system, private and public research organizations, the network of technological and scientific associations, and its legal institutions such as intellectual property rights as well as contract laws which provide incentives to develop and exchange technologies. The technological infrastructure backs up technological efforts of private firms by providing standards, information, scientific knowledge, and facilities which cannot be established and operated by individual firms.[8] Following this line of reasoning, unconventional though modern approaches identify a strong need for public policies including selective interventions to facilitate, encourage, protect, and induce technological activities in LDCs as well as in transition economies (Lall 1992 and 1997; Pack and Westphal 1986; Ahrens 2002b).

These observations suggest that socially beneficial economic institutions may vary across countries and even over time within a given country. The last point becomes clear if one looks, e.g., at South Korea in the 1990s when close institutional relationships between the *chaebols* and the government, which had a positive overall

[8]. See Ergas (1987), Lall (1992), and Evenson and Westphal (1995).

impact on the economy at earlier stages of development, increasingly became dysfunctional.[9]

Most of the institutional ingredients to a functioning market economy proposed by the German ordo liberals have not been rejected by modern economists but essentially taken for granted. As argued earlier, however, these institutions do not evolve automatically. This fact calls attention to the first qualifier mentioned above: how can these institutions be acquired? This question, in fact, needs to be addressed from two perspectives. First of all, it relates to the political institutions of a country's governance structure and how these deal with problems of implementing and enforcing new economic institutions. In most cases, the politico-institutional component of a country's governance structure has been a major determinant for the success or failure of policy or institutional reform. The more the political and administrative institutions are suitable to realize the fundamental principles that constitute effective governance, the easier is the acquisition, implementation, and enforcement of market-enhancing economic institutions. Secondly, the above question relates to the problem of strategy choice. What is the most conducive way to establish a distinct set of formal economic institutions? This question, in turn, is similar to the discussion about big-bang approaches versus gradualism in overall policy reform. Basically, two strategies to institution building can be distinguished; the first favoring the adoption of an institutional blueprint from advanced industrial economies, the second emphasizing the need to develop economic institutions locally by using indigenous experiences, experimentation, and local knowledge. While the first strategy suggests advantage be taken of the experiences of successful economies through importing their entire formal institutional framework at one stroke, the second strategy is by nature more gradual and hence time consuming.

At first glance, the big-bang approach to institution building is distinguished by its procedural clarity, conceptual simplicity, and straight-forwardness. It represents an attractive option to policy designers because it seems to offer a useful 'how-to manual' that can be as easily articulated as the policy prescriptions inherent in the *Washington Consensus*. This approach appears to be particularly feasible if the development objectives of a given country are clear-cut and sufficiently realistic to be achieved within a certain period of time. This was, e.g., the case with respect to the former German Democratic Republic (GDR) that, in the course of unification with the

[9]. With respect to the South Korean case, see the more detailed discussion in Ahrens (2002a).

Federal Republic of Germany (FRG), ‘simply’ adopted the whole institutional framework of the latter.[10] Also, the substantial progress in transition in Poland compared to other less successful PSCs may be (at least partly) attributed to the fact that both the Polish post-socialist governments and broad segments of society have had clearly defined objectives of transition, i.e., that Poland should become a full member of the European Union (EU) as fast as possible. However, most LDCs and PSCs cannot rely on ‘big brothers’ such as the FRG or the EU. In addition, development objectives are usually not so clear-cut and well defined. Even if a developing country seeks to emulate the development trajectory of more advanced countries and seeks to copy their institutional frameworks, the question arises which country ought to be the role model. The institutional matrices of modern capitalist economies are far from being the same. This becomes obvious if one compares the economic as well as the social and political orders of the United States, the EU, and Japan, or the institutional settings within the EU, e.g., those of Sweden and the United Kingdom. All of these countries display a great variety of stabilizing, legitimizing, and regulatory institutions that guide economic exchange. This implies, as Rodrik (1999) correctly emphasizes, that the institutional foundation of a successful market economy cannot be uniquely determined. Hence, the existence of, and the need for, institutional diversity has to be accepted as well as the fact that even the most advanced economies are constantly under pressure to search for new institutional arrangements that are suitable to better overcome existing problems (i.e., at lower costs or with higher social benefits) and to meet practical challenges in the future (Unger 1998).

Furthermore, the great variety of successful market economies indicates that the economic institutions of capitalism do not represent a ‘general purpose technology’ that promises to sustainably increase total factor productivity and to significantly shift the frontier of production possibilities outwards in any given country just by acquiring it off-the-shelf. The caveat against adopting institutions that have proved to be socially beneficial in other countries, especially if these are at a different stage of development, has been persuasively stressed by Rodrik (2007). Adherents to a more gradual approach to institution building emphasize that the efficacy of the economic institutions of a market economy is contingent on particular local problems,

[10]. Regarding the economic, institutional, and political transformation of the former GDR, see, e.g., Sinn and Sinn (1993), Willgerodt (1994), Brücker (1995), and Mummert and Wohlgemuth (1998).

capacities, preferences, and needs.[11] Similar to technology policy, tacitness and circumstantial sensitivity in implementing and operating economic institutions such as social security programs, social partnerships, rules guiding the representation of minorities, currency boards, or labor market regulations make it difficult to rely on best-practice approaches. Imported institutions may fail to meet the specificity requirements of local needs, and institutional blueprints are usually incomplete because the knowledge that is necessary to use these institutions properly can often not be delivered but has to be acquired through local learning and experimenting.

Although these are convincing points made by the adherents to gradualism, this mode of institution building is not without dangers either. A first caveat reminds us again of the importance of a secure political foundation underlying policy reform, namely that gradualism may come in different forms and shapes. For example, the gradual approach to economic transition in most successor states of the USSR is less a reflection of self-conscious and rule-based experimentation with the desire to build more efficient institutions, but an outcome of political instability, pork-barrel politics, rent seeking, and efforts to block market-oriented reforms. In contrast, the gradual approach to institution and capacity building in East Asian countries such as Taiwan, South Korea, as well as China and Vietnam during their recent history followed a more pragmatic approach that sought to enhance local knowledge and meet local needs.[12] A second caveat against gradualism stresses the costs of reinventing the wheel again and again. As Rodrik (1999) argues, gradualism may waste resources and time if policymakers do not take advantage of institutional arbitrage. In some particular (mostly technical or legal) areas, institutional arrangements can be adopted from more advanced countries. This holds, e.g., for the institutions underlying the operation of central banks, anti-trust agencies as well as financial regulations or auditing and accounting standards.

Considering the preceding arguments, one may conclude that the successful acquisition of economic institutions which help establish an appropriate governance structure for a Social Market Economy depends, on the one hand, on a secure political foundation of policy reform that ensures credible commitments and the capacity to implement new institutions and, on the other hand, on the strategy of

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11. See, e.g., Qian (1999) as well as Lau, Qian, and Roland (2000) who argue that the institutional peculiarities of the development process in China are solutions to local informational and political problems for the solution of which no blueprint exists.
12. See Sections VI.2 and VI.3.1 in Ahrens (2002) for further elaboration on this point.

institution building. Important lessons can be learned by LDCs and PSCs from the experiences of more advanced economies. But a simple transplantation of institutions from one country to another is basically associated with severe problems. This makes gradualism the superior way of establishing and maintaining a local economic order, especially if policymakers are not dogmatic so that they use institutional arbitrage where it is appropriate.

3.2 The paradox of the adjusting state[13]

In neoclassical models, the state is exogenous to the economic reform process. It is considered a black box which (usually unsuccessfully) seeks to solve problems arising in market processes. This perspective, however, is largely inappropriate for dealing with the *paradox of the adjusting state* which aggravates the practical problems of economic reform and transformation particularly in transition countries. This paradox concerns the ambivalent role of governments during the transition from a state-led model of economic development toward an open, market-oriented economy. While the state (i.e. the central government, sub-national authorities, the legislature, and the bureaucracy) is required to withdraw from policy interventions into economic processes and to perform a more passive role, economic transition and development usually require nimble and robust political authorities to be in place, ones capable of implementing and enforcing the new market-oriented policy directives. Performing this role is even more complicated if the executive branch of government needs to assume further (market-enhancing) tasks due to existing market imperfections. Making the state more effective so that it can meet new challenges and perform new roles in facilitating private-sector coordination is of utmost importance for feasible and successful economic transformation and policy reform strategies.[14]

In order to conduct effective policy or institutional reforms, governments need to assume roles for which they have typically lacked the capacity and capability. Establishing the institutions which constitute a stable market-oriented economic order, introducing policy instruments to indirectly steer market processes and to

[13] The following discussion is taken from Ahrens (2007a and b).

[14] This central issue, however, was not explicitly included in either the Washington Consensus or neoclassical approaches to policy reform; see, e.g., Aoki et al. (1997) and Streeten (1996).

effectively provide public goods, crafting effective devices to enforce market laws and regulations and to collect tax revenues, building up a meritocratic independent economic bureaucracy, and generating a transparent system of information exchange between the public and the emerging private sector – all these tasks are to be assumed by state actors. The underlying institutions do not evolve automatically but need to be explicitly crafted and enforced by the government, whereas the government at the same time is required to reduce the scope of its activities, to overcome overstaffing, and to cope with budgetary bottlenecks.

The paradox of the adjusting state precisely reflects this lack of institutional, administrative, technical, and political capacities. Regardless of whether a government decides to follow the policy recommendations of the Washington Consensus or whether it opts for a more activist role to overcome coordination failures and other market imperfections (which occur frequently in a transition process), a complex politico-institutional structure needs to be put in place in order to make government more effective in accomplishing whatever tasks it undertakes. Such institutionalization, however, cannot be taken for granted.

Similarly, this argument also holds for economic transitions taking place within authoritarian settings such as in China, Vietnam, Kazakhstan or Uzbekistan. Even if the problem of simultaneity, which has been a constituent characteristic of systemic transformation in most countries in Central and Eastern Europe (CEE) and much of the Commonwealth of Independent States (CIS), has been largely absent in East Asian and some Central Asian transition settings, the existing non-democratic regimes can only make use of their presumably strong states and become effective ordering powers of economic restructuring if they succeed in adjusting and reforming their political, administrative, and economic institutions in a way that helps authorities to maintain legitimacy and credibility from the standpoint of ordinary people as well as domestic and foreign investors. Thus, even in these authoritarian countries, which may basically allow to effectively conduct bold necessary, though possibly unpopular reforms without facing immediate political resistance, appropriate rules need to be introduced, organizations built up, and technocratic, administrative, and political skills accumulated which help to craft a secure and stable politico-institutional foundation of far-reaching market-oriented reforms.

3.3 Best-practice institutions?

Due to the complexity of systemic transition, policymakers as well as academics are frequently tempted to identify best-practice approaches from successful reformers. This was true at the beginning of the 1990s when the so-called Washington Consensus (originally compiled for debt-ridden countries in Latin America in the 1980s) was sought to be applied to many economies in transition. Several years later, new insights emerged due to the experiences in early transition phases. In fact, the Washington-Consensus type of policies emphasized important policy measures in an era of transition (such as stabilization and liberalization), but they neglected institution building (except for crafting private property rights). Particularly, the failure of IMF-led transition programs in countries such as Russia revealed that liberalization-cum-privatization approaches did not automatically bring about efficient and sustainable market structures. Without consideration of political and societal conditions as well as institutional restrictions, an efficient and politically feasible transition policy could not be implemented.[15]

This was taken into account during the subsequent debate about so-called second-generation reforms, when institutions were considered essential also from the viewpoint of analysts with a more neoclassical background. The next step was to identify best-practice institutions in order to make policy reform effective, market forces work, and eventually overcome government failure. An emerging consensus among scholars of economic development and transition as well as international organizations suggests that a distinct set of core institutions can be identified which spur economic growth and sustained development.[16] According to this view, key institutions, which should be crafted as quickly as possible, include, among others, the rule of law, private property rights, an independent judiciary enforcing private contracts impartially, thorough regulation to safeguard economic competition, sound corporate governance structures and a transparent financial architecture, undistorted

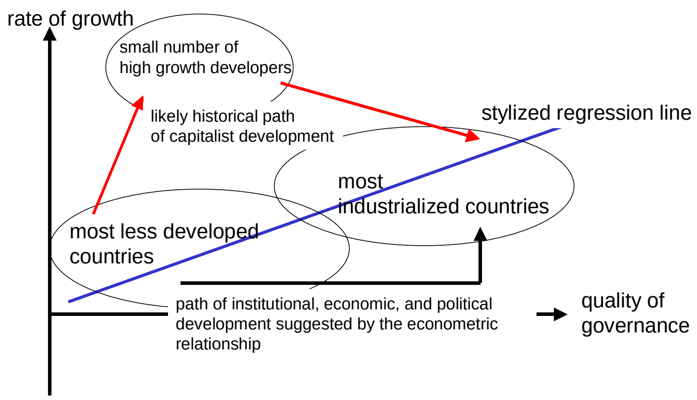
[15] Of course, some scholars had already taken those difficulties in policy formulation and implementation into consideration in early stages of transition. Some scholars questioned the Washington Consensus approach per se, whereas others postulated an explicit evolutionary-institutional transition concept which focused on microeconomic aspects such as asymmetric information and agency problems among others; see, e.g., Roland (2000) or Murrell (1995). This strand of analysis and policy advice, however, did not gain significant influence in the policymaking circles of CEE.

[16] Note in this context, that policy advisors as well as the international donor community may be also adaptive to new experiences and insights. The World Bank (2000), e.g., explicitly concedes that so-called best-practice models regarding governance and institution building may not be feasible.

markets characterized by low rents, social insurance, democratic accountability and participation rules, checks and balances, and strengthening civil society (Khan 2002, Bardhan 2005).

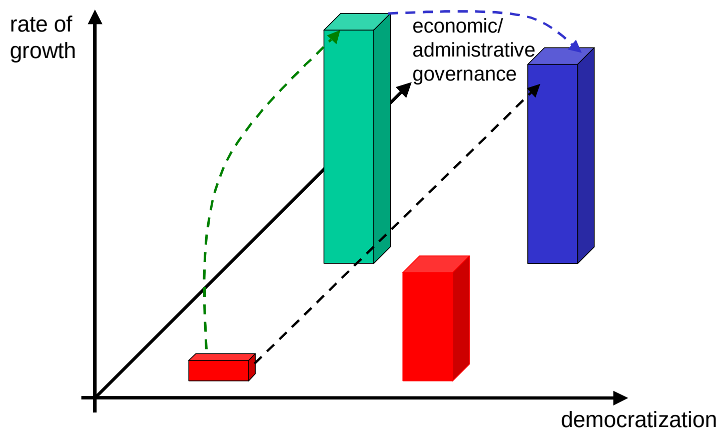
Basically, these Western-style best-practice institutions may represent a useful reference point for less developed countries and transition economies. However, experts advising governments on institution building have often neglected the *processes* of how these institutions are crafted and enforced. Frequently, a country's initial conditions are ignored and policy advice is driven by the presumed desirable goal of transition (i.e., Western-style best-practice institutions), and not by the search for a politically feasible path towards that goal (Qian 2003). In particular, it is hardly discussed that institution building needs to be driven by political actors in numerous cases and, hence, that is must be in the interest of these actors to craft those institutions.

Figure 2: Orthodox thinking about the relation between governance and growth



Source: Khan (2002); modified

Figure 3: Non-orthodox thinking about the relation between governance and growth



Source: author

The "liberal-market consensus" (Khan 2002) appears to suggest a benchmark for institution building which is to be achieved in a straightforward linear trajectory of institutional reform as quickly as possible (see Figure 2). However, the small number of highly-performing economies especially in Asia (but also in other parts of the world) followed a different path of development (and so did today's industrialized countries at the early stages of their economic development and growth processes). They realized extraordinarily high levels of growth and sustained them over a considerable period of time without fulfilling the criteria of Western-style institution building.[17]

Therefore, yet another consensus began to emerge even more recently which goes beyond institutions. Since it is not single rules but the interplay of economic and political institutions being crucial for economic performance, scholars and practitioners came to agree that governance matters. And again, we observe a new quest – this time for best-practice governance structures. Against the background of the liberal-market consensus, which still dominates numerous policy circles, think tanks, and academia, a governance structure, which is argued to be a precondition to structural change and sustained economic growth, ought to be modelled according to a Western-style governance model. This view is frequently supported by the fact that

[17] See, e.g., Khan (2002) and Chang (2002).

numerous people see a liberal democracy with particular social, economic, and environmental standards of advanced economies not only as an instrument fostering economic development, but as an end in itself.[18]

However, as history tells us, best-practice governance structures cannot be reasonably defined due to different initial conditions faced by transition countries, different economic structures and stages of economic development, different political interests and different societal preferences (Ahrens 2002a and 2007b). Instead, in the countries of Central and Eastern Europe as well as in China and Vietnam distinct governance structures have been emerging. In these successfully transforming countries, the emerging governance structures have proved to be market-enhancing and, hence, served as catalysts to economic transition. In all of these cases, country-specific *market-enhancing governance structures* (MEGS) contributed to positively affect the respective government's credibility and improved the attraction of these countries as an investment and production location despite significantly different initial conditions and economic transformation strategies. Although these cases differed from one another, they fit into the analytical comparative concept of a MEGS (Ahrens 2002a). Even if none of the countries was able to bring about a perfect MEGS, governance-related institutions in all countries scored *comparatively* high according to the dimensions credibility, predictability, and transparency – 'comparatively' relating to a comparison with other countries at a similar stage of economic development or in a similar phase of transition. Also, the relatively good performance in terms of institutional quality has not necessarily related to all pillars of a MEGS equally. But in sum, the emerging governance structures have been conceived to be growth-enhancing and sustainable over time from the viewpoint of foreign and domestic investors, and the respective governments proved to be able to credibly commit to honor investors' rights and to foster long-term growth.

What is remarkable about these positive developments in LDCs and PSCs is that especially the Asian economies in transition crafted effective institutions of economic and administrative governance which improved the quality of public policymaking, enhanced private sector development and market exchange, but did not undermine the power of incumbent governments. Contrary to most European transition countries, democratization played a minor if any role in this process – similar to the

[18] See, e.g., the arguments in Khan (2002), Feng (2003), and Kaufman et al. (2003).

process of long-term development in countries such as South Korea, Taiwan, Singapore, or Malaysia between the early 1960s and today.

On the contrary, in the transition countries which acceeded the European Union in 2004 and 2007, the processes of strengthening governance and fostering democratizaion coincided. This can be attributed *inter alia* to historical factors, cultural values, but also to the fact that the EU as an external anchor to transition forced these transition economies to adopt the so-called *acquis communautaire* before they joined the Union. Thus, while this group of countries pursued a linear path of reform and transition as portrayed in Figure 2, the Asian countries (as well as today's advanced countries such as Germany or Chile) chose a 'roundabout way' in order to realize high economic growth rates as well as social achievements such as lower poverty rates. Without engaging immediately in democratization steps, they built strong governments which could rely on effective administrative and economic governance structures. For these countries, this development trajectory proved to be sustainable. And as the example of Germany in the late 19th century or the cases of Chile (since the mid 1970s), Germany (after World War II), South Korea and Taiwan (since the early 1960s) indicate, such a development path can (or will) eventually lead to more democratic structures in the course of time.

Whether or not a country is better suited to follow the linear trajectory or the 'roundabout way' as depicted in Figure 3, depends on that country's economic starting position, its historical legacy, its internal power structure and the incentives faced by its leadership. For most of today's transition countries under authoritarian rule including most Central Asian countries, but also China and Vietnam the linear development path is simply not feasible under its current leadership.

3.4 Introducing a Social Market Economy in a non-democratic setting: the case of transitional institutions

In order to make the economic transition succeed, market-enhancing governance structures (MEGS) need to be developed. Today, a common understanding holds that no blueprint exists regarding the design, the evolution, or the components of a MEGS, but that effective governance structures need to be adjusted to country-specific characteristics (Rodrik 2007). However, numerous studies indicate that some general guiding principles do exist: Besides the need for a strong but limited state and market-oriented capacity building in the public administration, key economic institutions should be crafted and enforced which ensure a proper functioning of market processes and private sector coordination.[19]

According to Rodrik (2007), these key economic institutions relate to rules for macroeconomic stabilization and structural adjustment, rules of the legal, regulatory, educational, financial, and social infrastructure as well as institutions for conflict management. Although these areas point into the same direction as Eucken's *constituent principles*, they remain even more general and leave room for interpretation. In Rodrik's (2007: 6) words:

> "first-order economic principles (…) do not map into unique policy packages. Reformers have substantial room for creatively packaging these principles into institutional designs that are sensitive to local opportunities and constraints."

In particular, the high-performing countries in East Asia have convincingly demonstrated that pragmatic (not first-best) institutions can foster sustained economic growth in a non-democratic setting. Exemples include the East Asian tigers, South Korea, Taiwan, Singapore, Malaysia, and Indonisia, and more recently Vietnam and China. These cases indicate that unorthodox *transitional institutions* may turn out to be more effective than presumably best-practice institutional arrangements in a period of economic transition. Especially for an authoritarian regime, they could make market-oriented reforms a viable policy choice, because they help political authorities to maintain power and control and, in addition, open up ways to make political elites winners of reform. Finally, specific transitional institutions tailored to the needs, capacities, and capabilities in the respective countries could be much faster developed than best-practice institutions – the latter usually need a long period of time to be crafted and enforced, and in many underdeveloped autocratic transition economies (e.g., in Uzbekistan, Tadschikistan or Turkmenistan), there would be a lack of human capital to operate them (e.g., law drafting and enforcement). Evidence shows that transitional institutions can serve as functional equivalents to first-best institutions, e.g., with respect to creating incentives for doing business, to introduce competition, or to establish control rights over the means of production (Qian 2003).

[19] For an overview of these studies as well as an in-depth introduction into the concept of MEGS, see Ahrens (2002).

For example, special economic zones (SEZs) may represent a transitional institution regarding a gradual external opening-up strategy in the sense that a free-trade area or a customs union with third countries would be more efficient from a theoretical viewpoint, but at a given point in time it may not be feasible. Therefore, SEZs could serve as a second-best way to open up the economy and, in addition, signal a government's commitment to market-oriented reform. This would be reinforced, e.g., through public infrastructure investment, low tax rates, and liberal institutions and market rules governing the SEZs (Khan 2002).

With respect to internal economic reforms, transitional institutions may, incrementally but visibly, enhance a government's credibility. The starting point would be to create a strong state, i.e. to enable authorities to credibly pre-commit to market-oriented reforms and to enforce new rules of the game. A key challenge is to shield policymaking entities such as the economic bureaucracy and key government agencies from the influence of reform opponents. Thus, public administration reform and capacity building are essential to strengthen the state apparatus. This requires (i) strengthening economic policy formulation, coordination, and implementation, e.g., through a central economic planning board – possibly staffed with foreign experts; (ii) public financial management reform; and (iii) civil service reform. In addition, meritocratic recruitment and promotion standards could provide bureaucrats with long-term career rewards thereby reducing incentives for corrupt behavior.

In advanced democratic market economies, state strength is usually limited and political credibility enhanced through a subtle system of checks and balances. This option, however, is not available in autocratic transition countries. In such a case, one (far from perfect but) feasible option is to limit the government through an external flanking of the respective country's reform and international integration process. Gradually opening up the economy and increasing its exposure to foreign competition as well as membership in international organizations might help to incrementally and credibly enhance reform commitment. In the longer run, the authoritarian, though possibly reform-minded government can seek to bind its own hands at least regarding specific policy realms (e.g., through establishing an independent central bank).

Since measures such as performance-based employment policies, downsizing surplus staff, and organizational restructuring are central to improving the implementation capacities of weak executing agencies, it is necessary to complement sector-level capacity building with measures that concern the public administration in its entirety.[20] Such an approach to public administration reform would not threaten the political regime per se. To be effective, however, institutional and organizational reforms usually have to be complemented by human resource development, the more so as knowledge of market economics and modern management techniques is often absent in LDCs and PSCs.

Regarding economic reforms, macroeconomic stability is an unalterable precondition. This presupposes a market-oriented price system and a (possibly) independent central bank as well as prudent fiscal management and at least a rudimentary market-oriented tax system. However, in some country-specific contexts, a complete price liberalization would contradict the interests of the political leadership. The same may hold for large-scale privatization. In such cases, it may be more promising to legalize and foster already existing small-scale private transactions, e.g. on farmers markets, in the retail sector as well as in industry and in an emerging service sector. Promoting newly emerging small and medium sized enterprises and gradually creating a labor-intensive private sector in a bottom-up manner could reinforce a partial price liberalization, support supply-side reactions of the economy, and foster job creation.

Chinese reform experiences show that agricultural reform by abolishing agricultural collectives and establishing a household responsibility system can yield substantial and quick productivity gains. This might increase confidence in market forces and strengthen the support of further reforms at later stages (Lee 1997). Regarding industrial restucturing, China adopted a dual-track approach which allowed to maintain parts of the planned economy for a transition period, until a possibly emerging private sector will have gained sufficient economic strength so that it can absorb surplus labor from heavy industry (Qian 2003). This approach helped to enhance economic efficiency of state-owned enterprises (SOEs), to minimize opposition to economic reforms *ex ante* (due to temporarily protected status-quo rents) and to increase the opposition to reform reversal *ex post* (due to an increasing number of people benefiting from reforms) (Lau et al. 2000). In other countries, such an approach could make industrial reforms compatible with a prevailing, potentially market-skeptical political ideology. Furthermore, it would be consistent with a gradual strategy of opening up vis-à-vis the rest of the world.

[20] See Ahrens (2002a) for further elaboration regarding the following aspects.

Last but not least, as long as no dominant capitalist sector exists in the economy, growth-enhancing reforms need to be in the interest of regime officials at the central and local level. Only if these actors can preserve their power and privileges and become reform winners, economic transition will be politically feasible. Again China offers an example of how to deal with such a challenge: Decentralized public commercialization through the devolution of economic competencies and the creation of township-and-village enterprises (TVEs) with hard budget constraints could help to re-align incentives of local policymakers and bureaucrats and make them residual claimants of market processes. Moreover, the experience of TVEs suggest that control rights may be established and can foster entrepreneurial activities even if property rights are not clearly defined (Qian and Weingast 1997). Thus formal legislation is neither a necessary nor a sufficient condition for ensuring effective control. In practice, Rodrik (1999) concludes, the efficacy of control rights is contingent not only on legislation but also on private enforcement as well as informal norms such as customs and tradition. In order to avoid a capture of local governments by possibly emerging local groups owning immobile factors of production such as land, the introduction of a household responsibility system should be complemented by a possibly egalitarian distribution of land rights at the beginning of an economic reform process.

Thus, through an economic empowerment of local governments (and possibly parts of the military or other powerholders in a particular country), developing local public enterprises can be crucial for an economic take-off process even before large-scale privatization is undertaken. In addition, it would be conceivable to create competition under a dual-track approach; e.g., by fostering the emergence of private businesses in sectors such as agriculture, retail trade, and light manufacturing, and strengthening the corporate-control structures of, and introducing hard budget constraints for, TVEs and SOEs. At a later stage, industrial liberalization and privatization can proceed. Financial liberalization should be deliberately delayed in order to cope with potential fiscal decline during economic transition (Qian 1999).

4. Conclusion

At first glance, it may seem that the concept of the Social Market Economy is applicable only in differentiated, democratic, advanced capitalist countries. The preceding discussions, however, showed that the idea of the Social Market Economy can be, and in fact has been, applied in an incentive-compatible way for policymakers, entrepreneurs, managers, workers, and citizens even in non-democratic countries at lower stages of economic development. This can work if the transition process is not conceived as a quest for first-best, best-practice, or ideal institutions, but as a discovery process of institutional evolution during which diverse sets of institutions may emerge, fulfill various economizing or redistributive functions, and eventually vanish, because other, novel institutional arrangements appear to be superior. This phenomenon of transitional institutions has been hardly studied in academia, but theoretical reasoning as well as the existing evidence suggest that transitional institutions serving as functional equivalents to so-called first-best institutions may turn out to be not only efficient, but also politically feasible and widely accepted in society. The quest for these transitional institutions is not easy and cannot succeed from a private study in the ivory tower of academia. Instead, it is subject to trial-and-error procedures, experimentation, competition, but also political pragmatism. The task of policy advisors and policymakers is to craft an institutional framework which is appropriate to enhance what North (1990) called the adaptive efficiency of an economic system.

Eucken's constituent and regulating principles provide guidance on the direction of institutional change and reform. But as was argued in this paper, the attributes, i.e., the concrete institutional design, of a Social Market Economy are contingent on the stage of socio-economic development, the cultural environment, political constraints, and what Eucken (1990/1952) called the *historical moment*. Singular events and favorable historical moments may serve as trigger or catalyst, but they cannot substitute for good institutions and determined political leadership. The existence of policymakers who seize those opportunities and seek to craft a politico-institutional foundation, which helps to make effective market-oriented reforms a viable policy choice, is an unalterable precondition to successful transition.

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