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Ordoliberalism and ***Ordnungspolitik*** A Brief Explanation

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INTRODUCTION

In the debate surrounding the Eurozone crisis, “Germany’s rule-based legal approach”¹ has become a target of criticism by many of its European partners. Searching for the reason or “ideology” behind this approach, a number of commentators have pointed to the lasting influence of *Ordoliberalism*, exemplified by titles such as “The Long Shadow of Ordoliberalism: Germany’s Approach to the Euro Crisis”² or “Of Rules and Order – Germany’s Ordoliberalism has had a big influence on policy during the Euro crisis.”³

The purpose of this paper is to offer a brief introduction into the tradition of *Ordoliberalism*, its roots in the so-called *Freiburg School*, and the rationale behind the concept of *Ordnungspolitik* that is at the core of this tradition.

THE FREIBURG SCHOOL⁴

The *Freiburg School* was founded in the early 1930s by the economist Walter Eucken (1891-1950) and the jurists Franz Böhm (1895-1977) and Hans Großmann-Doerth. They were colleagues in Freiburg University's Faculty of Law and Economics ("Fakultät für Rechts- und Staatswissenschaften") which provided a most conducive environment for integrating the legal and economic perspectives that are the trademark of the Freiburg School tradition, a tradition for which later the name *Ordoliberalism* was coined.

While the founders of the Freiburg School placed themselves firmly in the tradition of classical liberalism, they emphasised, in contrast to some varieties of liberalism, that a market order is not a ‘natural event’ but a legal-institutional order, an order that requires careful ‘cultivation’ for its maintenance and proper functioning. They distanced themselves from a *laissez-faire liberalism* that fails to appreciate the essential role that government has to play in defining and enforcing what they called the *economic constitution*, that is the legal-institutional framework within which markets operate. How markets function, they insisted, is to a significant extent a matter of *constitutional choice*, the choice of rules that define the constraints within which market participants can pursue their own purposes.

After the Second World War, the Freiburg School assumed a decisive role in the creation of the *Social Market Economy* in post-war Germany. Ludwig Erhard who, as West Germany’s first economics minister and later chancellor, orchestrated the post-war economic and monetary reforms that lead to the so-called “German economic miracle” was very much influenced by the Freiburg tradition and relied on its advocates as advisors.

Eucken and Böhm emphasised that their interest was not in developing a research program as a purely academic enterprise, but in helping to solve the practical question of how a desirable economic order may be created and maintained. The joint efforts of law and economics were to them an indispensable prerequisite for what they called “*constitutional economic policy*” (“*Wirtschaftsverfassungspolitik*”), a

¹ Volker Berghahn and Brigitte Young 2013, 11.

² Sebastian Dullien and Ulrike Guérot 2012, 1.

³ *The Economist*, May 9th 2015, pp. 21-22.

⁴ For a more detailed discussion of the Freiburg School tradition see Viktor Vanberg 1998.

policy that seeks to improve the economic order in an *indirect* manner, by shaping the *rules of the game*. They contrasted such *Wirtschaftsverfassungspolitik* or *Ordnungspolitik* with an economic policy that aims at improving outcomes *directly* by intervening into the *playing of the game*, that is by specific interventions into the economic process. The general aim that, in their view, *Ordnungspolitik* ought to pursue is to create and enforce a framework of rules that guides the market participants' self-interested efforts into socially beneficial directions. In other terms, they considered it the task of *Wirtschaftsverfassungspolitik* or *Ordnungspolitik* to create conditions under which the "invisible hand" that Adam Smith had described can be expected to do its beneficial work.

The desirable working properties that the classical liberals attributed to market competition, so the Freiburg ordoliberals emphasized, cannot be expected from a competitive process per se. It requires the creation and maintenance of rules of the game that assure what they called "*Leistungswettbewerb*", that is a competition in which success can only be had through better service to consumers. And to create conditions conducive to such *Leistungswettbewerb* is, in their view, a genuine and indispensable political task, i.e. the task of *Ordnungspolitik*.

A major focus of the Freiburg ordoliberals was on a problem that they described as "*refeudalisation*", a problem that in contemporary economics is discussed under the label "*rent-seeking*". For them *the* constitutive requirement for a beneficially working competitive market order was that it must be a *privilege-free* order, an order in which all persons enjoy the same legal status. As the essential liberal principle they regarded that "the state should on no account be allowed to confer privileges," to grant preferential treatment to particular persons or groups from which others are excluded.⁵ In no lesser clarity than modern public-choice contributions on the problem of rent-seeking, the Freiburg ordoliberals described the fatal political dynamics that inevitably unfolds where governments and legislators are empowered to grant privileges and where, in consequence, interest groups seek to obtain such privileges. Such a government, so Böhm phrased it, is "constantly faced with a considerable temptation to meet the contradictory demands of many pressure groups" that seek preferential treatment "at the expense of other participants or groups of participants".⁶

In assigning to the state the task of acting as "Hüter der Wettbewerbsordnung," i.e. as "guardian of the competitive order", the Freiburg ordoliberals did not naively expect an unqualified 'state' to serve the common interest. A phrase that the founders of the Freiburg tradition used, and that is a continuing source of controversy, is that a 'strong state' is needed to fend off interest-group pressures. This was clearly not meant, as critics have charged, as an argument in favour of an authoritarian state with extensive powers. To the contrary, the formula 'strong state' was meant by them as a shorthand for a state that is constrained by a political constitution that prevents government from becoming the target of special-interest rent-seeking. They regarded the constraints on government that they pleaded for as an instrument that weakens the influence of special interests and works to make ordinary politics more responsive to citizens' common interests.

⁵ Franz Böhm 1989, 57.

⁶ *Ibid.*, 64.

While the ordoliberalists stressed the need for provisions that prevent governments and legislators from granting privileges to special interests, they did not discuss in detail the constitutional safeguards that ought to be installed in order to effectively prevent the perverse dynamics of privilege seeking and privilege granting. The principal remedy they saw, though, in strictly limiting government's discretionary power, its authority to intervene with special measures into the economic process. Government's ambition to shape or structure the economy should be confined to *Ordnungspolitik*, to government by *general rules* rather than discretion.

THE REASON OF RULES IN INDIVIDUAL CONDUCT AND IN SOCIAL INTERACTION⁷

The ordoliberal postulate that politics should be constrained by rules as opposed to be given discretionary authority to do what is deemed to be expedient under the given circumstances is surely not self-evident. It naturally invites the question why one may want to be bound by rules rather than being allowed to do in every choice situation what, all things considered, promises to produce the best consequences. Before looking specifically at the *reason of rules in politics* it is useful to consider first the reason of rules in personal conduct and in social interaction.

The ultimate reason for rule-following behaviour lies in the fact that, even if in an ever-changing world every choice situation we face is in a sense unique, there are kinds or types of problems we confront repeatedly. For *recurrent* problems, experience can accumulate over time as to how one can deal with them successfully, notwithstanding the uniqueness of each particular instance. The most general argument for rules is, in this sense, that by following time-tested rules we may do better *overall* than if we tried to pick discretionarily in every instance what appears to us to be the best option, given the specific circumstances of each particular case.

A recurrent theme in F.A. Hayek's social and economic theory is that the incurable limits of our knowledge and powers of reason require us to rely on rules. The "reliance on rules", so he argues, "is a device we have learned to use because our reason is insufficient to master the full detail of complex reality".⁸ Rules are typically "if-then" instructions, telling us that *if* we encounter problem situations of type X, *then* actions of type Y are called for, such as the traffic-light rule that tells us to stop at red and go at green. Rules instruct us to focus on specified aspects of a choice situation, such as the colour of the traffic light, and to ignore other aspects. Rules are, in other words, "selective" in what they instruct us to pay attention to, and an obvious question is why it can be advantageous to disregard in one's choices circumstances one may know.

The answer to this question lies in the comparison between the *selectivity of rules* and the unavoidable selectivity of the choices we make when we mean to consider *all things*. As Hayek argues, in face of the "inexhaustible complexity of everything" it is impossible for us actually to consider "all things" and correctly to anticipate all the

⁷ *The Reason of Rules* is the title of G. Brennan's and J.M. Buchanan's (1985) treatise on *constitutional political economy*, a modern research program with apparent affinities to the ordoliberal research tradition. On these affinities, see Viktor Vanberg 1988.

⁸ F.A. Hayek 1960, 66.

direct and indirect effects of our actions. In our discretionary choice, we will inevitably pay *selective* attention to particular aspects of the situations we confront and ignore others the significance of which we would recognize if we were in fact able to consider *all things*.

Neither discretionary choice nor rule following can be “perfect” in the sense of guaranteeing that in every single instance we do what would be best, all things considered. Under discretionary choice as well as under rule following we will, in this sense, make “mistakes”. The relevant comparison is in terms of the rate of mistakes, i.e. between the *overall pattern* of outcomes that is likely to result from discretionary choice as opposed to rule following. The argument for the latter is that time-tested rules are likely to provide in this regard better guidance than our discretionary choices because they incorporate experience that has been accumulated over numerous generations.

Closely connected with the “knowledge problem” is a further reason of rules, the “*incentive problem*”. As experience tells us, and psychological research confirms, in discretionary choice we may be tempted to give disproportionate weight to our *current needs* and to *short-term* effects of our actions at the expense of their long-term consequences. We are tempted, for instance, to postpone unpleasant but necessary tasks. The very rationale of many of the traditional rules of conduct is to remedy this deficiency in our motivational make-up. As Hayek has put it, they often “make us do what we should wish to do from a long-term point of view.”⁹

As much as we need to rely on rules in organizing our personal conduct, the reason of rules is even more obvious in our dealings with other persons. As Hayek observes, “where our conduct will directly affect not ourselves but others and where our primary concern ... is to adjust our actions to the actions and expectations of others”.¹⁰ Rule following is an essential pre-condition for predictability and effective coordination in social interaction. Without rules, we could not form reliable expectations about each other’s behaviour.

Of particular significance in this context is a reason of rules that has to do with how our own choices affect how other people perceive us, and what that means in turn for our prospects of achieving our goals. This reason, classified under the rubric “reputation problem”, is apparent when we consider, for instance, the question of whether one should always keep one’s promises or rather decide on each particular occasion, considering the specific circumstances of the case, whether one should do so or not. Obviously, discretionary case-by-case choice would allow one to capture opportunities to gain that a principled person will miss. Yet, it is surely also true that a person with a reputation for always keeping her promises will be a much more attractive partner in social dealings, compared to a discretionary opportunist. Being a more attractive partner for cooperative endeavours such a person will have opportunities for mutually beneficial dealings that the opportunist will be excluded from.

⁹ Hayek (1960: 66).

¹⁰ Ibid.

THE REASON OF RULES IN POLITICS

The previous section has looked at the reasons why we may benefit in our personal conduct and in our interactions with others from following rules. The same reasons of rules apply at the level of politics with no lesser force than in the private realm.

The issue of *industrial policy*, an issue that has since long marked a division between French political attitudes and German Ordnungspolitik, can serve to exemplify the *knowledge problem* in politics. If governments were perfect in identifying future winners, and in properly assessing the overall balance of desirable and undesirable consequences of granting privileges such as tax exemptions for, or direct subsidies to particular firms or industries, citizens might wish to grant their governments the authority to engage in such policies. Yet, if governments are not perfect predictors of future economic development and are susceptible to lobbying by special-interest groups, citizens have reasons to fear that such discretionary authority may be misused and mal-applied. In the face of such risks citizens' interests will be better served by denying government the authority for such discretionary interventions and limiting its authority to a rule-based policy, a policy that aims at providing a conducive legal framework for economic activity in general.

If government is given the authority to decide in a discretionary manner which industries to support, which firms to save from bankruptcy, or which banks to bail out, they face not only a knowledge problem but also the *incentive problems* that come from inviting rent-seeking by special-interest groups. Re-election-seeking politicians will be tempted to seek the support of the groups that are favoured by their discretionary interventions, especially if the costs to the rest of the citizenry are widely dispersed and not obvious to the economically untrained eye. Even if politicians are aware of the long-term damage that such interventions cause, the competition for votes may well induce them to act counter to such insights.

Again, considering such risks citizens will be well advised to prefer *rule-governed politics* over *discretionary intervention* even if, theoretically, there might be cases in which government interventions could do some good, *if* they were taken in full consideration of all relevant facts and unaffected by interest-group lobbying – a qualification that is unlikely to be fulfilled in real-world politics. – This is exactly the problem that, as noted before, the founders of the Freiburg School addressed with their formula of the “strong state,” meaning a state that is constrained by constitutional rules that do not allow it to give in to interest-group demands for privileged treatment.

No less important than the *knowledge* and the *incentive problem* is, in the political as much as in the private realm, the *reputation problem*. The *reputation effect* of rule following in politics has found particular attention in the context of fiscal and monetary politics. As F.E. Kydland and E.C. Prescott have argued in a famous article, entitled “Rules Rather than Discretion”, a discretionary policy which seeks to select “the decision which is best, given the current situation” is likely to fail to reach its objectives in a dynamic economic system in which the economic players will adjust their expectations. Because of how it affects the expectations of these players, so Kydland and Prescott reason, a policy of aggregate demand management, for instance, tends to result “in excessive levels of inflation” without lowering unemployment. The general policy conclusion they draw from their analysis is “that

policymakers should follow rules rather than have discretion ... (and) that economic theory should be used to evaluate alternative policy rules and the one with good characteristics should be selected.”¹¹ This corresponds exactly to the central message of the German Ordnungspolitik tradition.

It is worth noting that the American economist Henry Simons argued already in the 1930s for an approach to economic policy that comes close to the German conception of Ordnungspolitik. In his paper “Rules versus Authorities in Monetary Policy” Simons spoke about the “danger of substituting authorities for rules which especially deserves attention among students of money.” He explicitly argued: “An enterprise system cannot function effectively in the face of extreme uncertainty as to the action of monetary authorities ... We must avoid a situation where every business decision becomes largely a speculation on the future of monetary policy”¹². Without principles ruling over expediency, Simon concluded, “political control must degenerate into endless concessions to organized minorities, with gradual undermining of the ‘constitutional structure’ under which free-enterprise economy and representative government can function”.¹³

CONCLUSION

As noted at the beginning, “Germany’s rule-based legal approach” to the Eurozone crisis has been the target of critical comments, and Ordoliberalism has been blamed as its “ideological basis”. Critics refer to the ordoliberal tradition as “Germany’s iron cage”,¹⁴ and ask in its above mentioned article *The Economist* posed the question “Why are Germans ... obsessed with rules for their own sake.”¹⁵

The purpose in writing this short essay has been to show that the Freiburg School with its ordoliberal concept of Ordnungspolitik advocates rules *not for their own sake* but for important *reasons* and that there is a *rationale* for the alleged “iron cage”. It is worth quoting what Hayek said on this issue in his 1962 inaugural lecture at the University of Freiburg:

“This attitude is likely to be criticized as a dogmatic adherence to rigid principles. This, however, is a reproach which ought not to deter us ... because principles are the most important contributions we can make to the question of policy. ... Especially so far as economic policy is concerned, principles are practically all that we have to contribute”.¹⁶

¹¹ Kydland and Prescott 1977: 487. - Kydland and Prescott add an important argument when they state: “In a democratic society it is probably preferable that selected rules are simple and easily understood, so it is obvious when a policymaker deviates from the policy.”

¹² Simons, 1948 [1936]: 161.

¹³ Ibid.: 170.

¹⁴ Denord, Knaebel and Rimbart 2015.

¹⁵ So *The Economist* in the above (fn. 3) mentioned article.

¹⁶ Hayek, 2014 [1963]: 227.

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