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an der Randse Afrikaanse Universiteit

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New Economy and the Concept of „Soziale Marktwirtschaft“

Prof. Dr. Horst Hanusch

Ladies and Gentlemen,

in Germany, at the moment, we are confronted with an ongoing discussion about economic policy. This discussion is centered on two major and interrelated topics:

On the one hand – as in many other countries – we are preoccupied with the „New Economy”, a phenomenon which is characterized by the highly dynamic economic and technological evolution in the information and communication industries.

On the other hand, we have a reminiscent debate about an economic concept that was developed by two great economists after the Second World War – Ludwig Erhard and Alfred Müller-Armack. This concept, called „Soziale Marktwirtschaft“, or social market economy, profoundly influenced Germany’s economic and social development in the last fifty years. As you may know, it is a typical German concept, thought to be an alternative to the idea of a purely liberal and capitalistic free market economy. The latter still is, as it has always been, a dominant feature of the unprecedented Western industrialized country, the U.S.A.

In contrast to the US-type economy, Germany’s social market economy is typified by a strong and influential Government that intervenes in numerous economic and social affairs by legal or administrative regulations in order to commensurate with some desired political or social standards.

The focus of such regulatory interventions is mainly put on social and competition policy questions.

In this debate economists and politicians try to reflect in a basic and fundamental way on the future development of the “Soziale Marktwirtschaft”, a concept in former times well approved and commonly accepted in Germany. But, is it still an appropriate suit for a modern, high-speed dynamic economy? Or does the so-called „New Economy“ ask for a supplemental and different economic framework? Do we even have to turn the whole economic system up-side-down?

In my talk I will discuss this central economic problem from a German perspective.

Given the time restrictions of this workshop, I will focus mainly on the following fundamental issues:

Is there anything like a „New Economy“ at all? And if so, what are its characteristics?

Taking the „New Economy“ seriously, what consequences will arise with regard to the development of economic systems in general and concerning the economic policy in particular? In this context, is the concept of the „Soziale Marktwirtschaft“ (social market economy), as suggested by Erhard, still valid, and what would an alternative concept look like?

1. The buzz word „New Economy“ already seems to be a center piece of our daily life. Economists, journalists and politicians – even the highbrow of philosophy and cultural science are fascinated by this term. But what do we actually mean with the expression „New Economy“?

2. When we reduce the subject of the „New Economy“ to the fields characterized by the exchange of information, of knowledge and of creative ideas in the web, there is a simple concept in economic theorizing, especially known in public finance, which might tell us the story. There, it has been discussed for decades and has almost been forgotten in the context of the „New Economy“. It is the idea of „public goods“ which inhibits the functioning of a free market system. The main features of a public good are „non-rivalry“ and „non-exclusion“. „Non-rivalry“ means that

a public good can be consumed jointly. While „non-exclusion“ suggests that nobody can be hindered from consuming the good.

3. There are many examples for non-rivalry: Goods and services in sports, culture, education and science, but also and especially in areas where networks are prevailing, such as transportation, communication and information technologies. In addition, the rise of the information and knowledge society has given the concept of non-rivalry an unprecedented importance in economics. The exchange of information in the internet and the usage of software – to name it – are concerned just with that type of effects economists also call externalities. People use goods, but it is a challenge for entrepreneurs to make them pay for them.

4. From a management perspective, non-rival and quasi-public goods, respectively, induce high initial investment costs, which are sunk costs, and marginal costs that almost go to zero. Suppose the entrepreneur is able to generate revenues from each additional participant that joins the network by using a standard software. Then he can overcome the critical mass and create a „lock-in“ effect, that is consumers will stick to a standard product (or network) because externalities will prevent him from choosing an alternative standard. A lock-in can be regarded equally as a natural monopoly where the producer is able to use his market power to charge a higher price than in competitive markets. And, as we all know: monopolies lead to a dead weight loss, which means to a non-desirable result for society.

Therefore, in the context of quasi public goods we always have to consider whether an intervention by the government could be an alternative to a market supply.

5. This brings us to a first aspect in judging the concept of the „Soziale Marktwirtschaft“, namely *government regulation*. At Erhard's times, the state was the main provider of public goods. The educational and cultural systems, science as well as traffic and communication systems were in the public domain.

Private markets either did not exist at all or there were niche

markets at the most. But, in the meantime this has changed dramatically.

6. Nowadays, we are facing a completely different situation. To an unforeseen extent, private markets go also for the production of quasi-public goods. This is true for almost all industrialized nations in the world. On the one hand, privatization is the keyword, looking at once regulated industries. On the other hand, a flood of business founders can be detected, so-called start-ups, which undertake the venture to supply society with quasi public goods via internet.

This competitive element in a formerly explicit world of public economics definitely is a phenomenon that deserves to be called „NEW”.

7. New is also the enthusiasm, the imaginative power and creativity topped with a high risk-affinity of start-ups. The commercialization of quasi-public goods is a difficult challenge. As already said, on the one hand there are high initial costs that have to be raised. On the other hand, there is the risk that the costs of daily business cannot be covered. If there is a price, and if it is too high, consumers may abandon the market. Moreover, the ease of market entry, combined with the dynamics of the internet business prevailing, cause a fierce price competition. To survive in such a business, it is indispensable to show flexibility, the capability to react quickly, and it also requires strong financial resources. In the end, the weak will vanish and only the strong will survive and exploit their market power.

8. Yet, at the moment we haven't reached that state in the internet economy, although the tendency towards this scenario is apparent. The enthusiasm of venture capitalists providing the seed financing of start-ups is going down as competition goes up. The number of bankruptcies is growing, and, not surprisingly, financially solid „Old Economy“ companies are beginning to discover the „New Economy“. Perhaps, in the long run, the „Old Economy“-firms will overrun the bubble-companies of the „New

Economy“ and enter the „E-markets”, giving a new appearance to their business activities. And this scenario does not have to be the worst option to a modern economy.

9. Reflecting such aspects, one surely has to deal with phenomena like *dynamics*, *creativity* and *risk*. They already dominate the modern entrepreneurial spirit, and, as it seems, also have a large influence in today’s society and its expectations. Only policy, in Germany as well as in other European countries, seems to lag behind and is, more or less, sticking to an old-fashioned tool-box, also based on the concept of a social market economy. But, policy cannot refuse to follow such transmissions, which already show in business and in society. Modern economies have to be shaped differently than former economic systems. In particular, the relationship between markets and the government as well as between politics and economics have to be revised. Innovation, dynamics, and risk-affinity are specific entrepreneurial features, but they are no elements of governmental behavior. However, if society accepts such values, governments, and the political system as a whole, will necessarily also have to adapt their functions correspondingly. This implies that policy can no longer be intended to establish a relatively rigid economic and social framework, as proposed by the concept of „Soziale Marktwirtschaft”, where the social compensation for income and wealth inequalities is a major task. Instead, the public sector will have to take on a less dominant role in social and economic life. Maybe, it should play only the role of an unpretentious political moderator. This means, on the one hand that in those parts of the economy where there is too little dynamics, creativity, and risk willingness, it is up to the government to spur those factors by creating suitable incentive mechanisms. And in those fields, on the other hand, where the economic rules tend to be blown up in speculative bubbles, it has to prevent the economy from overheating.

Let me give you some concrete examples:

10. In a dynamic economy and society, it is the major target for economic policy to foster „growth“. Social policy finally, will also have to subordinate its actions to that target. In addition, innova-

tions and venture capital are the main prerequisites of growth. As you all know, innovations heavily depend on R&D in the private as well as in the public sector. And, as for R&D, it is highly determined by the so-called human capital of a society, meaning the knowledge and educational background its members have acquired. But, what does that mean for growth? It means that educational policy is an essential part of innovation policy which again is an indispensable element to achieve economic growth. So, in the end, growth and the process of change will decisively shape the development of dynamic societies.

11. As far as I know, relationships like these can hardly be discovered in the concept of a „Soziale Marktwirtschaft“ as proclaimed by Erhard or Müller-Armack, even if it has to be admitted, however, that both have put some emphasis on the importance of entrepreneurship for the development of an economy. But, frankly spoken, it is another German economist who formulated the right and important concepts to describe the functioning of dynamic change and growth, namely *Joseph Alois Schumpeter*. Let me mention here only his ideas about „dynamic competition“ on the basis of „innovative changes“ and the process of „creative destruction“.

12. Of course – and this is all too apparent – high dynamics in an economy will also have less desired outcomes, namely structural problems in employment and in the distribution of income and wealth. But these difficulties can be solved much easier in a growing and flexible economy, compared to a rigid one characterised by an extensive social system and much too broad interventions of the government. Wolfgang Stolper, also a German-born economist, once put the matter the following way:

„In an evolutionary economy the major function of social policy is to maintain incomes but not specific jobs.“

Actually, I do not want to add any further comments to that statement. Instead, I would like to make you aware of one aspect of a too fast development, now widely discussed in connection with the hyper-dynamics of the US economy. The high and astonishing

speed that has been driving productivity and growth in that country for more than a decade, has besides its very positive features, such as low inflation and unemployment, its negative ones as well. This is especially true for the financial markets: Its results seem to break free from the real economic sphere. They are, to a great deal, instead determined by future expectations, and thus, by speculations on the chances of the New Economy. Is it in a situation like this reasonable to rely solely on the restricted economic policy options of central banks and to cut back any other? Or isn't it a duty for the government to define necessary norms and standards in order to grant an acceptable level of security to all the participants of overheated financial markets? These relations between the monetary and the real sector of modern economies are also issues which the concept of „Soziale Marktwirtschaft“ cannot handle adequately as far as I know.

13. So let me come to an end and conclude with a very personal statement. I do not believe that without fundamental changes the concept of a „Soziale Marktwirtschaft“, as we know it - and as it has been applied in Germany after the Second World War - has either the theoretical or the political potentials to cope with the chances and with the problems of highly dynamic economies. But, allowing fundamental adaptations the initial characteristic features of that concept could not be identified any longer. So, why shouldn't we in that case switch to another approach in economic theory and policy which really is able to offer us an explanation of the transitional dynamics of economic systems and which can also be used to derive the policy actions we need to undertake. To my mind, only one approach is suitable to serve both demands, that of Joseph A. Schumpeter.