

# Rethinking The Social Market Economy – A Basic Outline<sup>1</sup>

**Willem Spanjers<sup>2</sup>**

Department of Economics, Kingston University London, United Kingdom and  
International Centre for Economic Analysis, Waterloo, Ontario, Canada

**and**

**Elettra Agliardi<sup>3</sup>**

Department of Economics, University of Bologna, Italy and  
International Centre for Economic Analysis, Waterloo, Ontario, Canada

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## **Abstract**

The purpose of this paper is to contribute to rethinking the Social Market Economy with respect to modern economic and technological structures. In doing so, we explore the limits of the traditional Social Market Economy for solving the economic problems of our time.

We find that the Social Market Economy's rigid focus on competitive markets as the corner stone for a decentralized economic order has become outdated and that the basic principle of competition should be extended to decentralized institutions and policies. It is proposed that the preferred choice of specific institutions and policies should reflect their legitimacy, i.e. a combination of their effectiveness and their public acceptance. On the basis of our findings, we propose to amend some of the principles of the traditional Social Market Economy and to supplement them with new ones.

The proposed principles relate to the economy, to politics, as well as to the uncertainty inherent in the long run future. The principles are illustrated by general examples covering regional economic policy, monetary policy, financial crises, and environmental sustainability.

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<sup>2</sup> Corresponding author: Department of Economics, School of Behavioural and Social Sciences, Kingston University, Kingston-upon-Thames KT1 2EE, Surrey, United Kingdom. Email: [w.spanjers@kingston.ac.uk](mailto:w.spanjers@kingston.ac.uk)

<sup>3</sup> Department of Economics, Piazza Scaravilli 2, University of Bologna, I-40126, Bologna, Italy. Email: [elettra.agliardi@unibo.it](mailto:elettra.agliardi@unibo.it)

*'Tradition doesn't mean holding on to the ashes, it means passing the flame'*

*attributed to Thomas More (1478 - 1535)*

## **1. Introduction**

Perfectly competitive markets harness the forces of competition and allow society to benefit from them. Market based economies realize efficiency gains through the workings of the forces of competition in markets which reduce wastage and the misallocation of resources. This key insight is captured in Adam Smith's principle of the invisible hand: in perfectly competitive markets the outcome of individual self-interested behaviour is to the benefit of all, as if it were directed to the common good by an invisible hand. But the outcomes obtained in market based economies are at times perceived to be unfair and unjust, despite the (theoretical) possibility of any desirable, efficient, and feasible outcome to be obtained through an appropriate re-distribution of income and resources.<sup>4</sup>

The Social Market Economy provides a tried-and-tested third way approach to reap the benefits of market based economies whilst preventing (grossly) unfair and unjust outcomes. It does so by providing a broad, non-intrusive, organisational framework to achieve a workable version of a market based economy. This framework is founded on (individual) freedom and responsibility, within the bounds of commonly shared ethical values.<sup>5</sup>

Important pillars in implementing the Social Market Economy are the familiar ones of: competition; private property; the rule of law; freedom of contract; a predictable and stable economic environment; and state intervention to correct market failures. But they also include social balance.

In an extreme interpretation of market-based economies, state intervention is a night-watchman state, or "minimal state", limited to the functions of protecting citizens against violence, theft and fraud, to the enforcement of contracts, and so on.<sup>6</sup> In the context of the present paper, the state has a much more extensive role involving, amongst other, organizing the process of competition to arrive at optimal decentralized institutions.

Some areas in which the principles of the Social Market Economy are being or can be applied are competition policy; regulation; global warming; fighting poverty; free trade; the EU; and specific international organisations.

Explicitly or implicitly, the principles of the Social Market Economy are at the heart of most contemporary national and international economic policy debates.

## **2. Issues with the Social Market Economy**

### **2.a. The Social Market Economy in Context**

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<sup>4</sup> See, Smith (1776, Book 4, Chapter 2), Debreu (1959), and e.g. Hildenbrand and Kirman (1976).

<sup>5</sup> For historical context and background see e.g. Dardot and Laval (2013).

<sup>6</sup> See Nozick (1974).

The foundations of the Social Market Economy were developed during the 1940s and 50s, reflecting the economic, political and societal structures of the era, as well as the technological possibilities and their outlook. Its principles succeeded remarkably well in capturing the pre-requisites for successful economic development in post-war West Germany and provided a reliable compass for its economic policies for almost five decades.

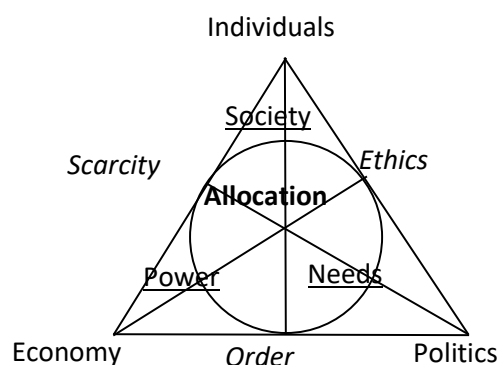
The economy and society, however, have changed. Some changes are political, cultural, or legal in their nature and have been triggered by the processes of European integration, by globalization, and by the collapse of communism. Modern economies and societies are fundamentally different from more traditional ones. Modern production technologies strongly depend on the synergies of geographical proximity and tend to be driven by cluster and agglomeration effects. Further crucial changes in the economic sphere are the vastly increased importance of the financial system, of knowledge, of innovation, and of uncertainty.

These changes affect the ability of traditional economic and societal institutions to harness individual self-interest. In particular, some market based institutions have become dysfunctional for channelling individual self-interest towards the common good. Areas in which such misalignment used to be a secondary issue have acquired paramount importance. Aspects of economic and social policy which hardly seemed to matter – for example ensuring equal opportunities – have become bones of contention and ‘game changers’ for successful economic development. Last but not least, the global interaction of a broad range of different values and cultures raises new questions of what is to be considered ‘the common good’.

## 2.b. Basic Structure of the Terminology

The basic structure of the concepts for our discussion of the Social Market Economy is outlined in the tradition of Pieter Ruys' tri-polar model.<sup>7</sup> The tri-polar model uses the mathematical framework of the Fano plane for representing three key concepts and their interconnections to understand the basic structure of a problem.

The problem at the heart of economic policy in general, and of the Social Market Economy in particular, is the allocation of resources in a society. As the three key building blocks in determining this allocation we consider individuals, the economy, and politics. In the diagram below they are represented as the corner points of a triangle which has the allocation at its centre.



<sup>7</sup> See Ruys (1974). The model has been discussed, applied, and extended in subsequent publications.

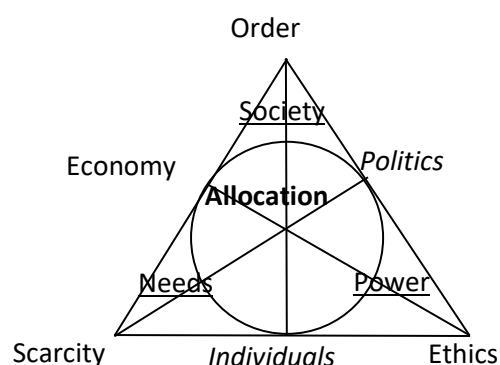
The tension between individuals and the economy takes the form of scarcity; the tension between individuals and politics is captured in the concept of ethics; and the tension between politics and the economy is captured in the economic order. Each of these is represented on one of the sides of the triangle.

The opposing forces of the model are the economy and politics as at the bottom of the triangle. The individuals in society, depicted at the top of the triangle, are the mediating force between the two.

The lines in the triangle which connect a corner point with the opposite side of the triangle represent an interaction which determines the allocation. The allocation is determined by the interaction of individuals with the economic order, but also by the interaction between the economy and ethics, as well as by the interaction of scarcity and politics.

The arcs in the diagram represent the forces connecting of the concepts of scarcity, ethics, and economic order around the basic problem of the allocation of resources. Here, society is the force shaping the connection between scarcity and ethics. Similarly, needs shape the connection between ethics and the economic order, whereas power is the force shaping the relation between the economic order and scarcity.

Due to the logical structure of the tri-polar model, its structure can equivalently be represented by interchanging the position of the corner points ('individuals', 'economy', and 'politics') with the position of the relations ('scarcity', 'order', and 'ethics'). This so called dual representation of the tri-polar model is represented below, where the economics order is the mediating force between scarcity and ethics. It provides an additional check on the soundness and consistency of the terminological apparatus.



## 2.c. Critical Areas in Contemporary Economies

Modern production technologies tend to rely on specialized resources, e.g. trained labour, advanced knowledge, developed infrastructure, and innovative suppliers. This makes it cost-effective for firms to concentrate their production in common geographical locations and to cooperate through specialized networks to more efficiently utilize shared resources, whilst continuing to be competitors

in output markets. This production in clusters tends to create significant regional disparities and strongly enhances the 'urban/rural' divide.

Contemporary economic structures are geared towards the future, which makes the alignment of current individual decisions and their future consequences with the 'common good' incomparably more important. The financial system plays a key role in connecting current decisions with their uncertain future consequences. Traditionally, the uncertain consequences of financial decisions were borne by the persons or companies making these decisions. In the current financial system, this often no longer is the case, as financial claims are traded and reallocated. Basically, these financial claims are promises regarding future payments. In an uncertain and unpredictable environment they tend to be vulnerable to 'opportunistic behaviour', i.e. to lying and cheating which cannot be proven in a court of law. This distorts the working of the 'invisible hand', which cannot prevent opportunistic behaviour. As a consequence its ability to align individual self-interest and the 'common good' in financial markets is significantly impaired.

Another important change is in the role of innovation. Both the challenges and the opportunities mankind is facing are immense. If the challenges are not overcome, civilization may collapse and descend into the dark middle ages or worse, but there may also be opportunities to reach an unimaginably improved future. In this race against time, knowledge and innovation have become crucial, vastly enhancing their importance for the economy and society. Knowledge and innovations can be shared without being reduced or diluted. This is an extremely powerful property from the perspective of growth and progress, but it hampers the functioning of the invisible hand, which is based on linking both price and value to scarcity. If knowledge and innovations can be shared at negligible costs, then they fail to be 'scarce' and may fail to create revenues for the inventor, as is the case when intellectual property rights are not respected. This may result in inefficient artificial barriers to the sharing of knowledge and inventions, in the worst case leaving knowledge undiscovered and inventions unmade.

One of the biggest obstacles in aligning current decisions with future needs is that the future is uncertain. This uncertainty not only means that we do not know which of the potential future scenarios will eventually obtain, or even the likelihoods of the different scenarios becoming reality. The future is uncertain in the sense that a wide range of medium and long term developments are beyond our imagination. There is a discrepancy between the things we know and may anticipate, and the things that matter to us. To some extent, 'we simply do not know', which leaves us torn between hoping for the best and fearing the worst. Inevitably, the evaluation of the consequences of decisions is, in part, not determined by a realistic assessment of the outcomes, but by our unreasoned hopes and fears.<sup>8</sup> Within a corridor determined by the extent of our ignorance, any evaluation of the consequences of our actions can be justified – and any decision supported – by psychological disposition or taste. Under such circumstances, it may become appropriate to restrict active decisions and policy interventions to situations outside a 'corridor of reason' which reflects the level and nature of our ignorance.

How would one best navigate the corridor of reason? In line with the intuition of optimal theory, one would aim for its the cost-weighted probabilistic middle. The closer to the middle, the lower the cost of risk (e.g. of variance), which in the decision making trade-off strengthens the pursuit of key policy

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<sup>8</sup> See Keynes (1937), pp. 213 – 215.

objectives. In the presence of ambiguity, i.e. of incalculable risk, appropriate amendments would need to be made, as e.g. in Agliardi and Spanjers (2021) regarding the optimal lockdown policies during the Covid crisis.

The present globalized world features the interaction of a wide range of cultures and of moral and ethical values, both internationally and within individual countries and societies. Individuals and groups of individuals may disagree about what is desirable or, indeed, what is the ‘common good’ of society. The principle of the invisible hand suggests that any economic outcome that is considered not to be desirable can be changed through an appropriate re-distribution of income and resources. But it may prove difficult to arrive at a consensus on which aspects of outcomes are undesirable and warrant a redistribution.

In principle, a voting process may provide a possible solution. But in general the outcomes obtained from the market process and from the voting process may be different. As Buchanan and Tullock (1962) argue, the market process should be preferred as a process of choice when the individual freedom is considered in isolation. The voting process should be preferred when the individual motivation in the choice is more relevant. It gives individuals a larger feeling of participation in forming social decisions and, possibly, defining the public interest. For the voting process to yield a social choice which is consistent and rational, individuals should be able to agree in advance on the fundamental objectives of society.<sup>9 10</sup>

### **3. Competition between Institutions**

#### **3.a. Economic Institutions**

The Social Market Economy as developed in the middle of the 20<sup>th</sup> century focusses on creating an environment which supports the functioning of the invisible hand, thus aligning individual self-interest with the common good, and separating economic policy from redistributive social policy. At the time, the economic, societal, and production structures were largely in line with the basic pre-requisites for the functioning of the invisible hand, which strongly contributed to making the Social Market Economy a success story.

During the past half century, the dramatic changes mentioned before have caused unregulated competitive markets to no longer align individual self-interest with the common good for significant parts of the economy. The ‘golden days’ of the initial design of the Social Market Economy are over. Aligning individual self-interest with the common good of society now requires a structure of economic institutions which is much richer and much more complicated than the traditional setting of ‘a full set of functioning competitive markets’.

The most familiar form of institutions is that of local and national governments, which are responsible for stipulated ranges of tasks within geographical areas. The design of such

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<sup>9</sup> See also Arrow’s Impossibility Theorem, e.g. Arrow (1951).

<sup>10</sup> The power structure among individuals before choices are made also plays an important role. Normally, the power structure for the voting process differs from the power structure in the market, which may make the voting process preferable to the market. But if it would be possible to modify the market power structure independently of the voting process, then this particular advantage of the political voting process would no longer apply.

governmental structures tends to be guided by the principles of federalism and subsidiarity. Other well-known institutions are (independent) central banks, state owned pension funds, and a range of independent regulators. It may often be convenient for the principles of federalism and subsidiarity to be applied to structures which respect the borders of nations and nation states, but this is not a necessity. Cross-border cooperation of EU-regions is an example of successful institutions which overcome the geographical boundaries of individual states.

The tasks and responsibilities of local and national governments tend to be too broad, however, to address the contemporary issues with the functioning of the invisible hand. Normally, these 'general purpose' institutions fail to satisfy the specific requirements for supporting the invisible hand. Often, they lack focus on the issues at hand, display a concentration of power, and suffer from conflicts of interest. Therefore, it would seem more appropriate to develop a multitude of independent institutions, each designed to help to overcoming issues with the invisible hand in specific settings.

For this purpose three kinds of institutions come to mind. The first kind of institutions would focus on the coordination of clusters and networks; the second kind would focus on providing guide-lines and regulations to contain opportunistic behaviour, e.g. in the financial system; and the kind type of institutions would attempt to provide guidance and flexibility within 'corridors of reason' to address issues related to uncertainty and 'fundamental ignorance' about the future.<sup>11</sup>

It may be tempting to consider centrally designing and managing such 'tailor-made' institutions to address the specific problems of different parts of the economy, leaving competitive markets in place where they are appropriate. This approach may make sense in a world in which the most important future scenarios and their likelihoods of arising are known to the centre, but less so in the presence of information that is private to individuals and of partial ignorance about the future.

Firstly, the type of arguments that speak against centrally planned economies may apply.<sup>12</sup> It may prove impossible to obtain and to process the relevant information. Also, the information gathered may be vulnerable to manipulation. Secondly, due to these distortions as well as to the presence of partial ignorance, regular adjustments of individual institutions' 'corridors of reason' would be required, potentially affecting the functioning of other institutions.

This would create problems in the institutional sphere of the economy that are similar to the problems which the Social Market Economy solved for the production sector by encouraging decentralized production and relying on the invisible hand to resolve coordination issues. It would seem a contradiction to decentralize society's production and consumption decisions by means of a centralized top-down planning and management of its more complicated institutional structure. An alternative decentralized bottom-up approach for managing the institutional structure is outlined below.

### **3.b. Legitimacy of Institutions**

The decentralized production and consumption decisions are directed by the self-interest of firms and consumers. The decisions of consumers are guided by their usefulness toward achieving the consumers' ultimate individual goals, often expressed by 'utility' as a measure of usefulness.

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<sup>11</sup> This terminology on this form of uncertainty relates to the concepts of 'incalculable risk', 'fundamental uncertainty', 'ambiguity', 'Knightian uncertainty' and 'Keynesian uncertainty'. They all share the common feature of 'not knowing (within bounds)'.

<sup>12</sup> See e.g. Hayek (1944).

Production decisions of the firms are guided by their contributions towards securing the firm's overall productive success, as indicated by its long term profits. Through the process of competition, profitable firms prosper and unprofitable firms perish.

The decentralized operation and evolution of institutions would be in line with the spirit of the Social Market Economy. The process could be designed along the lines of the decentralized production sector. Firms tend to focus on the production of a restricted range of products; individual institutions would be focused on a restricted part of the economy only. The restriction could be thematic, sectoral, geographical, or combinations thereof. Where the usefulness and success of firms is measured by their overall long term profit, the usefulness and success of institutions could be measured by the legitimacy they acquire. Typically, the legitimacy of an institution will reflect a combination of its effectiveness in achieving its stated goals and of its acceptance by the general public. The decentralized dynamics of the society's economically relevant institutional structure could now result from a suitable form of 'competition' between the individual institutions, based on their legitimacy. Institutions which achieve high levels of legitimacy would have their design copied as 'best practice', whilst institutions that fail to achieve the required levels of legitimacy would perish, either by being reformed or by being abolished.

In the context of 'competition between institutions' based on their legitimacy, the question arises how the required dynamics for the evolution of institutions can be achieved and implemented.<sup>13</sup> In particular: who will manage this process and in the interest of whom? Managing this process clearly is a political task, which should be resolved in the political sphere. But it may be so complicated that within the constraints of their often demanding everyday lives, many members of the electorate may struggle to acquire a deep understanding of the issues involved. In this context, it makes sense for the electorate to temporarily delegate their power to elected parliamentarians, that is to accountable, specialized, representatives of their trust and choice. It would seem that this is best achieved by means of a functioning modern representative democracy, acting on behalf of its sovereign, the electorate.<sup>14 15 16</sup>

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<sup>13</sup> In the context of structures of bilateral exchange institutions, this one of the questions discussed in Spanjers (1997).

<sup>14</sup> This reflects the principle of *sovereignty of the people* goes back to Jean-Jacques Rousseau's book 'The Social Contract' (1762). Regarding sovereignty of the people Benjamin Franklin is quoted as having said "In free governments, the rulers are the servants and the people their superiors and sovereigns". Legally, for most modern democracies the principle of *sovereignty of the parliament* applies, which means that, once elected, parliamentarians make independent decisions, accountable to their conscience only. Still, parliament's power originates with the electorate and parliamentarians may face the sanction of failing to be re-elected in the next election.

<sup>15</sup> Some of the relevant policy issues surpass economics. They may involve general areas of ethics, justice, and welfare, as well as general areas of political science, democracy, administration, and philosophy of law. In the context of economics, of redistribution, and of civic society participation in various institutions and institutional settings, a similar type of question arises: who is the sovereign? When facing a range of different views on what may be an appropriate re-distribution: how is a decision arrived at? Who decides on the forms and shapes in which the civic society participation takes place? How are the 'rules of engagement' decided on? These questions all boil down to: who decides in the end? In the terminology used above: who is the sovereign? In time-tested everyday language: where does the buck stop?



The codification of commonly shared values, key principles and procedures in difficult-to-change constitutions and treaties by elected representatives, in accordance with the wishes and best interests of the electorate at the time, is a valid part of the process. Delegating power by creating institutions of different shapes and forms also is. Such institutions themselves may, for example, contain elements of direct or representative democracy, as is the case in local governments; they may be independent, like the judiciary; or they may encourage a range of different forms of civic engagement, as in different thematic movements or in political parties.

Modern representative democracies as can be found, for example, in the EU, have the key properties discussed above. Therefore, they are well-positioned to implement the proposed competition of decentralized economic institutions on the basis of legitimacy, if they desire to do so.

The development of the institutional structure would now follow a dynamic process. In some respects, this dynamic process has similarities with the price exploration process in competitive markets, but there are important differences. The key similarity is that both adjustment process are exploring at best partially known relationships and interactions.

The first difference is that the price exploration process is a largely unmodelled disaggregated process, whereas the dynamic development of the institutional structure of the economy is driven by conscious decisions of the 'referee' trying to further their objectives. In this sense, the dynamic development of the institutional structure of the economy is similar to a constraint dynamic optimization problem for the 'referee'.

The second difference is that the price exploration process is based on numerical values for prices and can easily be represented by the use of difference or differential equations. The development of institutional structure, however, is driven by decisions about institutions which are difficult to represent by numerical values.

Despite the problems of using the standard mathematical formulation, the development of the institutional structure of the economy is similar to that of solving a dynamic optimization problem. Ideally, the 'referee' envisions the potential dynamic paths for the further development of the institutional structure, and takes decisions regarding individual institutions accordingly in line with its objectives. In broad terms, it would therefore seem reasonable to assume that the resulting path for the development of the institutional structure of the economy will tend to be optimal from the 'referee's' perspective.

Specific properties of the 'referee's' objectives would need to be established on the basis of the aggregation of individual objectives through political process. These aggregation processes are complicated and have many pitfalls, as is illustrated by, amongst others, the Condorcet Paradox and by Arrow's Impossibility Theorem.

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<sup>16</sup> Robinson (2016) argues that institutions can arise in two ways: driven by the state or driven by civic society. The former is referred to as 'top-down', the latter as 'bottom-up'. A simple stationary dynamic model is used to illustrate that the optimal outcome is achieved if there is a balance of power between the 'state' and 'civic society'. In the absence of an approximate balance of power, the dominated group becomes disengaged. This not only carries the risk of distorting the institutional structure, it may also induce the state to direct a sub-optimal level of effort and resources towards maintaining and improving the institutional structure. In the context of our discussion, the state may perhaps be interpreted as the elected representatives, and civic society as the electorate.

If the aggregation of individual objectives through the political system to referee's objectives work out well, and if it is possible to abstract from the dynamic process and to focus directly on the outcome, then the process of competition between institutions would result in an institutional structure which is optimal from the perspective of the 'referee'.

The closer the 'referee's' objectives are a balanced reflection the undistorted individual objectives, stronger the results of competition between institutions would be with 'the best interest of society'. This resembles the result that the outcome of the price process is aligned with the best interest of society as in the First Theorem of Welfare Economics and in the formalizations of Edgeworth's Conjecture.

But the outcomes under competition between institutions are not restricted by the initial distribution of resources and income. Therefore, the outcome of competition between institutions would be the counterpart of the Second Theorem of Welfare Economics. In addition, it would provide a political process for endogenously determining the 'desirable' economic outcome(s), in a much richer environment of potential economic, technological, and societal settings.

#### **4. Principles of the Contemporary Social Market Economy**

##### **4.a. Principles of Economic Policy**

The aim of the traditional Social Market Economy is to operationalize the mechanism of the invisible hand on the basis of a small number of key policy principles. These traditional principles relate to obtaining an efficient competitive market allocation; to securing suitable private property rights; to providing a stable and predictable policy environment; and to securing social balance. In practice, this boils down to providing a framework securing an effective legal system; eliminating concentrations of (economic) power; ensuring political good governance; and providing equal opportunities whilst balancing social security with incentives to perform well.

In the light of the above discussion of the contemporary critical issues in economics, it is clear that the traditional principles no longer suffice and need to be supplemented by further principles. The additional principles should relate to the effective coordination of agglomerations, clusters, and network effects; they should ensure a balance between trust, monitoring, and accountability in the face of potential opportunistic behaviour as in significant parts of the financial system; and they should encourage sufficient flexibility to facilitate ventures into the unknown, whilst providing sufficient security to ensure appropriate levels of safety and of funding for such ventures. Identifying appropriate additional economic principles on the basis of solid economic insights is our main purpose.

In the context of the proposed competition between institutions, however, it will not suffice to focus on economic principles alone. To ensure a functioning competition between institutions based on their legitimacy, a number of political principles need to be adhered to too. As argued above, the political system should be organized along the lines of a representative liberal democracy.

A constitutional rule may require that group decisions are to be taken on the basis of consensus amongst a given proportion of the electorate, or among their representatives. In this context, agreement based on simple majorities is a well-known mechanism in democratic societies. Still, in some cases, even this simple majority rule requires institutional constraints. For example, the

consensus of a required proportion of the electorate on a specific issue can be circumvented by multi-issue coalition formation. Thus, under a voting mechanism distortions may occur which are similar to those emerging under non-representative individual decisions.

Either way, there is a strong need for civil liberties to be upheld, for tolerance, and for respect for others and their views. All of these are not only necessary for the representative democracy to function effectively. They are also needed to ensure that the legitimacy of institutions – which is partially based on the perceptions of the public and of the electorate – is an adequate measure of the institutions' suitability.

#### **4.b. Identifying Additional Contemporary Principles**

The principles proposed by Walter Eucken (1952, Book 4, Chapter 16) are the basis for the traditional Social Market Economy. To identify additional principles to supplement them, we start by considering specific aspects of the prototypical solutions for each of the specified areas of special interest. We then proceed by translating these aspect into more general principles.

When considering clusters, agglomerations, and network effects, there seem to be two key issues to be dealt with. The first is the effective coordination of decisions relating to the relevant geographical or sectoral conglomerates. This coordination tries to capture the benefits of the positive external effects open to the units within the conglomerate, whilst minimizing the negative external effects. The second issue is to contain the inequality resulting from the divide between those inside the conglomerates and those outside of them; geographically this could be an urban/rural divide. The first issue can be addressed by the creation of appropriate coordinating institutions for the individual conglomerates. Dealing with second issue, however, requires institutions or policies: ensuring equal opportunities for 'insiders' and 'outsiders'; securing a sufficiently advanced general level of infrastructure which enables traditional economic development outside the conglomerates; and guaranteeing comparable living standards inside and outside the conglomerates. The latter would be much facilitated by disconnecting wage income receipts from labour costs through an appropriate system of income taxes and income subsidies. Such policy would also provide an effective tool for reducing and directing internal migration pressures.<sup>17 18</sup>

When considering the prototypical institutions for dealing with opportunistic behaviour within the financial system, the same key principles come to mind that are at the heart of successful policy implementation in general. First of all, there is the requirement of transparency. In addition, the appropriate use of: ex-ante scrutinizing; ad interim monitoring; and ex-post auditing, would help containing the negative effects of opportunistic behaviour as far as is reasonably possible. In particular, it is crucial to enhance the system's stability and legitimacy by reducing the negative consequences of the limited liability effect in the financial sector. The latter can be achieved by assuring appropriate levels of equity to reduce incentives for opportunistic behaviour and to absorb

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<sup>17</sup> See also Weber (1909), Krugman and Venables (1990), and Krugman (1991).

<sup>18</sup> As convincingly shown by Helpman (2016), wage inequality is mainly related to technology, viz. technological progress, cluster effects, and agglomeration effects. Wage inequality tends to occur at the top of the income distribution, making some better off, generally without making others worse off. Still, this kind of Pareto improvement may require policy intervention as it causes some groups not to participate fairly in society's progress. This situation becomes even more problematic if there is a geographical dimension to this increase in inequality.

reasonable ‘worst case’ losses. A multitude of financial innovations has recently been developed to absorb losses when capital falls below a threshold level in times of financial distress. Contingent convertible capital instruments (CoCos) are an example in the case of banks. Due to their capacity to absorb losses, many hybrid capital securities have the potential to satisfy regulatory capital requirements.<sup>19</sup>

For dealing with uncertainty, it is useful to distinguish between two types of it. The first type relates to information that is available to society as a whole, but not to all relevant individual decision makers. The second type of uncertainty relates to information which fails to be available at all. In the former case, the principle of transparency would be of help. It would be supported by civic liberties and the presence of strong, independent, objective, pluralistic information media and a culture of open factual discussions, in line with the freedom of expression. In dealing with uncertainty due to information not being available to the society as a whole, it is important to be aware of this ignorance, i.e. that ‘we just don’t know (yet)’.<sup>20</sup>

Dealing with ignorance requires tolerance regarding differing opinions as well as the flexibility to swiftly and effectively react to new information when it becomes available. This flexibility can be achieved in a number of ways. Transparency facilitates the diffusion of the new information as it arises. The presence of sufficient levels and quality of entrepreneurship make it possible to swiftly benefit from new the economic opportunities and to react appropriately to emerging challenges. Finally, an open and flexible institutional structure allows swift and appropriate adaption to new societal coordination and policy issues that may result. A further way to deal with the issue of not-knowing is to reduce the extent of the society’s ignorance by generating knowledge, e.g. through fostering curiosity and experimenting, through education, and through research.

As will be shown below in Section 5, in some cases existing institutions do not seem to work properly. This is due to mistakenly transferring the behavioural postulate of the *homo oeconomicus* to individuals in their political or public choice roles. If politicians, technocrats, or the dominant elite decide among themselves what is the ‘common good’ for society, without due recourse to the opinion of their sovereign – the electorate –, and if they maximize the social welfare function reflecting their version of the ‘common good’, then new distortions will appear. As a result politics may become dysfunctional for channelling the individual self-interest within the society into the common good. In the words of Buchanan (1991): ‘There are no superior agents – morally superior – that can use their power for some public interest’, while at the same time, ‘there is no economic theory of politics obtained from the behavior of individual choices’. The challenge is to design institutions or rules that may limit the distortions due to individual self-interested behaviour. Such institutions need to be dynamic and sufficiently flexible to adapt to evolving circumstances over time.

#### **4.c. Proposed Principles of the Contemporary Social Market Economy**

Our list of proposed principles for the contemporary Social Market Economy extends and slightly adapts Walter Eucken’s original list, which was aimed at operationalizing the principle of the invisible

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<sup>19</sup> See Calomiris (2013).

<sup>20</sup> See Keynes (1921), Knight (1921) and Keynes (1937). For a more mathematical treatment see e.g. Ellsberg (1961), Schmeidler (1989), and Chateauneuf et al. (2007).

hand.<sup>21</sup> The proposed new principles are organized under the headings ‘Economic principles’, ‘Political principles’, and ‘The long run’. They summarize and generalize the above discussion.

1. Economic principles
  - a) Markets
    - i. Private property (Eucken’s Fundamental Principle 2)
    - ii. Freedom of contract (Eucken’s Fundamental Principle 3)
    - iii. Competitive markets (Eucken’s Fundamental Principle 1)
  - b) External effects (locational and others)
    - i. Comparable living standards
    - ii. (Inter Regional) Fiscal transfers
    - iii. Corrective taxes, subsidies, and quantity restrictions
  - c) Opportunistic behaviour
    - i. Accountability
    - ii. Partial liability (modifies Eucken’s Fundamental Principle 4: Liability)
    - iii. Systemic stability
2. Political principles
  - a) Social policy
    - i. Equal opportunities
    - ii. Social security
    - iii. Distance between wage income and social security payments
  - b) Institutions
    - i. Independence
    - ii. Legitimacy
    - iii. Subsidiarity
  - c) Governance
    - i. Rule of law
    - ii. Representative democracy
    - iii. Civic liberties and tolerance
3. The long run
  - a) Dynamics
    - i. Entrepreneurship
    - ii. Flexibility
    - iii. Predictable framework (extends Eucken’s Fundamental Principle 5: Predictable Policy)
  - b) Uncertainty
    - i. Reserves and buffers
    - ii. Transparency
    - iii. Research and experimenting.

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<sup>21</sup> Eucken (1952, Book 4, Chapter 16, Sections 3 to 7). See also van Suntum et al. (2011).

In the next section we discuss examples from four modern broad policy areas illustrate these principles: regional policy; monetary policy; financial crises; and sustainability. In the examples, we treat ‘policies’ and ‘institutions’ as interchangeable, since institutions provide a specific way of implementing policies. In bold font within squared brackets we indicate the specific key principles that apply.

Regional policy is illustrated by economic aspects of German reunification in 1990 and thereafter as well as by the EU’s structural policy. Under the heading of monetary policy we discuss independent central banks and the introduction of the Euro. The financial crises we focus on are the Financial Crisis of 2008 – 2010 and Euro crisis. Finally, under sustainability we focus on environmental policy and discuss our stewardship of the earth, global warming, and the reduction in biodiversity.

## 5. Illustrations

### 5.a. Regional Policy

#### **German Reunification (1) – Governance**

*The situation:* One of the main forces bringing about German reunification was the deep and persistent loss of legitimacy of the government and governance structures in the GDR (former communist East Germany). **[Principles 2bii ‘Legitimacy’ and 2c ‘Governance’]** The political and economic reunification of the Germany required changes in the governance structure of the former GDR.

*What worked:* The change in governance structure was implemented by transferring the institutions of the FRG (West Germany) to the East of the country. This had two advantages. Firstly, only a relatively small amount of institutions had to be newly designed; most institutions had been thoroughly tried-and-tested. Secondly, with the transferring of these institutions, their legitimacy was also transferred, greatly contributing to (institutional) stability in times of historic change.

#### **German Reunification (2) – The Economy**

*The situation:* In line with the traditional principles of the Social Market Economy, the economic strategy for German reunification was based on the principles of competition and the workings of the invisible hand. On this basis, it was expected that economic reunification would be completed within a period of five to ten years, without requiring significant additional amounts of government expenditure, except for the provision of training and of general infrastructure during a period of transition. Although the policy was very successful in many respects, this expectation was not met.

*What didn’t work:* The competitive advantages of the West German economic structures due to clusters, agglomerations, and network effects proved effectively impossible to overcome for the East. After 30 years, only in areas where economics policies have taken into account cluster and agglomeration effects from the outset, the economic outlook seems positive. But even here economic sustainability still is far away. **[Principle 1b ‘External Effects’]**

#### **German Reunification (3) – Internal Migration**

*The situation:* The slow convergence process, combined with large differences in living standards, created strong migration pressures from East Germany to the rest of the country.

*What did work:* To contain these pressures, living standards in the East had to be improved dramatically. **[Principles 1bi ‘Comparable Living Standards’ and 2a ‘Social Policy’]** Wages were

increased much quicker than productivity allowed for, causing unemployment and further hampering economic convergence. The economic, social, and political situation could and can only be sustained by continued very large transfer payments in different shapes and forms. **[Principle 1bii '(Inter Regional) Fiscal Transfers']**

### **EU Regional Policy**

*The situation:* Regional disparities in living standards, economic performance, and opportunities for development undermine the legitimacy of the EU.

*What did work:* The EU's Structural Fund and its Cohesion Fund help to reduce these disparities by providing financial support for appropriate projects. **[Principles 1bi 'Comparable Living Standards', 1bii '(Inter Regional) Fiscal Transfers', and 2ai 'Equal Opportunities']** The available funding is in the order of magnitude of € 50 Mrd annually. Other EU funds also have aspects supporting regional development.

### **5.b. Monetary Policy**

#### **Independent Central Banks**

The primacy of monetary policy for achieving monetary stability is considered by Eucken to be the corner stone of economic policy.<sup>22</sup> The Social Market Economy too considers a stable value of money to be crucial. In Germany, this traditionally was reflected in the monetary policy of the independent Bundesbank. **[Principle 3aiii 'Predictable Framework']**

*The Situation:* In most countries, monetary policy was at the discretion of the government, be it directly or indirectly. As a consequence, there was a temptation for monetary policy to be used for political purposes as well as for achieving economic objectives. This compromised its economic effectiveness and monetary policy lost much of its legitimacy.<sup>23</sup>

*What worked:* A change of institutional structure, following the successful example of the Bundesbank, restored the legitimacy and effectiveness of monetary policy. Independent central banks were created and endowed with clearly defined objectives, typically in the form of inflation targets. **[Principles 1ci 'Accountability', 2bi 'Independence', and 2bii 'Legitimacy']**

#### **Creation of the Euro**

Exchange rate regimes range from fixed exchange rates to free floating exchange rates. Different intermediate forms of semi-fixed exchange rates seemed to provide the optimal combination of predictability and flexibility. But independent national currencies lose credibility when exchange rate policy is used as a tool for achieving political objectives.

*The Situation:* After the collapse of the Bretton-Woods system, the European exchange rate mechanism (EMS) was created to ensure exchange rate stability, whilst maintaining a desirable measure of flexibility. Although marred by competitive devaluations, the system served its purpose until it collapsed due to political conflict. **[Principle 1ciiii 'Systemic Stability']**

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<sup>22</sup> Eucken (1952, Book 4, Chapter 16, Section 2). See also Bofinger (2016) who considers Eucken's contribution from a macro-economic policy perspective. In the context of Eucken (1952)'s emphasis on the importance of a stable economic environment, Bofinger's perspective is surprising, to say the least.

<sup>23</sup> See e.g. Barro and Gordon (1983).

*What worked:* The collapse of the exchange rate mechanism damaged the credibility of a system of semi-fixed exchange rates in Europe beyond repair. The remaining choice now was between flexible exchange rates or irrevocably fixed exchange rates in the form of a single currency. As a myriad of small currency turned out to have become unworkable, a single currency in the form of the Euro was introduced. This repaired the vulnerability of the EMS' legitimacy due to political interference but, at the expense of the vulnerability of Euro's legitimacy due to the initial absence of effective instruments to dampen the impact and contagion of national and international economic shocks. **[Principles 2bii 'Legitimacy' and 3bi 'Reserves and Buffers']**

### **5.c. Financial Crises**

The financial system's main function is to align current financial decisions with their future consequences through the buying and selling of securities, i.e. of promises of future (re-)payment under specified conditions. This facilitates investment, fosters growth, and enhances living standards. But the future is uncertain and the occurrence of conditions of the promises can be manipulated, so the financial system also creates possibilities for destabilizing opportunistic behaviour. Thus, the organisation of the financial system involves a trade-off between growth and stability. **[Principle 1c 'Opportunistic Behaviour']**

The complexities of our age broaden the 'corridors of reason' of plausible values for the economy's securities. The particular value of the securities within this range is a matter of judgement and is largely determined by psychological factors. Such factors include individual investors' levels of optimism and pessimism, i.e. their tendencies toward 'hoping for the best' and 'fearing the worst'. A broadening of the 'corridors of reason' as during financial crises may enhance volatility and reduce the stability of the financial system.

There are two basic ways to counteract such increased tendency toward instability. The first is to reduce the incentives for opportunistic behaviour within the financial system. This can be achieved by intensifying monitoring, by increasing accountability, and by ensuring appropriate levels of liability in the context of prudential regulation. **[Principles 1ci 'Accountability' and 1cii 'Partial Liability']** The second way to reduce the tendency toward instability is to narrow the 'corridors of reason' as perceived by investors. This can be achieved by increasing transparency and by providing a safety net of guarantees to systemically relevant financial institutions.<sup>24</sup> **[Principles 3bi 'Reserves and Buffers' and 3bii 'Transparency']**

### **The financial crisis**

In the run-up to the financial crisis, an ineffective structure of regulations and regulatory institutions created serious vulnerabilities of the financial system. This became apparent to all in the sub-prime mortgage crises. Inappropriate political decisions in the run-up to the US presidential elections destroyed the confidence in the political establishment's ability and willingness to contain it. This turned the sub-prime mortgage crisis into a full blown international financial crisis.

*The Situation:* The financial crisis virtually wiped out the legitimacy of the existing national and international institutions governing the financial sector. Eventually, this resulted in changes in these

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<sup>24</sup> See e.g. Spanjers (2018).



institutions and the associated regulations. In the context of prudential regulation it led to, amongst others, the Basel III agreement.<sup>25</sup> **[Principle 2bii ‘Legitimacy’]**

*What worked:* In the context of the EU, the financial crisis triggered changes in its financial regulation and its regulatory financial institutions. The EU’s Banking Union with a ‘Single Rulebook’ was created, governing the financial sector throughout the EU. It covers the implementation of the Basel III agreement, of deposit insurance, and of procedures addressing failing financial institutions. **[Principles 1ciii ‘Systemic Stability’ and 2biii ‘Subsidiarity’]** For the Eurozone, the Banking Union is supplemented by the Single Supervisory Mechanism and the Single Resolution Mechanism. **[Principles 1ciii ‘Systemic Stability’, 3bi ‘Reserves and Buffers’, and 3bii ‘Transparency’]**

### **The Euro crisis**

*The Situation:* The financial crisis exposed the inability of a number of EU member states to independently absorb its fiscal impact. Failing banks needed refunding during a steep recession, a monumental task which stretched the confidence of the financial markets in governments’ ability and willingness to implement the necessary policy changes. The resulting vicious circle severely undermined the legitimacy of the financial system, of individual governments and national political systems, and of European integration.

*What worked:* This enormous loss of legitimacy of a broad range of institutions in Europe was counteracted by the creation of a number of generously funded new EU institutions and policies. **[Principles 2bii ‘Legitimacy’ and 2biii ‘Subsidiarity’]** This provided a focused boost to European integration in the general areas of financial regulation and fiscal policy, in a desperate attempt to regain legitimacy and popular acceptance.

The changes included improved financial regulation and procedures for rescuing failing banks, replacing national policies by EU frameworks. **[Principle 1ciii ‘Systemic Stability’]** They also involved the creation of new EU level institutions addressing emerging and existing fiscal problems, repairing weaknesses in the framework of the Maastricht Treaty.

These changes cumulated in the creation of the European Stability Mechanism (ESM) with the aim of supporting EU member states in financial difficulties in order to contain contagion effects. **[Principle 3biii ‘Reserves and Buffers’]** It replaces the transitional institutions of the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM). The European Fiscal Compact (EFC) replaces the defunct Stability and Growth Pact regarding member states’ fiscal policy.

### **5.d. Sustainability**

The sustainability of the earth’s natural environment and the depletion of some of its natural resources is one of the most important, complicated, and controversial problems mankind is facing. The degrading of the natural environment and the depletion of exhaustible resources cannot go on

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<sup>25</sup> Knight (2016) provides an overview of the key reforms to bank regulation and the global financial system. In this context, he proposes additional specific regulation for Originate-to-Hold financial institutions to ensure that these institutions are allowed to buy what they may perceive as under-priced financial assets in times of crisis.

forever; the ‘tipping point’ and doom always seem near. Fortunately, the saving grace of innovation always seems close at hand too.<sup>26 27</sup>

### **Stewardship of the Earth**

*The Situation:* Fundamental uncertainty is at the heart of the dilemma. We can imagine the catastrophes that may lay ahead if technology and policy remain unchanged. But we have no way of knowing the possibilities that invention and innovation may create. **[Principles 3ai ‘Entrepreneurship’ and 3aii ‘Flexibility’]** A mere century ago, a vision of our current reality would have defied the boldest imagination. **[Principle 3b ‘Uncertainty’]** To the extent that we don’t know the possibilities the future may hold in store, we are caught in a ‘corridor of reason’ created by our ignorance, torn between hoping for the best and fearing the worst.

Even though not all can be foreseen, our stewardship of the earth on behalf of future generations requires us to follow a path of ensured sustainability throughout the ‘corridor of reason’, if such path is available. **[Principles 3aii ‘Flexibility’ and 3bi ‘Reserves and Buffers’]** If it is not, we would be required to establish sustainability for as much of the ‘corridor of reason’ as is reasonably possible under the circumstances.

*What may work:* The effects of environmental degradation and the depletion of exhaustible resources, be they fossil fuels, water reserves, or arable land, will not affect all regions to a similar degree. Transfer payments relatively advantaged regions to disproportionately disadvantaged regions may be required, both to ensure acceptable regional living standards and to build a new future for those worst affected. **[Principles 1bi ‘Comparable Living Standards’, 1bii ‘(Inter Regional) Fiscal Transfers’, 2ai ‘Equal Opportunities’]**.

### **Global warming**

The release of carbon dioxide in the atmosphere by the use of fossil fuels causes global warming, which undermines the legitimacy of the excessive use of fossil fuels and of the economic and political systems that depend on them.

*The Situation:* Policies and institutions have been and are being developed to address the issue of reducing emissions at regional, international, and global levels. The Kyoto Protocol created three flexible emission reduction mechanisms: International Emissions Trading; **[Principles 1ai ‘Private Property’, 1aiii ‘Competitive Markets’, and 1biii ‘Corrective Taxes, Subsidies, and Quantity**

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<sup>26</sup> As outlined in Jones (2016), however, it would seem that ‘Ideas total factor productivity’ (a measure of innovation through new ideas) is falling, since over the last two centuries significantly more resources need to be employed to maintain a more-or-less constant growth rate of the overall economy of about 2% per year. Calculations suggest that to maintain this growth rate the amount of resources devoted to research and development on average need to be doubled every 12 years. The only relevant effect that may not be fully incorporated into these numbers is the effect of ‘visions’, ‘fantastic dreams’, and ‘crazy ideas’ (as in science fiction of, e.g. Jules Verne in his time, or Isaac Asimov in ours) becoming reality.

<sup>27</sup> Haltiwanger (2019) and Lerner (2019) indicate that, according to a broad range of measures, innovative efficiency has been declining for more than half a century. Although it seems reasonable to assume that this may temporarily be the case for a number of years after a crisis, it seems to contradict the experienced accelerated impact of innovation on living standards and the quality of life over this period. It would seem that one possible explanation for this contradiction could lie in the aggregation process, along the lines of Farhi (2019), which suggests that aggregates may strongly underestimate overall disaggregate effects.

**Restrictions’]** the Clean Development Mechanism; and Joint Implementation. **[Principle 3aii ‘Flexibility’]** Developed countries tend to have their own mechanisms for trading emissions; in the EU this is the European Union Emissions Trading Scheme. **[Principle 2biii ‘Subsidiarity’]**

*What works:* The Paris Agreement is considered to provide the first-ever legally binding global climate agreement. It sets out an ambitious global agenda with the aim of reaching ‘climate neutrality’ before the end of the century. For the first time, it introduces strategies to reduce climate change damages, both in terms of mitigation of greenhouse gasses and of adaptation to climate change. Mitigation addresses the source of the climate change problem by reducing the amount of emitted greenhouse gasses. It typically deals with a global public good aspect. **[Principle 2biii ‘Corrective Taxes, Subsidies, and Quantity Restrictions’]** Adaptation, in contrast, provides purely local benefits, usually limited to the period in which adaptation takes place. **[Principles 1bi ‘Comparable Living Standards’, 1bii ‘(Inter Regional) Fiscal Transfers’, and 2ai ‘Equal Opportunities’]**

Further policies and institutions have been and are being developed to encourage and support the development of new technologies for addressing the problem of global warming, e.g. by reducing the dependency on fossil fuels, by reducing the carbon dioxide emission they cause, and by capturing excessive carbon dioxide in the atmosphere. **[Principles 3ai ‘Entrepreneurship’ and 3biii ‘Research and Experimenting’]**

### **Biodiversity**

*The Situation:* As with global warming and the management of exhaustible resources, the extinction of species is perceived to be at odds with our stewardship of the earth. Thus, it contributes to inter-generational conflict, undermining the legitimacy of the economic use of the environment, and indirectly undermining the legitimacy of the current economic order and political system. It is a further example of ‘moral anarchy’.<sup>28</sup>

*What may work:* Preservation policies for maintaining biodiversity and associated institutions are being adopted at national level and through international cooperation. **[Principle 2biii ‘Subsidiarity’]** These policies include the protection and re-establishment of priority ecosystems, as well as developing a strategic, integrated approach towards sustainability and biodiversity. **[Principles 1biii ‘Corrective Taxes, Subsidies, and Quantity Restrictions’ and 3bi ‘Reserves and Buffers’]**

### **Genetically Modified Crops**

*The situation:* Genetic engineering enables big improvements in the resilience and robustness of crops. The results, however, tend to be patented and seeds to be marketed in versions that cannot reproduce, forcing farmers to buy new seeds for each sowing. This facilitates firms to recoup and make good returns on the technological progress through their genetic engineering, it restricts access to and use the improved crops, in particular by poor small farmers.

*What may work:* The patents which capture the fruits of genetic engineering may be purchased by international development agencies, who may market a version of the seeds that can reproduce, thus improving the dissemination of the improved crops.

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<sup>28</sup> See Nozick (1971) and Buchanan (1991).

## 6. Concluding Remarks

This paper is intended to contribute to rethinking the traditional principles of the Social Market Economy. During most of the second half of the twentieth century these traditional principles provided a workable summary of economic theory for supporting ‘best practice’ economic policy. But there have been significant changes in economic structures and in technology, causing the traditional principles to have become incomplete and to have lost much of their effectiveness.

Due to these changes, important aspects of contemporary economies are no longer adequately represented in the standard economic model of competition in markets, which is the foundation of the traditional Social Market Economy. We discuss the main discrepancies and arrive at the conclusion that contemporary market-based economic policy needs to supplement competition in markets – based in the principle of scarcity – with competition between (economic) institutions, based on their legitimacy, as argued in Section 3.

In Section 4 we propose to extend the traditional principles of the social market economy with additional economic principles, with political principles – including representative democracy and upholding civic liberties – as well as with principles for coping with the uncertainty of the more distant future. A broad range of illustrations is provided in Section 5.

We do not expect this paper to provide a final solution to the fiendishly difficult problem of constructing a coherent policy framework for a decentralized economic order. But we do hope that it reinforces the need for such framework, also and especially in our current turbulent times, and we hope that it may, perhaps, provide a useful starting point for a fruitful discussion on these and related issues.

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