

Tomas Krabec
University of Economics, Prague, Czech Republic

SOCIAL MARKET ECONOMY: AN EXPORT ITEM FOR CEE COUNTRIES?

Key words: economic policy, regulative policy, ordoliberalism, Social Market Economy, institutional quality, institutional evolution

ABSTRACT

Based on the methodological framework of ordoliberalism being a unique theoretical background for explaining the importance of economic order, institutional evolution and competitive and social dynamics, we consider two qualitatively different ways of incorporation as a particular example of market order efficiency. On the example of incorporation procedures in the Czech Republic and Bosnia and Herzegovina will be shown that not only the formal rules but also general rules of conduct are decisive for efficient market functioning and consequent welfare maximization. Even though there is an obvious convergence in formal institutions (relevant legislature) it is obvious that the informal rules of conduct play an important role, which may even in the long run influence the institutional quality regardless government policies. Consequently, the interdependencies between economic and social development will cause possible long lasting competitive disadvantage for some countries in terms of institutional performance. At the end a generally applicable solution dealing with informal social rules based on a traditionally German inspiration regarding some specifics of CEE countries will be provided.

The here presented results draw extensively on research program GAČR 402/05/2163 prepared at the University of Economics in Prague and previous work at Skoda Auto College in Mlada Boleslav. I acknowledge with thanks useful comments and help received from Marina Kozlik.

1. INTRODUCTION

The importance of institutional factors is strongly emphasized by maintaining a high market and business dynamics or by decision-making process of localizing foreign direct investments (FDI) or portfolio investments from both national and international perspective. The more stable and efficient the institutional order the more predictable are the outcomes of business ventures, the easier is the long-term planning and the higher is the investment activity. The market risk coming from local or international competitors is inevitable, however, factors such as political stability, government efficiency, regulatory burden, efficiency of legal order or corruption control can also have significant influence. This entry will concentrate on some aspects of importance of institutional order with particular focus on the CEE countries whereas special attention will be given to the Czech Republic and Bosnia and Herzegovina as suitable examples of formal institutional convergence towards stable western democracies nevertheless still there is a lack in long term stability of expectations.

New institutional economy and comparative economy are considered the main sources of recent evaluation methodologies of institutional quality (Williamson, 2000, Easterly, 2001, Jütting, 2003 and many others). The economic order and its underlying principles can be described also from a slightly different perspective by using the ordoliberal methodology (Eucken, 1990). Here we shall draw our attention on an important task of economic order analysis: which additional organizations, or in ordoliberal terminology regulative principles, should CEE countries implement apart from the basic legal and institutional prerequisites of the market order in order to further fine-tune institutional quality and ease decision making of economic policy bodies and participating businesses.

Countries used as examples in this contribution are chosen for their differences in economical, political, social but also market development in order to better compare institutional and bureaucracy systems and stability in response to investment opportunities. By focusing on setting up a new business in the form of Limited Liability Company and some related issues concerning the establishment conditions, the theoretical approach based on ordoliberalism will be used for comparisons and derivation of conclusions. This narrow focus will allow us to show that the quality of institutional order is the prerequisite for institutional and business dynamics and thus long lasting economic growth and maintenance of competitiveness. Though there are other important aspects that have to be in place at the same time.

Over the 1990s until now, CEE countries have been facing many similar issues as West Germany after the Second World War. After having developed a sufficient set of formal rules – mainly in terms of legislature – it became obvious that there are other two essential conditions for guaranteeing a stable and dynamic growth development:

- The *enforcement of formal* rules and its applicability depending on informal rules of conduct, which are on evolutionary basis present in the society

- The *expectations* and *business plans* of firms and households strongly depending on credibility and predictability of the economic order and ad hoc acting of its regulators (mainly as governmental stabilization policies)

The German political doctrine of Social Market Economy deeply based on ordoliberal theoretical background solved these both issues by introducing a so far unprecedented independent economic policy consultancy body – the **Council of Economic Experts** (*Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*) in 1963. Further in the text first ordoliberalism as a normative theoretical approach will be briefly described, than we will draw our attention to comparison of incorporation procedure in two different CEE countries providing us an insight in some legal aspects of market entry and finally there will be drawn conclusions regarding ordoliberal based recommendations of further fine-tuning regulative possibilities.

2. ORDOLIBERAL PARADIGM: REMARKS TO TERMINOLOGY AND METHODOLOGY

As the economic system is a complex bundle of rules a variety of theories have been developed to explain the way of how these systems are functioning. Why ordoliberalism? Economical theory consists of many different approaches to explaining the relation between the institutional stability and market development, however ordoliberalism is the theory that is an alternative theoretical explanation to institutional economics and has been highly influential in institutional reforms in certain European countries starting with West Germany (Erhard reform) in 1948.

Ordoliberalism evolved in the 1930s as a reaction to the economical and social struggles arising from the world economic crisis. The so-called “Freiburg School of Ordoliberalism” was founded by economists Walter Eucken and Leonhard Miksch and lawyers Franz Böhm and Hans Großmann-Doerth. In 1937 the journal *Ordnung der Wirtschaft* commenced to be published. The „Ordo-“ prefix originates from this title defining the approach as a differentiated concept comparing to *laissez-faire* liberalism. To other representatives belonged Alexander Rüstow, Wilhelm Röpke and particularly Alfred Müller-Armack .

One of the major methodological contributions of the Freiburg School consists in development of a unique theory of economic order. Economic order consists of all rules, norms and institutions, which create basic conditions for economic decisions and acts of the participants of economic processes. Thus the set of rules makes the living of a wide society of people possible. As Hayek (1969) is pointing out, the economic order enables to create expectations about the complex based just on knowledge of one part, which are likely to be reliable. This finding is important for understanding the nature of the order of rules. Concrete plans and acts are determined by and make sense only within a concrete economic order.

By Eucken (1990), the basic structure of the economic order is created by the so-called constitutive principles. The constitutive principles determine the art of allocation of resources and goods (in terms of market mechanism, central plan or others) and enable so the economic process to function. Complementary there is a need to optimize the economic process based on the configuration defined by the constitutive principles. This happens through a set of regulative principles.

Eucken (1990) refers to essential constitutive principles, which creates basic prerequisites for market order. These are price stability, free market, private ownership, free contracting, principle of liability and stability of economic policy.

Additionally to the constitutive principles there is a need to maintain a smooth functionality of the market system (despite of a pure laissez-faire approach). Therefore the free market is complemented by regulative principles, which are corporate policy, competition policy, correction of income distribution, regulation of externalities and of anomaly behavior of supply.

From 1948 all of these principles were incorporated in the West German institutional order. The practical implementation was given the name Social Market Economy. The name to this kind of economic order was given by Alfred Müller-Armack (1948) who contributed the most, together with Ludwig Erhard, to practical implementation of the ordoliberal concepts. On the other hand, some European countries together with the European Union itself have partly based their competition, social and monetary policy on the grounds of the Social Market Economy concept by using German laws as underlying inspiration.

3. IMPORTANCE OF INSTITUTIONAL QUALITY: EXAMPLES OF CONVERGENCE

Williamson (2000) showed that the change in formal rules is relatively easy and fast but in order for them to function smoothly it is also required to have the change in the formal application of the newly adopted rules.

The applicability is strictly related to informal rules (corruption, institutional applicability, cultural adaptability etc.), which are on the other hand subject to more gradual change. This fact has emerged as a consequence in many transitional countries that found inspiration in legislative pillars of European countries streaming to reach their level of economical, social and institutional stability in order to succeed in introducing a functioning market economy. This paper is addressing practical examples through concentrating on new limited liability companies` registration procedures in two countries: the Czech Republic and Bosnia and Herzegovina.

This example was chosen in order to provide some insides from the evolutionary ordoliberal perspective on the importance of credibility, transparency, long-term stability

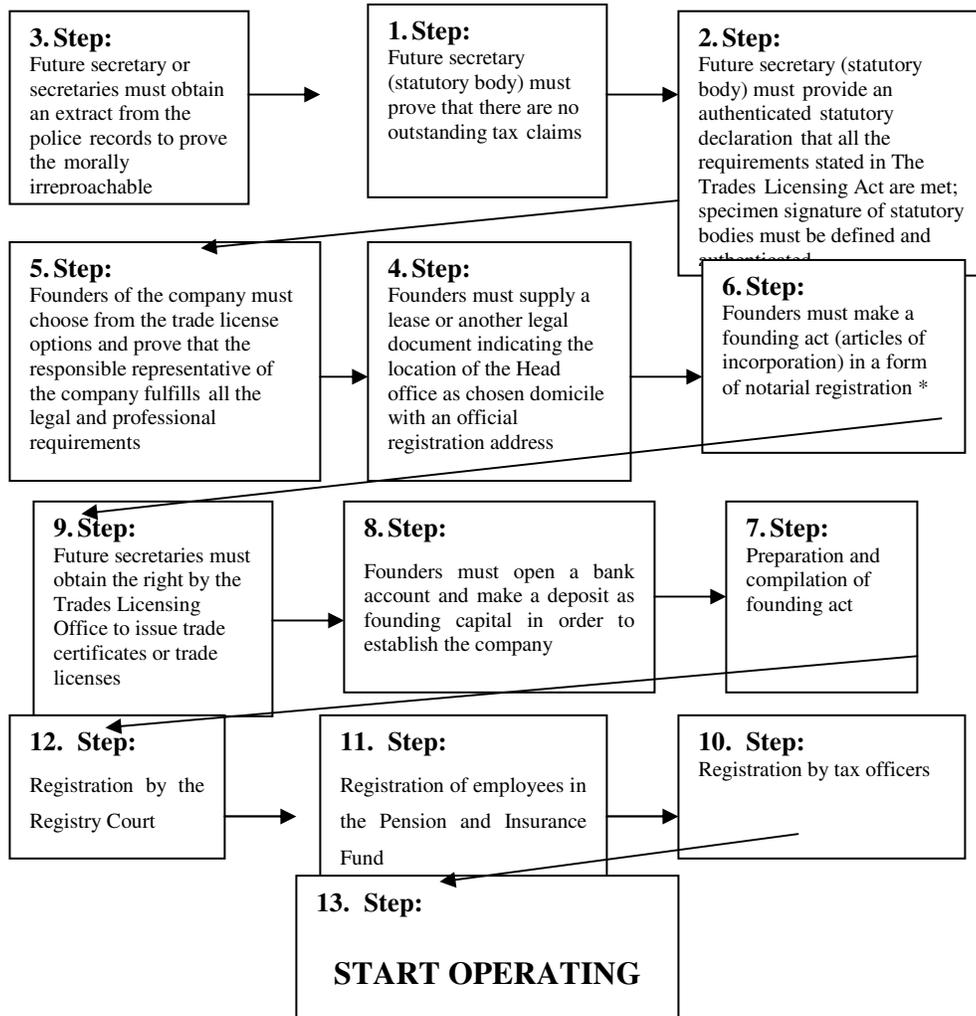
and efficiency of some basic rules, which consequently lead to better functioning and higher dynamics of the market order. This is of benefit for all the members of the society. An efficient and fast registration procedure plays a role of an “enabling technology”. First when the first step is easy to do, additional regulations such as FDI promotions will be able to show their impact efficiently.

3.1. Czech Republic - Registration Procedure

The creation of companies improved in 2005 with a updated version of the trade laws. Until 2005, the registration was connected with a regulatory burden, which made the procedure not only longer but more costly as well. For the time being after delivering all documents to the registration court, the company is considered legally personal after a five-day period. Still the time to establish a limited liability company takes approximately 1-2 months.

Until now the *on-stop-shop* mechanism still has not been introduced and is supposed to be postponed until late 2007. Since 2005 its is also possible to deliver all the necessary forms electronically to the registration court, however, all the documents have to be signed with a guaranteed signature. The paperwork should be reduced soon by an innovation enabling to all public institutions to share all the information related to registration of a company.

Figure 1 Registration procedure of limited liability company in Czech Republic



* If there is only one founder, the founding act has a form of founder's deed in a form of notarial registration. The founding act must compulsorily contain firm name, residence, definitions of companions, subject of enterprise, authorized capital amount, contributions of each companion, names and home addresses of first statutory members and the way in which the act for the company, appointment of a deposit controller. By this act the company is established

3.2. Bosnia and Herzegovina – Registration Procedure

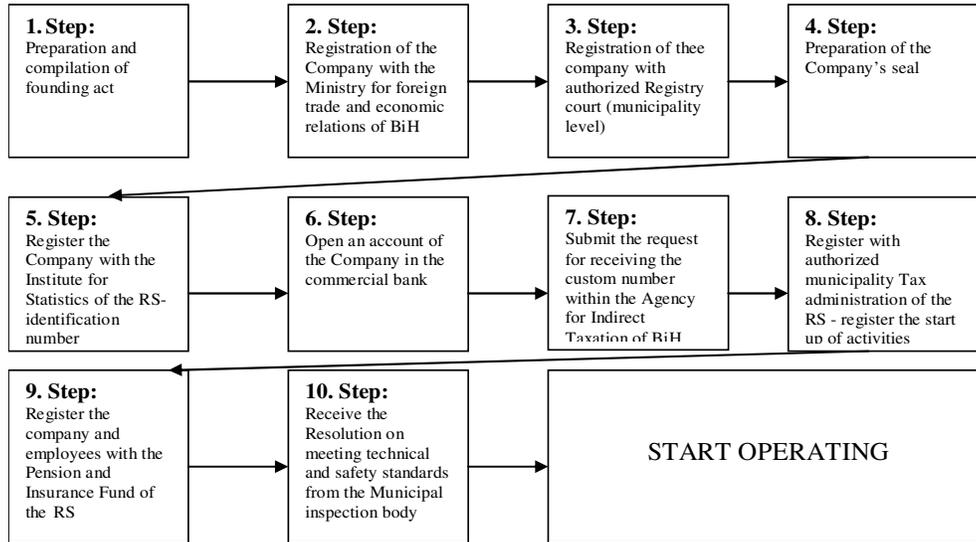
Registration procedure of establishing and registering a company in Bosnia and Herzegovina for a domestic or foreign person is not substantially different. Even though the Law on registration of companies in the Republic of Srpska and Federation of Bosnia and Herzegovina and the Law on Foreign Investments which regulates the FDI in the Bosnia and Herzegovina provides many benefits for the foreign and domestic person to establish a company in the territory of Bosnia and Herzegovina, procedure of registration makes it very complex and costly though.

Law that regulates the procedure of registering a company in Bosnia and Herzegovina is enacted on the Entity level and the procedure of establishing/registering the company is connected with the area/location on which the head office of the company is to be located (either in the territory of the Federation of Bosnia and Herzegovina or on the territory of the Republic of Srpska).

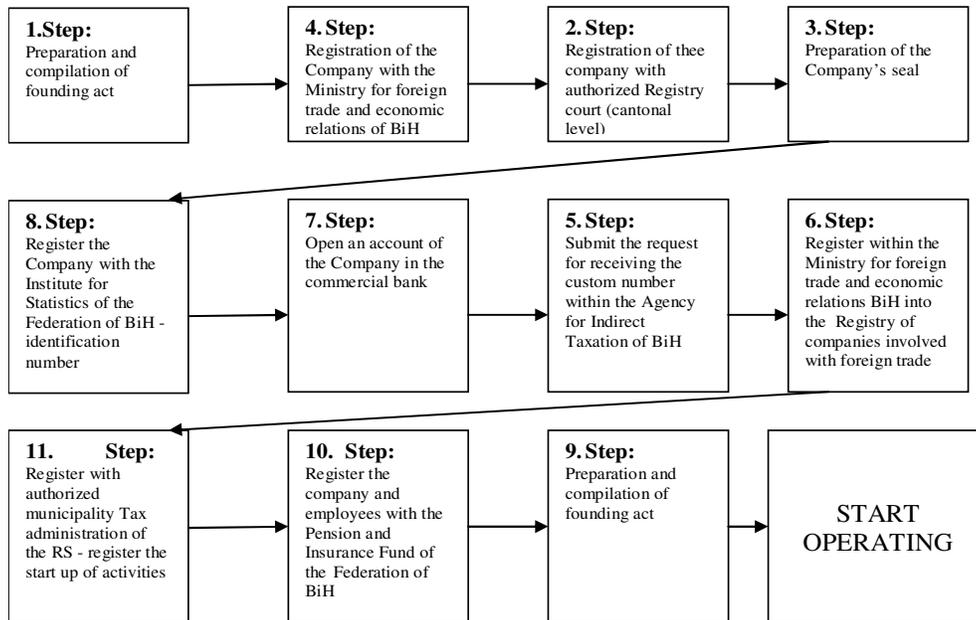
Registration procedures differ from one Entity to the other (in the Federation of BiH there are 11 steps and in the RS 10 steps of registering). This might not seem as a big difference but fulfilling of each step requires additional time, engagement of a lawyer and higher expenses. Another issue that makes the procedure complex is the different level of taxes a company pays in different entities (taxes are paid on the basis of the registration of the Head Office). For example: Company's profit tax is 30% in the Federation of BiH and 10% in the Republic of Srpska.

Registration time differs and is set to be from 15-20 days. However considering all the paperwork and different steps that need to be satisfied plus all the institutional bureaucracy it takes more than two months to establish the company in the BiH.

Registration process of limited liability company in the Republic of Srpska:



Registration process of limited liability company in the Federation of BiH



6. PROMOTING COMPETITIVE MARKET ORDER: SME INSPIRATIONS

Taking into consideration the institutional framework and requirements for registering a limited liability company in those two countries, it is obvious that the procedural aspect does not differ from country to country as much as the institutional ability to adopt to the provided framework leading to the great differences in expenditure, time and perhaps to a decision whether to set up a company or not.

In the long run there is an obvious tendency of convergence of formal institutions. The adoption of *acquis communautaire* could be another good example. However, the formal regulation will still be influenced by more general, informal rules (without codification), which evolved differently in particular countries. What are the economical and subsequently social consequences?

As ordoliberals made very clear already in the late 1930s, there is a strong link between the orders of economy and society. These two orders are interdependent (Eucken, 1990). The more complicated, time consuming and costly are the conditions for setting up a new business, the more difficult it is to maintain a high level of business dynamics and optimal functionality of the market system. The threshold for entering the market is too high for numerous private persons or even investors. This leads to conservation of status quo in terms of low market dynamism in Schumpeterian sense, higher charge for unemployment costs and at the end to lower overall performance.

Using the UK as an example where the whole incorporation procedure can be performed on-line within the time range of hours we can observe abysmal difference to the Czech Republic where the conditions for business start-ups are much more complicated in terms of administrative burden and financial costs. Bosnia and Herzegovina, even though it is the relatively poorest country in the CEE group, has the highest financial costs for a company's set up and the longest path of administrative steps. Whereas in the Czech Republic the costs for establishing a limited liability company reach at least 700 Euro, in Bosnia and Herzegovina is the minimal requirement three times higher (including lawyer's fee).

What are the major challenges the CEE countries are commonly facing? And what are the proposed recommendations for applied economic policy? In this part, let's concentrate our attention to further development and application of the basic findings.

To point out the main difference between Germany of 1950s and many of the CEE countries of 1990s until nowadays is the presence or absence of a concrete and sound, long lasting strategy in terms of economic policy (*Ordnungspolitik*). The more credible and long oriented the economic policy is, the easier it is for the entrepreneurs to create long run business plans. Thus, the resources are allocated more efficiently, there is no need to focus on short term profits characterized by lower profitability. The formal institutions should necessarily be accompanied by stable and credible economic policy. This was also one of

the main messages of ordoliberalism, which resulted later in the so-called “Eucken’s principle of stability of economic policy”.

Since the early 1990s all of the CEE countries have inspired themselves with institutions of the German Social Market Economy. Though not only the majority of CEE countries have adopted the best ordo-based practices, some of the recent European institutions show a big deal of inspiration as well. The clearest examples are the law-based independence of national banks aiming to achieve stable and credible monetary conditions, national and European regulation of competition, social policy and environmental policy. The concept of Social Market Economy as institutionalized and being performed in Western Germany until the mid 1960s is undoubtedly a highly inspiring source of economic policy experiences for CEE countries facing similar developing issues nowadays.

There is one important organization still missing in all CEE countries which importance is particularly aimed at establishing social consensus and acting as a corrective of economic policy decision making process: **independent law-based economic policy consultancy**. This regulative principle was introduced in Germany in 1963 as *Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*. I dealt with details in respect to the Czech Republic in another place (Krabec, 2004), here only the main points and generalizations should be outlined.

What are the prerequisites of an independent economic policy consultancy institution? Some basic characteristics could be identified (see Bartel, 1993) also with respect to CEE countries:

- Guaranteed independency from both assigners and addressants
- Complex analysis of the issues, not only suggestions regarding concrete recommendations
- Long-term analytic activity, not only randomly assigned research projects
- Analytical outcomes should be future oriented, providing deep insights into current situation and expected consequences
- Independence from particular interests, avoiding any kinds of explicit recommendations
- Wide publicity of the outcomes and highest possible intelligibility to the public
- Relevant economic policy bodies (ministry of finance, ministry of industry and others) should take responsibility for their acting and present their statements and explanations regarding the expertise provided by the consultancy body in the front of the Parliament

7. CONCLUSIONS

At the end one crucial fact should be explicitly stated again: the ordoliberalism based Social Market Economy as a legal and social framework promoting a free market mechanism and freedom of an individual was realized in West Germany from 1948 until the beginning of 1960s (see in details Tuchtfeldt, 1973). This period became also known as an “economic miracle” considering the exceptional growth performance lasting for almost

two decades. Social Market Economy, its institutions and organizations have provided an important source of inspiration for all CEE countries.

The codified rules of conduct in post communist countries of Central and Eastern European region, finding widely inspiration in established practices of stabilized western democracies, provide merely a *conditio sin qua non* for development of efficient and stable, competitive market order. As was shown here on a simple example of incorporation in two different CEE countries – the Czech Republic and Bosnia and Herzegovina – there is an obvious institutional convergence in formalized rules. Nevertheless **there is a need for cultivating the economic order and a possible solution consists in independent economic policy consultancy.**

Economic policy consultancy has to be institutionalized in a way that guarantees independence regarding particular interests. After more then 40 years, the German Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung has proven its justness. The first period after creation is crucial for establishing credibility and proving the necessity of having this particular kind of consultancy.

REFERENCES

- Arndt, H. (1976), *Kapitalismus, Sozialismus, Konzentration und Konkurrenz* (Second Ed.), J. C. Mohr, Tübingen.
- Bartel, R. (1993), *Wirtschaftspolitische Kontrolle und Beratung: Grundlagen, Probleme, Erfordernisse.*, Johannes Kepler Universität, Linz.
- Berghahn, V. (1985), *Unternehmer und Politik in der Bundesrepublik.*, Suhrkamp Verlag, Frankfurt/M.
- Easterly, W. (2001), *Can institutions Resolve Ethnic Conflict*. Economic Development and Cultural Change, no.49, p. 687-706 (The University of Chicago Press).
- Erhard, L. (1962), *Deutsche Wirtschaftspolitik, Der Weg der Sozialen Marktwirtschaft*. Düsseldorf – Wien – Frankfurt/M.
- Erhard, L. (1957), *Wohlstand für alle.*, ECON Verlag, Düsseldorf.
- Erhard, L., Müller-Armack, A.(1972). *Soziale Marktwirtschaft.*, Ullstein Verlag, Frankfurt/M, Berlin, Wien.
- Eucken, W. (1965), *Die Grundlagen der Nationalökonomie* (8th Ed.). Springer Verlag, Berlin – Heidelberg – New York.
- Eucken, W. (1990), *Grundsätze der Wirtschaftspolitik* (6th Ed.). J.C.B. Mohr Tübingen.
- Fasbender, K., Holthus, M., Thiel, E. (1992), *Principles and Instruments of the Social Market Economy*, Weltarchiv Verlag, Hamburg.
- Foreign Investment Promotion Agency of Bosnia and Herzegovina (2004), Handbook for foreign investments, Sarajevo.
- Grundtexte zur sozialen Marktwirtschaft (1981)*, Gustav Fischer Verlag, Stuttgart.
- Grundtexte zur sozialen Marktwirtschaft (Band 2) (1988)*, Gustav Fischer Verlag, Stuttgart.
- Hayek, F. A. (1978), *Constitution of Liberty*, University of Chicago Press, Chicago.
- Hayek, F. A. (1969), *Freiburger Studien*, Mohr-Siebeck, Tübingen.
- Hayek, F. A. (1996), *Individualism and Economic Order*, University of Chicago Press, Chicago.
- Hayek, F. A. (1994), *Právo, zákonodárství a svoboda.*, Academia, Prague,
- Jung, W. (ed.), (1991), *Social Market Economy – An Economic System for Developing Countries* (2nd Ed.), Academia Verlag, Sankt Augustin.

- Jutting, J. (2003), *Institutions and Development: A critical Review*. Paris, Organization for Economic Cooperation and Development 2003 (Working Paper No. 210) <http://www.oecd.org/dataoecd/19/63/4536968.pdf>
- Kodera, J., Olšovský, R. (1991), *Teorie a praxe hospodářské politiky v tržních ekonomikách*. VŠE, Prague.
- Krabec, T. (2003), *Ordoliberalismus a sociální tržní hospodářství*. Praha, Politická ekonomie, 2003, č. 6, s. 881–889.
- Krabec, T. (2004), *Německé zkušenosti z hospodářsko-politického poradenství*. Praha, Politická ekonomie, 2004, č. 5, s. 677–691.
- Müller-Armack, A. (1974), *Genealogie der Sozialen Marktwirtschaft*., Paul Haupt Verlag, Bern, Stuttgart.
- Müller-Armack, A. (1948), *Wirtschaftslenkung und Marktwirtschaft*, Verlag für Wirtschaft und Sozialpolitik, Hamburg.
- Müller-Armack, A. (1932), *Entwicklungsgesetze des Kapitalismus*., Junker und Dünnhaupt Verlag, Berlin.
- Schlecht, O. (1990), *Die Soziale Marktwirtschaft ist der dritte Weg*, Bundesministerium für Wirtschaft, Bonn.
- Stavenhagen, G. (1969), *Geschichte der Wirtschaftstheorie* (4th Ed.), Vandenhoeck&Ruprecht, Göttingen.
- Šulc, Z. (1990), *Jak se zrodil západoněmecký hospodářský zázrak*. Práce, Prague.
- Thieme, J. (1994), *Soziale Marktwirtschaft – Ordnungskonzeption und wirtschaftspolitische Gestaltung* (2nd Ed.), C. H. Beck, München.
- Tuchtfeldt, E. (1973), *Sozial Marktwirtschaft im Wandel*., Rombach Verlag, Freiburg im Breisgau.
- Vanberg, V. (2002), *F. A. Hayek und die Freiburger Schule*., Albert-Ludwig Universität Freiburg im Breisgau.
- Williamson, O.E. (2000), *The new Institutional Economics: Taking Stocks, Looking Ahead*, Journal of Economic Literature, 2000, np.3, p. 595-613
- World Bank (2005), *Governance Matters IV*. Washington, DC, World Bank 2005, <http://www.worldbank.org/wbi/governance/pubs/govmatters4.html>