

## **Political Economic Digest Series 32**

Dear Political Economic Digest Series Participant,

Welcome to the thirty second issue of Political Economic Digest Series. In the last issue of Political Economic Digest Series we discussed on readings on religion and economics. This issue will cover reading on The Social Dimension of Liberal Policy.

We hope you enjoy the reading.

## THE SOCIAL DIMENSION OF LIBERAL POLICY

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Liberalism is being identified – and rightly so – with policies centering on the individual, his right to freedom and his responsibility. It is emphasizing efficiency, competition, and economic progress within the framework of a market economy where the power of the state is limited to an indispensable minimum.

Such liberal policies, which appeal to self-determination and responsibility of the individual, have often been criticized for lacking a social dimension. Thoughtless contrasting of the individual and society, the market and ethics, the achievement principle and social justice, leads to the reproach of liberal indifference towards social concerns.

The misunderstanding of Liberalism’s “social coldness” can only arise among those who identify social policies with the state systems of social security. Long-standing habit then leads to the erroneous assumption of an identity of the improvement of social policy with the very expansion of the state system of social security. And when Liberals refuse to fall into the trap of such a narrow concept of social policy, they are accused of Economic Liberalism without a social dimension.

As long as the point is to lament the conspicuous absence of the Liberals on the barricades of the struggle for a further expansion of the compulsory collective systems of social security, the reproach could almost be perceived to be justified. But this approach is simply beside the point.

### **Liberal Policy is Inherently Social**

Liberalism rejects the very expansion of mandatory insurance systems, the socialization of private risks, and the nationalization of altruism. It rejects the tutelage and incapacitation of the citizen by a caring authority and the cultivation of an entitlement mentality.

Unfortunately it is often overlooked that liberal policy aims at a model of society where social questions are not primarily an addition to processes of the market, a mere corrective of market forces, limited more or less to the systems of social security.

Rather, liberal policy envisages a social and economic order which is intrinsically social. Liberal policy is inherently social not only because it aims at giving the citizens the freedom to look responsibly after their own well-being within a market economy without tutelage by the state and without discrimination. It is also inherently social because it strives for a legal and economic order determining a frame of action which ensures that what is good for the individual is generally also good for society. The social dimension of liberal policy means that the individual accepts responsibility for himself and his family according to his capacity, and it unfolds in the quality of “reciprocal effects where working for one’s own objectives at the same time enhances the objectives of the others” (Simmel).

### **Competition and the System of Rules**

These reciprocal effects are not only assured by the fact that exchange and cooperation within free markets are only taking place when they benefit all participants. Also, the legal and economic order as the foundation of the social dimension of liberal policy lays down the rules and the minimum norms, which ensure the congruence of individual actions with the common good. It is the undisputed merit of the “Ordo Liberals” of the Freiburg School around Walter Eucken and Franz Böhm to have perceived the importance of a legal and economic order for the market processes. They understood the function of the economic and competitive order, whose laws are duly to be set by society in the political process. However, institutions like the economic order need for their interpretation a lining of tradition. The ethics of the market have a decisive part in this interplay. They have been developed by the market society itself, partly found their way into legislation, and largely correspond to the ethics of the civil society.

In spite of all the lament about the decline of ethics and the controversies regarding the design of the economic and legal order, markets are by no means unbridled. Of course, they have to be kept free from excessive state interference and overregulation. Such interference and overregulation can be found in the labour and housing markets and in the state-sponsored statutory insurance systems and they produce sclerotic phenomena in economy as well as society. But markets also have to be protected from cartels, monopolies, and market domination to maintain their capacity to function as an instrument of choices, of nondiscrimination, and – last not least – of restraint of power. Normally, open markets and international competition are more effective instruments for preventing the concentration of economic power than state anti-trust policies, which nevertheless are indispensable. Here, Liberals have the social responsibility to act as guardians.

The interdependence of economic order and market behavior can perhaps best be shown by the example of sports. However important the behavior of the competitors and their game plans are for winning, the very rules of the game assure fair competition and the success of the match altogether. As long as the rules of the game are fair and are honestly respected, the moves of the individual players or the team enhance the performance of the participants and the success of the match.

In market processes as in sports the rules of the game do not exclude an even fairer behavior than requested. On the contrary, experience shows that fairness in competition beyond the rules has a positive effect on the reputation of the player. It may perhaps already signal a further development of the ethics of competition and may in the long run even lead to an adjustment of the rules of competition.

In a market economy things are very similar: if the legal and economic order corresponds to liberal requirements, the citizen who follows the laws of fair competition can assume that his actions are socially valuable, and benefit society even though he is pursuing his own interests (in a wider sense). An essential part of the ethical and social dimension of liberal policy is already contained in the legal and economic order, which influences the citizens' actions. Comparable to sports, the conditions of the system of rules to a large extent shape the structure of incentives for actions in politics as well as in the economy. And competition in sports as well as in society and the economy takes into account the system of rules and incentives. This by no means excludes that customs and civic ethics make stricter

demands on social behavior than those inherent in the rules of the ordering framework - the ethical minimum so to speak. On the contrary, with the level of prosperity the expectations of social behaviour grow along with other demands. And of course liberal policy envisages responsible individuals creatively and voluntarily engaged in the small communities of the civil society as well as in the larger arena of the state. One of the very aims of liberal policy is to strengthen the citizen's acceptance of this responsibility by granting greater autonomy.

Consequently, the social dimension of liberal policy is not to be found primarily in the repair shop of the social process where the social policies of the government are supposed to correct the results of competition and the market forces. To reduce the social dimension to this kind of repair shop, and presuppose a contradiction of social concerns and market policies, is a widely held basic misunderstanding. It gets intensified by most one-sided quotations of examples of so-called "market failures", which serve as an excuse to again call for state intervention, usually without considering the much more serious "failures of the state". The social dimension of Liberalism does not so much mean post facto repairs, but it is first of all inherent in the model of society itself, in its legal and economic order, which guarantees the right to property, and channels competition by rules aiming at the common good.

Liberal policy proves its social efficacy first of all via the markets, via market-oriented policies, and the application of incentives, which are part of the economic order. They are contained in a legal and economic order which reflects the social and ethical concerns of society in the sense of a minimal code. An assumed contradiction between market economics and social policies does not do justice to liberal policy, what is more, it ignores the essential elements of its social efficacy.

### **The Social Function of Markets**

The freedom of the citizen is the essential concern of liberal policy. Freedom constrains the powers of government and society vis-à-vis the individual. Freedom, of course, also means responsibility of the individual for the consequences of his actions for himself, his family as well as society.

It is, however, not just a question of "freedom from...", i.e. of the maximum freedom from state coercion and corporative tutelage, which is of course an important freedom. But it is also a matter of "freedom for". And here the essential element is the freedom of choice, the freedom of every single citizen to organise his life according to his preference and in his own responsibility within the framework of the legal and economic order, taking into consideration the freedom of others as well as accepting their competition.

To achieve this, alternatives are needed; for participation in the public sphere, of course, political alternatives are required. However, Liberalism is concerned not only with the freedom of choice at the ballot box and the expansion of plebiscitary elements but also with the freedom of choice in organising one's personal life. Freedom of choice should not be understood as restricted to its economic dimension, its value must be understood in a comprehensive way.

To guarantee this freedom of choice, to offer a multitude of alternatives, the market, market economic policy, is an indispensable, a social, albeit often misunderstood, instrument. Market economic policy is based on a fundamental guarantee of property and on free markets within the framework of a legal and economic order. Free Markets allow a free exchange of goods and services, free competition, and free co-operation. These are also the pillars of a liberal society. A liberal society requires the existence of markets where – within the legal framework – there is free exchange, but also competition as an incentive as well as a limitation of economic power. Last not least it requires free co-operation, the importance of which for a free market system is often overlooked and not sufficiently appreciated.

One must also not underestimate the importance of free exchange. In the market process and via market prices a central problem for economic progress, the information problem (on preferences and economic scarcity), is being solved. As the unsuccessful experiments of centrally planned economies show, the information problem can only be solved in a decentralized manner. With decentralization and through market economic incentives as well as the competitive process, which is at the same time a process of discovery, liberal policy achieves a high degree of efficiency and technical as well as economic progress. These policies generate an astonishing growth of wealth, particularly in industrial countries (but not only there). Strangely, its extent often goes unnoticed, particularly as large parts of it are consumed in an increase in leisure time and a reduction of the working life span. Last not least wealth has contributed to the remarkable rise of life expectancy. It is this increase in wealth in a wider sense which constitutes an important part of the social dimension of liberal policy.

The function of market-economic policy is often misunderstood since the concept of the market is being limited to the markets of consumer goods and because this policy is often seen as mere satisfaction of material needs. This overlooks the fact that services like concerts, theatres, exhibitions, lectures, and more are also subject to market transactions, hence cultural conceit vis-à-vis the market is a sign of ignorance rather than of moral superiority.

It is frequently overlooked that important decisions in life relate to markets. Choices at the labour, housing, education, and financial markets show how important these markets are for the autonomy of the individual and that there is no reason for prejudices against liberal policy, which trusts in the market.

### **The Example of the Labour Market**

Chronically high unemployment in Germany demonstrates what happens if the play of the market forces is not allowed and the market is overregulated. Involuntary unemployment is a social fate reaching far beyond questions of wages and salaries because it harms the social status and the self-esteem of the victims. It is here that the social dimension of liberal policy becomes especially evident, a policy which aims at the creation of a functioning labour market and by this at the reduction of unemployment. It does this by market economic means, namely by deregulation and improved flexibility, measures which have proven to be feasible in other countries. A liberal labour market policy would, among other measures, have to guarantee the individual's right to accept work at market conditions if offered (in hardship cases with payment of income supplements). A liberal labour market policy is social for three reasons:

Firstly, it can prevent that union and management – within the present state-supported constitution of the labour market – reach agreements at the expense of third parties, namely the unemployed and the taxpayers.

Secondly, this policy makes it more difficult for shirkers to evade their responsibility to support themselves and their families at the cost of society.

But thirdly, the most important aspect is that improving the flexibility of the legislation pertaining to the labour market would make a decisive contribution to the reduction of unemployment. Unemployment, given its socially negative side effects, is absolutely the most unsocial feature our society affords, in spite of claims that the relevant labour and labour market legislation is “social”. This clearly shows that liberal policy is often much more social than the mere expansion of the conventional, partly protectionist social legislation and the policies of social security.

### **Subsidiarity**

Liberal policy first of all secures and challenges the freedom of the citizens by facilitating and encouraging autonomous decisions with personal responsibility. Freedom, independence, and personal responsibility, the development and measuring of strength in competition as well as in free co-operation in the market, are core values of a specific liberal image of man. These values are closely linked to an important principle of social organisation, the principle of subsidiarity, which is often quoted but rarely taken as seriously as it deserves . It is a fundamental liberal principle, yet its importance is sometimes underestimated even by Liberals. Interestingly, the principle of subsidiarity has been formulated stringently in the encyclical “Quadragesimo Anno” (1931) where it is quoted as “the highest socio-philosophical principle” . It says in the language of this encyclical: “Just as it is gravely wrong to take from individuals what they can accomplish by their own initiative and give it to the community, so also it is an injustice and at the same time a grave evil and disturbance of right order to assign to a greater and higher association what lesser and subordinate organisations can do“

### **Free Markets, Economic Dynamics, and Scope for Genuine Solidarity**

The existence of free markets and a market-oriented policy are essential safeguards of freedom and co-operation without dominance. Free markets are of fundamental value for the individual, for his independence and the organisation of his life, and this irrespective of the arguments in favour of a free market economic order relating to efficiency and growth. As history has shown, free markets are the basis of a democratic society because of their fundamental importance for the freedom of choice and particularly because of the interdependence of orders (Walter Eucken), and therefore they constitute the core of liberal policy.

Liberal policy with its emphasis on and defence of the market economic system also contributes to the dynamics of the economy and hence to the well-being and affluence of society. A freedom-based economic order with a system of free markets not only facilitates autonomous decision making. By its incentive mechanisms this order also activates the productive forces as well as the striving for

excellence. And it creates scope for genuine (not enforced) solidarity through private charities, but also for public assistance to the really needy.

### **Markets and Equal Treatment**

An important feature of the markets is that in principle they guarantee equal treatment of the citizens and hence also their non-discrimination. Equal treatment is an integral part of the social dimension of liberal policy.

At markets, the point at issue is not (private) altruism towards the family, which goes without saying. Neither should market behaviour be a question of cohesion, camaraderie, or cliquishness vis-à-vis small groups, associations, and parties (in short of crony capitalism or corporatism). Free Markets mean equality of opportunity, which is a core value of liberal policies, not equality of results (different matters will surely be treated differently). They mean non-discrimination also of foreigners, but they also mean competition.<sup>10</sup> This equal treatment of the near ones and the far ones, this non-discrimination often earns markets and liberal market protagonists the reproach of “social coldness”. But non-discrimination is an essential element of social policies and the “good society”. Markets obviously economise on altruism – a very rare good – so that it can come into its rightful place at the appropriate occasion (Hayek).

### **Selfishness, Altruism, and Social Justice**

Often market choices have been contrasted to political choices to show that choices at the markets are guided by selfish, but political choices by altruistic concerns. However, one needs to consider that market choices are generally paid for by the individual with his own means whereas in political choices the individual can legitimately take care that he is the beneficiary himself. If the citizen votes for social measures benefiting others, he can at least hope not to contribute his full share or even nothing to their financing. For good reasons elections have been compared with auctions (Roland Vaubel) as they are often about the distribution of social benefits. Seen from this point of view, market decisions appear in a different, more social light, and the common argument that political choices as opposed to market decisions are more strongly influenced by altruism seems doubtful. And it becomes more easily understandable why liberal policies rely in many ways on the system of markets and market decisions.

Also in another context liberal policy relies on the processes of market competition: in the much debated question of “social justice”. Given differing interests, it is rarely possible to reach consensus as to when a distribution result can be considered just. Hence Friedrich von Hayek - who denies the term “social justice” any content - suggests to aim at “justice of procedure” rather than “justice of results”<sup>11</sup>. Following this proposition, liberal policy prefers – analogous to competition in sports - competition in the markets within the framework of rules set by the legal and economic order. And liberal policy also strives for the improvement of these rules and, of course, also for corrections of the results for those who cannot participate in this competition, partially or not at all.

By increasing affluence, by constraining the role of the state, and by generous fiscal rules Liberalism wants to create financial scope for private provisions as well as for private charities and government

assistance for the truly needy. Liberal policy wants to encourage a mind-set of private philanthropy as it exists in other countries under more favourable legal conditions<sup>12</sup>. To perceive as “social” only aspects concerning the demands of the individual on the collective is the result of breeding an entitlement mentality thanks to the provision of complete security benefits by the state. These benefits due to their system and due to their exploitation could well turn out to be either insufficient or impossible to finance.

### **Economic Progress**

Free Market Policy trusts in economic dynamism generated by a combination of individual initiatives and suitable incentive systems. Free trade with goods and services and free movement of capital facilitate the world-wide division of labour, and serve the “wealth of nations”. Economic growth and the increase in wealth – national and international – are of central importance for the social dimension of liberal policy. This even more so as economic growth has the tendency to accelerate, and depends increasingly more on knowledge and research than on raw materials and industrial production. This facilitates the efforts at sustainability of economic activities. But also the social dimension of one of the main focuses of liberal policy – the promotion of knowledge and education – gains in importance; and for the individual it opens chances to apply his personal talents.

The acceleration of economic growth is not without problems. Growth always means structural change, and increases not only chances but also risks. It demands flexibility and willingness to adapt, and it strains social cohesion. Knowledge and capital become obsolete more rapidly, and social differentiation may grow. All this is not without dangers for liberal ideas. It may intensify the call for the state and for equality (not of opportunities but of results), and generate opposition against the very conditions which favor economic progress. Much of this derives from resistance to change, from lack of education and flexibility. But it may also result from misconceptions about the conditions of wealth and economic growth as well as the role of the state; misconceptions which, however, cannot easily be removed.

### **Globalization and Liberal Policy**

If we talk of social policy, strangely enough, we mainly think of domestic problems. Even the social deliberations of those who desire a multicultural society get stuck in domestic reflections, at least when the political discussion transcends the payment of development aid. This, too, may be a consequence of the sole focus on the systems of social security – which are in many ways not social at all – that contributed in a large measure to wrongly viewing the social aspects of a society’s order in a very narrow perspective.

The discussion about the world economic order and globalization offers a lesson on the social component of liberal policy. Here, too, the social dimension of liberal policy does not primarily consist of paying development aid. Beyond the development of cultural relations and economic and technical co-operation, liberal policy creates free markets for trade, investment, and services. It stands for free access to the markets of the industrial countries also for suppliers from developing countries so that everybody who so desires can participate in the worldwide division of labour without discrimination.

With a narrow view on the home market, globalization is often perceived as a danger for the unskilled labourers. They now have to face the pressures of competition from so-called low wage countries, that is from workers in the Third World and in the reforming states of Eastern Europe ( "Hong Kong at the doorstep"). Jobs for unskilled workers in the industrial countries are indeed endangered without the necessary structural adjustments, which essentially consist of better training and lifelong learning, but also of spreading the wages and incomes scales.

On the other hand globalization offers equality of chances to the much poorer workers in developing countries. It becomes possible for them to participate in the advantages of the division of labour, and thus earn their income or raise their standard of living.

Another result of the expansion of the international division of labour - called globalization – is that the participating states and their policies increasingly get checked by locational competition. Due to this competition they lose part of their power over their citizens, and state interventionism is forced back. It becomes more difficult to further reduce the disposable income of the citizens by taxes and contributions to various social services as long as the benefits derived are not considered to be sufficient. Similar consequences will be felt by corporate associations which draw their power from market protection. Not everybody will welcome the limitation of the power of the state, particularly not those who nurse high expectations from state intervention, and concede a strong role to the state.

But in principle locational competition leads – fully in harmony with liberal principles – to another expansion of choices for the citizens. And it pushes back the power of the regulating and taxing state and its intermediary fiscal authorities, and concomitantly improves the conditions of competition worldwide.

### **The Danger of Protectionism**

The temptation, however, is strong not to accept the claims of the social principle, to define the collective of beneficiaries - "us" - very narrowly, and to protect oneself from undesirable competition "from outside". In this context it is easy to approve of social benefits in the form of development aid, particularly when paid for by others, but to refuse the free access to markets and free competition by painting horror scenarios of globalization.

In international economic relations there are many ways to prevent competition. Not all of them will easily be recognized as protectionist. This is true for free-trade coalitions in the form of a customs union (or more). Within such formations, as is well known, there exists not only trade creation but also trade diversion, the latter to the disadvantage of the non-members and to the advantage of the members. This is an offence against the most favored nation principle of the World Trade Organisation (WTO), which stipulates that all advantages conceded to one trading nation have to be given to all others.

Even more dangerous elements of discrimination (and of protectionism) are standards which on the surface sail under the "social" flag, but are often used as instruments of protectionism by being forced on the trading partners. They are so dangerous because they appear to be socially beneficial, as social or environmental standards for instance, but as standards forced on trading partners they can often be

socially most harmful. How can workers from Bangladesh be competitive if they have to conform to the social legislation standards of industrial nations? At home and abroad it is not necessarily socially responsible to improve the lives of those who are employed, but it is social to give a chance to the unemployed. Or: should and could a more affluent country not afford stricter standards of environmental protection than a poorer one? Is it social to prevent workers from less developed member countries of the European Union by wage regulation from competing by means of lower wages with those in the more advanced member states?

Contrary to all these attempts to defend one's own privileges against the poor by a dubious policy of social justice, to prevent or at least obstruct their access to the markets, a liberal policy of world trade with its central rules of non-discrimination and most favoured nation treatment presents a vigorous social profile. And this without taking recourse to development aid, which, however, – like social security at home – should not be excluded.

### **Liberal Policy and Social Policies**

We have to avoid a misunderstanding: we are here discussing the social dimension of liberal policy and not the liberal views on social security as for instance practiced in contemporary Germany. If we were talking about liberal social politics in this narrow sense, we would have to discuss the consequences of liberal principles applied to the security systems against the economic hazards of risks like illness, old age, disability, geriatric care, and unemployment.

One would have to debate whether the redistribution of the individual's life income forced on the citizen by the state, whether the incapacitation of the citizen by state statutory insurance systems against the economic risks in life are compatible with liberal principles. And particularly one needs to ask the question: given the considerable increase in wealth, are such statutory insurance systems still as appropriate as they might have been at the time of their introduction? Furthermore, one would have to ask: are these systems with their pay-as-you-go practice still operational in view of the shrinking population, and do they guarantee a minimum of interpersonal and especially intergenerational justice? In short, one would have to discuss how – from a liberal point of view – the citizens should nowadays make provisions against these and other risks of life. Obviously such a discussion, for instance regarding old age insurance, would lead to proposals strongly emphasising autonomy and individual private insurance based on the funding principle, possibly with a minimum insurance stipulated by legislation as it exists in the insurance against third-party risk for car owners to avoid moral hazards<sup>15</sup>. Similarly, in respect to protection from economic risks of illness ('health insurance') there would be proposals which more strongly stress the freedom of choice and private insurance with different forms of refunding and retention. Here, too, one could consider a mandatory minimum insurance as a concession to society because of the ubiquitous moral hazard.

It is important to recognize that liberal policy like the traditional social security policies is concerned with the protection of the individual against the economic risks of life. The social dimension of Liberalism means to appeal first of all to the individual and his responsibility, not to immediately establish claims on society, thereby allowing within certain limits the freedom of choice. Liberal policies

of protection against risks derive their specifically social dimensions from trying to prevent contracts at the expense of third parties as they are commonly the result of negotiations on the state systems of social security. The most telling example is the old age insurance where the negotiating parties often have reached agreements at the expense of the taxpayer and the next generations with the catchwords of solidarity and “intergenerational contract”.

In spite of the liberal criticism of the existing systems it has to be made clear that liberal policy must not lose sight of responsibilities towards the really needy. The fact that liberal policy is based more on the general increase in wealth, on private initiative, communities, and networks does not mean that one is not willing to provide the necessary funds for those in need. On the contrary, to strive for economic progress, to try to avoid windfall gains, and to concentrate social welfare on those really in need, means that they can be effectively helped.

### **Freedom and Responsibility within the Community**

Liberal policy has per se an important social dimension. It is based on a model of society which is intrinsically social, and safeguards the freedom of the individual to fulfil his life plan in the civil society. He should be able to do so autonomously, in his own responsibility, and as far as possible free from intervention by the state – in competition as well as in cooperation with others. This, of course, in a legal and economic order which should guarantee that the competitive behaviour of the individual does not solely benefit him or his communities in the civil society, but society in general, and that competition is fair in the sense of procedural justice. And liberal policy relies on economic dynamism unleashed by such a system. It also relies on the education of the citizens as a value per se and on the techno-economic progress and the increase in wealth that follows from it. To achieve this, a system of free markets is indispensable which permits the free exchange of goods, services, and capital also beyond national borders. Also indispensable are free market policies, which guarantee the necessary openness and functioning of the markets and the restriction of market power. The constraint of market power is one of the assignments of the state. The state should be cut back to its genuine tasks (like for instance internal and external security), which then should really be taken seriously.

The attempt at measuring the social content of liberal policy by the traditional social policies or even by increases in the state statutory insurance systems is misleading. Liberal policy has a social dimension, which by far transcends social policies in a narrow sense because this dimension is contained in the liberal blueprint of society itself.

In social security policies the principles of Liberalism lead to relying more strongly on the freedom and responsibility of the individual, who should decide on the protection against the economic risks of life for himself and his family within a wide range of choices, a method where the funding principle and differentiation of insurance tariffs would automatically gain in weight. At the same time windfall gains will be prevented so that the available means can be concentrated on the assistance to the genuinely needy.

In its market economic policies, Liberalism believes in a legal and economic order based on the principles of freedom and in the protection of property. It believes in market ethics, which have developed in the course of history, in the responsibility and self-interest of the citizens as well as in the dynamics of competition. Liberalism defends and maintains the freedom of the citizen from state tutelage and the power of corporate associations. However, together with the freedom granted to the individual citizen liberal policy not only burdens him with the responsibility for himself and his family, but also with responsibility for active co-operation in small communities and in the civil society. Liberal policy is a far cry from the misconception of a “wrong individualism” (Hayek), which nearly totally isolates the individual from sharing responsibility in the creative shaping of society.

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