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Veröffentlichungsversion / Published Version  
Zeitschriftenartikel / journal article

**Empfohlene Zitierung / Suggested Citation:**

Vanberg, V. J. (2013). Ordnungspolitik, the Freiburg School and the Reason of Rules. *Annals of the University of Bucharest / Political science series*, 15(1), 23-36. <https://nbn-resolving.org/urn:nbn:de:0168-ssoar-390042>

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## **ORDNUNGSPOLITIK, THE FREIBURG SCHOOL AND THE REASON OF RULES\***

**VIKTOR J. VANBERG**

### *Abstract*

Professor Vanberg received the title of *Professor Honoris Causa* of the University of Bucharest for his contribution to the development of the German school of economics. On this occasion, he made a brief presentation of the origins and development of the German Ordoliberalism and its impact. He further developed on how the Freiburg School reflected upon the legal instruments needed for the creation of an economic constitution.

**Keywords:** Freiburg School, rule of law, *Ordnungspolitik*, classical economy.

In the on-going debate on how to cope with the current financial and sovereign debt crisis in Europe the German position with its insistence on binding rules is met by many of our partners – in particular in southern Europe – with suspicion and resentment. As the American-German historian Volker Berghahn has observed in a most recent paper: “In this debate on the best solution to the EU crisis, many Keynesian economists, European leaders, and the international press have vociferously criticized... Germany’s rule-based legal approach to ensure fiscal discipline..., its defence of the independence of the Central European Bank ... (and) its strict adherence to price stability”<sup>1</sup>.

Even though the controversy on – what Berghahn describes as the German “rule-based conception of political economy” – provides the motivation for what I want to talk about today, my purpose is not to comment on the particular arguments that dominate the current debate. Instead, I want to take a closer look at the concept of *Ordnungspolitik*, a concept that has become the established label describing the German position. “Ordnungspolitik” denotes an

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\* Viktor J. Vanberg (14 May 2013). *Ordnungspolitik, The Freiburg School and the reason of rules*. Speech presented at the Award Ceremony for the Conferral of the Honorary Title of *Professor Honoris Causa* by the University of Bucharest.

<sup>1</sup> Volker Berghahn, Brigitte Young, “Reflections on Werner Bonefeld’s ‘Freedom and the Strong State: On German Ordoliberalism’ and the Continuing Importance of the Ideas of Ordoliberalism to Understand Germany’s (Contested) Role in Resolving the Euro Zone Crisis”, in *New Political Economy*, 2013, p. 11 (forthcoming, cited from typescript).

outlook at politics that, as Berghahn comments, is “shared by most of the German political parties... (and) is also endorsed by most of the economic profession, domestic media, and the large public”<sup>2</sup>. It appears, however, to be a concept that is difficult to appreciate for observers outside of Germany.

It is significant that the difficulty of explaining the concept of *Ordnungspolitik* in English – or, for that matter, in French, Italian, Spanish or any other language – begins with the fact that there exists no equivalent term into which it could be readily translated. In essence, as already suggested, it means that political efforts to “steer” the economy should primarily concentrate on providing and enforcing a suitable institutional-legal framework for a desirable socio-economic “Ordnung,” a term that, like the English term “order” derives from Latin word “ordo.”

What I hope to achieve with my talk is to convey a better understanding of the *rule-oriented* or “*Ordnungspolitik*”-approach that has informed and continues to inform – even if its precepts are not always faithfully honoured – German economic policy. I shall develop my argument in two parts, a history of ideas part and a systematic part. First, I will talk about the origins of the concept of *Ordnungspolitik* and about the research tradition that is associated with my home university, the University of Freiburg. In the second part of my talk I will discuss, under the heading “The Reason of Rules,” the systematic rationale that lends support to the *rule-based* concept of politics that Germany insists on in Europe’s search for a solution to the current crisis.

The research tradition within which the concept of *Ordnungspolitik* has been systematically developed and elaborated is called the *Freiburg School* or the *Ordo-liberal School*. The school was founded in the early 1930s by economists and jurists, in particular the economist Walter Eucken (1891-1950) and the jurist Franz Böhm (1895-1977), for whom Freiburg University’s Faculty of Law and Economics (“Fakultät für Rechts- und Staatswissenschaften”) provided a most conducive framework within which the combination of legal and economic perspectives could flourish that is characteristic of the Freiburg School tradition. As Böhm later said in retrospect, the founders of the school were united in their common concern for the question of the constitutional foundations of a free economy and society.

The ordo-liberalism of the Freiburg School starts from the premise that the market order is a *constitutional* order, that it is defined by its institutional framework and, as such, subject to (explicit or implicit) *constitutional choice*. It assumes that the working properties of market processes depend on the nature of the legal-institutional frameworks within which they take place, and that the issue of which rules are and which are not desirable elements of such frameworks ought to be judged as a constitutional issue, i.e. in terms of the

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<sup>2</sup> *Ibid.*, p. 12.

relative desirability of relevant constitutional alternatives. After the Second World War the teaching of the Freiburg School came to play a critical role as it became a major part of the theoretical foundations on which the creation of the *Social Market Economy* in post-war Germany was based. Ludwig Erhardt who, as West Germany's first economic minister and later chancellor, orchestrated the post-war economic and monetary reforms was very much influenced by the Freiburg tradition and relied on its advocates as advisors.

Eucken developed his approach in explicit contrast to the research program that Gustav Schmoller, the head of the German Historical School had propagated and that exerted its continuing influence on economic thought and economic policy in Germany. With his 1932 article "Structural changes of the state and the crisis of capitalism" ("Staatliche Strukturwandlungen und die Krise des Kapitalismus") and with his two major works, the *Foundations of Economics* (*Grundlagen der Nationalökonomie*, 1939 [1939]) and the *Principles of Economic Policy* (*Grundsätze der Wirtschaftspolitik*, 1952 [1952]), he wanted to provide an alternative to the Historical School's theoretical approach to economic analysis as well as to its unprincipled discretionary approach to economic policy. His aim was to develop a systematically integrated approach to the theoretical study and the political shaping of a constitutional social-economic-political order, or – to use the German terminology – a systematic approach to *Ordnungstheorie* and *Ordnungspolitik*.

As the term *Ordnung* (order) is *the* central concept in the research program of the Freiburg school, it is important to note that, in the context of that program, it is systematically related to the concept of the *economic constitution*, in the sense of the *rules of the game*, upon which economies or economic systems are based. As Eucken insists, since all economic activities inevitably take place within some historically evolved framework of rules and institutions, the research-guiding question must be: "What are the rules of the game?" Economic orders, this is the main message, must be understood in terms of the underlying *economic constitutions*, which not only includes the formal legal-institutional framework but also informal conventions and traditions that govern economic activities in the respective communities.

The founders of the Freiburg school emphasised that the principal means by which economic policy can seek to improve 'the economy' is by improving the institutional framework within which economic activities take place or, as they called it, the *economic constitution*. What motivated their work was an interest in applying theoretical insights from law and economics to the practical problem "of understanding and fashioning the legal instruments for an economic constitution", a concern that they saw as part of the broader project of inquiring into the constitutional foundations of a functional and humane socio-economic-political order.

Eucken and Böhm emphasised that their interest was not in developing a research program as a purely academic enterprise, but in seeking for answers to the practical question of how a desirable economic order may be created and maintained, a question that they approached as a problem of *constitutional choice*, i.e. as a question of how a desirable economic order can be generated by creating an appropriate economic constitution. The joint efforts of law and economics were to them an indispensable prerequisite for what they called “constitutional economic policy” (“Wirtschaftsverfassungspolitik”), a policy that seeks to improve the resulting economic order in an *indirect* manner, by reforming the rules of the game, by contrast to an economic policy that seeks to improve outcomes *directly* by way of specific interventions into the economic process. The general aim that, in their view, such constitutional economic policy had to pursue was to create conditions under which economic actors in seeking to further their own interest also promote the common interest. In other terms, they considered it the task of *Wirtschaftsverfassungspolitik* to *create* conditions under which the “invisible hand” that Adam Smith had described can be expected to do its work.

In the sense noted, the research program of the Freiburg school can be said to comprise a *theoretical paradigm* as well as a *policy paradigm*. The theoretical paradigm is based on the premise that an adequate analysis and explanation of economic phenomena ought to account for the nature of the constitutional framework, or the rules of the game, under which they occur. The *policy paradigm* is based on the premise that economic policy should seek to improve the framework of rules, the economic constitution, such that a well-functioning and desirable economic order results, rather than seeking to bring about desired outcomes directly by specific interventions into the economic process. *Ordnungstheorie* is the name for the explanatory part of the Freiburg research program, the paradigm of systematically studying the working properties of alternative institutional-constitutional arrangements, and the complex interdependencies between various components (company law, patent law, tax laws, labor law etc.) of a nation's economic constitution. *Ordnungspolitik* is the name for its policy paradigm, for an integrated approach to the various components of the legal-institutional framework in which a market economy is embedded.

While the founders of the Freiburg School placed themselves firmly in the tradition of classical liberalism, they emphasised, in contrast to some varieties of liberalism, that a free-market order is not simply what one would find if and where government is absent, that it is not a natural event but a political-cultural product, based on a constitutional order that requires careful 'cultivation' for its maintenance and proper functioning. In this regard they found it necessary to distance themselves from a *laissez-faire liberalism* that failed to appreciate the essential positive role that government has to play in creating and maintaining an appropriate framework of rules and institutions that allows market

competition to work effectively. The Freiburg ordoliberals made it clear that the desirable working properties that the classical liberals attributed to market competition can not be expected from any unqualified competitive process per se, but requires the creation and maintainance of an appropriate framework of “rules of the game of *Leistungswettbewerb*”, a competition in which performance is measured in terms of better service to consumers. And to create conditions conducive to such *Leistungswettbewerb* is, in their view, a genuine and indispensable political task, a task for *Ordnungspolitik*. This task they likened to the activities of a gardener who does not construct things, like an engineer, but provides for conditions that are conducive to the natural growth of what is considered desirable, while holding back the growth of what is not desired. As Franz Böhm put it, to maintain a well-functioning market economy requires a continuous nursing and gardening, comparable to creating and maintaining a highly cultivated park.

While the founders of the Freiburg School mostly focused on the threat that “private economic power” poses to a properly working competitive market order, they ignored by no means the fact that the deeper roots of anti-competitive contrivances must be sought much more in the political than in the private arena per se. In fact, most central to the research program that they initiated, and very much in line with modern political economy, is what the Freiburg ordoliberals had to say about a problem that they described as “*refeudalisation*”, and that in contemporary economics is discussed as the problem of *rentseeking*. The ordoliberals saw the essential feature of the competitive market order in the fact that it is a privilege-free, non-discriminating constitutional order within which economic actors meet as legal equals, and they regarded as the essential liberal principle that “the state should on no account be allowed to confer privileges”.<sup>3</sup> Accordingly, they regarded the granting of special privileges, in whatever form, as a violation of the very principles on which a competitive market order is built, as a violation of the fundamental constitutional commitment that is implied in opting for the market order and the privilege-free civil law society. In no lesser clarity than modern public-choice contributions on the problem of rentseeking, the Freiburg ordoliberals described the fatal political dynamics that inevitably unfolds where governments and legislators are empowered to grant privileges and where, in consequence, interest groups seek to obtain such privileges. Such a government is, as Böhm phrased it, “constantly faced with a considerable temptation to meet the contradictory demands of many pressure groups. ... The fact that this tendency is, as it were, in the nature of things makes it a weakness of the system which must be taken seriously”.<sup>4</sup> While, so Böhm argued, it is in citizens’ *common* interest that legislator and government create

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<sup>3</sup> Böhm 1989, p. 57; 1980, p. 141.

<sup>4</sup> Böhm 1989, p. 66; 1980, p. 166.

and maintain a framework of rules which provides for a well functioning market order, their *separate* interests may well work in the opposite direction. As he puts it, “it is possible for any participant and for any group of participants to obtain benefits by violating the rules,.... at the expense of other participants or groups of participants”,<sup>5</sup> be it by explicit rule violations such as the forming of cartels, be it by lobbying for special privileges. The latter strategy is, as Böhm pointed out, particularly attractive because “in this case, the individual does not expose himself to the odium of cheating but demands are made of the legislator or the government to elevate cheating to a... governmental programme... Protective duties, tax privileges, direct subsidies, price supports, initial support for establishing monopoly or 'orderly markets' can be demanded. ... It is the state itself which is to be enjoined to override the rules of the prevailing order in favor of one group and at the expense of other groups or citizens<sup>6</sup>.”

The insight into the conflict between citizens' common interests in a functioning market order and their countervailing special interests provides the logic behind the ordoliberal's diagnosis that the competitive market order is not self-generating and self-maintaining but needs the assistance of *Ordnungspolitik*. In assigning to the state the task of acting as “guardian of the competitive order”, as “Hüter der Wettbewerbsordnung”, the Freiburg ordoliberals found themselves facing a fundamental dilemma. The logic of their argument implied that the solution to the problem of guarding the competitive order had to come from an agency, the government, that they recognised, at the same time, to be a major source of the defects that it was supposed to cure. They did by no means naively expect an unqualified ‘state’ to act in the common interest but, instead, explicitly criticised as illusionary the belief that government per se can be trusted to act as a benign and omniscient agent of the common good. They insisted that – just as the economic order needs ‘cultivation’ – the political order as it exists must not be taken as an unalterable fate, but should be regarded as something that can be and must be reformed. And they were fully aware of the fact that the real challenge is, in the political realm no less than in the economy, to establish a framework that induces ordinary, self-interested people to do, in pursuit of their own interest, what is in the common interest of all. In other words, they recognised that the solution to the problem of rentseeking must ultimately be found in the political constitution. They saw that, in order for the state to act as reliable guardian of the competitive economic constitution, the constitutional order of ‘the state,’ or the rules of the game of politics, must be reformed in a manner that serves this purpose.

A phrase that the founders of the Freiburg tradition used, and that has often been misunderstood, is that a ‘strong state’ is needed to fend off interest-group

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<sup>5</sup> Böhm 1998, p. 64; 1980, p. 158.

<sup>6</sup> Böhm 1998, p. 64; 1980, p. 158f.

pressures. This was definitely not meant as an argument in favour of an authoritarian state with large discretionary power. To the contrary, the Freiburg ordoliberals expressly noted that it is the modern growth of the state's apparatus and activities, that have made it “a plaything in the hands of interest groups”.<sup>7</sup> The formula ‘strong state’ was meant by them as a shorthand for a state that is constrained by a political constitution that prevents government from becoming the target of special-interest rentseeking. Admittedly, they did not discuss in detail what such a constitution was to entail and how constitutional safeguards might be installed that effectively prevent the dynamics of privilege seeking and privilege granting. But they emphasized as the essential goal that the authority and the power to discriminate among citizens by granting privileges to some groups at the expense of others must be taken away from governments and legislators.

Eucken, in particular, emphasised the importance of extending the logic of *Ordnungspolitik* from the realm of the economic constitution to that of the political constitution. He explicitly stated that, just as *Ordnungspolitik* is needed in order to establish and to maintain an appropriate *economic* constitution, *Ordnungspolitik* is also needed at the level of politics in order to establish and to maintain an appropriate *political* constitution. His early death – he died in 1950 while delivering a series of lecture at the London School of Economics to which he had been invited by Hayek – prevented Eucken from working out his thoughts on the notion of *Ordnungspolitik* for the political realm. But the paradigm that he and Böhm have launched clearly invites such an extension of its logic from the market arena to the political arena. It is not least in this regard that the modern research program of *constitutional political economy* which has been launched by James Buchanan can be considered a natural supplement to the Freiburg tradition.

The significant contribution that both these research programs, the ordoliberalism of the Freiburg School and Buchanan’s constitutional economics, have made to the classical liberal tradition is that they have sharpened our awareness of the *constitutional dimension of the liberal paradigm*, an awareness of the critical role of the *rules of the game*, both in the market arena and in politics. Time constraints prevent me from commenting more extensively on the affinity between the Freiburg tradition and Buchanan’s research program. Buchanan’s contribution will be of direct relevance, though, for the second part of my talk, to which I shall turn now, and in which I will look at the general philosophy, or the systematic arguments, that lend support to the rule-based *Ordnungspolitik* approach. While within the Freiburg tradition the philosophical grounding of the rule-oriented outlook remained largely implicit, it is notably in Buchanan’s work and in that of Friedrich Hayek that the relevant arguments have been explicitly discussed. It is these arguments that I look at in the

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<sup>7</sup> Eucken 1990, p. 326; Böhm 1980, p. 258.

remainder of my talk. In fact, the heading “The Reason of Rules” that, as mentioned at the beginning, I have chosen for the second part is, as some of you may have noticed, exactly the title of a book that Buchanan wrote jointly with Geoffrey Brennan<sup>8</sup>.

Before looking more closely on the different reasons of rules that I want to comment on it is useful briefly to describe the general issue that is at stake in the current debate on the European crisis. At the heart of the controversy is the issue of the domains in which – and the extent to which – politics should be constrained by rules as opposed to be given discretionary authority to do what is deemed to be expedient under the given circumstances.

Discretionary authority means that government can adopt among its available options the one that, in the particular situation it faces, it considers “best” in light of its expected consequences, *all things considered*. By contrast, rule-governed politics means that government is bound either by *prescriptive* or *positive* rules, rules that require it in certain types of problem situations to adopt certain types of actions, or by *proscriptive* or *negative* rules, rules that require it to abstain from certain kinds of actions.

Most of the rules that regulate our lives, in the realm of politics no less than in the realm of our personal conduct, are, in fact, negative rules, rules that *exclude* specified courses of action as not permissible (“You shall not...”) but leave scope for *discretionary* choice within the remaining range of options. In this sense – and only in this sense – rule-following and prudential, discretionary choice are not mutually exclusive alternatives but may coexist.

Given how I defined before the contrast between rule-following and discretionary choice, an obvious question is, of course, why anyone may want to be bound by rules rather than being allowed to do in each and every choice situation what promises the best consequences, all things considered. The principal question that needs to be answered is: what can be the “*reason of rules*,” what arguments can be made in favour of rule-based as opposed to discretionary politics?

Before looking specifically at the reason of rules in *politics* I shall first consider the reason of rules in our personal conduct.

That there can be a reason for rule following at all is due to the fact that there are certain *types of problems* that we face recurrently as we go about our ordinary day-to-day business. Even if in an ever-changing world every choice situation we face is in a sense unique, certain kinds of problems we have to deal with repeatedly such as, for instance, how to organize our workday, how to deal with our family members, with friends or business partners, how to operate our car in traffic ... and numerous other kinds of problems that we confront again

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<sup>8</sup> Geoffrey Brennan, James M. Buchanan, *The Reason of Rules – Constitutional Political Economy*, Cambridge University Press, Cambridge, 1985.

and again. For such kinds of *recurrent* problems experience can accumulate over time for how they can – *in general* – be dealt with successfully, even if in certain respects each of them will be unique.

The most general argument for rules is that by relying on time-tested general recipes or rules for how to behave in such recurrent problem situations we may be able to do overall better than if we were to try to pick in a discretionary manner what appears to us to be the best option given the specifics in each particular case.

We can, however, specify *three reasons* in particular for why rule-following may be superior to discretionary choice, three reasons that I will consecutively discuss under the headings *knowledge problem*, *incentive problem*, and *reputation problem*.

The *knowledge problem* has been most explicitly stressed by Friedrich Hayek. It plays, in fact, a most central role in his social and economic philosophy. In various versions and at several places of his work he has emphasized that “the reliance on rules is a device we have learned to use because our reason is insufficient to master the full detail of complex reality”<sup>9</sup>. As Hayek points out, that there are advantages to following rules may seem paradoxical if one considers the fact that rules typically instruct us to focus on particular aspects of a choice situation we are facing and ignore other aspects that we may know about. The rule to keep promises, for instance, tells us that, if we have given a promise, we should keep it irrespective of other considerations that may induce us to prefer breaking it. Or, to use another example, the rule to stop at a red traffic light and to go on green at an intersection tells us to focus on the colour of the traffic light and ignore other aspects of the particular instance. In other words, rules are “selective” in what they instruct us to pay attention to, and such selectivity raises the obvious question how it can be advantageous at all to ignore in one’s choices circumstances one in fact can know about.

The answer to this question is to be found in the comparison between the *selectivity of rules* and the unavoidable selectivity of the choices we make when we try to consider *all things*. As Hayek argues, in face of the “inexhaustible complexity of everything” it is impossible for us to actually consider “all things” and to correctly anticipate all the direct and indirect effects of our actions. In our discretionary choice we will inevitably respond *selectively* to certain aspects of the situation and our selectivity may well lead us to ignore what would be crucial if we were in fact able to consider *all things*.

As noted, rules are selective as well. By contrast to the incidental selectivity of our deliberate choices, though, rules are “purposefully” selective. Their advantage lies in the fact that they not only *facilitate* our choices by

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<sup>9</sup> F. A. Hayek, *The Constitution of Liberty*, The University of Chicago Press, Chicago, 1960, p. 66.

allowing us to focus our attention on selected aspects of the choice situation but also promise to select those aspects that in fact help us to make *better choices* than would otherwise be the case.

For the purpose of illustration consider the above mentioned simple example, the recurrent problem of crossing an intersection:

- Discretionary choice would mean, to do always what is best, all things considered.
- Rule following would mean, to stop on red and to go on green, in other words, it means to focus one's attention on the colour of the traffic light and to treat other aspects of the situation that one may be able to observe as irrelevant for the choice one has to make.

To be sure, with discretionary choice, making use of all the information that we obtain in the situation, we may, theoretically, be able to make "better" choices than just complying with the colour of the traffic light. Yet, in our attempt to do what, all things considered, seems best to us, we may well make mistakes, overlooking a policeman and being fined a ticket for running a red light, or having misjudged the speed of an approaching car and getting into an accident.

On the other hand, with *rule following* we may also make "mistakes" in a sense, unnecessarily waiting at a red light when we could safely cross or getting nevertheless, despite our own rule-compliance, involved in an accident because some other driver ignores his red light.

The point of this example is that neither our discretionary choice nor the rules that we may follow are "perfect" in the sense of guaranteeing us always what would be best, all things considered, in every single instance. Yet, for us as unavoidably imperfect human beings what would be best to do if we knew everything is not the relevant standard of judgment. The relevant comparison is between the overall *pattern* of outcomes that is likely to result under discretionary choice on the one side and under rule following on the other. And *good* rules, especially time-tested rules that incorporate the experiences accumulated over generations, may provide in this regard much better guidance than our discretionary choices.

The second reason of rules, that I want to point out, comes, as I said before, under the heading "incentive problem". Even though it is somewhat related to the knowledge problem it is useful to consider the incentive problem in discretionary choice as a separate issue.

As human experience tells us, and psychological research confirms, in discretionary choice we are tempted to give undue consideration to *current needs* and *short-term* effects of our actions at the expense of their long-term consequences. We eat good-tasting, but unhealthy food stuff even though we know of its longer-term harmful effects. We postpone unpleasant but necessary tasks even though we know that we will regret it later, and so on. The very rationale of many of the traditional rules of conduct that are passed on from

generation to generation is to remedy this deficiency in our motivational make-up. They instruct us to behave in ways that require us to curb our current desires in favour of superior benefits to be reaped in the longer run.

I may mention here that, when James Buchanan was awarded in 1986 the Nobel Prize in Economic Science we decided at the Center for Study of Public Choice, where I spent the years from 1983 to 1995 to found the journal *Constitutional Political Economy*. As those of you who have seen the journal know, for the cover page we chose the image of Ulysses bound to the mast of his ship as a symbol for the rule-oriented focus of constitutional economics, a symbol that was meant to convey that to be bound by rules may allow us to reap benefits that otherwise we could not obtain, just as Ulysses needed to be bound to be able to enjoy the songs of the Sirens and not to perish.

The third reason of rules that I subsume under the heading “*reputation problem*” has to do with the effects of our own choices affect how other people perceive us and what that means in turn for our prospects of achieving our goals. Consider, for example, the problem of whether one should always keep one’s promises as opposed to deciding in each particular case in light of the specific circumstances whether one should do so or not.

It is certainly true that the discretionary opportunist who decides each case as he sees fit will be able to capture opportunities to default on promises with impunity, opportunities that a principled person will miss. But it is also true that the person who earns a reputation for always keeping her promises will be a much more attractive partner in business dealings and in other matters than the discretionary opportunist. And, being a more attractive partner for cooperative endeavours means that he or she will have opportunities for mutually beneficial deals that the opportunist will be excluded from.

In general it can be said that by following rules one can earn a reputation as an honest and reliable person, a reputation that constitutes a kind of social capital from which many benefits in our dealing with others can be reaped.

In the concluding part of my talk I want to discuss how the same three reasons of rules apply at the level of politics no less than to our personal conduct.

As an exemplification of the *knowledge problem* in politics consider the issue of *industrial policy*, an issue that has since long marked a division between French political attitudes and German *Ordnungspolitik* – even if, as I should repeat, German governments too were not always consistent in following the precepts of *Ordnungspolitik*.

If governments were perfect in identifying winners and in properly assessing the overall balance of desirable and undesirable consequences of granting tax-privileges or direct subsidies to particular firms or industries, citizens might wish to grant their governments the authority to engage in such policies. But if governments are not perfect predictors of future economic development and are susceptible to lobbying by special-interest groups citizens

have reasons to fear that such discretionary authority may be misused and mal-applied. In the face of such risks citizens' interests will be much better served by denying government the authority for such discretionary interventions and limiting its authority to conducting economic policy by general rules of the game that provide a suitable framework for economic activity.

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

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

Third and last there is the *reputation effect* of rule following in politics. This effect has found particular attention in the context of fiscal and monetary politics. Under the title “Rules Rather than Discretion” Kydland and Prescott published in 1977 a well-known article in which they argued that a discretionary policy which seeks to select the “best action, given the current situation” will fail to reach its objectives because in a dynamic economic system the economic players will adjust their expectations<sup>10</sup>. Because of how they affect expectations, so Kydland and Prescott argue, a policy of aggregate demand management, for instance, is likely to result “in excessive levels of inflation” without lowering unemployment. The general conclusion they draw from their analysis is “that policymakers should follow rules rather than have discretion... (and) that economic theory should be used (not to inquire into the effects of specific policy measures but) to evaluate alternative policy rules and the one with good

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<sup>10</sup> Finn E. Kydland, Edward C. Prescott, “Rules Rather than Discretion: The Inconsistency of Optimal Plans”, in *Journal of Political Economy*, 85, 1977, pp. 473-491.

characteristics should be selected.” – This corresponds exactly to the central message of the German Ordnungspolitik tradition.

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

It is worth noting that the American economist Henry Simons already in the 1930s argued for an approach to economic policy that comes close to the German conception of Ordnungspolitik, regrettably though without having a noticeable impact on the economics profession. In his paper “Rules versus Authorities in Monetary Policy,” originally published in 1936, Simons spoke about the “danger of substituting authorities for rules which especially deserves attention among students of money”, and he explicitly argued: “An enterprise system cannot function effectively in the face of extreme uncertainty as to the action of monetary authorities... We must avoid a situation where every business decision becomes largely a speculation on the future of monetary policy”<sup>11</sup>. Without principles ruling over expediency, Simon concluded, “political control must degenerate into endless concessions to organized minorities, with gradual undermining of the ‘constitutional structure’ under which free-enterprise economy and representative government can function”.<sup>12</sup>

In a recent paper in which he criticizes the bailing out of banks with taxpayers money, the monetary economist Lawrence White has noted: “If everyone knows that the rule of law will be followed, such that nobody will be bailed out, the incentive for imprudence disappears...., (at least) there won’t be system-wide mal-incentives producing an epidemic of imprudence”<sup>13</sup>.

I want to conclude with a few brief remarks on an argument that is a standard response in times of crises, and that is popular in the current crisis as well, namely that, as the German saying goes, “Not kennt kein Gebot”, meaning that in emergency situations one cannot be bound by rules. To this argument two comments are appropriate.

Firstly, prudence does indeed require us to acknowledge that there may be emergency situations in which we need to temporarily disband rules that in ordinary times we consider binding. But, if we do not want discretionary expediency to be allowed in by the back door, we need to adopt rules for *when* and *by whom* and according to *what procedures* an emergency can be declared as well as rules that constrain what the authority in charge is allowed to do in such emergency situations.

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<sup>11</sup> Henry C. Simons 1948 (1936), p. 161. Reprinted in Henry C. Simons, “Rules versus Authorities in Monetary Policy,” in *Economic Policy for a Free Society*, The University of Chicago Press, Chicago, 1948, pp. 160-183.

<sup>12</sup> Henry C. Simons 1948 (1936), p. 170.

<sup>13</sup> Lawrence White, “The Rule of Law or the Rule of Central Bankers?”, in *Cato Journal*, 30, 2010, pp. 451-463.

Secondly and more importantly, crises as the one we are currently faced with in Europe do not come upon us like natural disasters. They are typically the cumulative outcome of a continued violation of rules that, if they would have been followed, would not have allowed the crisis to come about in the first place. I think I do not need to enumerate the rules, such as the deficit ceilings and the no-bail-out clause in the Maastricht treaty, that have been systematically disregarded repeatedly, paving the way for the current sovereign-debt crisis.

Admittedly, it was the German government under chancellor Schröder which in 2004 set an unfortunate precedent in seeking an exemption from the Maastricht deficit criteria. All the more it is to be hoped that Germany's current insistence on binding rules may serve as a reminder that submitting to prudent rules is the only reliable protection against sliding into crises of the kind we are presently trying to escape from.

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