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## FROM ORDER TO PROSPERITY: THE IMPORTANCE OF COMPETITION IN THE SOCIAL MARKET ECONOMY MODEL

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Searching for an institutional structure which enables economic success is in the midst of the practical efforts of governments all around the world, as well as the academic studies endeavoring to understand the sources of success in the most prosperous national economies. The supremacy of the German economy in the European Union, as well as worldwide - from the level of the GDP *per capita* to high productivity, innovativeness and export performances - is the basic motivation this study rests on. Due to the fact that, unlike a failure, an economic success is always achieved in the long run, this study is aimed at revealing the (historical) institutional roots that have paved the way for the economic success of contemporary Germany. In that context, the model of the Social market economy, i.e. the competitive order (*Wettbewerbsordnung*), its meaning and importance in solving the allocative equation and reaching the high levels of economic efficiency are the subject matter of analysis in this paper. The key results refer to the identification of the diverse economic and social benefits that a competitive order brings into being, as well as the determination of and pointing to the essential institutional preconditions which such an order is feasible in.

**Keywords:** Social market economy, German model, competition, economic efficiency, institutions

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### INTRODUCTION

There is abundant evidence in the economic history of the attempts various countries have made in order to reform their economic systems. Successful stories are, however, rare. Although the development of the majority of today's developed countries can be seen as an evolutionary path, rarely or never interrupted

by radical social, political, or economic changes, yet there are some exceptions. One of these exceptions is the German model of the Social market economy (SME). The decisive moment in the emergence of this model relates to the monetary reform conducted in West Germany in 1948. The way in which the transformation came into being and the principles by which it was shaped were to a large extent the opposite of the practices in other Western countries at that time. The SME model was based on a free market mechanism and a strong institutional structure

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with limited state intervention. It was quite different from the extensive state regulation of the economy in some other developed countries, especially Great Britain under the rule of the Labor Party after WWII. Furthermore, it was a radical breakthrough not only with respect to the period when National Socialists were in power, but also with respect to the period preceding 1933. Even in the period of the Weimar Republic, the German economy was faced with a serious malfunction and was burdened with numerous social and economic problems. Even the rising of National Socialists to power can to a large extent be explained by the weaknesses of the system that had preceded them.

The ideas which the SME model is based on have had and still have a great influence on the institutional design in many countries and supranational organizations. Institutional solutions, especially those related to the high degree of independence of the German Bundesbank, have had a major impact on the institutional solutions that were applied in transition economies (Loungani & Sheets, 1997), as well as in developed countries, such as Great Britain (Hielscher & Markwardt, 2012). Particularly significant has been the impact on the institutional design of the ECB (Berger, 2006). On the other hand, the numerous challenges which developing countries and rapidly growing economies are being faced with, especially given the recent failures (in most of them) and the new risks created by the onset of the financial and economic crisis in 2008, the SME model can represent a significant alternative to further development in these countries (Wrobel, 2012). Some authors (John, 2007; Hillebrand, 2015) point to the potential significance of the SME model for redesigning the institutions which the economic and social policies at the EU level lie on. According to the EU founding agreements, the open market economy and free competition are the core mechanisms of an economic system. They are construction elements in the SME model as well. The potential of the SME model is also reflected in the comprehensiveness that addresses the economic reality (Wrobel, 2014) enabling the creation of the institutional environment which would enable a simultaneous accomplishment of a whole range of economic and social goals. Incorporating

both the constitutive principles (free prices, private property, the freedom of contracting, the openness of the market, the principle of the responsibility and consistency of the economic policy) and the regulatory principles (the strict competition policy, the labor market intervention, the internalization of external effects, the social policy measures and the provision of public goods), the SME model provides a potential framework in which economic and social problems are solved in the most efficient way.

The motivation for studying the SME model is manifold. The history of the economic thought, as well as economic history, may serve as a substitute for experimenting in real life, thus helping policy makers to avoid mistakes. On the other hand, this research also contributes to the relatively limited scope of research into the SME model in the Serbian-speaking area. The supremacy of the German economy at both the European and the global levels, whether with respect to the level of the GDP *per capita* or export results (Simonazzi, Ginzburg & Nocella, 2013), or innovation performances, or the adaptability of the economic system, especially confirmed after the financial crisis (Storm & Naastepad, 2015), suggests that this is a story about the specific economic system worth of being further investigated. The impressive evidence of economic excellence is the \$5,000 higher GDP *per capita* of those in the cradle of the industrial revolution, namely Great Britain! Such an outcome in an economic system is only possible to achieve over a long period of time. Therefore, the importance of the ideas which this system was built on and on which it still operates is apparent. The theoretical foundations of the SME model are found in the works of a number of authors, some of whom were active participants in the reconstruction of the German economy after WWII. Their particular role was in defining the institutional framework in which the market economy in Germany would be operating. Therefore, the story about the SME model brings together economic history and the history of the economic thought in a specific manner.

The request for the imposition of the competitive order (*Wettbewerbsordnung*) through the creation of a comprehensive institutional frame, which on its

part has a decisive influence on the efficiency and adaptability of the economic system, is at the heart of the SME model, which is at the same time the subject matter of the research conducted in this paper as well. At the same time, we are speaking about the order since it implies not only the establishment of the market structures based on competition, but also the establishment and implementation of a whole range of the principles that enable an economy to operate efficiently.

In that sense, the paper is aimed at identifying the potential advantages, both economic and social, which the establishment of the competitive order brings with itself, and at determining the basic principles which are necessary to follow in the construction of the institutional structure, which on their part enable the establishment of this order, all this being done through an analysis of the original texts by using a qualitative analytical instrumentarium.

The hypothesis that will be tested in the paper is as follows:

H: From the point of view of the results achieved in the competitive order, the competitive order generates a high quality of economic performances and leads towards the resolving of a significant portion of the social problems that appear in society.

The competitive order stands for a superior alternative to the other (available) mechanisms of resource and income allocation. This may be inferred directly from the very definition of the SME model given by A. Rüstow (1960, 51), according to which "in the social-market economy, production and distribution are determined by the system of free prices through competition between (mainly private) enterprises, which is done far more productively, purposefully, in a fair manner, at a lower price and more reliably" compared with other market and non-market economic models. The SME model provides an efficient allocation of resources, as well as the elimination of poverty, and the avoidance of the wrong distribution of income (Karsten, 1985). The chosen topic is interesting not only from the point of view of the results generated by Germany, but also because

the SME model was sharply criticized and caused skepticism in the period when its implementation began, especially by British economists. These criticisms, especially from today's perspective, are not supported by evidence. An additional reason for conducting this research lies in the close relationship between the ideas within the SME model and those of new paradigms in economics, such as the institutional economics, political economics, constitutional economics (Vanberg, 1988) or the Limited Access Order/Open Access Order (LAO/OAO) concept developed by D. C. North, J. J. Wallis, S. B. Webb and B. R. Weingast (Zweynert, 2015). In addition, there are various research studies in the domain of economic theory, as well as the numerous empirical studies, that found the link between (economic) freedom and economic growth (De Haan & Sturm, 2000; Gwartney, Holcombe & Lawson, 2004; Doucouliagos & Ulubasoglu, 2006; Ivanović & Stanišić, 2017). These findings represent the additional line of argumentation towards the validity and importance of the SME model. The reason for that lies in fact that freedom is of pivotal value in the SME model. It is a leading principle in building the institutional structure and an irreplaceable generator of economic progress.

The paper is structured into six parts. After the Introduction, the next three parts are dedicated to the analysis of the specific importance of the competitive order for generating efficient outcomes. The second part deals with the ways in which the competitive order stimulates economic agents towards a productive behavior, which results in an efficient allocation of resources. The third part addresses the issue of the significance of the competitive order in securing the (individual) freedom of economic actors in the broadest sense, which in turn affects the efficiency of the economic system as a whole. The fourth part is dedicated to the specific social benefits that the competitive order produces. As the SME model hinges on a clear and robust institutional structure, the fifth part focuses on identifying the requirements necessary for achieving such an order. In the Conclusion, the results of the research are summarized and the possible directions of future research are pointed out.

## COMPETITION AS THE *PERPETUUM MOBILE* OF ECONOMIC EFFICIENCY

One of the basic assertions within the SME model is that only the competitive order leads to efficient and sustainable social and economic outcomes. The especially visible link goes beyond competition and economic growth, and this relationship reflects “the relationship between a cause and a consequence” (Müller-Armack & Erhard, 1972, 215).

Competition is generally observed as a situation in a specific market segment in which there are no restrictions either on the supply side or on the demand side (Böhm, 1961). A large number of agents on both sides of the market imply that exchange relations are governed and dominated by cooperation rather than by subordination. This aspect is vital for an efficient exchange. In real life, however, the number of participants on the supply side is much more important than the number of participants on the demand side. It is particularly significant regarding the amount of potential efficiency losses.

The problem of the egoism of economic agents is solved in the competitive order in the best manner. Competition hinders the destructive effect of egoism, simultaneously using its enormous potential by channeling the engagement of economic agents towards the most productive activities. As a consequence, the best alignment between individual and group interests is achieved (Nawroth, 1961; Böhm, 1942). Such an alignment is possible in the competitive order because economic agents have no power to influence the exchange process on the market. In such circumstances, egoism and a lack of the power of individual agents lead to a behavior characterized by self-compliance to prohibitions and, generally, to the rules of the game. It is also a prerequisite of a useful and rationally structured interaction and cooperation. As a consequence, transaction costs are reduced and economic efficiency is additionally stimulated.

The price system is the pivotal mechanism by which competition affects economic dynamics and determines economic agents’ behavior. Only in the competitive order will the prices correctly direct

economic agents’ behavior. Prices are exogenously determined in the competitive order (Eucken, 1952). They are beyond the influence of any single agent. Economic activities and the planning of business operations are carried out on this basis. Prices are *ex ante* determined for all market participants and are not subject to change due to the action of any state or private instance or entity. If prices depended on the decisions of the state authorities or market participants’ individual decisions, there would neither be security nor a justifiable assumption that such prices are appropriate. If they were the result of someone’s will, they would inevitably lead to allocative inefficiencies. Such inefficiencies would be a consequence of the wrong basis on which economic agents would formulate a business strategy and make business decisions. As opposed to this, competitive constraints ensure that prices and costs are adequately linked, which leads to the business calculus which is highly exact (Röpke, 1961). The aforementioned exogenous character of prices does not mean that they stay unaltered over time. In fact, although monetary stability is one of the constitutive principles of an efficient economic system in the SME model, the variability of prices does not jeopardize this principle in any way as individual prices can go up and down, whereas the overall price level remains stable. In addition, competitive prices are essential for long-term cost alignment. They ensure that the prices of individual products are adjusted with the level of necessary costs in the short run and long run as well. The obvious advantage of such a price regime is especially evident if compared with the market structures characterized by the existence of an extra profit, where price responsiveness is far lower.

The main advantage of a flexible price regime within a competitive market structure reflects in producing relevant information for economic agents. A free price system corresponds to decentralized governance structures. Economic agents’ needs will be the most efficient within the competitive order, under the given income and the availability of production factors (Lutz, 1962). Not only does competition lead to the cheapest and largest possible production, but it also makes economic agents constantly motivated to reduce costs. In real economic life, there is a

constant differentiation of the needs on the demand side and competition compels economic agents on the supply side to constantly adjust themselves to this differentiation. This additionally ensures the adaptability of the system. The ultimate result of competitive pressure is not only the reduction of costs, but also a higher level of the product quality (Böhm, 1942).

The competitive order creates the stimulating structure of incentives that affects the engagement, actions, as well as reactions of economic agents towards the most productive economic activities. In this manner, complicated transactions are coordinated and regulated in the most efficient way. Exchange becomes well-structured and predictable. Economic agents' business calculus depends on the quality of business decision-making, and to a lesser extent on the external factors beyond their control. Creative engagement and an entrepreneurial initiative are in the best possible way awarded in such circumstances (Eucken, 1947). Since nothing is *ex ante* determined, all economic agents are maximally motivated to run for a better position on the market. Within the competitive order, the capabilities, ideas, and especially the efforts and abilities of the participants in the economic process are continuously contested (Stegmann, 1999).

Competition also provides the best framework for the adequate governance and the efficient use of capital. The competitive order gives the largest possible freedom to economic agents, which has to be accompanied by a proportional responsibility for the decisions they make. In such circumstances, the caution by investment decisions will be the largest. It is a prerequisite for a more efficient use of capital. A cautious approach to the market can only be ensured if business decisions are followed by the accountability of economic agents. According to W. Eucken (1953, 20) "whoever has the benefit must also bear the cost" of the economic activity. Responsibility for decisions and undertaking risk are adequately linked through that (Böhm, 1942). No less important is the fact that freedom has a sense only if it is coupled with responsibility (Eucken, 1953). The creative power of an order based on competition also stems from the fact that in such an order a large number of

individuals are independent. It enables a high degree of self-determination and motivates economic agents to search their most productive engagement.

The maintenance of stability and the mitigation of a cyclical downturn are also the strengths of the competitive order. Competition forces economic agents to also constantly invest in the other entrepreneurial activities that ensure that their activities are always focused on the maximum possible performance. Such a behavior leads to necessary adjustments and raises necessary reactivity of the system as a whole.

The relationship between competition and technical progress is ambivalent. On the one hand, technical progress leads to the takeover of small enterprises by large companies. As a result, concentration rises on many markets. On the other hand, it contributes to the development of (product and service) substitutes, the expansion of the market, and an increased adaptability in the production process, as well as the expansion of the labor market. As a consequence, the flexibility and mobility of the factors of production and products in many markets are increased (Eucken, 2001). In addition, competition stimulates technical progress, as economic agents are compelled by competitive pressure not only to continuously innovate according to customer preferences, but also to seek to accelerate the implementation of innovative solutions (Symanski, 1999).

It is as well certain that competition causes certain losses, especially when those weaker on the market are concerned. However, even they attain net benefits from participation in the competitive process through many other advantages generated by the competitive order (Vanberg, 2002). Therefore, not only does competition provide an adequate system of rewards for those who are the most successful, but it also provides a sort of compensation for the less successful. For example, there would be no effect of learning or focus on innovation on the part of individual agents unless they were under competition pressure. Although no order is perfect, and thus neither competitive one, it has nevertheless accentuated superior in comparison with alternative market structures (Lutz, 1953). This above all concerns the efficiency of functioning, the quality of results and their sustainability.

## FREEDOM AS THE STARTING POINT AND THE ULTIMATE OUTCOME OF THE COMPETITIVE ORDER

Only in the competitive order can it be expected that the order, understood as the system of rules which creates the institutional structure, and freedom are in equilibrium. In such an order, there is no force that could jeopardize freedom. In the competitive order, the freedom of every economic agent is protected from the activities of those in power (Eucken, 1947). Another aspect of freedom enshrined in the competitive order relates to the fact that an individual is free to act in accordance with his/her own interests and according to his/her own personal judgment (Müller-Armack & Erhard, 1972). It is the key requirement for an efficient exchange.

The point of departure in the relationship between freedom and economic efficiency in the SME model starts from freedom. The reversibility of the relationship is, in the best case, the fact of secondary importance. The significance is, therefore, in the welfare benefits of freedom (Böhm, 1961), not in the impact of prosperity on freedom. In that sense, the best way to create an economic value is to establish and protect freedom. Ensuring freedom through competition means securing growth in the economy (Müller-Armack & Erhard, 1972). The freedom provided by the competitive order is first and foremost intangible value (Böhm, 1942), securing it is a decisive requirement in enhancing economic efficiency.

The freedom inextricably related to the existence of the competitive order is also the main argument for the supremacy of this order in relation to the alternative forms of the organization of economic life. The competitive order ensures the freedom of planning for all economic agents. Under such conditions, the minimum resistance from and the violation of the rules are expected. There is no third party able to influence unilateral and arbitrary (inefficient) prices. As economic agents are free to plan their activities, also bearing responsibility for them, which is underpinned by market and institutional sanctions, the violation of the rules of the game is expected to be minimal. Such a behavior leads to the minimization

of transaction costs, an increase in the volume and number of transactions and the deepening of business relationships amongst economic agents.

The competitive order provides the highest level of the freedom of choice for both consumers and manufacturers. As competition fosters exchange relations, it also contributes to the peaceful resolution of disputes on the market. This aspect heavily relies on the price system. The price system in the competitive order implies that everyone freely decides how to use their own resources. There is no one in a position to force someone else to make decisions in a certain way. Reliance on prices is entirely based on the freedom of decision-making (Böhm, 1950). Although coordination shapes relationships between economic agents and although the freedom of individual actors is at the heart of such relationships, freedom is not absolute. Economic agents are faced with a limited (but not small) number of the business choices and behavioral options defined by the rules of the game. Furthermore, economic actors are not absolutely free because their actions depend on the behavior of other actors. They have to take into account the interests and behavior of other economic agents in order to be successful in their entrepreneurial activities. Although freedom is limited in the aforementioned way, it is far greater than the freedom available to economic actors in alternative market structures. Therefore, freedom does not imply freedom from (any) rules that are a condition for well-governed and structured transactions.

Competition is not only a prerequisite for the broadest and universally understood freedom of the individual, but it is also the assumption that some rights that constitute the guarantee of liberty do not deviate from and do not transform into the means of power. This particularly applies to the freedom of contracting. The freedom of contracting is essential for economic efficiency and the competitive order is irreplaceable when the preservation of the essence and nature of this freedom is concerned. The reason for this is that the very principles of the freedom of contracting depend on the economic and market order based on competition. Competition prevents the abuse of the freedom of contracting by restricting

the freedom of the parties in contractual relations (Eucken, 1953). The principle of freedom does not allow the abuse of power with the aim of narrowing down the freedom of the parties in a transaction. For that very reason, the meaning of the freedom of contracting is far beyond the formal legal meaning of its content.

The competitive order is directly related to the individual aspects of freedom, such as the freedom of contracting. However, the efficiency of the economic system is in the long run determined by the degree of freedom in the broadest sense. This arises from the fact that there is a close interconnection between different domains of freedom. Safeguarding one aspect requires the existence of another aspect. For example, the freedom of entrepreneurial engagement is a precondition for the consumer's freedom to choose (Müller-Armack & Erhard, 1972).

The competitive order is a precondition for the functionality of private law. Formal (legal) rules define relationships, responsibilities and the terms of exchange between equal parties in a transaction. These parties do not possess political power or social privileges in relation to one another (Böhm, 1966). Competition also works preventively against the establishment of political power. As such, it is compatible with both democracy and the legal order based on it. Relying on market forces, securing the functionality of the legal order and limiting state interventionism that would have consequences for restricting freedom (Böhm, 1961), the competitive order ensures the highest degree of economic efficiency. By limiting state interventions, competition preserves the autonomy of economic agents and thus the allocation of both production resources and (free) consumer decisions. For this reason, the competitive order is, by its very nature, a democratic mechanism.

## SOCIAL BENEFITS IN THE COMPETITIVE ORDER

The mere fact that a competitive order is considered to be the most efficient of all of the other alternatives

poses the issue of the consequences it produces in the social domain. The social benefits of the competitive order are of particular importance in the circumstances of an economic system facing difficulties. In these circumstances, there is an especially evident claim that what contributes to productivity growth has much more of a social than of an economic value (Stegmann, 1999). The social value of the competitive order should primarily be considered in this context. The market is unable to produce desirable social outcomes if the competitive order does not function adequately. Thus, the competitive order is *per se* a precondition for solving a significant part of the problems that arise in the social sphere. The need for relying on competition in the distributive domain arises from yet another assumption within the SME model: it is impossible to find a universal (material) indicator of justice. For each distribution, there is a danger that it will be influenced by the forces that will draw the distribution away from the principle that everyone has what he deserves according to the effort he has made. This principle tends to be materialized automatically in the competitive order (Lutz, 1953).

Within the competitive order, the largest and most diversified production is provided in the long term, which does not restrict the participation of any individual. Participation in the overall economic success of the national economy is also realized through the better accessibility and quality of public goods and services, job opportunities for employees or salary rises. The competitive order creates the framework in which the material basis of society develops in such a way that the existing social problems can be largely solved by such development. By providing a large number of opportunities to different individuals, regardless of their social background, it contributes to greater mobility and social cohesion. Since the existence of the competitive order implies the absence of power, the exploitation of individuals is largely hampered. The competition contributes to solving social problems "in the spirit of freedom" (Eucken, 1953, 24). Competition forces economic agents to react promptly, whether it is the question of solving problems or exploiting business opportunities. This may also be seen as a kind of the (economic) advantage that has a social character

because "he who reacts promptly helps twice" (Müller-Armack & Erhard, 1972, 280).

Since the competitive order rests on coordination rather than on subordination (Lutz, 1971), the terms of exchange between economic agents take place freely, which implies the relaxation of social relations and contributes to conflict mitigation. Coordination allows continuous adjustment regarding entrepreneurial plans. In this respect, coordination is a mechanism for regulating interpersonal relations in the sphere of trade and production. The mitigation of social conflicts in the competitive order also refers to the fact that such a structure contributes to the growth of wages for the majority of the population (Müller-Armack, 1962). Although a higher level of income is an explanation of economic agents' motivation mechanism and consequently of economic efficiency in general, its importance also reflects in the fact that it simultaneously contributes to the greater social recognition of the individual who achieves it. A higher level of income is a confirmation of an individual's work effort (Symanski, 1999).

The competitive order is based on the idea of justice arising from the fact that economic agents do not have power. In such an order, everyone is rewarded according to their contribution. If the balance of power changes in the sense that there is a significant asymmetry of power in the system, the system of relative prices and generally the efficiency of the economic system tend to be distorted. Not only are prices in such a system not a good basis for a business calculus, but the very idea of equity is also undermined by the nature of the decisions of those in possession of power. Opposite to that, prices in the competitive order prevent the formation of inefficient institutional structures by motivating economic actors to make continuous efforts and adjustments. It promotes the self-responsibility of all economic agents and supports efforts towards the continued efficiency of the economic process. This is also an explanation of the reasons why the principle of competition is seen as the core cause of social, economic and social progress. It has equal importance and equally tangles all of the members of a society, from entrepreneurs to all other professions. Prices in a competitive system

reflect a necessity, fairness and rationality (Böhm, 1947), making it an indispensable element of both economic efficiency and the precondition of equity in the system. The prices formed on the competitive market cannot be misused by any participant in the economic process. There is no individual will that determines them, but rather a certain collective will, which prescribes how and at what level they should be. However, they have a compelling effect and all participants in the economic process must adhere to them. This effect is a result of numerous, equal, free and spontaneous reactions following exchange. Due to that, competitive prices have no influence on political, social and economic freedoms.

As the competitive order denotes a state of the absence of restrictions on participation in a particular economic process, all those who participate or seek to participate in it have equal chances for achieving a success. Only under these assumptions, i.e. the absence of restrictions on entering and exiting the market, is it possible to expect all advantages from competitive structures (Kersting, 2010).

A reduction in costs in production is one of the significant impacts of competition in the social sphere. In the long run, every economic agent is forced to minimize his/her costs in order to survive. Consequently, products are cheaper. When cost reduction on a wider scale is in question, there is also a decrease in prices in an appropriate range. So, the benefits of reducing costs are not only attributable to the producer, but partly to the consumer as well. This leads to the socialization of economic progress without the use of legal coercion.

Although the competitive order generates many social and economic advantages, its fruition requires a political and ideological support. It needs to provide the long-term climate that protects and promotes such an order (Böhm, 1961). Economic agents' believing in themselves and their own power in a continuously changing environment occupies the central place in understanding certain prerequisites of the competitive order. Such attitudes of economic agents, together with the power of competition, provide such economic agents' mobility and a continued quest for

their most productive engagement. No less important characteristic attributed to economic agents is the attitude of individuals towards monopolies and other alternatives of the competitive order (Böhm, 1942). This is especially important because the attitudes and preferences of individuals determine the space in which the (formal) institutional structure is created and in general the overall political process takes place.

### INSTITUTIONAL PREREQUISITES FOR THE DEVELOPMENT OF THE COMPETITIVE ORDER

Within the framework of the SME model, there are basically three fundamental preconditions that could be identified as the prerequisites for the competitive order, and thus for the achievement of the advantages that this order brings. The list of the requirements is much broader, but these three conditions are pivotal.

According to the first, an economy should be open as much as possible. The competitive order is not conceivable within an autarchic economy. The highest degree of market openness must be an imperative and should be the guideline principle in shaping the economic policy (Eucken, 1952). An exception to this rule is the situations where foreign competitors are subsidized by the state and as such represent unfair competition. The importance of foreign trade is not only reflected in competitive pressures on domestic economic agents, but also in the fact that the competitive order cannot be fully developed without an adequate inclusion in the international division of labor. Only by the inclusion in the world economy will the fundamental incentives provided by competition be secured. Hence, it is not only the pressure foreign competitors provide in the internal market, but also the appearance of domestic producers in the foreign market, that provides irreplaceable incentives for overall efficiency in an economy.

The incentives resulting from competition exceed the immediate impact on the economic agents exposed to them. They are of decisive significance for the overall market. Competition influences the parties who are

only indirectly related with those who are directly competing. For example, suppliers will be strongly influenced to innovate and lower their costs in order to maintain contracts, although they are not under direct competitive pressure. In addition, market openness could be a significant factor in the stability of prices in the national economy. In this regard, the competitive order based on a free-price regime cannot be imagined without market openness.

The narrowing of the (specific) market through the protection policy in the domain of foreign trade not only results in the impact on the market segment which is under such measures, but also produces significantly wider consequences. Protection itself is a significant prerequisite for the creation of asymmetric power positions in exchange. In addition, such a policy distorts the links between individual markets, as the narrowing of one market automatically leads to the narrowing of other markets, too (Eucken, 1952). In the case of the distortion of the links between individual markets, the market system as a whole will not function in an efficient way. Closing the market works against one of the constructing principles in the SME concept: the interdependence of orders (*Interdependenz der Ordnungen*). There is a misallocation of resources. If the part of a market that is protected makes a significant part of the overall economic system, the effects on other orders can be particularly strong. It is especially true for the legal or political system (Eucken, 2001). Inefficiencies are caused by the phenomenon of rent-seeking, or the influence of interest groups, when the institutions of the political and legal systems are shaped according to the interests of certain groups, rather than being driven by the efficiency of the economic system as a whole.

The second request refers to private property. A successful market system is based on private property (Müller-Armack & Erhard, 1972). Private property represents a structural right and a fundamental prerequisite for the efficiency of the entire order (Nawroth, 1961). Based on this very fact, compatibility between private property and the competitive order is unequivocal. However, the impact that goes from competition to private property is of great importance as well. The competitive order is the only one that

secures the (highest) social value of private property. It also contributes to its legitimization (Rüstow, 1960). Competition is an irreplaceable instrument for controlling private property (Eucken, 1953). The mere existence of the competitive order implies a high degree of the dispersion of ownership in an economy (Böhm, 1942).

Private property is not only a feature of the competitive order. It is also a prerequisite of individual freedom. Private property is a warranty of individual freedom in two ways. First, private property protects individuals by providing a guarantee for the independence of their decisions and the responsibilities vis-à-vis other agents in the economic process. Second, it protects individuals from the state and its coercive monopoly (Röpke, 1957). On the contrary, in the absence of the competitive order, private property may become an instrument of restricting freedom, generating rents and may generally lead to disruption in the economic process and serious social costs (Eucken, 1952). Thus, the competitive order enables the use of private property in an efficient way and prevents its abuse. Private property brings a greater predictability for the parties to transactions, as well as greater security for its owners. In this sense, entering into a transaction will be facilitated if a business partner has assets. It implies the absence of the influence of a third party in business relations not directly involved in the transaction. Likewise, the business activities that are covered by the assets provide a higher degree of safety to the titular by providing greater responsiveness to change in market conditions. Such a type of responsiveness may to a large extent be narrowed if business activities are financed by a third party. Private property is a precondition not only for freedom, but for responsibility as well. If private property is a guarantee for decisions made by economic agents, then it will also be an important instrument affecting the allocation of resources (Lutz, 1962).

The third request refers to the rule of law. It is the key mechanism for protecting the competitive order, and consequently economic efficiency and productivity growth (Stegmann, 1999). It is only the state that may ensure adherence to the rule of law by providing

equality before law for all. The decision on the model of a legal order is the most important decision regarding an institutional structure (Lutz, 1971). A reverse causality also appears between the rule of law and the competitive order: the ability of the state is determined by the presence of the competitive order (Nawroth, 1961). *Interdependenz der Ordnungen* is especially visible between the state and the economic order.

The rule of law provides double protection for economic agents. The rule of law ensures the protection of an individual from the state or a coercive authority. An individual is protected by creating an institutional structure that clearly specifies the procedures and ways of state intervention, taking into account the preservation of the maximum level of freedom and protection of the individual. These procedures exclude the arbitrary and *ad hoc* treatment of state authorities. Many of these aspects are normatively regulated by the Constitution and are operative by solutions within administrative law. The second level of protection refers to the protection provided by a legal order to individuals in relation to other parties in an exchange. This aspect gains in importance especially in the situations characterized by the asymmetric relations of power (Eucken, 2001). A possibility of disrupting the exchange relationship is twofold. First, the one with power is able to directly determine the terms of exchange. Second, the agent with power may be able to influence the content of the rules created in the political process. Only in a situation where there is a symmetry of power is an individual forced or even able to achieve his/her goal by only taking into account the interests of (all of) the parties in the transaction (Nawroth, 1961). In this situation, the maximum freedom of each individual is guaranteed. Steadiness and impersonality are the features of the good rules underpinning an individual's freedom (Böhm, 1942). In addition, the rule of law also provides protection against interest groups. Thus, the rule of law protects the freedom by controlling the political and/or economic power of an individual or a group (Gutmann, 1991). Protecting an individual's freedom from the state and from the abuse of freedom by those who have power, the rule of law creates conditions for the emergence and survival

of the competitive order. In a system where there is an abuse of power by an individual and/or interest groups, as well as unregulated state intervention, the competitive order cannot arise, and, even if it exists, the same cannot survive (Müller-Armack & Erhard, 1972).

## CONCLUSION

One of the basic assumptions within the SME model is that the competitive order leads to efficient and sustainable economic and social outcomes. It does so in a better way than other market and non-market orders. The competitive order motivates economic agents to engage in the most productive activities, causes a reduction in transaction costs and enables mutually beneficial and rationally structured interactions and cooperation amongst them. Competitive constraints ensure that prices and costs are adequately linked, which makes the business calculus of economic agents exact to the greatest extent. Not only does competition lead to the cheapest and largest possible production, but it also makes economic agents constantly motivated to reduce costs. In addition to cost adjustment, competition makes it necessary for economic agents to adapt to the constant differentiation of needs on the demand side of the market. It consequently leads to a higher quality of products. Greater adaptability, as well as an innovative economy are the end result. In such a system, there are continuous changes followed by the fast implementation of innovative solutions.

Freedom is the leading feature following the activities undertaken by economic agents, but it has a(n) (economic) value only if it is followed by economic agents' responsibility. Freedom leads to progress only if economic agents bear responsibility for the decisions they make. The creative power of competition stems from the fact that, in such a system, a large number of individuals are independent. It enables a high degree of self-determination. Consequently, self-determination encourages a constant search for productive engagement.

Not only does the competitive order ensure freedom and encourage the productive behavior of economic agents, but it also produces significant social benefits. In accordance with the basic postulates within the SME model, everything that contributes to productivity growth is of great social importance. This aspect is of particular importance in the periods of economic downturns. The competitive order also provides a generally acceptable distribution of income. The social benefits of the competitive order are also reflected in a series of other results: it makes possible the largest and the most diverse production, the better accessibility and quality of public goods and services, better and plentiful job opportunities, and rising wages for the majority of the population as well. In such an order, the accent is on results. They are continually questioned, so individuals move upwards and downwards. As a consequence, the competitive order leads to greater social mobility. The system that provides everyone with the same chances implies a far higher degree of social cohesion and acceptability for the broadest population.

The attainment of effective social and economic outcomes implies the existence of an adequate institutional environment, in which such results are possible. It is imperative that there should be the highest degree of market openness, which, as a principle, must be incorporated in all of the domains of the economic policy. The competitive order is impossible without clearly defined proprietary rights. The competitive order lies *de facto* on the dominant importance of private property. Its significance reflects in strong incentives by economic agents towards the preservation of and increasing the value of property, and in providing greater security and predictability for parties in transactions. Private property provides an efficient allocation of resources, as well as certainty and the lowest obstacles when its use and entry into business transactions are concerned. However, if the institutional structure does not consistently protect what the competitive order requires, namely the freedom and responsibility of economic actors, among other things, it will consequently lead to deviations in exchange and efficiency will be distorted. If the institutional structure is weak, the individuals or groups that have economic power tend to socialize

losses and/or make gains thanks to the market position, rather than the competitiveness of the product or the service they offer. For this reason, the existence of the rule of law is the crucial precondition. The rule of law makes everyone equal before the law, deprives everyone of a privileged position and prevents rent seeking and the socialization of losses after the promulgation of wrong business decisions.

There are several possibilities of further research. The one concerns the possibility of further research study of the constitutive principles of the SME model and the relationship between them in the establishment of the competitive order. In addition to this, as the competitive order sometimes produces undesired consequences, the SME model provides certain principles which should underpin an institutional framework with the aim of mitigating them. These are regulatory principles. The significance, content and implications of these principles represent a potentially interesting field of research. A particularly interesting study would concern the rule of law and its importance and meaning for efficient exchange. In addition, it would be fruitful to analyze the cases that involve a deviation from competitive market structures and finding ways of preventive actions against the establishment of asymmetric market relations. Furthermore, the empirical analysis of the individual aspects of the SME model could represent an additional inspiration for future research. Particularly interesting would be the analysis of the similarities between the institutional economy and the SME model. An additional reason for this may be the fact that the founding fathers of the SME model sharply criticized classical economic theory, whereas institutionalists sharply criticized certain limitations of neoclassical economic theory. The future directions of the research are also the most important constraints of this paper, and they include reliance solely on theoretical analysis, the missing link between theoretical assumptions and the degree of their operationalization in the functioning of the German economy, and, possibly, the empirical valorization of the SME model in a comparative context.

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