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Edited by Ellen Frankel Paul, Fred D. Miller, Jr., and Jeffrey Paul

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## THE SOCIAL MARKET ECONOMY

BY NORMAN BARRY

## INTRODUCTION

The collapse of Communism in the regimes in Eastern Europe and the former Soviet Union has brought forth a plethora of alternative political and economic models for the reorganization of those societies. The vacuum that has been left could be regarded as an ideal laboratory for the testing of competing theories, and the temptations to experiment with the more benign forms of constructivist rationalism<sup>1</sup> are likely to prove irresistible. If liberal capitalism is to be successfully created, it will clearly not have the same biography as it has had in the Western European and Anglo-American countries, where its emergence was the result of slow evolution: often its appearance and survival were due to a quite fortuitous combination of circumstances. In those countries it was not the result of any deliberate democratic choice but the outcome of a happy confluence of traditional rules and customary practices, and the participants in them had little idea of the form of the system that they were creating. Indeed, ideological sanctification was almost an afterthought, and democratic approval was belated and in most cases not enthusiastic.<sup>2</sup> Britain was a liberal capitalist society, and possessed the necessary body of private law, some time before the franchise was significantly democratized (which did not occur until 1867). It is, of course, recent theoretical and empirical research which has revealed that the political choice mechanisms that developed haphazardly after the success of the market are a potential threat to it.<sup>3</sup>

<sup>1</sup> "Constructivist rationalism" designates that style of thinking which supposes that it is possible to impose on a social system a pattern of social and economic organization which is derived from a notion of human reason uninformed by experience and the lessons of tradition. It is most clearly exemplified in systems of centralized economic planning which dispense with the price signals provided by spontaneous markets. Constructivist rationalism presupposes that a single mind or institution is capable of organizing the necessarily dispersed knowledge in society. Its most articulate critic is F. A. Hayek, who does not limit his critique to rationalistic economic planning but includes refutations of attempts to design whole legal systems from *a priori* principles. See his *Rules and Order*, vol. 1 of *Law, Legislation, and Liberty* (London: Routledge and Kegan Paul, 1973).

<sup>2</sup> Though, of course, the U.S. has been, with the exception of slavery, a liberal democracy since 1789.

<sup>3</sup> James Buchanan's innovative works are especially relevant here. See his *The Limits of Liberty* (Chicago: University of Chicago Press, 1975), and *Fiscal Theory and Political Economy* (Chapel Hill: University of North Carolina Press, 1960); James Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962); and James

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The former Communist countries are not the lucky beneficiaries of a spontaneous order but the penniless inheritors of a past experiment in constructivism. A number—for example, Poland, Czechoslovakia, and Hungary—can attempt to recapture an order of either incipient or developed market capitalism that was shattered by Communism, and another, the former East Germany, can live for a while almost parasitically off the economic and intellectual capital of its partner in a natural but unexpected political marriage. But the immediate task for them all must be to create, almost in a “bootstraps pulling” manner, not merely new economic arrangements but also the set of intermediary or auxiliary social institutions of civil society which are essential for the maintenance and reproduction of economic order. Given the variety of cultural traditions on which Communism was imposed, there can be no one universal panacea for the problems it has bequeathed, though there are permanent constraints within which all must operate.

One must assume that the “market versus the state” debate is over. The immense calculational (and ultimately epistemic) problems involved in a socialist order which treats the economy as one giant firm have been demonstrated many times as a matter of theory<sup>4</sup> and these theories were corroborated with grisly repetition in reality. One must also dismiss the once fashionable convergence thesis,<sup>5</sup> i.e., the claim that fundamental similarities in the production problems that confront market capitalist and centrally planned economies will generate some economic hybrid that embodies the virtues of each. But there was no such convergence, rather the gradual admission from socialists that their fundamentally different planning method failed dismally in comparison to the market in the solution of the same problems that confront all economies. Of these, the most important are scarcity and the efficient allocation of resources. Without an internal price mechanism to indicate scarcities, planning authorities were compelled to rely on the international market to provide the necessary economic information. In any case, resources were not primarily allocated to satisfy consumer preferences but simply to fulfill the arbitrary dictates of political rulers. Shortages of basic goods were therefore an endemic feature of life under planned systems.

The absence of entrepreneurship in planned economies, and the inadequacy of all the surrogates (such as the replacement of profit-seeking

Buchanan and Richard Wagner, *Democracy in Deficit* (New York: Academic Press, 1977). See also Gordon Tullock, *The Vote Motive* (London: Institute of Economic Affairs, 1976).

<sup>4</sup> Ludwig von Mises, “Economic Calculation in the Socialist Commonwealth,” in *Collectivist Economic Planning*, ed. Friedrich von Hayek (London: Routledge and Kegan Paul, 1935), pp. 87–130; Hayek, “Socialist Calculation,” in Hayek, *Individualism and Economic Order* (London: Routledge and Kegan Paul, 1948), pp. 119–208; Don Lavoie, *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered* (Cambridge: Cambridge University Press, 1985).

<sup>5</sup> See John Kenneth Galbraith, *The New Industrial State* (Boston: Houghton Mifflin, 1978).

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private agents by paid managers) for this essential mechanism of coordination that were tried, revealed that the market and the plan are radically different types of economic organization. Furthermore, there is no evidence that the collectively owned industrial systems overcame that "alienation" between the worker and his product that was alleged to be a feature of private enterprise.

Yet the triumph of the market over the state is not an automatic endorsement of all the market systems now prevailing in the Anglo-American portions of the West, nor an intellectual license for their immediate transplantation to former Communist regimes, leaving aside the cultural factors that may inhibit the success of any proposed transplantation. It is not assumed by the inhabitants of these regions that the ideal of liberty is best illustrated by the Anglo-American conception or that the form of property which is most desirable for them is that which emerges from self-interested action in anonymous markets subject only to abstract rules. Above all, it cannot be assumed that notions of individuality and community which detach agents from all but the minimum of social bonds are likely to be attractive to populations which have little or no experience of the subtlety of these abstract rules. It would be the high point of naiveté to suppose that an economic order bounded by contract, tort, and the intricacies of corporate law can be grafted onto communities which have little experience of capitalist legality. This is especially true of Russia, whose nascent (but potentially successful) commercial order was swept away by the Revolution of 1917 and its aftermath.

Indeed, the vacuum created by the collapse of Communism is likely to feature pockets of anarchy in which the entrepreneurial spirit, subject to no legal restraint, and operating in the absence of specified property rights, is certain to function in a malign manner. Indeed, it would appear that this is already happening.<sup>6</sup>

It takes some persuasive art to convince inhabitants of communities which are still pervaded by the most primitive notions of social justice that there is both an economic rationale to pure entrepreneurial profit (i.e., profit that accrues not to a factor of production, labor, but to mental alertness to wealth-creating opportunities) and a moral justification for it.<sup>7</sup> This is especially so when those most alert are likely to be former officials of the Communist regime. Under Communism, individuals were alienated from the system because to them it appeared to be a mechanism for enhancing the interests of the Communist Party, whose members masqueraded as representatives of the public. For this reason it was accorded little legitimacy. However, this alienation is likely to be reproduced even if an inchoate capitalist legal system were to replace anarchy,

<sup>6</sup> See reports in *Express and Chronicle*, Moscow, March 3–10, 1992.

<sup>7</sup> Israel Kirzner, *Discovery, Capitalism, and Distributive Justice* (Oxford: Blackwell, 1989).

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since the immediate beneficiaries of it will most probably be those who acquire their assets by force.

In capitalist regimes the discovery of a profitable opportunity by a creative economic agent is regarded as legitimate if, and only if, existing legal forms and established private-property rights are respected. However, under post-Communism, entrepreneurial activity is almost certain to involve the seizure of hitherto commonly held assets by the *nomenklatura*. At the moment there are simply no rules of just acquisition, so a perverse form of privatization is taking place. This will, of course, prevent the legitimization of capitalist processes.

Within the range of possible market alternatives to Communism, the Anglo-American model (I refer to it simply as a model so that the very serious depredations to it that have occurred in this century can be conveniently ignored) is not the only one. It is rivaled by market socialism, the Scandinavian welfare state, and the original German doctrine of the social market economy. All three have been offered to former Communist regimes, although it is surely obvious that each depends upon the prior establishment of a predictable and stable constitutional and legal order. (However, it should not be thought that legal and economic orders are theoretically separate, that a neutral political order can be constructed which can accommodate any economic system.) There is a fourth alternative, South East Asian capitalism, but I have limited this inquiry to Anglo-American and West European models, since it is these that are being offered to former Communist regimes. This is probably because some of these countries, but by no means all, have histories and social structures which are, or were at one time, close to the mainstream European experience.

The first of these alternatives, market socialism,<sup>8</sup> is deeply flawed in theory, and has proved to be quite inadequate in practice. The only serious examples of its implementation are Yugoslavia and the voluntary system in Mondragon in Northern Spain.<sup>9</sup> Both are characterized by lower productivity than capitalist orders operating with similar natural resources. In Yugoslavia the power quickly shifted from workers to managers. The idea that there can be collective ownership and direction of resources alongside an individualistic market signaling system for labor and consumer goods is no more than an attempt to "square the circle."<sup>10</sup> In its efforts to simulate the perfectly competitive equilibrium model of resource allocation, market socialism enervates those human faculties that enable

<sup>8</sup> The most recent argument for market socialism is contained in David Miller, *Market, State, and Community: Theoretical Foundations of Market Socialism* (Oxford: Clarendon Press, 1989).

<sup>9</sup> See Brian Chiplin, John Coyne, and Ljubo Sirc, *Can Workers Manage?* (London: Institute of Economic Affairs, 1977).

<sup>10</sup> Antony de Jasay, *Market Socialism: A Scrutiny* (London: Institute of Economic Affairs, 1991), p. 22.

actual markets to work toward equilibrium. Again, entrepreneurship is the vital ingredient, for without the possibility of profits (as distinct from payments to a factor according to its marginal productivity) to lure actors, the necessary coordination will not take place and economizing opportunities will be missed. If capital is to be allocated by the state, how are its officials to *know* where the best investments are? Almost certainly, entrepreneurship (a fundamental category of human action) will reappear in a less benign form, i.e., in the search for the profits that accrue from political activity.

If workers are to be forbidden from owning individually any of the share capital of the enterprise, then rationality dictates that surpluses will be consumed in the form of wages, with the consequent lowering of investment. This is especially so if consumption and investment decisions are “democratized.” Yet if workers are permitted to own resources, and these are marketable, then a version of orthodox capitalism will quickly emerge, and with it the familiar inequalities that market socialism is supposed to eliminate.

The two other models, the Scandinavian welfare state and the German social market economy, are often confused—largely, I think, because the actual practice of the West German economy began to resemble the Swedish experience, from at least the 1960s, in significant ways. But they are theoretically different. The Swedish system originally involved the imposition of heavy welfare responsibilities on a more or less unhindered market system. It was a market system characterized by almost exclusively private ownership in the means of production. It was and is, in effect, a “transfer” state in which political intervention took the form of the establishment of extraordinarily costly welfare services.<sup>11</sup>

If a measure of personal liberty is the amount of income left in the hands of individuals, then by the 1980s Sweden had become a not particularly free society. In many areas, including health, pensions, education, and aspects of family life, personal responsibility for action had been removed.<sup>12</sup> Furthermore, the Swedish system had no comprehensive theory of the social welfare state, a theory that would connect social, legal, political, and economic life in both its explanatory and normative aspects. It was reasonably effective when central government left the economy alone and pursued its own welfare policies, preserving a rather unlikely division of labor. However, the encroachment of the state into

<sup>11</sup> Eric Brodin, “Collapse of the Swedish Myth,” *Economic Affairs*, February 1992, pp. 14–22.

<sup>12</sup> Swedish socialist thinkers (including Gunnar and Alva Myrdal) regarded the bourgeois family as an obstacle to the full realization of the welfare state. Hence, a whole range of family services, including home allowances, child care, and home care for the ill and elderly, are provided by the state. In addition to zero-priced medical care, everyone on sick leave gets 90 percent of their wage without a doctor’s certification. Furthermore, incentives exist for unmarried motherhood, the right of parental discipline is severely restricted by law, and social workers have extensive powers to interfere with family life.

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more and more areas of social life has made the terms of the contract economically disadvantageous.<sup>13</sup> Although large-scale nationalization has been eschewed, the state has taken significant stakes in industry, notably pharmaceuticals and steel.

Marginal income tax rates have been as high as 92 percent, and they are rarely less than 70 percent. Furthermore, the burden of company taxation has increased: until the mid-1970s it was exceptionally low, but since then successive Social Democratic governments introduced taxation on “surplus” profits (although this, at 20 percent, is at least an improvement on the original intention of confiscating all profits above a certain level). Also, there was a scheme to return the tax on surplus profits to the trade unions to invest in the shares of listed companies. This would, if implemented in full, lead eventually to the nationalization of Swedish industry. A modified version was introduced in 1982, but it was not successful. Nevertheless, it is a constant threat to private enterprise and has led to a massive increase in overseas investment by Swedish firms.<sup>14</sup>

The combination of high labor costs, a bloated public sector, and a very expensive welfare state has produced a marked decline in the Swedish growth rate. In the century 1870 to 1970, only Japan grew faster than Sweden, but in the 1980s, the rate had fallen to about 2 percent per annum. The conservative coalition government which was returned in 1991, after a long period of almost uninterrupted Social Democratic rule, specifically rejected the Swedish model as a “third way” between socialism and capitalism. It is in the process of dismantling parts of the welfare state and selling off state holdings in private industry.

## I. ORIGINS OF THE SOCIAL MARKET ECONOMY

A much more plausible model for former Communist regimes to follow is that provided by the German social market economy – or at least the model as it was described by its most prominent theorists. Although there are crucially important differences between the position of postwar Germany and former Communist regimes today, there are enough similarities to make some meaningful comparisons. Both areas experienced ruinous central planning and wrecked monetary systems. More important is the fact that the theory of the social market economy included significant modifications of pure *laissez faire*: variations which might make capitalism more palatable to societies struggling to end central planning. As I shall indicate below, in many respects some of the former Communist regimes are in such a perilous state that mere survival is their most immediate problem. But in some countries, notably Czechoslovakia, Poland,

<sup>13</sup> See Gabriel Stein, “The Death of the Swedish Model,” *Policy*, vol. 7, no. 1 (1991), pp. 2–5.

<sup>14</sup> *Ibid.*, p. 4.

and Hungary, some version of the social market economy appears to be appropriate.

In the original German *Soziale Marktwirtschaft* (social market economy), there was no attempt to locate some middle ground between the extremes of collectivism and the market economy. Ludwig Erhard, the economic architect of the regime and accomplished theoretician of it, specifically precluded the Scandinavian model.<sup>15</sup> He argued that it was too statist and that not only would its implementation be very costly in the circumstances of postwar Germany, but it would have a deleterious long-term effect on personal responsibility. It was not that Germans were unused to extensive social welfare; they had had it since Bismarck's day. The point was that for the theorists of the social market economy there were interrelations between economy and society, feedbacks from social institutions to personal action, which required explanation: society and economy, in other words, are not hermetically sealed entities. The theorists of the social market economy sought an account of the *Wirtschaftsordnungspolitik*, or the order of economic society. Such a comprehensive theory would explain economy, polity, and society and account for their interrelationships.

The social market economy is in principle the doctrine that private property and the price system are the best means of exploiting scarce resources for the maximization of human well-being. It enjoins a limited state with the primary responsibility of securing law and order and a stable monetary system. That state is in theory precluded from the use of Keynesian fiscal policies to cure unemployment, since the theorists argued that this is primarily a microeconomic problem caused by rigidities in the labor market, normally trade-union power. However, the social market economy differs, as we shall see, from classical liberalism in that its theorists were skeptical of the claim that a market system is always self-correcting, especially in relation to the emergence of monopoly power. The legal system would have to be designed so that freedom is preserved, and not threatened, as these theorists claimed it would be, by untrammelled markets.

They also believed that the state had certain welfare responsibilities for the innocent victims of necessary economic change. But in the theory of the social market economy, if not in the practice of West German policy making, the state should not take a role in those areas of welfare which most individuals can handle for themselves, e.g., in pensions and other forms of social insurance. The postwar West German government inherited a range of state welfare functions which continued, even though the purists were later to object to their extension. They thought that this would have feedback effects, not only on productivity but also on indi-

<sup>15</sup> Quoted in Hans-Joachim Braum, *The German Economy in the Twentieth Century* (London: Routledge, 1990), p. 178.

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vidual autonomy. Thus, the “order” of economic society could only be maintained by a judicious mixture of carefully designed welfare measures and regulatory devices which are required to modify and correct laissez-faire economics.

The obvious success of postwar Germany has led many people to think that the theorists got it right, that the rigors of the free market were softened by socially oriented institutions and policies without those arrangements weakening at the same time the productivity of the exchange system or undermining the autonomy of its inhabitants. It is not then surprising that the social market economy has been recommended for former Communist regimes. This was explicitly so in the debate leading up to German reunification and in the case of Hungary’s attempts to slough off the remnants of Communism. No doubt the phrase was used rhetorically, as an anodyne slogan designed to induce into markets populations which were alienated by Communism yet fearful of an unknown capitalist future.

The theory originated during the prewar and war periods. In Germany a remarkable group of social and economic thinkers had been working out a blueprint or rational plan for the post-Nazi and postwar reconstruction of the country. Although they are collectively known as the “Ordo” group (Ordo Kreis) there were two differing, if not distinct, strands: a group of economists, of whom the leading figures were Walter Eucken, Franz Böhm, and Fritz Meyer, based at Freiburg; and a number of more socially oriented thinkers, the “exiles” Wilhelm Röpke, Alfred Müller-Armack (who coined the phrase “social market economy”), and Alexander Rüstow.<sup>16</sup> It should be noted, however, that none of the latter, with the possible exception of Müller-Armack, had a doctrine that bore much resemblance to Scandinavian welfarism. Of great significance is the fact that West Germany’s first Economics Minister, Erhard, was closely associated with Ordo.

Before examining in detail the economic and political thought of the social market economy, it might be helpful to look briefly at the circumstances in which it arose.<sup>17</sup> From 1936 to 1948, during both the Hitler and the Allied Occupation periods, the German economy was subject to rigid

<sup>16</sup> Most of the major works of the Ordo group are now available in English. See *Standard Texts on the Social Market Economy* (New York: Ludwig Erhard Institute, 1982). Especially important individual works are: Walter Eucken, *The Foundations of Economics* (Edinburgh: William Hodge, 1951), and *This Unsuccessful Age* (Edinburgh: William Hodge, 1951); Wilhelm Röpke, *The Social Crisis of Our Time* (Edinburgh: William Hodge, 1950), and *A Humane Economy* (London: Wolf, 1960).

See also Konrad Zweig, *The Origins of the German Social Market Economy* (London: Adam Smith Institute, 1980); *Germany’s Social Market Economy: Origins and Evolution*, ed. Alan Peacock and Hans Willgerodt (London: Macmillan, 1989); and *German Neo-Liberals and the Social Market Economy*, ed. Alan Peacock and Hans Willgerodt (London: Macmillan, 1989).

<sup>17</sup> For a historical account, see Gustav Stolper, *The German Economy: 1870 to the Present*, new edition, revised by Karl Hauser and Knut Borchardt (London: Weidenfeld and Nicholson, 1967), pp. 219–72.



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controls. But price fixing, rationing, and a hopelessly inefficient monetary system (the reichsmark was worthless) had produced ruinous economic results: output plummeted, the black market flourished, and barter had replaced normal monetary exchange. Full employment was maintained, but only by a system which produced goods that nobody wanted. The Allied Occupation powers, engaged in the process of denazification, were determined that West Germany should not have a liberal market economy. In fact, the economic advisers at the time were Keynesian and broadly sympathetic to economic planning. However, it was realized that currency reform was essential, and Ludwig Erhard (chief official of the Administration for Economic Affairs for the British and American Occupation Zones), used the occasion of the establishment of the new deutschemark to secure (by the use of not a little chicanery)<sup>18</sup> the immediate lifting of a whole range of price and other controls. Erhard simply let the market operate freely in the new regime of monetary stability. He specifically did not use an expansionary budget to mop up the unemployment that inevitably appeared as an immediate consequence of the removal of controls.

This was greeted with skepticism by the Allied economists. None other than John Kenneth Galbraith was economic adviser to the American Military Government, and he made the following comment on the liberalization program: "There has never been the slightest possibility of getting German recovery by this wholesale repeal [of price controls], and it is quite possible that its reiteration has delayed Germany's recovery. The question is not whether there must be planning . . . but whether that planning has been forthright and effective."<sup>19</sup> Yet the subsequent events showed Galbraith, and almost all conventional economic observers at the time, to be spectacularly wrong.

As the liberalization of the hitherto controlled economy proceeded throughout the late 1940s and early 1950s, West Germany quickly recovered. From 1953 to 1963, GNP grew at an annual average rate of 6.7 percent, compared with 4.7 percent in France and 2.7 percent in Britain.<sup>20</sup> Alongside that of Britain, West Germany's performance in industrial output and exports was phenomenal, and by the 1960s the country was on top of the European economic league. Although factors other than the social market economy were important, such as a surplus of labor from Eastern Europe which reduced pressure on wages and ensured (relative)

<sup>18</sup> The three military governments had little idea what to do about the West German economy but probably favored the continuation of the controls. Erhard simply went ahead with the liberalization without asking their permission. He gambled that the success of the measures would make them irreversible. See Hans Willgerodt, "Planning in West Germany: The Social Market Economy," in *The Politics of Planning*, ed. A. Lawrence Chickering (San Francisco: Institute for Contemporary Studies, 1976), pp. 61–82.

<sup>19</sup> Quoted in *ibid.*, p. 64.

<sup>20</sup> See A. Gruchy, *Comparative Economic Systems* (Boston: Houghton Mifflin, 1977), ch. 5.

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trade-union docility, the application of that particular economic philosophy was instrumental in securing this remarkable transformation.

There was no *Wirtschaftswunder* (economic “miracle”) but merely the result of the pursuit of well-tryed economic orthodoxies (although at the time they were almost radical). Some credit must be given to Erhard, as senior Economics Minister in the Adenauer government, for sticking to free-market principles against many pressures, ideological as well as political. Nevertheless, there was no “pure” market economy in postwar West Germany. There were many state interventions, of which perhaps the most significant was the deliberate use of fiscal policy to encourage personal savings.<sup>21</sup>

It is a significant fact that the social market economy was imposed on the German people. Most commentators doubt that it had much support from the major political groups, including the Christian Democrats, who were wedded to a kind of Christian socialism; and but for the ruinous situation at the time, it might never have been given a hearing. It is also pertinent to note that Germany’s defeat had effectively destroyed all those special-interest groups that had succeeded in undermining the market system in Britain.<sup>22</sup> However, once the success of the social market economy became manifest, the doctrine came to be embraced by all the political parties, although the Social Democrats did not formally abandon Marxism until 1959.

Despite the devastation of war, there were some features peculiar to Germany which made it propitious for the establishment of a market economy. Although productive capacity was badly damaged by war, the effect should not be overestimated.<sup>23</sup> What was left was still serviceable in comparison to the vast tracts of more or less unusable heavy industry bequeathed by Communism. Although the Nazis had operated a command economy, it had functioned through a system of private ownership (heavily cartelized though it was) and private law (heavily compromised though that had become). Most important of all, there still existed significant social and intellectual capital invested in market arrangements, even though it required considerable replenishing. In comparison, most former Communist regimes will have to be marketized *ab initio*.

Nevertheless, there is one startling similarity. Former Communist regimes, if they are to introduce successfully a free-market economy, are likely to do so in a nondemocratic context. This is not to say that market arrangements, in principle, are unpopular, but rather than in the immediate short-term it is likely that a coalition, consisting of those who benefit from the status quo, could form against particular market proposals if they were put to an immediate vote. The market system is itself a pub-

<sup>21</sup> Tax incentives were offered to encourage investment, especially for house-building. There were also subsidies to agriculture and selected industries.

<sup>22</sup> Mancur Olson, Jr., *The Rise and Decline of Nations* (New Haven: Yale University Press, 1982), pp. 129–33.

<sup>23</sup> Braum, *German Economy in the Twentieth Century* (see n. 15 above), ch. 8.