



MARTIN-LUTHER-UNIVERSITY HALLE-WITTENBERG

Faculty of Law and Economic Sciences
Chair of Economic Ethics
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Ethics and Economics of Institutional Governance

Lecture 5
Winter Term 2025/26

Overview

Ethics and Economics of Institutional Governance: 14 Lectures (L)



Introduction (L 1)

1. The Ordonomic Approach (L 2 + 3)
2. The Social Structure of Modern Society (L 4 + 5)
3. The Semantics of Modern Society (L 6)
4. Social Learning Processes for the Reciprocal Adaptation of Social Structure and Semantics (L 7 + 8 + 9)
5. Case Study on Climate Policy (L 10 + 11)
6. Applications: The Ordonomic Line of Argumentation (L 12 + 13)

Summary and Outlook (L 14)



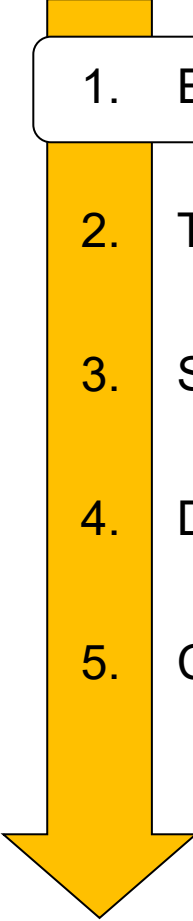
What have we learned?

The main lessons of the fourth lecture are:

- Competition puts competitors in a social dilemma. Using the example of suppliers: they undercut each other in price and outperform each other in terms of quantity (as well as dynamically: in terms of quality!) of their products.
- In the institutional vacuum, the bilateral exchange between supplier and buyer is also a social dilemma.
- As society, we deal with these two dilemmas very differently: the institution of the private law contract is an instrument for stabilizing brisant interactions. This serves to overcome vertical dilemmas. Conversely, economic policy, and in particular competition policy, relies on forcing horizontal dilemmas by opening up markets to (potential) competitors and by undermining cartels.
- Market arrangements are based on a differentiated management of social dilemmas: we establish horizontal dilemmas in order to overcome vertical dilemmas. – As society, we set up markets in such a way that competition enters the service of social cooperation.
- From a dynamic point of view, institutionalized imitation competition and innovation competition are the growth engines of modern society.
- Competition ensures zero profit and, in a dynamic view, the diffusion of innovation rents, so that all members of society ultimately benefit: workers benefit in the form of higher wages and improved working conditions; consumers benefit in the form of lower prices and improved product quality.

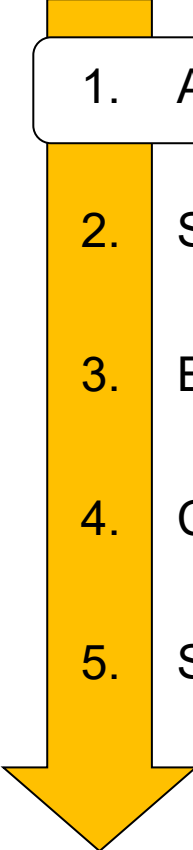


Structure of last Lecture

- 
1. Entrepreneurial profit orientation in market competition
 2. The market as an arrangement of dilemma structures
 3. Static effects of competition: rent diffusion
 4. Dynamic effects of competition: imitation and innovation
 5. Conclusion



Structure of Today's Lecture

- 
1. A preliminary consideration
 2. State
 3. Economy
 4. Civil Society
 5. Societal Learning Processes



Preliminary Consideration (I)

In their book "Free to Choose", Rose and Milton Friedman (1980; p. 116 f.) develop the following argument to criticize the expansion of the welfare state:

Rose und Milton Friedman



<https://www.dailysignal.com/wp-content/uploads/MiltonRoseFriedman.jpg>

„A simple classification of spending shows why that process [= expansion of welfare programs] leads to undesirable results. When you spend, you may spend your own money or someone else's; and you may spend for the benefit of yourself or someone else.“
(p. 116)

Their thesis is that the defects of the welfare state can be explained in this way:

„The bureaucrats spend someone else's money on someone else. Only human kindness, not the much stronger and more dependable spur of self-interest, assures that they will spend their money in the way most beneficial to the recipients. Hence the wastefulness and ineffectiveness of the spending.“
(p. 117)



Preliminary Consideration (II)

Rose and Milton Friedman (1980; p. 116) establish the following matrix: the horizontal dimension indicates that economicalness depends on whose money is spent; the vertical dimension indicates that the effectiveness depends on whose needs the money is spent on. Their thesis: delegated responsibility in the welfare state is clearly inferior to personal responsibility.

		<i>Economicalness</i>	
		<i>Someone else's money</i>	<i>Own money</i>
<i>Effectivity</i>	<i>Own needs</i>	(IV) Cost discipline: + Accuracy of meeting needs: +++ <hr/> Performance: ++++	(I) Cost discipline: +++ Accuracy of meeting needs: +++ <hr/> Performance: +++++
	<i>Someone else's needs</i>	(III) Cost discipline: + Accuracy of meeting needs: + <hr/> Performance: ++	(II) Cost discipline: +++ Accuracy of meeting needs: ++ <hr/> Performance: +++++

Examples

- I. Purchasing
- II. Gift
- III. Social Bureaucracy
- IV. Expenses

Efficiency:
 $I > II > IV > III$



Preliminary Consideration (III)

Rose and Milton Friedman (1980; S. 119) draw the following conclusion: „Most of the present welfare programs should never have been enacted.“ This is a non-sequitur error.

Syllogism

1. It is a moral concern to pay attention to economicalness and effectiveness when using money.
 2. In terms of economicalness and effectiveness, a social bureaucracy is clearly inferior to using your own money for your own needs.
-
3. That is why the social bureaucracy should be reduced and avoided as far as possible.

Here, the relevant alternatives are missed, and in two respects:

- Firstly, what is at stake is how to provide care for people who lack money. Quadrant I is irrelevant for this.
- Secondly, Quadrant III applies to all principal agent problems (in the state, business and civil society) and must therefore not be discussed in a vacuum, but only in terms of institutional arrangements and their suitability to solve the problem identified here.



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The History of the State

The institution of the state was created after the Neolithic Revolution. The most important achievement is internal peace through the rule of law. Historically, parliamentarization serves the societal control of political rule. The democratization of the (purely noble or estates-based) parliament is comparatively extremely young.



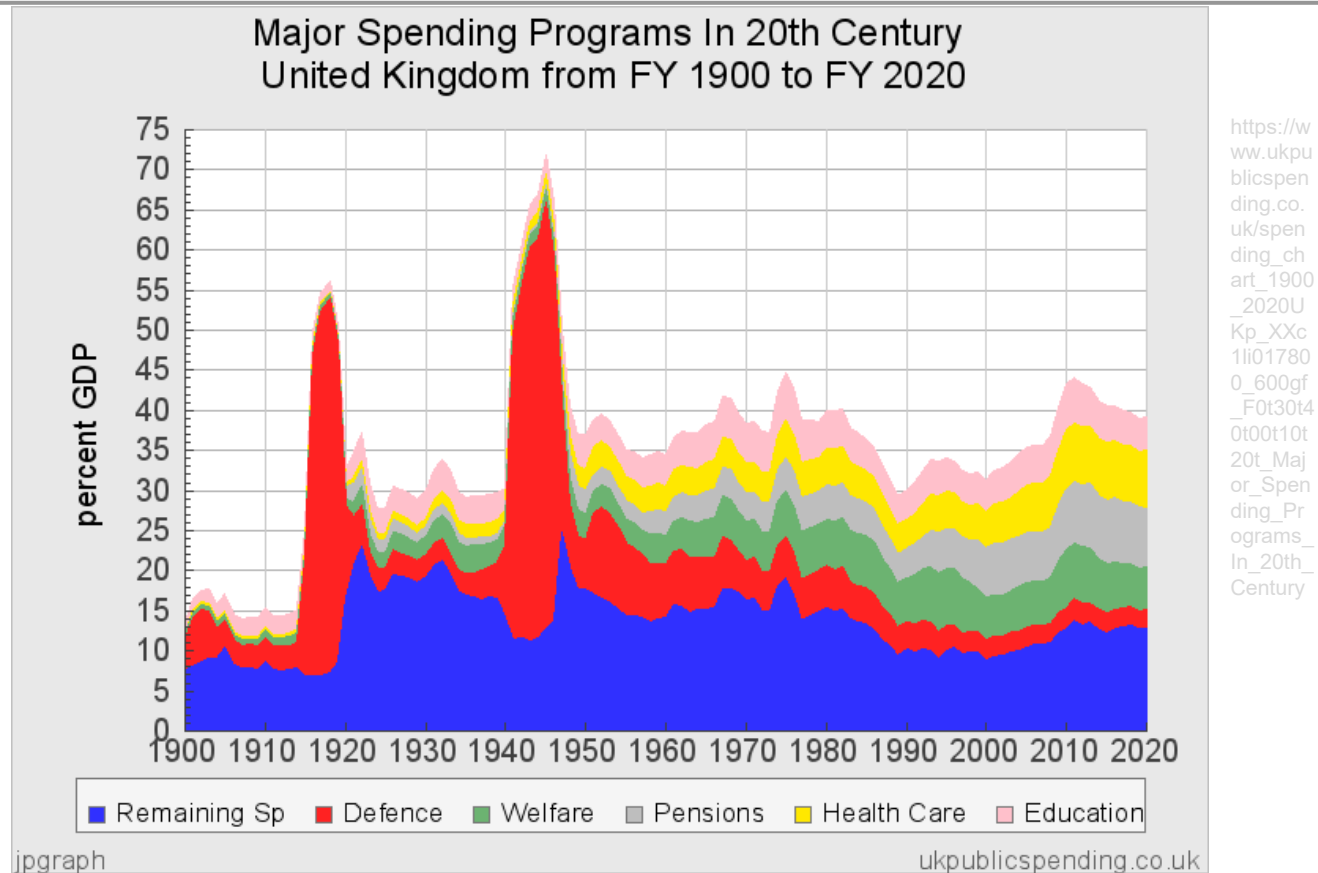
<https://pixabay.com/de/photos/bundestag-volke-deutschland-berlin-2375439/>

Milestones in German Constitutional History

- Introduction of universal and equal suffrage (for men from 25): North German Confederation, 1869
- Introduction of universal and equal suffrage (for men and women from 20): Weimar Constitution, 1919



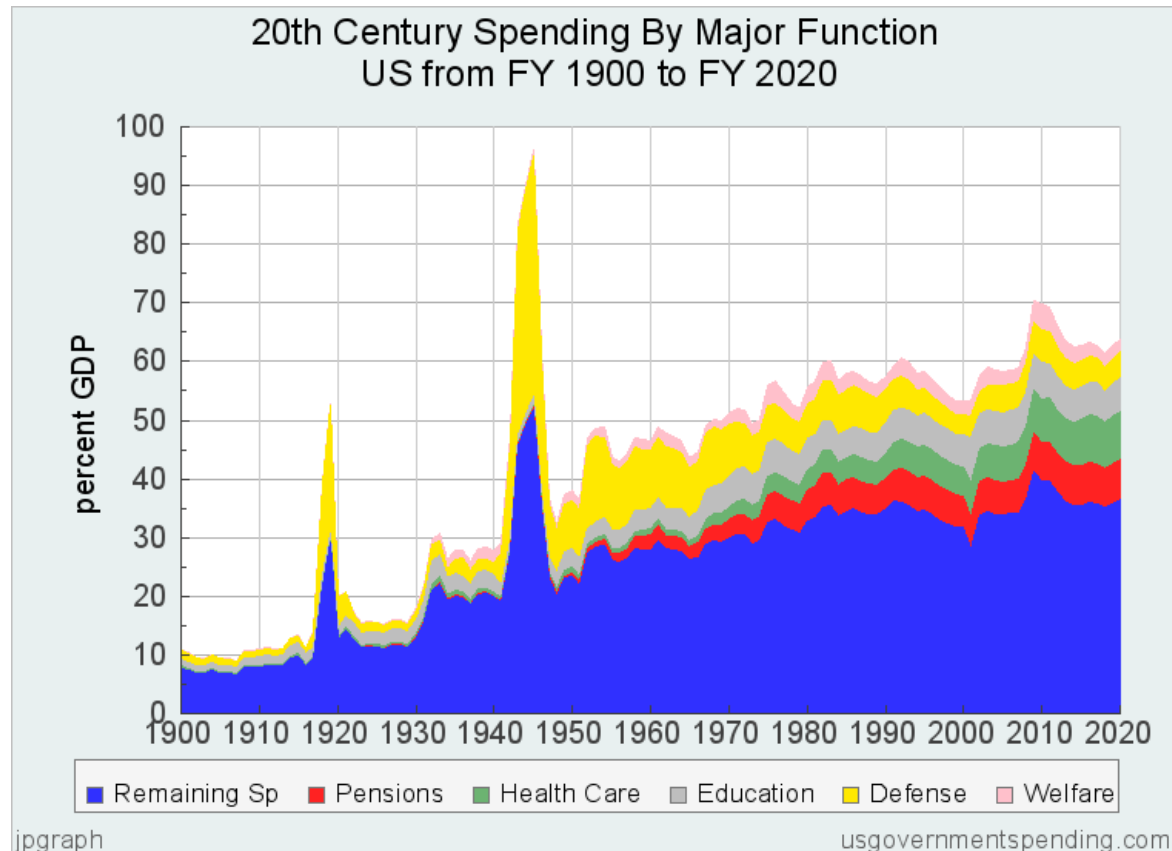
British Government Spending: 1900-2020



- The two world wars are causing a sharp increase in defense spending and leading to a ratchet effect.
- The expansion of the welfare state begins after the First World War.
- Previously, the state was primarily involved in education.
- Since then, social security, health and pensions have been greatly expanded.



Government Spending in the United States: 1900-2020



https://www.usgovernmentspending.com/spending_chart_1900_2020USp_Xs2li017800_600gn_F0t00t10t20t30t40t_20th_Century_Spending_by_Major_Function

- The two world wars are pushing up defense spending.
- During the Cold War, military spending remains high.
- The expansion of the welfare state begins after the Second World War.
- Previously, the state was primarily involved in education.
- Since then, social security, health and pensions have been greatly expanded.

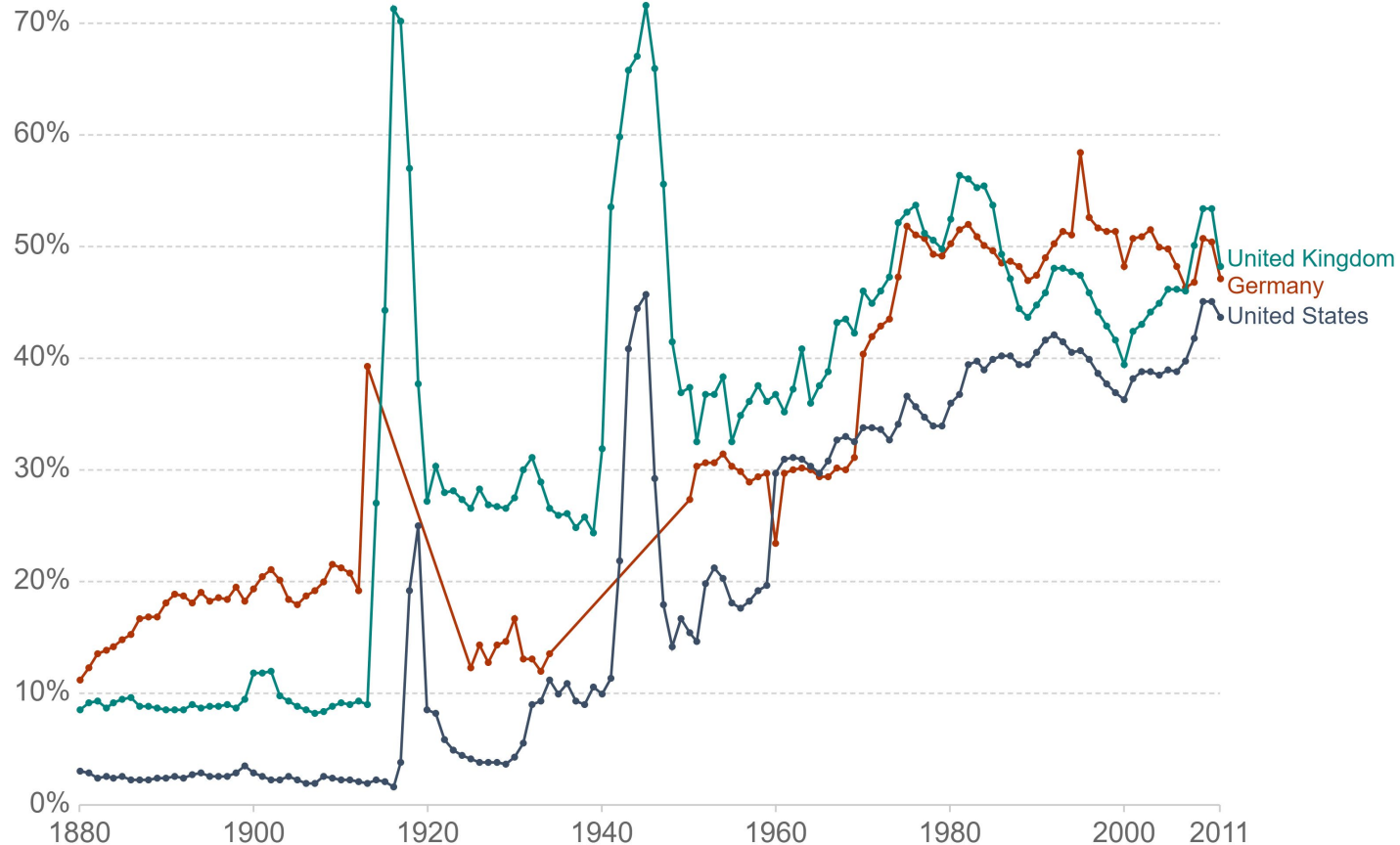


Germany Compared to UK and USA: 1880-2011

Government spending, 1880 to 2011

Total government spending, including interest government expenditures, as share of national GDP

Our World
in Data



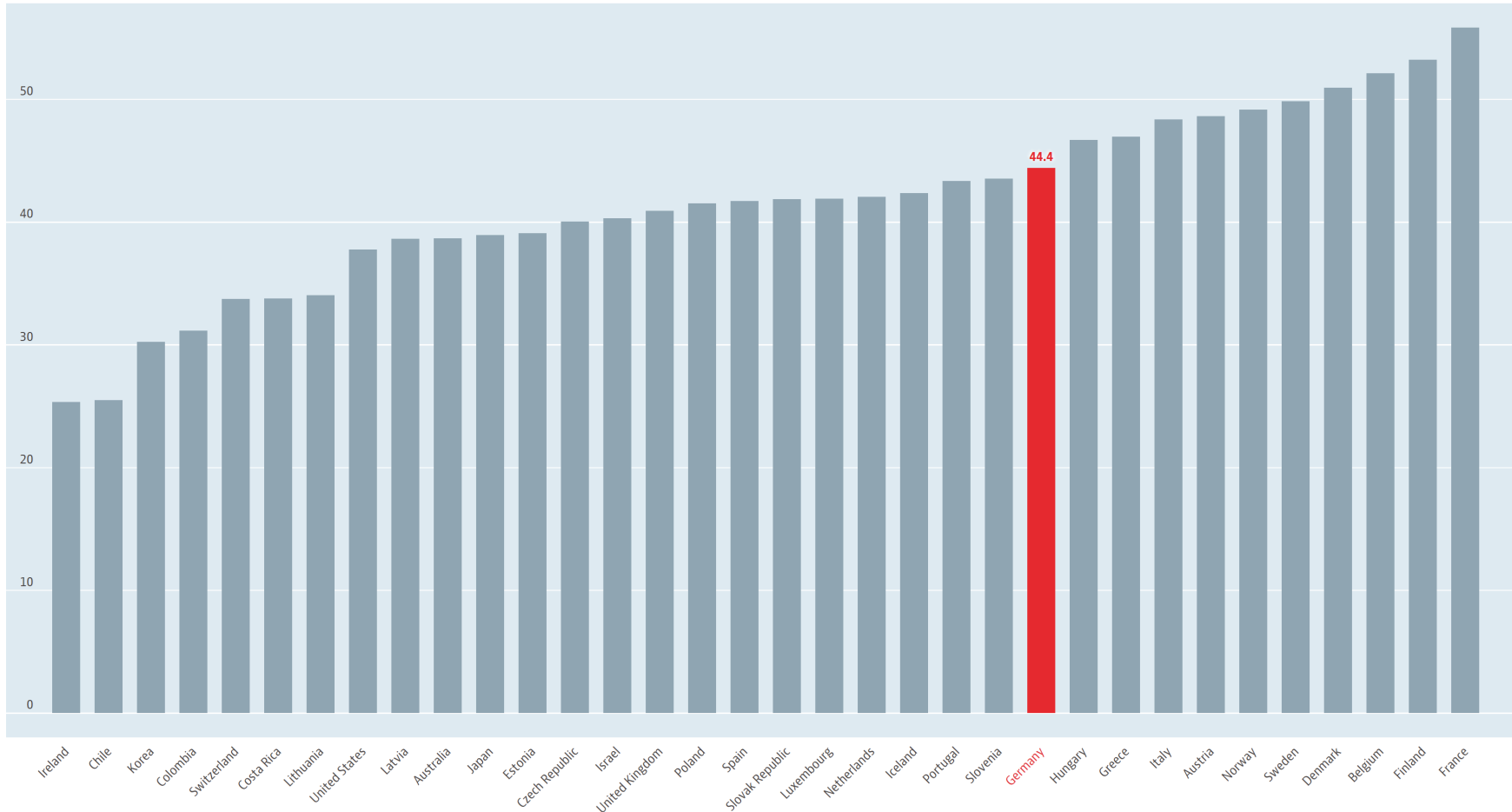
Source: IMF Fiscal Affairs Departmental Data, based on Mauro et al. (2015)

OurWorldInData.org/government-spending • CC BY



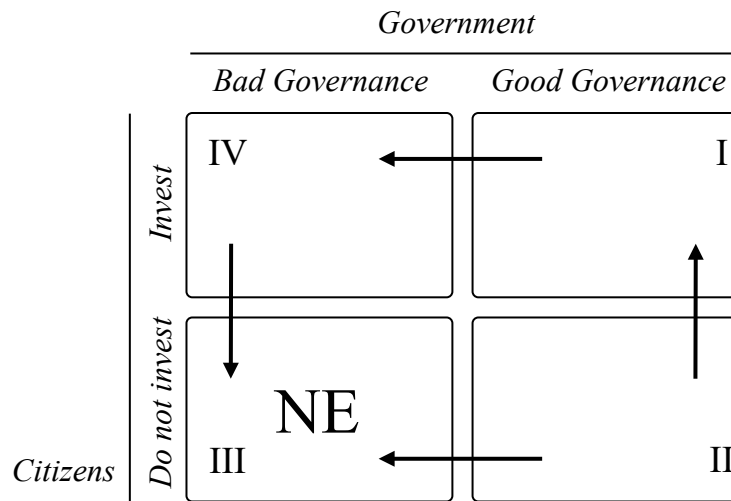
Snapshot 2018: Government Expenditure Ratio in OECD countries

General government spending Total, % of GDP, 2018 or latest available

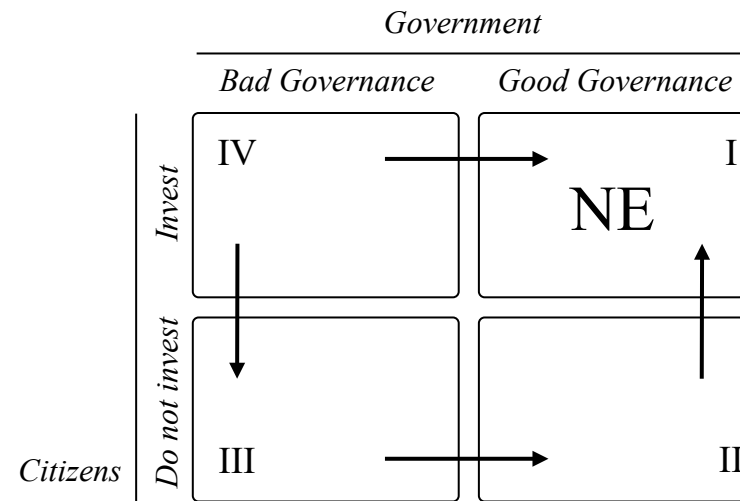


Conjectural History

The history of the modern state is a history of constitutional progress. The logic can be deciphered from an economic perspective: as a transition from a stagnation Nash Equilibrium (NE) with "bad governance" (a) to a growth equilibrium with "good governance" (b).



(a)



(b)

The paradigmatic example of the change from (a) to (b) is the "Glorious Revolution" in England in 1688/89. Howes (2020): „It was not until 1689, when there was a coup, that an incoming ruler allowed the English parliament to sit whenever it pleased. Before that, it was convened only at the whim of the ruler, and dispersed even at the slightest provocation. ... [I]ronically, it was when monarchs lost control that they did most to boost the capabilities of the centralised state.“ (<https://worksinprogress.co/issue/how-to-build-a-state>)

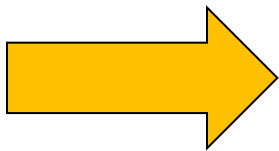
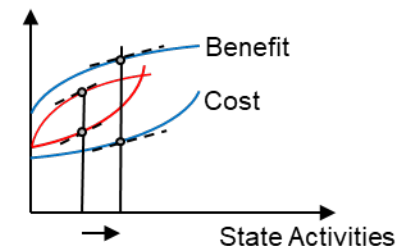


Three Functions of the State

The modern state pursues legal policy, economic policy and social as well as environmental policy. The logic can be deciphered with an economic perspective. Rent-creation is the primary reason, rent-seeking is just a secondary one.

When citizens trust the state, state activities increase:

- every euro that the state receives generates costs of more than one euro,
- but every euro that the state spends on public goods can create far more benefits.



- Task of legal policy: promoting cooperation by overcoming social dilemmas
- Task of economic policy: promoting competition (= establishing social dilemmas), to make cooperation more successful
- Task of social policy and environmental policy: Promoting cooperation by overcoming social dilemmas
 - Provide credit for human capital investments; Pensions
 - Social security against life risks
 - Pricing of natural resources



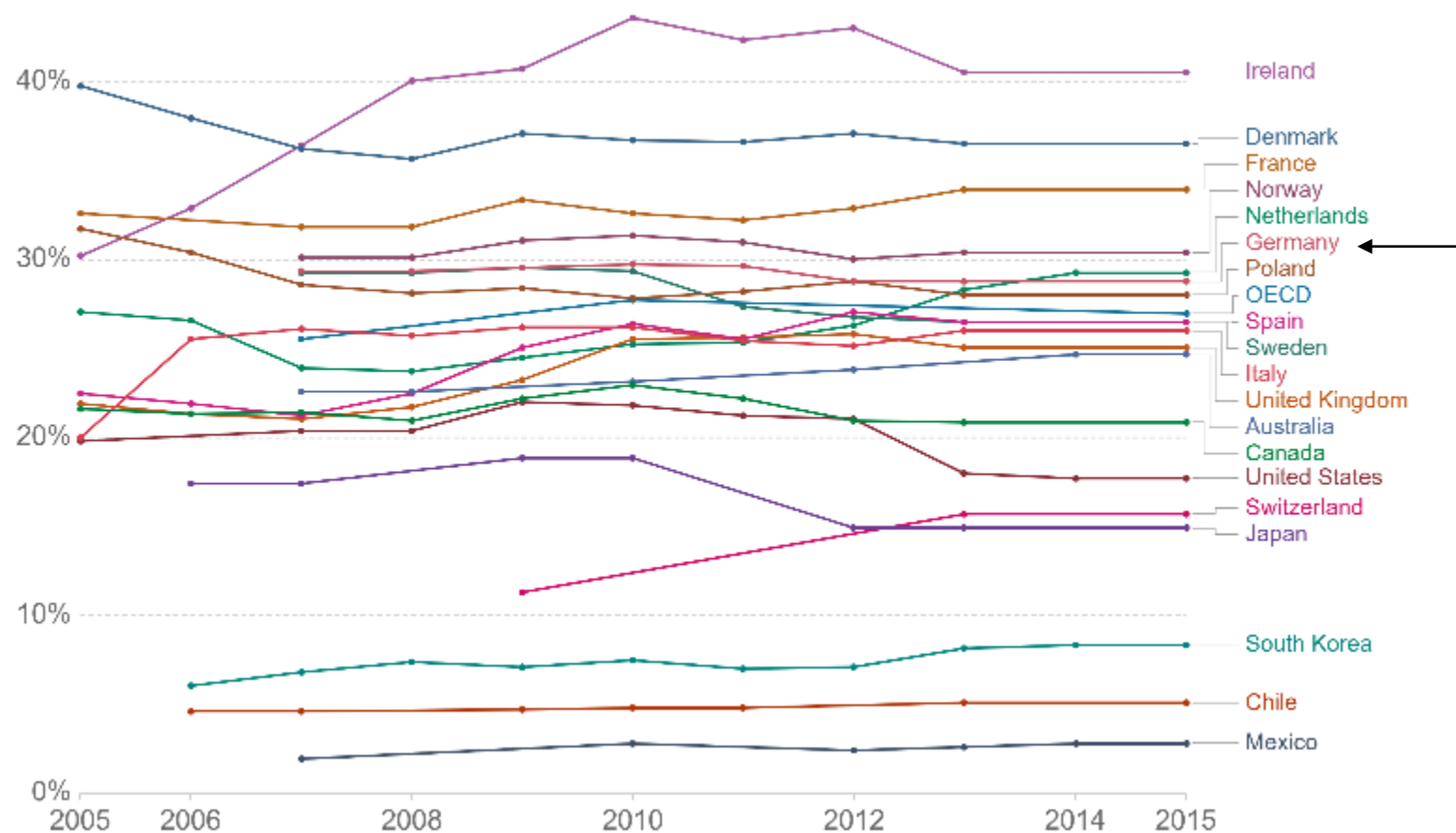
Via taxes and transfers, the state in D has a strong egalitarian effect

Gini coefficient reduction: Ireland 40%, D 30%, Canada 20%, USA 17%, South Korea 8%

Tax reduction in income inequality (%)

Percentage reduction in Gini coefficients before and after taxes and transfers.

Our World
in Data



Source: OECD Income Distribution Database (IDD)

OurWorldInData.org/public-spending/ • CC BY



The Ambivalence of Bureaucracy

Regulations are used to make the behaviour of state bureaucrats predictable and comprehensible. Ultimately, this serves to prevent corruption and to avoid arbitrariness. Bureaucracy is therefore not a bug but a feature: an integral part of governance.



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Companies in the Market Economy

The modern economy rests on competitive markets. Corporate organizations play a dominantly important role here. They have a societal mission as agents (= mandatees) for value creation.

The modern capitalist enterprise

- is based on private collective ownership of means of production
- is designed for an infinite time horizon
- is threatened with the death penalty in the event of insolvency
- is subject to competition under the system imperative to maximize the value of its assets (vulgo: profit maximization)
- depends on escaping the fate of zero profit through innovation

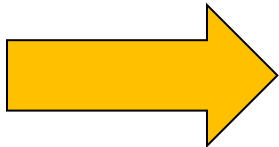
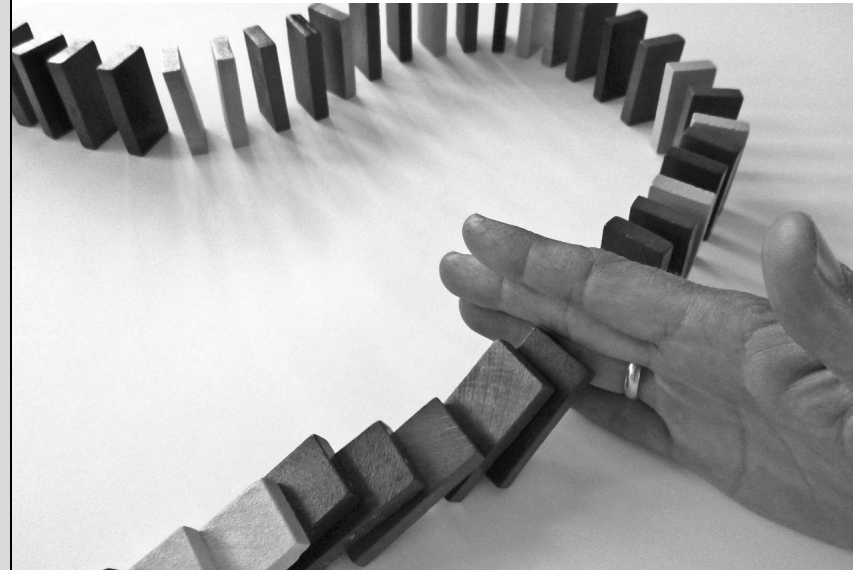


Private Collective Ownership of Means of Production

Stockholders pool their shares and are entitled to residual income. Why?

On the logic of capitalist corporate governance

1. Private individual ownership of machines would trigger a domino effect of veto rights: social dilemma!
2. Workers want high wages, banks want secure interest rates, customers want low prices, municipalities want secure local jobs – only capital owners have an incentive to maximize profits!



Corporate governance is regulated by society. It serves not to privilege the owners of capital, but to serve a socially desirable allocation efficiency. Companies have a societal mission for creating value!



Asset Value Maximization versus Profit Maximization (I)

Asset value maximization is an intertemporal problem that spans multiple periods and affects the company's future prospects over a potentially infinite time horizon. In this sense, profit is only the increase in the asset value related to one period.

Asset value maximization and profit maximization is strictly not the same.

This can be seen in the fact that it may be useful to accept **short-term losses** in the course of asset value maximization, for example when the sales price falls into the interval between the minimum of average total costs and the minimum of average variable costs.

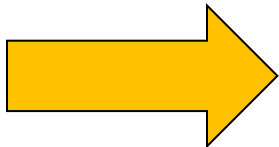
Nevertheless, it has become natural to speak of maximizing profits.



Asset Value Maximization versus Profit Maximization (II)

Possible misunderstandings can be contained if one considers that profit maximization does not mean a short-term but a long-term orientation:

- **Short-term** profit orientation often comes at the expense of asset value maximization, given that future cost increases or losses of revenue associated with current decisions are not fully accounted for (including discounting).
- **Long-term** profit orientation (including discounting) converges with asset value maximization.



Profit maximization is a commonly used abbreviation for the systemic imperative, which is institutionalized via competition, that companies must pay attention to the long-term value of their assets.



Once Again: Clarification on the Concept of Profit (I)

Business administration and economics use different notions of “profit”. This causes confusion, not only in the general public, but also within the academic disciplines.

- **Economics** defines profit as residual income: as the difference between revenue and cost, whereby cost means (without exception) the **opportunity cost of all the factors of production** that are used, i.e. the wage for labor, the interest on capital, the rent for land and buildings, the market prices for intermediate products.
- **Business administration** also defines profit as residual income: as the difference between revenue and cost, but **excludes two categories of cost** from consideration: the remuneration of the entrepreneur's own labor input and the return on equity. These two cost categories are not shown as costs but as profits.
- Therefore, $\text{Profit}_{\text{BusAd}} > \text{Profit}_{\text{Econ}}$

Econ.



Bus.Ad.



Once Again: Clarification on the Concept of Profit (II)

To make it concrete:

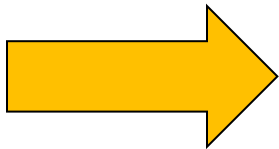
- A company that realizes zero profit (in the **business administration** sense) is in a crisis situation. Revenue is not sufficient to compensate the owners for their capital employed. (This involves destruction of value).
- A company that realizes a zero profit (in the **economic** sense) is in the comfortable situation of having enough revenue to satisfy every single compensation claim for using factors of production.



Once Again: Clarification on the Concept of Profit (III)

Companies are often traded on the stock exchange. This makes it easier to raise capital – and thus to scale value-adding production. But dividends are not equal to profit in the economic sense.

1. Dividends are taxable. If the tax amount is deducted, the gross dividend is reduced to the net dividend. (From an economic point of view, taxes on capital or on capital gains are costs.)
2. The net dividend is a nominal amount. Taking into account the devaluation of money (= inflation rate), the nominal net dividend is reduced to real net dividend. (Economic market analysis only works with real quantities.)
3. The real net dividend contains three components:
 - a) The first component is a risk premium
 - b) The second component is a mobility rent
 - c) The third component is the opportunity cost for a safe investment of the capital employed



- a) The first component must be interpreted as a cost component, because risk is used as a factor of production
- b) The second component is transitory. When competitive markets are open to new competitors, the mobility rent disappears over time
- c) In the long term, the remuneration of capital melts down to its pure opportunity costs. This is exactly what "**zero profit**" means.



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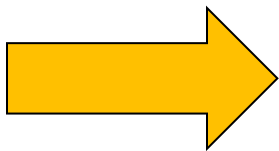


Non-Profit Organizations in Civil Society

Unlike the market economy, civil society is not populated by value maximizing companies (= for-profit organizations), but by non-profit organizations. But what exactly does that mean?

Beware of Misunderstanding!

Non-profit organizations **also maximize profits** (in the economic sense). They are limited only in the **use** of their profits. This particular form of **non-profit governance** serves to solve a principal-agent problem between donors and managers: it serves the promotion of **organizational integrity** in the face of the danger of opportunistic exploitation (= social dilemma of type 1-PD!)



Donors should be able to **trust** that their money will be spent according to their intended purpose (for a moral cause).



Fields of Activity of Civil Society Organizations (CSOs)

CSOs have two fields of activity: (a) service delivery and (b) advocacy.

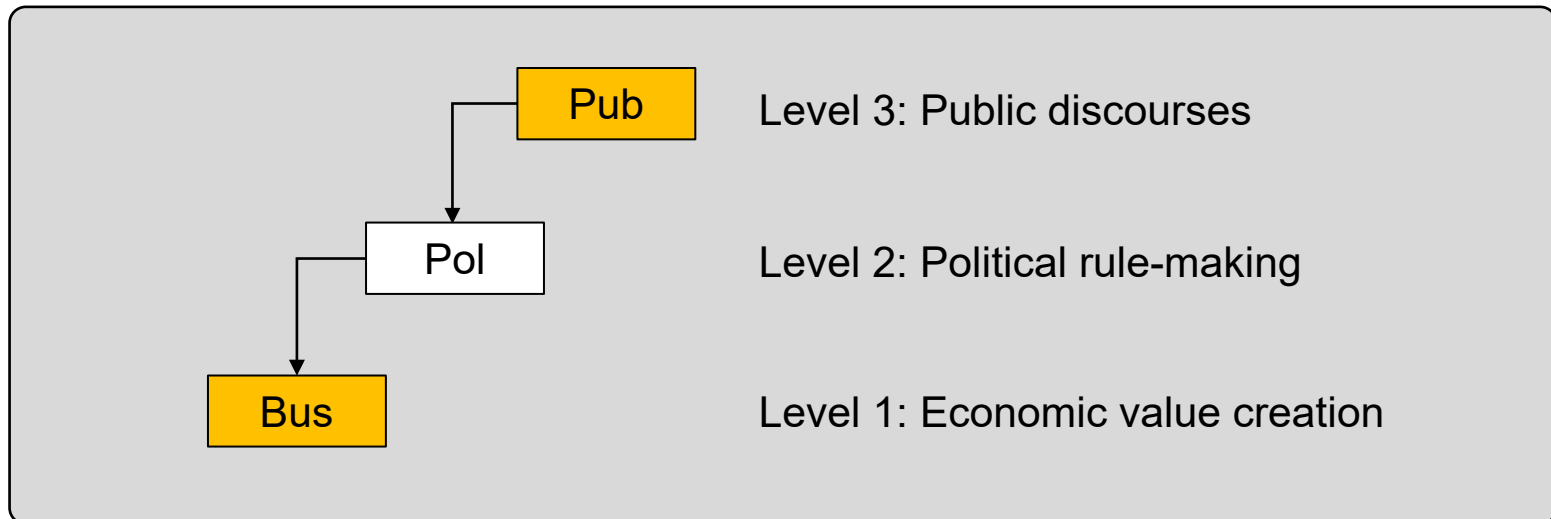


- CSOs organize social activities („service delivery“)
(e.g. church hospitals, Red Cross, trade unions, charity associations)
- CSOs engage as representing political interests („advocacy“)
(e.g. trade unions, environmental organizations, child protection associations, federal taxpayers' associations)



Comparison of Non-Profits and For-Profits (I)

In terms of the ordonomic three-level scheme, CSOs and companies are active on two levels: in the basic game, they create value ("service delivery"). In the meta-metagame, they lobby ("advocacy").



Examples:

Level 1: Charities provide socially vulnerable households with donated food

Level 3: Greenpeace pushes for tougher environmental laws



Comparison of Non-Profits and For-Profits (II)

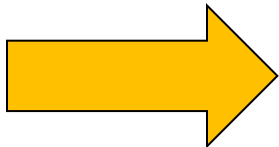
Companies compete in their procurement and sales markets, while CSOs compete primarily (only) in their procurement markets.

CSOs compete for

- donations in cash
- donations in kind
- volunteers
- sympathizers
- public attention

CSOs further compete for

- political influence



In line with the competitive behavior of companies, the competitive behavior of the CSOs also requires an appropriate institutional framework so that competition becomes an instrument for social cooperation (and in order to avoid undesirable social dilemmas).



Comparison of Non-Profits and For-Profits (III)

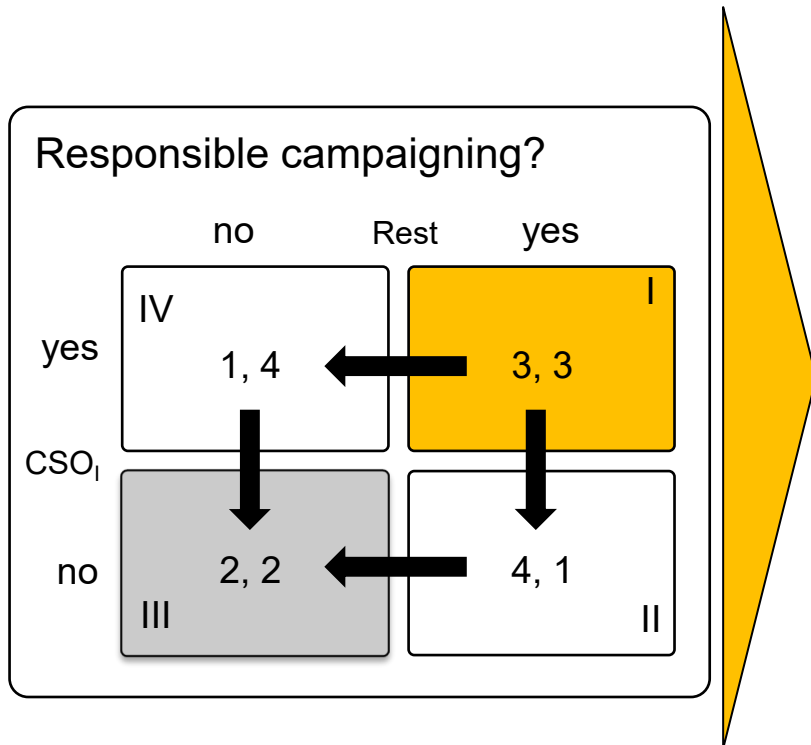
CSOs have a harder time than companies because they want to produce public goods!

	Non-Profits	For-Profits
What kind of production?	public goods	private goods
Free-rider problem with sales?	yes	no
relying on additional sources of funding (in addition to users of goods)?	yes	no
Pursuit of profit?	yes	yes
Free use of profit?	restricted	unrestricted
under competitive pressure?	mainly on input markets	on input and output markets
prone to black sheep?	yes	yes
prone to "media biases"?	strong	weak
prone to "mission creep"?	strong	weak
relying on functional rules for competition?	yes, primarily through self-regulation	yes, primarily through external regulation



Also CSOs can get into Dilemmatic Downward Spirals (I)

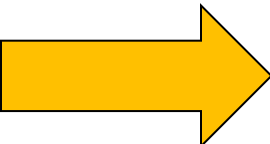
CSOs are tempted to rely on exaggerated negative reports ("alarmism") in their public relations work in order to get more donations. Example: Aid for Africa.



A Norwegian student initiative awards prizes to criticize the propagation of a false image of Africa. Motto: "Stereotypes harm Dignity".

– Video links:

- <https://www.youtube.com/watch?v=oJLgyuxm95k>
- <https://www.youtube.com/watch?v=xbqA6o8WC0>
- <https://www.youtube.com/watch?v=2x10Yec0QL8>
- <https://www.youtube.com/watch?v=oBrNa-VoJfc>
- <https://www.youtube.com/watch?v=swxay1lsaOU>

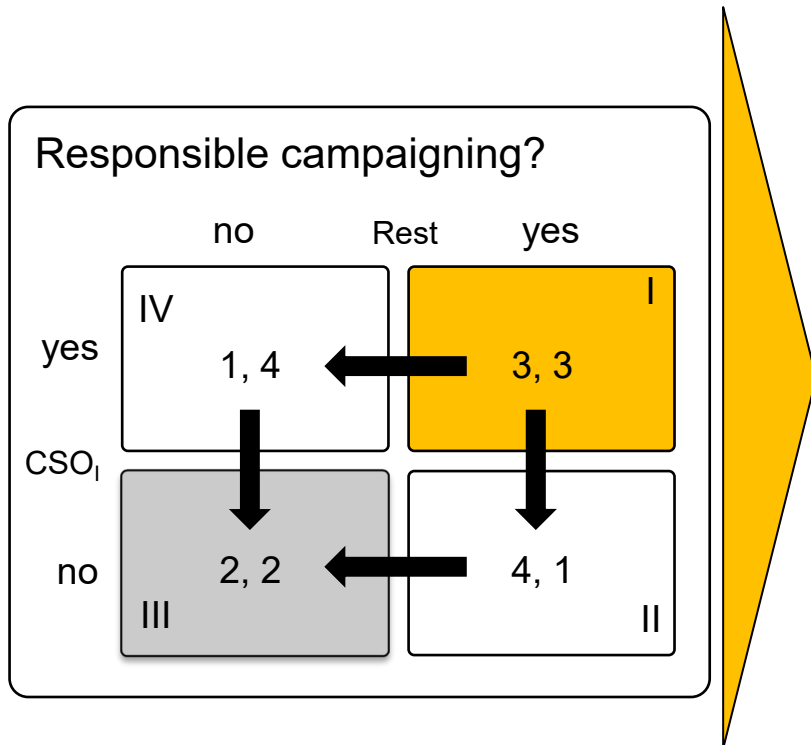


Ultimately, it is the "negativity bias" of the media that puts pressure on CSOs to rely on dubious practices to advance their moral cause.



Also CSOs can get into Dilemmatic Downward Spirals (II)

CSOs are tempted to rely on exaggerated negative reports ("alarmism") in their public relations work in order to get more donations. Example: False Alarm.



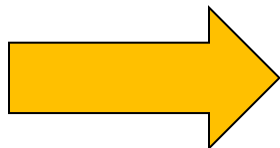
Self-regulatory initiatives:

„Accountable Now” – Link:

<https://accountablenow.org/>

Global Standards for CSO Accountability –

Link: <https://www.csostandard.org/>



CSOs have a common interest in fighting against black sheep and upholding the reputation of the sector. However, this requires collective commitments and an "enabling environment".



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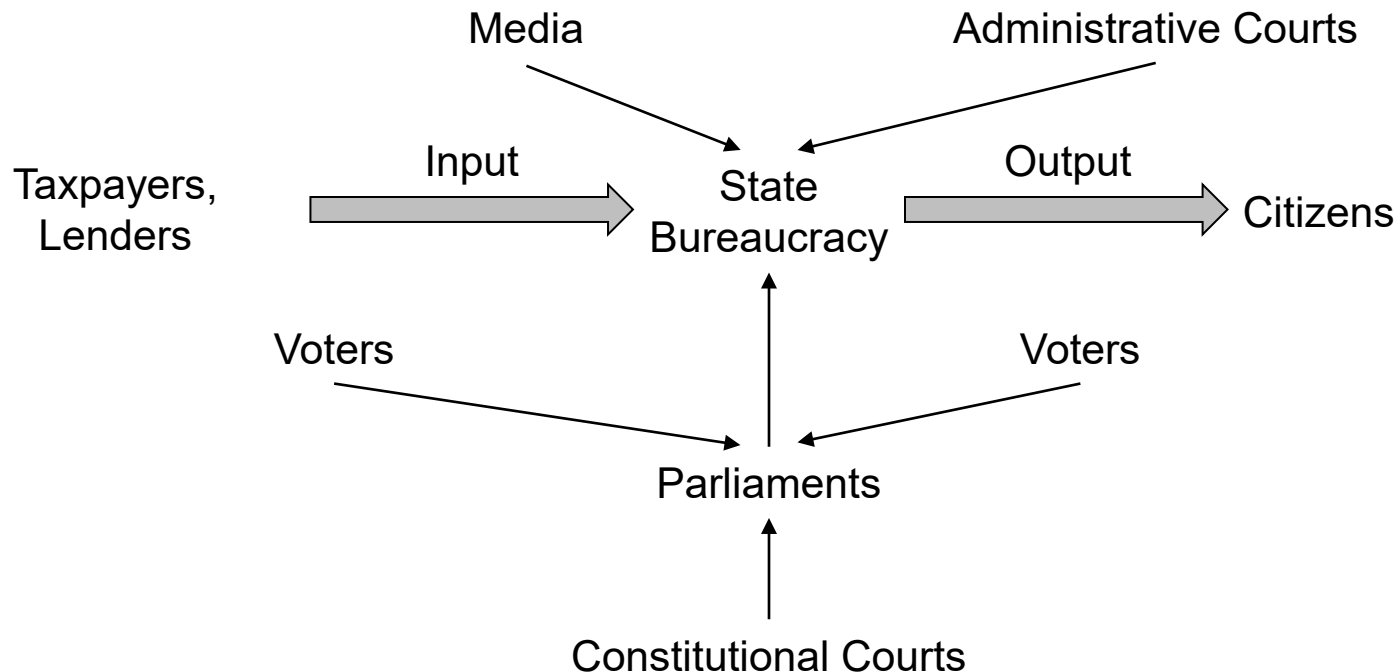
4. Civil Society

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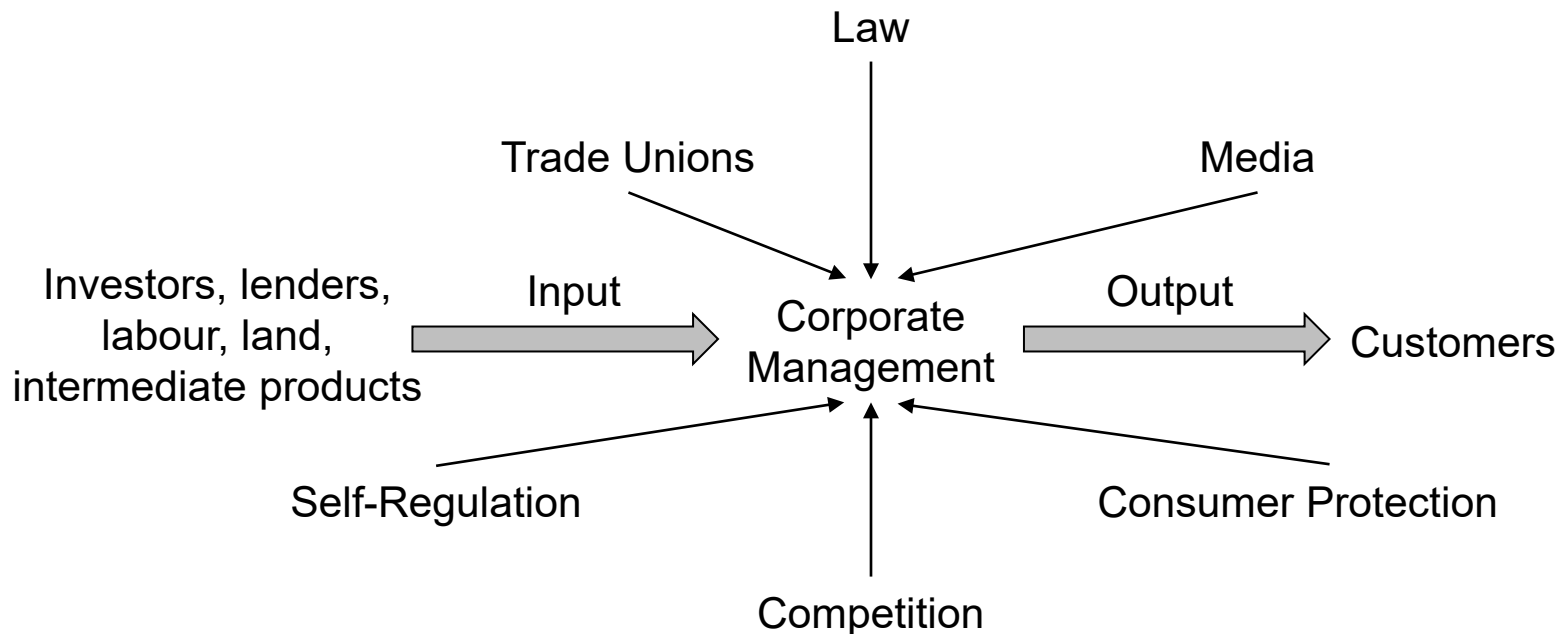
Governance of Democratic Politics

State bureaucrats are only indirectly responsible to citizens. Legislative, judicial and public institutions provide feedback mechanisms. (Analogous to political parties: not only the competition for parliamentary seats, but also the legal framework and the public have a disciplining effect.)



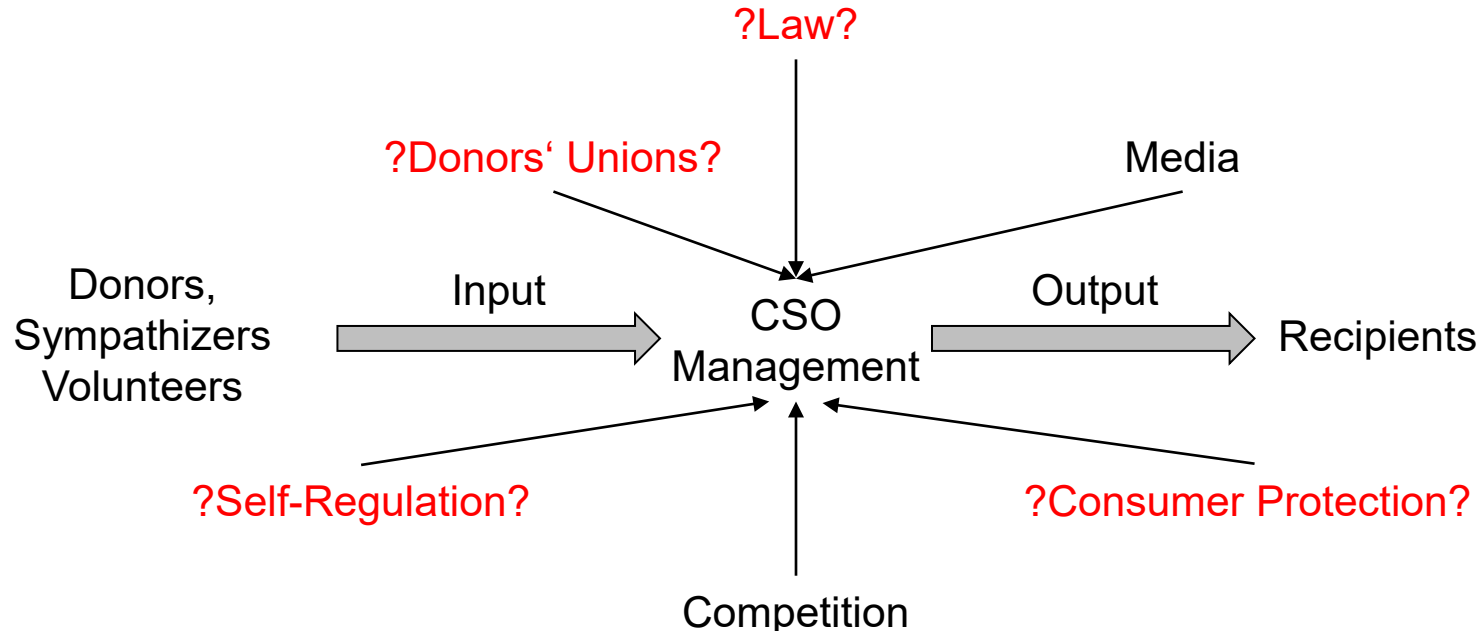
Governance of the Capitalist Enterprise

Corporate managers need to provide answers to equity investors. They are only indirectly responsible to other input providers as well as to customers. The legal framework, as well as civil society organizations and the media, provide feedback mechanisms. Background: Customers have exit options and can therefore use their purchasing power to set effective control incentives. (Where input providers have only a limited exit option, co-determination is created.)



Governance of Civil Society Organizations (Service Delivery)

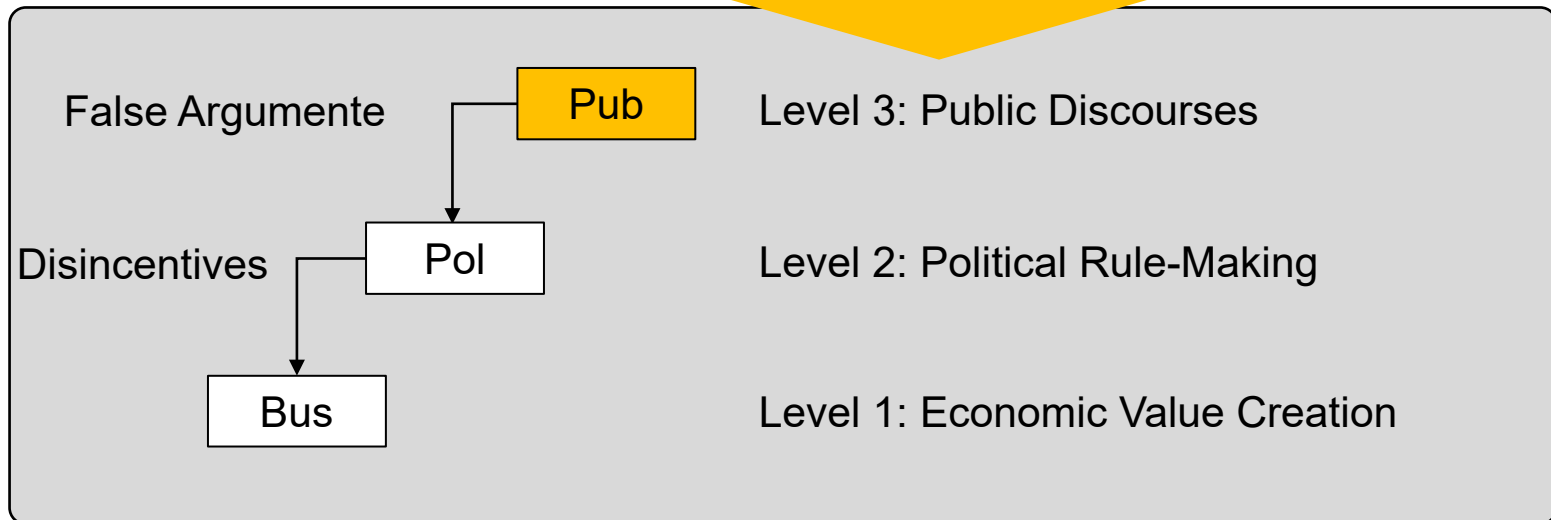
CSO managers are only indirectly responsible to their various input providers and their beneficiaries. The legal framework is often patchy. There is also (still) a lack of self-regulatory initiatives and no analogy with consumer protection to make effective feedback mechanisms work. Background: Recipients in need often do not have an exit option.



Diagnosis: Democratic Discourse Failure

Discourse failure can lead to policy failure and market failure.

Discourse Failure

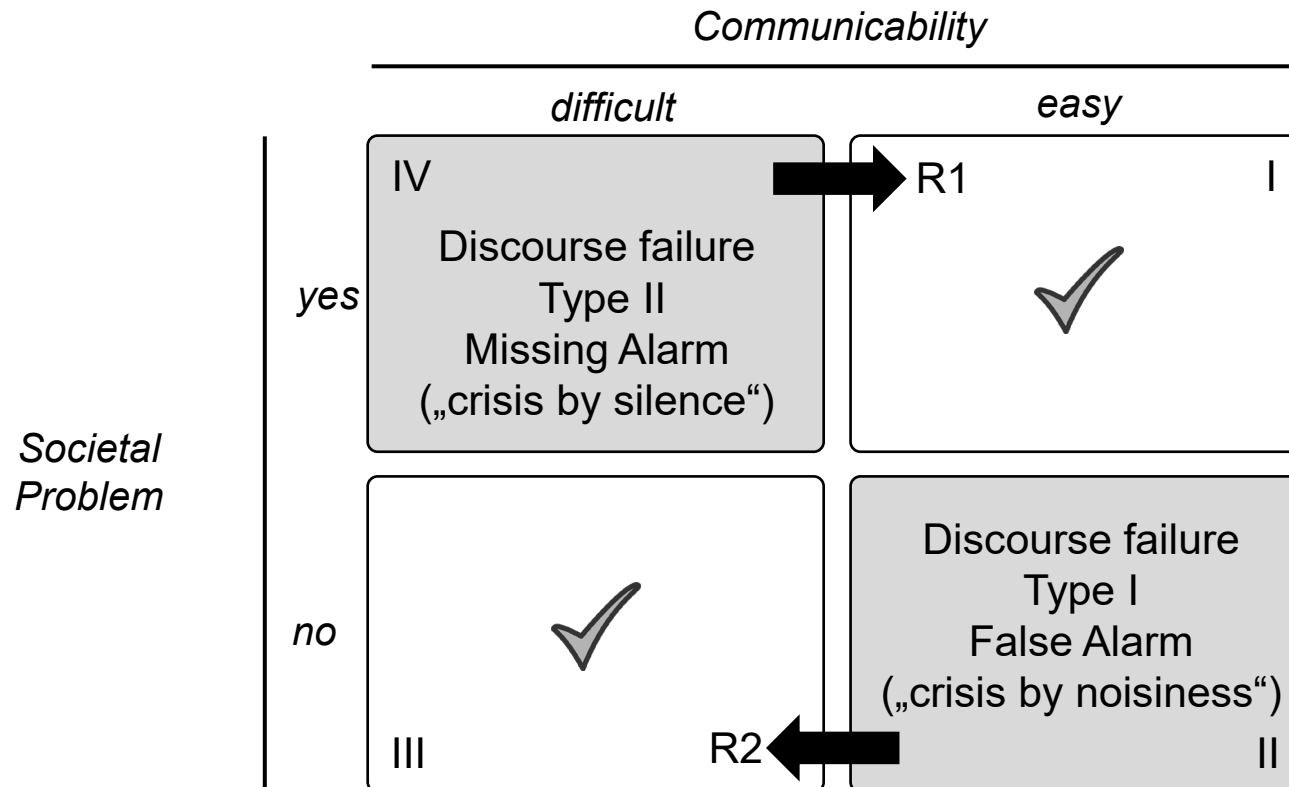


Discourse failure is the Achilles' heel of modern society.



Two Types of Discourse Failure

Discourse failure occurs in two variants: (I) as a false alarm and (II) as a missing alarm.



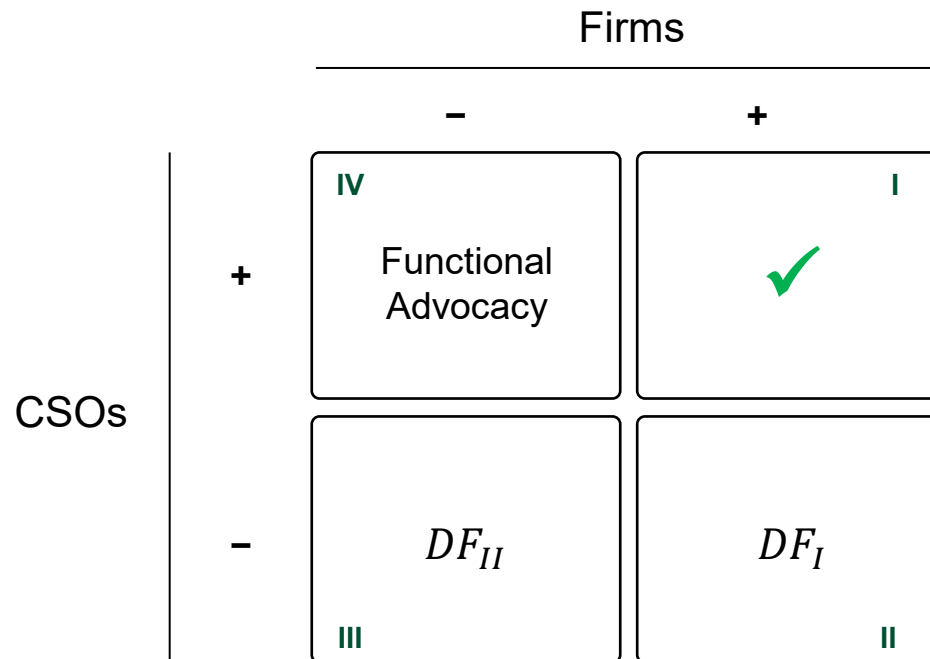
Example of type I: Warning against agricultural speculation

Example of type II: Precaution against pandemic before 2020



Interaction of CSOs (Advocacy) and Companies

Corporate misconduct damages the common good. Misconduct by CSOs leads to discourse failure (DF). Social learning processes aim at Quadrant I. Critical CSOs can handle QIV. Problem: How do we as a society deal with QII and QIII?



Societal Challenges at a Glance

Companies, political parties and CSOs may engage in misconduct. That is why we need a watchful public that can address grievances via reform.

L3: Public

CSO + Functional Advocacy
CSO - Discourse Failures Type I and Type II

L2: Politics

Parties + Functional Legislation
Parties - Client Politics (Rent-Seeking)

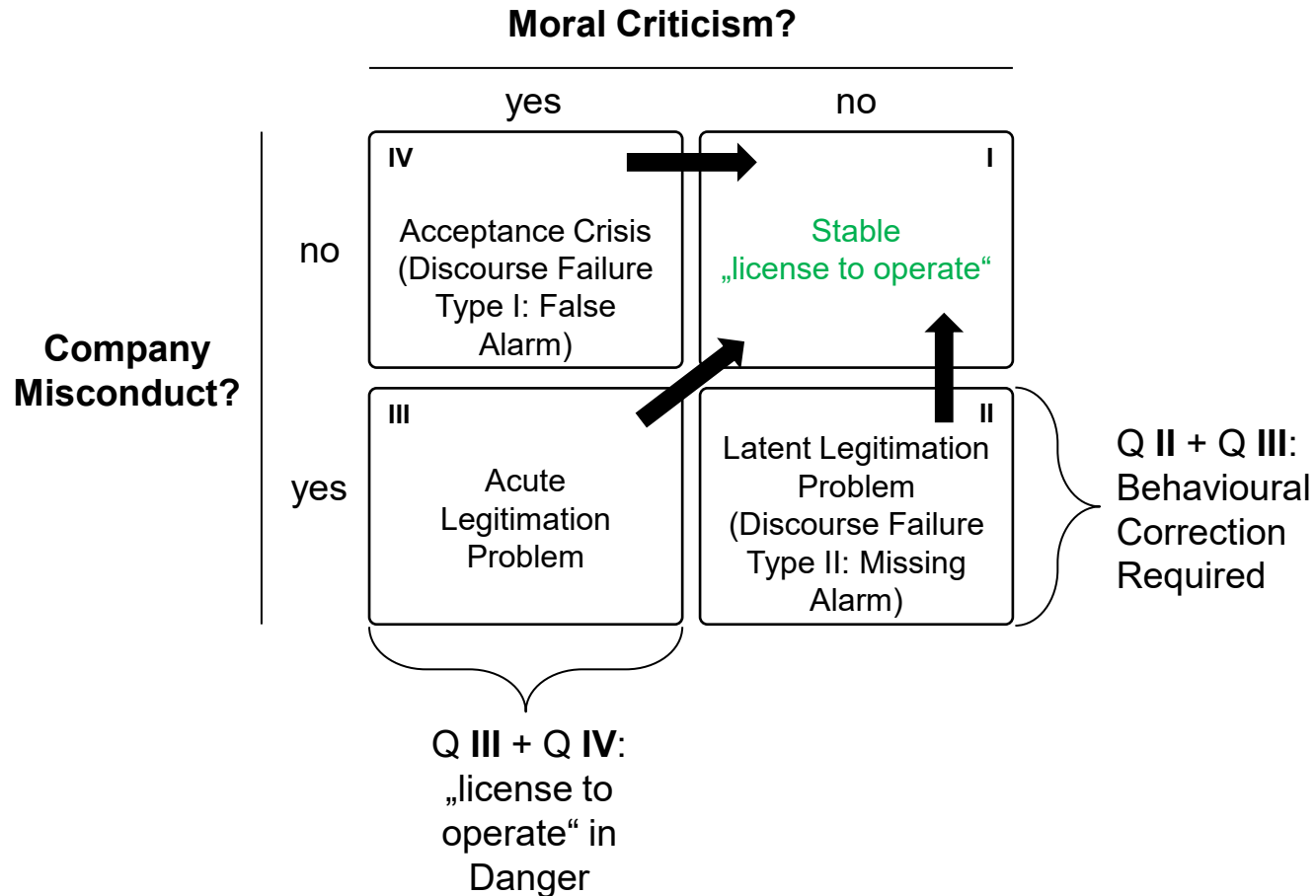
L1: Business

U + Functional Value Creation
U - Cartel Formation, Negative Externalities



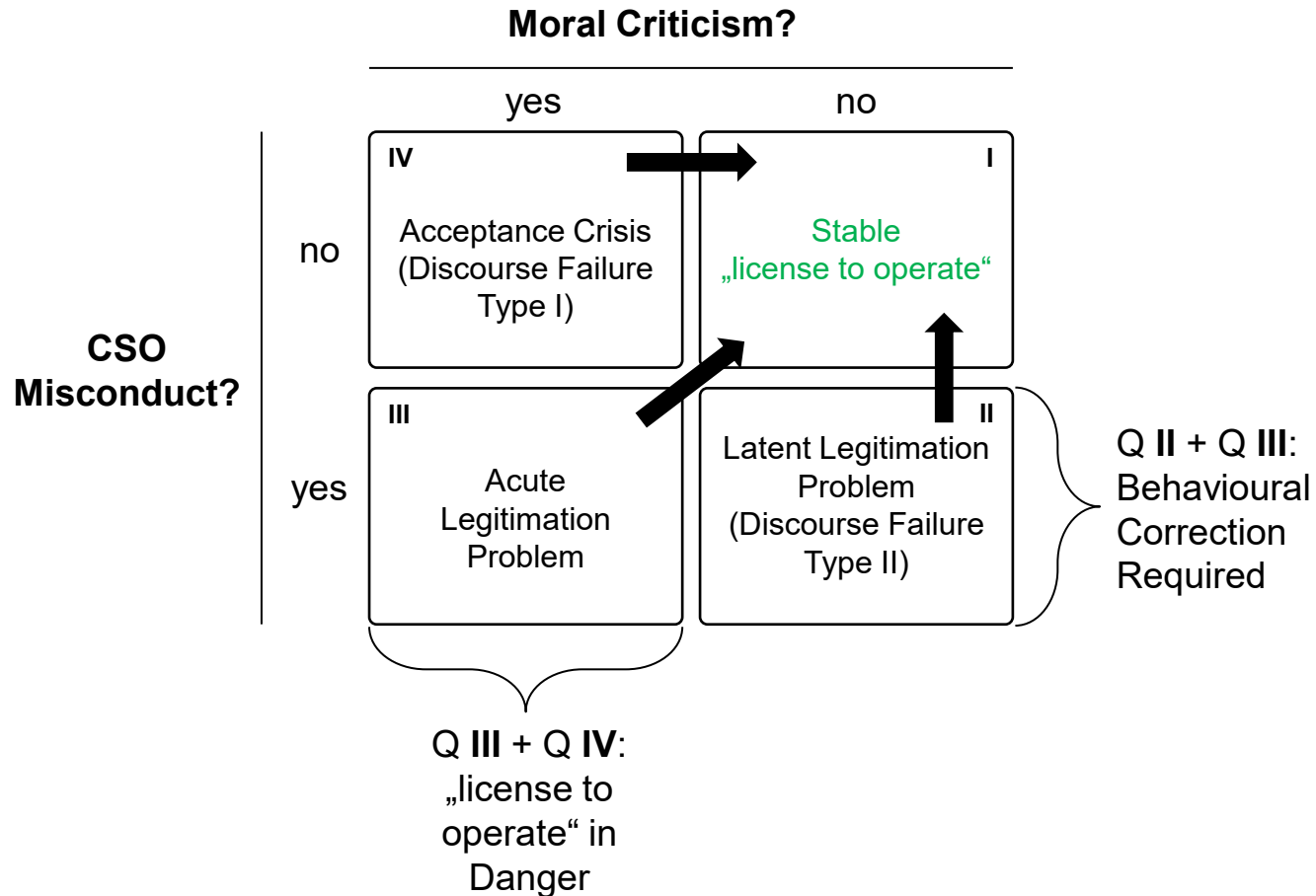
Challenges for Business Managers

Business managers need argumentation and governance skills.



Challenges for CSO Managers

Also CSO managers need argumentation and governance skills.



Challenges for Citizens

Citizens need to consider whether or not they are satisfied with the behavior of modern organizations (state bureaucracies, political parties, businesses and CSOs). In doing so, they must keep an eye on two forms of discourse failure (DF) – and support governance initiatives aimed at moving from QIII to QI through reform.

		Mod. Org.	
		-	+
Satisfied as a Citizen?	+	<div>IV</div> <div>DF_{II}</div>	<div>I</div> <div>✓</div>
	-	<div>III</div> <div>Reform</div>	<div>II</div> <div>DF_I</div>



Food for Thought

2024 Edelman Trust Barometer

Institutions Out of Balance: Government Seen as Far Less Competent and Ethical than Business

(Competence score, net ethical score)

GLOBAL 25 Excludes China, S. Korea, Thailand

2024 Edelman Trust Barometer. The ethical scores are averages of nets based on [INS_PER_DIM/1-4. Media and NGOs were only asked of half the sample. The competence score is a net based on TRU_3D_[INS]/1. Media and NGOs were only asked of half the sample. General population, 25-mkt avg. Data not collected in China and Thailand; Due to a translation inconsistency in S. Korea, it has been excluded from this analysis. For full details regarding how this data was calculated and plotted, please see the Technical Appendix.

