MARTIN-LUTHER-UNIVERSITY HALLE-WITTENBERG

Faculty of Law and Economic Sciences
Chair of Economic Ethics
Prof. Dr. Ingo Pies

Ethics and Economics of Institutional Governance

Lecture 4
Winter Term 2025/26

What have we learned?

The main lessons of the third lecture are:

- With the practical syllogism, moral value judgments can be divided into positive and normative elements, each of which can be criticized differently: with downstream or upstream arguments.
- The four-quadrant scheme for juxtaposing incentives and reasons serves to resolve a mismatch by adapting either the social structure to semantics or, conversely, semantics to the social structure. With its help, three approaches to moral analysis can be paradigmatically distinguished: individual ethics, constitutional ethics and order ethics.
- The ordonomic three-level scheme distinguishes three arenas: the basic game of rule compliance, the metagame of rule-setting negotiation, and the meta-metagame of rule-finding discussion. It illustrates the interplay of social structure and semantics.
- Not only good but also bad policy results are due to the discursive frames of the public. The ordonomic diagnosis identifies discourse failures. Semantic problems can lead to policy failures and market failures.
- Ordonomics asks about the moral suitability of our modern society and, conversely, about the societal suitability of our morality.

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2

Overview

Ethics and Economics of Institutional Governance: 14 Lectures (L)
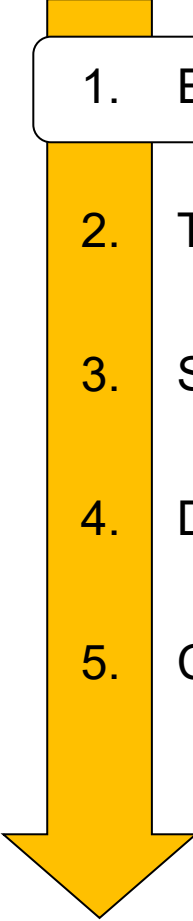
Introduction (L 1)

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)

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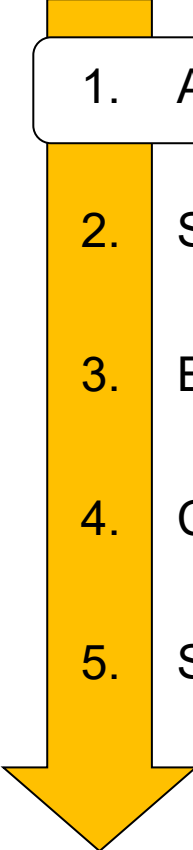Prof. Dr. Ingo Pies

3

Structure of Today's 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

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4

Structure of Next Lecture

1. A preliminary consideration

2. State

3. Economy

4. Civil Society

5. Societal Learning Processes

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5

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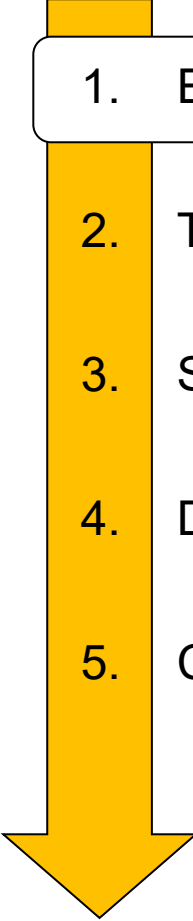Martin-Luther-Universität Halle-Wittenberg, Lehrstuhl für Wirtschaftsethik
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6

The Initial Problem (I)

Companies are often confronted with morally articulated demands. Long wish lists are kept in public discourse. They contain, among other things, the following claims:

- Workers want more attractive jobs
- Customers want cheaper products
- Suppliers want higher procurement prices
- Home communities want more local engagement
- Environmental organizations want to reduce the ecological "footprint"
- and many stakeholders want more entrepreneurial commitment to respect human rights in global supply chains

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7

The Initial Problem (II)

When you ask companies why they don't (want to) follow a specific moral request, you usually get the answer that they **can't** follow.

In support of this, reference is made at first instance to the need to avoid any losses. And in the second instance, reference is made to market competition.
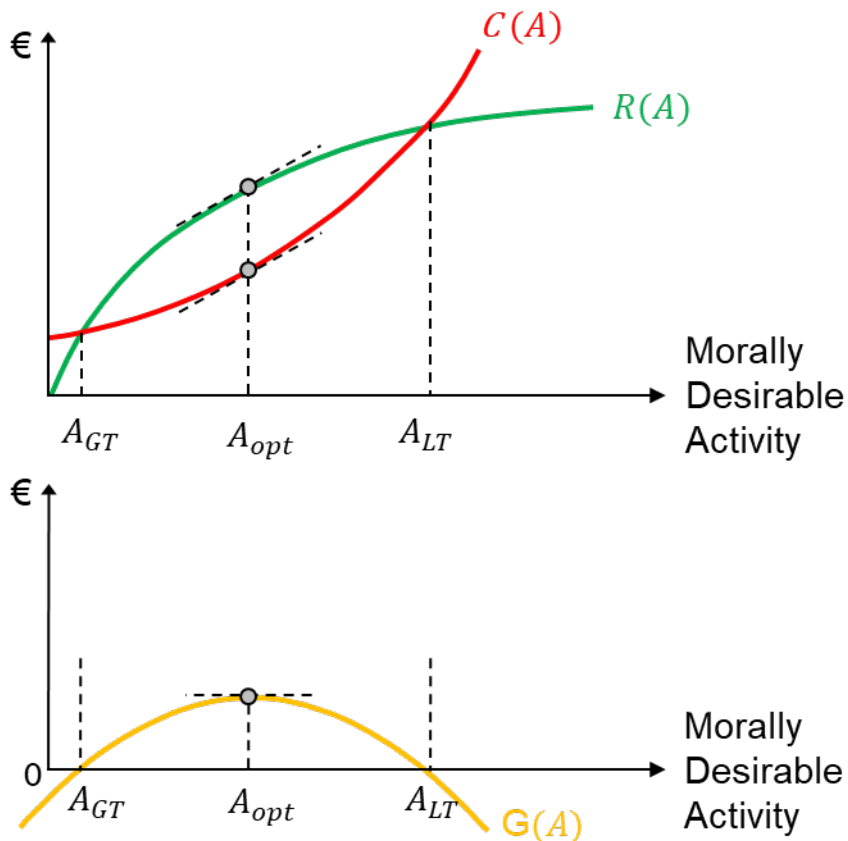
In fact, the two instances are closely related: Because of market competition, the entrepreneurial profit orientation becomes a **system imperative**. Under competitive pressure, companies are forced to pay close attention to avoiding losses and even marginal losses for the sake of not endangering their existence.

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8

# The Initial Problem (III)

We can illustrate this graphically.

Let's start with the top chart. The abscissa represents a morally desirable activity A, i.e. the payment of high wages or the improvement of the general working atmosphere in the company or qualitative or price improvements in the service of customer needs. Also depicted are the corresponding curves for costs – C(A) – and revenues – R(A). The two tangents mark exactly that level of activity at which the vertical distance between the two curves is maximized.

The bottom chart shows the profit lens. The profit threshold is A_{GT}, the loss threshold A_{LT}. The profit maximum is reached at A_{opt}. The interval between A_{opt} and A_{LT} is often disputed. In this area, no losses are generated, but marginal losses (i.e. reductions of profit). Would it therefore not be reasonable for the company to refrain from maximizing its gain and to be satisfied with a zero profit by extending the morally desirable activity from A_{opt} to A_{LT}?

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9

The Initial Problem (IV)

What happens if companies are exposed to competitive pressure? – Then marginal losses lead to losses that threaten the existence of the company.
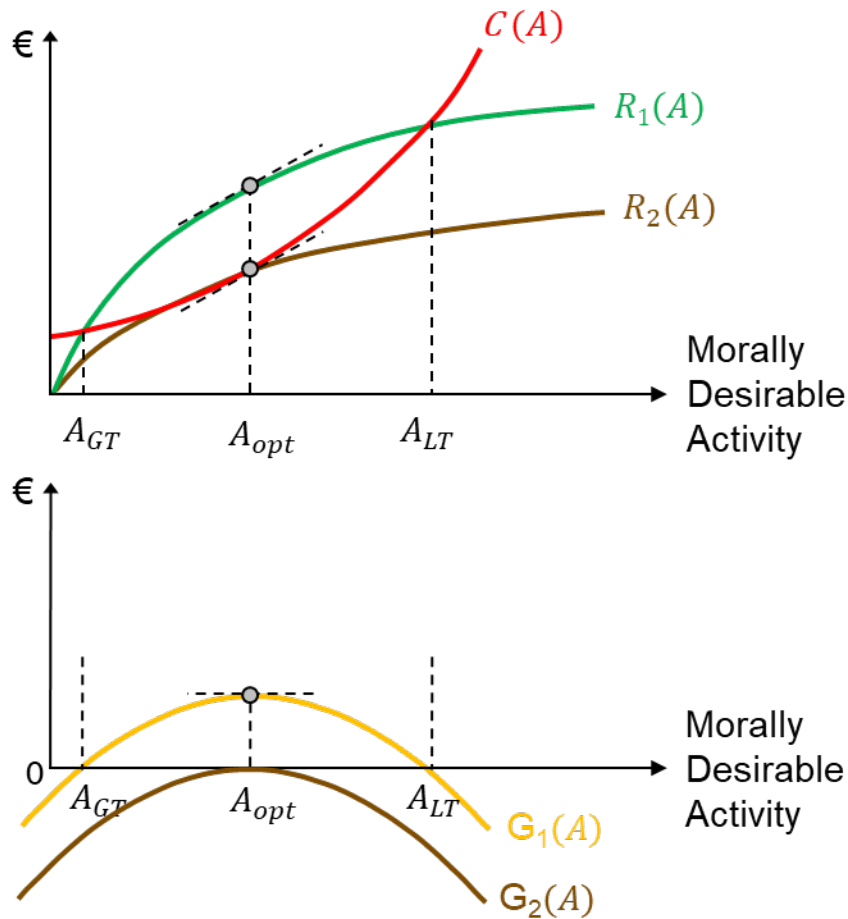
The logic is clear: when companies compete in factor markets, they are under pressure to pay higher prices (and thus to incur higher costs). When companies compete in goods markets – this case is shown here – they are under pressure to grant discounts (and thus settle for lower revenues). In our graphic representation, this means that the profit lens shifts downwards until, in the long-term market equilibrium, exactly zero profit (in the economic sense) is generated.

Economics: Profit = Revenue minus Costs
Bus. Ad.: Profit = Revenue minus Costs (except for the opportunity costs of the entrepreneur's own labour and equity, so that $G_{BusAd} \gg G_{econ}$)

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10

The Initial Problem (V)

We now proceed as follows: We are investigating the legitimacy of competition.

If it is competition that prevents companies from accepting losses or marginal losses for the sake of morality, then should competition not be restricted or abolished for the sake of morality?

In order to answer this question, let us investigate arguments which can be used to demonstrate the legitimacy of competition.

As a first step, we analyse the relationship between competition and cooperation: we consider the market as an arrangement of dilemma structures.

Then, in a second and third step, we analyze the static and dynamic effects of competition in order to investigate whether there are sound arguments for morally justifying the competitive principle as a core market-economy element.

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11

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12

Vertical and Horizontal Interaction Relationships in the Market
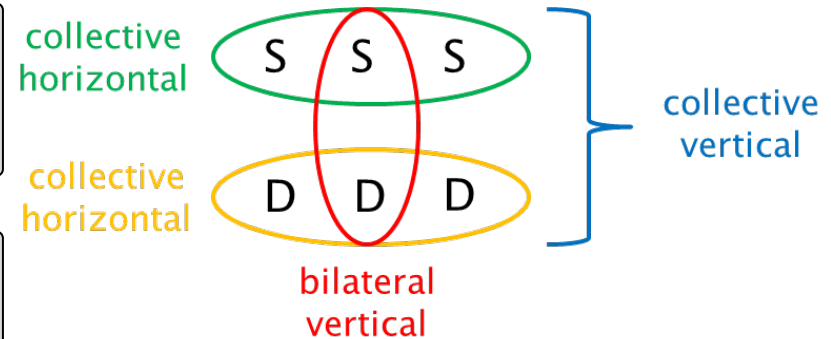
As far as supply (S) and demand (D) in the market are concerned, four relationships can be distinguished.

Case 1: the vertical (exchange) relationship between a supplier and a buyer

Case 2: the horizontal (competitive) relationship between suppliers on one market side

Case 3: the horizontal (competitive) relationship between the buyers on one market side

Case 4: the vertical (cooperation) relationship between suppliers as a group and buyers as a group

collective horizontal

S   S   S

collective horizontal

D   D   D

collective vertical

bilateral vertical

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13

Case 1: The bilateral vertical dilemma (I)

Suppliers and buyers make a mutual promise to exchange goods for money. As a result, both face a choice of whether to deliver on this performance promise.

D

	no	yes
yes	IV 1,4	I 3,3
no	III 2,2	II 4,1

S

Keep Promise of Performance?

We are now analyzing this situation under the assumption of an institutional vacuum. Then we have to deal with a classic two-sided prisoners' dilemma:

- For both market participants, it would be advantageous individually to exploit the respective counterpart opportunistically (best case: Payoff 4)
- It would be extremely detrimental for both market participants to be exploited (worst case: Payoff 1)
- Both market participants would prefer to carry out the exchange regularly (Payoff 3) than to let the exchange act burst (Payoff 2)
- Both market participants have a dominant strategy and realize the pareto-inferior Nash equilibrium (marked in grey) in Quadrant III (Payoff 2)

We see that, in the institutional vacuum, a normal act of exchange would fail because of misincentives.
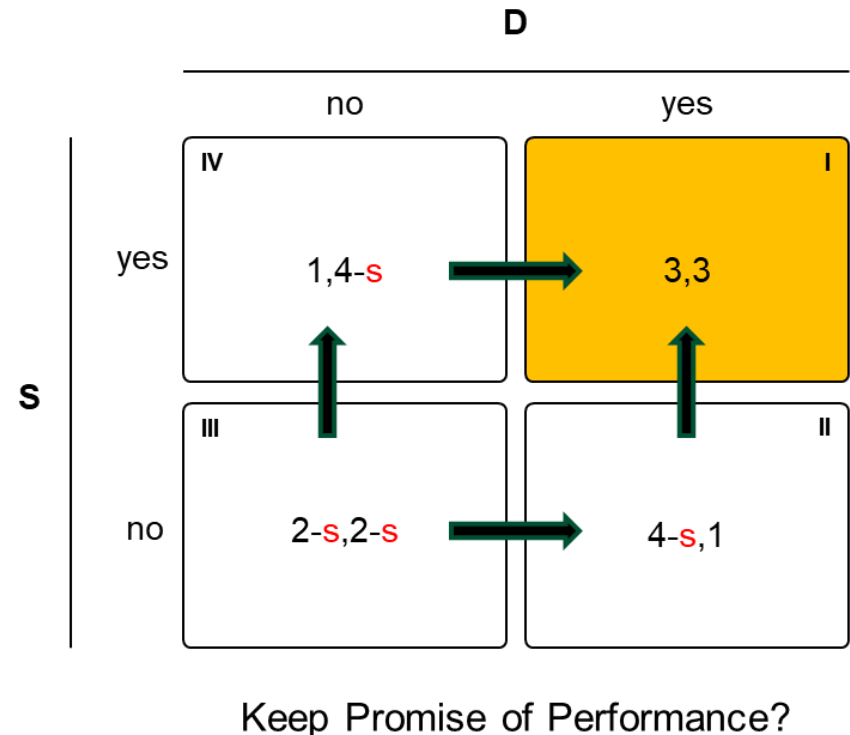
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14

Case 1: The bilateral vertical dilemma (II)

The fact that we can observe successful exchange acts every day is because a modern society does not leave the two interaction partners on the market alone, but actively supports them in stabilizing the unstable exchange act. The institutional vacuum is thus being filled.

The most important institutions for this are property rights and private law contracts. With their help, market players can manage to shape their interaction environment in such a way that the desired interaction actually occurs:

By imposing sanctions s on each other, they change the individual advantage of fulfilling the promised performance.

In this way, it can be possible to turn the pareto-superior solution into a Nash equilibrium.
Instead of Quadrant III, Quadrant I is realized.

D

	no	yes
yes	IV 1,4-s	I 3,3
no	III 2-s,2-s	II 4-s,1

S

Keep Promise of Performance?

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15

Case 2: The Collective Horizontal Dilemma (I)

The collective competitive dilemma between suppliers can also be seen as a social dilemma. We look at S_1 and combine all competitors (as the rest of the industry) into S_R.

S_R

	no	yes
yes	IV 1,4	I 3,3
no	III 2,2	II 4,1

S_1

Keep Promise of Cartelization?

Although the suppliers have a common interest in forming a cartel, they fail to realize this group advantage in the institutional vacuum:

- For both players, it would be advantageous individually to exploit the respective counterpart opportunistically, i.e. to marginally undercut the agreed cartel price and thereby to attract all buyers (best case: Payoff 4).
- It would be extremely detrimental for both players to be exploited (worst case: Payoff 1).
- Both players would prefer the cartel to come into being as agreed (Payoff 3) instead of competing against each other (Payoff 2).
- Both players realize the pareto-inferior Nash equilibrium in Quadrant III (Payoff 2).

We therefore see that the cartel agreement is inherently unstable.

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16

Case 2: The Collective Horizontal Dilemma (II)

Important contrast to case 1: Instead of rushing to the players' aid with institutional stabilization tools (such as property rights and private contract law) to actively help them overcome their dilemma, society here pursues the exact opposite policy of doing everything possible to maintain the social dilemma.

S_R

	no	yes
IV		**I**
yes	1,4	3,3
III		**II**
no	2,2	4,1

S_1

Keep Promise of Cartelization?

In case 1, the incentive situation is institutionally set up in such a way that the equilibrium is reached in Quadrant I.

In case 2, on the other hand, modern society aims at Quadrant III as the equilibrium:

The most important measures that prevent players from implementing what they see as a pareto-superior solution are the withdrawal of private stabilization aid – antitrust contracts are banned – and the principle of open markets, which increases the number of potential suppliers (and thus the organization costs of the cartel) indefinitely.

Competition is intended to effectively undermine the common cartelization interest of suppliers.

By analogy: Case 3 (demand cartel)

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17

Case 4: The Collective Vertical Dilemma (I)

In order to understand why it makes sense (and is legitimate) to institutionally stabilize bilateral exchange acts and at the same time to institutionally de-stabilize acts of cartelization, we need to take a broader perspective on the whole market. We now look at both sides of the market and write for the group of suppliers SG, for the group of demanders DG.

DG

	yes	no
no	IV Monopsony 1,4	I Competition 3,3
yes	III Bilateral Monopoly 2,2	II Monopoly 4,1

SG

Form a Cartel?

Both sides of the market face the choice of cartelizing their own market side. A total of four strategy combinations have to be distinguished, to each of which we can assign a market form:

- A competitive market emerges in Quadrant I.
- Quadrant II corresponds to a monopoly market (= suppliers act as a group).
- Quadrant III corresponds to a two-sided (= bilateral) monopoly.
- Quadrant IV corresponds to a monopsony market (= buyers act as a group).

We are now going through these four cases step by step and systematically determine the payoffs.

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18

Case 4: The Collective Vertical Dilemma (II)

In order to be able to systematically compare the four market forms, the producer rent is marked in blue, the consumer rent in green, and any welfare losses in red.
Important: Only in Quadrant I there is no red area! And QI is pareto-superior to QIII!
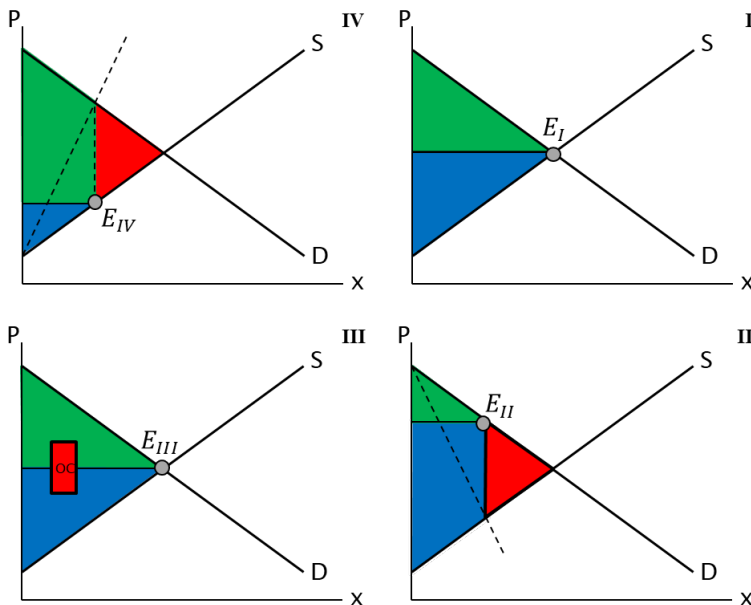
Both sides of the market face the choice of cartelizing their own market side. A total of four strategy combinations have to be distinguished, to each of which we can assign a market form:

- Quadrant I: Equilibrium E_I is attractive to both sides of the market.
- Quadrant II: Equilibrium E_{II} provides the highest payoff for suppliers and the lowest payoff for demanders.
- Quadrant III: Equilibrium E_{III} is less attractive to both sides of the market than E_I because of organizational costs (OC).
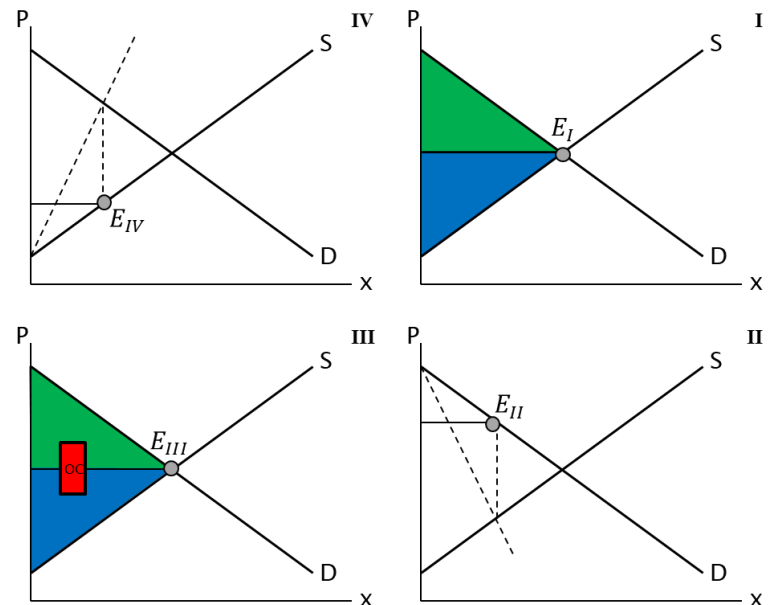- Quadrant IV: Equilibrium E_{IV} provides the highest payoff for demanders and the lowest payoff for suppliers.

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19

Case 4: The Collective Vertical Dilemma (III)

If the two sides of the market had been on their own, they would both cartelize and thus realize Quadrant III. A consistent competition policy can free both sides of the market from this social dilemma. They then realize the pareto-superior strategy combination in Quadrant I.

Maintaining horizontal dilemmas through competition serves to overcome the vertical dilemma structures (bilateral and collective).

In functioning competitive markets, **the competitive principle is an instrument of social cooperation**. Competition is not an end in itself, but it assumes the systemic function of stabilizing the cooperation relations between supply and demand and aligning them as productively as possible.

Both sides of the market are expected to have to infringe their own group interest – in order to benefit from the fact that the respective opposite market side is forced via performance incentives to behave competitively. **The mutual gains from exchange are thus maximized.**

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20

Interim Conclusion

The legitimacy of competition depends on the condition that the competitive principle is applied symmetrically and simultaneously on both sides of the market, thereby safeguarding functional incentives that encourage market players to be mutually useful to each other – as the unintended consequence of intentional action.

Markets serve to use the competitive principle as an **instrument of societal cooperation**. Functional market arrangements **create** two horizontal social dilemmas in order to **overcome** two vertical social dilemmas.

We can understand this argument even better by analyzing the competitive effects on companies in greater detail, distinguishing between static and dynamic competitive effects.

In the first case, we keep production technology and forms of organization constant;
in the second case, we use them in a variable way and allow them to be improved through innovation.

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21

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22

Very Briefly: To Refresh Your Economic Knowledge of Modeling (I)

The short-term supply curve:

The short-term supply curve in the market is formed by horizontal aggregation of the individual supply curves for the individual companies already on the market. It starts at the minimum of average variable costs and shows a positive slope, which reflects the course of marginal costs.

This is based on the assumption that the number of companies in the market is constant, so that variations in production quantity can only be achieved by individual firms changing their capacity utilization, which means that higher quantities also cause higher marginal costs in production.

The short-term supply is compatible with losses in the short term because it is worth staying in the market in the short term if the price falls into the interval which is stretched between the minimum of average cost total (= zero profit) and the minimum of average variable costs (= loss equal to the fixed costs).

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23

The long-term supply curve:

The following assumptions are made for the long-term supply curve: (a) There are constant economies of scale. (b) The number of companies is variable. (c) Market entry and exits are possible free of charge.

- The first assumption (a) means that it is possible to double production volume to exactly twice the total cost by adding an identical second company. Under this assumption, the long-term supply curve has a horizontal trajectory.

- The second assumption (b) means that the mechanism for long-term quantity adjustments is fundamentally different from the short-term quantity adjustment mechanism.

- The third assumption (c) states that it is possible to switch from short to long without friction.

To explain:

In the short term, a given number of companies produce different quantities by using a given production capacity at different utilization rates. For example, an increase in production causes overtime, which increases marginal costs, so that the short-term supply curve has a positive slope.

In the long term, this is quite different. In this case, the volume adjustment is achieved by companies entering the market or leaving the market. Each individual company produces exactly in the minimum of total average costs. As a result, each company realizes **zero profit**.

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24

Static Effects of Competition (I)

The left diagram shows the cost situation of a polypolistic company. The right diagram depicts the market aggregation. (Average Total Cost = ATC; Average Variable Cost = AVC)
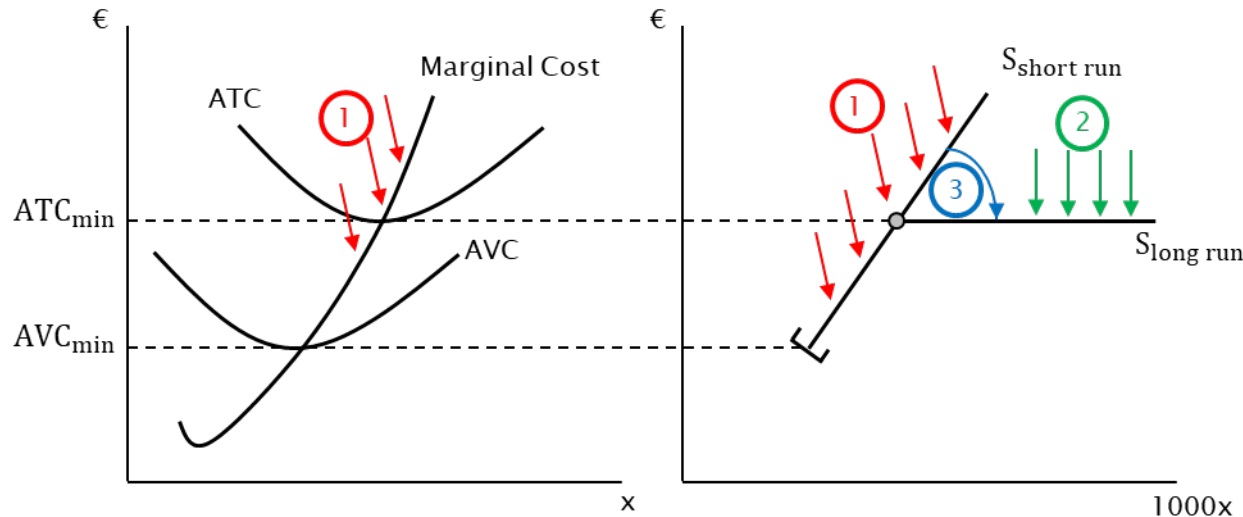
The **first** effect of competition concerns the short-term supply behaviour of companies: they are encouraged to supply according to their marginal costs (arrow 1).

The **second** competitive effect concerns the long-term supply behaviour of companies: they are encouraged to offer their goods and services at zero profit (arrow 2).

The **third** competitive effect concerns the transition from short to long: the principle of open markets allows potential competitors to become current competitors, so that any price increases are quickly reduced by competitive pressure until the price settles at the minimum of average total costs in the long term (arrow 3).

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25

Static Effects of Competition (II)

The left diagram shows the cost situation of a polypolistic company. The right diagram depicts the market aggregation. (Average Total Cost = ATC; Average Variable Cost = AVC)
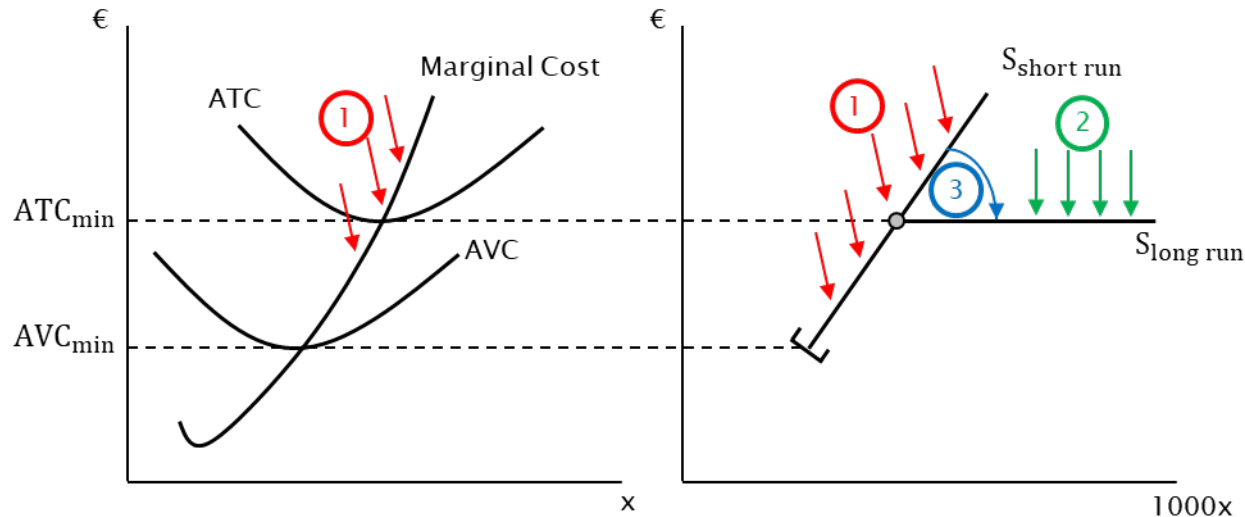
All three competitive effects benefit the demanders and thus ultimately the consumers.

They discipline the supply behavior of companies and ensure that scarce resources are handled economically, so that social cooperation – the market-based exchange between citizens acting as suppliers and customers in different markets – is as productive as possible.

Competition is an expropriation instrument: in the long term, the producer rent diffuses. It is completely transformed into consumer rent! Transitory corporate profits are therefore not an end in themselves from a societal point of view. They are simply used to put companies into service for the **common good**.

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26

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27

Dynamic Effects of Competition

Starting point: zero profit. As a result of an innovation, a company lowers its marginal costs from MC_1 to MC_2. This allows it to switch from point A to point B and to realize the blue area as profit. So what happens dynamically with this innovation rent?
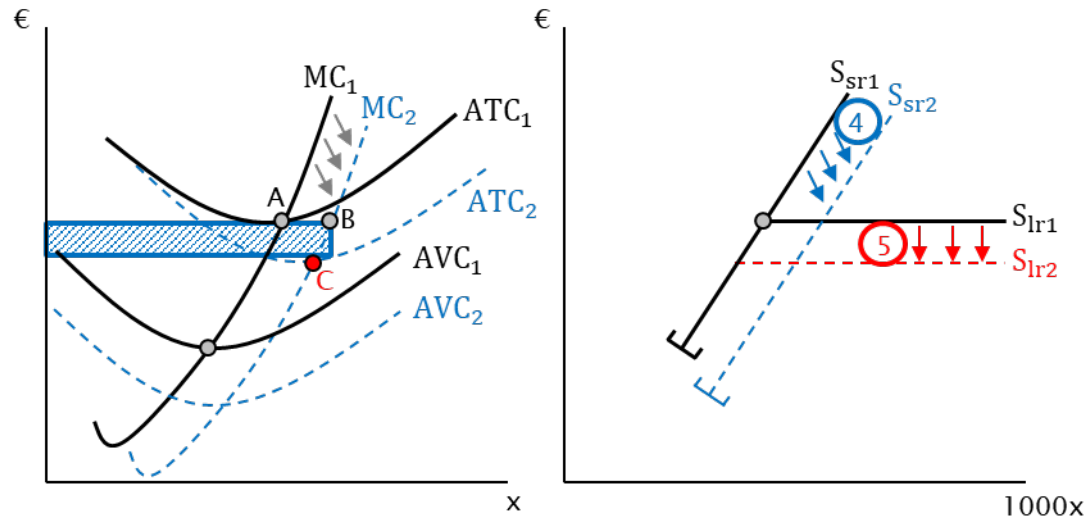
The pioneer profit (= innovation rent) corresponds to the blue marked area. This puts pressure on all other companies in the market to emulate this successful innovation. This imitation competition causes the short-term supply curve to shift downwards (arrow 4), and this brings about that the long-term supply curve also shifts downwards (arrow 5).

In the new long-term equilibrium, the price is again at the level of the (now lower) minimum of the total average cost curve. Like all other companies in the industry, the pioneering company realizes point C. The **zero-profit** situation has been restored. This means that the entire innovation rent is passed on to customers – forever, due to competition.

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28

Imitation Competition

The imitation competition begins as soon as a firm (F_1) has implemented a successful innovation. The other firms on the market (F_2, … F_N) thus find themselves under competitive pressure. We now consider F_2 to be a representative company and capture the remaining members of the industry (F_3, … F_N) as F_R.

F_R

	yes	no
no	IV 1 ⬇	I 2 ⬇
yes	III 3	II 4

F_2

Imitate innovation?

The (N-1) firms in this industry are faced with the choice of wanting to emulate the successful innovation of F_1:

- In Quadrant I, everything stays the same. The price remains at the level of the minimum of ATC_1. With the exception of the pioneer, all other companies in the industry – and consequently F_2 – achieve zero profit.
- In Quadrant II, only F_2 is emulating the innovator. Its costs are falling. Its profit is rising (Payoff 4).
- In Quadrant III, all companies follow suit. In doing so, they push the new price to the level of the minimum of ATC_2. As a result, the pioneer as well as all imitators now achieve a permanent zero profit. However, they must bear the (one-time) costs of imitation (Payoff 2).
- In Quadrant IV, all companies except F_2 follow suit. As a result, F_2 loses its competitiveness. It cannot withstand the lower prices of others and must leave the market (Payoff 1).

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29

Innovation Competition as an Innovation Dilemma (I)

Two perspectives are possible in the innovation competition. We start with the left graphic. Starting point: zero profit.

Less than optimal investment in innovation?

More than optimal investment in innovation?

For a representative company F_1 the following payoffs apply:

- If it invests more than its competitors, it has higher pioneer profits (Payoff 4).
- If it invests less than its competitors, it has lower pioneer profits and needs to respond more frequently as an imitator to the successful innovations of competing firms (Payoff 1).
- The second best case is that all companies invest optimally (Payoff 3).
- The third best case is that all companies invest sub-optimally (Payoff 2).

The equilibrium is reached in Quadrant I. Nobody invests below the optimum. All companies are satisfied. There is no dilemma here.

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30

Innovation Competition as an Innovation Dilemma (II)

Two perspectives are possible in the innovation competition. We now move on to the right graphic. Starting point: zero profit.

Less than optimal
investment in innovation?

More than optimal
investment in innovation?

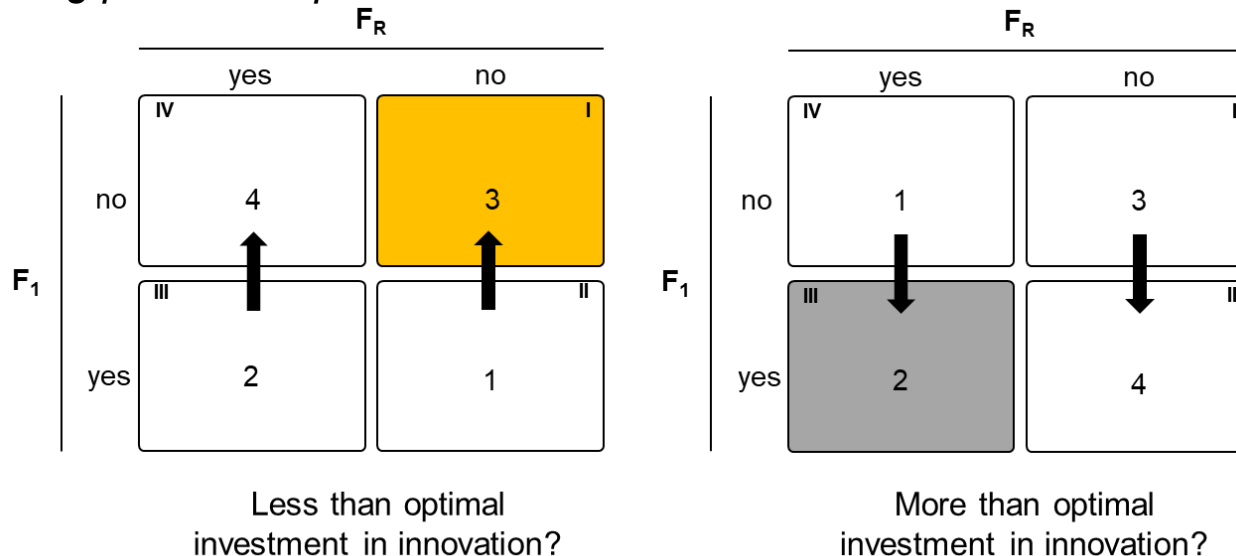For a representative company F_1 the following payoffs apply:

- If it invests more than its competitors, it has higher pioneer profits (Payoff 4).
- If it invests less than its competitors, it has lower pioneer profits and needs to respond as an imitator more frequently to the successful innovations of competing firms (Payoff 1).
- The second best case is that all companies invest optimally (Payoff 3).
- The third best case is that all companies invest too much (Payoff 2).

The equilibrium is reached in Quadrant III. Every firm invests too much. As a group, they are unsatisfied. They find themselves in a social dilemma of overinvestment.

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31

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32

Lesson I

Due to competitive pressure, companies cannot resist emulating successful innovations. Although they actually have an interest in a collective standstill agreement, they face an imitation competition in which they compete to emulate successful innovators as quickly as possible.

Imitation competition serves the **systemic functions** of a social diffusion of innovations as well as a social **diffusion of innovation rents**. Initially, they are reaped by the pioneering company alone, then also by imitators, until they are gradually passed on to the opposite side of the market through imitation competition, so that in the long term **zero profits** are realized again und consumers benefit permanently.

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33

Lesson II

Companies have an interest in innovation. Only in this way can they escape the static equilibrium condition, which is to achieve zero profit. If they are interested in pioneering profits, they have to invest in innovations.

Innovation competition forces companies to invest much more in innovation than they actually would like. If they could act as they wished, they would choose the level of innovation that promises them maximum pioneering profit. However, they fail in that endeavor.

In analogy to the static effect of competition, where profits are reduced to zero because firms cannot hold back in terms of their production volume, the dynamic effects of competition make sure that firms cannot hold back in terms of their innovation efforts. – From a static perspective, firms taken as a group offer too much production quantity. From a dynamic perspective, firms taken as a group invest excessively in innovation – und thus benefit the opposite market side.

In this way, competition serves the **common good**.

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34

Lesson III

We now have a better understanding of why competition is a legitimate core element of a successful market economy: because it fulfils the societal function of diffusing the rents of value creation (in the static sense) and the rent of innovation (in a dynamic sense) – thus exerting strong positive externalities that benefit all citizens – und thereby the common good.

Competition leads companies to pass on the fruits of their efforts, ultimately serving their interaction partners: employees benefit in the form of higher wages and more attractive working conditions, and customers benefit in the form of lower prices and higher product quality.

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35

Ludwig Erhard (1897 - 1977)

Ludwig Erhard refers to the competitive diffusion effect.

http://www.listal.com/viewimage/796569

„In the best sense of the word, a **socialisation of progress and profit** is achieved through competition, and in addition, the personal pursuit of performance is kept alive."

Ludwig Erhard (1957, 1964): Wohlstand für alle, p. 8, emphasis in original

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36

William D. Nordhaus (*1941)

Nobel Laureate 2018:

„[I]nnovational profits depend upon the appropriability of innovations as well as the rate of depreciation of profits from the innovations. Using data from the U.S. nonfarm business section, I estimate that innovators are able to capture about 2.2 percent of the total social surplus from innovation. This number results from a low rate of initial appropriability (estimated to be around 7 percent) along with a high rate of depreciation of Schumpeterian profits (judged to be around 20 percent per year). In terms of the rate of profit on capital, the rate of profit on the replacement cost of capital over the 1948-2001 period is estimated to be 0.19 percent per year."

William D. Nordhaus (2004):SCHUMPETERIAN PROFITS IN THE AMERICAN ECONOMY: THEORY AND MEASUREMENT, NBER working paper, p. 34.

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37

William D. Nordhaus (*1941)

Nobel Laureate 2018: He cites:
Watson OJ, Barnsley G, Toor J, Hogan AB, Winskill P, Ghani AC. 2022. Global impact of the first year of COVID-19 vaccination: a mathematical modelling study. Lancet Infect. Dis. 22(9):1293–1302

https://www.nobelprize.org/images/nordhaus-57922-portrait-medium.jpg

„One of the major innovations of modern times was an effective vaccine for COVID-19. … The benefits of securing an effective vaccine one year earlier are literally in the tens of trillions of dollars according to studies by public health specialists and economists. How much of this is earned by the developers of successful vaccines? If we look at one of the major firms, Moderna, its market value rose from $20 billion prevaccine to around $120 billion in 2022–2023. Say all the vaccine makers gained $300 billion. This reward is surely not a pittance, but it would be only circa 1% of the one-year social value of the vaccines (Watson et al. 2022). Notwithstanding this success story, the gap between social and private returns is a major impediment to effective innovation, and poor incentives appear to have slowed the development of later-generation COVID-19 vaccines.“

William D. Nordhaus (2024): Looking Backward, Looking Forward, in: Annual Review of Resource Economics, vol. 16, pp. 1-20, p. 4f.

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38

William J. Baumol (1922 – 2017)

http://channer.tv/monday23.jpg

„The capitalist economy can usefully be viewed as a machine whose primary product is economic growth. … It is the spectacular and historically unprecedented growth rates of the industrialized market economies – the growth rates of their productivity and their per capita incomes – that, above all, set them apart from all alternative economic systems."

William J. Baumol (2002): The Free-Market Innovation Machine; p. 1 and p. 3.

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39

What does "Social Market Economy" mean?

Andrew Young is an icon of the US civil rights movement (and founding president of the Wittenberg Center for Global Ethics). He came up with a great translation for the term "social market economy".

Andrew Young
*1932

http://www.fluoridealert.org/wp-content/uploads/andrew_young.jpeg

„[I]n a free enterprise system, you don't have to take from the rich to give to the poor. You grow an economy and include everybody, and people get their share according to their abilities. That, basically, is what I call "**public purpose capitalism**."

http://www.gcn.org/articles/Sharing-as-a-survival-capitalism-as-public-purpose-Ambassador-Andrew-Young-on-a-lifetime-of

Core idea: Commissioning the market economy for the implementation of moral desiderata.
This includes environmental protection!

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40

More Food for Thought

Here are some hints at optional literature on the legitimacy of competition and the profit principle:

Allcott, Hunt et al. (2023): An economic view of corporate social impact, abrufbar unter: https://www.nber.org/system/files/working_papers/w31803/w31803.pdf, Zugriff am: 26.10.2023.

Pies, Ingo and Stefan Hielscher (2023). The moral legitimacy of profit orientation, in: Talaulicar, Till (Ed.): Research Handbook on Corporate Governance and Ethics. Cheltenham and Northampton: Edward Elgar, pp. 328-347.

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41