

# **Balancing Efficiency and Solidarity: The German „Soziale Marktwirtschaft“ as a Model for Equitable and Resilient Economic Development<sup>1</sup>**

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Dear Minister Velloso, distinguished audience, ladies and gentlemen:

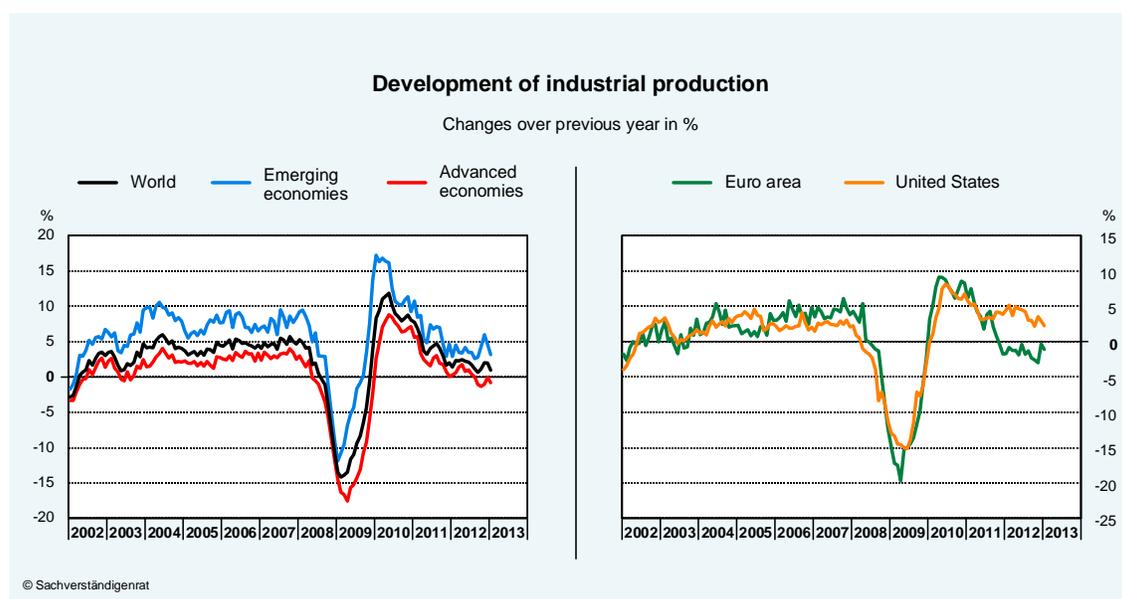
Let me first of all convey my congratulations to the National Forum for its Silver Jubilee, which is addressing the fascinating issue of “Tomorrow’s Brazil”! Moreover, I would like to express my gratitude to the organizers, the National Institute of Advanced Studies and the Konrad-Adenauer-Foundation, for receiving the invitation to his outstanding event! My thanks go also to BNDES which is acting as today’s host. It is truly a great honor for me to be asked to address the audience with my remarks on a well-proven example of equitable and resilient economic development – Germany. My thesis is that much of Germany’s economic success during the last six decades has rested on its underlying economic and social model – its “social market economy”.

As we are speaking, the world economy is still under the impression of the large financial and economic crisis which has engulfed advanced and emerging economics alike, and in 2009 led to the most severe downturn in economic activity since the Great Depression in the first half of the 20<sup>th</sup> century. As graph 1 undoubtedly documents, while the global economy recovered in 2010 and 2011, it has been heavily affected by the Euro Area crisis during the last two years, and it is likely to grow only moderately in the years to come. And while the recent slump in economic activity has been most pronounced in the Euro area, no region has been spared completely. Advanced and emerging economies tend to display quite different levels of growth rates, but their inter-temporal developments are highly synchronized.

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<sup>1</sup> Ich bedanke mich herzlich bei der Konrad-Adenauer-Stiftung und dem Nationalen Institut für Höhere Studien für die Einladung zum 25. Nationalen Forum, Rio de Janeiro 2013, bei Wim Kösters für seine hilfreichen Kommentare und bei Nicole Kodat für ihre editoriale Unterstützung.

**Graph 1: The World economy under the impression of the Euro crisis**



Yet, despite all uniformity in being affected by this crisis, a closer look reveals that underneath this overall picture there is a lot of heterogeneity in the individual experiences of countries and regions during the crisis. Thus, these are also times which expose the strengths and weaknesses of the way economics are organized. – And, as I will try to demonstrate in what follows, the German economy has displayed a comparatively high resilience to the crisis. Most importantly, the core of my arguments will convey my conviction that this resilience is not at all an accident of history. Rather, to a considerable extent, it is the consequence of Germany's economic model, the "Soziale Marktwirtschaft", ("social market economy").

This argument is also shaping the outline of my presentation, which is organized in five sections. I will start by asking the audience to follow me in taking a step back and posing the following question: What should be the overarching objectives of the search for a viable economic model? In the second and third sections, I will then proceed to argue that the German "Soziale Marktwirtschaft" is a good answer to this quest for a viable economic model<sup>2</sup>. – I'll do this in two steps: First, in section 2, by explaining the well-matured principles of this model, and then, in section 3, by demonstrating how this model needs to

<sup>2</sup> There are numerous seminal publications on the German social market economy on whose ideas I will be drawing extensively, without having the opportunity to pay credit to them in their entirety. Here I will draw most extensively from two contributions by Kösters (1990a and 1990b).

be adapted to new challenges, more specifically to the sustainability paradigm. It turns out that one of its strengths is precisely that it can easily be adapted to new requirements.

But any good economist would not remain in the realm of the abstract. – I will also, in a fourth section, sketch the evidence regarding the viability of the German social market economy during the current crisis. Finally, in a fifth section of the talk my remarks will outline how our society is enabled by this model to engage into fundamental reform. I will argue that social balance is the essence of the ability of this system to manufacture the resilience that appears to be so remarkable to many outside observers.

### **1. Searching for an economic model: overarching objectives**

Let us start with adopting the birds' eye view of a hypothetical social planner who would like to provide an ideal framework for social progress. From this vantage point, we can detect three overarching objectives guiding the search for an economic model – which are closely entangled with one another, but are certainly not identical.

First, placing the focus on the average member of the society, we would want average (economic) prosperity to grow steadily and remarkably, taking advantage of the opportunities given by the continuous advances in human knowledge and by the constant source of human creativity. – How should we go about this: By investing into a comprehensive “infrastructure” for enabling prosperity. This broad concept of infrastructure comprises

- investment in physical capacity (“capital”);
- investment in human capacity (“human capital”); and
- investment in administrative capacity (“infrastructure”).

That is, the first priority of a viable economic model should be to enable prosperity, it should encourage individuals to delay gratification for the prospect of increased prosperity in the future.

Second, taking a broader view addressing the society as a whole, we would like to live in an equitable society (“fairness”) which provides some protection against poor endowments, while recognizing that economic activity can and should not always generate equitable

results – taking risks has an upside and a downside. The economic model should, thus, ascertain that the resulting distribution of prosperity displays considerable stability. Consequently, social policy should be enacted to correct inequities, but without stifling risk taking, economic initiative and, thus, growth of prosperity. It should do so for reasons of fairness, especially correcting for inequities in endowments, but also ameliorating the consequences of sheer bad luck, and of acceptance: In the end, any viable economic model needs to be accepted by all members of society in order to provide a sustainable framework for individual activities.

Thus, in practice there is always a conflict between correcting the market result to ascertain fairness and acceptance, and setting the right incentives to achieve a satisfactory market result: Finding the right balance is the key to solving this trade-off. Most importantly, a viable economic model needs to provide ample opportunities for working oneself up the social ladder, since finding yourself at the bottom end of the distribution might be quite acceptable, if there is a decent chance of working yourself out of this calamity in due time. If upward mobility is essentially precluded, however, perhaps even for your children, accepting the economic model is difficult at best.

Third, while in “normal” times finding the best balance between growth and inequality is the most prominent objective of a hypothetical social planner, in market economies there will always be severe crises from time to time. – The ideal economic model should be able during these exceptional periods to specifically improve the lot of those most hit by the crisis and of those most vulnerable to its consequences.

## **2. Principles of the German „Soziale Marktwirtschaft“**

It already becomes evident from this description of overarching societal objectives that enabling an efficient functioning of the economy, providing the opportunity for individual success and the incentives for private initiative should be combined with correcting the (primary) market outcome with respect to social balance. There is just such a model in existence, the well-matured and praxis-proven German social market economy: “The purpose of the social market economy is to combine the principle of liberty in the market with the principle of social compensation” (Müller-Armack, cited after Kösters 1990a).

The principal idea behind this concept is searching for the appropriate balance in the combination of a competitive market economy with compensating provisions to ascertain social progress. The key source of economic prosperity which is unleashed in this system is private initiative, of entrepreneurs, works, scientists and all other relevant actors. This concept is nothing less than the application of the concept of the liberal constitutional state to economic policy (Kösters 1990a): The idea of the rule of law in the political arena implies that the state has no right to interfere with individual rights. In the economic arena, the counterpart of this idea is the principle of the individual freedom: the state has the right – and the obligation – to design and protect the rules of the game, but no right – and certainly no obligation – to specifically determine individual economic outcomes.

A comparison with the abstract set of objectives sketched in the second section of this presentation immediately reveals how these ideas are directly aiming at a good balance of all three overarching objectives. Most importantly, by organizing the economy as a competitive market economy, with two constituent elements, unhampered competition on factor and goods markets, and the free movement of prices, one ensures that scarce resources are allocated efficiently, and that, consequently, prosperity can increase rapidly. In addition, the state has a highly important, albeit very challenging task: ascertaining that the “rules of the game” are observed, keeping the competitive market economy functioning. This is only possible, as the founding fathers of the social market economy knew already, if the state’s actions themselves are stable and predictable.

The state is, thus, responsible for preserving an unhampered functioning of the market mechanism, in particular ascertaining a viable level of competition on all relevant markets. This implies fighting against cartels, especially price arrangements, and against the capture of the state’s institutions by pressure groups. Arguably, when interference in the price mechanism is permitted, inequality in income and wealth tends to be larger than in the ideal market economy which is coupled with redistribution to achieve social progress. As a corollary to this insight, the state should also engage into a liberal foreign trade policy, adamantly avoiding protectionism.

The state is, secondly, responsible for preserving a stable currency, in particular by ascertaining price level stability. According to the historical experiences made in the last

century, rapid inflation is highly unsocial and, in the extreme, might even lead to political destabilization. With respect to concrete policy action, these insights call for conscious stabilization policy, either exclusively via a stable monetary framework or –perhaps – also via active monetary and fiscal policy. Finally, the state is responsible for preserving social coherence, by correcting the primary income distribution and, in particular, by generating a strong sense of equality of opportunity. After all, fostering fairness and social justice tends to preserve social peace and acceptance of the underlying economic model. Thus, the primary distribution of market incomes should be corrected by taxes and transfers.

### **3. New conceptual challenges: the sustainability paradigm**

The world has changed since the founding fathers of the “Soziale Marktwirtschaft” designed the German economic model and implemented it so successfully. It has become ever faster changing, old political antagonisms between East and West have made way to heterogeneous alliances which change with the topic at hand, and – overall – the challenges have become more global in nature.

This calls for an economic model which displays the ability to learn from its successes and failures and to adapt smoothly to new challenges. The German social market economy is satisfying these requirements. Its underlying insights will remain valid under all circumstances: First, from a social perspective, even if your aim is the achievement of social balance and an equitable society, one can only re-distribute the prosperity which has been generated before by economic activities. And, second, the best help that one might be able to grant is to help people helping themselves, which is the principle of “subsidiarity”.

But nevertheless there is more to human prosperity than material progress. This more encompassing concept of prosperity comprises both, non-material aspects of wealth and quality of life, and the sustainability of current actions in all relevant realms of human existence. The issue of sustainability is variegated – it comprises three principal fields.

The first field is economic sustainability. This aspect of sustainability again comprises several aspects. One is referring to public debt: The state needs to avoid the built-up of a public debt overhang, to ascertain freedom of action in future years to come. A second aspect is regarding private credit markets: Economies should avoid the built-up of credit or real estate

price bubbles. And a third aspect is future growth: To ascertain future prosperity, it is inevitable to invest into physical capital – reflected in aggregate net investment, to invest into human capital – reflected in efforts of education, and to invest into innovation capital – reflected in efforts in research and development.

The second field of sustainability is social sustainability. This requirement implies readjusting, in a public discourse, the balance between equity and efficiency, to reflect the ever changing environment for all economic and social activity. As a corollary, this also implies backing up individual risk taking, by allowing a return to prosperity (“giving a second chance”) even after failure. Finally, the third field of sustainability is ecological sustainability. In essence, human economic activity should respect environmental boundaries, both limitations of exhaustible resources and the earth’s absorptive capacity.

All these requests can be built into the fabric of a social market economy. As the nation state reaches its boundaries in the face of global (predominantly, but not exclusively environmental) challenges, an additional requirement is the growing global coordination of the relevant political efforts.

#### **4. Evidence on performance: Germany in the current crisis**

There is in fact ample evidence on the success of a social market economy, as it was implemented in Germany after World War II. The first piece of convincing evidence is the unprecedented „economic miracle“ of the post-WW II era: The reconstruction of the West German economy after “hour 0” in 1945 has to be viewed, in particular, vis-à-vis the tremendous failure of the Socialist East German economy.

As the account of German economic historians documented (Kösters 1990a), at the end of WW II in West Germany there was neither any jurisdiction nor public administration, about 50 % of the production capacities were destroyed, some 40 % of the population were bombed out, and some 60 % of the population were undernourished. Regarding basic aspects of the economy, the currency was ruined and the state of economic depression extreme. But, after heavy political struggles, a new economic model was installed in a conscious act by the proponents of the idea of generating prosperity through efficient

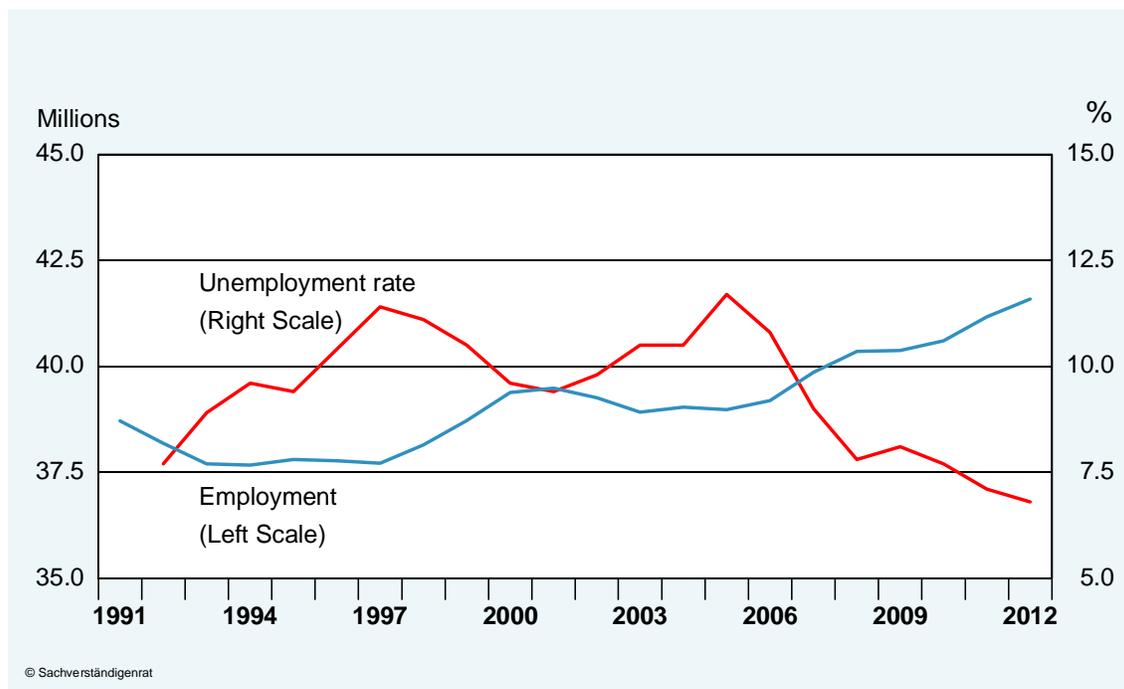
economic solutions, with the state ascertaining the functioning of the market, the “rules of the game”.

At first, this was not the solution which was pursued, as authorities intended to organize reconstruction by government planning and monitoring, but with little success. Then the allies decided to support the Western occupation zones with the Marshall-Plan, and to bust the large industrial conglomerates. And in 1948, the director of the administration of the economy of the Bizone, Ludwig Erhard, advocated a simultaneous currency and economic reform: “The currency reform was enacted on June 20, 1948, and soon after, many rationing regulations were lifted and most prices were decontrolled” (Kösters 1990a). “And the newly established central bank was given complete independence to just pursue one objective, ascertaining a stable price level” (Kösters 1990a).

This reform proved to be a huge success, leading to double-digit growth rates for years to come. This success was fortified in the Federal Republic of Germany by implementing the law against the restriction of competition and the law governing the operations of the German Bundesbank. It was also strengthened by enhancing the well-matured system of social security by regulating dynamic pension payments. Finally, it very much benefitted from the establishment of collective bargaining without interference by the government. I shall mention the „second economic miracle“ associated with German reunification only in passing: After 1990, the German economy took only some 1 ½ decades to digest the integration of completely decrepit East German capital stock, of a work force completely inexperienced with respect to competition and labor flows, and an administration which originally was not set up to support the operations of a democratic market economy.

During the recent crisis, one cannot help oneself but notice the extremely high level of heterogeneity of labor market experiences in the – otherwise quite homogenous – Euro area. This holds for employment which has been declining in most Euro area member states, especially in the “problem countries” Portugal, Spain, Greece, and Ireland. And yet, it has even increased in Germany and Austria during the same time. But it also holds for unemployment as well. Unemployment rates have skyrocketed especially in Greece and Spain. But the performance of the German labor market is simply outstanding.

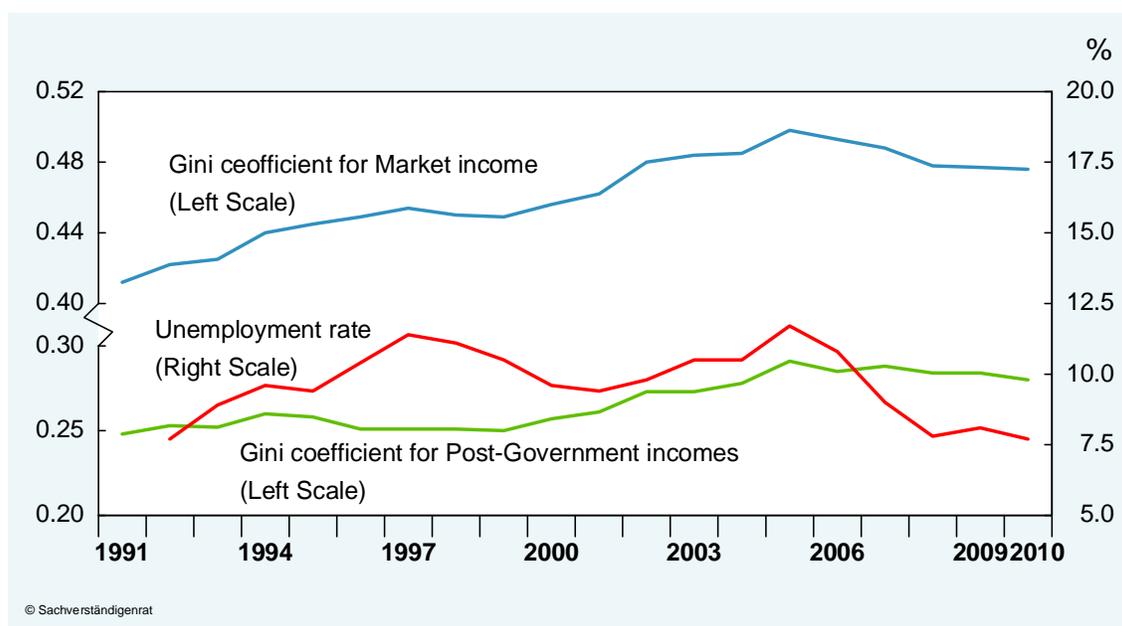
**Graph 2: Employment and unemployment in Germany in recent years**



While in terms of the low levels of their respective unemployment rates, Austria and the Netherlands had been quite ahead of Germany for a while, it is the resilience of the German labor market which is so remarkable. After all, unemployment rates have even been declining during the recent crisis years. Graph 2 documents that German unemployment rates had been less remarkable before the current crisis. This was at least to some extent a reflection of the “second economic miracle” of reconstructing, albeit yet imperfectly, and integrating the formerly socialist – and completely run down – East German economy. But this somewhat deplorable state was also a reflection of an entrenched welfare state into which the German economy had slowly transmuted over time.

It is a particularly remarkable achievement of the social market economy that it provided the basis for change. I will discuss this in the final section of my talk. For now let me just discuss two empirical facts. First, as can be gleaned from graph 2, after 2005 employment increased and unemployment rates fell, and these tendencies have not been altered fundamentally by the crisis that started to accelerate in the fall of 2008.

**Graph 3: Unemployment and income inequality in Germany in recent years**



Second, graph 3 documents that since 2005 unemployment and income inequality have been declining together. Both the Gini coefficients characterizing inequalities of market and of post-redistribution incomes have declined in recent years, after increasing moderately in the years before. This happened during a time, in which inequalities increased remarkably in other advanced economies, for instance in the United States.

### **5. Manufacturing resilience: enabling fundamental reform**

But how was this possible? Well, the social market economy is a system which allows for painful reforms to happen which foster efficiency, under the guiding principle of subsidiarity, but also entail beneficial social effects. This is possible, because as a matter of principle the aim of improving economic prosperity is always combined with social progress through redistribution. In that sense, following an appropriate economic model, with all necessary adjustments to make the adaptation viable in the real world, there can be win-win situations: “combining efficient market outcomes with social compensation”. It very much seems that other economies might learn from this example, as they themselves need to engage into fundamental reforms as well.

For Brazil, if I may be so daring, I see the following implications. With respect to enterprises, it seems to be a good strategy to allow Brazilian industry to find – on its own initiative and

responsibility – its place in the international division of labor and in internationally fragmented supply chains, instead of asking for the autarky of industries and protecting them from outside competition. With respect to people, it seems highly advisable to invest in the trinity of aspects fostering the knowledge economy: education, research, and knowledge transfer, always protecting property rights and free market entry. And with respect to public finance, it seems tremendously important to ascertain future room to manoeuvre by providing solid public finances and by making pensions more resilient to demographic change, and to invest in the trinity of innovation by unleashing private initiative and creativity. Then a genuinely great economic potential might express itself in genuinely great economic and social progress.

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