

# 60 YEARS OF SOCIAL MARKET ECONOMY

FORMATION, DEVELOPMENT AND PERSPECTIVES  
OF A PEACEMAKING FORMULA

**Christian L. Glossner**

**David Gregosz (Eds.)**

*Overview of a conference organised by the Konrad-Adenauer-Stiftung (KAS) in cooperation with the European Business Circle (EuBC) and the University of Oxford in Sankt Augustin, 30<sup>th</sup> November 2009.*

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## PREFACE

Since its political implementation by mainly Ludwig Erhard and Konrad Adenauer in the Economic Council, West Germany's first post-war legislative parliament, and subsequently in the *Bundestag* of the emerging Federal Republic of Germany in 1949, the Social Market Economy as Germany's distinguished 'Third Way' of regulatory policy between centralist socialism and unbridled capitalism has been proving to be very successful. In particular in times of so-called 'globalisation' and the current worldwide economic crisis, the deliberately holistic though loosely defined and thus flexible economic, political and societal model has received general praise.

Despite great attention and even the recent constitutional anchoring of the Social Market Economy in the Lisbon Treaty of the European Union<sup>1</sup> entering into force on 1 December 2009 – precisely 60 years after its political implementation and public validation – however, some confusion remains about the formation, definition, implementation and potential of the distinctive German model of economic and social policy.

Due to the 60<sup>th</sup> anniversary of the Social Market Economy, it is the intention of this publication resulting from the preceding international conference held conjointly by the *Konrad-Adenauer-Stiftung (KAS)* and the European Business Circle (EuBC) in November 2009 to recall the historical origins and basic principals of the economic and socio-political model. Furthermore, the transformations of the concept over time are traced back and potential future developments are presented to the readership.

Moreover, the role and potential of the Social Market Economy in an increasing European Union and an intensifying globalisation are examined.

Oxford & Bonn/Sankt Augustin, December 2009

*Dr. Christian L. Glossner | David Gregosz*

1/ *Article 2 para. 3 Treaty of Lisbon, Brussels, 2009.*

# I. FORMATION AND IMPLEMENTATION OF THE SOCIAL MARKET ECONOMY

# THE MAKING OF THE GERMAN POST-WAR ECONOMY<sup>1</sup>

*Christian L. Glossner*

*Economic policy ensured by the  
concept of the Social Market Economy  
is the best social policy.<sup>2</sup>  
(Konrad Adenauer, 1949)*

Precisely eighty years after the Great Crash in 1929 arguably precipitating the following Great Depression in the 1930s by rampant speculation in the stock market,<sup>3</sup> once more, history appears to repeat itself. In view of the current financial and economic crises generally respected magazines, such as *The Economist*, question modern economic theory apparently unable to avoid the mistakes of the past,<sup>4</sup> and, internationally, politicians across the political spectrum seek for explanations. Intellectuals, such as Peter Sloterdijk and the recently deceased prophet of liberalism, Ralf Dahrendorf, request a new work and social ethics and call for a return to a more responsible and restrained capitalism.<sup>5</sup>

Similarly, in his book *An Inquiry into the Principles of the Good Society* published in 1937, the American philosopher and political commentator, Walter Lippmann, criticised both socialist tendencies and neo-classical economic theory,



which he blamed for the then prevalent social and economic crises.<sup>6</sup> In appreciation of the US-American journalist and his views, the French philosopher Louis Rougier invited to an international conference named Colloque Walter Lippmann on the apparent crisis of liberalism. Beside the eponym, twenty-five intellectuals, academics and industrialists followed the invitation and met at the *Institut International de Coopération Intellectuelle* in Paris between 26 and 30 August 1938. United in one front, the participants including the distinguished economists Ludwig van Mises, Friedrich August von Hayek, Alexander Rüstow and Wilhelm Röpke aimed to revise and redefine economic and political liberalism – and indeed socialism.

The lessons gained from the historical experiences of failed economic liberalism in the early 1930s and the inhumane totalitarianism, depotism and fascism of National Socialism, and, in addition, the preoccupation with the social question since the late nineteenth century led to the discussion and eventual development of a new liberalism or 'neo'-liberalism as a so-called 'Third' or 'Middle Way' between the extremes of unbridled capitalism and collectivist central planning. This neo-liberal conception encompassing economic-political and socio-philosophical ideas was based on classical liberalism and neo-classical theory. In contrast to *laissez-faire*<sup>7</sup> or free market liberalism, however, the neo-liberal concept considered regulatory interference as legitimate provided it was solely to safeguard the functioning of the market. Despite general agreement upon the elaboration and definition of a viable combination of greater state provision for social security with the preservation of individual freedom, the discussants' views differed mainly regarding the importance attached to the state and to the individual; thus, there is no single school of thought known under the name 'neo-liberalism' but the notion covers a wide spectrum of various schools and interpretations, such as monetarism, libertarianism, or ordo-liberalism.

Liberals like Friedrich August von Hayek defended classical liberalism and free market capitalism against any interventionist approach, which he considered to be harmful to both liberalism and democracy. The free market economist argued that such socialist and collectivist theories, no matter their presumptively utilitarian intentions, lead to totalitarian abuses. The developments in Nazi Germany and his home country, Austria, affirmed his fears and predictions. According to Hayek, who became a British subject in 1938 and later founded the *Mont Pèlerin*

*Society*<sup>8</sup> as a leading think tank of neo-liberalism near Montreux in Switzerland in 1947, 'Liberalism was to all intents and purposes dead in Germany and it was socialism that had killed it.'<sup>9</sup>

After the collapse of the totalitarian Third Reich with its statist, corporatist economic policy, academics at the University of Freiburg im Breisgau in Germany also advocated a new liberal and socio-economic order. In this context, it is important to distinguish between the Freiburg School and the Freiburg Circles. Frequently, the two schools of thought were believed to be the same<sup>10</sup> although the first emerged from the latter and among the members of the Freiburg School only the founders Walter Eucken and Franz Böhm belonged to the Freiburg Circles and, conversely, no member of the Freiburg Circles can be attributed to the Freiburg School, which partly advocated different economic objectives. Both schools of economic thought considered that a certain form of planning was necessary for a transitional period following the war. However, whereas the pivotal members of the Freiburg Circles, Erwin von Beckerath, Adolf Lampe and Jens Jessen, favoured 'productive' governmental intervention, i.e. an economy regulated by a relatively strong state,<sup>11</sup> Walter Eucken, Franz Böhm and Constantin von Dietze believed in self-regulating market forces and limited indirect state interference.<sup>12</sup> According to Eucken, the state must solely create a proper legal environment for the economy and maintain a healthy level of competition through measures that follow market principles. Thus, the paramount means by which economic policy can seek to improve the economy is by improving the institutional framework or '*ordo*'.

In drawing on both Eucken's ordo-liberal competitive order and Wilhelm Röpke's 'Economic Humanism' leading to a '*Civitas Humana*',<sup>13</sup> the ordo-liberal competitive order was further developed by the Cologne School around the economist and anthropologist Alfred Müller-Armack, who therefore coined the term '*Soziale Marktwirtschaft*' (Social Market Economy) in a publication in December 1946.<sup>14</sup> Although it evolved from ordo-liberalism as a new variant of neo-liberalism, this concept was not identical with the conception of the Freiburg School. In contrast to Eucken, who favoured a strictly procedural or rule-oriented liberalism in which the state solely sets the institutional framework and abstains generally from interference in the market, Müller-Armack emphasised the state's responsibility actively to improve the market condition and simultaneously to pursue a social balance.<sup>15</sup> In putting social policy on a par with

economic policy, Müller-Armack's concept was more emphatic regarding socio-political aims than the ordo-liberal economic concept. However, the Social Market Economy as an extension of neo-liberal thought was deliberately not a defined economic order but an adjustable holistic conception pursuing a complete humanistic societal order as a synthesis of seemingly conflicting objectives, namely economic freedom and social security.<sup>16</sup> Although it is often viewed as a *mélange* of socio-political ideas rather than a precisely outlined theoretical order, the conception possessed an effective slogan, which facilitated its communication to both politics and the public. The eventual implementation, however, required not only communication but also political backup.

Here, Müller-Armack's concept soon met with the conception of the then Chairman of the *Sonderstelle Geld und Kredit* (Special Bureau for Money and Credit) within the Administration for Finance, i.e. an expert commission preparing the currency reform in the Anglo-American Bizone, Ludwig Erhard. Although Erhard was rather inclined to Walter Eucken's ordo-liberal competitive market order<sup>17</sup> and even considered himself an ordo-liberal,<sup>18</sup> he was strongly impressed by Alfred Müller-Armack most of all not as a theorist, but instead as one who wanted to transfer theory into practice.<sup>19</sup>

When Erhard succeeded Johannes Semmler as Director of the Administration for Economics in the Bizonal Economic Council on 2 March 1948, the Social Market Economy entered the political sphere. Soon after, on 21 April 1948, Erhard informed the parliament about his economic policy and introduced the concept of the Social Market Economy.<sup>20</sup> Although there was no unanimous applause, both the Liberal Democrats and the conservatives widely welcomed the transition to a more market-oriented economy.<sup>21</sup> Thereupon, the Chairman of the *Christlich-Demokratische Union* (CDU) in the British zone of occupation, Konrad Adenauer, invited Erhard to also inform the party members about his socio-economic conception at the party convention in Recklinghausen on 28 August 1948. In a visionary and stirring speech, entitled *Marktwirtschaft im Streit der Meinungen* (Market Economy in Dispute),<sup>22</sup> Ludwig Erhard defended his concept of the Social Market Economy alluding to the dualism between a controlled economy and a market economy.<sup>23</sup> In view of the upcoming regional and federal elections, Adenauer, who was initially sceptical about Erhard,<sup>24</sup> was not only impressed by the polarising slogan, i.e. 'Controlled or Market Economy', but also by the efficacy of Erhard and his

programme.<sup>25</sup> The foundation for a successful political alliance was laid.<sup>26</sup> After the *Christlich-Soziale Union* (CSU) also expressed its commitment to a market economy with social balance, and the then newly-elected Bavarian Minister for Economic Affairs, Hanns Seidel, advocated Erhard's liberal and social economic model at the CSU's party convention in Straubing in May 1949,<sup>27</sup> the economic principles elaborated by the Working Committee of the CDU/CSU as liaison body and information centre of the two political parties commonly referred to as the '*Union*', centred the Social Market Economy.<sup>28</sup> Finally, these principles were adopted as party platform and manifesto for the upcoming federal elections at the CDU's party conference in Düsseldorf on 15 July 1949.<sup>29</sup> In contrast to the previous ideological *Ahlener Programm* suggesting a rather abstract and anti-materialist '*Gemeinwirtschaft*',<sup>30</sup> these so-called '*Düsseldorfer Leitsätze*' not only provided a concrete, pragmatic and materialist economic programme but also an attractive slogan to reach consensus within the party and the public. While eventually the union of the two recently established political parties, i.e. the CDU and the CSU, possessed a coherent and unifying economic programme enabling a more consistent public front, the oldest German political party, the *Sozialdemokratische Partei Deutschlands* (SPD) led by the advocate of economic planning and extensive socialisation, Kurt Schumacher, did not introduce its own economic concept. This not only complicated the parliamentary work of the party in the Economic Council but also limited the public relations of the party as a whole especially in times of campaigning where the partially complex political programmes were simplified and popularised.

In the run-up to the federal elections in August 1949, the CDU/CSU consequently aligned their party platforms, policies and manifestos and campaigned with the Social Market Economy. In particular the former advertising manager for consumer goods, Ludwig Erhard, who affirmed that he would 'go into the upcoming political party clashes with particular energy for the CDU',<sup>31</sup> realised the potential of subtle and systematic marketing to transform the concept from an economic theory, or even abstract economic policy, into the basis of a political party's propaganda and public image that held broad appeal. Eventually, on Sunday 14 August 1949, around 31 million Germans were called to cast a vote for the first German *Bundestag* and to decide between the Social Market Economy and a controlled economy advocated by the SPD. Of those eligible to vote 25 million or 78.5 per cent actually went to the ballot boxes often set up in restaurants and public houses and showed a clear

commitment to the emerging post-war democracy. Although the SPD, gaining 29.12 per cent of the votes, turned out to be the most successful single party, the CDU/CSU combined attracted more votes, totalling 31 per cent, and 139 mandates compared to 131 for the Social Democrats. However, in fact both *Volksparteien* had suffered large percentage losses over their previous *Land* election totals by failing to capture a comparable share of the enlarged electorate. The most remarkable advance by winning over a million extra votes and achieving 11.9 per cent of the total votes was that made by the liberal *Freie Demokratische Partei* (FDP) led by the chairman Theodor Heuss. The politically progressive and economically conservative Free Democrats were in fact the only political party consistently gaining percentage of votes between 1946 and 1949.<sup>32</sup> While these results affirmed the then general pro-market trend in public opinion, eventually, the electorate made its decision contingent on the satisfaction of its practical needs rather than on any particular theoretical economic system. The advantage of the CDU and the CSU lay precisely in the fact that they were quasi-governing across the Bizonie and thus increasingly identified with the economic recovery and the improving economic conditions. Although the implementation of the Social Market Economy benefited also from other crucial factors – including the east-west conflict and a favourable political and social climate within Germany and abroad, the stabilising alliance between the conservative and liberal parties, the pro-market composition of the Economic Council and even the Federal Republic's own *Grundgesetz* (Basic Law), which stressed individual freedom, human dignity, and the subsidiarity of societal organisation – it was also the consistent efforts at political communication of the cooperative and corporate model that led to the implementation and eventual electoral validation of the Social Market Economy in post-war West Germany.

In essence, precisely eighty years after the Great Crash in 1929, more than seventy years after various think tanks, political parties and individuals gave impulse to and then shaped the development of a viable socio-political and economic alternative between the extremes of laissez-faire capitalism and the collectivist planned economy, and, precisely sixty years after the successful implementation of the Social Market Economy as a convincing variant of a neo-liberal model of coordinated economic and social policy, both the political and the public debate is once again on the (ir)reconcilability between capitalist profit seeking and social responsibility. Although the current discussion is no longer on capitalism

versus socialism, it centres on capitalism versus capitalism and on corporate governance and the form of capitalism. Due to the current financial and economic crises, all market-oriented economic and thus societal models are under considerable strain and consideration. In this climate, it is important if not imperative to recall the origins, development and definition of the Social Market Economy and to renew its principles and fundamental ideas. Eventually and, indeed, arguably, the distinguished German socio-political and economic model may not merely form an attractive alternative between an Anglo-American Market Economy and a Chinese Socialist Market Economy, but it may also help to reorganise our global economy, to redefine our understanding of capitalism and to reinvigorate the philosophical and economic standing of liberalism in general.

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# ON THE ECONOMIC ETHICS OF WALTER EUCKEN

*Manuel Wörsdörfer*

## **1. INTRODUCTION**

2008/9 sees the 60<sup>th</sup> anniversary of the German economic and currency reform of June 20, 1948, and the adoption of the Grundgesetz on May 23, 1949, which committed the country to the ideals of a socially bounded economy. Both of these events are important points along the path taken by the Federal Republic of Germany to reach the system of a Social Market Economy. Since the term “Social Market Economy” is often used in several different contexts and sometimes to mean contradictory things, we must ask: What exactly does the term Social Market Economy entail? What economic-ethical ideas and theories are behind it? This paper will trace the origins of the Social Market Economy (chapter 2) and explain the central characteristics of the Freiburg School of Economics (chapter 3), one of the main pillars of the Social Market Economy. Central to this paper is the oeuvre of Walter Eucken, one of the leading representatives of the ordoliberal Freiburg School. The aim is to identify socio-political factors of influence and inspiration on his theory of economic policy (chapter 4) and evaluate similarities to the works of Kant, Smith and other economic philosophers. Chapter 5 will seek to elucidate Eucken's

“Program of Liberty”. We shall also allow ourselves a slight diversion to elaborate on the parallels between this work and Kant’s understanding of freedom and autonomy. Chapter 6 deals with Eucken’s dual requirements of an economic and social order (i.e. functioning and humane socio-economic order). In chapter 7, we seek to answer – with considerable reference to Adam Smith – to what extent it can be assumed that self-interest and the common good are mutually compatible. This paper concludes with a few remarks about the topicality of ordoliberalism in relation to modern, German-speaking economic ethics (chapter 8).

## **2. THE NORMATIVE ORIGINS OF THE SOCIAL MARKET ECONOMY**

The fact that the idea of the Social Market Economy rests on several pillars is of fundamental importance. The following normative origins should be mentioned: 1. The ordoliberal Freiburg School of Economics. The founding members of this movement included the economist Walter Eucken, and the jurists Franz Böhm and Hans Großmann-Doerth. 2. Sociological Neoliberalism respectively the extended circle of Ordoliberalism gathering around the emigrants Alexander Rüstow and Wilhelm Röpke. 3. The Cologne School of Economics and its main proponent, Alfred Müller-Armack.<sup>1</sup> 4. (Franz Oppenheimer<sup>2</sup> and his scholar) Ludwig Erhard.<sup>3</sup> In addition, *Christliche Sozialethik* (i.e. Christian social ethics) and *Katholische Soziallehre* (i.e. Catholic social teaching) in chapter 5 also gave sustained impetus to the Social Market Economy; here, we are drawn to the works of Oswald von Nell-Breuning (1954/1960; 1956/1960; 1975/1990) and Joseph Höffner (1959/2006), as well as their emphasis on the principles of subsidiarity and solidarity. Finally, we must not neglect to mention media support, particularly with reference to the popularization and social legitimization of the Social Market Economy (cf. i.a. Erich Welter, co-founder of the *Frankfurter Allgemeine Zeitung*).

## **3. THE FREIBURG SCHOOL OF ECONOMICS**

One of the main distinctions drawn by the ordoliberal Freiburg School is in relation to *Ordnungs- and Prozesspolitik* (i.e. regulation and process policy, respectively rules of the game vs. plays of the game within these rules<sup>4</sup>). The state must limit itself to the formation of regulation, or frameworks; state intervention in the economic plays of the game must

be on the grounds of *market conformity*,<sup>5</sup> i.e. it must not impair the functioning of market and price mechanisms. Process policy-oriented intervention which does not conform to the market must be avoided. In this instance, state regulation must take into account the *Interdependenz der Ordnungen*<sup>6</sup> (i.e. Interdependency of Orders, Eucken), i.e. the fact that economic intervention can also have an impact on the remaining social structures. (Interdisciplinary) *Denken in Ordnungen* (i.e. Thinking in Orders, Eucken), which takes account of these interdependencies, is, therefore, of great importance. It is incumbent upon the “strong state” (Rüstow<sup>7</sup>), as an “ordering power” and “defender of the competitive order” (for: *Hüter der Wettbewerbsordnung*)<sup>8</sup>, to use regulation to establish an economic system, which allows competitive performance to flourish, as this promotes innovation (i.e. competition on the merits and in terms of better service to consumers (*Leistungswettbewerb*, i.e. competition in performance))<sup>9</sup>, and in which complete competition (for: *vollständige Konkurrenz*) ensures that socio-economic interest groups are stripped of power (“competition as an instrument of disempowerment”<sup>10</sup>). The liberal ideals, which are at the basis of Ordo-liberalism, include *freedom of privileges* and *non-discrimination*.<sup>11</sup> The strong, powerful state – governed by the rule of law – must be, constitutionally speaking, in a position to ward off particular interests; it should ideally be above interest groups, seek to remain neutral and serve the common good. In this respect, it is particularly important that the role of the state, but also the boundaries for state activity, are clearly defined, so as to prevent abuses of power and particular interest groups from exerting influence.

According to Eucken,<sup>12</sup> companies, associations and the state pose several, socio-economic threats to liberty. These threat scenarios, which will be expanded upon later in this paper, must be prevented using the rule of law, the competitive order (for: *Wettbewerbsordnung*) and the control mechanisms invested in them. Eucken’s *Fundamentals of Economic Policy* and the *Constituent and Regulatory Principles* – fundamentals and principles form a coherent entity – serve as a means to an end; they enable competition, which, in turn, minimizes the abuse of power and facilitates the exercising of civil liberties. The Kantian moments relate to the prevention of power (i.e. socio-economic limitation of power and limitation of the state’s authority) and the facilitation of liberty.<sup>13</sup>

#### 4. WALTER EUCKEN (1891-1950): SOCIO-PHILOSOPHICAL FACTORS OF INFLUENCE

In order to interpret Walter Eucken's writings in the most sophisticated and least stereotypical manner, we must not just limit ourselves to his two main (economic) works: *Die Grundlagen der Nationalökonomie* (*The Foundations of Economics*) and *Grundsätze der Wirtschaftspolitik* (i.e. *Principles of Economic Policy*). On the contrary, we must also consider his early publications, particularly his *Die Tatwelt* essays, his ORDO papers and his correspondence (letters between him and his family, Rüstow, Röpke, et al.). Furthermore, it is vital to deal with the biography and personality of Eucken. It then becomes apparent that this is extremely complex and full of inner tensions, fractures and ambivalences – not least of all linked to the historical context and the fact that Eucken lived in a transient society, with a number of caesura-like incisions (e.g. the First and Second World Wars, hyperinflation, the global economic crisis, mass unemployment, the emergence of radical and totalitarian ideologies, such as National Socialism and Communism). Eucken's path through life was not just subject to a profound change in terms of methodology and philosophy of science (i.e. gradual renunciation of the Historical School of Economics), but also in a socio-political respect. Oswalt (2005, 2008) and Dathe (2009) provide helpful insights into the route Eucken took to reach democratic liberalism.

The main influences on Walter Eucken's writing were his parents, Rudolf and Irene Eucken, and his wife, Edith Eucken-Erdsiek. Through his father, Rudolf Eucken, who himself was a professor of philosophy in Jena and received the Nobel Prize for Literature in 1908, Walter Eucken came into contact with (neo)Kantian and (neo)idealistic ideas, as well as the Christian social ethics. His wife, Edith Eucken-Erdsiek, a publisher, philosopher, economist and student of Husserl, put him in touch with the founder of phenomenology. The relationship between economics and phenomenology, as well as the related field of "noology" (for: *noologische Methode*) inherited from his father, feature strongly in Eucken's epistemological writings.<sup>14</sup> In addition, we must also mention the debates between the *Historical-Ethical School* and the *Austrian School of Economics*: The field of tension linked to the (value judgment and) methodology dispute (for: *Werturteils- und Methodenstreit*) is also reflected in Eucken's works (the so-called "Great Antinomy"<sup>15</sup>). Finally, the networks within and around Freiburg also had a socio-economic impact: On the one hand, his contact

and friendship with the other members of the Freiburg School and expanded ordoliberalism (in particular, Böhm, Miksch, Röpke and Rüstow, but also von Hayek and the Mont Pèlerin Society); and on the other, the resistance movement of the Freiburg Circles (Diehl, Dietze, Lampe, Ritter and other members of the Confessional Church [for: *Bekennende Kirche*]).

## 5. EUCKEN'S "PROGRAM OF LIBERTY"

Having gained an overview of the normative foundations of the Social Market Economy and the important characteristics of the ordoliberal Freiburg School, we would now do well to consider the teachings of Walter Eucken – particularly his understanding of liberty. Eucken's ORDO papers from 1948 and 1949 are fundamental for this: *Das ordnungs-politische Problem* (i.e. *The Regulatory Problem*) and *Die Wettbewerbs-ordnung und ihre Verwirklichung* (i.e. *The Competitive System and Its Realization*). In order to evaluate the (contextual and terminological) parallels to Kant, we would be well advised to consider Kant's own political writings.<sup>16</sup>

At the heart of Eucken's discourse on liberty is the (Kantian) term, autonomy. The aim is to overcome the immaturity and minority of humanity<sup>17</sup>, personal enlightenment and emancipation, and the realization of an individual's right to self-determination.<sup>18</sup> Eucken always emphasizes individual responsibility in relation to the realization of autonomy. In this regard, Eucken opposes socio-economic and political dependency, oppression and exploitation.<sup>19</sup> Liberty is, therefore, incompatible with totalitarianism and imperialistic systems. Furthermore, it cannot be reconciled with the process of social "massification" and "stereotyping" (for: *Vermassung*), whereby the individual's personality is "expunged" and a wide-scale "de-souling" (for: *Entseelung*) and "de-individualization" (i.e. *Entindividualisierung*) takes place. In the wake of such a development, the individual becomes increasingly incapable of expressing his or her right to self-determination. The topos of massification is expressed by many proponents of Ordoliberalism as part of the subject of the "social crisis of the present" (for: *Gesellschaftskrisis der Gegenwart*); according to this, the loss of religious ways of life and the suppression of religion in public has led to a sustained crisis in meaning and orientation. Its features include a widespread inner emptiness, an ethical nihilism and a distinct decline in values. It is argued that a religious-spiritual reformation and the creation of a new social way of life are necessary,



which will allow the spiritual crisis to be overcome and the ethical-religious vacuum to be filled. Here, and in other places, the meta-economic cultural and socio-critical direction of ordoliberal arguments becomes clear.<sup>20</sup>

Eucken's essay of 1938 entitled *Die Überwindung des Historismus* (i.e. The Conquest of Historicism) seizes on the topos of the social crisis and links it neatly with the Kantian understanding of liberty and rationalism. Eucken, by taking the fight to historicism and criticizing the irrationalism it represents, draws a direct parallel to the tradition of the Enlightenment. Eucken specifically accuses the proponents of historicism, such as Sombart, Götzl-Ottlilienfeld and Spann, of expounding a fatalistic, deterministic and romanticized ideology. Eucken warns against the relativization of the notion of truth, the relativity of knowledge and the danger that science will lose its creative and ordering function (relativism accusation). Furthermore, he criticizes skepticism and the mistrust several historicists have towards the ratio (irrationalism accusation).<sup>21</sup>

Let us now return to Eucken's actual understanding of liberty. This is not, as often claimed, merely a negative one based on defensive rights (for: *Abwehrrechte*) and which disregards central positive performance rights (for: *Leistungsrechte*); as we shall show, there are, in fact, links to positive or real liberties as well.

Liberty is – according to Eucken – a constituent of human existence: “Without liberty, without spontaneous individual action, man is not a ‘man’”.<sup>22</sup> Liberty is closely connected with humanity, human dignity and social justice.<sup>23</sup> In addition, liberty is not limitless or anarchic; individual liberty finds its boundary where another's sphere of liberty begins.<sup>24</sup> That is why, for Eucken, liberty must always be coupled with a comprehensive sense of responsibility towards oneself and towards others (i.e. individual *and* social responsibility).<sup>25</sup> Finally, liberty is not just limited to economics. Liberty is also relevant in a political context and taken to mean basic and human rights<sup>26</sup> and is closely connected with the term human dignity – the central (ordoliberal) value. Economic liberty is coupled with consumer sovereignty and the postulate of “coordination” of individual plans about markets instead of (authoritarian) “subordination”.<sup>27</sup> The economic, liberal ideals, which underlie the basis of this idea, include freedom of privileges, non-discrimination, as well as the rule of law, equal rights, and basic and human rights.

Often, Eucken (and other proponents of Ordoliberalism) are accused of absolutizing the economy and not fulfilling the “market economy’s ability to serve” (*Zweck-/Lebensdienlichkeit der Marktwirtschaft*).<sup>28</sup> However, this is countered by the fact that Eucken distances himself explicitly from a super-elevation and absolutization of normative, economic aspects<sup>29</sup> and that he uses competitive and market mechanisms instrumentally: “Competition as a tool of disempowerment” is not an end in itself, rather it is a means to an end, seeking to prevent improper, market-dominating and monopolistic structures, abuses of power and exploitation.<sup>30</sup> Therefore, competition – by removing market power, diluting market concentration and minimizing imperialistic pressures – serves to enable the free development of the individual from an economic and socio-cultural perspective.<sup>31</sup> Moreover, Eucken’s *Constituent and Regulatory Principles*<sup>32</sup> contradict the accusation of economic absolutization. For example, the principle of contractual freedom is only a relative one, since contracts restricting competition, and hence liberty, are not permissible. The principle of private property requires control mechanisms such as the principle of liability and competition. It is always embedded in the market form of complete competition. Furthermore, the owner has a social and societal obligation.

After all, regulatory principles are a matter of moderate correction of the distributive results of the market-process (in the case of market failure), or rather their socially acceptable configuration (i.e. progressive income taxation according to the principle of performance (i.e. *Leistungsfähigkeitsprinzip*) and, as may be necessary, the safeguarding of existential minimums with the help of minimum wages). Competition prevents concentration of market power and the market form of complete competition channels self-interests down the lines of the common good. The Euckenite competitive system is, thus, not only a system that promotes prosperity, but one that also promotes liberty and society. Even if Eucken does discuss the role of trade unions as part of the *Spezielle Sozialpolitik* (i.e. Special Social Policy)<sup>33</sup> and the importance of co-determination, workers’ rights and the social security system, his focus is still on the principle of subsidiarity; that is to say, before the state intervenes, it is down to self-initiative, self-help and the personal responsibility of an individual and the community (communal neighborly help); only then should the social security system intervene and, as a last resort, the supporting measures of the state or society.

As we have seen, it is incumbent upon *Constituent and Regulating Principles* as well as the *Fundamentals of Economic Policy*, i.e. as a means to an end, to safeguard liberty and these should work towards the disempowerment of socio-economic interest groups and the establishment of regulatory policy instead of process policy (for: *Ordnungs- anstelle von Prozesspolitik*).<sup>34</sup> State intervention into the plays of the economic subject, which do not conform to market mechanisms, must be avoided (criterion of market conformity). The state should limit itself to regulatory policy, i.e. the formation of (framework) regulation. Process policy is rejected on the following grounds: It is arbitrary, selective, ad hoc and paternalistic. In addition, it is based on interest groups and grants (non-democratic, illegitimate) power groups too much discretion in decision-making and the opportunity to exert particular interests through influence on the legislative and executive branches. Ultimately, this only sees them function unfairly, and reduce prosperity *and* liberty. A “strong” ordoliberal state is required, an independent and powerful state governed by the rule of law, which wards off particular interests and prevents the concentration of market power and market-dominating companies.<sup>35</sup>

In relation to this, we must also mention Eucken’s criticism of state interventionism and the interventionist state, which again makes clear his anti-totalitarian stance.<sup>36</sup> Eucken criticizes the “position of power held by the [totalistic], all-pervasive, modern, industrialized, technological state” and the “superiority of the [interventionist and concentrated (for: *Vermachtung*<sup>37</sup>)] economic state”. The link between political and economic power, i.e. the politicization of the economy and the economization of politics, increases the danger of abuses of power. In addition, it goes against the central Kantian ideal. Eucken notes: “The state monitors and controls economic day-to-day activity and it [...] partly or wholly controls the economic machine. Man is merely a small piece of an anonymous, state-economic machine [...]. The individual becomes a thing and is no longer a person. The machine is an end, man the means”.<sup>38</sup> Here, and in other places, Eucken’s advocacy of political liberalism becomes clear. He strives to protect the privacy and liberty of the individual against state intervention and collective usurpation. He asks: “Which forms of regulation guarantee freedom? Which forms can also limit the misuse of liberty? [...] Is it possible to create an economic system, in which man is not just a means to an end, not just part of a machine?”<sup>39</sup> The answer, which Eucken himself gives, is, of course, the ordoliberal competition policy.

### Excursus: Eucken versus Kant

Just as Kant has done, Eucken also moves between the fields of liberty, power and law, or rather regulation. According to Eucken<sup>40</sup>, there is a threefold, socio-economic threat to liberty: From the private power of producers, from the semi-public power of social collectives and from the power of the state. Using the rule of law and in connection with the competitive order (i.e. Fundamentals of Economic Policy plus Constituent and Regulatory Principles), it is possible to prevent the aforementioned threat scenarios – the continual danger of an abuse of power and “group anarchy”<sup>41</sup> – and to secure individual liberties. The idea of liberty under the law serves, therefore, to protect the individual from the caprice of others. The Kantian moments relate to the *prevention of power* (i.e. socio-economic limitation of power and limitation of the state’s authority) and the *facilitation of liberty*.<sup>42</sup>

Furthermore, we can draw parallels between Eucken and Kant in respect of their views of humanity, their understandings of liberty and autonomy, and their definitions of freedom. For both, man is an end in himself; he is not a means to an end and, under no circumstances, may he be exploited. This refers to the Second Formulation of the Categorical Imperative, the Formula of the End in Itself.<sup>43</sup> Eucken – with considerable reference to Kant – always emphasizes the importance of maturity and autonomy, as well as Kantian rationalism, particularly in his opposition of historicism and when accusing it of irrationalism and relativizing truth.<sup>44</sup> Let us now briefly consider Eucken’s definition of liberty, which is almost identical to that of Kant. Eucken writes: “Just as for the state governed by the rule of law, the competitive order should create a framework, in which the free pursuit of the individual is limited by the sphere of liberty of another, thus creating a balanced liberty between humans. In reality, the will for competition policy is closely linked to the will for liberty.”<sup>45</sup> Here, it is also the case that individual liberties should be protected from (abusive) private and state power using the rule of law, Eucken’s *Fundamentals of Economic Policy* and his *Constituent and Regulatory Principles*. Eucken also writes: “This sphere of liberty has to be upheld by the law. [...] Just as man who is part of this order, may not renounce his own liberty, so too may he not infringe another’s sphere of liberty. Another’s sphere of liberty limits his own. By taking account of this sphere of liberty, man practices humanity. Liberty, understood correctly, humanity and law belong together and are inextricably

linked."<sup>46</sup> "The state is governed by law. [...] Therefore, it should recognize the liberties and rights of [...] citizens and protect these. [...] Thus, the state governed by the rule of law must protect the rights of its citizens on two fronts: against the [capricious] force of state bodies, which have [...] the tendency to impinge upon personal liberty, allegedly on the grounds of being in the public interest; and, against the threat citizens pose to each other [i.e. encroachments by others into an individual's sphere of liberty]".<sup>47</sup>

## 6. THE FUNCTIONALITY AND HUMAN WORTH OF AN ECONOMIC SYSTEM

From an economic-ethical perspective, Eucken poses a particularly interesting question: How is it possible to achieve a functioning and humane (i.e. self-reliant, fair, and just), socio-economic order?<sup>48</sup> The aim is to conquer the dilemma or conflicting goals between the efficiency and performance of an economy, on the one hand, and social justice and equality of the socio-economic order on the other. Eucken suggests a two-stage argument, similar to that of Adam Smith: He supplies efficiency and allocation arguments as well as ethical arguments for his ideal competitive economic system. He strives to overcome the primacy of ethics (Ulrich's *Integrative Wirtschaftsethik*, i.e. *Integrative Economic Ethics*) and the primacy of economics (Homann's *Moralökonomik*, i.e. *Moral Economics*), by relying on a set of dual requirements towards a competitive market economy, which is socially bound.

An economic system must be able to cope adequately with economic shortages, to satisfy basic needs and to supply the population with essential economic goods. The criterion of functionality provides the foundation for a "humane" (Eucken) and "vital-political"<sup>49</sup> life which "serves humanity" (for: *Lebensdienlichkeit* (Ulrich)). In other words, it creates the material conditions for an autonomous, independent life with freedom and the (immaterial) development of intellectual personalities.<sup>50</sup> This points at Eucken's external, but not meta-economic criterion of a humane social order.

Eucken is well aware, however, of the interdependency and reciprocity of both criteria<sup>51</sup>: Eucken does not prioritize the criteria; or rather, there is only a limited primacy for him. There is indeed a repercussion from social cohesion and stability resulting from a just order in terms of *Tausch*- and

*Verteilungsgerechtigkeit*, affecting the functionality of the economic system. We should add that the economic categories of competition on the merits and competitive order should be seen solely as a means to an end. They serve as an instrument to realize individual liberties and achieve human dignity for the individual. Competition is construed, therefore, in the Freiburg School as a tool of disempowerment and control. All this argues against a unilateral absolutization of the economic sphere, and argues, instead, in favor of the "market economy's ability to serve humanity" (for: *Zweck-/Lebensdienlichkeit*), as Ulrich (1997/2008) stipulates.

In addition, Eucken's dual criteria can be taken as a positive idea of liberty; in contrast to formal or negative liberties (defensive rights), the realization of real or positive liberty (performance rights) requires certain material conditions. These are referred to by Eucken when he calls for a functioning economic order. Furthermore, competition policy respectively the Monopolies and Mergers Commission and the antitrust office are of primary importance in this respect<sup>52</sup>: For, only with the help of a competitive order and its diverse institutional control mechanisms, can the ideal of power freedom be approximated and, thus, (positive) liberties be achieved.

## **7. COMPATIBILITY OF SELF-INTERESTS AND THE COMMON GOOD**

The question of compatibility of self-interests and the common good is one of the most commonly debated issues in economics and ethics. Eucken also discusses this issue in his book *Grundsätze der Wirtschaftspolitik (Principles of Economic Policy)*<sup>53</sup>, amongst other places. The focus is on the (formal) institutional-ethics level. Eucken writes that (only) a (competitive) economic system can ensure a harmonious relationship between individual and common interests<sup>54</sup> and that (only) competition has the power to subdue egoism.<sup>55</sup> His trust in what Smith has called the "invisible hand" to solve potential conflicts between self-interest and the common good is somewhat limited: "The "invisible hand" cannot create forms on its own, which reconcile individual and common interests. [...] The task of economic policy is to direct the forces, which result from self-interest, along such lines that they promote the common good, so individual interests are coordinated sensibly".<sup>56</sup> He goes further: "In [Kant's] opinion, the state's role is to find a form, in which [...] there is both

co-existence and the greatest possible leeway for an individual to develop their own powers. Absolute liberty in its natural state should be limited by laws, which protect the individual from the caprice of another. However, on the other hand, the free pursuits of the many, which are competing with one another, should promote society".<sup>57</sup>

If we consider other Euckenite writings, however, particularly his socio-religious<sup>58</sup> and his crisis works<sup>59</sup>, it becomes clear that Eucken does not rely solely on institutional ethics and ordoliberal frameworks; instead, he believes that ethics at the institutional level must be complemented by ethics at the individual level (i.e. individual or virtue ethics).<sup>60</sup> The following quote illustrates this: "The overall order should be designed such that it enables man to follow a life guided by ethical principles".<sup>61</sup> This individual-ethics level has, up to now, been widely overlooked in academia (the focus has clearly been on Euckenite institutional ethics). Therefore, it seems wise to deal with this level in more detail and to draw parallels between the remaining ordoliberal thinkers, e.g. Rüstow, Röpke (and Müller-Armack).

The individual-ethics level within Eucken's work can be detected in two forms: Firstly, in a *Kantian form* (i.e. the individual as the origin according to the Kantian understanding of freedom and autonomy, and his image of humanity<sup>62</sup>) and, secondly, a *socio-religious form of individual-ethical self-commitment*.<sup>63</sup> Since the Kantian understanding of liberty and autonomy has already been dealt with in our fifth chapter, we shall only briefly mention the socio-religious form of self-commitment. This is closely related to Eucken's understanding of religion. As a member of the Confessional Church, Eucken always emphasizes Christian values, in particular solidarity and love for thy neighbor. He also emphasizes the need for an ethical-religious reformation.<sup>64</sup> Religion in general, and in particular the Christian churches have a prominent role with regard to social cooperation and cohesion. In his *Grundsätze der Wirtschaftspolitik (Principles of Economic Policy)*, Eucken discusses religion and the Christian churches as potential regulatory or ordering powers – besides (economic) science and the state.<sup>65</sup> In the *Volkswirtschaftsfibel*" (i.e. *Economic Handbook*), which Eucken has written together with von Dietze and Lampe, it is clear that Eucken does not just strive for an ordoliberal post-war economic and social system, but also a Christian-based ordoliberal one. His understanding of religion, which has partial individualistic and rational traits<sup>66</sup>, is complemented by his autobiographi-

cal remarks (“I could neither exist nor work, if I did not know of God’s existence”<sup>67</sup>) and Rudolf Eucken’s understanding of religion, as well as Husserl’s phenomenology, with whom Eucken has had close personal contacts.

Noteworthy are the distinct parallels to Adam Smith<sup>68</sup>, since Smith also strives to establish both *formal*, i.e. institutional-ethical and regulatory controls and sanctions, as well as *informal*, i.e. individual-ethical, ones.<sup>69</sup> For Smith, formal control mechanisms include formalized competitive measures (contracts, market exchange, etc.) and state legislation; informal controls incorporate the individual’s capabilities to empathize (i.e. Smith’s notion of sympathy), the figure of the impartial spectator and informal social norms (i.e. public pressure). Furthermore, both Eucken and Smith make a distinction between self-interest and egoism: Smith differentiates between egoism and self-love, whilst Eucken speaks of egoism and the economic principle (i.e. adequate dealings with socio-economic shortages).<sup>70</sup> Both reject unrestrained egoism. Other ordoliberal thinkers also warn against the “unleashing” of the economy.<sup>71</sup> Just as Smith, for whom the pursuit of self-interest always has to be justified in the eyes of the independent observer, so too do Rüstow, Röpke and Müller-Armack demand a normative, meta-ethical embeddedness of Ordoliberalism, or rather the Social Market Economy. Not least of all, this is a clear link to Eucken’s interdependency of orders, i.e. the integration of the economic system within a meta-economic society.

It is more than obvious that the plays of the game within the rules of the game are not amoral (for: *moralfrei*), as Homann and others assumed<sup>72</sup>; and, remaining with the terminology of Homann’s Moral Economics, the systematic location of morality is not exclusively the regulatory framework<sup>73</sup>, rather individual ethics as well!

Finally, the current financial crisis has shown that the institutional-ethics level alone cannot provide protection from individual and institutional misconduct. It must be expanded to include a self-commitment at the individual- and corporate-ethical level. Due to the high innovative capacity of financial market intermediaries, but also because of the high complexity (and intransparency) of financial products, as well as a lack of expertise, regulatory bodies are only able to (re-)act *ex post*, not *ex ante*, and they cannot anticipate particular trends (problem of time-lag).



The question, therefore, comes up: To what extent can individual-ethical self-commitments be realized, such as with investor behavior and on the corporate-ethical level, in the form of codes of conduct, for example? The ethos of the honorable banker or businessman can be taken as a first approach, which suggests both individual- and corporate-ethical implications.

## 8. CONCLUDING REMARKS

The topicality of ordoliberalism is not just limited to the methodological debate surrounding the *Neuen Methodenstreit der Ökonomik* (i.e. new debate over methods in economics), but it is also highly relevant in the wake of the financial crisis. Even from an economic-ethical perspective, Euckenite Ordoliberalism has innovative (timeless) elements to offer. In particular, these include the dual criteria, which an economic and social system must fulfill: Functionality and human worth. The overarching aim is always to establish and implement an ethical-normative order, which is committed to the basic principles of humanity and justice. We should also mention efforts to achieve compatibility between self-interest and the common good using institutional *and* individual ethics (i.e. channeling of self-interest via individual and institutional ethics). Furthermore, ordoliberalism also provides an impetus for the modern, German-speaking debate surrounding economic ethics – not least of all in terms of the connection of Walter Eucken to Moral Economics, but also to Integrated Economic Ethics. Eucken's work is able to soften the field of tension, in which the German economic ethics finds itself, and he, therefore, can act as a mediation authority between Homann and Ulrich.

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- 1| *As undersecretary at the Federal Ministry of Economics (i.e. Head of the Policy and Planning Section Department and Parliamentary Secretary for European Affairs), Müller-Armack was heavily involved in implementing the Social Market Economy (see Schefold (2004)). The emergence of the term "Social Market Economy" can be traced back to him (see Klump (1997), Klump (2001)); he defined the Social Market Economy as an "irenic formula", an integration formula, which always aimed to strike a balance between economic liberty and social fairness (Müller-Armack (1956)).*
- 2| *See Oppenheimer's essay "Weder so - noch so. Der Dritte Weg", in which he sought to elaborate an intermediate position (i.e. "Third Way") between capitalism on the one hand and socialism on the other hand; ; see also Eucken 1942: p. 37, Röpke 1942: p. 43, p. 278 et seq., and Rüstow 2001: p. 41 et seq.*
- 3| *Ludwig Erhard was – along with the ordoliberal, Leonhard Miksch – the architect of the economic and currency reform in 1948. The spiritual "father of the German economic miracle", Erhard, was Minister of Economics between 1949 and 1963, and Chancellor of the Federal Republic of Germany from 1963 to 1966.*
- 4| *Cf. Eucken (1999).*
- 5| *Röpke (1942 / 1948), pp. 258 et seq.*
- 6| *For more information about the ordoliberal slogans "Denken in Ordnungen" and "Interdependenz der Ordnungen", see Eucken (1950 / 1965), pp. 50 et seq. and p. 62, Eucken (1940) and Eucken (1952/2004), pp. 13 et seq., p. 19 et seq. and p. 183.*

- 7| The term “strong state” was introduced into the ordoliberal debate by Rüstow in 1932 at a conference of the Verein für Socialpolitik. His lecture was entitled “Free Market - Strong State”.
- 8| Eucken (1952/2004) pp. 325 et seq.
- 9| Eucken (1952/2004), p. 247, p. 267 and p. 297.
- 10| Böhm (1971/2008), p. 306.
- 11| Cf. Vanberg (2008).
- 12| Eucken (1952/2004), p. 177.
- 13| Cf. Kant (1977a).
- 14| Cf. Eucken (1950/1965).
- 15| Ibid.
- 16| Cf. Kant (1977b).
- 17| Cf. Kant (1987).
- 18| Cf. Böhm (1950), p. XXXV.
- 19| Cf. Eucken (1932a), Eucken (1932b), Eucken (1948) and his biography.
- 20| Cf. Eucken (1926), Eucken (1932a), Eucken (1932b), Röpke (1942/1948).
- 21| Eucken (1952/2004), pp. 340 et seq.
- 22| Eucken (1948), p. 73.
- 23| Ibid., p. 73.
- 24| Kant (1977a), pp. 337 et seq.)
- 25| The individual-ethical bounds of liberty are (sacrosanct) human dignity and the common good.
- 26| Eucken (1952/2004), pp. 48 et seq.
- 27| Ibid., pp. 244 et seq.
- 28| Cf. Ulrich (1997/2008).
- 29| Eucken (1938), p. 81.
- 30| Böhm/Eucken (1948), p. XI.
- 31| (Facilitation of) liberty and (prevention of) power are two sides of the same coin for Eucken.
- 32| Eucken (1952/2004), pp. 254 et seq. and pp. 291 et seq.
- 33| It is noteworthy that Eucken could not finish his chapter on special social policy because of his sudden and unforeseen death in 1950. The chapter remained fragmented during his life-time and it was completed posthumously by his wife and one of his students.
- 34| Eucken (1952/2004), pp. 334 et seq.
- 35| Adam Smith also opposed monopolies, cartels and exclusive social privileges. He criticized the weak state, which was dominated by interest groups, and the increase of group egoism. He specifically condemned exclusion, discrimination, particularism, the abuse of hidden and semi-public powers, as well as arbitrary, ad hoc and case-by-case policy and jurisprudence, which is linked to the granting of privileges. Just as Eucken, Smith also emphasized the constitutional framework and its checks and balances, as well as the importance assigned to free, competitive markets and the rule of law in demarcating market structures. Institutional control mechanisms are decisive when trying to limit the concentration and abuse of power. The fundamental criteria, against which good governance should be measured, include impartiality, universability, and the ability to reach consensus and compliance. The main problem is, then, particularism and partiality, not the pursuit of self-interest in and of itself. The aim must be to produce clearly verbalized, precise, transparent and universally applicable rules. It is important to have a judiciary and legislature that is as neutral and objective as possible, which limits the margin for discretionary decision-making by powerful groups (cf. Klump/Wörsdörfer (2010)).
- 36| For a contrary point of view, see Haselbach (1991) (“Autoritärer Liberalismus” (Authoritarian Liberalism)), Ptak (2004) and Ptak (2007).

- 37| Cf. Eucken (1932b).
- 38| Eucken (1948), p. 74.
- 39| *Ibid.*, p. 77.
- 40| *Ibid.*, p. 74; Eucken (1952/2004), p. 177.
- 41| Cf. Eucken (1952/2004), p. 79 and Eucken (2001), p. 16.
- 42| Cf. Kant (1977a).
- 43| Eucken (1948), pp. 76 et seq.
- 44| Cf. Eucken (1938).
- 45| Eucken (1949), p. 27.
- 46| Eucken (1952/2004), p. 176. Cf. Kant's definition of liberty (Kant (1977a), pp. 337 et seq.): "Law is the paragon of the conditions, under which the will of one person can be reconciled with that of another according to the universal laws of liberty. [...] "Any action is permissible, whose maxim permits the co-existence of one's arbitrary will with that of another according to universal laws." [...] Thus, the universal law: act externally in such a way that the free expression of your will can co-exist with the liberty of another ..." *Id.*: p. 345: "Liberty (free from coercion by another), insofar as it can co-exist with the liberty of another according to universal laws, is the only, original right that exists for every man by virtue of his humanity" (p. 345); for a similar definition of liberty, see: Smith (1978), p. 8 and Smith (1976a), p. 324 and p. 687.
- 47| Eucken (1952/2004), p. 48.
- 48| Cf. Eucken (1952/2004), p. 14, p. 166 and p. 369 and Eucken (1950/1965), pp. 239 et seq.
- 49| Rüstow (1955), pp. 53 et seq.
- 50| Eucken (1952/2004), p. 48, p. 125 and pp. 130 et seq.
- 51| Cf. Eucken (1952/2004), pp. 370 et seq.: "Es ist aber nur die eine Seite der Wettbewerbsordnung, daß sie auf die Durchsetzung der ökonomischen Sachgesetzlichkeit dringt. Ihre andere Seite besteht darin, daß hier gleichzeitig ein soziales und ethisches Ordnungswollen verwirklicht werden soll. Und in dieser Verbindung liegt ihre besondere Stärke. Denn ein sozial-ethisches Wollen ohne Verbindung mit der ökonomischen Sachlogik ist ebenso ohnmächtig, wie andererseits die wirtschaftliche Sachlogik nicht zur Auswirkung kommt, wenn nicht ein soziales Ordnungswollen die Gestaltung der Formen beeinflusst".
- 52| Eucken (1952/2004), pp. 291 et seq. and Eucken (2001).
- 53| Eucken (1952/2004), pp. 350 et seq.
- 54| *Ibid.*, p. 368.
- 55| *Ibid.*, p. 365.
- 56| Eucken (1952/2004), p. 360.
- 57| *Ibid.*
- 58| Cf. Eucken (1932a).
- 59| Cf. Eucken (1926) and Eucken (1932b).
- 60| Interestingly, Kant makes a similar distinction between institutional and individual ethics, differentiating between Rechts- and Tugendpflichten (i.e. statutory duties and moral duties), or rather between Legalität and Moralität (i.e. legality and morality)(see Kant (1977a), pp. 318 et seq.).
- 61| Eucken (1952/2004) p. 199 and pp. 370 et seq.
- 62| Here, this concerns (sacrosanct) humanity and the common good as an individual-ethical boundary to liberty.
- 63| We are unable to give an answer here as to whether Eucken's understanding of liberty is linked to obligatory and binding religious standards. It would be worthwhile to investigate the tense relationship within Euckenite individual ethics, i.e. the ambivalence between religion and individualistic, rational liberty.



- 64| Cf. Eucken (1926).
- 65| Eucken (1952/2004), pp. 347 et seq.
- 66| Cf. Eucken (1932).
- 67| Cited in: Lenel (1991).
- 68| There are further parallels between Eucken and Smith in relation to the Kantian understanding of autonomy and liberty (i.e. emancipation and enlightenment of the population, conquering of minority; liberty understood as autonomy requiring the constitutional rule of law, the market economy and education policy) and the understanding of justice (i.e. focus on commutative justice (contractual and exchange justice (for: "Vertrags- und Tauschgerechtigkeit"), as well as "Regel- and Verfahrensgerechtigkeit" instead of "Ergebnis- or Endzustandsgerechtigkeit" (i.e. final state justice), emphasis on the principles of impartiality, reciprocity and equal treatment/non-discrimination; however, only limited consideration of distributive justice). Finally, both Eucken and Smith stressed consumer sovereignty, competition on the merits and intervention for poorer social classes, or rather the solution to social questions.
- 69| The differences include the Smithian underestimation of the importance of the institutional-ethics level and the neglect of systematic and consciously formed regulation. Whilst Smith tends to accentuate the individual- and virtue-ethical levels, Eucken is (more) aware of the necessity of a (complementary) institutional ethics. For this reason, Eucken underlines the importance of constitutional methods of restriction and the ordoliberal level of an ordering economic policy (cf. Klump/Wörsdörfer (2010)).
- 70| Cf. Recktenwald (1985), pp. 112 et seq. and pp. 380 et seq.
- 71| Cf. Eucken (1952/2004), pp. 350 et seq. and Eckstein (1985) p. 124.
- 72| Röpke (1937/1946), p. 287.
- 73| Homann/Blome-Drees (1992), p. 35.
- 74| Homann/Lütge (2004/2005), p. 87.

# EMIL BRUNNER'S SOCIAL ETHICS AND ITS RECEPTION IN ORDOLIBERAL CIRCLES

*Tim Petersen*

## **1. PRELIMINARY REMARKS<sup>1</sup>**

The question of the Christian roots of the Social Market Economy is one that has often been asked. Many texts with different approaches to this question have seen publication.<sup>2</sup> A further possibility would be to investigate in detail the encounters of the spiritual fathers of the social market economy with Catholic social teachings and Protestant social ethics.

The conflict between Catholic social teachings and neo-liberalism assumes great importance in the socio-philosophical debates that take place in West Germany in the 1950s and 1960s.<sup>3</sup> The Protestant background of most of the ordoliberal economists begs the question of the extent to which Protestant social ethics was drawn into the discussion.<sup>4</sup> In comparison with Catholic social teachings, the Protestant counterpart gets significantly less attention from them. Ordoliberal economists believe that Protestantism has little to offer in this respect. Thus it is that Wilhelm Röpke, speaking in 1944, sees Protestantism as suffering under a body of literature on the subject that is socio-philosophically impoverished and, above all, unstable.<sup>5</sup>

With hindsight, one cannot quite go along with Röpke's verdict.<sup>6</sup> However, in a way he is right: Protestant social ethics does not possess a coherent body of teachings such as is offered by its Catholic counterpart. Moreover, social ethics has not long been anchored in the institutions of the Protestant church. This has to wait until after the Second World War.<sup>7</sup>

With this background in mind it becomes clear why, in Röpke's eyes, the book *Justice and The Social Order* by Emil Brunner (1889-1966), published in 1943, fills "a real gap".<sup>8</sup> It is not just Röpke, but also Walter Eucken (1891-1950) who absorbs Brunner's social ethics. For this reason, my aim in this text is to present both Brunner's social ethics and Eucken and Röpke's reactions to it. To achieve this, I will place Brunner's theology in its historic context and introduce the man himself. The second main part will be devoted to Brunner's social ethics. Röpke and Eucken's reception of Brunner will round off the study.

## **2. HISTORICAL-BIOGRAPHICAL BACKGROUND**

### **2.1 Historical Background**

Of defining importance before the First World War is a notion of progress shaped by historicism and enshrined in philosophy, theology, theoretical economics, politics and economic systems. This is rooted in German Idealism. With the historical philosophy of Georg Friedrich Wilhelm Hegel (1770-1831), the idealistic teachings gain a dynamic element.<sup>9</sup> The Hegelian notion of evolution also makes its way into other strands of 19<sup>th</sup> century philosophy.<sup>10</sup> It is only with the object-centered philosophy of the 20<sup>th</sup> century that the evolutionary teaching loses importance.<sup>11</sup>

The situation is similar in the German Protestant theology of the 19<sup>th</sup> century. The key figure here is the Romantic Friedrich David Ernst Schleiermacher (1768-1834). The evolutionary notion occurs in his thinking at the point where he interprets religious history as a progressive process leading toward Christianity.<sup>12</sup> Further on in the 19<sup>th</sup> century, the idea of progress gains yet more ground in theology.<sup>13</sup>

The extent to which German economic science develops along similar lines is striking. The evolutionary idea becomes apparent in the thinking of Friedrich List (1789-1846).<sup>14</sup> This notion continues to hold sway in the Old Historical School (for: *Alte Historische Schule*).<sup>15</sup> Gustav von

Schmoller (1838-1917), head of the New Historical School and leading economist in Imperial Germany, also declares his loyalty to the evolutionary notion.<sup>16</sup>

The theoretical evolutionary notion shadows the real-life development of Germany. The patchwork of small territories is transformed in 1871 into a nation, somewhat delayed in her emergence but demanding a place in world affairs that fits her new-found status.<sup>17</sup> The German economy also undergoes rapid transformation. Out of a predominantly agrarian economy emerges a leading industrial power.<sup>18</sup> The optimism born of ideas of progress goes hand-in-hand with an overblown European nationalism that results in the First World War.<sup>19</sup>

As far as theology is concerned, the First World War marks a significant break with the past. Historical-optimistic cultural Protestantism has to give way to dialectical theology. Alongside Karl Barth (1886-1968), Emil Brunner is one of its major exponents.

## 2.2 Emil Brunner<sup>20</sup>

Emil Brunner is born in Winterthur, Switzerland on December 23, 1889. As a child he moves to Zürich. Both here and in Berlin he studies theology. In 1912 he completes a doctorate on the typically cultural Protestant subject of *Das Symbolische in der religiösen Erkenntnis* (i.e. the symbolic in religious awareness). After military service he undergoes a period of theological training for the ministry with religious socialist Hermann Kutter (1863-1931).

Between 1916 and 1924 Emil Brunner works as a pastor in Obstalden. Stimulated by the theological discussions initiated by Karl Barth, he switches to a scientific career. In 1921 he qualifies as a professor. In 1924 in Zürich he becomes a Professor of Systematic and Practical Theology, a chair that he occupies until 1955. In 1924 his book, *Die Mystik und das Wort (Mysticism and the Word)*, is published. It contains a critical examination of Schleiermacher's theology. For a while after this Brunner works on the key Barthian publication, *Zwischen den Zeiten (Between the Times)*.

*The Divine Imperative*, Brunner's book on social ethics, published in 1932, leads to a split with Karl Barth. This conflict strongly influences

Brunner's work in the following years. His personal direction takes him for a time to the Oxford Movement of the American evangelist Frank Buchman (1878-1961).<sup>21</sup> At the same time, however, he is influenced by the rise of totalitarianism and the Second World War. Such is the backdrop to his 1943 work, to be considered in this essay, *Gerechtigkeit. Eine Lehre von den Grundgesetzen der Gesellschaftsordnung (Justice and the Social Order. A Teaching about the Basic Laws of Social Order)*.

After the Second World War, Brunner spends more than 16 years working on a three-volume collection of dogmatics, intended as a counterweight to Karl Barth's *Church Dogmatics (Kirchliche Dogmatik)*. In the 1950s he continues to express his views on political-ethical issues. In so doing he adopts an anti-Communist stance, which again sets him at odds with Karl Barth. Emil Brunner died in Zurich on 04.06.1966.

### **3. EMIL BRUNNER'S JUSTICE AND THE SOCIAL ORDER**

The reception given to Brunner by the ordoliberalists basically rests on the book *Justice and The Social Order*. This can only be understood in the light of the changes to Brunner's theological position that took place in the course of the 1930s. For this reason I will begin by assigning the book to a particular place in Brunner's spiritual development. Then I will describe the content of the general part of *Justice and The Social Order*. The last section will be devoted to the work's economic aspects.

#### **3.1 *Justice and The Social Order* in its Theological Context**

For theology, the First World War represents a fundamental break with the past. The previous progressive optimism gives way to a more pessimistic attitude. Instead of proclaiming the advent of harmony between God and the world, theologians now start to emphasize the unbridgeable gulf between God and man. Theology departs from its previous focus on historical works. Contemporary theologians even look back and speak in terms of an "anti-historical revolution".<sup>22</sup>

Bestriding this upheaval is theologian Karl Barth. His "dialectical theology" stands in stark opposition to the teachings of the 19<sup>th</sup> century. Barth counters liberal historical-critical empiricism with an apodictic "dominus dixit" (i.e. the Lord has spoken). He casts aside ideas of culture and religion with their old positive connotations. Instead, he stresses God's

divinity and thus the distance between God and man that can only be surmounted through Christ (hence, “dialectical theology”).<sup>23</sup>

Karl Barth proves a magnet for other young theologians, whose lot it will be to shape the history of theology in the coming decades. One of these is Emil Brunner. Just like Barth, Brunner criticizes 18<sup>th</sup> and 19<sup>th</sup> century philosophy.<sup>24</sup> In systematic terms, Brunner nails his colors to Barth’s mast when the latter makes his distinction between theology and philosophy.<sup>25</sup>

In his work of social ethics, *The Divine Imperative (Das Gebot und die Ordnungen)*, published in 1932, Brunner takes the daring step of going beyond the prevailing ideas of dialectical theology. He believes that it is time to apply the results of dialectical theology to the field of practice in everyday life.<sup>26</sup> His contention that worldly ethics of happiness and duty are not sufficient in themselves is fully in keeping with the tradition of dialectical theology. To counter these he cites Christian revelation.<sup>27</sup> On the anthropological level, he uses the example of the Christian view of humanity as an alternative to the directions taken by Naturalism and Idealism, both of which he finds wanting. Brunner understands the Christian view of humanity as meaning that man has to turn away from egocentricity and devote himself to the service of God. The mundane reflection of this is to be found in service to one’s fellow man.<sup>28</sup> It is this call to personalism that takes Brunner beyond the limits of dialectical theology. The question of just how one is to serve one’s fellow men in a complex society is answered by the reformed theologian with an appeal to old reformatory teachings of social order. It is the Christian’s duty to render service within the divine and natural orders of things and – here Brunner’s reformed tradition makes itself felt – to change it for the better.<sup>29</sup> For Brunner, such orders include the institutions of marriage and the state, culture and the economy.

As an order the economy has its own set of laws. These, however, are variable and can be changed.<sup>30</sup> Correspondingly, he calls for a new economic conception. In *The Divine Imperative*, Brunner rejects both individualism and collectivism. He sees the human being as a social creature. However, his attacks are mainly reserved for capitalism. He thereby explicitly aligns himself with neo-historian Werner Sombart (1863-1941) and Institutionalist Thorstein Veblen (1857-1929).<sup>31</sup> The Christian should nonetheless participate in the capitalist economy and use his Christian

witness to reform it.<sup>32</sup> It is the task of the church to participate in this reform process through proclamation and Christian works.<sup>33</sup>

The parting of company with dialectical theology which becomes apparent here continues with *Natur und Gnade. Zum Gespräch mit Karl Barth* (*Nature and Grace. About the Conversation with Karl Barth*). In this work Brunner defends the thesis of divine revelation in nature. Barth counters this in his polemical essay "Nein!", (No!), in which he condemns natural theology as unchristian.<sup>34</sup> Undeterred, however, Brunner sticks to his path. One of the focal points of his theology is social ethics. During the Second World War Brunner meets an array of men skilled in practical economic life and science alike, including economist Karl Brunner (1916-1989). One of the results of these meetings is Emil Brunner's work of social ethics, *Justice and The Social Order*.<sup>35</sup>

### 3.2 Principal Content

Totalitarianism and the Second World War form the political-historical back drop to the book *Justice and The Social Order*, published in 1943. For Brunner, the major injustice of the age has resulted from the decline of the occidental Christian notion of justice. The idea of natural justice has given way to legal positivism. It must at this point be said that Brunner is not merely calling for the reinstatement of natural justice, which he also views in a critical light. It is for this reason that he tries to develop another concept of justice altogether.<sup>36</sup>

For Brunner, justice is defined in terms of just apportionment. The principal notion behind this is encapsulated in the proverb: "To each his own".<sup>37</sup> For Brunner, justice entails acting in accordance with law. However, law is not to be understood here in a legal positivistic sense.<sup>38</sup> Brunner's basic assumption is of an identity between divine law and justice. Divine law is seen to be observed when a person created by God is permitted to occupy the social rank to which he has been assigned.<sup>39</sup> Just as there is a connection with law, so is there a connection with the principle of equality. This must not however be understood as some kind of egalitarianism; it means rather that similar cases should receive similar treatment.<sup>40</sup> Brunner sees the basis of this equality as deriving from the fact that people are children of God.

Brunner's views of law and equality define his ideas of society and human nature. Individual rights only make sense in the context of the relationship with God. For Brunner these include the rights to religious freedom and individual property.<sup>41</sup> The fact that people are not equal, however, means that they are dependent on one another. This means that communities as well as individuals must have rights. It is for this reason that the individual is under obligation to take up his assigned place in the institutions of family and state.<sup>42</sup>

Postulating community and individual rights in this way leads Brunner to occupy the middle ground between individualism and collectivism. Individualism represents an atomistic theory of the state and favours unbridled capitalism. However, he also condemns collectivism. Brunner counters the latter with his third way of freedom in the context of community, to be brought into being through the vehicle of a federally-organized social structure.<sup>43</sup>

Similarities between his views and the Catholic concept do not however lead Brunner to become a proponent of the philosophy of natural justice. Whilst recognizing the latter's merits in respect of justice, he rejects the formulation itself. To support his case he draws on the different interpretations of the term in the various different schools of natural justice. Brunner also believes that collisions between postulated natural justice and positive law often culminate in the unjust defeat of the latter.<sup>44</sup> It is this scepticism vis-a-vis natural justice that allows him to make concessions to historicism in respect of the question of the relativity of the concept of justice. Whereas he does believe in absolute justice, he simultaneously avers that all means of bringing it about are contingent upon time and space.<sup>45</sup> It is for this reason that Brunner also rejects building the concept of justice on a foundation that is directly Biblical-exegetical in nature.<sup>46</sup>

Brunner derives concrete requirements for a just social order from his theory of justice. He sees the concrete manifestation in the classical family structure<sup>47</sup>, a society structured according to function<sup>48</sup>, a just state<sup>49</sup> and a just community of peoples.<sup>50</sup> The economy also has its part to play in the formation of the just society.



### 3.3 The Economy in *Justice and The Social Order*

According to Brunner, the economy as a divine order of creation is, like the family, a holistic value, that may not in the atomistic sense be reduced to individual economic subjects.<sup>51</sup> On the basis of this economic blueprint Brunner lists the following points as elements of a just economic order.

- 1. *The justice of property*

Brunner's position midway between individualism and collectivism influences his stance on private property. On the one hand he subscribes to the dictum of "no property, no freedom".<sup>52</sup> On the other, however, he also believes in restricting the individual's right to hold property. As property always stands in relation to society, the property owner is under obligation to support society through the payment of taxes and duties.<sup>53</sup> Nonetheless, Brunner warns against overstating this duty to render payments to the state, thereby hobbling society's will to work.<sup>54</sup>

- 2. *Just interest*

Whilst branding interest as "unearned income",<sup>55</sup> Brunner also recognizes it as legitimate. This stance he justifies by citing the postponement of consumption it brings about and the function of interest as a return for risk incurred.<sup>56</sup> He does not consider the Biblical prohibition of interest to be applicable here, because the Bible does not take productive capital into account, merely talking instead about consumer credits.<sup>57</sup> Just as he rejects a prohibition of interest on grounds of principle, Brunner also refuses to countenance such a prohibition as applied to the rate of interest. However, in his opinion, the rate of interest charged must be commensurate with the level of income.<sup>58</sup> This "primacy of the right of the workers"<sup>59</sup> is from an economic perspective unworkable and appears vague. It is this position that leads Eucken to a misunderstanding in his reception of Brunner.

- 3. *Just price*

Brunner concedes that the issue of just prices is a very difficult one. Here, however, ordoliberal competition theory comes to his aid. Brunner sees the cause of perceived price injustice as lying in markets

dominated by monopolies. For this reason, he believes that it is not direct state intervention that will lead to just prices, but that which is nowadays termed regulatory policy.<sup>60</sup> The conditions for a market free from monopolistic domination would have to be created. "When these conditions are fulfilled, something like a just price arises on the market of itself."<sup>61</sup>

- *4. Just wages*

In contrast to the question of just prices, Brunner's ideas on the subject of just wages represent a significant departure from liberal thinking. He sees the labor market as a *sui generis* market. For Brunner, the principle of just wages means that, in times of crisis, the community as holder of capital must observe the compensation principle, and capital should be used to maintain wage levels.<sup>62</sup> As is the case with the determination of interest rates, Brunner's ideas appear largely impracticable when seen from an economic point of view.

- *5. Just distribution of economic power*

What Brunner understands by the distribution of power is not the power of competition but its redistribution within individual companies. These considerations emerge in their totality from the perspective of his personalistic social philosophy. Employers and employees should take their respective places within a company community. Hierarchies should be maintained, but in concert with a willingness on the part of both sides to listen to one another.<sup>63</sup>

- *6. Capitalism and Communism*

Brunner sees the opposing pair consisting of Capitalism and Communism in much the same way as he does the antipodes of individualism and collectivism. From the center ground he rejects capitalism as a form of overblown economic individualism and communism as a collective economic order that robs the individual of his rights.<sup>64</sup> Here, Brunner explicitly disagrees with Röpke. He rejects Röpke's thesis that its multiplicity of possible interpretations means that the term "capitalism" should not be used. He continues to regard the term as applicable, drawing on Werner Sombart to support his case.<sup>65</sup>

- 7. *The just economic order*

In Brunner's eyes, the question of command versus market economy is not coterminous with that of capitalism versus collectivism. Here he makes the case for a middle way. He affirms the positive effects of the market economy. At the same time, however, he sees the necessity of state intervention. This he says should take the form of measures to preserve the economic order.<sup>66</sup> In his opinion, this leads him to contradict Röpke, with whom, in his own words, he otherwise has so much in common.<sup>67</sup> Here we seem to have stumbled upon a semantic problem: Brunner's notion of state economic management is in fact very close to Röpke's concept of regulatory economics.

In comparison to *The Divine Imperative, Justice and The Social Order* demonstrates a change in Brunner's position. He does admittedly remain sceptical of capitalism. However, this scepticism seems less informed by historicism than by the ordoliberalism that was emerging at the time.<sup>68</sup> In respect of wage and interest theory, however, there are significant differences.

#### 4. RECEPTION IN ORDOLIBERAL CIRCLES

Brunner's book *Justice and The Social Order* is known by ordoliberal economists. Walter Eucken subjects it to scrutiny in his *Grundsätze der Wirtschaftspolitik (Principles of Economic Policy)*. Wilhelm Röpke even gives Brunner's social ethics its own recension.

##### 4.1 Wilhelm Röpke

In order to be able to place Röpke's reception of Brunner in its historical context, it is important to know that Röpke, during his period in exile, underwent the transformation into a thinker deeply influenced by social philosophy. It is for this reason that I shall preface the subject of his reception of Brunner with an account of this development.

###### 4.1.1 Röpke as Social Philosopher<sup>69</sup>

The young Röpke was strongly influenced by the social reformist and empirical historicism of economist Walter Troeltsch (1866-1933). Röpke's dissertation "Die Arbeitsleistung im deutschen Kalibergbau"

(“The Efficiency of German Potash Mining”) testifies eloquently to this. His professorial essay “Die Konjunktur. Ein systematischer Versuch zur Morphologie der Verkehrswirtschaft” (“The Economy. A Systematic Attempt to Create a Morphology of Transport Economics”) has significantly more theoretical characteristics, such as make their way into the entire post-war German national economy. At this time, Röpke reveals his disquiet about the whole field of historical economics.

The 1929 global economic crisis helps propel Röpke in the direction of social philosophy. He interprets the Depression as a crack deep in the foundations that highlights the problems of higher orders.<sup>70</sup> The following years see Röpke, always a political animal, intensifying his involvement in socio-political debate. Röpke’s move to Istanbul University shortly after the National Socialist takeover in Germany reinforces his interests outside the economic sphere yet further. In collaboration with Alexander Rüstow (1885-1963) he works on a socio-philosophical concept.<sup>71</sup>

Using the work done in Istanbul as a basis, in 1942 Röpke publishes the first part of his trilogy. Under the title *The Social Crisis of Our Time*, he diagnoses a serious cultural crisis, especially apparent in the phenomenon of massification. One possible way forward lies for him in the *Third Way*<sup>72</sup> between laissez-faire and collectivism, denoting a state-regulated free market economy.<sup>73</sup> He goes on to flesh out this program in the second part of the trilogy, *Civitas humana*, published in 1944. At this time Röpke is engaging strongly with Christian religious trends. So it is that he reads the papal encyclical *Quadragesimo anno*.<sup>74</sup> When he falls ill at the beginning of 1944<sup>75</sup> and *Civitas humana* starts to roll off the presses,<sup>76</sup> he also turns his attention to Brunner’s *Justice and The Social Order*.

#### **4.1.2 Röpke’s Reception of Brunner**

For technical printing reasons Röpke can only express his great appreciation of Brunner’s book and basic agreement with its author<sup>77</sup> in a short footnote to *Civitas humana*. A few months later Röpke has the opportunity to use a review of his work to grapple more intensively with Brunner.

As Röpke’s brief remark in *Civitas* reveals, he finds himself in basic agreement with Brunner’s premises. He gives the work his warmest recommendation.<sup>78</sup> His feelings toward Brunner’s basic ideas are, in his

own words, feelings of agreement and enrichment and gratitude.<sup>79</sup> There are various reasons for this attitude. Röpke sees parallels with the methodological approach that he himself espouses. Just like Röpke, Brunner is in quest of a synthesis of the social sciences. Röpke therefore hails Brunner as an effective and enriching comrade in arms.<sup>80</sup> This comradeship, however, goes far beyond mere methodology. Röpke agrees with Brunner's basic insights, values and conclusions.<sup>81</sup> Going into more detail, Röpke praises Brunner's rejection of collectivism, whether with a National Socialist or a Communist face. Röpke naturally applauds Brunner for his support for the right to private property. At the same time, Röpke also notes Brunner's positive attitude to the family and federalism.<sup>82</sup>

However, these passages in which Röpke states his agreement also contain critical elements. These also have to do with Brunner's economic-technical statements, which comes as no surprise. Nonetheless, his criticisms on the grounds of economics do not take precedence. Röpke does not want to appear to be a wiseacre. For this reason he only briefly addresses the difference in the meaning of the term "capitalism" highlighted by Brunner. Other differences in opinion in respect of the inevitability of monopolies, the working conditions in the early industrial age and economic policy are only touched upon in passing.<sup>83</sup>

He reserves his principal criticisms for the field of social philosophy. Here, Röpke the humanist, who describes his own theological stance as "Erasmic"<sup>84</sup>, takes up a position of opposition to the cultural sceptic Brunner, who cannot deny his roots in dialectical theology. Röpke criticizes Protestantism for its sceptical attitude to the Ancient World. He himself sees a strong continuity between occidental Christianity and the history of ideas from antiquity. In his view, Christianity takes its socio-philosophical cue from antiquity. This applies in his opinion above all to the views of Marcus Tullius Cicero (106-43 BC).<sup>85</sup> Röpke's criticism of Brunner is that he does not take this continuity sufficiently into account. It is his belief that Brunner does not accept the true significance of general human cultural inheritance with particular reference to the legacy of the Ancient World – or, if he does, then only reluctantly.<sup>86</sup> In Röpke's view, this could lead to an idolization of the state, such as can be found in the works of Martin Luther (1483-1556)<sup>87</sup>, or to a theology of confinement. Evidence of this he claims to see<sup>88</sup> in Brunner's assertion that worldly justice must be subject to divine revelation.<sup>89</sup> The opposition of humanism to dialectical theology takes more concrete

form at another point. Brunner attacks Greek philosophy for its pantheism. In keeping with the religious scepticism of dialectical theology, he avers that the concept of justice to be found in Greek philosophy is modelled on the laws of nature.<sup>90</sup> Röpke refutes this, drawing on a contradictory assertion made by Anaximander (610-547 BC). He does at the same time, however, affirm Brunner's criticisms of Plato (428-348 BC) and Aristotle (384- 322 BC).<sup>91</sup> However, this is by no means unusual for a representative of Humanism who takes his guidance from Hellenism than from Attic philosophy.<sup>92</sup>

The review says a lot about Röpke as he is in 1944. It must be admitted that Röpke is assuredly still in the economists' camp. However, the principal focus of his attention is on social philosophy. In this, Röpke's recourse to antiquity and Christianity is in line with the tradition of 16th century Christian humanism.

## **4.2 Walter Eucken**

Walter Eucken's reputation derives from his theory of economic order, which is at once coherent and dogmatic. This is the yardstick Walter Eucken uses to approach Emil Brunner. It is for this reason that I will first outline the development of Walter Eucken's theory of economic order.

### **4.2.1 Walter Eucken's Regulatory Economics<sup>93</sup>**

Walter Eucken hails from an academic background in the classic Wilhelminian mould. His father is the philosopher of life and winner of the 1908 Nobel prize for literature Rudolf Eucken (1846-1926). Walter Eucken's 1913 dissertation "Die Verbandsbildung in der Seeschifffahrt" (i.e. The Establishing of Associations in Maritime Shipping) bears a typically historical title. Like Röpke and the dialectical theologians, Walter Eucken parts company with historicism in the 1920s. After his professorial work "Die Stickstoffversorgung in der Welt. Eine volkswirtschaftliche Untersuchung" (i.e. An Investigation of World Nitrate Supplies, An Analysis by Political Economics), his essay "Kritische Betrachtungen zum Deutschen Geldproblem" (i.e. Critical Observations on the German Money Problem) marks the point of rapprochement with theoretical national economics. In his 1932 essay, "Staatliche Strukturwandlungen und die Krisis des Kapitalismus" (i.e. Structural Changes in the State and the Crisis of Capitalism), he analyzes the collapse of the German economy.

In his view, an interventionist economic policy has led to the admixture of economic and state spheres. He bemoans the fact that Germany has turned into a nation of state-run capitalism.<sup>94</sup> He claims to see the historical trigger of this development in the Historicist School. Eucken uses two essays from 1938 and 1940 to carry the fight above all to historical relativism,<sup>95</sup> along with the notion of progress and historicist empiricism.<sup>96</sup>

At the same time, Eucken is working out a scientific alternative program. In order to overcome the “great antinomy”<sup>97</sup> between theoretical and historical research in the national economy, in 1940, in *The Foundations of Economics (Die Grundlagen der Nationalökonomie)*, he develops his own methodological conception. Borrowing from Max Weber (1864-1920) and Edmund Husserl (1859-1938), Eucken advocates the teaching of the “market” and “command” economic models. Economic reality, he avers, always combines the two systems.<sup>98</sup> The answer to the question of which type appears better to him is answered in Eucken’s *Grundsätze der Wirtschaftspolitik (Principles of Economic Policy)*. Here he postulates the ideal of a competitive order, whose foundation should be a market economy in which competition holds total sway.<sup>99</sup> It is the role of institutions to implement and maintain this competitive order. Alongside the state and science, Eucken cites churches as having the power to fulfill this function.<sup>100</sup>

The considerations that Eucken brings to bear on the church have to be understood in their historical context. When it comes to the question of the church’s political activity, Eucken seeks a compromise between Calvinist theocracy and the Lutheran teaching of twin kingdoms. This argument rooted in the Reformation takes on new significance in respect of national socialist totalitarianism.<sup>101</sup> Eucken does not want the church to get involved in daily political life; what he does want is for it to make its views known on questions of existential importance.<sup>102</sup> This aligns him with a modified version of the two-kingdoms teaching. This latter is represented by Helmut Thielicke (1908-1986)<sup>103</sup> and the report entitled *Politische Gemeinschaftsordnung* (i.e. *Political Order of Communal Life*), on the political-economic part of which Eucken collaborated.<sup>104</sup> Eucken’s sceptical response to Catholic social teachings follows closely that of his own pupil Karl Paul Hensel<sup>105</sup> (1907-1975). In his view, the twin pillars of the social teachings, subsidiarity and professional order, are irreconcilable.<sup>106</sup> In a third point on the question of the church as a regu-

latory power, Eucken turns his attention to protestant theology. He criticizes its scepticism in respect of natural orders and the concomitant separation of theology from the other sciences,<sup>107</sup> whereby he makes a critical allusion to dialectical theology.<sup>108</sup> Eucken sees Brunner nonetheless as giving rise to the hope that the isolation arising from the Protestant theological position may be overcome. This is the background to Eucken's treatment of Brunner's *Justice and The Social Order*.<sup>109</sup>

#### ***4.2.2 Eucken's Reception of Brunner***

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Comparing Eucken's attitude to Brunner with Röpke's reveals some parallels. Both Eucken and Röpke praise the basic direction of Brunner's social philosophy whilst criticizing his grasp of economics. It must be said, however, that the emphases in each case are completely different.

Eucken initially says of Brunner that his ideas are aligned to a great extent with those of the competitive order, some of whose basic premises he explicitly acknowledges.<sup>110</sup> This, however, is as far as his praise goes before giving way to criticism. For Eucken, Brunner is one of those theologians who does not sufficiently take into account the fact of economic interdependence.<sup>111</sup> This, he claims, is apparent from Brunner's teaching on interest. At this point it is unclear whether Eucken really understands what Brunner is saying. He writes that:

"Like other ethicists, Brunner too has come to the conclusion that only a low rate of interest can be justified: a higher rate of interest, say, of over 5 per cent, cannot be justified and is morally reprehensible."<sup>112</sup>

This representation of Brunner's ethics of interest does not quite hit the nail on the head. Eucken's representation is at fault in that his words can be so interpreted as to lead to the mistaken conclusion that Brunner is demanding a maximum interest rate of five per cent. This is not the case. Brunner does in truth say that such a limit had a certain justification at the time of the Reformation. However, in respect of the present day he finds himself in explicit agreement with the ordoliberal, as the following makes clear:

"On the contrary, we must say that a 'just' rate of this kind cannot be determined and that, moreover, in a free economy, a regulation by statute, even with the best will of all concerned could hardly be carried through without a dislocation of the whole economic apparatus."<sup>113</sup>



However, Eucken is right in pointing out that Brunner turns the whole idea of interest into an ethical problem. Brunner postulates a priority of income over interest and admits that, at this point, his notion of justice contradicts the market concept.<sup>114</sup>

Eucken's interpretation of Brunner's ethics of interest is the pivotal point of the former's criticisms. Eucken claims that Brunner's insistence on low rates of interest would lead to misallocations, misdistributions and inflation. It would be nothing other than unacceptable selective intervention by the state. By holding to such a view Brunner is contradicting himself (and Walter Eucken's ideas of regulatory policy).<sup>115</sup> Thus it is that Eucken challenges Brunner and the church not to forget how things work in the real economy and to get behind his project to promote the competitive order.<sup>116</sup>

Eucken reveals himself as a consistent but rigid thinker. His verdict on a work of social ethics is determined by his concept of economic order. Unlike Röpke, who is capable of overlooking differences in economic thinking, Eucken can only accept a social philosophy that can be integrated into his system of economic order.

## 5. CLOSING REMARKS

The example of Brunner's reception by the ordoliberalists serves to accentuate the Christian roots of the Social Market Economy. Its founding fathers grappled intensively with the theological and socio-ethical concepts of their age. These same founding fathers strongly influenced Ludwig Erhard and the practice of the Social Market Economy.<sup>117</sup> In Brunner's case there is a yet more direct connection to post-war West German politics. Eugen Gerstenmaier (1906-1986), long-serving president of the Bundestag, or lower house of parliament, and the "Union's chief ideologue"<sup>118</sup> in the Adenauer era, saw in Brunner's *Justice and The Social Order* the foundations for the reconstruction of Germany.<sup>119</sup> The extent to which this influenced economic practices in the early years of the Federal Republic cannot be examined here but would be an interesting question.

At the same time, both common ground and differences in the thinking of Walter Eucken and Wilhelm Röpke become apparent.<sup>120</sup> Eucken's reception of Brunner is conditioned by his very strong adherence to his

own system of economic order. This makes for clarity and consistency. At the same time, however, his thinking appears narrow. Röpke, on the other hand, is, as far as economics is concerned, much more conciliatory and places greater emphasis on the socio-philosophical elements. This makes his thinking more open in a positive sense. It must at the same time be said that a clearer stance on Brunner's economic statements would be desirable. Some commentators have used these different perspectives to conclude that Eucken's break with historicism is much more definitive than Röpke's.<sup>121</sup> Eucken and Röpke's reception of Brunner shows that this thesis has value. At the same time, one must not lose sight of the fact that Eucken and Röpke, not with standing completely different emphases, finally arrive at similar verdicts.

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- 1| This paper was originally published as a research paper entitled "Die Sozial-ethik Emil Brunners und ihre neoliberale Rezeption" (The Social Ethics of Emil Brunner and its Reception by the Neoliberals). For the formal review of this paper and advice regarding its content I owe a debt of thanks to Dr. Joachim Zweynert (HWWI Thuringia). The revised version was proofread for formal mistakes by Pascal Klockmann (Intern at the Tax Consultancy Bureau Petersen), to whom I am likewise grateful.
- 2| Lachmann (1988) investigates market economic and Christian ethics, seeing the two as complementary. In a later contribution (2002), he looks more closely at the historical background. Brakelmann and Jähnichen (1994) develop the thesis of continuity between the Social Market Economy and economic historicism and related social Protestantism of the late 19th century (pp. 14-21), which in my view is not unproblematic. Nutzinger and Müller (1997) also talk in terms of this continuity (pp. 31-32), whilst simultaneously attempting to trace the Protestant influences in biographies (pp. 34-37) and in the religious-sociological work of the founding fathers (pp. 55-57), all the while continuing to investigate the fundamental socio-philosophical principles of the Social Market Economy (pp. 28-53). Roser (1998) conducts a historical-biographical (pp. 23-207) and systematic (pp. 208-339) investigation of "Protestantism and the Social Market Economy", using the example of Franz Böhm (1895-1977). Rieter and Schmolz (1993) describe the relationship of the Freiburg School to the resistance to National Socialism inspired by ecclesiastical Christianity (pp. 103-108). Goldschmidt (2005b) later published a series of works on this subject. Dietzfelbinger (1997) examines the religious sociology (pp. 118-185) of Alfred Müller-Armack (1901-1978) and the Christian influences on his concept of the Social Market Economy (pp. 239-278).
- 3| Cf. Petersen (2008).
- 4| Among others, Stefan Kolev (HWW Thuringia) and Daniel Braun (KAS Erfurt) as well as Consistory Dr. Thomas Seidel (International Martin Luther Foundation) all pointed me toward this question. My thanks go to them for this.
- 5| Röpke (1976), p. 74 (letter to Dr. Heinrich Drosz dated January 29, 1944).
- 6| Thus it is in the 1920s that a group of economists and theologians gathers around Paul Tillich (1886-1965) and the religious socialists, all wishing to see a synthesis of Christianity and socialism (cf. Zahrnt (1966), pp. 461-462.). In the field of sociology of religion, the liberal theologian and friend of Max Weber (1864-1920), Ernst Troeltsch (1865-1923) makes an important contribution (1922/1961). It is with his "Evangelische Wirtschaftsethik" (Protestant Economic Ethics) that Georg Wünsch (1887-1964), religious socialist and student of Troeltsch, sees his contribution to the renewal of Protestantism.
- 7| Rauscher (1977/1988), p. 14.
- 8| Röpke (1976), p. 74 (letter to Dr. Heinrich Droz dated January 29, 1944).
- 9| Höffe (2001), pp. 216-218.
- 10| So it is that Karl Marx (1818-1883) (Hirschberger (1952/2007), pp. 472-477), August Comte (1798-1857), the founder of French Positivism (Ibid., p. 528), and the English empiricist Herbert Spencer (1820-1903) (Ibid., p. 533) all base their assumptions on the notion of a progressive historical process.
- 11| Hirschberger (1952/2007), p. 570.
- 12| Pannenberg (1997), p. 70.
- 13| Thus it is that Richard Rothe (1799-1867) sees a positive development in the rise to pre-eminence of the state and the decline of the Church that will culminate in the establishment of God's kingdom on earth (Barth (1947/1960), p. 550).
- 14| Pribram (1998), p. 409.



- 15| Thus it is that one of the latter's exponents, Bruno Hildebrand (1812-1878), makes it his objective to turn economics into a teaching based on evolutionary principles (1848/1998, V).
- 16| Schmoller ((1893/1949), pp. 9-13) postulates an evolutionary progression from domestic husbandry, through local economy, up to national economy.
- 17| Mann (1958/1992), 55-569.
- 18| Treue (1962/1973), 534-594.
- 19| Mann (1958/1992), 563-569.
- 20| Portrait from: Brunner (1986), in particular pp. 389-391; Berger-Gerhardt (1958), pp. 137-139.
- 21| Later on, Wilhelm Röpke also encounters this movement, also known as "Moral Re-Armament", with its European headquarter in Caux on Lake Geneva. He feels aesthetically repulsed by it, even though he acknowledges the positive role it plays in the struggle against Communism (Röpke (1976), pp. 114-115, letter to Gertrud Fricke dated January 25, 1951).
- 22| Pannenberg (1997), pp. 341-342.
- 23| Zahrnt (1966), pp. 13-65.
- 24| Brunner. (1922/1962), pp. 262-263.
- 25| Brunner, (1925/1962), pp. 290-298.
- 26| Brunner (1932/1939), pp. VII.
- 27| *Ibid.*, pp. 3-94.
- 28| *Ibid.*, pp. 136-146.
- 29| *Ibid.*, pp. 277-292.
- 30| *Ibid.*, pp. 388-389.
- 31| *Ibid.*, pp. 401-411.
- 32| *Ibid.*, pp. 419-423.
- 33| *Ibid.*, pp. 423-425.
- 34| Zahrnt (1966), pp. 72-84.
- 35| Brunner (1986), pp. 81-84.
- 36| Brunner (1943), pp. 3-11.
- 37| *Ibid.*, pp. 15-24.
- 38| *Ibid.*, pp. 24-28.
- 39| *Ibid.*, pp. 54-64.
- 40| *Ibid.*, pp. 29-36.
- 41| *Ibid.*, pp. 64-76.
- 42| *Ibid.*, pp. 77-89.
- 43| *Ibid.*, pp. 89-100.
- 44| *Ibid.*, pp. 100-112.
- 45| *Ibid.*, pp. 113-129.
- 46| *Ibid.*, pp. 130-147.
- 47| *Ibid.*, pp. 167-174.
- 48| *Ibid.*, pp. 218-230.
- 49| *Ibid.*, pp. 230-267.
- 50| *Ibid.*, pp. 268-307.
- 51| *Ibid.*, pp. 174-175.
- 52| *Ibid.*, p. 175.
- 53| Brunner encapsulates this in the following formulation: "The Christian doctrine of justice demands [...] not equality but compensation." (*ibid.*, p. 185)
- 54| *Ibid.*
- 55| *Ibid.*, p. 187.
- 56| *Ibid.*, pp. 189-190.
- 57| *Ibid.*, pp. 194-195.
- 58| *Ibid.*, pp. 191-193.

- 59| *Ibid.*, p. 193.
- 60| Brunner himself does not use the term “regulatory policy”. Following along ordoliberal lines he makes demands for an anti-monopoly policy, speaking in this context of a necessary “relative stability and relative freedom” of the market (*Ibid.*, p. 199). Whether, or to what extent, these ideas reflect a direct absorption of Walter Eucken’s regulatory economics cannot be gleaned from reading the book. This would be a field for further research.
- 61| *Ibid.*
- 62| *Ibid.*, pp. 200-204.
- 63| *Ibid.*, p. 206.
- 64| *Ibid.*, pp. 207-213.
- 65| *Ibid.*, p. 327. Röpke, for his part, rejects Sombart’s theory of capitalism as an over-simplification. (Röpke (1937/1994), pp. 32 and 59).
- 66| Brunner, (1944), pp. 213-218.
- 67| *Ibid.*, p. 328.
- 68| This is also indicated in his use of the term “profit economy”. Whereas he still freely uses this term in “The Divine Imperative”, borrowing from Sombart (p. 402), in “Justice and The Social Order” he sees the use of the dichotomy of profit versus subsistence economy (p. 199) as only applicable to a limited extent. Brunner’s socio-ethical development could therefore be the object of a description of the history of theology based on economic theory.
- 69| Taken from Tuchtfeldt/Willgerodt (1994); Hennecke (2005), unless otherwise indicated.
- 70| Röpke (1937), pp. 325-326.
- 71| Neumark (1980), pp. 15-16.
- 72| In later editions of his text book Röpke distances himself from this term (Röpke (1937/1994), p. 330).
- 73| Röpke (1942).
- 74| Röpke (1976), p. 69 (letter to Alexander Rüstow dated May 13, 1943).
- 75| *Ibid.*, 73 (letter to Dr. Heinrich Droz dated January 29, 1944).
- 76| Röpke (1944/1946), p. 28.
- 77| *Ibid.*
- 78| Röpke (1944), p. 171.
- 79| *Ibid.*
- 80| *Ibid.*
- 81| *Ibid.*
- 82| *Ibid.*, p. 172.
- 83| *Ibid.*, p. 171.
- 84| Kuehnelt-Leddihn (2000), p. 281.
- 85| Röpke (1944), p. 171.
- 86| *Ibid.*, p. 172.
- 87| Luther and his notion of the state are subjected to vehement attacks by Röpke during these years. For more on this see Röpke (1944/1946), pp. 199-201 among others.
- 88| Röpke, (1944), p. 172.
- 89| Brunner (1943), p. 108.
- 90| Brunner (1943), p. 57.
- 91| Röpke (1944), p. 172.
- 92| See on Humanism and its criticism of Aristotle: Hirschberger (1952/2007), pp. 19-21.
- 93| Taken from Klinckowstroem (2000), pp. 53-115; Lenel (1989), particularly pp. 292-294.
- 94| Eucken (1932b), p. 303.

- 95| Eucken (1938), pp. 198-204.
- 96| Eucken (1940), pp. 474-488.
- 97| Eucken (1940/1965), p. 21.
- 98| *Ibid.*, pp. 78-112.
- 99| Eucken (1952/1990), pp. 245-250.
- 100| *Ibid.*, pp. 325-350.
- 101| Zahrnt (1966), pp. 218-259.
- 102| Eucken (1952/1990), p. 347.
- 103| Zahrnt (1966), pp. 242-251.
- 104| Ritter (1945/1979).
- 105| Hensel (1949).
- 106| Eucken (1952/1990), p. 348.
- 107| *Ibid.*
- 108| Eucken (1932a, pp. 88-89) had already taken a critical stance vis-a-vis dialectical theology in "Die Tatwelt". His Freiburg comrade in arms, Constantin von Dietze (1891-1973) talks in his memoirs of Eucken's total rejection of Barth's theology (quoted in Goldschmidt (2005b, p. 306)). During the time of National Socialism his position on ecclesiastical politics converges with that of Barth, although he continues to be alienated by the latter's very Christocentric theology (Oswalt (2005), pp. 343-344). I am grateful to Uwe Dathe from the University of Jena for some important information on this subject.
- 109| Eucken (1952/1990), pp. 348-349.
- 110| *Ibid.*, p. 349.
- 111| *Ibid.*
- 112| *Ibid.*
- 113| Brunner (1943), p. 192.
- 114| *Ibid.*, p. 192.
- 115| Eucken (1952/1990), p. 349.
- 116| *Ibid.*, p. 350.
- 117| For more on Eucken and Röpke's influence on Ludwig Erhard see Mierzejewski (2006), pp. 45-49.
- 118| Klein (2006), p. 61.
- 119| Gerstenmaier (1960/1962), p. 407. He also mentions that Kurt-Georg Kiesinger (1904-1988) also greatly appreciated Brunner's social ethics (*ibid.*, p. 406). My thanks go to Klein (2006, p. 67) for leading me to this quotation.
- 120| Kolev (2009, p. 1) talks of significant similarities and divergences in essential elements.
- 121| Zweynert, (2007), p. 11.

# ADVANCING THE NOTION OF A SOCIAL MARKET ECONOMY

CONCEPTS FOR A RENEWAL OF ORDOLIBERALISM FROM THE  
PERSPECTIVE OF INTEGRATIVE ECONOMIC ETHICS

*Alexander Lorch*

## **1. THE SOCIAL MARKET ECONOMY AND ITS 60<sup>TH</sup> ANNIVERSARY**

This year's anniversary of the Social Market Economy provides plenty of reasons for a review of the history of this politico-economic concept.<sup>1</sup> Within this anniversary, not only the origins but also the changes and the sustainability of the Social Market Economy are discussed time and time again. Yet even without the anniversary, the concept of the Social Market Economy is vehemently debated and is on everyone's lips. Indeed, the Social Market Economy has had a vast impact on both political and academic discussions in Germany for decades now. This has barely abated to this very day, hence German Federal Chancellor, Angela Merkel, repeatedly stresses the importance of the "Freiheit in einer Ordnung der Sozialen Marktwirtschaft"<sup>2</sup> (i.e. Freedom within an Order of a Social Market System) in her speeches and the Bavarian state government has set up a "Zukunft Soziale Marktwirtschaft" committee (i.e. Future of the Social Market Economy). The relevance attributed to this politico-economic concept became even clearer when the EU constitution

defined the “Social Market Economy” as the shared economic system for the European Union recently.<sup>3</sup>

However, the Social Market Economy is not a concept that can be explained adequately with a few choice words on its anniversary. This is because the “style”<sup>4</sup> of the Social Market Economy, which Müller-Armack believes should be understood as a “strategy within the social sphere”,<sup>5</sup> is continually *changing* and forever subject to a range of different interpretations. Exact definition of the concept can only be undertaken with some difficulty and room for interpretation exists. The conscious openness (or vagueness, indeterminacy even) of the concept by the founding fathers is, on the one hand, one of the greatest strengths of this order’s concept, but at the same time also its main flaw. Only because of this openness can this concept find broad acceptance across all parties, associations, trade unions, churches and sections of the population at all times. On the other hand however, this is also accompanied by an enhanced undermining of the concept.<sup>6</sup> Because what often is not clear during discussions on the subject of the Social Market Economy is which understanding of the Social Market Economy is being alluded to in the individual wording. In spite of its historic significance, the term “Social Market Economy” is today more indeterminate and in need of clarification than ever before. At the end of his overview of the history of the Social Market Economy and ordoliberalism, Ralf Ptak provides a rather succinct summary: “No orientation can be found in the Social Market Economy. Its conceptual content is as depleted as it conversely lives alone from the myth of times past.”<sup>7</sup>

The Social Market Economy has been attempting to present an alternative economic order between the polarity of laissez-faire liberalism and socialist economic control for more than sixty years now. As Ptak correctly states, the notion of the Social Market Economy currently offers too little orientation to actually provide a convincing politico-economic concept however. At a conceptual level, this is primarily due to its in part contradictory, in part outdated basis. Hence the term can be used or abused in many ways, depending on the focus of interest.

To state this attribute in the conclusion of an overview as Ralf Ptak did is somewhat symptomatic of the academic discussion of the concept – alternatives and development of the concept are in fact conceived rather rarely. All too often, research remains at analyzes and reflections of the

historic concepts and developments; conceptual development is almost always left out.

Ideas for such a development from the point of view of an integrated understanding of economic ethics will be presented here. The integrative economic ethics is to be understood as a philosophical ethics of reason, which rests on an “orientation in politico-economic thinking”.<sup>8</sup> The aim of the following article is to consider preliminary ideas and perspectives, and to stimulate further development of the concepts by means of this perspective over and above the mere reflection of the concepts.

## 2. THE SOCIAL MARKET ECONOMY AND ORDOLIBERALISM

Generally speaking, differentiation in the use of the term “Social Market Economy” may be made at three levels: The Social Market Economy is either understood as a *political buzzword*, as a *guiding principle* of a politico-economic concept or as *socio-economic reality*, that is: *Realpolitik*.<sup>9</sup> In the following discussion, the *concept* (i.e. the guiding principle) of the Social Market Economy and the central themes therein are to be considered, as these are, after all, the basis for all further discussion. This article is therefore about basic research of the term, which should be analyzed and developed further.

The term Social Market Economy is used very differently by various trends in Realpolitik and academia (today, as it was 60 years ago) and seems to fall victim to a certain arbitrariness. This stems from certain discrepancies inherent to the concept, as well as from contradictory and vague wordings. In the sense of its creators, the Social Market Economy was never definitive and ultimately developed as a theoretical concept. Thus Müller-Armack spoke of a central theme for example that was open to evolution and adaptation, a “progressive style concept”,<sup>10</sup> in whose usage the particularities and changes in the historic circumstances were always to be taken into account.

And this is exactly what the Social Market Economy has ultimately always remained – a central theme, a style concept for the practical implementation of ordoliberal designs. Similarly, ordoliberalism itself was not a uniform school. There are of course unifying central themes among its representatives, yet in questions of substantiation, elaboration and also implementation, there are differences between the individual positions

as well as discrepancies between the different theoretical strands.<sup>11</sup> Ordoliberalism is mentioned for the first time here and it assumes a weighty role in the entire discussion, as the concept of the Social Market Economy is inextricably linked with elements of ordoliberal thought. Regardless of how the Social Market Economy and ordoliberalism are defined and distinguished from one another, one cannot get around considering the interaction of these ideas and the path dependency of the two trends. This further complicates exact examination of the term however.

A debate on the Social Market Economy must inevitably equally take place in line with the history of ideas of ordoliberalism in particular. Likewise, it must consistently also deal with the (suspected) faultiness and contradictoriness (or at least vagueness) of both concepts.<sup>12</sup> The indeterminacies and the openness of the terms then lead to a certain arbitrariness. The Chancellor of the Federal Republic of Germany, Angela Merkel, commented on this in a speech as follows: “Because the Social Market Economy is so important to us, we are all meanwhile inclined to exploit it for our own individual purposes; hence it is sometimes good to return to the origins.”<sup>13</sup>

This is still expressed very graciously, as it is not because the Social Market Economy is so *important* to us that it can be exploited, but rather because it is conceptually so open (or vague); an issue that can be seized upon. The comment by Chancellor Merkel that a return to the origins might be necessary is correct – yet in a different way to that which she intended. Let us consider these origins a little closer.

### **3. THE ROOTS OF THE SOCIAL MARKET ECONOMY**

Both academics and politicians have concerned themselves intensively with questions of the “roots” of the Social Market Economy, with the history of ideas and the theoretical assumptions underlying the concept, for a long time now.<sup>14</sup> It is assumed that the disclosure and substantiation of the original ideas will make the intentions of the founding fathers clearer and less contradictory. Only in this way can the theoretical and pragmatic confusion surrounding the concept be eliminated – or so it is said.

The majority of literature thus concludes with the presentation, interpretation and application of these roots, be these *personal roots* in the sense of the ideas of a specific author such as Müller-Armack, Erhard, Eucken et al or else the *ideas underlying the roots*, such as the system of values of the Christian West<sup>15</sup> or the fundamental liberal convictions of the founding fathers. Here, it is always about a return to the roots, questions on the future viability of the concept are mostly only answered with the statement that it depends on how well one succeeds in consistently returning to the roots.<sup>16</sup> The assumption that the vagueness of the political-regulatory ideas can be overcome through an exact analysis of the roots of the concept is misleading however. It can be assumed that this is because the roots are the cause and not the solution of the present lack of orientation. Ordoliberalism itself was well substantiated theoretically and thought through and developed by renowned academics, but at the same time also characterized by contradictions and – from a present-day perspective – occasionally characterized by antiquated ideas and values (such as the strong cultural pessimism, the fierce fight against socialism or the in part authoritarian understanding of government, for example).<sup>17</sup> And although the notion of the Social Market Economy was strongly characterized by ordoliberal thought, it was equally characterized by a political pragmatism that generally paid more attention to enforcement of Realpolitik than to conceptual stringency.

Furthermore, it is often unclear what exactly is even meant with “the roots”. It is virtually impossible to actually fulfill the request to “return to the roots” because the roots are rather contradictory and entangled so that no consistent concept can be derived from them.<sup>18</sup> So those who speak of a “return to the roots” of ordoliberalism or the Social Market Economy mostly only mean a particular strand of these roots, as one would otherwise get caught up in the vagueness of the concepts. Many only associate the ideas of Ludwig Erhard<sup>19</sup> or only the liberal-economic perspective and the rejection of the welfare state by the ordoliberals with “the roots” for example; others consider the socio-humanistic ideas of embedding the market economy in an idea of social subservience. This selectivity in consideration of the roots then inevitably transfers to the concept of Social Market Economy derived from this and the discussion on its viability – it ultimately explains why the terms seem so vague and versatile.



Considering this, the historical context is also relatively problematic. The functionality of the Social Market Economy is always measured according to the example of the German “economic miracle” that followed the Second World War. Its superior performance seems to be to have made a prosperous country out of one that was entirely devastated. However, the unique historic situation is misjudged here. The (certainly important) question whether the Social Market Economy as an economic policy was (jointly) responsible for the revival of the German economy following the Second World War has to be disregarded at this point – relevant for us is the historical context for the concept itself.<sup>20</sup>

The ordoliberal approach of a Social Market Economy was implemented during and after the Second World War, so in times of political instability, in order to build a functioning economic system that should try to “pacify” society and to an extent “align” and “reorient” politics. The present-day scenario for economic policy (at least in Germany and the developed Western world) is exactly the opposite however: The political situation is relatively stable and society is (mostly) “pacified”, yet the economy increasingly causes instability and must be “aligned” and “reoriented”. In this regard, the historic roots are also less useful than hoped. As how should the present-day politico-economic discussion seriously be stimulated solely through concepts and ideas that rebuilt a Germany devastated by two world wars and that have entirely different purposes and circumstances?<sup>21</sup> Alfred Müller-Armack stated that “politico-economic models [can] not be removed from their temporal setting. They best fulfill their purpose when they are the mandatory response to the question of a particular time.”<sup>22</sup> The concept essentially reacts to questions of its time with the possible responses of the time. But in our time of a financial crisis and global regulatory competition the perspectives and orientation of an economic policy should surely be different than in the post-war period suffering from famine and the Cold War.

The hope that a clear and clean representation of the roots would solve the conceptual problems is therefore rather misguided. And should one assume that the above-mentioned diverse roots could all be interpreted unambiguously, many of these roots can nonetheless no longer be adhered to today as the basis of an economic policy from the perspective of a pluralistic, enlightened and reasonable society. The canon of values of the Christian West should ideally not serve as the basis for a truly enlightened economic policy in times of a globalized world, and conserva-

tive cultural criticism and opposition to democracy are not acceptable anyway.<sup>23</sup> A modernization of the concept, a new basis and prospects for progress are required.<sup>24</sup>

#### 4. ETHICAL ENLIGHTENMENT OF THE CONCEPTS

It is overly optimistic to hope to derive all relevant information for a modern concept of economic policy and solutions for problems that must be overcome *today* from these kinds of (rather problematic) concepts while insisting on stringent adherence to the history of the *roots*. The approach of this article seeks to advance a differentiated notion of the concept and aims to gain knowledge from an enhancement of the historic roots with new ideas.

It is remarkable that the concepts have only rarely been renewed or complemented by modern knowledge in the fields making up its roots over its 60-year history. Only economics has increasingly allowed for new ideas to flow in, such as discussions on institutional economics and the Social Market Economy,<sup>25</sup> the issue of principal agent problems in the Social Market Economy and also the marginalization of the social question by libertarian market apologists.<sup>26</sup>

But what about the political philosophy, i.e. the liberal theory that represents the actual basis of ordoliberalism, for example? The ordoliberals' concept of freedom is sometimes a little ambiguous – one can find a latent economic liberalism in some ordoliberal thought, such as in Eucken or also in Böhm.<sup>27</sup> Why was this never replaced with a consistent, politico-philosophical liberalism; why was it not enhanced and modernized with insights of more recent political philosophy? The *Theory of Justice* or *Justice as Fairness* by John Rawls and ideas from *Development as Freedom* by Amartya Sen could have interesting consequences for the term “social” in the Social Market Economy, for example. Where are further insights from political theory, republican ideas for example; that overcome the ordoliberals' scepticism to democracy? Where are modern, enlightened ideas that can replace the profound cultural pessimism of Röpke and Rüstow? Or that avoid the “vital-political fall from grace” (for: *vitalpolitischer Sündenfall*)<sup>28</sup>, as Peter Ulrich named the repeated cases of ordoliberals emphasizing *market conformity* time and time again as the criterion for appropriate regulatory policy – despite stressing the primacy of politics.<sup>29</sup> And finally: Where is a uniform concept of a Social

Market Economy? Why are the underlying notions only dealt with selectively, not only without making the omitted problematic aspects a subject for discussion, but also primarily making improvements? Indeed, this was in fact Müller-Armack's ultimate idea: An open concept – a style idea that can be adjusted to different historical and cultural conditions, complemented with new knowledge.

## **5. PROPOSING A REFLECTED DEBATE ON THE SOCIAL MARKET ECONOMY**

It must be clarified that under no conditions should a renunciation of the preliminary conceptual work of the theoretical fathers of the Social Market Economy and ordoliberalism occur here. The historic notion of a Social Market Economy has too much of an appeal and potential to simply be cast off – otherwise this article would never have come into being. To fade out the roots entirely would be unwise as “[...] I can only renew what I know or know how it is currently formed and in which direction

it should be renewed.”<sup>30</sup> However, what can and should be overcome with regard to the roots of the concepts is the limitation of debates to a rumination of ideas that are now over half a century old and no longer all up-to-date.

The genesis of the term and its history of ideas are indispensable for the intended analysis. The suggestion to “return to the roots” should in this sense be taken seriously – and from here a type of genealogical approach can then reveal what is actually concealed in the roots and where the problems lie. The aim should be to modernize the projects of ordoliberalism and the Social Market Economy, allowing for their roots “[...] to be entirely rethought beyond the alternative of “adjustment to new circumstances” and retention of the old attitude.”<sup>31</sup> A renewed, stringent concept of the Social Market Economy is required with a solid, modern ethical basis that then also curbs the arbitrariness of the interpretations. In the long run, support for an economic policy characterized by unclear roots that are in turn interpreted and designed differently by virtually all academic and political opinions is implausible. This way, the “Social Market Economy” is essentially nothing more than an empty vessel, an arbitrary political buzzword without the ability to provide orientation. To fill this vessel and lend the concept the ability to provide orientation is the task to turn to for a reflected treatment with the concepts. In this

sense, the aim of the “Future of the Social Market Economy” committee of the Bavarian state government is to “develop new stimulus for discussion, to contribute to a renewed and clearer view of the Social Market Economy.”<sup>32</sup> Debates should first be about conceptual enlightenment before such things as political guidelines or solutions can be derived.

The principles of ordoliberalism should not be dropped. Indeed, the roots should be considered in the foreground so interfaces can be revealed at which the existing thoughts can be complemented or corrected by politico-philosophical knowledge of the present-day (and the past 60 years). It is ultimately about finding suitable links and about correcting and avoiding conceptual errors and indeterminacies. The definition of the status quo of the concept that is dealt with extensively in the literature and the interpretations of its meaning for the present day can therefore – as important as they may be – only be a start. The notion of the Social Market Economy should be considered further – indeed, the ideas from 60 years ago are not set in stone.

## **6. CONSIDERATIONS FOR A CONTEMPORARY SOCIAL MARKET ECONOMY**

This article is meant to stimulate further discussion of the advancement and sustainability of the Social Market Economy and ordoliberalism. There is no simple, clean solution for the many problems with the Social Market Economy, but the direction must be clear: Away from the backward-looking exorbitance and forward to an enlightened, well-understood development of the concept. To undertake this here would be beyond the scope of such a paper<sup>33</sup>, the suggestions for complements mentioned here have intentionally been kept somewhat vague in order not to stifle any discussion just yet. These ideas may therefore seem rather “utopian” at first sight, yet not utopian in the sense of an idea of an impossible ideal society, but far more as a “gesture that changes the coordinates of the possible.”<sup>34</sup>

To conclude, research should be about a regulatory ethical enlightenment of the concepts and not about regulatory political programming. Discussions about questions of the implementation of *Realpolitik* are, from an ethical perspective, not appropriate anyway; such things must be clarified in practical socio-political discourses and not academically, prescribed from the desk so to speak. The basis for the discourse consists of

good ideas however and even better arguments, and these should be sketched here in the form of some preliminary thought. Thus, it can then come to a politico-philosophical “enlightenment” of the understanding of the Social Market Economy, to its normative (orientational) basis and the systematic consequences of its renewal for a sustainable concept of ordoliberalism and the Social Market Economy. Initiation and advancing of these types of discussions is ultimately the aim of integrative economic ethics.

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- 1| For example Aszländer/Ulrich (2009).
- 2| Such as in her speech on the occasion of German Reunification Day, October 3, 2009.
- 3| "The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive Social Market Economy, aiming at full employment and social progress [...]". (see European Union (2007): Article 2 (3)).
- 4| Müller-Armack (1966), p. 243.
- 5| Müller-Armack (1962), p. 13.
- 6| Quaas (2000), p. 11.
- 7| Ptak (2004), p. 299.
- 8| This is meant according to Kant's dictum of "orientation in thinking". For the perspective of integrative economic ethics, see Ulrich (1997/2008).
- 9| Hentschel (1998), p. 25.
- 10| Müller-Armack (1966), p. 12.
- 11| See in great detail: Ptak (2004), pp. 199 et seq.
- 12| The previously-mentioned work by Ralf Ptak offers an introduction in this context in particular: "Vom Ordoliberalismus zur Sozialen Marktwirtschaft". In this context, he speaks of a "reciprocal relationship" between ordoliberalism and the Social Market Economy. Ptak (2004), p. 11.
- 13| Speech held by The Chancellor of The Federal Republic of Germany, Angela Merkel on June 2, 2009 on the occasion of the "Erfolg made in Germany – die Soziale Marktwirtschaft" event of the Initiative Neue Soziale Marktwirtschaft (INSM).
- 14| See also Körner (2007), pp.16 et seq. for dealing with the roots of the Social Market Economy, for example.
- 15| Röpke (1958), pp. 140 et seq.
- 16| E.g. Quaas ((2000), p 169)): "[...], the renewal of the Social Market Economy seems to be less on the agenda than the return to its actual content." – whatever this "actual content" may be in particular.
- 17| Lenk (1989), pp. 208 et seq.
- 18| Ptak (2004), p. 71.
- 19| The "Initiative Neue Soziale Marktwirtschaft" (INSM) did this for example with its very one-sided recourse to Ludwig Erhard. Yet every other ordoliberal also finds his or herself again in a similar circle of admirers.
- 20| For an interpretation of the significance of the Social Market Economy in post-war Germany, see Hentschel (1998) for example.



- 21| *Here too, the correlation between the actual politico-economic performance and favorable circumstances as well as aid from the occupying forces is far less clear than many advocates of the "economic miracle thanks to the Social Market Economy" would like to lead to believe.*
- 22| Müller-Armack (1974), p. 129.
- 23| *E.g. Rüstow (1959), p. 102, Eucken (1932), p. 312 or Röpkes idea of a "Nobilitas naturalis", Röpke (1958), p. 176, amongst others.*
- 24| Körner (2007), p. 30 arrives at a similar conclusion, albeit by means of a different line of argument.
- 25| *As discussed in Hauser (2007), pp. 85 et seq.*
- 26| *Interestingly this tendency could already be observed in the historic ordoliberalism, which actually "fully supports [the economic] progress of modern capitalistic production" but at the same time the "social consequences in society through the altered production conditions no more accepts than the changes of the political decision-making structure[...]" (Ptak (2004), p. 36). This selective approach could be considered the start of the selective renewal or reappraisal of the concepts that are dealt with similarly to this very day.*
- 27| *Represented in Böhm (1937), p. 42, discussed in Werner (1994), p. 89 and also Ptak (2004), p. 108. Similar discussion also already in Blum (1969), pp. 90 et seq.*
- 28| Ulrich (1997/2008), p. 382 and also Ulrich (2009), p. 16.
- 29| *Röpke described the criterion of market conformity in such a way that state interference in the market should be provided so that it "[...] does not override the price mechanism and the self-control of the market, but classifies it as new 'data' and is assimilated by it" – Röpke (1942), p. 253. This naturally directly violates the primacy of politics. Müller-Armack also calls for a "social policy in conformance with the market" in other areas. Müller-Armack (1948), p. 128.*
- 30| Biedenkopf (1983), p. 167.
- 31| Žižek (2005), p. 160.
- 32| *Kommission Zukunft Soziale Marktwirtschaft (2009), p. 5.*
- 33| *In this context, it should be noted that the theses presented here give a short, preliminary overview of my intended dissertation topic, which is still in its early days and shall be developed extensively over time. In this, an economic-ethical ideal, a draft of a Social Market Economy is to be drawn up to stimulate further reflection and discussion of new ideas and lines of thought on economic policy.*
- 34| Žižek (2005), p. 199.

## II. TRANSFORMATION OF THE SOCIAL MARKET ECONOMY

# THE SOCIAL MARKET ECONOMY AT SIXTY: PATH DEPENDENCE AND PATH CHANGES

*Lothar Funk*

## **1. INTRODUCTION**

The theory of path dependence has been a widely used concept recently. It tries to explain the often inferior development of economies compared to situations when efficiency-enhancing reforms are implemented more vigorously. Some commentators even argue that path dependence “is currently the most fashionable explanation for the persistence of such apparently irrational [...] outcomes”.<sup>1</sup> It has to be mentioned, however, that this approach has been rather neglected by adherents to the concept of the Social Market Economy. Only very occasionally path-dependency-related explanations were used to explain the origins, the gradual evolution and occasional path-breaking changes of the actual Social Market Economy in Germany by economists<sup>2</sup> while the issue was foremost neglected by traditional ordoliberalists.<sup>3</sup> Even if the theory of path-dependence may be regarded as a somewhat fuzzy or “elastic” approach that may be challenged for several reasons<sup>4</sup>, it can provide a potentially useful framework to highlight basic shifts in the vision of the Social Market Economy and how it was put into practice.

Path-dependence tries to explain how the current political practices and real policies and their institutional foundations evolved over time. Therefore, the author concentrates to a large extent on these aspects rather than the original intellectual ideas of the ideal concept.<sup>5</sup> Nevertheless, the article takes the basic theoretical ideas as the starting point and a benchmark for analysis. Moreover, the author focuses above all on employment-related issues, as these were at the heart of the German maladjustment over around three decades since the 1970s. The following chapter will, firstly, give in a broad-brushed way a quick overview on the basics of the idea of path dependence as appropriate for the following short analysis. Secondly, the chapter sketches Germany's labour market problems in a bird's eyes view without putting too much emphasis on details. This section also highlights that path dependency may be an important ingredient in explaining the (West) German experience. Finally, the article draws some lessons for the future of the Social Market Economy.

## 2. THE CONCEPT OF PATH DEPENDENCE

Path-dependency has several important implications for the analysis of policy-making that are of interest to understand the development of the German Social Market Economy over time. A main reason lies in the fact that implementing policies generates outcomes that feed back into the policy process. This may happen either with *positive* feedback which reinforces the implemented policy, or with *negative* feedback which undermines the policies pursued by the government. "‘Positive feedback’ occurs because actors that have adjusted their expectations and behaviour to a policy or that benefit from it will mobilize to defend it. [...] These actors enjoy a political advantage in that, unless the policy has a built-in expiration date, the policy represents the default position".<sup>6</sup> Conversely, political measures that radically alter such a status quo may mobilise negative feedback loops from the potential losers if these changes actually occur which may mean that the short-term costs of changing policies may be politically very high. Therefore, despite of the fact that the longer term benefits of a change of structural economic policies which cure existing problems fundamentally may be a net welfare gain to society, such a change is postponed as a result of the effective lobbying by the often politically powerful *insiders* – the incumbent employees with protected standard jobs – and replaced by inefficient short-term symptomatic solutions which shift the burden onto others

that are less able to defend themselves, the politically negligible *outsiders*, for example new entrants into the labour market or low-skilled workers with low productivity. In other words, additionally to institutional veto players in a country (for example the blocking possibilities as a result of the federalist structure or due to a Federal Constitutional Court and an independent Central Bank that can block or counteract the policies of a government), the beneficiaries of existing policies have to be seen often as factual veto players in the political process due to their voting power that reinforce the resilience of a given policy in their favour despite of the potentially harmful effects of these measures on the economy as a whole. Often these beneficiaries are supported by well-organised interest groups, above all the trade unions.

Therefore, the theory of path-dependence states the following hypotheses with respect to policy-making: "First, it stresses the significance of the timing and sequencing of decisions. Decisions taken earlier will constrain those taken later. Second, even apparently small events, if they occur at a crucial moment ('critical junctures'), can have significant, enduring effects [...] Third, over time policies may become sub-optimal: they may perform a function that is no longer valued or at a cost that is no longer acceptable [...] Fourth, path dependence may be sufficiently strong as to lead to there being non-decisions, in which previously viable alternatives are not considered [...] Path dependence suggests that policy change occurs as the product of 'punctuated equilibrium': long periods of policy stability disrupted by abrupt change when the mismatch between the policy and its objectives becomes unsustainable or when there is an external shock".<sup>7</sup>

### **3. SKETCHING GERMANY'S SHIFTING CONCEPT OF THE SOCIAL MARKET ECONOMY**

It is probably hardly disputed nowadays that Ludwig Erhard who had been appointed Director of the Administration for the Economy of the United Economic Area (Bizone) in the western part of Germany in 1948 successfully started a market economic order. He persuaded the western Allies, above all the representatives of the United States, as well as the affected Germans with two strategic moves, first, *price reform* that proved more successful than expected by many observers (this may serve as an example that apparently small events at critical junctures may have significant, enduring effects), second by advertising the *new*

*economic and social order* with the – according to Zweynert<sup>8</sup> – “killer phrase” Social Market Economy. Particularly two issues apart from coining the name of the economic order demonstrate the genuine German contribution to the new economic order: Firstly, he lifted without coordinating with the military government large parts of existing price control mechanisms of consumer goods and the associated rationing and government control of the economy. This liberalisation was much more radical than the US military government representatives of the US had in mind. Secondly, while the establishment of a market order in western Germany was regarded as absolutely necessary by the US in times of the emerging Cold War, the specific organisation as suggested by the adherents of the essential Social Market Economy in Germany was rather disputed among US-economists, for example due to the rather strict rejection of Keynesian macroeconomic demand management in the economic concept advertised by Erhard and his adherents.

These facts and the vision of this economic concept had convinced a majority of voters and the Social Market Economy was established as the factual economic order after the first election to the *Deutsche Bundestag* (i.e. Federal Parliament, the lower house of the (West) German Parliament) in September 1949. The realised economic order was, however, a compromise.

On the one hand, it consisted of prevailing and in details differing innovative theoretical concepts developed since the 1930s which all strove for introducing a better functioning market economy in Germany than the one established during the Weimar Republic (and definitely compared to the order during period of National Socialism). On the other hand, in line with the idea of path-dependence – “decisions taken earlier will constrain those taken later” – earlier German traditions and institutions were kept in parts or gradually gained influence again “and paved the way for the development of an economy organised along corporatist lines”.<sup>9</sup> Politicians accepted or even supported this in order to achieve sufficient acceptance among the population as well as among vested interests and a smoother immediate functioning of the new economic order that had to be established and maintained. The need to strongly increase and ensure the acceptance for a market-based economic system among the population was particularly strong at the time as it was almost completely missing among after a devastating and demoralising war<sup>10</sup> and because the trade unions and the social democrats initially

fiercely resisted accepting the market economy advertised by Ludwig Erhard and tried to establish a much more interventionist counter-concept.<sup>11</sup> Nevertheless, after having overcome early problems and becoming visibly a role model for other countries due to the celebrated alleged *Wirtschaftswunder* (i.e. Economic Miracle) in western Germany<sup>12</sup> the Social Market Economy as the label that is attached to the practical policy that has been and still is conducted in Germany proved resilient.

The Social Market Economy developed during the last six decades to an economic order which is nowadays accepted in principle by each party in Parliament<sup>13</sup> as well as all the main associations including the trade unions. However, for example the Social Democrats officially accepted this economic order only since 1959, and it is unclear if the parties further to the left will really stick to the basic values of the Social Market Economy if they became part of a federal government in the future. Additionally, it has to be noted that the majority of the wider public still has confidence in the established German Social Market Economy despite of certain cyclical swings and a considerably decreased trust compared to the mid-1990s.<sup>14</sup>

Up until now a successful counter-concept to the (West) German Social Market Economy has never been established in spite of considerable setbacks for (West) Germany since the mid-1970s in terms of labour market performance and economic growth. Rather, the formula was used by all parties as the starting point or frame to amend the existing system based on the uncontroversial basic elements with their own ideas, for example a largely failed attempt to integrate Keynesian demand management as regular macroeconomic policy and an increase role of state interventionism particularly between 1967 and 1978.

One reason why all parties apart from extreme far-right or far-left or other minority parties have supported the concept in general is the fact that, overall, the first twenty years after establishing the Social Market Economy can be regarded as “a period of positive surprises”<sup>15</sup> in terms of the West German economic performance compared to most of its neighbouring countries as well as the USA. This success was largely attributed by traditional ordoliberal economists to the fact, that after the Second World War, the ruling Christian Democrats under Konrad Adenauer, which included the Economics Minister of the first federal government in West Germany (and later Chancellor himself), Ludwig

Erhard, proclaimed the goal of the Social Market Economy in a fundamental reform of the economic constitution. A further cause for this may be that the Social Market Economy has become among the German society a part of the enculturation process where “actors make themselves familiar with institutions through a process of *enculturation* and they enforce existing institutions through a process of reproduction”.<sup>16</sup> All of this may result in institutional stability while at the same time “the suitability of existing policies is continuously assessed against existing or plausible alternatives”.<sup>17</sup>

While it has to be said that already since the end of the 1950s the actual policies in the Social Market Economy moved gradually from the original idea of the state as the guarantor of economic order (that is, the one setting the rules who stands above economic processes) to a more interventionist state that meddles with economic processes and runs the risk of being captured by special interests, this situation worsened particularly afterwards periods when distributional struggles were increasingly on the agenda. The situation improved to a considerable extent during the 1980s but worsened again as a result of the difficult adjustments to unification.

In terms of the basic theory used here, the Social Market Economy developed in a more or less path-dependent way via different stages<sup>18</sup> driven by, above all, two very different international economic environments, sometimes called the “Golden Age” or “good weather period” (until the early 1970s) and the much harder times of a “Silver Age” or “bad weather period” thereafter. The latter period was characterised by a number of foremost negative shocks which started with two oil price jumps in the early 1970s and which include also the difficult adjustment of the German economy to its unification.<sup>19</sup>

These developments left some of the pillars of the Social Market Economy<sup>20</sup> intact, namely a commitment to private ownership combined with a social welfare-enhancing and tough competition policy to guarantee free and open markets and a politically independent central bank committed to the pursuit of price-level stability. However, other components came during this bad weather period considerably under stress, particularly the idea of a strong but limited government separated from the power of vested interests, a social security system foremost beyond the reach of politicians as well as limited and mainly tax-funded social-welfare programmes.



Key factors to understand the different behaviour of the German economy over two longer phases – 1950s until the 1970s and 1980s until now – are above all the employment-related institutions under different conditions of a series of unanticipated positive shocks in the first period and foremost negative shocks in the second one. The German economy has been in crisis with respect to persistently high unemployment and comparatively low growth as well as rising public expenditure and social spending since the mid-1970s and, therefore, for more than thirty years.

It would be misleading, however, to think that steadily rising social spending is connected only to social policy measures taken by governmental actors. Particularly important for the suboptimal outcome has also been the path-dependent very resilient organisation of the labour market despite of numerous new challenges which has supported insiders and created barriers for unemployed workers to (re-)enter. The German labour market has traditionally been strongly influenced by the idea of free collective bargaining in general and a large role of specific practices erected by governments since the late 1960s as, for example, active labour market measures and all kinds of regulatory policies including, for example, dismissal or product market protections by the government and the belief in early retirement as a way to solve labour market problems.<sup>21</sup> There are obviously also interconnections among social policy and the performance of the labour market. For example, everything else the same, a more generous unemployment assistance for reasons of “social equilibration” very likely increases at least after some time the reservation wages and, therefore, decreases the opportunities to successfully fighting unemployment and aggravates the critical situation even more.

Obvious steering deficits according to ordoliberal critics of the policy-making in the German Social Market Economy include particularly the following aspects which led to the evolution of the German economic order to an “inflexible Social Market Economy” with respect to, above all, labour market performance:<sup>22</sup>

- The system of social security that had become established since the 1880s was not adapted to the organisational principles of the Social Market Economy, which focuses rather on subsidiarity instead of status protection which became an important feature during the development of the Bismarckian system of social security. Even worse,

those principles of the Social Market Economy did not play a decisive role during the further expansion of the welfare state as well as during the German process of unification. Only the recent employment-related reforms (*Hartz IV*) abolished the status protection of many long-term unemployed persons by offering only flat rate monthly payments to the persons concerned. The political economy of the welfare state can explain these patterns of asymmetric political adjustment measures in longer periods of good and bad times rather convincingly and in line with the basic predictions of path dependency theory. "Welfare expansion usually generated a popular politics of credit claiming for extending social rights and raising benefits to an increasing number of citizens, while austerity policies affront voters and networks of organized interests". In other words, "frontal assaults on the welfare state carry tremendous electoral risks." Such direct assaults may "induce political backlash and this has been taken to explain the striking inertia of social programmes".<sup>23</sup>

- Treaty partners in collective bargaining neglected until at least the end of the 1990s the limits which they have to take into account to protect the stability of the labour market and the economy as a whole and contributed in this way to stabilise or to increase low unemployment. However, the accumulation of the problems did not lead to fundamental solutions which dealt with the real roots of the problem for a long time. Symptomatic "solutions" like increasing early retirement or decreasing schematically the working time per week without lowering the cost of labour to the same extent only made the problem of high unemployment and low employment worse in the longer term.<sup>24</sup> The political economy of labour market reforms cannot only explain why rigidities arose when they did. This approach sheds also light on the question why they persisted even if they proved costly in terms of employment.<sup>25</sup> The general argument here is that high structural unemployment is often self-reinforcing because high unemployment ironically increases the political support for labour market rigidities by large groups, the majority of insiders that felt secure in their jobs after the experience of the early good times in countries like West Germany with rather strict dismissal protection and that often could gain from badly functioning labour markets at least in the short-term.<sup>26</sup> All in all, the set of institutions that worked well during good times

contributed to an ongoing dualisation of the German labour into the rather well-protected insiders and the employment-searching outsiders often in long-term unemployment with low chances to re-enter the labour market during the bad weather periods since the mid-1970s. The obvious reason was that governments not only constrained themselves more or less to allowing few liberalising reforms, for example more options for the use of temporary contracts for specific types of workers, while leaving the degree of job protection largely intact for the insiders; they as well as the collective bargaining partners also supported measures to decrease labour supply which deteriorated the ability of the labour market to create additional new jobs lastingly even further.

These are important factors that contributed particularly to the problems that have been addressed at least to a noteworthy extent effectively only recently as will be shown below. They are primary factors why the Social Market Economy by becoming more and more inflexible compared to the rising demands for flexibility in order to solve the economy's problems became, in fact, "unsocial" in terms of its early understanding by Erhard during the first west-German campaign by the Christian Union in 1949.

- Indeed, there is nothing social in this sense about a model that persistently has very high unemployment up to double-digit rates.
- It is also not made clear what can be regarded as social in this sense in a model which gave since the mid-1980s up until quite recently the respective working generations the opportunity (and often also the subtle duty) to retire at the expense mostly of everybody else at the age of below 60 on average despite the significantly higher regular age of 65 for men (female rates only gradually increased to this age in the last years). In fact, such regulations will likely condemn the already living future generations to work five to ten years longer if they want to maintain the same standard of living (although it has to be taken into account that their average age expectations are higher than the ones of older generations).

Therefore, it has to be acknowledged that the contents of the actual Social Market Economy differed sharply in the 1950s to, for example, the 1970s or the 1990s and today. These changes of content under the same heading, may explain at least in parts why it is often so difficult for

foreigners to grasp the Social Market Economy and why it had become a successful role model for other countries only with respect to parts of its content, for example the independence of the central bank.

Partly in order to become politically viable, the original Social Market Economy had to compromise and was established as a “fair weather model” from the point of view of the second half of its existence when Germany faced new challenges which proved more difficult to solve in contrast to the earlier “good times” of the “economic miracle. The reason for these predicaments appears to be, above all, the lower adjustment capacity of the German system today compared to its early years. In other words, the German economic order became an “inflexible Social Market Economy”<sup>27</sup> which did not adapt sufficiently to the increased challenges due to a lower political viability of necessary reforms of at least partly outdated institutions and policies, as explained above.

Additionally, one must not forget an often underestimated problem. Traditional German ordoliberal academics did not accept that suitable solutions for economic problems that emerged in western Germany like persistently high unemployment and lastingly low economic growth have to combine increasing efficiency with their likely political viability. Quite a few traditional German ordoliberals that still reigned in the German University’s economic departments during the 1980s and early 1990s all too often neglected political viability in order to ensure maximum efficiency in their proposals. As a result, during these periods politicians often did not take economic advice serious enough as it often would have meant committing political suicide. This is an all too-often neglected reason for the reform-blockage during the 1980s and 1990s in Germany. The situation improved when economists gradually changed their minds and offered increasingly economic policy advice which tried to find efficiency-enhancing solutions that took into account the “political economy of structural reforms” since about the mid-1990s also in Germany.<sup>28</sup>

Such a criticism by no means rejects that the market (or “economic order”) component has to be dominant in the term Social Market Economy at least in the following sense: the more the markets, especially the labour market, function satisfactorily, the lower should be the need for high social transfers to citizens on average. In other words, all other things being equal, successfully establishing full employment relieves governmental social policy and social security systems by increasing

revenues as well as decreasing social expenditures in a sustainable system. Consistently shaping the economic order to achieve high employment, therefore, has to be regarded as the social policy of prime importance in the Social Market Economy even if such a policy does by no means imply that other forms of social policy become superfluous.

Overall, one finds a cycle of path dependence and path change from flexible towards inflexible and then again more flexible Social Market Economy. This cycle can be highlighted, in principle, with the tool-kit of path dependency analysis. The Social Market Economy lagged considerably compared especially to the more dynamic Anglo-Saxon economies especially during parts of the 1980s and particularly since the 1990s. Reform efforts to overcome these problems proved in line with the general arguments put forward in the theory of path-dependency too weak despite of partial successes, for example with respect to lowering the public debt problem during the 1980s.

Arguably, the German economic order was called the sick man in Europe at the end of the 1990s and in the first years of the current decade as the country was during this period at the end of the economic growth league during that period on average. Finally however, the painful “reform logjam” particularly with respect to fundamental labour market reform just described drove, however, the German structural reform efforts almost perfectly in line with the idea of punctuated equilibria as Germany saw with the “Agenda 2010” announced in 2003 and implemented gradually in the following years a sudden transformation in the development of the incentives in the labour market after a long period of gradual change only. Agenda became effective by factually increasing pressures on the unemployed to find new jobs (also at lower compensations), giving more room to fixed-term, temporary employment and part-time work while simultaneously reducing jobs protection. The pro-competitive effects of such much broader reform efforts than previously put indirectly also the insiders in the labour market under pressure as they immediately can see that their productivity gap is often much smaller than their labour cost gap compared to the outsiders. This latter situation probably also explains at least partly why the insiders in the labour market moderated their wage demands during the last years considerably.<sup>29</sup>

In spite of the fact that quite a few ordoliberal economists predicted immediately after its announcement that the German Agenda 2010 reforms would not open up the German labour market, precisely this has occurred to a surprisingly large extent as soon as an upswing started in 2005. "For the first time in three decades, the German labour market has achieved a previously unimaginable milestone: A reduction in the base jobless level. The total number of unemployed in the last boom in 2008 was about 600,000 people less than at the lowest point in the previous boom in 2000. And the number of people receiving long-term unemployment support is now 20 per cent less than in early 2006".<sup>30</sup> Nevertheless, such a positive evaluation obviously does not exclude that certain fine-tuning and increased reform efforts will most likely still help to improve the labour market situations further.

#### **4. LESSONS FOR THE FUTURE OF THE SOCIAL MARKET ECONOMY**

Nowadays the concept of a Social Market Economy defines a policy concept of economic order which combines free markets whenever economically justified and elements of social balancing.<sup>31</sup> The problem in practice was, however, that it proved difficult politically to avoid a considerable increase of the allegedly "social" elements in fair weather periods when they hardly led to unwanted side effects. This backfired during harder times since the mid-1970s and particularly after German unification when negative side-effects on economic dynamism showed up as persistently low economic growth and steadily increasing unemployment from business cycle to business cycle.

As a result of blueprints to reforms which try to strike a balance between economic efficiency and political viability and that opened the doors to the fundamental employment-related changes since 2003<sup>32</sup>, the labour market performance improved considerably since then and for the first time since the 1970s persistently high structural unemployment could be lastingly decreased despite of the current economic crisis. Moreover, the economic reforms during the last decade seem to have made the labour market much more robust in general. The increased flexibility combined with the current policies taken by the government, especially subsidising short-time pay during the crisis, appear to have avoided more than expected by the majority of economists the spreading of the negative economic growth into the labour market at least up until now.<sup>33</sup> Such

a gratifying experience after previously rather painful adjustments demonstrates that a flexible Social Market Economy should be the way forward into German future which builds on a few lessons of the past experience of the paths taken by the German economic order.

All in all, an important lesson to be learned from the German experience is that also a Social Market Economy has to accept a basic fact that was described already by Ludwig Erhard, namely that “too social” can prove to be “unsocial”. Overregulation and real wages that do not react sufficiently to high unemployment for institutional reasons destroy economic growth and employment as well as social inclusion opportunities for persons who want to enter the labour market and are unable to find employment. It has to be said additionally, that academics who currently emphasise potentially negative side effects of the recent employment-related reforms have to make appropriate comparisons. According to such critics<sup>34</sup>, the recent reforms allegedly lead to a dualisation of the labour market that undermines solidarity, “producing new rifts in the welfare system and the society”. However, such a criticism must not forget that the triggers for the reforms were precisely the lasting dualisation into protected insiders and employment-seeking outsiders with low chances to enter the labour market which could not be resolved with the interventionist measures taken for decades before meaningful reform measures to improve the supply side incentives were implemented.

Moreover, the generous entitlements of previous generations cannot serve as yardsticks as they will be definitely unsustainable when taking into account the future pressures on public finance due to, for example, an ageing society.

A second lesson may be that the extent of path dependence very much depends on the institutional structure of an economy and its political system which to a large extent sets the framework conditions. The period of adjustment-rigidity in the German Social Market Economy – in short the “German disease” – was difficult to cure because it was “triggered by a complex combination of *institutional causes* such as the federal structure, the electoral system [...] and strong interest group representation [...] and *cultural causes* such as Germany’s consensus culture, the commitment to social equality and justice, or the deeply rooted appreciation of long-termism, stability, and security”.<sup>35</sup> However, the longer-term changes resulting from piecemeal “salami-slicing tactics”<sup>36</sup>, shifting

politically difficult reforms to the European Union level or by phasing in reforms decided now only several years later helped to implement also more fundamental employment-friendly and growth-enhancing reforms also in Germany. Risky strategic leadership by political actors as in the case of the "Agenda 2010" reforms may have finally lead to path-changes away from an inflexible towards a sustainable flexible Social Market Economy. The thrust of these reforms was based, however, on a hidden consensus also with the Christian Union opposition parties. It had become gradually obvious to the main actors in the political process that when taking into account the future pressures of ageing and further adjustment needs to globalisation, the structural gap "between Germany's institutionalized culture of continuity, consensus and caution, on the one side, and the contemporary imperatives of flexibility, innovativeness, and speed, on the other side"<sup>37</sup> had become too huge to go on with "business as usual".

Hopefully, as a result of former mistakes in the practices of the Social Market Economy and improvements in the conceptual foundations, further learning effects will occur as the traditional approach left at least in practice insufficient room for a more appropriate concept of justice that departs from traditional notions of justice of distribution in terms of, above all, monetary transfers to secure a previous social status for rather long time periods. Such a new approach should place the emphasis on political and economic participation through social inclusion and gainful employment, on equality of opportunities through improved access and incentives for education and lifelong learning, better ways to combine work and family and more efficient forms of dealing with financial resources as well as improved education in these matters. Simultaneously, the financial crisis proved that better regulations in the financial sector may help to increase its longer-term performance by, above all, aligning again private profits and risk-taking. It is definitely not compatible with the Social Market Economy economic order that, on the one hand, huge profits in very risky businesses are privatised while as soon as losses occur the losses become public.<sup>38</sup>

The cycles in the actual policies within the Social Market Economy show that also within this institution at least with respect to its non-eternal elements "policies are continuously being contested by those that did not get their way when the policy was adopted, by new actors or by established actors whose interests the policy no longer serves [...]"



As a consequence of these dynamics, policies may gradually atrophy, be redirected to new purposes, or even collapse... Thus, while there is positive feedback supporting policy stability, there is also negative feedback creating pressure for change".<sup>39</sup> As far as there is still an ongoing controversy among politicians with respect to policies either in line with an inflexible or a flexible Social Market Economy, academics can strengthen the proponents of the latter type by innovative policy proposals that are not only in line with economics (above all, efficiency enhancing) but also take into account their political economy aspects.<sup>40</sup>

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- 1| Schmitter (2010), p. 255.
- 2| Cf. for example Allen (2005), Körner (2007), pp. 27-29 and Zweynert (2004).
- 3| Cf. Leipold (2001), p. 346.
- 4| Cf. Eichengreen (2006), pp. 808-809 and Scherrer (2005), pp. 18-20.
- 5| Funk (2002), for example, gives great detail on the theoretical background.
- 6| Young (2010), p. 65.
- 7| Young (2010), p. 65.
- 8| Zweynert (2004), p. 18.
- 9| Cf. Hartwich (2009).
- 10| Zweynert (2004), p. 16.
- 11| Schlecht (2005), p. 402.
- 12| Cf. Funk (2001b).
- 13| Cf. Wohlgemuth (2006), p. 217.
- 14| Mildner/Prentice (2009), p. 10.
- 15| Siebert (2005), p. 3.
- 16| Berg et al. (2010), p. 136.
- 17| Young (2010), p. 66.
- 18| Cf. Quaas (2008), pp. 386-387.
- 19| For an overview see Leonhard/Funk (2002).
- 20| Cf. Funk (2000), pp. 20-21.
- 21| Cf. Funk (1999), (2004) and (2007).
- 22| Cf. Funk (2001a).
- 23| All quotes from Kersbergen/Manow (2008), pp. 540-541.
- 24| Cf. Funk (2004).
- 25| Saint-Paul (1998), p. 274.
- 26| For details see Saint-Paul (1998).
- 27| Cf. Funk (2001a).
- 28| See for example Funk (1999) and Kramer (2003).
- 29| For details on the reforms see Funk (2007).
- 30| Cf. Zimmermann (2010).
- 31| Cf. John (2007).
- 32| Cf. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2002).
- 33| Cf. Möller (2010).
- 34| Cf. for example Palier (2009), p. 392.
- 35| Blühdorn/Jun (2007), p. 18.
- 36| Funk (2007), p. 122.
- 37| Blühdorn/Jun (2007), p. 18.
- 38| Cf. Funk (2009); see also the chapter by Gregosz in this book.
- 39| Young (2010), p. 66.
- 40| Cf. Kramer (2003).

# FREE COLLECTIVE BARGAINING

SUPPORT COLUMN OR CRUMBLING PILLAR OF  
THE SOCIAL MARKET ECONOMY

*Hagen Lesch*

## **1. ABSTRACT**

In the last sixty years free collective bargaining has turned into a support column for the Social Market Economy. The process of free collective bargaining grants employees and employers the right to negotiate salaries and working conditions, without any state influence through coalition organizations. The system has been fragile for two decades. Businesses are less inclined to apply collective agreements and employees are less likely to be organized in trade unions. This reduces the range of collective provisions, whereas so-called outside competition is growing and increasingly placing collective bargaining standards under pressure. The bargaining partners have responded by introducing opening clauses into collective bargaining. These made collective agreements more flexible. Wage pressure has nevertheless continued, as has the erosion of collective bargaining coverage. Moreover, in recent years, competition has been generated between different trade unions. While undercutting adds to wage pressure, overbidding shakes up wage demands. If these new developments are intensified, the collective bargaining system will become fragmented. The question arises of whether the bargaining partners are able

to prevent this, and to what extent outside competition and trade union competition conform with the system of collective bargaining. The bargaining partners are calling for legislation. The trade unions want statutory minimum wages and employers want to preserve the principle of “one company, one trade union” (tariff uniformity). Such state interventions in free collective bargaining are discouraged, for the time being at least. Experiences with opening up collective agreements to business operational deviations have revealed that the bargaining partners are definitely capable of responding to changed general economic conditions. The state is only called upon if the trade unions and federations of employers are unable to ensure reasonable application for their collective agreements in the long term. To the extent that the state slips into the role of a replacement bargaining partner, free collective bargaining is placed in a crisis of legitimacy.

## **2. FREE COLLECTIVE BARGAINING: ESSENCE AND HISTORICAL ROOTS**

With the exception of the *Die Linke* (i.e. The Left), all political parties represented in the *Bundestag* (i.e. Federal Parliament, the lower house of the German Parliament) are explicitly committed to free collective bargaining, which has turned into a support column for Germany's Social Market Economy. Free collective bargaining is derived from the freedom of association, as laid down in Article 9 section 3 of the Basic Law of the Federal Republic of Germany (for: *Grundgesetz der Bundesrepublik Deutschland, GG*). This ensures that all individuals and professions have the right to establish coalitions in order to preserve and promote economic and employment conditions. This provision encompasses positive and negative freedom of association. Positive freedom of association creates the opportunity for employees and employers to join forces in coalition organizations, such as trade unions or federations of employers, which are able to conclude collective agreements without any state influence. As a result of this assurance, free collective bargaining is guaranteed for coalition organizations.<sup>1</sup> Negative freedom of association includes the right not to act within such consortia and to regulate working conditions on an individual basis. However, it does not go so far as to allow for general withdrawal from collective agreements.<sup>2</sup> The universal coverage of collective agreements – laid down in the *Collective Agreements Act* (for: *Tarifvertragsgesetz, TVG*) –, the *Act on Posting Employees Abroad* (for: *Arbeitnehmer-Entsendegesetz, AEntG*) and the *Minimum*

*Working Conditions Act* (for: *Mindestarbeitsbedingungsgesetz, MiArbG*) provide for the opportunity, under certain conditions, to force “outsiders”, who are not covered by the collective agreement, to comply with collective bargaining standards.

The idea of free collective bargaining was laid down in the Collective Agreements Decree of 1918. This first placed the system of collective agreements in Germany on a legal basis. A few years later however, the state granted wide-ranging powers, with the option of compulsory arbitration. This situation changed after the Second World War. Freedom of association was granted specific protection under basic constitutional law and the state restrained itself in its interventions into free collective bargaining. Where state interventions occurred, they were limited to declaring collective agreements universally binding (at the request of the bargaining partners). Overall, however, the instrument of universal coverage was used sparingly.<sup>3</sup> Even during the heyday of universal coverage, i.e. in the 1980s and 1990s, just slightly over one per cent of all collective agreements were declared universally binding. Federations of employers tried to keep their distance from this instrument in the 1990s.<sup>4</sup> The practice was completely different at the time of the Weimar Republic. By the end of 1928, 1,829 collective agreements were universally binding, out of a total of 8,925. This share is equivalent to more than 20 per cent. Overall, just over half of all employees covered by collective agreements came under the scope of universally binding collective agreements. Against this background, it is not surprising that prior to the enactment of the TVG, consideration was given to declaring collective agreements universally binding, even against the will of the bargaining partners.<sup>5</sup> This idea was not included in TVG at that time, but later experienced a renaissance in the framework of *AEntG*. Because this Act (since its amendment in 1999) has allowed for the declaration of universal coverage for a minimum wage collective agreement – via a statutory instrument executed by the Minister of Employment – even when there is no majority for such a measure on the Collective Bargaining Committee, which has equal representation of trade unions and employers.

Even in the case of industrial disputes, the state has failed to intervene on a regular basis in the past 60 years. This was largely against the background of the negative experiences of compulsory state arbitration at the time of the Weimar Republic. Given that the bargaining partners, at the time of transition to democracy after the First World War, were



incapable of reaching arbitration agreements on their own, or no settlement could be made through the bargaining partner's untried arbitration procedures, the government decided to introduce compulsory state arbitration. The *Arbitration Decree* – enacted in 1923 - granted labor market players the right to make settlements without any influence from the state. In cases of disputes with macroeconomic significance however, the state reserved the right to intervene and to issue binding arbitration verdicts, even against the will of the contracting parties. This provision was intended to stabilize the system of collective agreements, but at the same time the state also ensured that it had a massive impact on wage negotiations.<sup>6</sup>

Strike mediators initially acted as helpers in times of need, in order to arbitrate in disputes between employees and employers, but the influence of the state grew increasingly stronger after 1924, until eventually, after the outbreak of the world economic crisis of 1929/30 and in conjunction with emergency state decrees (wage stops), this resulted in de-facto suspension of free collective bargaining. It was essentially due to this development that both bargaining parties advocated non-State freely negotiated collective agreements.<sup>7</sup> Since then the state has quite consciously kept out of disputes.

### **3. INSTITUTIONAL FRAMEWORK FOR FREE COLLECTIVE BARGAINING**

#### **3.1 The Players: Trade Unions and Federations of Employers**

The founding congress of the *DGB* – The Confederation of German Trade Unions (*Deutscher Gewerkschaftsbund, DGB*) was held in October 1949. The new umbrella organization first represented trade unions in the three western zones. The Soviet occupied zone had the Free German Trade Union Federation, which had already been founded three years earlier, and was disbanded in 1990 shortly before German reunification, with its individual trade unions joining their West German counterparts in the *DGB* by 1991. The *DGB* was originally made up of 16 individual trade unions and now has eight members, following various mergers.<sup>8</sup> The *DGB* is seen as a uniform trade union and therefore represents all denominational, political and ideological trends. However, this concept was breached by the reestablishment of Germany's Christian Trade Union Federation (for: *Christlicher Gewerkschaftsbund, CGB*) in 1955 (initially

as Germany's Christian Trade Union Movement, but renamed in 1959). Moreover, in 1949, the German Civil Servants Association was reestablished, which primarily constituted an organization for officials in the civil service.

Trade unions coordinate the interests of employees and thereby minimize the structurally inherent inferiority of employees to employers. The quote about the trade unions having contributed to turning the "Laboring Poor" at the beginning of industrialization into today's responsible and respected workers, holding equal rights, has been attributed to Götz Briefs. Employee organizations helped to accord the status of an individual to the working man. However, Briefs stresses that trade unions were formed as "foreign bodies within laissez-faire capitalism".<sup>9</sup> Today, however, they represent an essential player in free collective bargaining, and – from the perspective of employers federations – have turned into "a support pillar of the Social Market Economy".<sup>10</sup> Nevertheless, trade unions are far from being uncontroversial today. In a representative survey conducted by *Infratest dimap* and published in *ARD Deutschland Trend* in May 2008, 55 per cent of respondents agreed with the statement "Trade unions in Germany do good work overall" but still 41 per cent did not agree.<sup>11</sup>

Federations of employers were historically formed as a response to the organization of employees into trade unions.<sup>12</sup> Though this was initially a matter of building a self-contained defensive front against the trade unions, work related to collective bargaining and political lobbying soon moved into the foreground. The traditional role was for trade unions to make demands and the federations of employers to react.<sup>13</sup> This role continued even after the Second World War. Under conditions of export-led growth, the federations of employers were able to develop into "dynamic wage policy players".<sup>14</sup> With globalization – which began in the eighties – the general economic conditions changed. Competition became sharper and many businesses criticized the industry-wide collective agreement and the collective bargaining policy of their federations. It became even more difficult for federations to maintain the loyalty of their members with the help of industry-wide collective agreements, because they have been affected by globalization in different ways. Export-oriented companies, which are fully exposed to the pressure of international competition, are faced with companies, which are relatively protected on local sales markets. Suppliers of stable niche products are

producing next to ailing mass producers and large companies, which set up international production sites, are faced with small businesses which (have to) remain in Germany. With the increasing heterogeneity of interests, the inter-company room for maneuver of employer federations is reduced, so they are forced to increasingly assume a role in collective bargaining policy.

### 3.2 Collective Agreements

Collective agreements may be concluded centrally, based on sectors, or on the business plant level. In the event of central negotiations, the bargaining partners negotiate nationwide, cross-sector agreements. In the case of sector negotiations, sector-wide agreements are concluded. Decentralized negotiations at the business plant level are essentially excluded in Germany by the Works Council Constitution Act (for: *Betriebsverfassungsgesetz, BetrVG*) and *TVG*. Article 77 (3) of *BetrVG* contains a provision stipulating that wages and other conditions of employment, which have been or are usually governed by the collective agreement, may form the subject of a works agreement, unless the collective agreement expressly allows for such a provision. The so-called favorability principle (for: *Günstigkeitsprinzip*) is laid down in Article 4 (3) of *TVG*. Pursuant thereto, deviations from the industry-wide collective agreement are only permitted if they contain a change in favor of the employee, or are allowed for by the collective agreement. Business operational provisions, which “undercut” the collective agreement, are thereby excluded, unless the bargaining parties explicitly consent thereto. Company-based negotiations are not legally excluded. Individual enterprises may conclude company wage agreements.

By means of free collective bargaining – as laid down under basic constitutional law – and the prohibition on business plant-based negotiations, a specific structure has been developed for working relationships in Germany, under which trade unions and federations of employers primarily conclude sector-based collective agreements, which are sometimes concluded across regions, and sometimes slightly differentiated by regions. These are designated industry-wide collective agreements. Although at present only around one in five employees are organized in trade unions, working conditions are negotiated collectively for almost two thirds of all employees. The remaining one third negotiate with the employer individually, but frequently with reference to existing wage

agreements. Under the collective provisions, industry-wide collective agreements are predominant, by contrast with company wage agreements: In the western part of Germany 90 per cent of employees covered by collective agreements are paid based on industry-wide collective agreements and the figure for Eastern Germany is 77 per cent.

The dominance of the industry-wide collective agreement is also linked to the interests of bargaining partners in sector-wide collective agreements. Employers save on transaction costs because they do not have to negotiate a series of individual contracts of employment. They also benefit from the administrative function: Longer-term collective agreements in particular create planning reliability, and a uniform non-strike obligation within the sector – beyond the term of an industry-wide collective agreement – stabilizes the general conditions for an interlinked economy. Given that wage disputes are distributed across industries and are thereby largely kept out of business plants, a settlement function is also devolved to the industry-wide collective agreement. The fact that companies which are not bound by collective agreements may gain competitive advantages through wage undercutting has a detrimental impact. Trade unions have an interest in the industry-wide collective agreement because it checks the structural power of the employer and assures the involvement of employees in economic progress.<sup>15</sup> Furthermore, it is important for sector-based trade unions to pursue the goal of “equal wage for equal work”. This is essentially facilitated by a cross-industry wage policy. The same applies to the objective of a solidarity-based wage policy, which does not only target wage equalization between various professional groups and their qualifications, but also aspires to achieve harmonization between sectors. This makes it clear that wage increases are directed at sectors with high productivity gains, and therefore primarily at capital-intensive export branches, as well as at macro-economic productivity growth, as in the case of wage increases at work-intensive branches with low productivity gains, which might include the civil service or commerce.

## 4. STRUCTURAL CHANGES

### 4.1 Trade Unions and Federations of Employers

The organizational base of German trade unions remained amazingly stable overall until shortly after reunification. In 1950 the degree of organization among employees (net degree of organization) was 34 per cent. Until 1993 the net degree of organization fluctuated in a range between 32 and 36 per cent. It then fell into constant decline. Eventually, in 2007, it was just 18 per cent, and had therefore almost halved. A more in-depth analysis reveals that stable trade union domains only exist in large business plants with 4,000 or more employees.<sup>16</sup> In particular in the service sector, the diminishing organizational base results in a declining capacity for implementation and arrangement.

In addition there are structural changes to the "market for trade unions". The *DGB* trade unions have faced increasing competition from Christian trade unions and divisional trade unions, which represent specific professional groups, such as the Cockpit Association (pilots), the Marburg Federation (doctors) or the locomotive drivers trade union GDL (transport staff). While competition from Christian trade unions forces the *DGB* trade unions to offer employers larger wage concessions, the divisional trade unions are forcing the large trade unions to conduct more aggressive wage negotiations and to question their traditional solidarity-based wage policy, in case of which the singled-out professional groups go without wage increases, to the benefit of weaker groups.<sup>17</sup>

Similar trends may be observed on the employer side. In parallel to the foundation of *DGB*, a consortium of employers had already been formed in the western zone in 1947, from which the Confederation of German Employer Organisations (*Bundesvereinigung der Deutschen Arbeitgeberverbände, BDA*) emerged in 1950, as an umbrella organization for various multidisciplinary national and regional federations, alongside a whole series of specialist national federations. By comparison with trade unions, the membership trend at most employer federations is less transparent. The largest German federation of employers, the metalwork employers federation, registered a decline in West Germany between 1970 and 2008, from 9,594 to 3,803 businesses. The absolute decline began back in the 1980s, but accelerated in the 1990s. A large indicator for the inclination of businesses to get organized into employer federa-

tions is the collective bargaining coverage of businesses. This has been in decline since the mid-1990s (see Chapter 3.2). In structural terms, a lot of employer federations have reacted to the fall in members by forming so-called "OT" (*ohne Tarifbindung*) federations (federations not covered by collective bargaining). In the metal and electrical industry alone, almost 2,500 businesses were organized in OT federations in 2008. All services are provided in these federations (legal advice, political lobbying or professional expertise), but none of the collective agreements negotiated by the employer federation must be applied. This ensures the federations of employers have a certain financial stability, but does not counter the decline in collective bargaining coverage. Where there is no willingness to employ collective agreements at enterprises and a lack of assertive trade unions, ultimately no more collective agreements will be concluded. Where free collective bargaining no longer works, the clamor for state interventions grows louder. The discussion on the minimum wage, which has been held for several years, is one example of this.

Another structural change is noticeable in employer federations: In recent years collective bargaining associations, which have existed for decades, have been dismissed or completely disbanded. An example of the full disbanding of collective bargaining federations is the vehicle trade, where federal state guilds began to disband as employer federations in 2007. The steel and metall workers union *IG Metall*, which is responsible for this sector, thereby faced the problem of no longer having any collective bargaining partners. Examples of the termination of collective bargaining associations can be found in public service, where the federal states have negotiated collective agreements independently of the Federal Government and the municipalities since 2005, the banking industry, where the federation of employers of German *Volksbank* and *Raiffeisen Bank* branches terminated the collective bargaining association with public and private banks in 2006, or the East German Construction Industry, where a new employer umbrella organization (Association of East German Building Federations) was founded in 2002.

#### **4.2 Collective Bargaining Coverage**

The structural changes in respect of the players involved in wage bargaining policy are also reflected in the development of collective bargaining coverage. Even if almost two thirds of employees are still covered by collective agreements, the fact that only a minority of establishments

are still covered by collective agreements cannot be overlooked. According to the *IAB establishment panel (IAB Betriebspanel)*, 63 per cent of all establishments in the western zone and 75 per cent in the eastern zone were not bound by a collective agreement. Though a share of around 40 per cent of these businesses not covered by collective agreements are voluntarily guided by collective agreements. However, a look at the longer-term development of collective bargaining coverage reveals that it is in decline. While the share of establishments with company wage agreements largely remained stable at a low level, the share of establishments with an industry-wide collective agreement has fallen since the mid-1990s, from 53 to 35 per cent in the western zone, and from 28 to 21 per cent in the East. In parallel, the share of employees with industry-wide collective bargaining coverage fell from 72 to 55 per cent in the western zone and from 56 to 40 per cent in the East. Collective bargaining coverage depends on the size of the business, the sector and the region. Smaller business plants are less frequently bound by collective agreements than larger ones; in industry, banks or public service, collective bargaining coverage is higher than for company or personal-related services; in Eastern Germany, collective bargaining coverage is generally lower than in the western zone.

However, in addition to this “external erosion” of collective bargaining coverage, there is also an “internal erosion”.<sup>18</sup> This is shown by the fact that businesses are authorized to escape from collective bargaining standards using opening clauses (for: *Öffnungsklauseln*) on collective bargaining. Opening clauses on collective bargaining are instruments, which allow business partners, in certain cases – mostly to ensure employment –, to make time-related deviations from the collective agreement in respect of working hours or fees. This may be transacted between the works council and management, via business agreements, or between the works council, trade union and management, by means of supplementary collective agreements. Of businesses which are aware that the opening clauses may be applicable, one in two made use of this instrument in 2005.<sup>19</sup> In addition however, there is also illegal undercutting of collective bargaining standards, which comes about without the consent of the bargaining partners. Based on the estimates of works councils, this has occurred in around 15 per cent of all establishments in recent years.<sup>20</sup>

### 4.3 Trade Union Competition and Tariff Uniformity

In recent time several individual trade unions have appeared in Germany's Christian Trade Union Federation, which have concluded independent collective agreements.<sup>21</sup> The DGB trade unions criticize the fact that the *CGB* trade unions are competing by means of undercutting and are therefore only selected as negotiating partners by employers because they make larger concessions than *DGB* trade unions.<sup>22</sup> Employers view this development as completely positive because the *CGB* trade unions are supplanting *DGB* trade unions in poorly organized sectors, such as small trade, and do not thereby endanger tariff uniformity (essentially only one collective agreement may be employed at one business plant).

However, there is also a race to the top in progress. Since 2001, several professional associations in the transport and health sectors have cancelled the collective bargaining agreements which existed between them and the sectors' trade unions, following which they have forced through their own collective agreements.<sup>23</sup> Through the autonomous effect of collective bargaining policy, better wages and working conditions should be negotiated for the represented professional group(s) than was the case within the framework of the inter-profession collective bargaining policy of sector-based trade unions. For the affected enterprises, this means that decades of tariff uniformity have been replaced by plurality in collective bargaining, in respect of which there are various overlapping collective agreements within the scope of application. At Lufthansa in Germany, two trade unions are competing for cabin crew, and they negotiate independent collective agreements. The situation is similar at *Deutsche Bahn* (i.e. German Railways) and in hospitals.

The consequences of overbidding are not only felt by employee organizations in the form of member migrations and the growing pressure to realign the strategy for collective bargaining policy. Employers are also affected. On the one hand, they have to negotiate more frequently, while on the other hand they are confronted with building up wage demands of rival trade unions. Both result in confrontational collective bargaining negotiations. At the former public transport enterprises, industrial disputes have occurred at Lufthansa and German Railways, as well as in the hospitals. The risk of build-up in the wage demands should definitely be taken seriously. Because if assertive professional groups, which are capable of mobilizing, are able to achieve better working conditions than



branch trade unions in their own organizations, there is a threat of additional divisional trade unions being formed and the collective bargaining system becoming frayed. To prevent this, the branch trade unions have to react. On the one hand, they may attempt to make a maximum number of improvements in collective bargaining negotiations for all professional groups. This would signify a general drift away from the course of wage restraints, which has been noticeable since the mid-1990s. On the other hand, they would have to sacrifice their solidarity-based wage policy, in respect of which the singled-out professional groups do not exploit their potential room for maneuver in terms of wage policy, to the benefit of other professional groups. The United Service Union has already tried out such a strategy. In summer 2009 it implemented its own, improved schedule of salaries in the education system for employees in pre-schools and childcare facilities and therefore represented, in a completely targeted way, the interests of well-organized (and thereby likely to form spin-offs) professional groups.

The *BDA* (2008) regards the core of free collective bargaining as damaged if – despite an existing collective agreement at a business plant – there is a threat of collective bargaining disputes and the obligation to avoid industrial action therefore being devalued. In case of competing trade unions, a company can no longer rely on not being exposed to industrial action during the term of a concluded collective agreement. In order to prevent an employer having to negotiate with different trade unions at various times, where necessary the legislator should ensure that tariff uniformity is retained as a central element of collective bargaining law. The intention is to prevent a cluster of strikes due to the new “rules of the game”. The agreement of collective bargaining associations, obligatory arbitration procedures or cooling-down phases are recommended after the breakdown of collective bargaining negotiations.<sup>24</sup>

#### **4.4 Industry-Wide Collective Agreement**

The short review makes it clear the German system of collective bargaining is in an upheaval phase. The industry-wide collective agreement is thereby under pressure from two sides. On the one hand, the collective bargaining system is being destabilized by falling collective bargaining coverage, and on the other hand by growing trade union competition and the resultant fragmentation of the collective bargaining system. Both

developments result in a call for legislation. Whereas trade unions demand statutory minimum wage limits, employers are requesting a clear commitment from the legislator to tariff uniformity. As a negative factor, both bargaining partners thereby acknowledge that they can no longer complete free collective bargaining without the assistance of the legislator. As a positive factor, the social partners are making demands for the legislator to adjust the regulatory framework to the changed general conditions in such a way that free collective bargaining is not jeopardized. Whether viewed negatively or positively: The call for legislator has a long history.

Until the 1960s, free collective bargaining was implemented in Germany on the basis of strong economic growth. Increasing prosperity allowed the trade unions not only to regularly achieve wage increases, but also the five-day week with full wage adjustment or continued payment of salaries in the event of illness.<sup>25</sup> Despite the two oil price shocks of 1973/74 and 1979/80, the Bonn Republic returned to reasonable economic growth. However, the bargaining partners were then negotiating against the background of a drastic increase in unemployment. In order to improve redistribution of existing work, the trade unions rely on reducing working hours. The metalworkers and printworkers trade unions went on strike in 1984 for the introduction of a 35-hour week, with full wage adjustment. Following reunification, the general economic conditions then deteriorated in a sustained manner. With the 1992/93 recession, there was a crisis of transformation in the eastern zone of the Republic, while the consequences of globalization became increasingly noticeable in the western zone and the industry-wide collective agreement, which is distinctive of the German system of collective bargaining, underwent a crisis.

Already in the eighties free collective bargaining was heavily criticized and even called into question by *Kronberger Kreis* (1986) and later also the *Deregulation Commission* (1991) and the *Monopolies Commission* (1994). The federal government acknowledged free collective bargaining in its comments on the main report of the *Monopolies Commission* and expressed the view that the two sides should resolve their problems themselves.<sup>26</sup> The two bargaining sides in fact responded to the crisis in 1994 with the so-called job security collective agreement. This allowed opportunities in some industries for temporary reduction of working hours without (full) compensatory wage increases, if the companies

undertook in return to refrain from layoffs for operational reasons. After the end of the recession, however, it was soon apparent that the pressures of globalization made necessary further flexibility in and differentiation of the collective agreements. Initially the majority of unions were trying to prevent opt-outs wherever possible. An exception was the Mining, Energy and Chemicals Union (for: *IG Bergbau/Energie/Chemie*), whose collective bargaining sectors had adopted different kinds of opening clauses for working-hours and salaries already in the “nineties”.<sup>27</sup> With the “opening” of the collective wage agreement, employment should be secured (Business Alliances for Work). Although other industries followed suit, overall development was slow. In the economic policy debate, further elements of flexibility were called for.<sup>28</sup> This culminated finally in the threat of the then-Chancellor Gerhard Schröder, who in his famous “Agenda 2010” speech threatened the collective bargaining parties with legal opening clauses.<sup>29</sup>

In essence, this debate was about a reform of the *favorability principle* laid down in the TVG (see Section 3.2). Since the TVG did not explain further what is meant under the regulation to be in favor of the worker, adjudication developed the so-called *Sachgruppenvergleich* (i.e. *classification comparison*).<sup>30</sup> Accordingly, only rules that stand in a material connection to each other can be compared. As a result, Business Alliances for Work were unable to withstand the consequences of a “favorability” challenge. For in such an alliance, employer and employee exchange wage concessions for expanded protection against redundancy; therefore, regulatory matters, although indeed economical, are in a narrow sense not legally related to each other.<sup>31</sup> The discussion of a legal clarification of the favorability principle resulted in various legislative initiatives from the *FDP* (Free Democratic Party) and the *CDU/CSU* (Christian Democratic Union/Christian Social Union), which however did not win majority backing in the German Bundestag. The *FDP* initiative was designed to include job security in favorability comparison and then to support the favorability of a barter (wage cut against greater protection against redundancies) if at least three quarters of the employees agreed with a barter deviating from the collective agreement.<sup>32</sup> The bill of the *CDU/CSU* parliamentary group also envisaged a consideration of the employment prospects in the favorability comparison. Here, too, the assessment of what is “favorable” should be aligned with the degree of acceptance by the workforce. A barter is considered favorable if two thirds agree with it. A deviation from the collective agreement, however,

should not extend past the term of the collective agreement that it departs from.<sup>33</sup>

From an economic perspective these draft laws should essentially be welcomed.<sup>34</sup> However, the subject has lost some degree of relevance in recent years. Following the threat from the German Chancellor to introduce opening clauses by law, the bargaining parties have shifted their positions. In the largest German sector, the metal and electrical industry, the *Pforzheimer Agreement* was concluded in 2004, which does not only restrict deviations from the industry-wide collective agreement to crisis situations, but also allows for prevention. In the meantime, in almost all larger sectors, there have been opening clauses related to working hours or fees. The statutory requirement for action has therefore become less urgent from the perspective of employer federations. The *CDU/CSU* has also taken the subject off its agenda, and only the *FDP* still included the proposal in its last election manifesto.

#### 4.5 Statutory Minimum Wages

Another subject has moved to the center of the discussion on collective bargaining law. The erosion of the industry-wide collective agreement, in addition to the increasing share of low-income earners, led to trade unions demanding statutory minimum wages for several years. If the individual trade unions within the *DGB* were initially at odds on this issue, the *DGB* managed to steer its member federations to a common course at its 18th ordinary Federal Congress in May 2006. In concrete terms, the *DGB* Congress calls upon the legislator to introduce a law on the minimum wage, at a rate of 7.50 Euros an hour. This was selected as an introductory rate, so that full-time employees can achieve a living-wage market income through their work. Regardless of this aspect, the trade unions actively pushed for an expansion of *AEntG*, in order to allow for the extension of collective bargaining minimum wages to businesses not bound by collective agreements. The *AEntG* was introduced for the building industry in 1996, in order to protect the German building industry from wage dumping by foreign construction firms. Back in 1997, sector-specific minimum wages were introduced in the main construction trades and declared universally binding. They were followed by several sectors of ancillary construction trades. As the Schroeder Government was considering extending the Act to all sectors in 2005, but had not yet taken a decision, the number of economic branches was expanded on

several occasions by the Grand Coalition. In addition to the construction industry, the scope of application presently includes building cleaning, mailing services, security services, specialist mining works, laundry services, waste management, education and training services, and the care sector. Due to this expansion, the state may extend sector-specific minimum wages to up to four million employees.

Inclusion in *AEntG* assumes that at least 50 per cent of employees in this sector are bound by collective agreements. In order to allow lower wage limits to be stipulated in sectors with lower collective bargaining coverage, the *MiArbG*, enacted in 1952 but never used, was amended. This Act now provides for a steering committee, which is intended to establish whether social distortions exist in a branch of the economy and whether minimum wages should be stipulated, amended or annulled. If the steering committee discovers distortions, the Federal Ministry for Employment and Social Affairs sets up expert committees, which work out minimum wages for the affected branches, which can then achieve legal force via a statutory instrument.

The Grand Coalition was unable to reach agreement on the introduction of a general statutory minimum wage. With the changeover to a Christian Democrat-Liberal coalition, expectations in this area are even lower because the *FDP* rejected any form of statutory minimum wages in its election manifesto. In the next legislative period there is no expectation that the state, beyond the current level, will slip into the role of bargaining partners and enforce collective agreements wherever employers and trade unions are no longer willing or able to do so. The same applies to extensions of the *AEntG* and *MiArbG*.

## 5. THE FUTURE OF FREE COLLECTIVE BARGAINING

In the last fifteen years three “break points” have been identifiable in the support column of free collective bargaining: If reform of the favorability principle and therefore the securing of jobs were in the foreground within the context of business alliances, the issue currently at stake is primarily to combat low wages through minimum wages and the assurance of tariff uniformity through organizing trade union competition. An example of the favorability principle reveals the following: The credible threat of state influence resulted in particular in trade unions shifting their position, and collective agreements have since become flexible to

such an extent that there is presently no statutory requirement to act on the employer side. Free collective bargaining has therefore removed one breaking point.

The issue of tariff uniformity could be clarified in a similar way. Only the threat of the legislator to force competing trade unions to form collective bargaining associations, to be included in wage negotiations with agreed salary demands, may produce a behavioral change. It is already noticeable that the sector trade unions (in their own interests) are trying out new collective bargaining policy strategies, in order to prevent spin-offs from divisional trade unions. One feasible strategy would be to agree separate schedules of salaries for certain professional groups, and to make stronger differentiations in wage increases. To the extent that the stabilization of sector trade unions succeeds, (under otherwise equal conditions) the by now historic collective bargaining structures and hence tariff uniformity will be retained. Before the legislator makes regular interventions into trade union competition, the players should first be granted the opportunity to try out their own solutions. The legislator is only called upon if further professional groups with the capacity to strike combine their interests in divisional trade unions, and the system of collective bargaining has thereby become fragmented.

Before mandatory minimum wages are introduced, it is also worth considering whether stimulus mechanisms exist which could compel the unions and management to implement wage rates without legislative intervention. It is theoretically possible to introduce mandatory memberships, such as those which exist for employers in Austria, and which existed for employees in Anglo-Saxon countries up until the end of the 80s (closed shop). Mandatory memberships strengthen the coalitions, but violate the so-called freedom of association. According to German law, they would represent a stronger intervention in wage autonomy than legally mandated minimum wages. There are "other" possibilities; wage-related differentiation clauses – which provide for the regulation of bonuses for trade union members – could be legalised, in order to create a selective incentive to join a trade union.

The German Federal Labor Court (for: *Bundesarbeitsgericht*) declared differentiation clauses as permissible in principle in a 2009 judgement, thus setting aside its existing objections.<sup>35</sup> However, the differentiation clauses should not have any impact on the powers of an employer –

based on individual rights – to provide an appropriate bonus to employees not organized in trade unions. A “simple differentiation clause”, which takes this factor into consideration, may be compatible, according to the Federal Labor Court, with negative freedom of association because it does not place any undue pressure to join a trade union on those who do not belong to any such organization. Even if the question of the size of the bonus that may be omitted in the individual case remains open, the trade unions have a new instrument available for membership campaigns. Employee organizations then have the medium-term option of expanding the organizational base in such a way that once again they will become more assertive in non-collective bargaining zones.

Without any changes to behavior at employers, the bargaining partners will however not be able to comply with their regulatory duties. Federations of employers secure their financial base by forming so-called *OT* federations, but do not counter creeping wage erosion. In order to strengthen collective bargaining coverage, the collective bargaining federations had to court *OT* members in a targeted way. Even newly founded enterprises must be courted in a targeted way, since they are less frequently bound by collective agreements. At enterprises where the level of organization in trade unions is low, this might prove less successful because there would be no cause to fear the possibility of trade unions, where necessary, achieving collective bargaining coverage through an industrial dispute. This shows that the inclination to revoke collective bargaining coverage is favored by weak trade unions. However, with regard to all considerations, it should not be forgotten that negative freedom of association also forms part of free collective bargaining. Ultimately each employer is free not to join any organization. It is precisely this “outside competition” that contributes to the discipline of the bargaining partners.<sup>36</sup> Since it gives both employers and employees the opportunity to defend themselves against a collective agreement practice that is against their interests.

Yet the question arises of how far “outside competition” from businesses that are not bound by collective agreements can go. To what extent should the bargaining parties pull back and the provision on working conditions be surrendered to the individual contractual level? Free collective bargaining is indeed a freedom right and not a freedom obligation.<sup>37</sup> However, an excessive renunciation of the use of this freedom right by the collective agreement parties may result in the state being called upon

– on account of the relevant protection and regulatory duties under basic constitutional law – to create appropriate minimum working conditions.<sup>38</sup>

With the extension of *AEntG*, the state regularly intervenes in the organization of working conditions, at the request of the collective bargaining partners. Unlike in the case of a universal statutory minimum wage, the state does not set wages. Such a situation would arise if minimum collective bargaining wages were extended, via a statutory instrument, to all employees working in the relevant sector. Nevertheless free collective bargaining is in a deep crisis. Because, on the one hand, the state must ensure that collective agreements are provided with a reasonable scope of application. And where there are no collective agreements, the amended version of *MiArbG* allows the state to stipulate minimum wages. There has been no such state assistance in the past six decades of the Social Market Economy. The possibility still arises of both social partners reviving themselves and once again being able to improve and collectively govern their freedom right and working conditions. If they fail to take this opportunity, the state will assume the role of a replacement collective bargaining partner. Or it will allow for a split in the system of collective bargaining system, into collective bargaining-regulated and individually-regulated zones, while allowing for a further increase in “outside competition”. In the medium term, both routes lead collective bargaining into a deep legitimacy crisis and will shake up an important pillar of the Social Market Economy.

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1| Löwisch (1996), p. 816.

2| Cf. Lesch (2006).

3| Lesch (2003), pp. 5 et seq.; Bispinck et al. (2003), pp. 134 et seq.)

4| Bispinck/Schäfer (2005), p. 29.

5| Lesch (2003), p. 6.

- 6| Bähr (1989), pp. 21 et. seq., Huck (1993), p. 127.
- 7| Zachert (2009), p. 179.
- 8| Keller (2001), p. 93.
- 9| Briefs (1965), p. 549.
- 10| Cf. Bundesvereinigung Deutscher Arbeitgeberverbände (2010).
- 11| <http://www.infratest-dimap.de/umfragen-analysen/bundesweit/ard-deutschlandtrend/2008/mai/>
- 12| Schroeder/Silvia (2003), p. 256.
- 13| Schroeder (1996), p. 601.
- 14| Schroeder/Silvia (2003), p. 253.
- 15| Traxler (1997), p. 102.
- 16| Cf. Biebeler/Lesch (2007)
- 17| Cf. Lesch (2008), Schroeder/Graefe (2008).
- 18| Bahnmüller (2002), Streeck/Rehder (2005).
- 19| Cf. Kohaut/Schnabel (2007).
- 20| Bispinck/Schulten (2003), Massa-Wirth (2007), pp. 99 et seq.
- 21| Bispinck/Dribbusch (2008), p. 157.
- 22| *Ibid.*, p. 160, Schroeder (2008), p. 3.
- 23| Cf. Bispinck/Dribbusch /2008), Lesch (2008). *The pilots association Cockpit started this process in 2001. They were followed by other professional groups, such as doctors, air traffic controllers, cabin crew or locomotive drivers. Locomotive drivers were already represented in their own trade union, which, however, formed a collective bargaining association along with other railway trade unions. The other professional groups achieved trade union status for their organizations and ended collective bargaining policy cooperation with the United Services Union (for: "Vereinte Dienstleistungsgewerkschaft ver.di").*
- 24| Cf. Bundesvereinigung deutscher Arbeitgeberverbände (2008).
- 25| For details see Bispinck (2009).
- 26| See Bundestag paper 13/1594 of June 1, 1995.
- 27| Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (1998), pp. 125 et seq.
- 28| E.g. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (1995), pp. 226 et seq., *idem* (1998), pp. 123 et seq., Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Arbeit (2004)
- 29| The government statement, *verbatim*: "Suitable provisions shall create an appropriately flexible framework within collective agreements. This constitutes a challenge and a responsibility for bargaining partners. Article 9 of the Basic Constitutional Law grants constitutional status to collective bargaining. But this not only constitutes a right, but also an obligation [...]. I would therefore expect the bargaining partners, under the existing situation, - but to a much greater extent -, to agree on business alliances, as is already the case in many branches. If this does not happen, the legislator must act." See Federal Government bulletin no. 21-1 of March 14, 2003.
- 30| Cf. Bundesarbeitsgericht (2000).
- 31| Lesch (2006), pp. 31 et seq.
- 32| See "Entwurf eines Gesetzes zur Sicherung betrieblicher Bündnisse für Arbeit", Bundestags-Drucksache 14/6548 of 4 July 2001.
- 33| See "Entwurf eines Gesetzes zur Modernisierung des Arbeitsrechts", Bundestags-Drucksache 15/1182 of June 18, 2003.
- 34| Lesch (2006), pp. 32 et seq.
- 35| See press release no. 27/09 on the judgment of the 4th Senate of March 18, 2009 on the legitimacy of "simple differentiation provisions".
- 36| Cf. Lesch (2003).
- 37| Rieble (2004), pp. 423 et seq.
- 38| *Ibid.*, p. 426.

# SOCIAL SECURITY SYSTEMS IN THE SOCIAL MARKET ECONOMY

BETWEEN THE POLES OF SOCIAL POLICY AND MARKET FORCES?  
AN ANALYSIS OF THE STATUTORY HEALTH INSURANCE IN GERMANY  
IN THE CONTEXT OF THE SOCIAL MARKET ECONOMY'S FOUNDATIONAL  
PRINCIPLES

*Christine Wolfgramm | Ines Läufer*

## **1. SUMMARY**

In this article we present fundamental principles of the Social Market Economy and analyze their role for the design of social security systems. The great potential of the Social Market Economy lies in the simultaneous provision of an efficient allocation of resources and of an efficient, that is, accurate redistribution in the tax-transfer-system. The resulting efficiency gains contribute to social welfare.

The advantages of the Social Market Economy are decreasingly appreciated by the German society. Besides the uncertainty caused by the financial and economic turmoil, the growing need for higher contributions to the social security systems with simultaneously shrinking coverage lead to a loss of reputation of the Social Market Economy.

Trust in the market mechanism is especially lacking in the German statutory health insurance system. Health is re-

garded as “special good” which should not be supplied by anonymous market forces. Despite the – consequently – massive public interventions in the health care sector, the design of the statutory health insurance is perceived as unfair. More public action has thus not led to more social justice.

We will show in this article that the inconsequent implementation of the Social Market Economy’s fundamental principles contributes to the current problems in the social security systems. Since social security is seen as one of the fundamental pillars of the Social Market Economy, their unsystematic design leads to an erosion of trust in the economic system itself.

Trust will only be regained by a systematic implementation of the Social Market Economy’s fundamental principles. In this case, the Social Market Economy can serve as an example and act as an instigator in the debate over different economic orders.

## **2. PRINCIPLES OF THE SOCIAL MARKET ECONOMY**

Whereas German politicians praise the Social Market Economy as a means to overcome the international economic crisis<sup>1</sup>, the population loses its trust in the economic system. Even before the economic crisis, there were doubts if the Social Market Economy was indeed a social economic system, because German people are under the impression that the number of the systems’ losers is rising.<sup>2</sup> In this paper it is however put into question if people are really criticizing the system as a whole or its imperfect design. In the following we will present our view of the foundational principles of the Social Market Economy.<sup>3</sup> After this theoretical foundation we will analyze if these principles are adhered to in the German health care system before suggesting a reform that combines competition in the health sector and social security measures to help the needy.

### **2.1 Individual Liberties**

The normative base of a market economy is the freedom of individuals, i.e. the realisation of their preferences and ways of life. Therefore, voluntary individual exchanges can be interpreted as a mutual betterment and an increase in social welfare.<sup>4</sup> The price mechanism coordinates

individual interests and goals: Prices mirror the individuals' subjective appreciation of products and services and thus coordinate the different interests of consumers and suppliers.

Individual freedom (negative rights of freedom) can only be guaranteed if individuals do not harm others by their actions.<sup>6</sup> The protection of individuals from the negative consequences of others' actions is a constitutional characteristic of a state of law on which a free society builds on. Within this constitutional framework individuals can assume their civil rights and liberties. Their freedom will only be curtailed if they act against others civil rights and liberties. In contrast to socialist societies, the Social Market Economy does not intend to educate people or change their values, that is, it does not have any interest in forming a "good citizen".<sup>7</sup> The rules are set in a way that the system is robust even if people act exclusively egoistically. The focus on potentially egoistic people can be thought of as a preventive, worst-case oriented set of rules. The assumption of egoistic behaviour is a "social-technical" assumption<sup>8</sup> which is necessary to protect the society from exploitation by members who do not act altruistically.

The orientation on potentially egoistic individuals does not imply that moral behaviour<sup>9</sup> is neither wished for nor possible in a market economy. The "moral" is integrated in the rules of the market economy. Moral behaviour does therefore not need to be an extraordinary individual achievement, but is binding for all individuals through its institutionalisation in the market rules. A systematic integration of moral elements in the rules of the market economy combines the advantages of competition with ethical social values. Due to the rules, originally intrinsically motivated moral behaviour becomes egoistic behaviour and is therefore more probable. Environment harming behaviour would thus be penalized and consequentially reduce company profits, while "morally right", environment protecting behaviour would be maximizing profits.<sup>10</sup>

## **2.2 Competition on the Merits**

In a world of scarce resources, the realisation of individual goals and the coordination of individual actions can only be attained by market competition. By contrast, the allocation of scarce resources by a central planner is incompatible with individual liberties, since considering all individual preferences at once and creating a hierarchy of needs is impossible even

for a benevolent planner. A central planner will therefore always violate some people's preferences, thus exerting coercion. By contrast, individual goals can be achieved by market competition in due consideration of scarce resources: The price mechanism reveals scarcity and individual needs, thereby ensuring the coordination of demanders and suppliers. Competition forces providers to satisfy demands at the lowest possible cost and consequently avoids any waste of scarce resources.<sup>11</sup>

In a market economy, remuneration reflects the other individuals' appreciation. Competition thus forces individuals to direct their actions into those areas which are most important to their fellow citizens. This principle of competition on the merits that has been promoted by the Freiburg School corresponds to the ideal of consumer sovereignty.<sup>12</sup> All actions are directed towards fulfilling the consumers' demands. The consequent orientation of the production process on consumers' interests can guarantee a social order free from privileges and therefore a social order on which consensus might be reached behind the veil of uncertainty.<sup>13</sup> Sovereignty of producers by contrast would be an obstacle to a privilege free order since producers' interests often lie in protectionist measures.<sup>14</sup>

This ideal form of competition is rarely achieved in practice. It is however important to bear this ideal in mind as a reference order for the analysis of and the debate on current economic and social issues.

### **2.3. No Competition Without Rules**

Competition as discussed above can only be as good as the rules under which it operates. This implies that cartels and monopolistic structures are incompatible with competition on the merits and act against consumer sovereignty: Under cartelistic or monopolistic structures, remuneration does not reflect consumer's appreciation: Monopolists can set prices autonomously and preclude other competitors from market entry.<sup>15</sup> Even if a social order's benefits are generally accepted, it is nevertheless constantly at risk, because the violation of rules and the achievement of power can be an attractive strategy for some members of the society.<sup>16</sup> Without rules of law channelling individual actions, individually rational behaviour can produce drawbacks for the society (market failure). The well-known prisoners' dilemma clearly depicts the discrepancy between individually desired goals and the final outcome in the absence of general rules.<sup>17</sup>



Market failure should however not be the sufficient requirement for public market interventions, since there is the risk of a government failure: In the latter case, public action does not lead to welfare gains but welfare losses.<sup>18</sup> Therefore the need for and the advantages of public interventions must be thoroughly analyzed.

If the market mechanism is accepted as an efficient means to coordinate individual and free actions, only the rules of competition and not its results can be evaluated.<sup>19</sup> If the society has agreed on fair competition rules then its results can be regarded as fair under the perspective of performance-based justice (for: Leistungsgerechtigkeit). This result does however not necessarily imply that the market mechanism ensures a life in decent conditions for all members of society. That is why market competition has to be complemented by social policy measures outside of the market.

#### **2.4 Social Policy Without Intervening in the Market**

The fact that remuneration is determined by the other individuals' willingness to pay implies that without this willingness, even basic human needs are not taken into account by the market. An individual can therefore only achieve a decent standard of living if the other individuals have a sufficient willingness to pay for her performance. Furthermore, neither prestige nor social status determines the level of remuneration.<sup>20</sup>

There is a general social consensus that each individual should be offered a decent minimum living standard. Without the guarantee of a minimum income, a competitive market order would probably be less accepted by society. If an individual can not accomplish enough to satisfy her basic needs, solidarity requires helping her to live a decent life. This is not to say that there is an entitlement to keep a certain social status. The risk associated with competition to lose one's social position cannot be compensated for by society, since this would imply privileges for some at the expense of others. What the society can guarantee is a minimum income, the amount of which is defined in the political process. Its amount is therefore theoretically indeterminate, what matters is the guarantee for every citizen in need that she will not be forced to live below a decent living standard. The provision of this minimum standard is however no unilaterally binding contract: Even people in need do have to help themselves as far as possible, thus avoiding overburdening the society.<sup>21</sup>

Protectionist measures, such as maximum prices or minimum wages are to be avoided. Prices lose their signalling function when they simultaneously have to serve distributional goals. Curtailing the signalling function leads to a waste of social resources. The conservation of scarce resources however works especially to the advantage of people in need since it increases the margin of distribution. Likewise, price interventions do not take into account social status. Price interventions affect every citizen regardless of her income and wealth with exception of the most needy: Without any market income, they cannot take part in the market and thus not profit from "social" prices. Means-tested transfer payments by contrast are a targeted and resource-protecting means to achieve social security outside of the market.<sup>22</sup>

### **2.5 Justice of Rules and Procedures Instead of Protection of Vested Rights**

The overview of fundamental principles of the Social Market Economy has shown that a liberal order does not preclude solidarity, that is, helping people in need. On the contrary: Guaranteeing a minimum income is essential for the functioning of a liberal society. The liberal order can however not guarantee absolute security. The freedom to choose one's activity and to reap the fruits of one's labour always goes along with the risk to fail. The society cannot avert all individual risks: Individual losses have to be answered individually and are not to be socialized. Otherwise there would be no incentive to assume responsibility for one's actions.

Guaranteeing social status for some would go at the expense of others: If for example certain jobs are preserved by subsidies the latter have to be financed by taxes. Thus, citizens are forced to pay for the preservation of a company for the products of which they did not have enough willingness to pay in the first place. Likewise, the tax burden leads to job cuts in other companies and/or hinders the creation of new jobs.

Justice can only be understood as justice of rules and procedures if all individuals should be treated equally and if their liberties should be respected. If these general rules are accepted, the only important action is to guarantee a minimum standard of living for the needy. This minimum living standard is financed by taxes which are paid in accordance to the respective individual ability-to-pay. Further redistribution would create privileges for some groups of society at the expense of others without justification.

As discussed in the following chapters, there are good reasons for supplying the needy not only with subsistence aids but also with access to medical treatment. Both have to be financed by society. It is however important to bear in mind that this can only mean equal access to a minimum health benefits basket defined by society. Equalizing all health status is neither possible nor desirable in a world of scarce resources.<sup>23</sup>

Solidarity with the needy should however not imply governmental intervention in the health care sector at the expense of market forces. On the contrary, relying on market forces with the resulting improvement in efficiency can lead to more justice in the health sector.

### **3. SOCIAL MARKET ECONOMY IN PRACTICE: STATUTORY HEALTH INSURANCE**

In reality, many principles of the market economy are violated, not only in the health care sector. The breach of fundamental principles generates feelings of injustice. Therefore many citizens lose their trust in this economic order. The question is if this opposition is directed against the ideal form of Social Market Economy or against its flawed implementation. Especially in the emotionally-charged realm of social security, the unsystematic implementation of Social Market Economy principles results in an inexplicable redistribution which in turn leads to problems of acceptance of the whole economic order.

Germany has a long tradition of Bismarckian Social Security Systems by which over time, more and more risks have been shifted from the individual's area of responsibility to the society's area.<sup>24</sup> The willingness to assume responsibility for individual risks has declined substantially during the last decades because the state assumes more and more risks by forcing its citizens in public insurances against unemployment, illness etc. With statutory insurance, the freedom to choose is curtailed in favour of an alleged security, without ensuring "social justice" in these insurance systems. This leads to an erosion of trust in the social part of the market economy.

The seeming contradiction between freedom and security – or rather between freedom and social justice – is cited as the reason why "special goods" cannot be traded in the market but have to be supplied by government interventions or at "social" prices. Health services are regarded

as special so that many do not trust anonymous market forces for their supply. If health services are special, it is however important – given the scarce resources – to produce these “goods” in an efficient way, that is, using market forces as far as possible.<sup>25</sup>

As shown in the following sections, the problems of the current institutional setting in health care can be analyzed by reference to the principles of the Social Market Economy. Within this framework, approaches for an efficient and systematic implementation of social security systems can be found, which take into account the interaction between social security and market mechanism.<sup>26</sup>

### 3.1 Compulsory Insurance

Following the principle of **consumer sovereignty**, citizens should principally be free to choose which risks to insure and in which way. However one can find reasons for a compulsory insurance in the health care sector. Compulsory insurance is a means against unjustified utilization of minimum benefits. Otherwise citizens could have the incentive not to provide for illness, despite having sufficient financial means for insurance. They count on help from society in case of emergency.<sup>27</sup>

Compulsory insurance requires no government intervention in form of a statutory insurance. It can be left to the individuals which insurance to choose. Governmental action is only needed for the definition of the minimum health basket which has to be insured to prevent underinsurance. Citizens who are not able to pay their insurance premium receive financial support.<sup>28</sup> **Thereby they are able to act independently in the market.** Renouncing totally to individual freedom to choose or to a market solution is therefore not necessary. Within this order, citizens can still choose the insurance which fits best their needs.

This is not the case in the current public health insurance in Germany. It is a statutory insurance for the major part of population; only 10 per cent of the citizens can opt for full coverage in a private insurance. By a statutory insurance, the state substantially curtails the citizens' freedom to choose without compelling reasons. There are no such serious market failures in the health care sector that health insurance could not be supplied by private providers.<sup>29</sup>

The current public health care scheme however has to be obligatory for the major part of society because it is organized as a pay-as-you-go system which needs sufficient net-contributors to cover the older people's expenses.

### **3.2 Competition on Health Insurance Markets<sup>30</sup>**

Especially in the health care sector, the merits of a competitive setting have to be taken advantage of since resources are particularly scarce. That is why an order has to be found which allows competition for efficient health care provision.

The principle of actuarial fairness is fundamental to (health) insurance: Insurers provide individuals with insurance against financial losses due to illness and demand a premium in turn which allows them to break even.

Competition can only be achieved by adhering to this principle. If insurers cannot demand risk-equivalent premiums, they have the incentive to enter in competition for good risks, that is, for individuals whose expected present value of premiums exceeds the expected present value of expenses.

Risk-equivalent premiums correspond to the average risk of a cohort when insured from birth on because risk differences are not known at this point of time (genetic tests precluded). By accumulating ageing provisions and individualising them by adapting to age and illness of insureds, the premium is smoothed over life-time and a (real) increase in premium is avoided. At a given premium, insureds with illnesses or higher risks have to be provided with higher ageing provisions than relatively healthy individuals. Hence, there is no incentive for insurers to choose only young and healthy insureds and to refuse elderly or sick people. Thus a risk-equivalent calculation does not imply higher premiums for sick or elderly people.

Switching insurers is possible by transferring individual ageing provisions.<sup>31</sup> Ageing provisions ensure that even sick people can change insurers without suffering disadvantages because ageing provisions serve to level the cost risk for the new insurance. The possibility to change insurers leads to a competition on the merits and in efficiency, because it creates incentives for insurers to provide all insureds with the best possible health care provision.

In the current social security scheme, competition has been most widely curtailed to the advantage of distributional goals, so that “the principle of actuarial fairness been given up in favour of the principle of solidarity<sup>32</sup> [...]”. The breach of the principle of actuarial fairness leads to massive inefficiencies in the system. These inefficiencies are accepted because public opinion holds that health insurance should be financed in a “solidary way”. In the German statutory insurance, the financial means for this purpose are to be raised according to the ability to pay of its insurants. This ability to pay is measured by wage income (income related contributions).

Income related contributions prevent efficient competition in the health insurance sector. Contributions based on wage income are only accidentally equivalent to the risk of the insurant and therefore to the expenses caused. Without equivalence between premiums/contributions and insurance benefits, insurants are regarded as low, respectively high risk individuals. Therefore, insurers have incentives to only attract insurants whose expected premiums exceed their expected expenses. This cream-skimming leads to a massive waste of resources because insurers do not strive to provide their insurants with efficient health benefits but to develop mechanisms for avoiding high risk individuals. The missing price signals thus prevent an efficient competition.

Governments try to circumvent the problem of cream-skimming and missing competition by obligation to contract for insurers and (morbidity-oriented) risk-adjustment schemes. These assign the insurers with a lump-sum and surcharges or deductions which depend on an insurant’s morbidity, age and gender as well as disabilities. Apart from administrative costs, these risk-adjustment schemes create the incentive for insurers to claim that the health status of their insurants is worse than in reality in order to get higher surcharges.<sup>33</sup> Insurers can also circumvent obligation to contract by concentrating their marketing activities on young people or by delaying health insurance membership applications from the elderly.<sup>34</sup>

These facts mirror the fundamental problems of administrated “markets”. As soon as the signalling function of prices is weakened or suspended by “solidary” prices, there will be evasatory reactions from suppliers and demanders. The insurers try to attract only insurants who are net payers, while the insurants will try to get as much benefits as they can out of the

system. Both reactions lead to a false allocation and a waste of resources. The redistribution margin shrinks, because inefficiently allocated means in the health sector lack for other purposes.

### **3.3 Insurance Markets and Social Policy**

The advantages of competition can also be reaped in the health care sector without abandoning generally acceptable redistribution to the needy. Redistribution is conducted outside of the market by giving financial support to people who cannot afford their insurance premiums.

Redistribution is based on the ability-to-pay, which can be most effectively accounted for in the tax-transfer-system. The latter includes all sources of income in the tax base without contribution assessment ceiling.<sup>35</sup>

The redistribution within the statutory health insurance in Germany is not only an impediment to competition. Due to the contributions levied on wage-income, the resulting redistribution is neither systematic nor based on the actual neediness. Proponents of wage-income related contributions are convinced that levying contributions on income reflects solidarity of the rich with the poor. This might have been the case in the past: With the introduction of a statutory health insurance in the 19<sup>th</sup> century, wage income was an appropriate indicator for the citizen's ability-to-pay. Nowadays, the ability-to-pay is not sufficiently defined by wage-income, because other sources of wealth, such as capital income are neglected. That is why asset rich people are regarded as needy in the statutory health insurance in Germany, if they have low income from wages. Their contributions to the system will automatically be lower than those of people with high income from wages but no assets, although both can have the same total amount of income.<sup>36</sup> Additionally, there are contribution assessment ceilings, that is, contributions are only levied on a certain amount of income. Furthermore, individuals can opt out of the statutory system for health insurance (including long term care insurance) when earning more than a defined amount per year. This amount is fixed by the German government on a yearly basis and is set at 49,950 Euro for the year 2010.<sup>37</sup> Consequently, a part of the society can evade solidarity, whereas the most needy are actually excluded from the redistribution mechanism within the statutory health insurance: Their contributions are actually paid by the taxpayer.<sup>38</sup>

With the current design of the statutory health insurance, competition resulting from market mechanism is repressed in favour of allegedly social aspects. As shown in the previous sections, unjustified redistribution is accepted on top of the serious disadvantages that result from dirigiste market planning.<sup>39</sup> Additionally, the current system is highly vulnerable to demographic changes and to cost increases due to medical-technological progress. Cost increases are economically uncritical if these date from modified preferences and the respective willingness-to-pay. Problems arise when these cost increases can be traced back to an unsystematic and inadequate design of the health insurance system.

It is imperative to first exploit all potentials of rationalisation in the health care sector, not only for economical but also for ethical reasons. That is why market forces should be strengthened. It is important to stress that this does not preclude generally accepted redistribution.

#### **4. CONCLUSION**

A Social Market Economy needs compatible social security systems. In a first step, we have presented the relevant principles of an Social Market Economy to show approaches for a system-compatible health insurance. Reaping the advantages of competition in the health care sector does not imply precluding the needy from health insurance. Our critique of the statutory health insurance scheme in Germany is not based on the redistribution itself, but on its unsystematic integration in the health care system, thus undermining efficient competition.

The morbidity-oriented risk-adjustment scheme tries to combine competition and redistribution. The goal of providing every citizen with efficient health care can however not be achieved herewith. It rather creates incentives for insurers to gain profits which have not been generated by the provision of efficient health care.

A systematically designed health insurance can offer both “goods”, security and health, without wasting scarce resources. The needy who cannot afford to buy this “security” in the market, are supported by the society outside of the health insurance system.

That means that governmental actions have to be complementary to the market systems. The fundamental principles of a market economy do not



only separate governmental actions from the market sphere, that is the market for health insurance, but they simultaneously legitimate publicly supplied and accurate support of the needy.

The demand for security rises in times of crisis. Above a given point, however, this security can only be publicly guaranteed at the expense of the citizens' freedom. Justice of rules and procedures cannot guarantee comprehensive economic security, but the certainty to be treated equally and to be able to act under non-arbitrary conditions.

We expect the acceptance of the Social Market Economy to rise when its fundamental principles are not only adhered to in theoretical discourses, but applied in the everyday political process.

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2/ Press release Bertelsmann Stiftung, June 16, 2008 (online).

3/ *This is surely no exhaustive account of all Social Market Economy's principles. We will only address the most important features, which serve as guiding principles for the analysis of social security systems.*

4/ *Schlecht (1990), pp. 35 et seq., Roth (2002), p. 58. It should be stressed here that this notion of social welfare is not compatible with the goal of maximizing an aggregated social welfare function. Rather, the theoretical possibility of consent to a social order is taken as a benchmark. See for a thorough analysis Vanberg (2008), pp. 23-48.*

5/ *E.g. Zeppernick (1987), p. 9.*

6/ *Schlecht (1990), pp. 42 et seq, p. 198.*

- 7| *Schlecht (1990), pp. 188 et seq.*
- 8| *Watrin (1980), p. 491.*
- 9| *We will not discuss the notion of moral here. Referring to Homann, moral behavior is regarded as intrinsically motivated orientation on values such as environment protection, care for others etc. Moral behaviour could however lead to cost disadvantages in competition if these values are not generally binding for all market participants (Homann (1994), pp. 16-17).*
- 10| *Cf. Homann (1994).*
- 11| *E.g. Schlecht (1990), pp. 62 et seq., Vanberg (2008), pp. 61 et seq. Roth (2002), pp. 118 et seq.*
- 12| *Vanberg (2008), pp. 36 et seq.*
- 13| *It would lead too far to analyze thoroughly the idea of constitutional economics here. See e.g.: Vanberg (2008), pp. 24 et seq.*
- 14| *Ibid., p. 38.*
- 15| *Eucken (2004), pp. 30 et seq.*
- 16| *Vanberg (2008), pp. 57 et seq.*
- 17| *Kirchgässner (1991), pp. 49 et seq.*
- 18| *Watrin (1985), pp. 138 et seq.*
- 19| *Watrin (1980), pp. 486 et seq.*
- 20| *Hayek (1969), pp. 118 et seq.*
- 21| *Roth (2007), p. 53.*
- 22| *Cf. Hayek (2003).*
- 23| *Gäfgen (1989), pp. 14 et seq. Totally equalizing health status – even if it was possible – would imply consuming many resources which would in turn be lacking for other, more beneficial purposes.*
- 24| *Cf. Milbradt (2005).*
- 25| *Maitland (2002), p. 453.*
- 26| *These approaches follow the model of “Private Citizens’ Insurance”, which has been developed at the Institute of Economic Policy and the Otto-Wolff-Institute. A more detailed account can be found in Eekhoff et al. (2008).*
- 27| *Eekhoff et al. (2008), p. 75, Oberender/Zerth (2004), p. 114.*
- 28| *Zimmermann (2007), p. 158.*
- 29| *Informational asymmetries for instance and the resulting moral hazard issue can be limited by deductibles.*
- 30| *This section basically follows Eekhoff et al. (2008), pp. 80 et seq. and pp. 105 et seq.*
- 31| *Without medical-technological progress and without changes in relative prices, insurers calculate with constant premiums over the life-cycle. When young, the premium is higher than the expenses for the insurant. Thereby, ageing provisions are accumulated to finance higher expenses when insurants get older.*
- 32| *Solidarity as a mutual acceptance of responsibility in a society (Thuy (1999), p. 29. Translation by the authors).*
- 33| *Jankowski/Zimmermann (2003), p. 11, Eekhoff et al. (2008), p. 43.*
- 34| *Eekhoff et al. (2008) p. 36.*
- 35| *The proponents of an all citizens’ health insurance scheme also advocate the inclusion of all sources of income in the contribution base. The all citizens’ health insurance is a statutory insurance for the whole population, contributions are levied on all sources of income. Apart from the difficulties which arise from the inclusion of (house) rents (negative income possible), bureaucratic costs have to be born in mind: The process of examining the ability-to-pay and means-testing would have to be made both in the health insurance and in the tax-transfer system for the whole population (see Eekhoff et al. (2008), pp. 68 et seq.).*

36/ Knappe/Arnold (2002), p. 11.

37/ [http://www.bundesregierung.de/nn\\_1272/Content/DE/Artikel/2009/10/2009-10-07-neue-rechengroesse-in-der-sozialversicherung-fuer-2010.html](http://www.bundesregierung.de/nn_1272/Content/DE/Artikel/2009/10/2009-10-07-neue-rechengroesse-in-der-sozialversicherung-fuer-2010.html).

*The opt-out-threshold is higher than the contribution assessment ceiling, which is set at 45,000 Euro yearly income from wages for the year 2010. If someone has decided to opt-out at a certain time, it is almost impossible for this person to return to the statutory system.*

38/ Eekhoff et al. (2008), pp. 45 et seq.

39/ *Besides income redistribution, further distributional measures are implemented in the health insurance, such as non-contributory insurance of children and spouses. These measures are also conducted for alleged solidarity reasons. The unequal treatment of singles and spouses and of different models of division of labour within a family are however not solidary at all, all the more because the most needy are excluded from this "solidarity". Please see Zimmermann (2007) for a thorough investigation of the unsystematic redistribution.*

### III. POTENTIAL AND PERSPECTIVES OF THE SOCIAL MARKET ECONOMY IN THE CONTEXT OF EUROPEANIZATION AND GLOBALIZATION

# OLD WINE IN NEW SKINS?

ECONOMIC POLICY CHALLENGES FOR THE SOCIAL MARKET ECONOMY  
IN A GLOBALIZED WORLD

*Bodo Herzog*

## **1. ABSTRACT**

The growing interactions of the real and financial economy – one of the main features of trade and financial globalization – is increasingly alarming, since the aftermath of the financial crisis of 2007 and 2008. This paper analyzes the lessons and challenges of Germany's unique model: The "Social Market Economy". More and more countries notice that Germany has an interesting alternative due to its distinctive balance between the idea of free and competitive markets, combined with social systems and justice. The potential benefits are illustrated by the historical growth performance after World War II and the current employment policy free from increasing unemployment rates despite the recession. Achieving the primary goals within the Social Market Economy requires a strong government and a distinct economic framework including a property rights scheme. However, globalization limits the domestic effectiveness of national policy decisions and thus the positive implications of government decisions in the Social Market Economy are not realized. Additionally, in a globalized world there is more competition, even between the different economic systems. To close the gap between the old German model and the chal-

lenges of globalization, we develop some necessary extensions. In particular, we take into consideration a so-called threefold sustainability model, including economy, ecology and demography. This triad fully encases the historical idea of the Social Market Economy and is in line with the needs of globalization. Finally, the paper analyzes the current conflict areas, and develops guidelines for the future challenges in a globalized world.

## 2. INTRODUCTION

In recent years and since the onset of the financial crisis, concerns have grown about the negative aspects of globalization and especially financial globalization. The belief that free trade and free markets favor only rich countries and rich persons is discussed all around the globe. The current crisis showed how volatile capital markets and frozen interbank markets hurt the country's economic growth performance and the citizen's well-being. The "anti-globalization" movement highlights the social costs of the crisis, the loss of local control over economic policy instruments and developments, and the disappearance of jobs. They also criticize the governments for moving too slowly in tackling these concerns. With the current financial crisis in mind, we would argue partly right.<sup>1</sup>

However, in recent years both sides began to realize that the debate should center on how best to manage the process of globalization – at the national and international level – so that the benefits are widely shared and the costs kept to a minimum. There is no question about the challenges ahead, and that greater integration and coordination efforts in the world economy are needed. Moreover, the offering of a brighter future for all, provides perhaps the surest path to greater global security and world peace. This understanding should attract support for the work needed to address the remaining challenges of globalization, as it is necessary for the future development and diffusion of the Social Market Economy.

The rigorous economic theory represented by the old Heckscher-Ohlin or the Stolper-Samuelson model of trade suggests that a fully integrated world economy provides the greatest scope for maximizing human welfare. However, this proposition is based on strong assumptions. In the real world, we all know that there are still many barriers and market imperfections. Recent developments of increasing inequality and volatility



showed that model implications are only one side of the coin. Therefore to a greater extent people are skeptical and even critical to the globalization process. In addition, people have the same attitude towards Germany's Social Market Economy. In the last decade, there has been a dramatic decline in the acceptance of the Social Market Economy, despite the historical and current success: Catch-up process after World War II and the unique approach of short-term working hours during the current recession.

The following paper is organized as follows. The next section compares the historical and the recent process of trade globalization and identifies the driving forces. Section 3, analyzes the impact of financial globalization and the challenges of financial market stability. Basically the weak point during the current financial turmoil. In section 4, we derive policy conclusions to tackle the immense problems of – in particular – financial globalization. However, the current challenges and problems arise due to the fact that income-inequality and financial-stability are more international policy issues than domestic. Hence, we argue to extend the model of the Social Market Economy towards these international dimensions. The last section 5 concludes the main body of the paper.

### **3. EXPERIENCE OF GLOBALIZATION FROM A HISTORICAL PERSPECTIVE**

It is instructive to start and compare the post-1950 period of globalization with the previous phase of strong globalization that occurred in the late 19<sup>th</sup> to early 20<sup>th</sup> century, as they are probably the two periods of strongest sustained output growth in world history. The turn of the century also exhibited rapid growth in particular in world trade. The share of exports in world output reached a peak in 1913 that was not surpassed in 1970. Growth in trade occurred partly as a result of reduced tariffs, but more importantly due to sharply falling transaction and transport costs and the technological process in this time period (Table 1).

*Table 1: Comparison of Transport/Communication Costs, 1920-1990 and 1960-2000*

<b>Years</b>	<b>Ocean Freight</b>	<b>Cost of a 3-minute Telephone Call in US \$ (New York to London)</b>
1920	100,00	
1930	65,00	
1940	67,00	
1950	38,00	
1960	28,00	60,42
1970	29,00	41,61
1980	25,00	6,32
1990	30,00	4,37
2000		0,40

Source: Baldwin and Martin (1999)

In the 50 years before World War I, there was a massive flow of capital from Western Europe to the rapidly developing countries. At its peak, the capital flow from Britain reached nine per cent of GNP, and was almost as high in France, Germany, and the Netherlands. Capital importing countries, such as Canada, had current account deficits that reached 10 per cent of GDP. These levels of net capital flows were favored by the fact that the world was on the gold standard which ensured convertibility and stable exchange rates. Moreover, migration was also very large during this time period and equaling five to seven per cent of the population in several of the European countries sending emigrants, four to nine per cent in the United States, and much higher figures for other "new world" countries receiving immigrants.<sup>2</sup>

The late 19<sup>th</sup> century to the early 20<sup>th</sup> century period of globalization came to an immediate end with the outbreak of World War I. Additionally, the unsuccessful attempt to revive the gold standard, and the onset of the great depression nearly stopped globalization. Governments mistakenly thought that they could protect their citizens from an economic downturn abroad by raising tariffs and restricting imports. In fact, this just worsened the global depression and led to dramatic decline in trade, plunging output, and pervasive unemployment. The post-1950 years of globalization and prosperity in particular in destroyed countries as Germany has been driven by the lowering of the barriers to trade and capital

flows erected in the 1930s, as well as continued decline in transportation costs and, especially recently, communication costs due to IT-revolution.

The current period of globalization is in several respects less pronounced than the pre-World-War-I period; maybe with some exception of the financial booms and busts in the past years. While the nature of technological innovations that characterize the recent period (such as computers, internet and mobile-communication) is no doubt unique, the earlier period was also characterized by major inventions (steamship and trains, telephone) that decreased communication and transportation costs. Even then technology change was a major force for increasing the interdependence among countries, thus catalyzing globalization.<sup>3</sup> Conversely, globalization, in the form of the spread of information across borders, has allowed a far greater number of people to share in the benefits of those innovations.

Clearly, real GDP growth between 1950 and 1970 creates the means necessary for sharing the benefits of globalization among the population: Only with growth are the poor able to lift themselves from poverty. Cross country evidence suggests that incomes of the poorest 20 per cent of the population increases roughly one-for-one with average per capita income: Growth is good for jobs and the poor.<sup>4</sup> The evidence is strong that openness in international goods trade is a key ingredient of more rapid growth and world wealth.<sup>5</sup> However, it is a huge fallacy to believe that openness in financial trade and free financial markets – in other words financial globalization – have the same positive implications as trade globalization.<sup>6</sup> Not surprisingly, recent economic studies and the recent experience of the financial bubbles and financial crises teach us the opposite.

#### **4. FINANCIAL GLOBALIZATION AND FINANCIAL STABILITY**

Financial globalization is just one dimension of the complex process of globalization. Without doubt, this process has changed the economic landscape worldwide in recent decades, and not only the economic landscape. The main changes brought by financial globalization are trends towards intensive cross-border financial and payment flows, greater risk-share of cross-border activities through a broader array of financial instruments, an increasing share of cross-border holdings of assets and an increasing international profile of financial markets,

market players and institutions.<sup>7</sup> These developments in the global financial system are, to some extent, the source of the current crises due to the lack of regulation and rules. In this sense, we are now ready for a “second wave” of financial globalization – hopefully in a more sustainable manner and a framework embedded in the Social Market Economy.

The well-known driving forces of this process are technological advances in transmission of information, the decreasing cost of communication and the quickening pace of financial innovations – names as ABS CDO, MBS CDO, CDS and so on.<sup>8</sup> These developments lead to a gradual shift from the government-dominated system to a market-dominated system. Market-based financing has taken place as the standard tool and hence the banking core business has forced them to search for other opportunities both at home and abroad.<sup>1</sup>

Undeniably there are several positive effects. For instance, FDI has clear benefits for host countries because it is often associated with transfer of technology as well as financing, and it tends to be more stable than other countries flows. Recent crises have pointed to the need to provide appropriate incentives for capital to stay in a country and not flee at the first sign of trouble. Generally countries with open capital accounts tended to grow faster. In the 1980s and 1990s some papers<sup>9</sup> found that financial openness – i.e. not financial markets without appropriate rules and oversight over the institutions and financial market – brings significant more stability, efficacy, competition and improved diversification of domestic risks and lower moral hazard.<sup>10</sup> Despite several positive effects the current crises illustrated the big negative points.

The trade-off of costs and risks were not accompanied by frequent supervision or regulation. Hence, the trade-off was imbalanced and increased the risks for financial instability. There is a definitive lack of institution-building, a lack in control and no appropriate regulation for some financial innovations. Financial instability implies that due to some shocks the financial markets are not properly performing their standard functions, i.e. effective mediation between creditors and debtors, spreading of risks and efficient allocation of resources over time.

#### 4.1. Policy responses: How to preserve financial stability?

The main avenues for coping with the impact of financial globalization on financial stability which have not developed properly in recent decades are:

- (A) The departure from the pegged exchange rate regime of the Bretton Woods tradition and the shift to flexible exchange rates;
- (B) The problem of global imbalances and the massive development of currency reserves in particular in Asian countries;
- (C) The implementation of an extensive system of prudential regulation and supervision as well as a financial product control body;
- (D) The proper sequencing of liberalization and institution-building, an issue of particular importance to all economies as the current crises show.

Each of these approaches has its merits, but also its limits. Their contribution to the preservation of financial stability has proved to be only partial reality and, consequently, the search for further solutions inevitably goes on. In this respect, one issue of reasoning appears to open up for discussion: Should monetary policy also address financial stability?

The ultimate goal of price stability and financial stability are in principle mutually reinforcing. Data show that central banks and their monetary policies have been quite successful in keeping inflation in check in recent decades. A low-inflation environment has been sustained in most national economies, including transition economies and emerging markets. However, the frequent occurrence of financial imbalances, asset and house price bubbles and overt financial, banking and currency crises has proved that low inflation does not guarantee financial stability. In fact, several financial crises and asset price bubbles have developed in an environment of low and stable inflation. The US economy is the best example.

The ongoing debate on what role financial imbalances and asset prices should play in monetary policymaking can be classified into two opposing approaches. According to the first one, central banks should take into account information from asset price movements and financial imbalances if and insofar as they have an impact on the inflation figures and the goals of monetary policy. This seems to be subject to little disagreement.

The other approach suggest that central banks should respond to imbalances as they build up, even when the (short-term) outlook for inflation and growth does not seem to be affected and remains favorable. The argument is that growing imbalances will have adverse consequences if left unchecked. This will become true if and when these imbalances develop too far and prove to be out of line with fundamentals. The unwinding of such imbalances can be rather costly to the real economy as the current crises shows.

Therefore, many international economic institutions and advisory body's in particular the "German Council of Economic Experts" (for: *Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung*), an institution that supports the idea of the Social Market Economy, suggested the implementation of the financial stability target into the "Two-Pillar-Strategy" by the European Central Bank. The so-called pre-emptive or proactive approach should be used not only to cushion the consequences of financial imbalances, it should be used to decrease ex ante the probability of such imbalances and decreasing their potential magnitude, having a negative impact. Despite some disagreement among experts, even the International Monetary Fund (IMF) and the Bank of International Settlements (BIS) discusses this idea right now.

Regarding the issues listed from (A) to (D) above, we have an ongoing discussion on the national, the European and the International level – for instance during the last G20 meetings. The current and past crises illustrate the necessity of new international institutions in the field of financial markets. Each market needs an appropriate institutional framework – that is one key message of the Social Market Economy. The current national and international regulatory and institutional framework in financial markets is an absolute structural weakness for the globe.

According to the Social Market Economy model each free and competitive market needs certain rules of working to be in line with the principles.<sup>12</sup> However, due to the international aspects of financial markets all domestic policy solutions are neither possible and in most cases not appropriate. The German model does not offer any answer to the past financial dynamics. The key question based on an extended version of the Social Market Economy is: Who controls international financial markets?

The implementation of the Social Market Economy on the international level will provide an adequate analytical tool to detect such weaknesses along with timely possible solutions. Hence, prior to liberalization of (financial) markets we need sound macroeconomic policies, effective supervisory and new regulatory institutions like the German cartel office in the 1950s. These are the key lessons for policymakers at home and abroad.

Moreover, liberalized financial systems appear to be “inherently procyclical”, as Borio<sup>13</sup> shows. Credit spreads, asset prices, internal bank ratings and loan loss provisions all move procyclically. Keeping this in mind, the regulation applied has also proved to be procyclical in nature, exacerbating cyclical developments in individual economies.<sup>14</sup> To correct for this, a more systematic response to the expansionary and contractionary phases of the business cycle has been sought when devising prudential regulation instruments. The current financial turmoil shows the importance and necessity of a macro-prudential regulatory framework that putting more emphasis on the health of financial system as a whole, rather than the state of individual institutions, as was the case in the past.

To contrast these findings with the model of the Social Market Economy, we learn that the old Social Market Economy model is in the present period not entirely appropriate. Therefore, we argue, that we need an extension of the Social Market Economy in a globalized world. We identify two dimensions: Sustainability and international aspects. In the next section, we develop the modern version of the Social Market Economy that is ready to tackle the challenges of globalization.

## **5. POLICY CHALLENGES FOR THE SOCIAL MARKET ECONOMY ACCOMPANYING GLOBALIZATION**

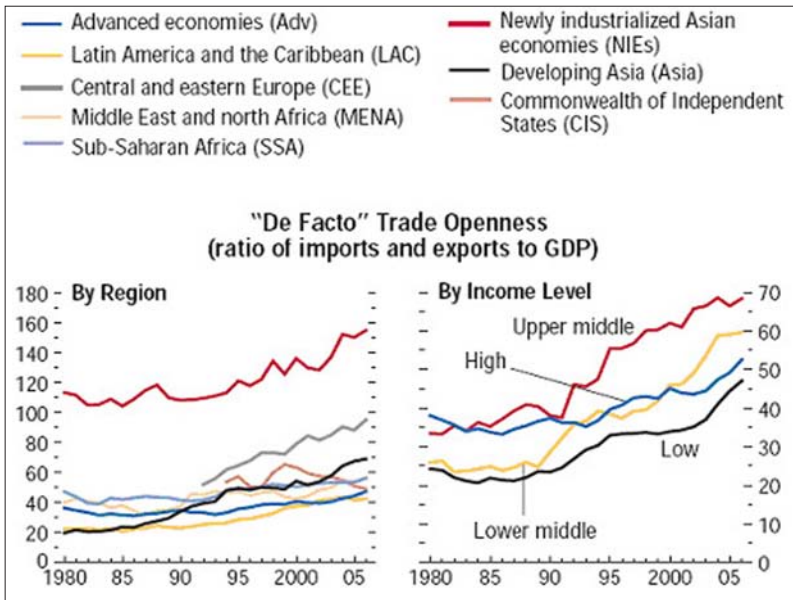
While globalization generally brings benefits, it is also associated with problems which have raised legitimate concerns.<sup>15</sup> Apart from cultural, environmental, and political issues, which are not discussed here, the two principal areas of concern are both essential fields in the concept of the Social Market Economy: Firstly, inequality both within and across countries and secondly, stability and volatility in economic and financial markets. In particular, there has not been a narrowing of global income inequalities in recent years. This is proven by the large number of de-

bates in Germany, in the USA and many countries around the globe. Moreover, in the recent period volatility has increased dramatically as the large number of financial crises and stock market crashes illustrates. In both areas, there is lots of room for improving government policies and the operation of the international institutions in order to widen the access and acceptance to globalization, and in particular the acceptance to the concept of the Social Market Economy.

### 5.1 Inequality

World trade has grown five times in real terms since 1980, and its share of world GDP has risen from 36 per cent to 55 per cent over this period (Figure 1).

Figure 1: Trade Globalization



Source: WEO (2007)

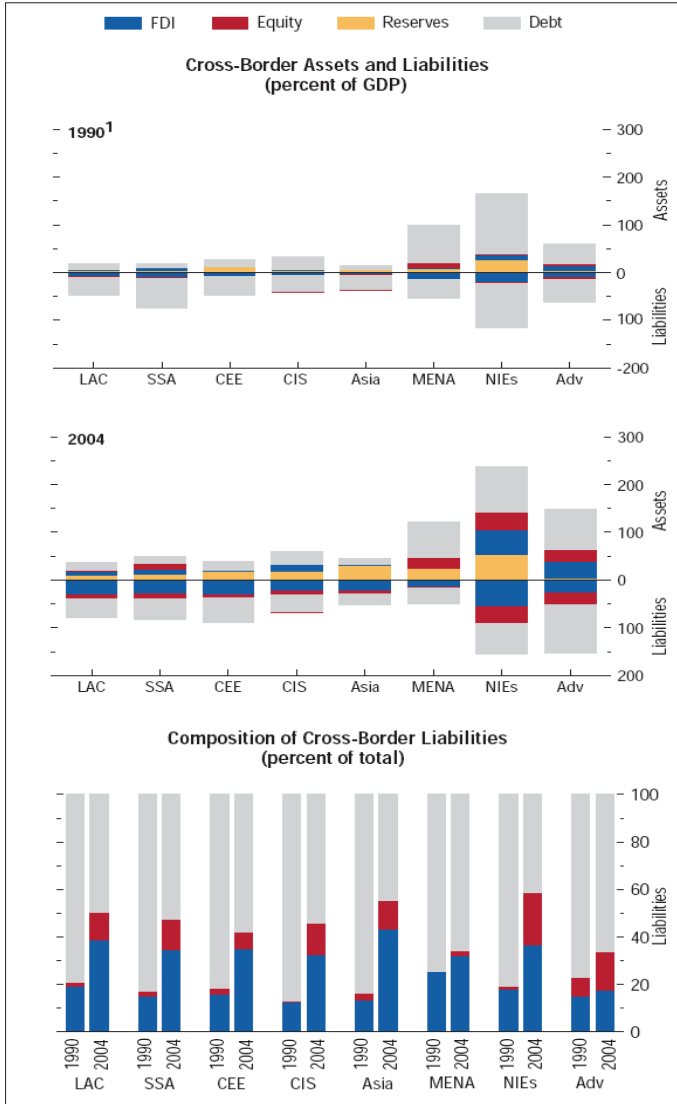


Trade integration accelerated in the 1990s, as past Eastern bloc countries integrated into the world trade system and as emerging Asia – one of the most closed regions to trade in 1980 – progressively dismantled barriers to trade. However, it is remarkable that all groups of emerging market and developing countries, when aggregated by income group or by region, have been catching up with or surpassing high-income countries in their trade openness, reflecting the widespread convergence of low- and middle-income countries' trade systems toward the traditionally more open trading regimes in place in advanced economies.

Financial globalization has also proceeded at a very fast pace over the last two decades. Total cross-border financial assets have more than doubled, from 58 per cent of global GDP in 1990 to 131 per cent in 2004. The advanced economies continue to be the most financially integrated, but other regions of the world have progressively increased their cross-border asset and liability positions (Figure 2).

However, *de jure* measures of capital account openness present a mixed picture, with the newly industrialized Asian economies (NIEs) and developing economies showing little evidence of convergence to the more open capital account regimes in advanced economies, which have continued to liberalize further. The share of FDI in total liabilities has notably risen across all emerging markets – from 17 per cent of their total liabilities in 1990 to 38 per cent in 2004 – and far exceeds the share of portfolio equity liabilities, which rose from two per cent to 11 per cent of total liabilities over the same period. Reduced government borrowing needs have also contributed to the changing of liability structures, with the share of debt in total liabilities falling across all emerging market and developing country regions. Not surprisingly, the share of international reserves in cross-border assets has also risen, reflecting the accumulation of reserves among many emerging market and developing countries in recent years.

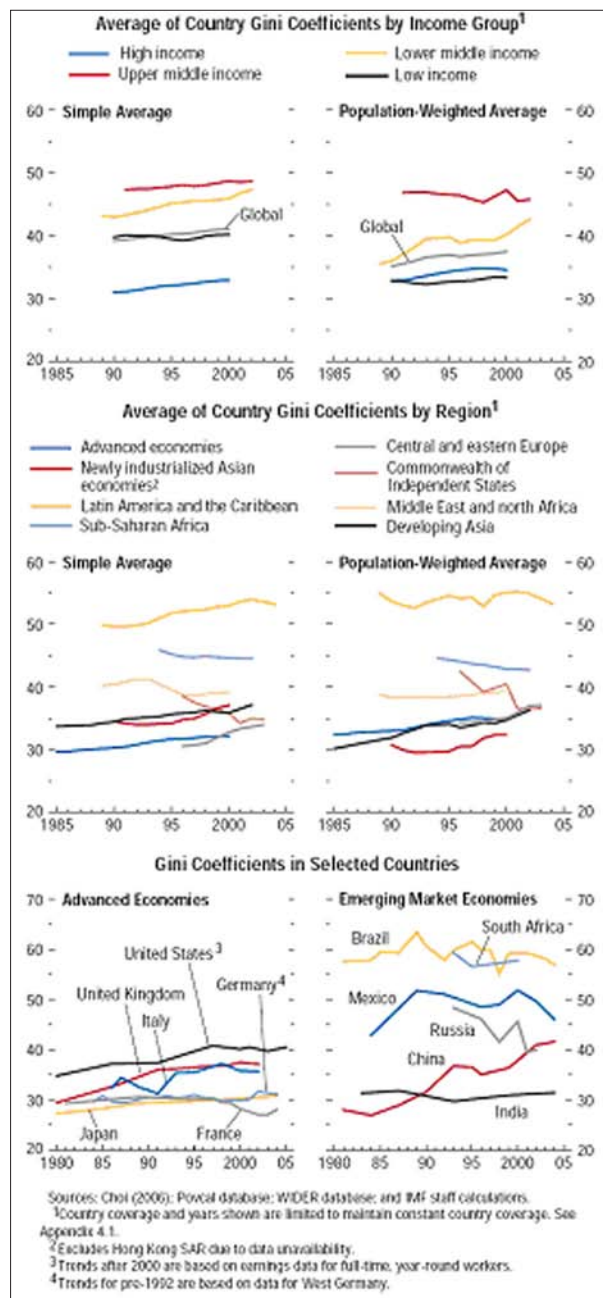
Figure 2: Financial Globalization



Source: WEO, 2007

Based on observed movements in Gini coefficients (the most widely used summary measure of inequality), inequality has risen in all regions except the low-income country aggregates over the past two decades, although there are significant regional and country differences (Figure 3).

Figure 3: Inequality



The channels through which globalization affects inequality are complex. The principal analytical link between trade liberalization and income inequality provided by economic theory is derived from the Stolper-Samuelson theorem: It implies that in a two country two-factor framework, increased trade openness in a developing country where low-skilled labor is abundant would result in an increase in the wages of low-skilled workers and a reduction in the compensation of high-skilled workers, leading to a reduction in income inequality.<sup>16</sup> After tariffs on imports are reduced, the price of the (importable) high skill-intensive product declines and so does the compensation of the scarce high-skilled workers, whereas the price of the (exportable) low skill-intensive good for which the country has relatively abundant factors increases and so does the compensation of low-skilled workers. For an advanced economy in which high-skill factors are relatively abundant, the reverse would occur, with an increase in openness leading to higher inequality.

An important extension of the basic model that weakens the dichotomy between advanced and developing economies in terms of distributional effects is the inclusion of “non-competing” traded goods, that is, goods that are not produced in a country and are imported only as a result, for example, of very large differences in endowments across countries. Tariff reductions would reduce the prices of these goods – and therefore increase the effective real income of households – without affecting wages and prices of other traded goods. If this non-competing good is a large share of the consumption basket of poorer segments of society, a drop in the tariff on the non-competing good would diminish inequality in that country. In general, in both advanced and developing economies, if tariffs are reduced for non-competing goods that are not produced in a country but are consumed particularly by the poor, it would lead to lower inequality in both advanced and developing economies. The implications of the Stolper-Samuelson theorem, in particular the ameliorating effects of trade liberalization on income inequality in developing countries, have generally not been verified in economy-wide studies.

A particular challenge has been to explain the increase in skill premium between skilled and unskilled labor observed in most developing countries. This has led to a range of alternative approaches, including the introduction of (1) multiple countries where poor countries may also import low skill-intensive goods from other poor countries and rich countries may similarly import high skill-intensive goods from other rich countries; (2) a continuum of goods, implying that what is low skill-

intensive in the advanced economy will be relatively high-skill intensive in a less-developed country<sup>17</sup>; and (3) intermediate imported goods used for the skill-intensive product. However, these extensions have presented additional challenges for empirical testing, and none of them has been consistently established.

This has led to explanations for rising skill premiums based on the notion that technological change is inherently skill biased, attributing to the observed increases in inequality (including in advanced economies) to exogenous technology shocks. Any empirical estimation of the overall effects of globalization therefore needs to account explicitly for changes in technology in countries, in addition to standard trade-related variables. An additional important qualification to the implications deriving from the Stolper-Samuelson theorem relates to its assumption that labor and capital are mobile within a country but not internationally. If capital can travel across borders, the implications of the theorem weaken substantially. This channel would appear to be most evident for FDI, which is often directed at high-skill sectors in the host economy. Moreover, what appears to be relatively high skill-intensive inward FDI for a less-developed country may appear to be relatively low skill-intensive outward FDI for the advanced economy. An increase in FDI from advanced economies to developing economies could thus increase the relative demand for skilled labor in both countries, increasing inequality in both the advanced and the developing economy.

The empirical evidence on these channels has provided mixed support for this view, with the impact of FDI seen as either negative, at least in the short run, or inconclusive. In addition to foreign direct investment, there are other important channels through which capital flows across borders, including cross border bank lending, portfolio debt, and equity flows. Within this broader context, some have argued that greater capital account liberalization may increase access to financial resources for the poor, whereas others have suggested that by increasing the likelihood of a financial crisis, greater financial openness may disproportionately hurt the poor. Some recent research has found that the strength of institutions plays a crucial role: In the context of strong institutions, financial globalization may allow better consumption smoothing and lower volatility for the poor, but where institutions are weak, financial access is biased in favor of those with higher incomes and assets and the increase in finance from tapping global rather than just domestic savings may further exacerbate inequality.<sup>18</sup>

Thus, the composition of financial flows may matter, and the net impact may also be influenced by other factors, such as the quality of financial sector institutions. In summary, analytical considerations suggest that any empirical analysis of the distributional consequences of globalization must take into account both trade and the various channels through which financial globalization operates, and also account for the separate impact of technological change.

## 5.2 Volatility

The second major problem in financial markets concerns the volatility that openness to global capital markets seems to bring, and more generally the volatility of economic activity. Since 1970, we have seen a series of financial crises affecting individual countries, regions, and even global financial markets. Recent international financial crises seem to be the result of home-grown vulnerabilities related to financial sector weaknesses, overvalued exchange rates, huge current account deficits, and unsustainable fiscal positions. All of which are often accompanied by volatile market sentiments and contagion effects from other countries. But the experience of these crises has been that they brought dramatic movements in stock markets, exchange rates and current account balances that far exceeded any initial disequilibrium, and were associated with severe economic downturns. In fact, we have to realize that over the recent period the economic system was more in disequilibrium than in equilibrium which is not appropriately modeled within the “dynamic stochastic general equilibrium” (DSGE) models.

Another aspect of globalization is that the spread of the information technology (IT) revolution has strengthened real and financial linkages across countries.<sup>19</sup> The prices of IT goods have gone through large swings in recent years, and as a result a number of Asian countries and others have been exposed to high volatility in their export earnings. In addition, business cycles, flows of foreign direct investment, and stock prices indices have become more synchronized as a result of the increasing importance of IT goods for many countries.<sup>20</sup> Volatility derived from exposure to the global market for IT goods, combined with the uncertainty concerning underlying productivity growth, call for greater prudence in setting macroeconomic policies.

### 5.3 New Policy Response

Governments, with the help of the international institutions, need to address both problems boldly and swiftly. However, the political credibility to change both problem fields is of equal importance because nobody can easily change these issues alone. Moreover, it needs a longer time horizon and a sustainable approach.

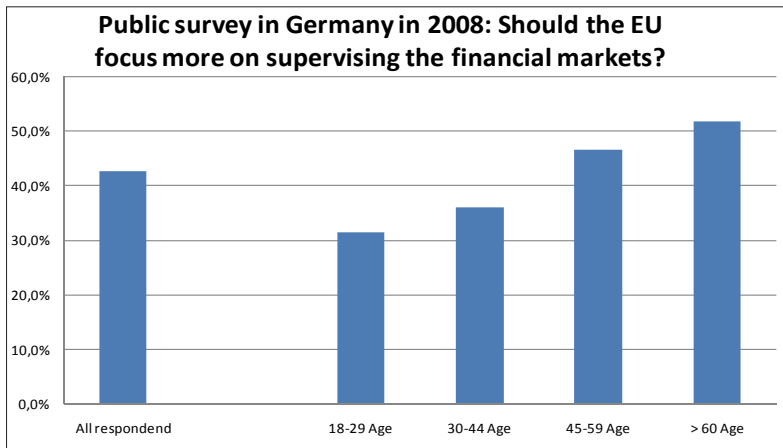
The persistence of poverty requires adequate social safety nets to mitigate negative effects on the most disadvantaged, as well as government spending on public education, health, and security, which helps to equalize opportunities. Tax competition and the growing debt level, however, limit the scope for governments to raise revenue. Hence, international coordination is necessary not only to tackle the current financial crisis, it is also necessary to solve the big problems in a globalized world. Policies aimed at maintaining macroeconomic stability can help moderate the unemployment and wage losses associated with economic contractions, as well as the unfavorable effects of inflation, which has a disproportionately heavy impact on the poor.

Another important step is the further opening by rich countries of their markets to exports from developing countries by reducing tariff and non-tariff barriers and domestic subsidies so that the less developed countries can get the full benefits of the global trading system. Calls in rich countries for environmental and labor standards in developing countries are often presented as being motivated by a concern for limiting the adverse impact of globalization on poor countries. In fact, their effect would be to create barriers to the growth-creating trade that permits poor countries to narrow the gap with the rich countries.

Currently, improvements in the international financial architecture are of highest priority. The ultimate goal is a decreasing likelihood of crises and mitigation of their costs. We need appropriate regulatory institutions for the financial markets (at least at the European level), enhanced early warning systems and improved rating schemes, transparency, and appropriate equity insurance schemes in particular for systemic institutions.<sup>21</sup> In a public survey in 2008, the *Institut für Demoskopie Allensbach* asked German citizens to assess the perception towards the Social Market Economy and to evaluate a solution concept to tackle the current financial turmoil in line with the Social Market Economy (Figure 4).

Surprisingly, more than 40 per cent are in favor of more European (or international) institutions regarding the financial markets. However, at the same time roughly 30 per cent are in favor of the Social Market Economy and have a positive opinion about Europe. Moreover, older people with more historical experience have even a higher support for European institutions. Without doubt, the German citizens see the necessity to extend the old Social Market Economy for a globalized world. It's now time for politics to support this positive judgment and to change the Social Market Economy towards globalization.

Figure 4: Public opinion in Germany about the international dimension



Source: *Institute für Demoskopie in Allensbach* (2008)

Firstly, besides finding solutions to the above mentioned problems, we need to find ways to effectively implement all of these solutions. This means keeping in mind that issues formerly seen as national – including financial markets, the environment, labor standards, and economic accountability – are now seen to have international aspects. The ripple effects of actions taken in one country tend to be far greater and to travel faster than ever before. A purely national approach to solving some problems risks merely pushing the problem across the frontier without providing a lasting solution even at the national level. Secondly, we need to ensure that measures are taken to meet internationally agreed explicit targets. Failing to reach the targets should have an immediate impact to politics. Thirdly, we need to revisit the institutions of global governance, to establish mechanisms to implement global sustain-



able solutions to global problems, and to ensure that governments become responsible and more accountable. The fact that countries usually participate in open and cooperative multilateral systems when it comes to economic issues is reflected by the now virtually universal membership of IMF, World Bank and G20. These lessons add up to a heavy agenda for the international and European community. Globalization holds the promise of enormous benefits for all citizens of the world. To make this promise a reality, however, we must find a way to carefully manage the process. Better attention must be paid to reducing the negative effects and ensuring that the benefits are widely and fairly distributed. The revitalized and extended German model of the Social Market Economy is one of the best alternatives to capture the future challenges of globalization even on the international level due to the predictable structure and universal values and the success during both periods of globalization.

## **6. CONCLUSIONS**

In a nutshell, the first step is to strengthen the macroeconomic and financial stability in a sustainable way. Indeed, globalization that is managed properly has widespread benefits and is in line with the Social Market Economy. However, politicians must become aware of dramatic global changes – huge financial integration without any regulatory and supervising framework at the international level. Hence, we have to include the new globalized dimension into the concept of the Social Market Economy. An excellent way to grip the extension of the old Social Market Economy model is straightforward: (A) economical, ecological and demographical sustainability and (B) higher degree of internationality in respect of the solution concepts.<sup>22</sup> These newly designed policies, can be harnessed to reduce the negative aspects of globalization while at the same time keeping financial markets in check. Moreover, it strengthened the credibility of the “Sustainable-International Social Market Economy” in a responsible manner. The alternative, to do nothing and keep the old Social Market Economy model wouldn’t solve the current national and international problems and challenges. In fact, it will more likely reduce prosperity and stability with unfavorable effects on both the rich and poor alike.

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- 1| Herzog (2009a).
- 2| Cf. Baldwin / Martin (1999).
- 3| Cf. Imbs (2006).
- 4| Cf. Dollar / Kraay (2001), Matusz / Tarr (1999).
- 5| Cf. Srinivasan/ Bhagwati (1999), Lindert / Williamson (2001).
- 6| Cf. Rogoff et al. (2006).
- 7| Cf. Lane / Milesi-Ferretti (2001).
- 8| Cf. Gordon /2008) and Herzog (2008).
- 9| Cf. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2007/2008).
- 10| Cf. WEO (2001).
- 11| Cf. Litan et al. (2001), Mishkin (2001).
- 12| Cf. Abelshausen (2009).
- 13| Cf. Borio et al. (2001).
- 14| Cf. Rochet (2004), Kahn/Santos (2005), Mitchell (2000), Boot/Greenbaum (1993).
- 15| Cf. Matthes et al. (2008).
- 16| Stolper / Samuelson (1941).
- 17| Cf. Feenstra / Hanson (1996).
- 18| Cf. Prasad (2007), Claessens/Perotti (2008).
- 19| Cf. WEO (2001).
- 20| Cf. Bordo / Helbling (2003).
- 21| Cf. Herzog, (2009a), Herzog (2009b).
- 22| Cf. Herzog (2008).

# ADDRESSING THE MARKETING PROBLEM OF THE SOCIAL MARKET ECONOMY

*Marcus Marktanner*

## **1. ABSTRACT**

Although the model of the Social Market Economy increasingly enjoys interest from other countries, it has a marketing problem. First, the term social is still too easily confused with socialist. Second, the meaning of order, which is so crucial to German speaking economists having grown up in the tradition of the German historical school, could never be successfully popularized among colleagues educated in the tradition of Anglo-Saxon economics. Third, the idea that the combination of the efficiency of the market is possible with equitable social development, which defines the idea of the Social Market Economy, has never been seriously explored from an empirical perspective. Fourth, neither have there been efforts to conceptualize Social Market Economics in a formal method, which could have helped it to gain academic interest from economists in the Anglo-Saxon tradition as well. The objective of this paper is to explore avenues to ameliorate this marketing problem.

## 2. INTRODUCTION

The Social Market Economy has a marketing problem. The attribute social is too easily confused with socialist. The meaning of ordoliberalism could never be successfully placed in mainstream economics. Empirical studies have been neglected. Not trying to formalize Social Market Economics has kept it marginalized. English publications are scarce. Social Market Economics does not even have a separate Journal of Economic Literature classification. There is no major textbook for Social Market Economics, not even in German. Neither are there any major international Social Market Economics conferences or academic journals.

The food, fuel, financial, and economic crises, which have begun in 2007, have led to an ideological crisis as well. Some lament the hegemony of unfettered market liberalism, others governmental interferences such as subsidies to agriculture and biofuel, or the lack of equality of economic opportunities, or the resort to hyperactive Keynesianism. Again the question is asked: What is the role of the state and the market? It is a question to which Social Market Economists have positioned themselves already beginning in the 1930s, but failed to make them clearly heard, although these early positions are as timely today as they were back then. This is therefore a good time for Social Market Economists to address its marketing problem, clarify again some misunderstandings, re-highlight important concepts, explore new avenues of research, and launch efforts to make Social Market Economics a louder voice in academia and politics. In this marketing campaign, five aspects deserve particular attention:

- Social Market Economy – Social, Not Socialist!
- Ordoliberalism – Law and Order for Economic Freedom and Equitable Social Development
- Social Market Economics – Microeconomic Foundations and Limits
- Social Market Economics – Macroeconomic Sympathies and Limits
- Social Market Economics – Is there Empirical Evidence?

## 3. SOCIAL MARKET ECONOMY – SOCIAL, NOT SOCIALIST!

Social Market Economics was developed as a third way<sup>1</sup> to socialism and unfettered market liberalism in Germany. The social question of industrialization, the rise of socialism, and cartelization during the Republic of

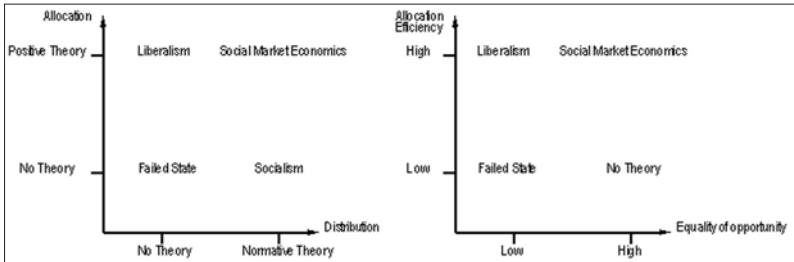
Weimar caused the intellectual fathers of the Social Market Economy to search for such a third way. Social Market Economics was meant to put post World War II Germany on a path that avoids the pitfalls of either alternative. It is not a combination of both.

What is the difference? Socialism is a normative theory of distribution that cannot be linked to a positive theory of efficient allocation while non-constrained market liberalism is a positive theory of efficient allocation that cannot be linked to a normative theory of distribution. Social Market Economics is a positive theory of allocation that is embedded in a normative theory of distribution.

Mueller-Armack (1956) defined Social Market Economics as the combination of the efficiency of the market with equitable social development. How to accomplish equitable social development is a normative question. Socialists believe that capital is concentrated in the hands of few industrialists who in the production process skim off the value added created by workers. In the words of Marx: "Capital is dead labor, which, vampire-like, lives only by sucking living labor, and lives the more, the more labor it sucks".<sup>2</sup> The presumably natural tendency of capitalism to create unequal societies could only be stopped by the nationalization of the means of production and central planning. Or, in the words of Marx and Engels: "The theory of Communism may be summed up in the single sentence: Abolition of private property".<sup>3</sup> Classical market economists, on the other hand, were much more optimistic. Infinite opportunities for the division of labor and market exchange would empower everyone. "It is the great multiplication of the productions of all the different arts, in consequence of the division of labour, which occasions, in a well-governed society, that universal opulence which extends itself to the lowest ranks of the people".<sup>4</sup> Social Market Economics rejects the socialist idea that states can replace markets and the market liberal prediction of markets empowering everyone. In line with Smith, Social Market Economists note with delight his emphasis on a "well-governed society," although Social Market Economists may have preferred the term well-ordered society. Figure 1 positions Social Market Economics relative to socialism and liberalism in terms of theoretical foundations and normative orientations.



Figure 1: Social Market Economics – Theoretical Foundations and Normative Orientation



According to Social Market Economics, neither the state nor the unconstrained market solves the scarcity problem. The socialist economy fails fully because it cannot assign scarce resources a scarcity indicator.<sup>6</sup> Market economies fail partially, because individual markets may fail. Social Market Economics is about limiting market failures without distorting the functionality of the price mechanism. To accomplish this objective, Social Market Economics has adopted certain principles of economic policy, which mostly go back to the work of Eucken (1952).<sup>7</sup>

Social Market Economics disagrees moreover with the normative assumptions underlying the just distribution of income. In socialism, equality of consumption is considered just, and in pure market liberalism whatever the market distributes. For Social Market Economists, socialism leads to ever more equal consumption with ever less production, beautifully analyzed by Buchanan (1993), while liberalism without equal opportunity leads to ever more production with ever less competition, as is implicit to Schumpeter's (1942) theory of creative destruction. In Social Market Economics, just is whatever the market distributes, provided that equal opportunities persist.

Equal opportunity justice, as opposed to socialist distributive justice and neoliberal efficiency justice, mirrors the principles of individuality, solidarity, and subsidiarity, which in turn have strong roots in the social ethics teachings of the Catholic Church.<sup>7</sup> The economic freedom of the individual is in the heart of Social Market Economics (individuality principle). Yet, as individuals may not have access to economic opportunities due to the presence of negative or the absence of positive externalities, the community will assist the individual in gaining access to equal opportunities through the provision of public goods (solidarity principle). For rea-

sons of efficiency, accountability, ownership, and capacity building, such public goods must be provided by the immediately affected citizens of these externalities (subsidiarity principle). The social in the Social Market Economy is therefore the combination of an economic model to solve the scarcity problem with a political model that gives individuals equal opportunities, whereas it is believed that the more equal opportunities exist, the better the scarcity problem will be solved.

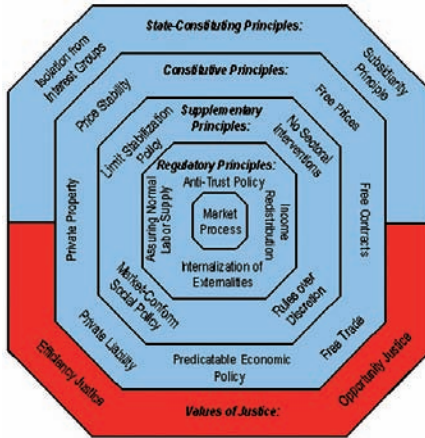
#### **4. ORDOLIBERALISM – LAW AND ORDER FOR ECONOMIC FREEDOM AND EQUITABLE SOCIAL DEVELOPMENT**

Ordoliberalism describes state- and market constituting principles as well as principles of economic policy that lend markets the law and order necessary for economic freedom and equitable social development. This order is illustrated by answering the following five questions:

1. What is the normative value system of the Social Market Economy?
2. What are the state-constituting principles?
3. What are market fundamental principles that are untouchable by the state?
4. When is the state supposed to interfere?
5. If the state is supposed to interfere, how is it supposed to so?

The Social Market Economy's value system is based on market efficiency that rests on equal opportunity. In terms of organizing public affairs, the subsidiarity principle and the separation of politics from special interest groups constitute the main state-constituting principles. Market actors must operate under free prices, free contracts, free trade, private property rights, private liability, price stability, and predictability of economic policy (market-constituting principles). The state is supposed to interfere, however, when market power emerges, social costs from inequality arise, the labor supply behaves abnormally, and negative technological externalities occur or positive externalities are under-supplied (regulatory principles). If government interferes, it must avoid sectoral interventions, conduct social policy market-conform, use stabilization policy with moderation, and prioritize rules-based over discretionary policy. Figure 2 summarizes the order of the Social Market Economy graphically.

Figure 2: The Order of the Social Market Economy



The rationale behind these principles is derived from both historical experience and economic theory. Social Market Economics is a product of the German historical school, while modern market liberalism and socialism are the result of laboratory economic designs that have detached themselves from real world economics. The order of a Social Market Economy goes far beyond the nature of an action plan like the Washington Consensus. It is a political and economic theory of social organization.

## 5. SOCIAL MARKET ECONOMICS – MICROECONOMIC FOUNDATIONS AND LIMITS

Social Market Economics has strong microeconomic foundations in the market-constituting principles. Little, however, is said about the social utility of equitable social development. This is particularly surprising as there are natural tendencies within the standard assumptions of microeconomic theory that suggest that equitable social development has a social value.

First, assuming a typical production function of an individual  $i$ , which produces per capita output  $y$  with per capita capital  $k$ , of the kind

$$y_i = k^a \text{ with } 0 < a < 1, \text{ so that } y' > 0 \text{ and } y'' < 0$$

aggregate output,  $\sum y_i$ , is maximized if capital is equally distributed.

Second, societies may derive utility out of function like

$$U(c_i) = \frac{c_i^{1-e} - 1}{1-e}$$

where higher values of  $e$  indicate greater preferences for equal distributions (if  $e=1$ ,  $U(c_i) = \ln c_i$ ) and  $c$  stands for per capita consumption.

Assuming a society consisting of two citizens, a total capital stock of

$\sum k_i$ , which citizens hold the shares  $k$  and  $(1-k)$ , the society maximizes aggregate utility by solving the first order condition of

$$Welfare = U_1 + U_2 = \frac{(k^a)^{-e} + ((1-k)^a)^{-e} - 2}{1-e}$$

which yields the first order condition

$$(k^a)^e = ((1-k)^a)^e$$

showing that as long as a society is not completely egalitarian ( $e=0$ ), which is when the first order condition is always met regardless of the distribution of equality of opportunities ( $1=1$ ), equal opportunities always maximize welfare ( $k=1-k$ ).

Complete egalitarianism towards the distribution of opportunities is extremely unlikely. Game theoretical applications like the ultimatum game suggest that people have preferences against perfect inequality. In a review article of ultimatum games, Bearden<sup>8</sup> summarizes their findings shortly as: "People do not like unfairness." It is thus hard to understand why the study of market-conform policies towards the creation of more equal opportunities does not receive more attention. In light of this, there should be plenty of opportunities to test preferences for Social Market Economic ideas in game theoretical settings.

Despite strong microeconomic foundations to motivate the study of the importance of the combination of market efficiency with equitable economic development, the use of microeconomic analysis has also its limitations in Social Market Economics. This is because Social Market Economics is essentially a dynamic and institutional theory while modern economics is mostly static. The strength of Social Market Economics is

not to explain allocation efficiency, but to extract its relevance to understand real world economics and to support economic policy.

## **6. SOCIAL MARKET ECONOMICS – MACROECONOMIC SYMPATHIES AND LIMITS**

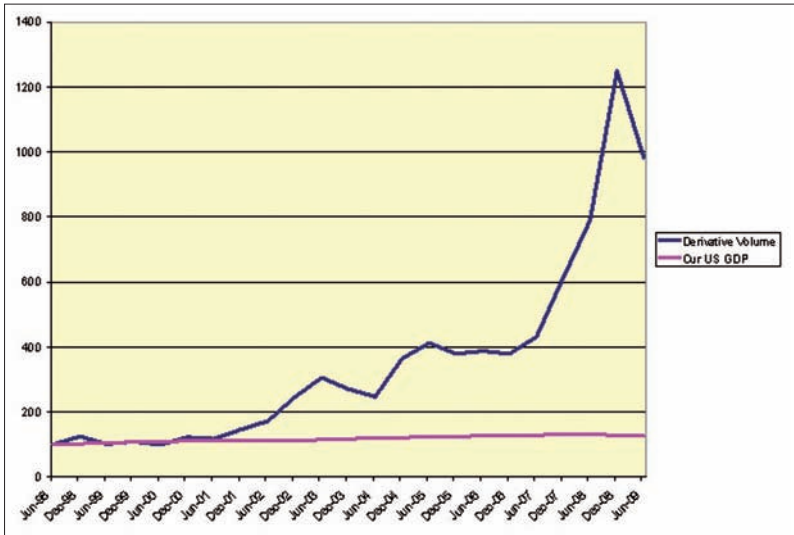
The fact that Social Market Economics calls for a proactive state, which is often compared to a referee in a football match, makes drawing parallels to Keynesian economics intuitive. There are, however, fundamental differences that need to be addressed. This is particularly important as there is a trend back to post-Great Depression Keynesianism that ordoliberalists and Social Market Economists should strongly reject. The danger is that fiscal hyperactivity is gaining legitimacy as a last resort policy instead of ordering markets such that make fiscal last resort activities obsolete. The current bailouts and sectoral interventions are ordoliberal offenses. They are against the Social Market Economy's value system of equal opportunity, violate the principle of subsidiarity, undermine almost all market-constituting principles, are not justified by any regulatory principle, and turn supplementary principles ad absurdum. Of course, the prelude of the crisis was already caused by spurning ordoliberal principles. We find ourselves in a cycle of fighting ordoliberal sins with ordoliberal sins. This cycle must be broken.

A word of caution on the legitimacy of drawing parallels between today's crisis and the Great Depression may be appropriate. It is important to note that already the Great Depression of 1929 was caused by a deterioration of a market-constituting principle, namely the rise of deflation. Because in the 1920s economic output grew faster than the money supply, deflation undermined aggregate demand. The problem was the Gold Standard, which prevented the money supply from keeping pace with the growth of the real sector. Gold reserves could not be accumulated as quickly as would have been necessary to supply the economy with stable money. During the three years prior to Great Depression (1926-1928) prices fell by 1.1, 2.3, and 1.2 per cent, respectively (US Bureau of Labor Statistics). In the build-up to the depression, the stock market boom and investor over-confidence were only gun powder while deflation was the fuse. The persistence of the mentality of the Gold Standard<sup>9</sup> was a major reason for transforming the stock market crash into a depression.

Although it has become popular to compare the current crisis to the Great Depression, they have in fact very little in common. A comparison to a traffic jam may be illustrative. Both crises resemble a situation in which traffic comes to a standstill. Yet, during the Great Depression, the cars ran out of gasoline but were otherwise intact. In today's crisis, cars crash because government removed traffic rules and let ever more cars on the road. During the Great Depression, government provided road assistance and jump started the cars again. In today's crisis, government fixes demolished cars with tax payers' money and sends them back on the streets instead of scrapping them and confiscating drivers' licenses.

More specifically, during the Great Depression aggregate demand fell short of aggregate supply, so that with the onset of the Great Depression a sustainable stock of factor capital was underutilized. Fiscal stabilization policy made sense. In the current crisis, however, aggregate demand was pushed non-sustainably beyond aggregate supply until aggregate supply became non-sustainable too, so that factor capital became increasingly over-utilized. Reckless sectoral interventions in the US housing market, whose origin dates back to 1994 when the Clinton administration made the expansion of homeownership a policy priority, was further complemented by 1999 financial market deregulations that ended the traditional separation of commercial and investment banking and led to the decoupling of the financial from the real sector, especially since 2001. This is illustrated in Figure 3. It shows the amounts outstanding of over-the-counter (OTC) derivatives (blue line) from the real sector as proxied by the US GDP (pink line). Because most of the capital was fictitious and aggregate demand inflated, fiscal stabilization policy makes no sense. It is a difference whether stabilization policy matches two sustainable parameters or two non-sustainable ones.

Figure 3: The Decoupling of the Financial Derivatives Market (Amounts outstanding of over-the-counter (OTC) derivatives, Blue line) from the Real Sector (US GDPcurrent US Dollars, pink line), Index, 01/06/99 = 100)



Source: Bank for International Settlement and US Bureau of Economic Analysis.

Prior to the application of stabilization policy, the exact history of the crisis must be known. The supplementary principles of the Social Market Economy are not per se against Keynesian stabilization policy, but they warn of its excessive use. Excessive stabilization policy is more likely after excessive market interactions. Interactions that occur in markets that are ordered according to Social Market Economic principles are less likely to require excessive stabilization policy. The current crises have shown that it is not always daring more markets. It is not always daring more state. It is daring more order.

## 7. SOCIAL MARKET ECONOMICS – IS THERE EMPIRICAL EVIDENCE?

The Social Market Economic literature is predominantly qualitative. It has also a strong focus on Germany and Europe. Many countries, however, are committed to the combination of the efficiency of the market with equitable social development, especially developing countries. The

East Asian experience would be a case in point. Other developing countries articulate great interest in the concept of the Social Market Economy. Syria, for example, has officially adopted the Social Market Economy as its political-economic model. In order to further support the case for Social Market Economics, empirical evidence backing its philosophy would be clearly welcomed. But how can one test empirically the concept of the combination of the efficiency of the market with equitable social development?

Ideal would be a Social Market Economy index, which takes into account all the order aspects of Social Market Economics. These could then be related to performance indicators such as market efficiency and equality of opportunities. However, the required amount of research to construct a Social Market Economy index is far beyond the scope of this paper. Yet, what can be done here is to work with a very few variable that are readily available and may point towards a Social Market Performance index, which looks at market efficiency combined with equitable social development.

The following is just a simple proposal for a Social Market Performance index. It may be easily expanded or modified. As the concept of market efficiency must involve an indicator that represents a country's ability to pass the selection test of markets, a country's manufacturing and services export share may serve as a proxy for market efficiency. The inequality component can be added by dividing the manufacturing and service export share by an indicator of inequality. Therefore, a given manufacturing and service export share is more Social Market conform when the level of inequality is low. This Social Market Performance indicator is formally written as

$$\text{Social Market Performance Index} = \frac{\text{Manufacturing and Services Export Share}}{\text{Inequality}}$$

How does this Social Market Performance Index perform? In order to test it, the Manufacturing and Service Export Share data was calculated from the 2008 World Bank Development Indicator Database as an average for the period 1960-1990. For the same period, the average inequality, using data from the University of Texas Income Inequality Data Project, was calculated. The period was chosen in order to have a sample of countries that includes socialist and market oriented economies. The dataset is



summarized in Appendix Table 1. Generally, this index ranks East Asian economies and European countries high, Latin American, Arab, and Sub Saharan African Economies low.

Countries that rank strong in market efficiency (as measured by manufacturing and service outward orientation) and have low values of inequality were also the countries that had the highest average growth rates. Figure 4 shows three scatter plots. Scatter plot 4a, 4b, and 4c show the relationships of average per capita income growth (y-axis) with manufacturing and services export shares, inequality, and the Social Market Performance Index, respectively.

*Figure 4: Approaching the Combination of Market Efficiency with Equitable Social Development*

*Fig. 4a: Growth vs. Manufacturing and Services Export Shares*

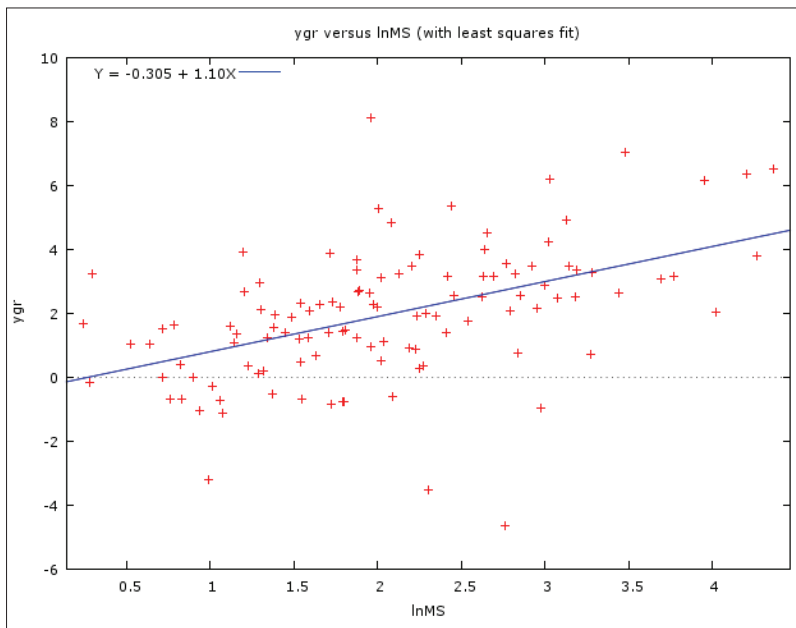


Fig. 4b: Growth vs. Manufacturing and Services Export Shares

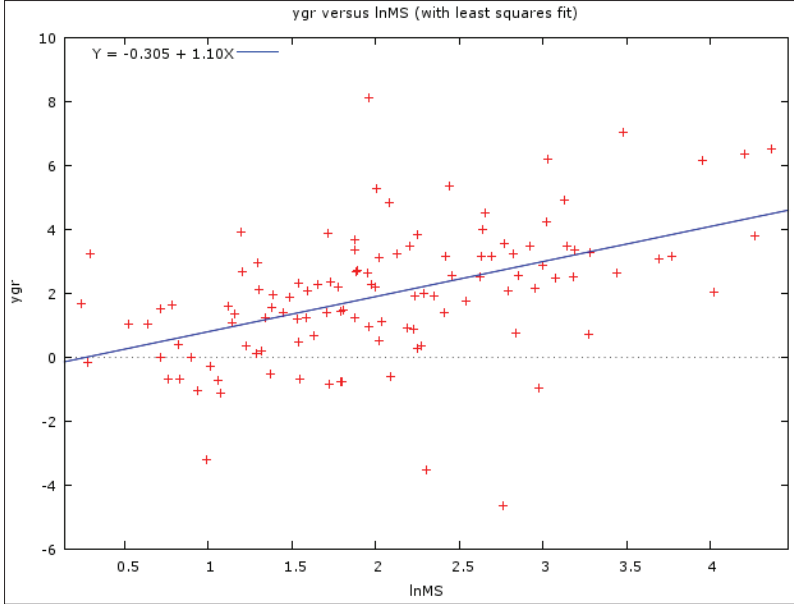
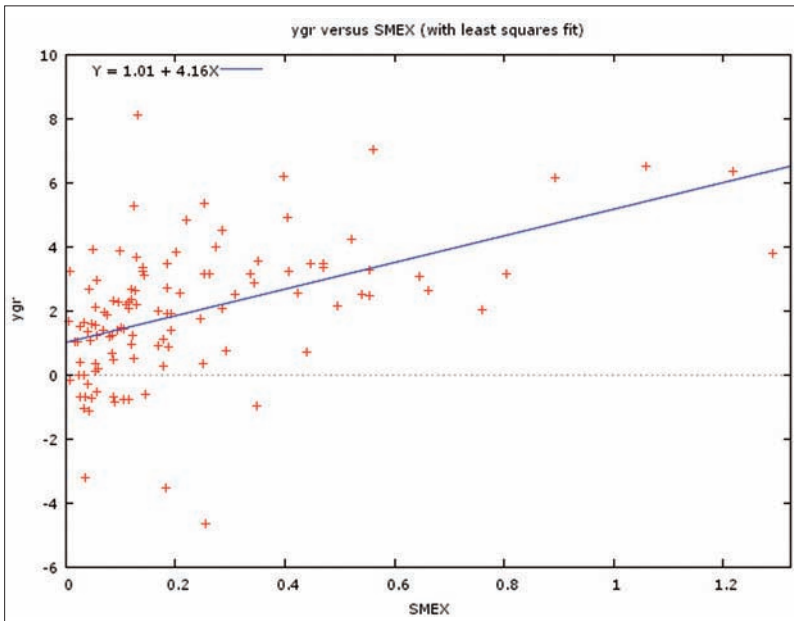


Fig. 4c: Growth vs. Social Market Economy Performance Index



The hypothesis that market efficiency and equality of equitable social development interact favourably with economic growth can be further corroborated using simple regression analysis. For this, the following equation is tested:

$$\text{Per capita income growth} = \beta_0 + \beta_1 \text{Manufacturing and Services Export Shares}_i + \beta_2 \text{Inequality}_i + \beta_3 \text{Social Market Economy Performance Index}_i + \beta_4 \text{Per Capita Income}_i + \varepsilon_i$$

Table 1: Regression Results (N=115)

	Model I	Model II	Model III	Model IV	Model V
Intercept	-0.30 (0.42)	79.6*** (4.2)***	9.7** (4.5)	1.0*** (0.23)	0.76 (0.93)
Manufacturing and Services Export Share (ln)	1.1*** (0.19)		0.9*** (0.2)		
Inequality (ln)		-4.8*** (1.1)	-2.6** (1.1)		
Social Market Performance Index				4.2*** (0.7)	4.0*** (0.7)
Per Capita Income (ln)					0.04 (0.7)
Adj. R2	0.23	0.13	0.25	0.23	0.23

Standard errors in parentheses, \*\*\* Significant at 1%, \*\* Significant at 5%.

Table 1 shows that the market efficiency indicator “Manufacturing and services export shares” as well as the equitable social development proxy “Inequality” have considerable statistical significance and explanatory power with regards to real per capita income growth, and so has their interaction as the “Social Market Performance Index.” The Social Market Performance Index is also robust when controlling for, for example, per capita income.

## 7. CONCLUSIONS

The objective of this paper is to create awareness for the various problems that one faces when working as a Social Market Economist. In essence, Social Market Economics has a marketing problem.

This marketing problem begins with the term social, which is still too easily confused with socialist. The term social in Social Market Economics is to be understood as "Equal Opportunity Market Economics." It has a normative orientation in terms of empowering the individual to gain access to market opportunities. Unlike in socialism, the individual in the Social Market Economy is not supposed to subordinate itself to the state, but the state to subordinate itself to the individual. Although Social Market Economics is closely related to classical liberal economics, it does not stop at the question of market efficiency. Whereas classical liberal economics is exclusively a positive science, Social Market Economics embeds the positive science of economics into a normative framework. This may be criticized from a purely scientific perspective, but is imperative from a practical. Eventually, the neglect of normative values in economics has led to the collapse of socialism and popular opposition to economic liberalization programs in many developing countries.

A distinct feature of Social Market Economics is the thinking in terms of order, which reflects an interdependence of normative values, state-constituting guidelines, and principles of economic policy. Social Market Economics is much more than an economic science. It is also a political science, the study of history, and sociology.

The interdisciplinary nature of Social Market Economics is both a blessing and a curse. The blessing is that Social Market Economics has an intellectual appeal that goes beyond mainstream economics. Its interdisciplinary nature is a curse though in the sense that it dilutes Social Market Economics, which prevents it from becoming established in mainstream economics. However, for this problem Social Market Economists are to blame, not mainstream economics. Standard microeconomic theory provides many avenues for Social Market Economic thought to establish itself in a formalized method, which have not been tapped yet. Market efficiency and equality of opportunities are not mutually exclusive concepts within the standard assumptions of microeconomic theory, but complements.

Social Market Economics has more friendly relationships to classical economics than macroeconomics, although Social Market Economics is not completely against the spirit of Keynesian stabilization policy. In principle, whether stabilization policy is justified or not depends on the nature of excess capacity of which aggregate demand fell short of. Is excess capacity the result of a non-discretionary event like a decrease of money supply or a natural disaster, or is it the result of discretionary market manipulation like the housing bubble? If anything, only non-discretionary events that lead to an excess supply qualify for stabilization policy.

Lastly, Social Market Economics has a marketing problem, because the hypotheses that are implicit to its theory are barely subjected to empirical research. Similar to the fact that Social Market Economics is to blame for not having itself opened up much yet to microeconomic analysis, Social Market Economics must be blamed for not having made much use of empirical analysis, although opportunities do exist.

Of course, old habits die hard. This is particularly true for Social Market Economics, which has cultivated a particularly strong resistance to market itself more aggressively. After sixty years of Social Market Economics, it celebrates its birthday mostly on the academic fringe. If it does not solve its marketing problem, it may become forgotten by its 100<sup>th</sup> birthday.

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- 1) The idea of a "Third Way" between classical liberalism and socialism already emerged at the beginning of the 20th century. It was probably Ludwig Erhard in 1964 though, who popularized the term "Social Market Economy" as a third way (Goldschmidt/Wohlgemuth (2008), p. 266). The term "Social Market Economy" was introduced by Mueller-Armack (1947).
- 2) Marx (1887), online. For an overview of the flaws in Marxist economics see Blaug (1996), Chapter 7.
- 3) Marx/Engels (1848), p. 14.
- 4) Smith (1776), p. 25.
- 5) Mises (1951), pp. 113-122.
- 6) For an English summary of Eucken's work and his legacy from an international perspective see Meijer (1987) and Meijer (1994), whose papers are not only good analyzes of an important chapter of German economic thought, but are also indicative of the marketing problem that it faces.

7| *E.g. Tietmeyer (2001).*

8| *Bearden (2001), p.6.*

9| *Eichengreen / Tenim (2000), p. 183.7. Conclusions*



# THE SOCIAL MARKET ECONOMY IN EASTERN EUROPE – AN UNDERESTIMATED OPTION?

*Marc Stegherr*

## **1. ABSTRACT**

After the fall of the Berlin wall, the former Communist-ruled Eastern European countries did not set up a Social Market Economy according to the successful German model, but one which was “without attributes”, according to the current Czech president, Václav Klaus. As the victor of the Cold War, the United States and their unregulated market economy model were seen as a role model for the new rulers in Central and Eastern Europe, and also in the former Yugoslavia. For ideological reasons, Russia could not acknowledge the USA as a role model. However it moved towards an extensive free market economy with the considerable restriction that its laws placed on the small social stratum of the so-called oligarchs, while the middle stratum was left empty-handed. On the one hand the excessive social state influenced by Germany is a deterrent, on the other hand the social problems of an unregulated economic system are becoming increasingly clear, especially in the light of the financial crisis. The only way out is through reflection upon the actual nature of the Social Market Economy. This is currently on the agenda in Germany.

## 2. INTRODUCTION

Critics of the Social Market Economy, whether in their own countries or in other eastern European countries, see this as an outmoded model. After the collapse of communism and the end of the system debate, it was not German ordoliberalism which succeeded, but “liberalism without a prefix” and the “market economy without an adjective”, as the current president of the Czech Republic, Václav Klaus, called it. As Klaus had so passionately fought against the dictatorship of the Czech communists, any meddling of the state in things which in his opinion should regulate themselves was suspect. This definitely applied to the economy. In this respect it is not insignificant that the radically free-market Klaus completed his economic education at the University of Chicago; from a European point of view a Mecca for conservative, free market economics. Due to his experience under the communist dictatorship – which painted a picture of social security and equality through accumulating enormous national debt – and his schooling in economics, to him the Social Market Economy way of thinking which underpins the economies of Germany, Austria, and also France is highly suspect, and he is working with all his might against the extension of the power of the “regulation-mad” EU, as he sees it. The failure of the Social Market Economy in Eastern European history would appear to prove Klaus right. After the collapse of the communist regime in Eastern Europe, German and French politicians expected the Social Market Economy to conquer Eastern Europe, which unfortunately proved to be a misjudgement. Jacques Attali, adviser to Mitterrand and President of the European Bank for Reconstruction and Development, saw exporting the values of old Europe to Eastern Europe as his bank’s task. He was a fierce opponent of radical reforms, like those being attempted in Russia at the time and popular elsewhere too. When Attali visited Prague in the early 1990s and met with the heads of government, he found the pro-American attitude of the then still Czechoslovakian government in economic matters as vulgar and above all wrong. The French President Jacques Chirac thought the same and complained about the Eastern European support for the US-led Iraq war.

Germany and France simply underestimated the reputation that the United States had politically and economically in the transition states in Central and Eastern Europe. In the late phase of the Soviet Union, later Russian reformers such as Yegor Gaidar or Anatoly Chubais were especially interested in the classic American national economy as they

believed that the secret to the success of their ideological opponent was to be found there. This moment is important if one wishes to understand why almost all communist nations opted for a pure market economy. As early as 1990, the current Czech President and then Finance Minister, Václav Klaus predicted that the majority of the Eastern European countries would reject the German-style Social Market Economy and instead opt for a pure market economy. It is of note that left-wing intellectuals in the Czech Republic as well as in other Eastern European countries thought this. Václav Havel, Klaus' presidential predecessor in the Czech Republic and certainly not a radically free-market thinker, wrote in 1992 that "Though my heart may be left of center, I have always known that the only economic system that works is a market economy... It is the only one that leads to prosperity, because it is the only one that reflects the nature of life itself." Although it is the commitment of a left-wing politician to the market economy, it is not commitment to an absolutely free market, as Wolfgang Münchau writes in his book, *Das Ende der sozialen Marktwirtschaft*.<sup>1</sup> It is the commitment to an end to the nannyism which led to the bankruptcy of both the economy and society and whose effects have still not been overcome today, as Ondřej Matějka from the Prague network, "Anti-Komplex" notes – The main problem of the post communist nations is that society still hasn't entered into real dialogue with those in power. If parties in Poland such as the Kaczyński brothers' "Law and Justice" party are depicted as universal providers, while at the same time those democrats who were in power before them are seen as corrupt, then they are simply exemplifying the old, undemocratic world view: Those communists were bad, but at least they could provide for us. Instead of the provision mentality, Havel put his hopes in the independence of the individual, without forgetting the interests of society. Klaus took a huge step forwards and left it to its own devices. The fact that something fundamental was neglected is criticized not only by Matějka. The Czechs did not accept any responsibility for the common good. The promotion of education was not seen as a public issue for example. Society seemed to be split, and the individual left to his/her own devices. According to Matějka's conclusion, "Marxist materialism was simply transferred to Capitalist materialism."<sup>2</sup>

As both Czech politicians pronounced themselves in favour of the market economy, they had the example of the counter model of a planned economy before them as a deterrent, which is why Klaus labelled the Social Market Economy as "soft socialism". Less dirigisme, a lower public spend-

ing ratio, flaws which brought the Eastern European Social Market Economy into disrepute, would certainly increase market dynamism, reminds Münchau. But outside the successful Eastern European economic circles there are clear doubts that the free market is the solution for everything, as Matějka's quote highlights. In Russia, too, the "market radicals" were victorious, dividing the raw material market up amongst themselves with the blessing of the Kremlin, and taking away society's responsibility. They made light of the critics of the "Westernisation" and the uncritical takeover of the Western free society and economic model. The same criticisms by Matějka on the transition of Marxist to Capitalist materialism are formulated by representatives of the national Orthodox churches. Astonishingly, they refer to the patron of the Social Market Economy, Alfred Müller-Armack, who perceived Nazi totalitarianism to be a replacement religion at a time of a drop in religious belief. Today Russian and Serbian orthodox bishops and theologians suspect that neoliberalism and limitless capitalism are the replacement religions of today. With the help of Müller-Armack, one could interpret the radical about-face of the absolute dirigisme of the former planned-economy nations to market liberalism. Müller-Armack studied the repercussions of cultural concepts on the economy alongside many others. In his opinion, religious legacies proved to have left a deep impression on culture which could also have a large influence in a largely secular society on fundamental values and world views.<sup>3</sup> One might ask Müller-Armack whether it is a coincidence<sup>4</sup> that the cultural border which runs between the Orthodox countries on the one side and the Protestant and Catholic countries on the other are almost identical to the EU's Eastern border today.<sup>5</sup> It also marks the dividing line between a group of largely successful and another less successful group of transition countries up to now. Looking at the economy, but also the politics of the Orthodox countries, it is a decisive moment for pronounced holism.<sup>6</sup> The organic integrated feature of the Orthodox view of the world was not unknown to the western Catholic world either, until the age of industrialization. An organic interdependence of the economy and society was aimed at.<sup>7</sup> While the secular model gained acceptance throughout Western Europe, Russia above all maintained a close interconnection not only between the church and society, but also in all areas of society which held common interest. This carried on after the 1917 Revolution. Communism used the traditional leaning towards Holism to prevent the economy working freely (and not only this). So it comes as no great surprise that the pendulum swung to the exact opposite direction after the collapse of the dictator-

ship in Russia. The “unexpected” free market economy, as its critics label it, was a holistic, whole, closed model, whereas the Social Market Economy presents a compromise, a “soft Socialism”, to borrow Václav Klaus’ exaggerated term. This compromise, which attempted to keep the interpretation of the economy by society, just as the emancipation of society itself far away, is closest to Catholic social doctrine and was also accepted by Orthodoxy. According to Müller-Armack, the trend-setting sense of the Social Market Economy is “to join the principle of market freedom with the principle of social balance”.<sup>8</sup> The remarks by Patriarch Kirill of Moscow and the whole of Russia on the outgrowth of market liberalism in his country could fall under this compromise formula, with a pinch of salt. Also those of his predecessor Alexij II, who when asked in 1991 what the Church thought of the market economy said, “the market economy is not so new for us. But when we return to market conditions, we must make sure that souls and fates are not flattened. We will work for more social protection, but that too is still overtaxing us.”

### **3. RUSSIA AND THE MARKET ECONOMY**

Behind this are the experiences of renowned Perestroika reformers such as Gaidar or Chubais, who adhered to the radical liberal American model. Free prices, free external trade, guaranteed property rights and monetary equilibrium – the rest was taken care of by the market. Distribution of income or policies for medium-sized businesses did not form part of this model. The situation of medium-sized businesses in Russia is a classic example of the liberalisation of the Russian market, which was only shared by a very few super and mega rich, politically reliable people on the wishes of the government. The problems that enterprising small and medium-sized businesses need to deal with have not changed a great deal in recent years. In 2006 the Russian government actually declared that they wanted to promote medium-sized businesses and to increase their share of business, and they offered some help in the form of low-interest loans, micro-credit and venture capital. Critics believed, however, that this would not change the biggest problems, i.e. bureaucracy, corruption and abuse of authority. Russian medium-sized enterprises are still a long way from being in a strong position. Growth and innovation are only seen in large companies. Large companies such as Gazprom, Lukoil, Rusal, Sual, Evraz Holding and Severstal dominate the Russian economy. Russian politics, which equates diversification with lack of control, is consciously leaning increasingly towards large companies or

industry conglomerates, especially in strategically important sectors such as aircraft construction or in areas of engineering<sup>9</sup> – which obviously fundamentally contradicts the basis of the Social Market Economy.

This and similar flaws have provoked not only religious and cultural criticism, but has also drawn criticism from economists, even when they initially appear to be champions of the free market economy. The critics' voices became louder after Klaus lost parliamentary majority in the Czech Republic. His radical "crash model" transition from the planned to market economy swiftly led to unemployment and created social problems. In Russia, liberalization of prices and privatization of state-run businesses did breed entrepreneurial talent who were able to support the market economy, although many had strong doubts about this. The concentration of market powers, which neither Yeltsin nor his successor Putin promoted, worsened the social problems. However there were no political remonstrations. According to commentators, what was responsible was the fact that civil participation and social partnerships were things which after decades of Communism were yet to be accepted. Something which was not particularly easy in a political landscape which was often labeled a "controlled democracy". It would only be then that the concept of a Russian Social Market Economy would stand a chance. As previously stated, at the end of the Soviet Union, Russia aligned itself with its predominant economic and political main rival, rather than with its small neighbor Germany, and with its social and economic order. The Social Market Economy of the United States and that of the Anglo-Saxon countries in general was and is considered a serious economic and political concept, much more than the German post-war situation.

As a consequence, the Soviet Union successor states – an irony of history in itself – did not assume the Western European compromise model of the Social Market Economy, but instead the free market model of their ideological opponent which had won the Cold War, had been vilified for decades, and which was by no means problem-free. This schizophrenia, which is even more distinctive when one looks at the failures of Russian patriots compared with the degenerate Western social structure has its critics, not only in Russia. Serbia feels joined to Russia through its history and culture and has already become closer to Russia economically through cooperation agreements. The Serbian Orthodox bishop Irinej (Dobrijević), who grew up in America, gave a speech during a seminar on "Orthodox ethics and the spirit of capitalism" in April 2009 which one

would not have expected from a Western bishop. He said that Orthodox Christianity could not approve of an economic system which rewarded laziness and gave the poor the alms of the state to live on, and that productive work was an essential part of human life. While Orthodoxy condemned the unbridled, unregulated capitalist (*laissez-faire*) system, they approved of a “socially responsible free market system.”<sup>10</sup> This could be seen as a criticism of both the western-influenced excessive social state, and of the unbridled free market liberalism which had entered Eastern Europe.

But the discussion in Serbia also shows that the situation is closer to a “watered down” version today, than to Müller-Armack and Erhard’s social market model. The Serbian economist, Miroslav Prokopijević is critical of the Social Market Economy in Germany. However less so in its beginnings in the 1950’s and 1960’s when the concept was still balanced and the needs of companies as well as employees were satisfied, than in its later phase. The changes in the 1980’s and 1990’s watered down the concept and transformed social security into a burden for the economy. In the light of a constantly changing population and a growing number of unemployed, clear limits were set by the Social Market Economy. Social expenditure had to be arranged using existing financial resources, according to the Serbian political scientist, Zoran Stojiljković.<sup>11</sup> The acceptance of the Social Market Economy would not only impede structural deficit, but also a socialist mentality, which did not want to reject the old system outright, or which reacted allergically to every new supposed leaning towards new state intervention, popular “socialism” – see Václav Klaus or Yegor Gaidar. As for structural deficit, the reformed nations of Eastern Europe were in a fundamentally different situation to Germany in 1945. Russia had over 70 years of state economy behind it, without private property or a free market, nor any of the characteristics of a civil society. In Germany by the end of the war, despite all of the failures due to the war, there was still a market economy structure.

In the twelve years under Hitler’s dictatorship the economy was controlled through compulsory cartels, but the companies were not nationalized. So the only thing missing was the monetary reform and the price approval of 1948 to get farmers, bakers, butchers, goods manufacturers and business people back on track. In contrast, in the eastern European reform countries, and especially in Russia, there were no companies still intact. First the central planning authorities had to be broken up and

made independent economic entities through privatisation. In post-war Germany, the allies made sure that the old ruling class was repressed. On the other hand in Russia and other eastern European reform countries, the old monopoly structures still ruled and obstructed market economy newcomers. As an economic area, Russia was not a blank slate to be revitalized by owners with guaranteed property rights à la Chicago under the motto, "The market will regulate itself!" as a commentator in the Russian financial paper "Kommersant" wrote. The military-industrial complex was weakened, but above all the raw material monopoly maintained its position and influence over politics so that market economy innovation was practically closed off. In such circumstances, a Social Market Economy was almost unthinkable.

The "large-scale" privatisation which began on October 1, 1992 expressly excluded natural resources, power generation plants, the aerospace and nuclear power industries. So these were the natural resources which were to later form the basis of the raw material monopoly of the "oligarch system". State-owned enterprises were transformed into stock corporations by presidential decree. Every Russian citizen received a free stock certificate for national property to the value of 10,000 rubles. The people were supposed to have the possibility to buy privatised national property such as stocks, accommodation or pieces of land. The stock certificate could be sold, exchanged, given away or traded on the stock market. The stock certificate could also be taken over by investment funds. The basis of the Russian economic reform was the floating of most consumer and capital goods prices from January 1, 1992. This decision by the Russian government under Gaidar was as courageous as it was risky. Because there was no appropriate range of goods at this time, the reformers had to estimate that prices would rocket and inflation would escalate. Between July 1, 1992 and November 30, 1994 the ruble/dollar exchange rate on the Moscow currency exchange rose from 125 ruble/dollar to 3,200 ruble/dollar. Gaidar was ejected from the government as early as December 1992, as a scapegoat for the price rises. He was replaced by Viktor Chernomyrdin. Nevertheless, the price liberalization was necessary. Without this there would have been no chance to increase the offer of consumer goods through imports from the West. In addition, this decision gave the reform process in the west credibility and made it irreversible for Russia. Alongside the price liberalization, the rapid start of privatization was the core of the Russian way from a planned to a market economy.



#### 4. CROATIA AND THE TRANSITION TO MARKET ECONOMY

After the end of socialism the conditions for entry into the Social Market Economy were more advantageous for the transition nations of South Eastern Europe than for Russia. Although Yugoslavia was centrally governed, it was a non-aligned nation, which had freed itself from the COMINTERN and it had elements of self-governance, especially in the economy. Upon its independence, Croatia introduced an economic model which the European Union recognized in the light of the accession process. The transformation of the economic system in Croatia from "real socialism" to a Social Market Economy with a private structure was relatively successful. Before this there were however great upheavals. The first state president of Croatia after independence was Franjo Tuđman, who still thought in the outdated national and national economic categories. His time in government was plagued by pronounced clientelism and considerably reduced freedom of opinion and press.

He ratcheted up the state share in companies, which meant that the successive government under Prime Minister Ivo Sanader was forced to press ahead with privatisation of the companies the national share of which was 40 per cent at the time. Structural reforms such as the improvement of financial administration, monitoring of banks, development of the financial market and the reduction of tax burdens followed. Income tax was set at 15 per cent and tax on profits at 20 per cent. With the reform of Croatian procurement, the government challenged the black economy, by trying to limit the "uncontrolled public contracts". Thanks to restrictive credit, finance and income policies, the inflation mentality which had prevailed for years was successfully destroyed, which could be seen through the stability of the Croatian currency, the Kuna, whose inflation rate in the 1990's was between four to six per cent. However, the reform policies were less successful on a micro-economic level, especially in strengthening the private sector. Political power struggles meant that there was no constant line which was followed. The process of property transformation was not transparent, favoured insiders and impeded the influx of foreign capital. Companies were rarely pressed to modernise, which damaged the competitiveness of the Croatian export economy and led to a growing trade balance deficit. However the Croatian government under Prime Minister Ivo Sanader did manage to move the country towards stability in the following years, with accession to the European Union already in mind, which

will not be until after the slump due to the financial crisis has come to an end. The Croatian economy sank by 6.7 per cent in the first quarter of 2009. The Croatian Central Bank predicted a decrease in the Gross Domestic Product of four per cent for the whole year. As a consequence there were mass demonstrations and several calls for a stronger state engagement against the self-importance and egoism of individual market participants. Prime Minister Sanader stepped down, officially for personal reasons and Jadranka Kosor (like Sanader a member of the Croatian Democratic Union – HDZ) took over the post with the promise to even out social inequalities in Croatia, which had become more apparent during the crisis. In Serbia, too, there were many victims of the transition, the fast changeover to the market economy and not least the financial crisis.<sup>12</sup> President Boris Tadić as well as the new Prime Minister Mirko Cvetković said that the interests of individual participants should not be put before those of society as a whole.

## **5. MODEL EXAMPLE OF SLOVENIA**

Unlike the Czech Republic and Hungary and like Croatia, Slovenia did not opt for shock therapy to transform the centrally planned system into a market economy. Slovenia proved to be a champion of gradualism,<sup>13</sup> which was especially apparent in the privatization of state companies. The privatization concept was shared out among employees and management, which however virtually shut out shareholders from abroad. Slovenia thus proved that although privatization of banks and infrastructure is still ongoing today, it is the only new EU member state which still has an astonishingly high government share of GDP. Through direct and indirect shares the state holds around 40 per cent of the companies in the country. After the attempt to privatise the second largest bank in Slovenia “Nova Kreditna Banka Maribor (NKBM)”, with foreign shareholders failed, a 49 per cent share was floated on the stock exchange in 2007.

When Slovenia declared its independence in 1991, the question was often asked as to whether the small country with only two million inhabitants could even survive economically – fears which soon proved to be unfounded. Today Slovenia is the most economically successful country among the central and eastern European countries which joined the European Union (EU) in 2004 and 2007. If you look at the Gross Domestic Product (GDP) per head, the country has reached an economic level

which is higher than that of Greece and Portugal. Unemployment is around five per cent under the EU average and the budget deficit amounts to less than one per cent of the GDP. Already at the beginning of 2007 Slovenia became the first new EU member state to join the Eurozone. Slovenia was aided by its more auspicious starting position which differentiated it from those of the other transition nations. On the one hand, the economy was significantly higher and on the other hand it already had well-developed business relationships in Western Europe. While it was still part of the former Yugoslavia, Slovenia benefited from a trade and cooperation agreement with the European Community (EC) which came into force in 1980. One thing which was significant for the economic power of the small constituent republic was that in 1990, with only eight per cent of the entire Yugoslav population, almost 30 per cent Yugoslav exports came from Slovenia. For foreign investors it was possible to invest early on in the former Yugoslavia. The constituent republic Slovenia, which specialized in the manufacturing industry above all and had an industrial structure similar to that in Western Europe, which was closely interlinked with the other constituent republics. After the breakup of Yugoslavia these trade relationships were largely ruptured. Many large companies which had previously been Yugoslav market leaders went bankrupt. The collapse of the Soviet Union, one of its most important foreign trade partners led to serious changes.

The system transformation brought with it a fundamental change from industry, which had dominated in the 1990's to the service sector which makes up two thirds of the gross value added. Agriculture was also driven back. It shrank to around two per cent, whereas before it had played an important role with around nine per cent. With its employment share of around 55 per cent, the service sector, in particular in banking and finance services and tax consulting, is far below the Western European level of 73 per cent. The influx of direct foreign investment is low in comparison with other new EU member states, because as already mentioned, the Slovenian privatisation model previously almost completely shut out foreign investment. Secondly, the long transformation process did not encourage private businesses to look for strategic partners abroad. And thirdly, the Slovenian authorities are very hesitant in privatizing financial services and infrastructure companies.<sup>14</sup> In total only around one third of the Slovenian banking sector is in foreign hands, while in other new EU member states the banking sector is majority controlled by foreign banks. In neighbouring Croatia this is as much as

90 per cent. Until the end of 2006, the portfolio of direct foreign investments amounted to 6.8 billion Euros, where companies with shares in the export industry above all played an important role. Although only five per cent of all companies fall under this category, they make up more than one third of all exports. Until the end of 2006, Slovenian companies invested around 3.5 billion Euros abroad, especially in Serbia and Croatia, which represent almost half of all Slovenian foreign investment.

A further difference between Slovenia and other transition countries is political stability. Until the 2004 elections, when the Social Democrat Janez Janša came to power, the Liberal Democrat Party (LDS) was the most voted-for party throughout the course of politics, in coalition governments (with the Christian People's Party, the Slovenian People's Party and the Pensioner's Party). From the beginning of the legislative period, there were great efforts for reform, such as the introduction of a flat tax, the rapid privatization of infrastructure companies, banks and insurance, as well as reduction of social benefits. However the Slovenian public refused most of these reforms. After a report on flat tax showed more disadvantages than advantages, the idea was dropped and the tax groups were instead reduced from five to three. The unhappiness of the Slovenian people with the social and economic concepts of the liberal government were shown with the clear election of a new state president who was not the candidate from the government party, the former prime minister and later member of the European Parliament, Lojze Peterle, but the left-wing politician Danilo Türk. How much the discussion on the orientation of economic and social policy divides Slovenia can be seen not only in the fact that the former governing Liberal Party has now split into splinter parties, but also the fact that some of the leading members, including the former prime minister, Anton Rophave now moved to the Social Democrat Party.

## **6. POLAND AND THE SOCIAL MARKET ECONOMY**

In Poland, the regulatory policy discussion on the correct political economic course included many participants who consistently adopted a central position between the very diverse stances of, on the one side, the socially-oriented critics of the transformational approach and the liberal proponents thereof on the other.<sup>15</sup> The renowned national economist and President of the Polish Economic Society for many years,

Zdzisław Sadowski, considers the transformation to be a success because the country managed to introduce a functioning Social Market Economy and simultaneously establish democracy. However, social deficits went along with it, which is why he believes that the solution to existing economic problems lies in academic discussion and in the political economic implementation of the constitutionally binding idea of the Social Market Economy. Moreover, he believes that the state, alongside its regulatory activities, should work to create a long-term and consistent development concept for the country, which would deal with Poland's economic, social, demographic and ecological problems. In numerous articles Sadowski and other national economists from the "middle way" support the opinion that future development in Poland should not be left to the laissez-faire principle alone. The market needs correction from the state's regulatory policy as well as a developmental strategy implemented over the long-term. Jerzy Hausner's opinions are also interesting in this context: Without actually speaking of ordoliberalism and the Social Market Economy, he voiced support for market economy action being subject to strict rules which would apply to every economic agent. At the forefront he placed the organization of the institutional rules of the economy.

The demand for a transformation of the constitutional model of the Social Market Economy, so often repeated by the most important actors in regulatory policy discussion, gains even more significance when the fact that Poland's transition was of a rather asymmetrical character is taken into account. The main interest of the responsible political actors is, first and foremost, economic growth and macroeconomic stabilization, which pushes a long-term regulatory policy based on the synthesis of economic, social and ecological goals of economic activity into the background. Equally, according to academic discussion, the socio-anthropological basis of the market economy should be included in reflections on regulatory policy. Economic theory assumes that in the process of economic activity free people will use their scope of activity responsibly, yet this is not always the case in the real world. Therefore economic agents can and should learn and practice the responsible use of freedom, which is something regulatory policy can certainly promote.

## 7. THE FUTURE OF THE CONCEPT IN EASTERN EUROPE

In view of the costs of the transformation and the financial crisis, the world's leading national economists have strengthened their view that in the era of internationalization and globalization the market economy process needs a regulatory framework which meets market requirements. Nobel Prize Winner, Paul A. Samuelson's sentence has become classic: The market has no heart, the market has no brain, it does what it does, which is why the market needs rules and a reliable legal system. It is not only in Poland, where the realization of the Social Market Economy is laid down in Article 20 of the constitution, but also in the Czech Republic, in Croatia or in Serbia, where the transformation has led to considerable societal distortions, that there is growing support for regulatory policy being given a greater importance. A synthesis of Erhard's concept of the Social Market Economy and Walter Eucken's *Wettbewerbsordnung* (i.e. economic order based on competition) could be used as a basis for such a regulatory policy. The principles of rules on competition (for: *Wettbewerbsordnung*) not only create the best regulatory framework for all market participants, but also the concept of the Social Market Economy is aimed, above all, at strengthening and stabilizing the all too often neglected socio-anthropological basis of the market economy. With *Wettbewerbsordnung* the market economy stays within a framework appropriate to it, and one in which all citizens can freely and responsibly undertake economic activity for their own benefit and for the good of society. But it was difficult to discuss an economic model which seeks to unite growth and social equality in the countries of central and south east Europe after the fall of the iron curtain, because the main interest of the transition states was a rapid re-orientation of the planned economy model into a free market economy system.

The unlocking of development in the European Union member states was supposed to be secured by strong economic growth, whereas this one-sided orientation, on the one hand, brought very strong liberalising tendencies with it and, on the other hand, plans of privatisation were in part implemented to only an unsatisfactory condition. In many states in the region the state's role in the economic process continues to be ill-defined. At the same time, a majority of countries in central and south Eastern Europe are struggling with social hardship and stark income disparities. The danger that populist tendencies in politics receive support is growing, and in Hungary, for instance, this has already led to trust in

the state declining to dangerous levels. After a transformational phase of almost 20 years things seem to have changed: Interest in possible alternative models, such as the Social Market Economy, is growing. The readiness to engage in a regulatory policy dialogue is present, now that the epithet “social” is beginning to lose the bad reputation which it received through its misuse by the communist system.

Whether the idea of the Social Market Economy can fulfill the wish for a humane third way between market radicalism and destructive socialism for Eastern Europe, is not least dependent upon how we treat Ludwig Erhard’s legacy. Will we manage to preserve social partnership, solidarity, inner peace according to market conformity and without being part of a welfare state in the coming times of hard competition? Economic efficiency must not be an end in itself, rather it should always also bear in mind the common good. That could also serve as a model for Eastern Europe and the European Union having enlarged eastward, in order to prevent societal fractures and to safeguard general prosperity. The fact that the concept of the Social Market Economy in Eastern Europe has not (yet) reached the desired scale is linked to political and, as mentioned, also with cultural circumstances. The political circumstance is quite simply the fact that the United States is viewed as the pioneer and ultimately as the victor in the struggle for freedom, while Western Europeans are more often seen as hesitant stragglers.

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1| Cf. Münchau (2006).

2| Cf. Spielmann (2009).

3| Cf. Zweynert (2006).

4| Cf. Müller-Armack (1941), et al.

5| Drawing this line is somewhat problematic only in the case of the Ukraine, as West Ukraine, which took its starting point from the "Orange Revolution", is Greek-Catholic and so in this respect belongs to the Latin cultural area.

6| Holism is a philosophical model, according to which, all forms of existence in the universe (physical, biological, but also cultural) are joined together to make a higher, integrated whole. Holism treats given forms of existence as something complete, and not as parts of a composite whole. Orthodox theology nears reality in an integrated, coherent and extensive way.



- 7| *The theological argument of the "Filioque" was the background to this. While the three persons of the Trinity are equal in Western Christianity, in Orthodoxy, the Holy Spirit only comes from God. This doctrine has political implications, against equal rights, but also towards the subordination of part of society such as the economy beneath everything.*
- 8| *Müller-Armack (1956).*
- 9| *This development can be seen in the figures. Small and medium-sized enterprises only contributed 16 percent to the Russian economic output in 2006. Others show them having only an 11 percent share of the Russian Gross Domestic Product. Only 14 percent of employees work in small and medium-sized enterprises in comparison to 70 percent of employees and 40 percent turnover in Germany.*
- 10| *Cf. Lakičević (2009).*
- 11| *Cf. Stojiljković (2009).*
- 12| *Businessmen and -women, merchants and farmers saw their livelihoods destroyed and they often opted for the last resort. Small Serbia with its low population occupies the inglorious position of number 12 in Europe for the number of suicides. (Cf. Lopušina).*
- 13| *Cf. Vidović (2008).*
- 14| *Foreign investment in Slovenia has recently been around 500 million Euros per year. 2002, when more than one billion Euros was invested, is an exception. At the time the Swiss pharmaceutical company Novartis took over the Slovenian market leader Lek and the Belgian KBC Group acquired 34 percent of the largest Slovenian bank, "Nova Ljubljanska Banka".*
- 15| *Cf. Pysz (2008).*

# THE IMPORTANCE OF THE STATE FOR CLIMATE PROTECTION IN A SOCIAL MARKET ECONOMY

*Janina Jänsch | Christian Vossler*

## **1. ABSTRACT**

A Social Market Economy centers on the individual freedom of the society's members. The realization of individual goals can be permitted by the competitive order existing in a Social Market Economy because the market allows for voluntary acts of exchange. This leads to a rise in the welfare of society. Another characteristic of a Social Market Economy is the provision of a minimum social security system, which offers support for citizens who are unable to earn a sufficient income on the market. There should, however, be a clear distinction between competition on the one side and social security on the other side. This distinction creates a maximum welfare effect. The state should never interfere in situations where an efficiency contest is feasible. However, state intervention may make sense in cases of market failure as long as the intervention results in a benefit for society. Still, deadweight losses are caused not only by wrongful intervention but also by excessive intervention.

The authors use the example of climate policy to demonstrate the role of the Social Market Economy and the effect

of excessive state intervention. An intervention by a government may be legitimized based on negative external effects; however, many of the implemented measures are inefficient. This is illustrated by the example of the advancement of renewable energy sources. An important responsibility of the state in coming years will be the creation of an international regulatory framework for achieving climate protection. In doing so, the principle of a Social Market Economy should be followed, so that a separation between the market in the form of global emissions trading and social transfers to developing nations will lead to more efficient climate protection policies. The importance of compensation payments will be highlighted separately.

## **2. THE IDEA BEHIND THE SOCIAL MARKET ECONOMY**

The natural center of all considerations regarding social coexistence is the individual citizen. Any social order must aspire to grant individual citizens within the society their individual liberties and, at the same time, allow for a social coexistence that will benefit society as a whole. This is a slippery slope, because any time an individual submits to societal rules, this individual inevitably gives up a portion of individual freedom. Even Thomas Hobbes pointed out that it can be a rational decision by citizens to give up some of their freedom in exchange for the benefits of social coexistence. The price citizens have to pay, in the form of constant fear living in a state of anarchy, is higher than the practical loss associated with giving up certain liberties.<sup>1</sup> Vice versa, this means that the benefit loss that results from submitting to societal rules is less than the added benefit of a peaceful coexistence. Generally, a state is only legitimate if its citizens voluntarily transfer rights to the state so that they can ultimately profit from the benefits. However, it is often difficult to find the dividing line between the responsibilities of the state on the one side and individual freedom of the citizens on the other.

These considerations on the concept of governance lead to the conclusion that the Social Market Economy is the most appropriate social order, as the idea behind the Social Market Economy guarantees personal freedom for all citizens while protecting them against governmental disposal.

Arising directly from the central importance of individual liberties in the Social Market Economy is a system of market-oriented competition, which is characterized by voluntary acts of exchange on the part of the

market players involved. Competition thus is not the goal but the means to achieve an increase in the welfare of society.<sup>2</sup> Voluntary acts of exchange are of paramount importance in this regard. It may reasonably be assumed that both parties agree to the exchange only if at least one of the partners is better off after the exchange without the other partner being worse off (*Pareto criterion*).<sup>3</sup> This banal observation is followed by the fact that each act of exchange leads to an increase in social welfare. At the same time, consumer sovereignty is taken into account, as the production structure caters to the preferences of the citizens. Since companies, in contrast, are also unrestricted in the products they offer, it is in their own interest to satisfy the desires of consumers, which is a necessity in order to realize profits.<sup>4</sup>

General belief holds that citizens act rationally on the market, i.e. in accordance with their preferences and information.<sup>5</sup> Accordingly, these will consume the goods of the manufacturer who satisfies their preferences while charging the lowest price, whereas manufacturers will try to charge the highest possible price in order to increase their profits.<sup>6</sup> What results are prices, and thus price ratios on the market, that reveal the citizens' subjective terms of trade based on their preferences. Therefore, the price as a paramount signal on the market guarantees that the available resources are optimally allocated within the economy. In a functioning market, the widespread knowledge within a society is being used efficiently.<sup>7</sup> This corresponds to the "invisible hand" of the market described by Adam Smith<sup>8</sup> and constitutes the opposite of the "visible hand" of a planned economy.

However, the Social Market Economy does not only comprise a free market economy. It also emphasizes the importance of well-defined state responsibilities, which places the Social Market Economy between the extremes of a *laissez-faire* and a planned economy.<sup>9</sup> A functioning competitive environment requires the provision and implementation of a regulatory framework by the state. The most important criterion is the provision of a functioning competitive market price system as a fundamental economic legislation principle.<sup>10</sup> A positive economic policy can constitute a competitive order.<sup>11</sup> This includes a monetary policy that is committed to the goal of currency stability, as both inflation and deflation distort the price signal. A competitive environment predicates the existence of open markets that can ensure the continuance of the dynamic incentives that result from the pressure of competition and that allow

for an efficient allocation of resources across the entire economy. In addition, private property creates a dynamic incentive for efficient economic activity, since effort results in the generation of income and the potential to acquire property. Vice versa, poor performance may lead to a loss of existing income.<sup>12</sup> Thus, importance is also placed on the principle of liability within the competitive order, which ensures that the consequences of poor decisions are noticeable on an individual level and that decisions thus be taken responsibly. In order to enable voluntary acts of exchange, freedom of contract must be granted and may only be restricted if used to conclude contracts at the expense of third parties. In order to ensure planning reliability for investors, which is the basis of long-term and sustainable investment, consistency in economic policy is key. Ultimately, these constituting principles only develop their positive effect if all principles are being observed concurrently.

In the broader sense, this actively designed economic policy may already be considered state regulation. In addition to establishing a regulatory framework, further action by the state may make sense and is characteristic of a Social Market Economy. This manifests itself in direct intervention into citizens' individual freedom of contract and may be defined as a form of regulation, in a narrower sense, or as a special regulation.<sup>13</sup> Normative considerations on the theory of regulation aid the analysis of the extent to which direct state intervention in the market improves efficiency and thus increases social welfare. As a result of these considerations, competitor monitoring is to be seen as a constitutive element of a Social Market Economy. It provides a basis for direct intervention in the event that behavior that is adversely affecting the market, such as the abuse of market power, is ascertained. Furthermore, direct state intervention can also be justified in the event of market failure. A failure of the market exists if individual rational behavior does not lead to collective rational results. This is typically the case when public goods, external effects, asymmetrical information distribution and natural monopolies are involved. In reality, it is usually nonetheless not immediately apparent whether such a failure is present and what its consequences are for economic policy applications. In many cases, classic welfare economics is used as a framework for determining market failure. However, this involves the risk of constantly declaring a failure of the market, since the perfect market, which is used as a reference standard in welfare economics, cannot exist in reality.<sup>14</sup> This precludes the conclusion that the state should intervene in cases where market failure has been deter-

mined in such a way, as the problem of market failure is accompanied by the great danger of state failure. In addition to the sufficient requirement that a failure of the market must in fact be present, the necessary stipulation that the benefit of state intervention be greater than its associated cost must also be met. Otherwise, the result may easily be government failure, as intervention by the state reduces social welfare. A relatively certain assumption is that the government is not systematically better informed than the market. This, however, would be required in order to better control the allocation of resources. Failure of both the state and the market demonstrates the limits of the potential associated with market coordination structures on the one hand and state or political structure on the other hand.<sup>15</sup> Finally, the question whether and with what measures the state should intervene needs to be considered. According to the idea behind the Social Market Economy, the advantages of a competitive environment should be leveraged wherever competitive structures are possible. Consequently, the question of how far the state should intervene in economic life is also a matter of a society's level of freedom.<sup>16</sup> It is precisely the freedom awarded in the system of a Social Market Economy which creates responsible actions and, through the incentives mentioned earlier, leads to the greatest possible welfare of society.

In addition to the described failure of the welfare economic market, a market failure may be more comprehensively defined as a terminus technicus for the situation in which a market is unsuitable for solving economic problems or where better solutions exist for improving the situation of the citizens. For example, a failure of the market might be determined after considering the wealth distribution policy within the social order. The market only rewards efforts that are put forward by the market players. In the event that some citizens' efforts are insufficient, it makes economic sense to guarantee a minimum level of security for these citizens.<sup>17</sup> As the sole goal of the social order is to help citizens, the Social Market Economy is characterized by its offer of a minimum level of security to all persons in need, whether the need is self-inflicted or occasioned through no fault of their own, which allows for a minimum standard of social participation.

However, despite the existence of a minimum level of security, economic and social policies should be separated, meaning that in a first step competitive advantages should be leveraged in order to increase social

welfare to the greatest extent possible. Independent of this, the state may implement redistribution through a tax and transfer system. That way, the highest level of overall welfare is reached.<sup>18</sup>

In summary, the certain advantage of the Social Market Economy lies in the fact that its highest priority is the preservation of civil liberties and that the benefits that result from the free actions of its citizens in the competitive environment are being leveraged for society as a whole. What counts in the market is only individual performance, independent of race, sex or personal status. This ensures equal treatment, as all citizens are equal before the law and no one is denied access to public institutions such as schools or agencies.<sup>19</sup>

### **3. THE PRACTICAL IMPLEMENTATION OF THE SOCIAL MARKET ECONOMY**

The practical implementation of the idea behind the Social Market Economy clearly demonstrates the shortcomings of state intervention. In reality, the question of whether or not and to what extent state intervention is necessary must be weighed carefully. This leads to a number of problems, which is evident from the fact that there are far too many regulations. For example, the ratio of public spending<sup>20</sup> in Germany has risen to nearly 50 per cent, in part because of massive state intervention during the economic crisis.<sup>21</sup>

The competitive environment is certainly not popular with the players on the market, as the pressure of competition forces them to constantly come up with new products and services. Resting on the performances of the past is not possible. For this reason, many market participants try to demand special regulations on the grounds of “special factors,” usually due to reasons of “obvious” market failure, national independence, product safety, job creation or the social importance of their industry. Effectively, the interest groups attempt to achieve a redistribution of economic rent in their favor and usually at the expense of third parties. A positive analysis of the regulation shows that this behavior can often be accomplished by small, well-organized minorities. The surplus is thus distributed from the majority to a minority.<sup>22</sup> As a matter of principle, the distribution of the surplus is not an economic problem, as the issue of where the social surpluses are accrued is ultimately irrelevant for social welfare. Yet government regulations routinely lead to deadweight

losses for society, thus thwarting normative considerations regarding the role of state intervention in the economy. In addition to a direct dead-weight loss, this results in other, not immediately visible costs, as the lobbying efforts of interest groups unnecessarily use up resources.<sup>23</sup> In addition, intervention creates social costs in the form of excessive restrictions of liberties.

#### **4. THE ROLE OF THE STATE IN CLIMATE PROTECTION POLICY**

Climate protection policy can be used to analyze the role of the state and of the Social Market Economy, both in theory and in practice, in overcoming market failure.

In economic theory, the problem with climate protection lies in (negative) external effects. Energy generation from fossil fuels is accompanied by the emission of greenhouse gases. The anthropogenically increasing amount of greenhouse gases<sup>24</sup> in the atmosphere leads to a rise in the average global temperature. The negative effects for humanity, such as increasing desertification or rising ocean levels, are widely known.<sup>25</sup> Businesses do not have to include the cost of climate damage created by greenhouse gas emissions into their expense calculations, as the consumption of "clean air" doesn't come with a price tag.<sup>26</sup> In other words, the private marginal costs of energy production incurred by business owners are lower than the social marginal costs incurred by society. Businesses are able to offer their products at a lower price, which in turn leads to excessive consumption of these products. Due to the presence of negative external effects, the price ratio between products that are harmful to the climate and those that are neutral is distorted, resulting in a disruption of the price signal function. Consequently, it can be considered the state's responsibility to correct the price ratio by internalizing the negative external effects, which will allow resources to be allocated once again to their most efficient use in the competitive environment, thus preventing waste. This only applies if the state measures consume fewer resources than the state intervention preserves. As no reliable data on the amount of externalities exists, state intervention can only achieve the correct price ratio by accident, if at all. State intervention can therefore only produce a second-best solution.



## **5. THE RESPONSIBILITY OF THE STATE TO CREATE A FRAMEWORK FOR ACTION**

A competitive solution is the implementation of a charge for greenhouse gas emissions, which will force businesses to consider these expenses and create a convergence of private and social costs. In principle, this could be achieved through taxation or certificate trading.<sup>27</sup> In a tax solution, each greenhouse gas unit is taxed, which gives it a price. The business is now forced to consider the cost of emissions during production. The responsibility of the state in certificate trading consists of generating property rights<sup>28</sup> for the emission of one unit of greenhouse gas. The number of emission rights is limited, making the emission of a unit of greenhouse gas a scarce right. Because these rights are marketable, a price for emission rights emerges on the market. This scenario also calls for the emitting business to pay a price for each unit of greenhouse gas, forcing it to consider these costs during production. The business now weighs up whether to buy a certificate for the emission of a unit of greenhouse gas or whether it is preferable to avoid the emission. As long as avoidance is cheaper than buying an emission right, the business will prefer the option of avoidance. Thus, the price signal is used to create an efficient allocation of pollution rights, i.e. only those businesses that gain the greatest benefit from emissions produce them. This sounds contradictory at first; however, one must not forget that society benefits greatly from the production of energy, for instance. Such an intervention changes the framework for action for society. Within this framework, competition may take place without further regulation.

## **6. NO JUSTIFICATION FOR THE SUBSIDIZATION OF RENEWABLE ENERGY SOURCES**

Emissions trading meets the basic principles of the Social Market Economy, because the forces of the market continue to be used. Climate protection is efficiently pursued. Further measures are not required and should be avoided. The European Union should take the first step here and subscribe to the sole goal of climate protection.

Notwithstanding the European Union implements other climate protection measures. However, its pronounced 20-20-20-goal i.e. the reduction of CO<sub>2</sub> emissions by 20 per cent, the increase of energy efficiency by 20 per cent and the increase of the share of renewable energies to 20 per cent

by 2020<sup>29</sup> only leads to a loss of efficiency. This shall be explained on the basis of subsidization of renewable energies. In addition to direct subsidization of various technologies, the main measures are the Renewable Energy Sources Act (for: *Gesetz für den Vorrang Erneuerbarer Energien*, in short: *Erneuerbare-Energien-Gesetz, EEG*) and the Combined Heat and Power Act (for: *Gesetz für die Erhaltung, die Modernisierung und den Ausbau der Kraft-Wärme-Kopplung*, in short: *Kraft-Wärme-Kopplungsgesetz, KWKG*).<sup>30</sup> The Renewable Energy Sources Act requires the operators to feed any energy that is available from renewable energy sources into their networks and to compensate it at a rate determined by the state. Because energy production from renewable energy sources is more expensive than production from fossil energy sources, the compensation rate exceeds the price of electricity from fossil fuels.<sup>31</sup> These additional costs are apportioned to the price of electricity by the electricity company. The Combined Heat and Power Act represents the corresponding measure for supplying energy from combined heat and power generation plants. In contrast to direct subsidies, which are also widely available for renewable energies, the costs of the *EEG* and the *KWKG* are paid directly by the consumer and therefore do not appear in the household budgets of the federal government.

The high costs created by these subsidies have serious effects on the economy. Due to tax increases caused by the subsidy and rising energy costs caused by the apportionment of the *EEG*, both households and businesses are disadvantaged. Because of these high costs, businesses are unable to invest as much, if at all, and may even be forced to file bankruptcy in extreme cases. Overall, jobs are lost.

The subsidies also cause many resources to be misallocated. For instance, if workers are only employed in the area of photovoltaics because of the subsidy,<sup>32</sup> these workers could be used more productively in a different business or sector. An employee's salary reflects his or her opportunity cost, i.e. the amount that this employee could earn somewhere else in the economy. Hence, valuable resources are being wasted.

In addition, private commercial initiatives to develop technologies for eliminating emissions are seriously impeded, as it must seem futile for projects that are financed solely by the private sector to compete with highly subsidized technologies.

Ultimately, there is great danger that an intervention by the state will fail to advance the most efficient technologies. A direct subsidization of individual technologies would be beneficial only if the state was systematically better informed than all players on the market. However, this is not feasible. Direct subsidization of individual technologies or sectors is therefore a pretence of knowledge<sup>33</sup> by the state.

Furthermore, subsidization of renewable energies on the electricity market does not affect climate protection measures, as energy production is integrated in emissions trading. Even though the subsidy helps eliminate emissions from electricity production in Germany, this only means that electricity corporations have to hold fewer emission rights. As a result, demand decreases, which leads to a drop in carbon prices. At that point, other industries in Germany and other European countries become interested in buying these emission rights and using them for their own production. The overall number of emission rights, and therefore total emissions within the European Union, is not affected by the feed-in compensation; it merely leads to a subsidization of CO<sub>2</sub> emissions in other industries. For example, an individual household may conserve energy and electricity costs by buying an energy-efficient lamp, yet this does not mean that even an ounce of CO<sub>2</sub> is being saved in the European Union. Still, politicians and the media suggest to consumers that by buying energy-efficient lamps or conserving energy in general, they are contributing to climate protection. This flawed information policy has to come to an end and must be replaced by a broad and transparent education effort about the opportunities and costs of climate protection.

Despite the fact that those sectors that until now have not been included in emissions trading are indeed registering reductions in CO<sub>2</sub> due to the use of renewable energy sources, subsidization is not justified in this case either.<sup>34</sup> One example comes from the Renewable Energies Heat Act (for: *Erneuerbare-Energien-Wärmegesetz, EEWärmeG*), which went into effect at the beginning of this year in the thermal energy sector.<sup>35</sup> The Act requires all owners of newly built houses to generate some of their heat with renewable energies. As a result, the use of fossil fuels to generate heat is reduced and emissions are ultimately abated; however, high costs ensue because reductions are no longer made in the most cost-efficient areas. Those affected by the regulation are burdened with higher than necessary costs. A more beneficial solution would be to expand emissions trading to other industries, which would allow all

consumers to use the price per ton of CO<sub>2</sub> or the higher price for heating oil or gas to adjust their demand in accordance with their personal preferences. This allows everyone to decide on an individual basis whether to let a price increase keep him from building a sun room or motivate him to switch his heat supply to a renewable energy source. The latter makes economic sense if the price for heating oil, including the cost for emission rights, is higher than the price for the cheapest renewable energy source. If the price is lower, there are cheaper options for reducing CO<sub>2</sub> emissions, as the carbon price corresponds to the marginal abatement costs. After a comprehensive internalization of the negative external effects, state support or subsidization is no longer necessary. Hence, subsidization of renewable energy sources must be stopped with urgency. The sole goal of an efficient climate protection policy should be the reduction of greenhouse gas emissions. An increase in the share of renewable energy sources should be a consequence of climate policy rather than its goal.

## **7. THE SOCIAL MARKET ECONOMY AND NATIONAL CLIMATE PROTECTION POLICY**

Social debate is ongoing concerning the rising energy costs, which are usually attributed to the market power of the dominant electricity providers. However, the problems described above reveal that rising energy costs are economically intended in order to calculate climate damage into the cost of energy production and create an incentive to conserve energy. A significant advantage of the Social Market Economy is undeniably the ability to afford each citizen a minimum standard of social participation, which includes a sufficient energy supply. A problem results from the political tendency to interfere in the pricing system for social reasons. This creates serious inefficiencies on the market and frequently puts a burden on those groups that are supposed to be getting relief. For instance, there was a serious discussion about the introduction of social tariffs on the electricity market, which rightly were not implemented in the end. In the area of welfare aid and *ALG II (Arbeitslosengeld II)* unemployment benefits, however, the state intervenes directly for social reasons. By absorbing energy costs, it attempts to keep poor citizens from feeling the effects of high energy prices. One advantage of this measure is that only those citizens of a society who are actually in need receive support, as these benefits are tied to a means test.<sup>36</sup> Still, this social measure lacks efficiency.

With a view to climate protection, this measure doubtlessly leads to tremendous misdirected incentives, as the price ratio is further distorted in the wrong direction. The absorption of the heating costs of citizens in need results in a lack of incentives to conserve this expensive energy. In contrast, a greatly reduced price leads to increased consumption, thus thwarting the government's climate protection efforts.

Goods that are needed on a daily basis and whose prices show less regional differentiation, as well as energy costs, are better subsidized through a standard flat rate. A transfer that is at their disposal underlines the individual freedom of the poor to use these means according to their preferences and to increase their personal benefit. Therefore, the benefit could be increased if the absorption of living and heating costs (transfer in kind) was replaced by a rise in the standard rates to the extent of the energy cost increase (transfer in cash). Due to the change in the price ratio, it is highly likely that the poor will not use the full standard rate increase for energy costs, but that there will also be a substitution effect toward other goods. Overall, the level of benefit to the poor will rise.

From a climate policy perspective, a subsequent safeguard for the poor makes sense, as this does not distort the price ratio and achieves an optimal allocation of scarce resources by not undermining incentives for energy conservation.

## **8. PROBLEMS ASSOCIATED WITH EMISSIONS TRADING IN EUROPE**

During the third UN Climate Change Conference (COP-3) in Kyoto in 1997, the introduction of emissions trading established a system for using the described market forces. In the Kyoto Protocol, the European Union committed to an eight per cent reduction of greenhouse gas emissions by 2012 and, in 2005, established the European Emission Trading System<sup>37</sup> for CO<sub>2</sub> for this purpose.<sup>38</sup> In doing so, it led the way in climate protection on the international level. In 2008, the European Union expanded its reduction goal to 20 per cent (by 2020).<sup>39</sup> However, this leading role is accompanied by high costs for the European economy. Emissions trading is considered an efficient system in economic theory; however, this assumes a comprehensive system. Yet the European Emission Trading System has regional restrictions, which causes significant problems with regard to efficiency and the attainment of targets.

To begin with, the regional restriction creates competitive disadvantages for those European businesses engaged in international competition. The requirement to hold emission rights increases production costs for all goods whose production creates CO<sub>2</sub> emissions. In the case of local products, businesses can pass on those increased costs to consumers in the form of higher prices, which will also lead to the desired demand reaction. This is possible because all businesses in this industry are burdened with these additional costs, which means that the competitive conditions are the same for all businesses offering this product. This, however, is not the case with businesses whose goods are traded on the global market. These businesses are engaged in international competition and compete with businesses outside Europe whose production does not carry a charge for the costs of pollution. Passing on the additional costs through the price tends to be impossible, as this would mean that the affected businesses would lose market share in the best-case scenario or fail to survive on the market in the worst-case scenario. This can lead to bankruptcies or relocation of businesses abroad with the corresponding negative effects on the European labor market. In both cases, the demand for products that are harmful to the climate is being satisfied by countries outside Europe that are not involved in climate protection efforts. These countries gain a competitive advantage by not engaging in climate protection. The European Union thus fails to reach its original climate protection goal, i.e. preventing the rise in the average global temperature. Although emissions within the European Union are being reduced through the abandonment of production plants, the reason is not a reduction in demand but rather a shift in demand from the European Union to countries outside Europe. From a global perspective, there is no change in the amount of emissions. On the contrary, it is likely that emissions will increase, due to the fact that lower technology levels in many countries, especially in newly industrialized nations, will create more greenhouse gases during production than in the European Union.

Another problem exists on the international energy markets. Emission rights trading causes energy costs to rise, which creates a proportionate demand reaction in the European Union. Decreased demand for fossil resources in the European Union also leads to lower demand on a global scale. By nature, this means that the global market price for fossil energy sources will drop, which allows other businesses to use fossil resources at a lower price. The global production of energy using fossil fuels is not affected. This problem can only be solved through a global emissions

trading system, as this would create restrictions on global emissions irrespective of how much the global market price for fossil fuels is dropping. Consequently, the leading role of the European Union creates a burden on the European economy and its own citizens. As long as the other countries cannot agree on an international settlement, non-European countries will reap the benefits in the form of an improved climate (even if only slightly) and a better competitive environment.

## **9. PROBLEMS ASSOCIATED WITH INTERNATIONAL COORDINATION**

Climate protection only makes sense if it is pursued on an international level. Therefore, the goal should be to get all countries to agree on a coordinated international climate protection effort.<sup>40</sup> Even so, the notion that every country must assume an obligation to reduce emissions or that those countries with the highest emissions the greatest obligation for reducing emissions must be abandoned. Such a belief is based on subjective principles of justice, making the conclusion of an international climate protection agreement unlikely. A fair measure would be an allocation key that is approved by all nations. The famous proposition of a per-capita-allowance, meaning the allocation of a certain amount of emission rights for each global citizen, is also rather unlikely, as countries with high emissions but a rather small population size would not give their consent. The only feasible way to reach the goal of unanimity is that all countries agree on a commitment to reduce emissions based on their willingness to pay. The fact that willingness to pay is not very high in developing countries, where food supply or the establishment of a health care system are priorities, is comprehensible. These countries are particularly affected by the early effects of climate change such as prolonged droughts and desertification. For this reason, a number of developing countries demand compensation from the industrialized nations based on their responsibility for these damages due to high emissions in the past. If the consent of the affected countries can only be gained by promising compensation payments, such a decision could be made during negotiations for an international climate protection alliance. An important task for economists consists of convincing all nations of the advantage of an emissions trading system, as it provides the most cost-efficient options for reductions and thus creates the lowest costs for all countries.

The consent of all countries to a global emissions trading system is only conceivable if all countries are able to actively participate in emission rights trading, i.e. a country must in fact have the financial means to buy emission rights in order to enable growth of its national economy. This is also a question of the redistribution effect created by assigned property rights. The compensation payments or the distribution of rights to the individual countries must guarantee that this is possible. The question of compensation payments must, however, be addressed separately from emissions trading insofar as an intervention in the market mechanism is avoided. Resources are optimally allocated only when the market mechanism of emissions trading is able to work freely. Only then has the measure reached its highest efficiency. An earlier intervention results in a loss of efficiency with corresponding welfare losses, which reduces the elbow room for compensation payments. If the international community determines that the market result does not represent the desired distribution result, payments for countries in need must be decided separately. A direct link between the income from emission rights trading and the compensation payments, as currently envisioned by the European Union, should not automatically be taken for granted. Since the citizens are entitled to the income from the sales of property rights, this income must initially be passed on to them, for instance in the form of tax cuts or debt reduction. If this income is used for other purposes, a further decision is necessary. For the citizens of industrial nations, it may make sense to lend financial support to developing countries in order to entice them to join a climate protection agreement, provided that the cost of compensation payments is lower than the climate damage that can be expected, both in a strict and in a broad sense.<sup>41</sup>

International climate protection efforts can learn from the idea behind the Social Market Economy. The goal should be the establishment of an international regulatory framework, within which the scarce resource "clean air" can be used across the global market as efficiently as possible and every global citizen can act as freely as possible. The state's responsibility lies in protecting the freedom of individuals and in ensuring functioning markets. However, the social issues of the individual nations must not be forgotten; rather, all countries must be allowed to share in the resources. It must be emphasized, however, that there should be a separation of allocation and distribution, as that is the only way to ensure efficiency in climate protection.



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1| Cf. Hobbes (1980).

2| Cf. ORDO (1948).

3| However, errors cannot be ruled out, as the decision to engage in an act of exchange is invariably based solely on the information available at the time. In the light of new information, the decision may well turn out to have been a mistake; willful deception is not considered here.

4| Ludwig von Mises refers to this principle as economic democracy: in the end, the consumer chooses which products will be produced by the entrepreneurs. [Profit] "is the instrument that turns the masses into rulers."

- 5| *If this wasn't the case, economic actions would be impossible to evaluate, as the results of each would be purely arbitrary and in no way predictable. Occasionally, of course, there are examples of individuals who obviously engage in irrational market actions. Consequently, the behavior of a single individual cannot be predicted, and economic policy recommendations are derived from the expected behavior of multiple individuals.*
- 6| *This is the dominant strategy even for an altruistic citizen or entrepreneur, because it leads to maximum savings and profits to be used for altruistic purposes.*
- 7| *Cf. Hayek (1968).*
- 8| *Cf. Smith (1976).*
- 9| *Cf. Ordo (1948).*
- 10| *Cf. Eucken (2004).*
- 11| *Below according to Eucken (2004).*
- 12| *Antisocial tendencies caused by private property may only arise in an environment of imperfect competition, as this allows property owners to abuse their power.*
- 13| *Cf. e.g. Weizsäcker (1982).*
- 14| *According to Demsetz (1969), such a comparison is called a Nirvana approach.*
- 15| *Cf. Watrin (1999).*
- 16| *Cf. Ibid.*
- 17| *Cf. Buchanan/Tullock (1962), and Brannan (1973).*
- 18| *This consideration is a result of the first and second principle theorems of welfare economics.*
- 19| *Cf. Arentz et al. (2008).*
- 20| *The ratio of public spending measures total state expenditures as a percentage of the Gross National Product.*
- 21| *Cf. Handelsblatt (2009).*
- 22| *Cf. Stigler (1971).*
- 23| *Cf. Tullock (1967).*
- 24| *Greenhouse gases refers to gaseous substances that contribute to the Greenhouse Effect. The most widely known greenhouse gases are the so-called Kyoto gases, meaning the greenhouse gases that have been included in the Kyoto Protocol. This includes carbon dioxide (CO<sub>2</sub>), methane (CH<sub>4</sub>), nitrous oxide or laughing gas (N<sub>2</sub>O), fluorocarbons and sulfur hexafluoride (SF<sub>6</sub>). Cf. United Nations (1998).*
- 25| *Cf. Stern (2006).*
- 26| *"Clean air" constitutes a common pool resource, i.e. no one may be excluded from its consumption. Cf. Donges (2004).*
- 27| *Both the tax solution and certificate trading constitute second-best solutions, because the ideal tax rate and the ideal volume of available rights are not known and ultimately would need to be estimated.*
- 28| *The idea of property rights is attributed to Ronald Coase, who determined that whenever property rights are clearly defined and marketable, an efficient outcome occurs on the market without further intervention by the state. Cf. Coase (1960).*
- 29| *Cf. European Parliament (2008).*
- 30| *Cf. Federal Ministry of Economics and Technology online (2009).*
- 31| *A reference could be made here to the Renewable Energy Sources Act, for example. Here, the most expensive renewable energy source, photovoltaics, has the highest compensation rate, at a maximum of 43.09 Eurocents per kilowatt hour. Cf. Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (2009).*

- 32| *According to calculations by the RWI, subsidies in the amount of 150,000 Euros are being paid for each position in this sector. Cf. Frondel (2008).*
- 33| *Cf. Hayek (1975).*
- 34| *At this point, the European Emissions Trading Scheme registers only 40 percent of overall CO<sub>2</sub> emissions in the entire European Union. Cf. EurAktiv (2009).*
- 35| *Cf. Federal Ministry for the Environment, Nature Conservation and Nuclear Safety (2008).*
- 36| *This is not a matter of course for social measures by the state. Many measures are not based on a means test or based only on insufficient indicators, such as wage earnings in the case of redistribution within the compulsory health insurance system.*
- 37| *Technically, this should be called "emission rights trading system", as it concerns the trading of emission rights rather than emissions. In the following, the term "European Emission Trading System" will be maintained as the name for the European system; otherwise, the term "emission rights trading" will be used.*
- 38| *The "bubble" concept stipulated in the Kyoto Protocol allowed two or more countries to fulfill their obligation to reduce emissions jointly. Only the overall amount of emissions is relevant. Cf. Umweltdatenbank (2009).*
- 39| *In the event that the international community agrees on an international certificate trading system in a post-Kyoto protocol, it is even willing to reduce its CO<sub>2</sub> emissions by 30 percent. Cf. European Parliament (2008).*
- 40| *An international agreement is hard to achieve, as climate protection represents a prisoner's dilemma. The costs for climate protection measures must be assumed by the private sector, while profits are passed on to society. In other words, it makes thorough sense for a country to refrain from climate protection within its own boundaries while profiting from the efforts of other nations. This behavior leads to an insufficient overall level of climate protection efforts.*
- 41| *In addition to direct climate damage, an increase in natural disasters may lead to further damage, for example due to global unrest.*

# CAUSES AND REGULATORY CONSEQUENCES OF THE FINANCIAL MARKETS CRISIS

*Ekkehard A. Köhler | Andreas Hoffmann*

## **1. INTRODUCTION**

In its report on the origin of the financial crisis, the “President’s Working Group on Financial Markets,” which was charged with investigating the financial crisis, came to the conclusion that the crisis was made possible due to a relaxation of credit issuing standards with regard to sub-prime mortgages and by mistakes relating to their evaluation and securitization processes.

Furthermore, weaknesses in the risk management procedures of financial institutions and state monitoring agencies contributed to a general “erosion of discipline” affecting the issuance of securities. However, when the underwriters, whose representatives include the US Treasury Department, the Federal Reserve, the stock exchange watchdog U.S. Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission, attribute the cause of the financial crisis to the inadequate regulatory frameworks governing financial markets, their causal analysis falls short. Building upon previous research of Hoffmann and Schnabl, Goldschmidt and Köhler<sup>1</sup> this paper combines international

crisis analysis from an overinvestment view and the analysis of constitutional frameworks to deal with the problems we are currently facing.

There is broad consensus that two conditions must be fulfilled for the build-up of a speculative overinvestment bubble: First, liquidity must be available to feed such speculation; second, investors must be able to expect high – i.e. above-average – returns in a specific market.<sup>2</sup>

In keeping with these criteria, the first part of this article will account for the origin of the financial crisis as a consequence of stimulation via monetary policy (liquidity) and misleading institutional incentives (positive expectations). The development of monetary policy in the United States since 2000 and its contribution to creating the real-estate bubble will also be taken into consideration.

In the second part, the international conversion to accommodative monetary policy and its effects on capital markets will be analyzed. Next, the events of the financial crisis will be briefly summarized. Finally, the state responses to the crisis will be described and critically examined with regard to their external effects and their implications for moral hazard behavior.

The third section explores alternative principles for monetary policy in order that may help containing future speculation by modifying monetary policy strategies. In addition, another part will examine the reorganization of the monetary regime from a constitutional perspective. A brief summary follows in conclusion.

## **2. CAUSES OF THE SPECULATION BUBBLE IN THE UNITED STATES**

The first part of this section will examine the development of monetary policy in the United States since the turn of the millennium. In this connection, the turn to accommodative monetary policy will be discussed, tracing the thesis of a paradigm change in the scholarly discourse in monetary policy. The effects of excess availability of liquidity on the US real-estate market will also be described.

## 2.1 US Monetary Policy since the Turn of the Millennium

After the internet bubble burst in 2000/2001, Federal Reserve policy aimed at avoiding a recession that threatened the US real economy. To achieve this, the American central bank increased liquidity availability via drastic interest cuts and reduced the fed funds rate to one per cent within a matter of months. As a result, banks acquired more liquidity from the central bank and expanded lending. This resulted in monetary expansion at a rate of 10 per cent annually (on average) from 2001 to 2004.<sup>3</sup>

According to "quantity theory of money", such a development in the money supply will either have an effect on the growth of the gross domestic product or on consumer price inflation, provided money demand remains stable. Yet both growth and consumer price inflation remained moderate at about three per cent and two to three per cent, respectively. Accordingly, money demand increased at the low interest rates. The increasing money demand was accompanied by an expansion of available money. Since no increased inflation pressure was discernible, the Federal Reserve kept the interest rate low to support growth and reduce the risk of a recession.

In keeping with the so-called Jackson Hole consensus, US central bankers and leading academics<sup>4</sup> view speculative bubbles in financial markets as acceptable in order to stimulate economic activity. The Jackson Hole consensus was that bubbles should not be burst because they are difficult to identify as such and moreover, bursting bubbles could endanger the entire economy. When a bubble does burst, the Fed is supposed to intervene and recapitalize financial intermediaries, if applicable.<sup>5</sup>

This monetary policy had far-reaching consequences. Although the development of money supply did not fuel consumer price inflation, assets such as stocks and real-estate reacted to increased money supply.<sup>6</sup> The latter were not included in the monetary policy reaction function. Thus the Fed kept interest rates low although the money supply exploded between 2003 and 2007. It was not until mid-2004, that the effects of expansionary monetary policy were felt in rising consumer prices. Then the Fed slowly raised interest rates.<sup>7</sup>

The excessive liquidity expansion in the US between 2001 and 2005 was the first necessary condition for the creation of speculative bubbles.<sup>8</sup>



## **2.2 The Boom in the US Real-Estate Market**

### ***2.2.1 Positive Expectations Meet Institutional Incentives to Create a Boom***

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The second necessary condition for the build-up of an overinvestment bubble is positive expectations.<sup>9</sup> After the collapse of the internet bubble, there were no such positive expectations in the US stock market.<sup>10</sup>

Yet US housing prices had been rising since the mid-1990s at a more rapid rate than the general price index (the asset price development is not included in consumer price inflation). This development was regarded as “good for growth” even after the internet bubble burst.<sup>11</sup> The expectations in this market continued to increase primarily due to fiscal policy support and the attractive general investment conditions enjoyed by institutions. For example, it is possible in the USA to apply tax write-offs to real-estate financing expenses. Moreover, general access to attractive mortgages is subsidized by state-backed financing institutions. When the mortgages were structured and bundled into so-called Mortgage Backed Securities (MBS), which were sold as investment banking products to third-parties – usually institutional customers – state-backed institutions also underwrote the default risk, resulting in more than half of MBS issued in the USA being guaranteed by the state.<sup>12</sup>

Furthermore, general institutional conditions, such as the controversial Community Reinvestment Act and lax monitoring of securities issuance practices contributed to expectations of high returns on the US real-estate market. Thus both conditions for the creation of a bubble in the housing market were fulfilled.

### ***2.2.2 The Boom in the US Housing Market***

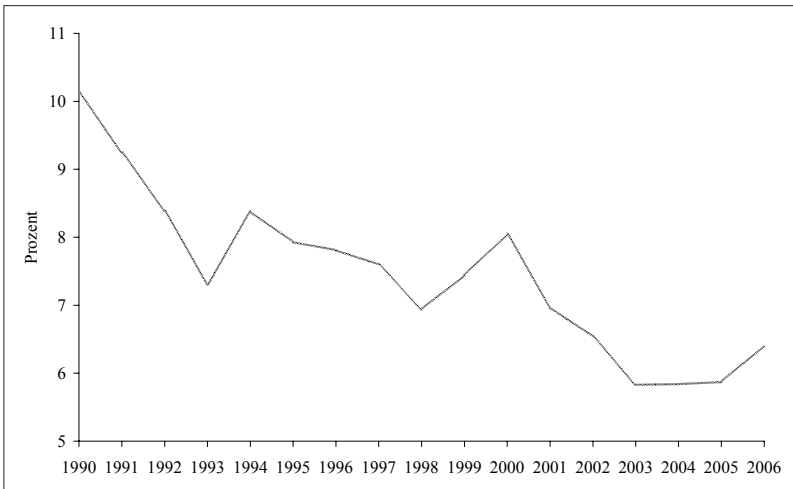
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Considering these favoring conditions, the demand for real-estate and credit increased dramatically. The banks sought more money from the central bank. This demand for money was satisfied at low interest rates such that the financial institutions were able to reduce interest rates on credit and mortgage markets to the historically lowest financing level of six per cent by 2005 (Graph 2), although the demand for credit was increasing.

Since the demand for real-estate is not elastic due to the low circulation frequency, the prices increased more rapidly than before. In turn, increasing housing prices had an effect on the banks' credit granting procedures. The high demand for real-estate also promoted the creation of credit by the commercial banks and increased the demand for money from the central bank. Starting in 2000, the house prices doubled within five years.

Moreover, the newly-created securities fed the upward spiral of credit issuance and US housing prices (innovations in Minsky's sense). Credit for residential buildings was pooled together into safe investments, given AAA ratings, and resold. This gave banks the opportunity to remove the default risk for their mortgage market operations from their balance sheets and transfer it to third parties. Buyers quickly lined up for AAA-rated securities.<sup>13</sup>

*Graph 2: Average interest rate on mortgages in the USA from 1990 to 2006*



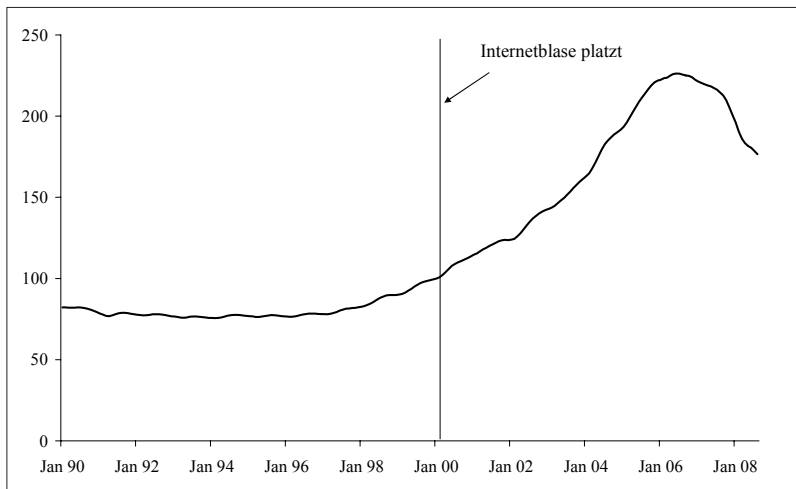
Source: Office of Federal Housing Enterprise Oversight, interest rate for a 30-year amortization period.

The transfer of payment claims deriving from mortgage and credit operations further expanded the financial leeway of mortgage financing entities and of the commercial banks involved. It created the basis for financing new credit operations. The banks anticipated this new situation by ex-

panding lines of credits to borrowers with lower credit ratings who would previously not have been considered viable borrowers. The subprime segment created in this way was intentionally served and soon accounted for a majority of new credit granted.<sup>14</sup>

The credit granted in this connection was later termed “Ninja loans” (No Income, No Job or Assets) and their value was entirely dependent on the increasing housing market prices. Flexible-rate loans were especially favored. These were often structured such that the interest payments due at the beginning of the term were low (so-called “teaser rates”), and only after several years did they increase to the normal market rate. As long as housing prices increased and interest payments were moderate, the relationship between the amount of credit and the value of the real-estate property improved across all mortgage loans.

*Graph 3: Case-Shiller Home Price Index 1990-2008*



Source: Standard & Poors 2008, Composite 10.

The course of the Case-Shiller Home Price Index, which represents the development of the home prices in the most significant US metropolitan regions, clearly illustrates the boom described above (Graph 3). At the same time, the percentage of home owners increased from 67 to 69 per cent between 2000 and 2006 (an all-time high).

Soon, the boom in the housing market began to affect the overall economy because the asset situation of homeowners was improving - as long as interest rates remained low and housing prices continued to rise. This increased the creditworthiness and consumption capacity of the American people, which ultimately stimulated the economy in general – and contributed to the misallocation within the real economy and increased the debt ratio of budgets.

### **3. THE WORLDWIDE MONETARY EXPANSION AND ITS EFFECTS**

After 2001, monetary policy aimed at avoiding recessions and promoting growth, not only in the US economy but in all major economies. As a result, attractive refinancing opportunities were available on international capital markets, which promoted worldwide growth. Below, we examine developments in the monetary policy of East Asia (China in particular) and Europe after 2001. The implications of these policies for capital markets will then be elucidated.

#### **3.1 East Asia**

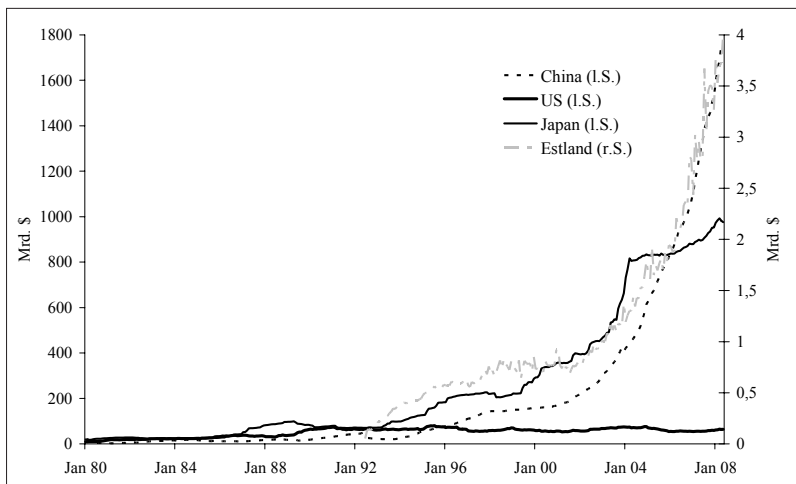
In the 1990s, many East Asian central banks (that of China, in particular) stabilized their currencies against the US dollar. This exchange rate peg appears to be beneficial for two reasons: First, the US is East Asia's main trading partner. Since East Asian economies do not have international reserve currencies, transactions were processed in US dollars. Second, a fixed exchange rate guarantees the value of reserves that have already been accumulated. For this reason, reference is often made to a world dollar standard.<sup>15</sup>

By pegging their exchange rates against the dollar, these economies also imported US monetary policy. On the one hand, the expansionary US monetary and fiscal policies after 2001 heated up consumption in the US. Additionally, it exposed the dollar to devaluation pressure. To maintain the stability of the exchange rate, the East Asian central banks had to intervene by purchasing additional dollars and selling their own currencies on foreign exchange markets (Graph 4). East Asia thus can be argued to have pursued a strategy of undervaluation to stimulate exports and economic growth.<sup>16</sup>

Since East Asia primarily invested the accumulated reserves and savings from exports in US state-backed securities, additional liquidity was available to financial institutions, which reduced the long-term interest rate in the US. The process of creating money in the US thus received additional impetus from the monetary effects of East Asia's export-induced growth strategies. Bernanke<sup>17</sup> regards this "savings glut" from East Asia as the main reason behind global imbalances and bubbles. Capital imports from East Asia speed up the boom in mortgage markets because the amounts of money that were initially absorbed from East Asia were once again made available on the market via the sale of US state-backed securities. The fertile ground for speculation grew (first factor identified by Minsky and Hayek).

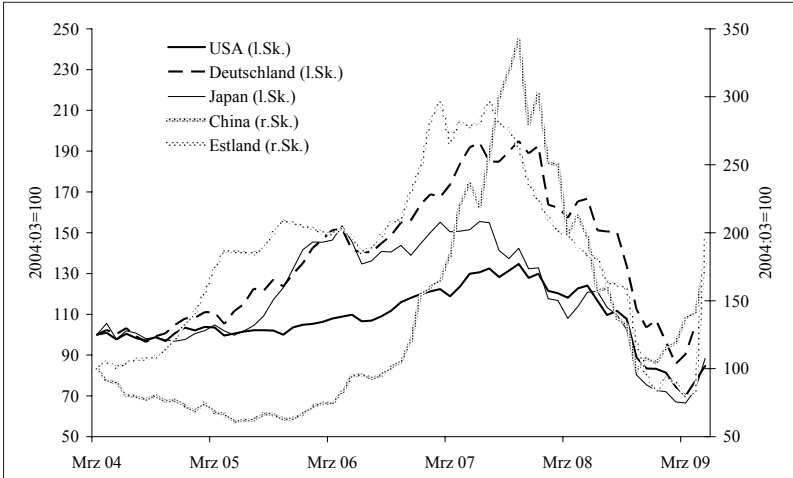
During the boom, both profited from one another. The US profited due to the attractive situation for the financial sector and East Asia was given opportunities to export industrial products. Graph 5 illustrates the boom in the countries of East Asia on the basis of stock price development in China.

*Graph 4: Development of Foreign Currency Reserves*



Source: IWF, IFS 2009.

Graph 5: International Stock Price Development



Source: IWF, IFS 2009 and Ecowin 2009.

The East Asian export-led growth strategy has contributed to coordination with the accommodative monetary policy of the Federal Reserve System, which finally put the onus on the European Central Bank.

### 3.2 Europe

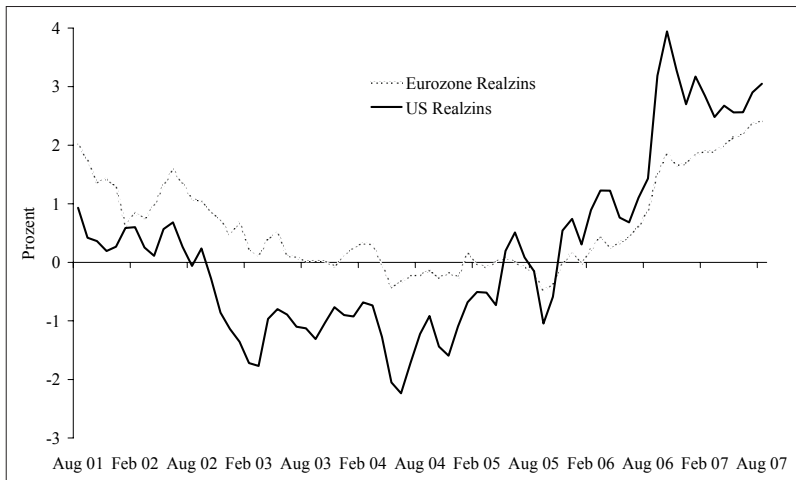
Until 1999 the German Bundesbank put the emphasis on the development of money supply to keep the quality of the currency. When the European Central Bank took on the role of making monetary policy, the money supply lost its importance. Instead, monetary policy was subsequently aimed at achieving a consumer price inflation goal of less than (but close to) two per cent. European monetary policy became more closely allied with US monetary policy, especially after the change of the ECB's concept in nary monetary policy of early spring 2003.<sup>18</sup>

One reason for the departure from controlling the money supply within a Friedman paradigm was the empirical observation that the level of consumer prices continued to remain stable despite the rapid growth in money supply during the 1990s. For this reason, doubt was cast on the monetary connection between growth of the money supply and price development in academic discourse.<sup>19</sup> De Grauwe and Polan<sup>20</sup> take the assertion further by claiming that growth of the money supply exerts no

influence on price development, since the demand for money is not constant. When the demand for money is increasing and/or the velocity of money is falling, the money supply can increase more quickly than under Friedman's principles. Since the money supply was no longer regarded as a good indicator of future price developments, the current development of the price index and of the GDP should be taken as an indicator of future price developments.<sup>21</sup>

In June 2001, the European Central Bank lowered the main refinancing rate because deflation tendencies were observable in parts of Europe. Similar to the situation in the US, real interest rates continued to be negative over an extended period (Graph 6). The money supply in the Eurozone also increased between 2002 and 2006 by about 10 per cent annually. This prepared the ground for asset price bubbles.

*Graph 6: Parallel Real Interest Rate Development in the USA and Eurozone*



Source: IWF, IFS 2009.

In Europe, the low interest rate additionally promoted the flow of capital into the emerging markets of Central and Eastern Europe, in particular the Baltic states and Bulgaria, which stabilized their exchange rate against the Euro and offered high returns on investments. Similar to the situation in East Asia, foreign currency reserves increased dramatically in these countries (Graph 4). In Central and Eastern Europe too,

stock and real-estate prices literally skyrocketed (Graph 5). Capital infows were reflected in large current account deficits and overinvestment in real-estate markets.<sup>22</sup> While East Asia and Eastern Europe were the most dynamic regions, similar developments could be observed in a number of emerging market economies. This was true in particular of countries that export raw materials, which profited from the rapidly rising price of raw materials (Russia, Brazil).

### **3.3 The Effects on Capital Markets**

It wasn't only the countries of East Asia and Europe that pursued the goal of providing inexpensive liquidity, rather Japan, Russia and most of the other G-20 states also followed. As a result of the worldwide monetary expansion, the real world interest rate remained near zero for a long time after 2001. The commercial banks responded to this development by expanding their investment, credit and financing operations.

In search for attractive investment, Asian and European commercial and investment banks took notice of the securitized payment claims due from US homebuilders. AAA-ratings promised above-average returns. Thus these products appeared to be both low-risk and lucrative. The international demand intensified securitization even further, since the US banks found a way not only to bundle the risks, but also to resell and further distribute them, almost without limit. This increased the leverage and capacity of the banks to grant credit and banks were less dependent on central bank liquidity. The proportion of foreign capital invested in enterprises rose dramatically. In an environment of rising asset prices, companies were able to absorb more foreign capital since the asset side of their balance sheets became increasingly inflated due to the increase in asset prices.

## **4. THE FINANCIAL CRISIS AND STATE MEASURES TAKEN IN RESPONSE**

In this section, we describe the crisis events and worldwide transmission of the financial crisis. Afterwards, we examine the responses of governments and central banks to the crisis and analyze their effectiveness.



#### 4.1 The Crisis in the USA

In July 2004, the Federal Reserve began to increase interest rate with the European Central Bank following in December 2005. In the United States, this initiated the reversal of expectations and profitability in the real-estate market: The increasing interest rate reduced demand for real property and mortgages. Moreover, the rate increase led to defaulted payments, since many subprime borrowers could only pay the mortgages on their houses as long as interest rates were falling and home prices were rising.

Due to the payments defaulted on by subprime debtors, beginning in summer 2007 mortgage refinancers, investment banks and insurance companies like IndyMacBank, Bear Stearns, AIG and Merrill Lynch lost billions, were sold or had to apply for creditor protection. While the state-backed real-estate financing institutions Freddy Mac and Fannie Mae were saved from bankruptcy in July 2008<sup>23</sup> by government intervention, the failure to save Lehmann Brothers in October 2008 contributed considerably to the uncertainty affecting the financial markets. Trust in the markets eroded and all mortgage financiers were pushed to the brink of insolvency.

The losses of investment banks resulted in a reduction of the willingness of private and institutional investors to assume risk. The latter then quickly withdrew considerable amounts from the capital markets or refrained from making new investments in high-risk products. The stock market collapsed (Graph 6). This reduced the banks' equity. In addition, mistrust among the banks was rife and they were generally no longer prepared to help one another secure credit. Finally, the inter-banking market dried up entirely so that it was only possible to obtain liquidity from the central bank.

The next sector to be hit was the US real economy; due to the payment problems experienced by homeowners, many houses were subject to foreclosure and compulsory auction, and these households no longer had access to income of any kind. As a result, real-estate prices fell dramatically starting in mid-2007. With the fall of real property value, Americans lost their securities backing consumer credit. Private consumption fell. In a second wave, the reduced credit availability from the banking sector, which had been hit hard by the crisis, reduced both

investment and consumption. Thus unemployment started to rise. In 2009 US GDP declined substantially.

#### **4.2 International Transmission of the Crisis**

The world economy slowed down as the economies of East Asia, Europe and the emerging markets were also affected by the crisis. Due to their role as major providers of credit to the US, East Asia and Germany were affected by the crisis from the very beginning. European financial institutions like Northern Rock, the IKB and German Regional State Banks, as well as East Asian financial institutions lost because they had bought toxic securitized paper. In addition, falling US imports caused growth projections to worsen for export-based economies. The GDP in both Germany and Japan contracted considerably by the end of 2009. Unemployment started to rise.

The emerging market economies were affected primarily by a lower influx of capital. This exposed their currencies to devaluation pressure and, in countries that had pegged their exchange rate to the Euro or dollar in particular, to a monetary contraction that slowed growth. Most of the world's economies thus contracted more dramatically than ever before. The GDP of the Baltic countries fell by approximately 10 to 15 per cent over the course of the year. Graph 6 illustrates how asset values in Estonia and China (among others) collapsed in 2007.

#### **4.3 State Measures in Response to the Crisis**

Immediately after the outbreak of the financial crisis, central banks hastily reduced fund rates. The latitude for monetary policy operations open to the central banks was strongly limited, however, because the interest rate was already relatively low at the outbreak of the crisis in comparison to earlier boom periods. Since the minimum level of interest rate reduction was reached as early as the end of 2008, the central banks granted the commercial banks any amount of money they requested. Since then, this policy of "monetary easing" has meant that unlimited liquidity is available in the US, the Eurozone and the UK.

In addition to this monetary policy response to the financial crisis, the governments of the G20 have "initiated what are probably the largest state interventions since the 1930s,"<sup>24</sup> including the provision of state

guarantees for bad assets and fiscal policy stimulation programs of unprecedented scope. While state guarantees and the nationalization of commercial banks were intended to prevent looming bank collapses, the economic programs sought stabilize the economic system. From the outset of this policy, the governments hoped to reduce the risk of deflation and to moderate the effects on the real economy. As a result of this response to the crisis characterized by debt financing, state debt will reach all-time highs over the course of the next few years, especially in developed economies.<sup>25</sup> This further reduces the latitude for political action for the future.<sup>26</sup>

These policies were actually able to preserve the markets from a feared widespread collapse of banks in fall 2008. Even if it has not been possible to date to restore faith in the financial market players and with it, the interbank market, it is possible that the intervention of policymaking could affect the expectations of market participants and thereby shorten the length of the crisis. In this sense, the rapid and massive state intervention would have been the right course of action.

Doubt has already been cast on the long-term effectiveness of this policy response, however: Even if the effect of the crisis on the real economy can be moderated over the short-term by such expansive fiscal and monetary policies, this type of policymaking will serve to virtually guarantee the reoccurrence of a similar crisis.<sup>27</sup> How could governments and central banks credibly signalize, that they abstain from bail-outs and stimuli packages during the next crisis? Ultimately, governments are continuing the policies that originally contributed to the crisis<sup>28</sup>: Bad investments and overinvestments are maintained and newly stimulated by guarantees and economic programs. Restructuring of the economy is impeded and conduct informed by moral hazard is promoted.<sup>29</sup> Finally, the ECB's cheap long-run jumbo loans and its reduced security standards might jeopardize the efficacy of this response in the future.<sup>30</sup>

## **5. THE POLITICAL AND CONSITUTIONAL IMPLICATIONS OF THE FINANCIAL CRISIS**

The doubt we cast on the long-term efficacy of the state responses to the crisis can also be interpreted as a qualitative problem, that these policies are aimed at the symptoms of the financial crisis rather than at the political and institutional reasons that primarily caused it. Therefore,

we would now like to advocate a variation of the predominant concept of monetary policy and a variation of the monetary regime to contribute to the solution of this problem. We will proceed in two steps:

First, the question will be asked how the existing monopolized monetary regimes can be improved by modifying the procedures in the conduct of monetary policy – that is, by varying the “monetary policy strategy” of the central bank – such that the recurrence of excess liquidity scenarios can be best avoided. In this connection, we will summarize three suggestions to reform monetary policy.

Second, we discuss the possibilities for changing the existing monetary regime from a perspective of constitutional political economy. In contrast to the first step, we examine the effect of varying the existing monetary constitution and inquire into the institutional arrangements and polity changes that are advisable to ensure an effective monetary regime over the long-term. With its constitutional approach, constitutional economics attempts to correct neoclassical economics in which the institutional perspective has been widely neglected.<sup>31</sup>

### **5.1 The Necessity of Modifying Monetary Policy Concepts**

As has been illustrated in Sections 2.1 and 3.2, a paradigm shift has occurred in monetary policy discourse over the last twenty years. The worldwide conversion of central banks to accommodative monetary policy, which is related to the above paradigm change, and its contribution to causing the financial crisis, raises the question of how the monetary policy strategy of central banks should be reformed to avoid future crises and to ensure a stable currency within a monopolistic monetary structure.

In this connection, Borio and White<sup>32</sup> recommend that central banks should monitor asset prices and credit developments in the future to limit the banking sector’s capacity to create liquidity. Money supply developments should therefore receive more attention than during recent years. The integration of credit and asset aggregates into central banks’ response function would clearly not be a return to the monetarist money supply rule, which was displaced from its leading role in the scholarly discourse due to new insights gained from research into the transmission mechanisms of monetary policy. At the same time both

scholars reject the dominant neo-Keynesian conclusion that we introduced in Section 2.1.

The President of the Bundesbank, Weber<sup>33</sup>, also advocates this opinion and additionally calls for an end to the expansive monetary and fiscal policies within the foreseeable future, i.e. after the market has stabilized. According to his position, a reformed monetary policy should assure that interest rates should meander along the business cycle to avoid low interest rate levels over the long-term. This would allow the central bank to better ensure that the effects of monetary policy are predictable, at least over the mid-term.

Neumann<sup>34</sup> carries these ideas even further. In contrast to the Greenspan-Bernanke-Mishkin view, he argues that central banks should modestly lean against asset price bubbles by contracting monetary supply once they are monitored.

All three approaches aim – at least implicitly – at a revision of the Jackson Hole consensus, since the proposed monetary policy is intended to prevent the formation of speculation bubbles.

Because of their aim, these new approaches can be recommended to regulatory bodies for implementation, since effectively incorporating these new monetary policy strategies at the institutional level is equivalent to a return to a stability-oriented and predictable monetary policy that adequately addresses the money supply issue especially on the formation on overvaluation bubbles.

Beyond these recommendations to reform monetary policy, the state should also be advised to reform the economic constitution due to the interdependency of the monetary and the economic order.<sup>35</sup> In this connection, Wohlgemuth, Straubhaar and Zweynert<sup>36</sup> have noted that attention should also be devoted to the principle of liability as the guiding ideal for the reform of the monetary and economic system.<sup>37</sup>

Other interdependent areas of the economic order should also be subject to corrective measures; however we cannot explore this further here. These primarily include institutional incentives to stimulate consumption and investment, regulations that limit moral hazard, as well as instruments to discipline public spending.<sup>38</sup>

## 5.2 Reforming the Monetary Constitution

The question which alternative rules can be recommended to improve the monetary constitution represents a problem of choice among constitutional constraints. But how does constitutional economics evaluate the quality of alternative constitutional rules?

The variation of the monetary constitution can be regarded as advantageous for society from a constitutional political perspective, if it can receive voluntary and informed consent from all affected individuals. Consent therefore constitutes a *sine qua non* condition for a legitimately recommended constitution of the monetary constitution.

The second, downstream criterion for evaluating the extent to which an alternative constitutional rule or particular regulatory changes can be legitimately recommended concerns the functional characteristics it unfolds on the subconstitutional level. Of course, only action patterns (in the sense of Hayek's "pattern prediction"<sup>39</sup>) that underlie an alternative monetary system or alternative regulations in the existing system can be predicted here. From a constitutional political perspective, the question is thus raised as to which monetary system best meets the common constitutional interests that money users have in their currency in comparison to the existing or alternative monetary system proposals. A decision is then reached based on a functional test, in conjunction with the legitimacy criterion of voluntary consent regarding the extent to which a particular monetary structure can be legitimately recommended.

Since an overall examination of such a discussion cannot be provided within the scope of this article, we have limited ourselves to a short summary of the results of such an evaluation.

Monetary regime proposals can be divided into two categories, based on their institutional structure and the type of conduct that can be expected for each: On the one hand, systems that require discretionary control and on the other, systems that pursue rule based control. From the perspective of constitutional economics, rule-based monetary regimes are preferable to discretionary regimes, with regard to the extent that they can be legitimately recommended.

The necessary institutional arrangements range from a commodity reserve currency<sup>40</sup>, which was recently discussed by the Chinese central bank,<sup>41</sup> to the idea of an independent central bank structure,<sup>42</sup> through to a currency competition model.<sup>43</sup>

Within the scope of research into competitive monetary systems, which has received renewed attention since the outbreak of the financial crisis, two lines of development can be identified that can each be traced back to the time when the gold standard collapsed: One is largely an Austrian development that advocates returning to a free banking system with a 100 per cent minimum reserve backed by gold,<sup>44</sup> while the other is a more heterogeneous/Anglo-Saxon development that calls for multiple forms of a free banking system – with at least the partial participation of the central bank – with various institutional arrangements.<sup>45</sup> The proposal by Leonhard Miksch can also be classified in this line of development; Miksch introduced what amounts to a precursor of a free banking system into the Freiburg School's monetary system discourse.<sup>46</sup>

Both camps are divided with respect to the legitimacy principle on one hand, and with regard to the specific institutional recommendations on the other.

A further investigation is required regarding the institutional structure of such a system, and regarding its integration into the entire economic system. There are good reasons to support the idea that a competitive currency system that includes active participation of the central bank and regulations to standardize the circulation of money would be a viable alternative to a monopolized monetary structure, based on the expected results.<sup>47</sup> This is not the place to conduct a more specific consideration of this idea, however.

## **6. SUMMARY**

One cause of the financial crisis among others can be seen in the mismanagement of monetary policy since 2000. The accommodative monetary policy pursued worldwide distorted the refinancing incentives of the commercial banks, leading to the global financial markets becoming inundated by a flood of investment. The commercial banks responded to the historically advantageous refinancing conditions offered by the central banks by expanding their investment, credit and financing opera-

tions, which in turn increased the level of debt considerably. The general institutional conditions promoted not only passing on structured credit and mortgage products to third parties, but also promoted granting credit to customers with low creditworthiness. The questionable evaluation of these risks and the high demand for investment products increased the accumulation of securitized credit risks. A globally-fuelled speculation bubble was created in the US housing market. After the bubble burst in Summer 2007 and the effects associated with it spread to the markets and companies involved, all major economies that were already suffering from the ill effects of the global economic slowdown (via the trade channel) were befallen by the financial crisis we are familiar with.

Once it burst, the bubble was followed by drastic interest rate cuts by the central banks and far-reaching interventions to stabilize the financial markets. To date, the response to these measures has been able to avert a feared contagion of bank collapses. The long-term efficacy of this response, however, must be doubted since a long-term solution would require a restructuring of the rules and institutions that govern the monetary and economic systems.

A conceivable way would be to integrate asset price developments into the central banks' criteria for setting interest rates, as discussed in Section 5.1. Although the path back to controlling money supply is not advisable, it is worthwhile to reconsider Milton Friedman's criticism of his own profession, which he proposed to his colleagues on the occasion of the 80<sup>th</sup> annual meeting of the American Economic Association: "The first and most important lesson that history teaches about what monetary policy can do – and it is a lesson of the most profound importance – is that monetary policy can prevent money itself from being a major source of economic disturbance."<sup>48</sup> For this reason, further investigations that discuss alternative monetary regimes from a constitutional political perspective should follow. Instrumental arrangements that have been discussed within the ordoliberal discourse on the monetary system – in an updated and well-thought-out form – may offer a paradigmatic alternative within discourse around the further development of the European Monetary Union.



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- 1| *Schnabl / Hoffmann (2008), Hoffmann/Schnabl (2009), Goldschmidt/Köhler (2008) and Köhler (2010).*
- 2| *Hayek (1929) and Minsky (1986) also identify similar principles for the genesis of financial market crises. Although both approaches are properly categorized as theories of monetary overinvestment, they differ with regard to the course the crisis is expected to take. Moreover, Hayek and Minsky come to opposite conclusions regarding the implications for policy see also Schnyder (2002).*
- 3| *Specifically, the monetary reserves which include the banks' credit aggregates.*
- 4| *Cf. Blinder/Reis (2005), Mishkin (2007).*
- 5| *Ibid., p.67.*
- 6| *Cf. Aladid / Detken (2007), Borio (2008).*
- 7| *Cf. Hoffmann / Schnabl (2009).*
- 8| *Cf. Hayek (1929), Minsky (1986).*
- 9| *Cf. Hayek (1929), Minsky (1986).*
- 10| *Cf. Case / Shiller (2003).*
- 11| *Cf. McCarthy/Peach (2005).*
- 12| *Cf. Jaffee (2008).*
- 13| *Securitized credit and mortgage risks are evaluated by private enterprises.*
- 14| *Cf. Osman (2007).*
- 15| *Cf. McKinnon / Schnabl (2004), McKinnon / Schnabl (2009).*
- 16| *See Bretton Woods II System in Dooley et al. (2004).*
- 17| *Cf. Bernanke (2005).*

- 18| Cf. Neumann (2009).
- 19| Cf. Estrella / Mishkin (1997).
- 20| Cf. De Grauwe / Polan (2005).
- 21| Cf. Gerlach / Svensson (2002), Stock/Watson (2002).
- 22| Cf. Hoffmann/Schnabl (2008).
- 23| Cf. Jaffee (2009).
- 24| See *Neue Zürcher Zeitung* of September 22, 2008, p. 9.
- 25| Cf. IMF (2009).
- 26| Cf. Hoffmann / Schnabl (2009).
- 27| Cf. Straubhaar et al. (2009), Schnabl/Hoffmann (2008).
- 28| Cf. Wohlgemuth (2008).
- 29| Cf. Hoffmann / Schnabl (2009).
- 30| Cf. Neumann (2009).
- 31| Cf. Vanberg (1998).
- 32| Cf. Borio (2008) and White (2008).
- 33| Cf. Weber (2008).
- 34| Cf. Neumann (2009).
- 35| Eucken (1952/2004), p. 257.
- 36| Cf. Wohlgemuth et al. (2008).
- 37| Also Eucken (1952/2004), p. 279.
- 38| *In this connection, accounting regulations that have a procyclical effect, methods of evaluating securitized credit risks, as well as the competition monitoring system for structured products should be mentioned, among others.*
- 39| Hayek (1968 / 2003), p. 135. See also Vanberg (2008), p. 311.
- 40| Cf. Eucken (1952), Hayek (1943 / 1976), Buchanan (1962 / 1990).
- 41| Cf. Zhou (2009). In Part III of his talk, Zhou explicitly advocates that money be backed by real assets, in opposition to cursory interpretations that reduce the suggestion of the Governor of the People's Bank of China (central bank) to J. M. Keynes' idea of introducing the "bancor": "The allocation of the SDR can be shifted from a purely calculation-based system to a system backed by real assets, such as reserve pool, to further boost market confidence in its value".
- 42| Cf. Miksch (1949a), Bernholz (1989), Buchanan (2004).
- 43| Cf. Miksch 1949b, Hayek (1976), Hayek (1977), Buchanan (1990/1999), Buchanan (2004), Gerding/Starbatty (1980).
- 44| Cf. Rothbard (1962), Huerta de Soto (2006).
- 45| Cf. Meulen (1934), Smith (1936), Hayek (1976), Buchanan (1990), White (1983), Yeager (2009).
- 46| Cf. Goldschmidt / Köhler (2010). Leonhard Miksch (1901-1950) was a student of Eucken and academic advisor to Ludwig Erhard; he played a pivotal role in the success of the 1948 currency reform (see Goldschmidt/Köhler (2008)). Shortly thereafter he developed his idea of a "Metric Monopoly," which was the first conception of a competitive monetary system in ordoliberalism. As early as the time of German hyperinflation in 1923, Walter Eucken developed the idea that in order to recover, "the power to determine the size of the money supply [must] be taken away from the state" (Eucken (1923)).
- 47| Cf. Hayek (1976), Buchanan (1990), Yeager (2009).
- 48| Cf. Friedman (1968).

# THE FINANCIAL AND ECONOMIC CRISES: A THREAT TO THE SOCIAL MARKET ECONOMY?

*David Gregosz*

## **1. INTRODUCTION**

Both the financial crisis and the Social Market Economy are the subject of countless articles in the press, speeches and essays. The Konrad Adenauer Stiftung also hopes to shed some light on the matter with its recent publications and conferences. This paper draws on this motive and creates a link between the two topics – the financial crisis and the Social Market Economy – in an effort to answer the key questions of today, namely: Do the financial and economic crises pose a threat for the Social Market Economy? And, what conclusions can be drawn?

Without wanting to forestall a more sophisticated answer, one thing can be said with certainty: the German economic system (popularly described as the “Social Market Economy”) together with the financial and economic policies of the Federal Government are now facing enormous challenges. Challenges, which will characterize the next legislative period. These are predominantly the result of an unusually deep recession, in which the global economy found itself during the spring of 2009 and from which it is now gradually recovering, and the need for reform for individual political



areas (e.g. fiscal or social security system). If the important early economic indicators are to be believed, then the economic downturn has now been overcome; however, academics cannot agree about the forthcoming recovery scenario. Quite apart from whether the economic recovery will turn out to have a W, V or U shape, there are certain observations, which can be made now. The main assumption is that there is a need to overhaul the financial markets, so as to ensure that money and capital once again play a helpful role for human beings.

## **2. CAUSES AND FISCAL IMPACT OF THE FINANCIAL CRISIS**

The scale of the current crisis is due to the co-occurrence of several factors: The financial crisis, an economic downturn and an international structural crisis in certain markets (e.g. the automotive industry and suppliers, who have to reduce surplus capacities) – three economic phenomena which feed off each other.

Significant macroeconomic imbalances, inefficient regulatory structures and flawed incentive mechanisms in the banking system have been identified as the starting point for the banking, or rather financial crisis, as has failed American social and monetary policy, which encouraged a real estate bubble and, ultimately, led to this bursting. This caused several financial institutions, which were linked to each other, to get into difficulty and culminated in the collapse of the investment bank, Lehman Brothers, on September 15, 2008. As a result of this unexpected shock, the inter-bank market came to a near standstill. The consequence of this was that the cost of borrowing soared, lending was reduced, markets were compartmentalized and there was a huge loss of confidence about the fate of the economy (evident from the stock market crashes). In turn, this led to massive economic problems, which placed the greatest strain yet on the Eurozone; and tensions continue to grow within the single currency area. The effects of the financial and economic crises are being compounded in countries such as Greece, Italy, Portugal and Spain due to certain economic failures. In the past, these countries all lived beyond their means, which aggravated their individual problems during the crisis and made wage and price adjustments in the real economy a necessity.

Citizens and businesses alike have experienced firsthand how interconnected economies – which, without a doubt, are advantageous for Germany – can also transfer shocks throughout the system. When the world economy slows down as the result of a shock, then the (former) leading export nation is subject to the full force of the situation. Economists are referring to an “imported recession” in the case of the current crisis, which, of course, affects growth and employment. That is precisely why the new Federal Government must show a keen interest in coming to terms with the crisis and in improving international regulation. However, contractions in an economy based on the division of labour are not distributed symmetrically: Some sectors, mainly regional ones such as the capital goods industry, have been hit much harder than others. This confusion in certain sectors can be explained because the crisis has not reached them yet. Only when the situation becomes wholly apparent, with wage cuts, short time or unemployment, will many people fully appreciate the extent of the dislocation. From a macroeconomic perspective, these dislocations are undeniably large, which is why industrialized nations strove to cushion the drop in demand through concerted efforts.

### 3. EFFECTS ON THE “REAL ECONOMY”

In spite of these measures, the Federal Government expects GDP to fall this year by 5.0 per cent in real terms. The Federal Statistics Office published figures in May 2009 that showed that economic output had fallen by 3.8 per cent in the first quarter (in the second quarter, the economy grew slightly by 0.3 per cent). Never before has there been such a sharp decline in the Federal Republic’s sixty year history. As a consequence, there is an increasing number of insolvencies and a rise in the average annual number of unemployed people, a delayed indicator for the state of the “real economy”. The Institute for Employment Research (for: *Institut für Arbeitsmarkt- und Berufsforschung, IAB*) calculated the average number of unemployed people to be 3.5 million in 2009. The average annual figure for 2010 is expected to reach 4.1 million.<sup>1</sup>

Of course, the worsened conditions also impact on the public purse. On the income side, the results of the May tax estimate for 2009 to 2012 show a reduction in tax receipts of 316 million Euros (nevertheless, forecasts show that this year will see the third highest tax revenues ever – only in 2007 and 2008 were higher tax revenues collected). Around

two-thirds of the losses are linked to the worsened overall economic situation; the remaining third is due to fiscal reform.

The erosion of income, as well as additional burdens on the expenditure side (such as employment and economic stimulus packages) will shape the national finances over the coming years. It is already clear that the deficits expected for 2009 and 2010 will exceed those seen after reunification. Adhering to the European Growth and Stability Pact has faded in importance, since redressing the structural deficit is not something that can be achieved quickly. The fact that this task must be made a priority for the coming legislative period arises from the debt brake stipulation rooted in the constitution.

#### **4. CHALLENGES FOR GERMAN ECONOMIC POLICY**

Talk of “economically challenging times” seems well founded; they are challenging because we face the worst economic crisis since the great depression of the 1930s and we do not have a regulatory “formula for success”. Furthermore, the current crisis is more complex, on a more global scale and more synchronous than the one of 80 years ago. However – and this is the crucial difference – central banks have reacted more prudently, today. The mistake the central banks made then of reducing the money supply has not been repeated. In addition, the times are challenging because social insecurity – evident in the decline in approval for the Social Market Economy – coincides with the “triumphant shouts” of left-wing populism, a group that has always been skeptical towards the market economy and an open society. One could almost say that state interventionists’ elation knows no bounds during this economic crisis. One does not have to listen to all the gloom about the disaster that has befallen the market economy and the end of liberalism. One can quite simply refer to the economist Joseph Schumpeter, who once wrote: “Capitalism stands its trial before judges who have the death sentence in their pockets.”<sup>2</sup>

However, the nascent criticism of the “market” misses the fact that the events we have witnessed are the product of human action. “The” market is not an autonomous entity, rather a guidance mechanism for the action of countless human beings within a regulatory framework. The state willingly carries the responsibility for this framework, for economic rulemaking and for the results – be they positive or negative – of

the market. Against this backdrop, it is unfair to lay the blame for the economic and financial crises at the foot of the market economy and its proponents alone. It is even less justified to accuse so-called ordoliberals (from the Latin *ordo*, meaning order), such as Walter Eucken, who have always seen the state as playing a constructive role. Who were these ordoliberals?

## 5. TAKING THE PRINCIPLES OF A SOCIAL MARKET ECONOMY SERIOUSLY

Seeing as it would be sensible to consider the writings of the masterminds of the Social Market Economy, so as to deal with the current global economic crisis, we should start by looking at the Freiburg School. A year after the banking crisis of 1931, at the nadir of the global crisis, the ordoliberals pleaded for “a strong state, a state above the economy” to oppose the “swamp of capitalism”.<sup>3</sup>

Even then, the role of the state was, therefore, not only to exist in guaranteeing property rights and security, but should first and foremost create a new economic order through the constituent and regulating principles of competition, i.e. the market: “This seems to be one of the most important points where the state must intervene, so as to implement market rules and to overcome the frictions which prevent these rules from being fulfilled.”<sup>4</sup>

Back then it was nothing more than a rehashing of liberalism: In the 1930s, the ordoliberalists pointed out that the market did not generate order from itself, as classical liberalism would have it. The state, as the ultimate guarantor of economic order, plays a particular role. Over the past few years, politicians and certain market agents seemed to lose sight of the state’s priority towards the economy – as required by the pioneers of the Social Market Economy – namely, the maintenance of a clearly regulated and structured market economy. Accordingly, state and market failure went hand in hand.

Remember, the central tenet of the Freiburg School was a free market economy with a functioning price system. Private property, contractual freedom, as well as clearly defined, secure property rights are prerequisites for allowing human beings to act freely and responsibly. At the same time – and this is important – the state must give the market a

framework and follow certain principles. Walter Eucken summed up the fundamentals of this in his paper – which still rings true today – entitled *Grundsätze der Wirtschaftspolitik (Principles of Economic Policy)*<sup>e</sup>:

- It is crucial to protect competitiveness; companies tend to inhibit competition, through acquisitions or price-fixing, for example. Therefore, the state must guard against monopolies or cartels and keep markets open for potential competitors to enter. Only competition's "whip" can produce cost efficiencies and the pressure to innovate.
- Furthermore, there must be clear rules on liability, so as to ensure that an aggrieved party is not lumbered with the cost it has incurred and that actors do not take excessive risks.
- The central bank must ensure sufficient monetary stability, in order to prevent the pricing system from sending out distorted signals and triggering bad investments.
- So as to improve long-term planning, economic policy should be geared towards reliability, consistency and predictability.

If one goes against these principles, which represent the central points of the Social Market Economy, then it supports the following conclusion: Today's financial and economic crises are not proof that the Social Market Economy has failed. Rather, they emphasize the validity and the essential value of its universal principles, such as monetary stability, liability, scale, powerful competition and the renouncement of partial interests.

In reality, the observed market exaggerations were direct consequences of misguided policies in the past. People went against the regulatory principles of the Social Market Economy. In the USA, attempts were made to finance the economy on the basis of low interest rates and private debt was encouraged by the state. This was one cause for the enormous monetary escalation. If money and goods are misaligned, then stable prices are jeopardized. Although it did not result in excessive inflation in the USA, this immense liquidity did contribute to the growth of a real estate bubble. Furthermore, several banks rid themselves of their risks of loan defaults and, consequently, their liability for particular business by bundling up ("securitizing") their mortgage lending and selling these on the markets to other banks, financial institutions or private investors (without being forced to retain co-liability by regulators). The direct lender-borrower relationship was abandoned in favor of an anonymous, opaque liability structure, which proved to be unsus-

tainable in the end. In addition, the concentration process in the banking sector – which was of global proportions and continued with almost no regulation – lead to the problem of institutions being “too big to fail”. Furthermore, blatant misincentives amongst ratings agencies and weaknesses in international accounting rules became apparent.

## 6. WHAT LESSONS CAN BE LEARNED FROM THE CRISIS?

In partial answer to this question, one can say that the financial crisis has not jeopardized the idea – “idea” being the key word – of the Social Market Economy. Rather it has served to emphasize its key elements! However, and this is the main lesson to be drawn from the crisis, the state – both in America and in Germany – failed to take the idea seriously enough and to deal with the correct regulatory issues (e.g. effective financial market regulation), instead, getting bogged down in the details of particular policy areas.

Now, there is the real danger that the state – motivated and ideologically fired up by the current crisis – will continue down this interventionist route and place freedom and prosperity at risk further down the line. The distorting competitive impact of the car scrappage scheme, which the Grand Coalition introduced, is a good example. Any ordopolitician will be unnerved by statements, such as those in § 3 Paragraph 1 of the amended *Financial Market Stabilization Act*: “The Federal Finance Ministry is responsible for carrying out expropriation procedures”<sup>6</sup> – particularly since the act was only designed to deal with the case of the Hypo Real Estate Bank.

And so we cannot be accused of misinterpretation, it was necessary in those exceptional circumstances, which now seem to have been overcome, to protect the financial markets from collapse using the special financial market stability fund. The economic stimulus packages – as the second measure – should not be dismissed per se: On the one hand because of the limited effectiveness of monetary policy and, on the other, to ensure stability of economic expectations. This approach involved the slow-acting economic stimulus packages I and II, the total volume of which was around 80 million Euros. However, the main point is – and this is the challenge for the coming legislative period – not to lose sight of regulatory principles completely and to redress the balance between the state and the market.

As a result, the regulatory test is yet to come, where state interventions – which, in the case of market failure, are also an integral part of the Social Market Economy – must be aligned with market principles and the withdrawal of the state from the economy must be cleverly achieved.

It seems presumptuous to derive the basic need for comprehensive Keynesian measures, i.e. higher, debt-financed state expenditure or new economic stimulus packages, from state emergency aid and to hazard further economic intervention. Especially in light of the exorbitantly high levels of state debt – in the region of 1.6 billion Euros (this does not take into account implicit promises by the state), which limits future leeway for policymaking. And irrespective of the debt problem, the state cannot control the extent of its interference in economic activity or act in time, as history has shown. Furthermore, households and companies react – sometimes in an undesirable way – to state intervention (e.g. drop in consumer demand/investment). Therefore, the influence of economic policy on economic development is, and remains, limited.

In addition, the state's contribution to the global crisis cannot be ignored. After all, it was the US central bank that promoted national, as well as global, economic growth thanks to its policy of low interest rates, and, therefore, paved the way for the overheating of the US economy. "Market failure", which is so often mentioned, must be seen in conjunction with the potential "failure of the state".

It is important that the new Federal Government remains committed to an economic regulatory policy, which sees and treats the economic stimulus program as a solution to a very particular exceptional situation. This is distinguished by the fact that normal market forces also negatively affect those companies, which may necessarily be healthy, but are capable of surviving. And these may end up fighting for their existence as a result of this special form of crisis – a situation, which it was, and is, not possible to rule out in the current crisis. This viewpoint, namely regulation and liberal interventionism, is concordant with the pragmatic variant form of economic policy, which Ludwig Erhard implemented with the Social Market Economy.

Nowadays, unfortunately, Ludwig Erhard's Social Market Economy is equally culpable for the excesses of the global economy due to kin liability. There is a great difficulty when the two are equated – some-

thing, which is unreflective but not unpopular; this could even be called the “original challenge” for convinced followers of the Social Market Economy. From an economic perspective, one must differentiate between the idea of the original creators, Alfred Müller-Armack and Ludwig Erhard, and the partially implemented version. For, right from the start, whole sectors of the economy (e.g. agriculture, energy, transport or housing) were excluded from the force of competition, the “core” of the Social Market Economy. This shows that the constitutional economic reality of the Federal Republic never represented the “true” form of the Social Market Economy.

However, these observations fall on deaf ears: Blanket criticism of capitalism is en vogue and the system has been unexpectedly called into question again. The reason for both phenomena is that there has been an accelerated loss of confidence in our economic system and this is embedded in a particular liberal model of society. At the same time, people have forgotten or suppressed the fact that other economic systems are not free from scandal and social problems. There have been countless surveys which have shown - even before the financial crisis started - a loss in confidence. They also claim, indirectly, that the Social Market Economy, taken to mean the economic order that was established after the Second World War, has increasingly lacked social cohesive force.

## **7. STRENGTHENING THE SOCIAL COHESION OF THE SOCIAL MARKET ECONOMY**

All responsible actors must interpret the signals linked to this erosion in confidence, and question why the German model has seemingly lost its integration force and its ability for people to identify with it over the past sixty years. The last economic boom (2005 to 2007) may provide an answer to this question.

What might sound paradoxical, is, in fact, statistically proven: By no means all of the population benefited from the last economic boom in Germany. The linear relationship between growth and personal wealth, between corporate success and individual welfare, which had been valid for years, was broken for many people, especially those in employment. As a result, doubt was cast on life security and certainty; the fear of decline now reaches deep into the heart of society. Social problems, such as selective education, increased risk of pension poverty or unstable



employment must also be considered. However, these cannot be solved if market mechanisms are ignored or the “power of the market” is only affirmed from one side.

The impression that increased corporate profits cannot secure individual job security and that mass unemployment can stimulate the stock market creates distrust in a market economy and strengthens calls to abandon the Social Market Economy. Irresponsible action by senior executives in the wake of the financial crises increases the pace of this. Recently, Wolfgang Schäuble spoke of the “grave diggers of the Social Market Economy”.<sup>7</sup>

A second partial answer to this question can also be seen in the issue that the financial crisis erodes confidence in the economic order, which is commonly described as the Social Market Economy, because its central claim, namely “prosperity for all”, has now been called into question. It is of utmost importance to overcome this mistrust for the sake of future opportunities in the economy, for the political climate within the Republic and for the success of the new Federal Government.

If one intends to defend a proven, successful economic system, one must face up to its downsides and, at the same time, name “external” challenges, which must be overcome. Thus, there is now a double dilemma: Whilst acceptance of the German economic model is being undermined and certain individuals are trying to discredit it “from within”, the Social Market Economy must stand up to global competition amongst the different economic ideologies.

This is only possible if politicians push the guiding principles of the Social Market Economy on the international stage. This must include the much called for “state retreat” – in spite of the conspicuous difficulties in regulation. Finally, a national model for economic order, such as the Social Market Economy, hits a brick wall if other countries do not feel bound by its competitive principles.

If one were able to see other images of humanity and foreign state understanding with sufficient liberality and distance, then, in a world of free trade, national economic systems would not be subject to disruption. Sport provides a good allegory: If a referee does not insist that players observe the same rules, then play turns rough. A game has begun on a

global scale, without a competent referee having been chosen. The consequences of the current crisis are clear in terms of the financial markets. One must not forget, however, the commodity markets, the current infringements of property rights, environmental problems, child labour or external foreign economic inequalities. Even these phenomena are the product of a global regulatory vacuum and distort fair competition between companies.

In reality, everything that seems important to a citizen in the Federal Republic, for example a social framework for employment or individual performance and its place within the competition system guaranteed by the state, is often ridiculed on an international level. If one takes the ordoliberal approaches of key thinkers, such as Walter Eucken, Wilhelm Röpke, Alfred Müller-Armack or Ludwig Erhard, these points constitute the Social Market Economy and must be strengthened internationally. Wealth with values – which is not just defined in quantitative terms – is the aim. Even, or especially in a globalized world.

The opportunities for global economic and social reform are certainly there. On the one hand, the Americans and the British are questioning their economic models as a result of the crisis - that makes it easier to achieve international consensus. On the other hand, the *Konrad-Adenauer-Stiftung* has seen an increased interest in the Social Market Economy. Particularly young democracies or governments in peril are prepared to enter into a discussion about regulation. Furthermore, the importance of constitutive and regulatory principles for a functioning global economic system in the wake of the financial crisis is also visible on an international level. Germany's experiences legitimize the case for strengthening these principles in and throughout Europe (EU). What is true for the individual nation state is also important for the global economic community and centers around the core requirement of ordoliberalism: "Freedom needs order".

## 8. OUTLOOK

At this point, we might venture a few comments about the road ahead. Presumably, the financial markets will become more transparent after the crisis; bank managers will receive more appropriate salaries and bank regulation will be reformed. The decisions of the G20 summit in Pittsburgh in 2009 do go some way towards this, even if they have not

been implemented in national law yet. However, even complete implementation would not be sufficient. After all, this will only make the “hidden problems” of the German economic and social systems clearer. When compared to the challenges, which we face on a global scale, these are easier to overcome. However, even these require political strength and efforts. These challenges principally include:

- Ensuring the state's financial ability to act (demographic pressures on public spending, increased debt);
- Reforming tax and benefit systems;
- Improving education;
- Taking climate change and energy security into account;
- Following the economic structural change and identifying new distribution issues.

This list is not intended to produce fear; there are solutions to the aforementioned problems. They have to be bravely carried out, however. Admittedly, the challenges are complex. Just tackling them with the phrase “Social Market Economy” is insufficient. Responsible actors must convince fellow human beings of the value and the strength of the German system. Perhaps this has been done too little in the past. The Social Market Economy has always been a “progressive way of thinking”.<sup>8</sup> Although, occasionally, it makes light of political interests. However, this is the very reason why it can be revived! It must be reconsidered in light of new framework conditions. These include taking increasing account of its central values of equality of opportunity and performance.

Here, one must make two observations: Firstly, wages, which are considerably higher than the average income, cannot be justified by equality of performance; secondly, the main task for government social policy is to improve opportunity, i.e. to give every human being the opportunity to use his or her skills in society through education, politics and integration. One must also mention two other values of the Social Market Economy: Scale and responsibility. These are not old fashioned; rather they are fundamental for reform to ensure freedom. There is the explicit assumption that a market economy requires an ethical base. Without virtue, decency and weighing up the consequences of one's actions, it is not possible to live together in harmony. Wilhelm Röpke spoke of this relationship several years ago.

The Social Market Economy provides the regulatory superstructure to deal with the domestic challenges that have been mentioned. For several reasons, it is still a contemporary ideology:

- Firstly, compared to other economic models (state-authoritarian capitalism, free market capitalism), the Social Market Economy is based on anthropological findings and is, thus, much more than a mere economic system. It is a model for society. The main tenet of this model is the personality of human beings, whose powers of judgment and decision-making can be trusted. This Christian understanding gives rise to an ethical framework for commerce and trade; criteria for equality are explicitly included and taken to be part of a right to participate.
- Secondly, the Social Market Economy is correct, because it places the market mechanism at the center. One must not forget that the current crisis is the product of the failure to observe these market mechanisms. The ability of the market to generate wealth on a broad scale has not been achieved. For this, there is a need for institutions, property, contractual freedom, self-interest, market, price control and competition. A competitive economy is the most efficient and democratic economic system, since it creates equality not by force, but through market coordination.
- Thirdly, only the Social Market Economy ensures the state plays a constructive and suitable role. It does not try to minimize it, but also does not exaggerate it. The state must act as the guardian of a functioning economic order and, thus, enters into a productive relationship with the market. Especially today, people are all too aware of this need.
- Fourthly, the subsidiarity principle is available as a guide, towards which state action should be oriented, particularly in terms of social policy. Failure to observe this principle has a negative impact on the well-being of humans and discredits responsible citizens.
- Fifthly, the Social Market Economy is not a doctrine, rather it is a “progressive way of thinking”.<sup>9</sup> For this reason, it can be adapted and implemented internationally.

These points briefly illustrate why the Social Market Economy has encountered problems in light of the financial crisis. It must try to revitalize its central values and principles (freedom, subsidiarity, solidarity) and build on them to connect – as Alfred Müller-Armack said<sup>10</sup> – the performance of the market economy with a suitably market-oriented policy of social equality. Now more so than ever, politics must show its communicative abilities, its leadership power and its world view.

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1| See Bach et al. (2009).

2| Schumpeter (1950), p. 233.

3| Cf. Rüstow (1932).

4| Alexander Rüstow on April 3, 1930 to Walter Eucken; cited according to Vogt (1997), p. 265.

5| Cf. Eucken (1952), pp. 254-291.

6| Gesetz zur weiteren Stabilisierung des Finanzmarktes.

7| Schäuble (2009).

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## THE AUTHORS

**Prof. Dr. Lothar Funk**

is Professor of Economics and International Economic Relations at the Duesseldorf University of Applied Sciences (for: *Fachhochschule Düsseldorf*). He is also the Coordinator of Foreign Exchange at the Business Studies Department and heads the International Management Bachelor. Until mid-2005 he was also responsible for research in International Labour Relations at the Cologne Institute for Economic Research where he is still a Fellow now. He is a Visiting Fellow at the Institute for German Studies, University of Birmingham, as well as a member of the council of economic advisers of the *Konrad-Adenauer-Stiftung*, Berlin, and a co-editor of *Sozialer Fortschritt. Unabhängige Zeitschrift für Sozialpolitik* (German Review of Social Policy). He has published widely on labour market-related issues, varieties of capitalisms and questions of welfare state reform. He (co-)authored and edited several books on these issues as well.

Fachhochschule Düsseldorf  
 Fachbereich Wirtschaft FB 7  
 Prof. Dr. Lothar Funk  
 Universitätsstraße  
 Gebäude 23.32  
 40225 Düsseldorf | Germany  
 Phone: +49 (0) 21 18 11 47 96  
 E-Mail: [lothar.funk@fh-duesseldorf.de](mailto:lothar.funk@fh-duesseldorf.de)

**Dr. Christian L. Glossner**

is Teaching Fellow and Assistant Lecturer for Political Economy and Political Communication at the University of Oxford and the Université de Fribourg. Currently, he is also the chairman of the European Business Circle (EuBC). Previously, Glossner held a Europaeum Research Fellowship at the Institut Universitaire de Hautes Études Internationales (IUHEI) in Geneva and worked for various management consultancies, industrial corporations and public sector institutions including the Directorate-General for Economic and Financial affairs (ECFIN) of the European Commission in Brussels. He is a graduate

from the Université de Fribourg as well as the London School of Economics and Political Science (LSE) and received his PH.D. on economic theory and political history from the University of Oxford. He has published various articles on contemporary international political and economic affairs and co-authored a book on the European Union. His most recent publication is *The Making of the German Post-War Economy*.

University of Oxford

Oriel College

Dr. Christian L. Glossner

Oxford OX1 4EW | United Kingdom

Phone: +44 (0) 77 21 69 21 23

E-Mail: christian.glossner@oriel.ox.ac.uk



**Dipl.-Pol./B. Sc. (Econ.) David Gregosz**

graduated in 2008 with a Diploma in Political Science, and in 2009 with a Bachelor of Science in Economics from Philipps-University Marburg. He was stipendiary of *Konrad-Adenauer-Stiftung* and worked during his study as an Assistant for two chairs at the University of Marburg. Furthermore he worked for parliamentarians in Brussels and Berlin during that time. His graduate theses addressed economic questions within the German electricity market as well as the sustainability of Germany's economic model, the Social Market Economy. Since the beginning of 2009 David Gregosz is working as a Researcher within the Department Politics and Consulting (for: *Hauptabteilung Politik und Beratung*) of the *Konrad-Adenauer-Stiftung* in Berlin. His research interests include the history of economic thought and economic history, the political economy of economic policy reforms, macroeconomics and labour economics. Much of his recent research has been concerned with the impact of the financial crises.

Konrad-Adenauer-Stiftung e.V.

Hauptabteilung Politik und Beratung | Team Wirtschaftspolitik

David Gregosz | Koordinator Grundsatzfragen/Ordnungspolitik

Klingelhöferstr. 23

10785 Berlin | Germany

Phone: +49 (0) 30 2 69 96 35 16

E-Mail: david.gregosz@kas.de





### **Prof. Dr. Bodo Herzog**

is Professor of Economics at ESB Business School, Reutlingen University. He was former head of the Economics Department at the *Konrad-Adenauer-Stiftung* in Berlin.

From 2005 to 2007 he was member of the German Council of Economic Experts. Herzog studied mathematics and economics at the Universität Konstanz. He holds a Ph.D. in Economics – financed by the German Research Foundation (for: *Deutsche Forschungsgesellschaft*, DFG). Since, 2006 he is Research Fellow at Massachusetts Institute of Technology (M.I.T.) and Sloan School of Management, Cambridge, USA. Furthermore, he is a member and director of several research committees and political advisory councils. Moreover, he is policy fellow at the *Institut zur Zukunft der Arbeit* (Institute for the Study of Labor, IZA) and he is Research Associate to interdisciplinary research groups in neuroeconomics and econophysics. In addition, Herzog is visiting-professor at the International Summer University Macedonia (ISUM). His research focuses mainly on macroeconomics, in particular on monetary economics and financial economics as well as economic sustainability. He has published many articles in professional journals, books and papers in conference proceedings.

ESB Business School

Prof. Dr. Bodo Herzog

Alteburgstr. 150

72762 Reutlingen | Germany

Phone: +49 (0) 71 21 27 16 03 1

E-Mail: [Bodo.Herzog@Reutlingen-University.de](mailto:Bodo.Herzog@Reutlingen-University.de)



### **Dipl.-Vw./-Kfm. Andreas Hoffmann**

is a Doctoral Candidate and Research Assistant for Gunther Schnabl at the Institute for Economic Policy, University of Leipzig. His research focuses on monetary, exchange rate and fiscal policy analysis, international economics and history of financial crisis. First publications in international refereed journals document his research interests. He is currently visiting the Department of Economics at New York University, where he pursues doctoral studies under the supervision of Mario Rizzo. He holds a doctoral scholarship

from the Friedrich Naumann Foundation and a Bradley Fellowship from New York University

Universität Leipzig  
Wirtschaftswissenschaftliche Fakultät  
Andreas Hoffmann  
Grimmaische Str. 12  
04109 Leipzig | Germany  
Phone: +49 (0) 34 19 73 35 78  
E-Mail: ahoffmann@wifa.uni-leipzig.de



**Dipl.-Regional-Wiss.'in Janina Jänsch**

is Research Assistant at the Institute for Economic Policy at the University of Cologne (for: *Institut für Wirtschaftspolitik an der Universität zu Köln*). Previously, she was Research Assistant at the chair of Economic Policy at the University of Cologne. She graduated in Regional Studies with specialization in Economics. During her studies, she gained international work experience by working in the Department of Economy at the German Embassy of Santo Domingo and in an interdealer broker company in New York. Jänsch is specialising in climate policy and energy policy and has published various articles on these subjects.

Institut für Wirtschaftspolitik an der Universität zu Köln  
Janina Jänsch  
Pohligstr. 1  
50969 Köln  
Germany  
Phone: +49 (0) 22 14 70 53 55  
E-Mail: jaensch@wiso.uni-koeln.de



### **Dipl.-Vw. Ekkehard Köhler**

is a Doctoral Candidate at the IAW – *Abteilung für Wirtschaftspolitik* (i.e. Institute for Economic Policy of the Department of Economics) at the University of Freiburg and a Research Assistant at the Walter Eucken Institut. His main research interests are in the areas of constitutional political economy, institutional and evolutionary economics, monetary and fiscal regime analysis, and history of economic thought. Ekkehard Köhler has published various articles on economic and political affairs and has been a visiting scholar of the Adam Smith Program at the Jepson School of Leadership of the University of Richmond, VA in 2009 and 2010. He holds a doctoral scholarship from the Friedrich Naumann Foundation.

Walter Eucken Institut

Ekkehard Köhler

Goethestrasse 10

79100 Freiburg im Breisgau | Germany

Phone: +49 (0) 76 17 90 97 11

E-Mail: [ekkehard.koehler@walter-eucken-institut.de](mailto:ekkehard.koehler@walter-eucken-institut.de)



### **Dipl.-Vw. Ines Läufer**

is Economist and Research Assistant at the Institute for Economic Policy at the University of Cologne (for: *Institut für Wirtschaftspolitik an der Universität zu Köln*). She studied Economics and Sociology at the University of Cologne and at the Institut d' Etudes Politiques (IEP) in Lyon, France. During her studies, she was involved in several research projects, amongst others at the Max Planck Institute for the Study of Societies in Cologne. Furthermore, she gained work experience as an intern at the Federal Ministry of Health in Berlin. Her current research focus is on health policy in general and on the German statutory health and nursing care insurance.

Institut für Wirtschaftspolitik an der Universität zu Köln

Ines Läufer

Pohligstr. 1

50969 Köln | Germany

Phone: +49 (0) 22 14 70 53 54

E-Mail: [laeuffer@wiso.uni-koeln.de](mailto:laeuffer@wiso.uni-koeln.de)



### **Dr. Hagen Lesch**

is Senior Economist and Head of the Wage Policy and Collective Bargaining Section at the *Institut der deutschen Wirtschaft Köln* (i.e. Cologne Institute for Economic Research, IW) where he has been working since 2000. He studied economics at the Rheinische Friedrich-Wilhelms-Universität Bonn. After finishing with the degree "Diplom-Volkswirt" he was Research Fellow and Senior Researcher of Economics at the *Institut Finanzen und Steuern* (i.e. Institute "Finance and Taxes") in Bonn from 1991 to 2000. He received his Ph.D. (Dr. rer. pol.) from the University of Bonn in 1998. Between 2002 und 2007 he was Visiting Lecturer in Economics at the University of Applied Sciences, Cologne. Lesch has published widely on wage policy and labour relations. His most recent publication is *Arbeit und Fairness – Die Suche nach dem gerechten Lohn*, a booklet on justice in the labour market that he co-authored in 2010.

Institut der deutschen Wirtschaft Köln

Dr. Hagen Lesch

Gustav-Heinmann-Ufer 84-88

50668 Köln | Germany

Phone: +49 (0) 22 84 98 17 78

E-Mail: lesch@iwkoeln.de



### **Dipl.-Kfm. Alexander Lorch**

is a Doctoral Candidate of Prof. Dr. Peter Ulrich at the University of St. Gallen's Institute for Business Ethics (for: *Institut für Wirtschaftsethik*) in Switzerland, where he is working on a philosophical modernization of ordoliberal thought. In his thesis, he analyzes the historical ordoliberal thoughts from an integrative economic ethics point of view and enriches it with modern politico-philosophical ideas. He graduated from the European Business School, Oestrich-Winkel in Germany in 2007.

Universität St. Gallen  
Institut für Wirtschaftsethik  
Alexander Lorch  
Guisanstrasse 11  
9010 St. Gallen  
Switzerland  
Phone: +41 (0) 71 22 43 10 8  
E-Mail: alexander.lorch@unisg.ch



**Dr. Markus Marktanner**

is Assistant Professor in the Department of Economics at the American University of Beirut (AUB). He received his Ph.D. from the Technical University of Ilmenau, Germany. In his doctoral thesis he examined the political economy of the transformation and global integration process of former socialist economies. Before joining the faculty of AUB, he held teaching and research positions in Germany and the USA. His research focuses on the interrelationship of political, social, and economic determinants of development. His research is accepted by journals such as the Journal of International Development, Journal of Economic Studies, Journal of Developing Areas, and Review of Middle East Economics and Finance. He also contributed various book chapters. Moreover, he has been involved in public policy consulting, including work for the United Nations Economic Commission for Western Asia, the United Nations World Food Program, and the Konrad-Adenauer-Stiftung. He also serves on the Editorial Board of the Global Business and Economics Review.

American University of Beirut  
Department of Economics  
Dr. Markus Marktanner  
P.O. Box 11-0236, Riad El Solh  
Beirut 1107 2020 | Lebanon  
Phone: +961 (0) 13 50 00 0/4072  
E-Mail: marktanner@aub.edu.lb



### **Dipl.-Kfm. Tim Petersen**

is Doctoral Candidate at the Department of Economics at the University of Hamburg. The subject of his Ph.D. thesis is "Theological Influences on German Economic Theory in the 19<sup>th</sup> and 20<sup>th</sup> Centuries." Tim Petersen studied business administration at the University of Hamburg from 1999 to 2003. From 2004 to 2007 and since 2009, he works for the tax consultancy bureau of Klaus Petersen. In 2007 and 2008 he researched as a scholar of the *Konrad-Adenauer-Stiftung* at the office in the federal state Thuringia in Erfurt of The Hamburg Institute of International Economics (HWWI). His research interests are the history of economic and theological thought, ordoliberalism and business ethics.

Dipl.-Kfm. Tim Petersen  
 c/o Steuerberatungsbüro Klaus Petersen  
 Auf dem Baggersand 17  
 23570 Lübeck-Travemünde | Germany  
 Phone: +49 (0) 45 02 50 02  
 E-Mail: [petersen@hwwi.org](mailto:petersen@hwwi.org)



### **Dr. Marc Stegherr**

is Assistant Professor at the Ludwig-Maximilian University of Munich. He studied Slavic Philology. His most recent publications are *Abschied von der Wiege des Serbentums?*, *Das Kosovo in Politik und Kultur Serbiens* and *Die Medien in Osteuropa – Mediensysteme im Transformationsprozess*.

Ludwig-Maximilians-Universität München  
 Fakultät für Sprach- und Literaturwissenschaften, Department II  
 Institut für Slavische Philologie  
 Dr. Marc Stegherr  
 Geschwister-Scholl-Platz 1  
 80539 München | Germany  
 Phone: +49 (0) 89 21 80 23 74  
 E-Mail: [marc.stegherr@minews.de](mailto:marc.stegherr@minews.de)



### **Dipl.-Kfm. Christian Vossler**

is Research Assistant at the Institute for Economic Policy at the University of Cologne (for: *Institut für Wirtschaftspolitik an der Universität zu Köln*). After completing his banking education he worked as a Customer Service Representative before taking up his studies in business administration at the University of Cologne. During his studies he worked as a student trainee at HSBC Trinkaus Global Asset Management. He graduated in 2007 with specialization in economics. His special research interest lies in climate policy and energy policy and has published various articles on these subjects.

Institut für Wirtschaftspolitik

an der Universität zu Köln

Dipl.-Kfm. Christian Vossler

Pohligstr. 1

50969 Köln | Germany

Phone: +49 (0) 221 470 5349

E-Mail: [vossler@wiso.uni-koeln.de](mailto:vossler@wiso.uni-koeln.de)



### **Dipl.-Vw. Christine Wolfgramm**

is Economist and Teaching Assistant at the Institute for Economic Policy at the University of Cologne (for: *Institut für Wirtschaftspolitik an der Universität zu Köln*). Next to her studies at the University of Munich and Cologne she worked as a Research Assistant for several institutions including *Deutsche Bundesbank* and United Nations Economic Commission for Europe. After graduation she has gained further work experience as a credit analyst in international real estate before returning to university to pursue her Ph.D. From 2008 on she has given several talks and courses on economic policy issues and health economics in particular. She has published or co-authored articles on health policy issues and a study on the role of real estate valuation in the current financial crisis. Currently, she works on reform perspectives for the German statutory health and nursing care insurance.

Institut für Wirtschaftspolitik  
an der Universität zu Köln  
Dipl.-Vw. Christine Wolfgramm  
Pohligstrasse 1  
50969 Cologne | Germany  
Phone: +49 (0) 22 14 70 53 56  
E-Mail: wolfgramm@wiso.uni-koeln.de



**Manuel Wörsdörfer, M.A.**

is a Research Fellow of the Cluster of Excellence “The Formation of Normative Orders”, Goethe-University, Frankfurt am Main (Research Project: Genesis of Economic Norms). As a Doctoral Candidate he is writing his thesis about the “Normative Foundations of Ordoliberalism”. He is a graduate from the University of Bayreuth and received his Master-degree in philosophy and economics. His current research interests are the economic-ethical implications of ordoliberalism and Social Market Economy, furthermore economic/business ethics and the history of economic thought.

Universität Frankfurt am Main  
Professur für VWL, insb. Wirtschaftliche Entwicklung und Integration  
Manuel Wörsdörfer, M.A.  
Grüneburgweg 1  
FB 2, H.P.O. Box 47  
60323 Frankfurt am Main | Germany  
Phone: +49 (0) 69 79 83 47 78  
E-Mail: woersdoerfer@wiwi.uni-frankfurt.de