

# ADDRESSING THE MARKETING PROBLEM OF THE SOCIAL MARKET ECONOMY

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## **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!

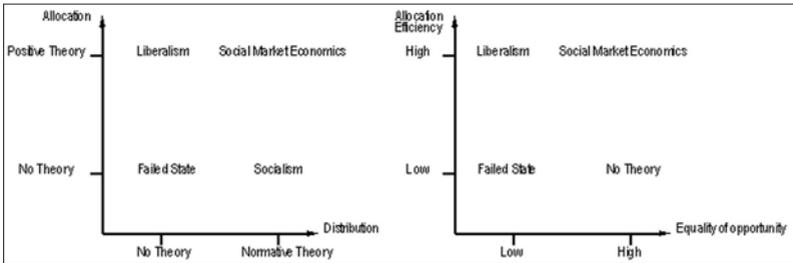
Social Market Economics was developed as a third way<sup>1</sup> to socialism and unfettered market liberalism in Germany. The social question of industrialization, the rise of socialism, and cartelization during the Republic of

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.

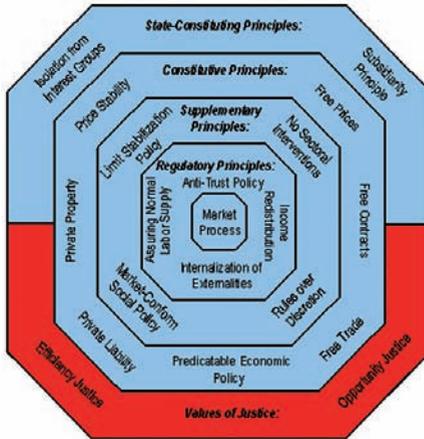
#### **4. ORDOLIBERALISM – LAW AND ORDER FOR ECONOMIC FREEDOM AND EQUITABLE SOCIAL DEVELOPMENT**

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**

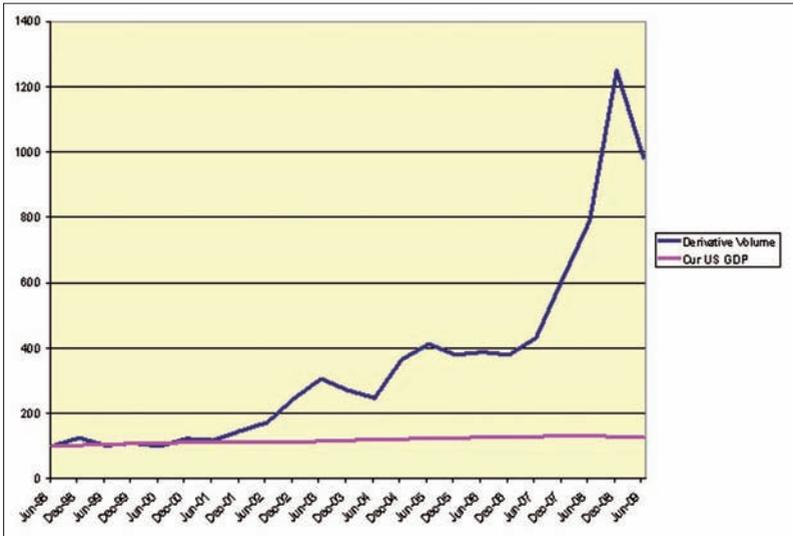
The fact that Social Market Economics calls for a proactive state, which is often compared to a referee in a football match, makes drawing parallels to Keynesian economics intuitive. There are, however, fundamental differences that need to be addressed. This is particularly important as there is a trend 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*

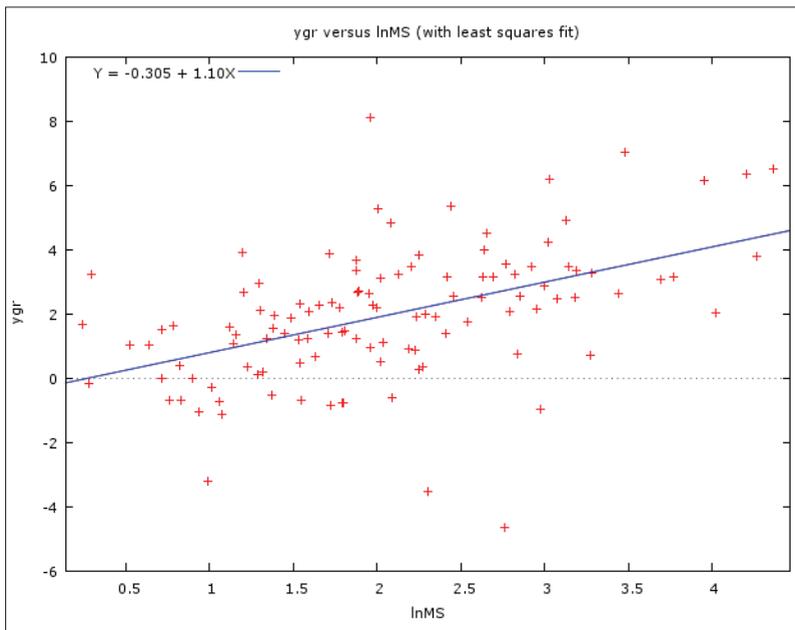


Fig. 4b: Growth vs. Manufacturing and Services Export Shares

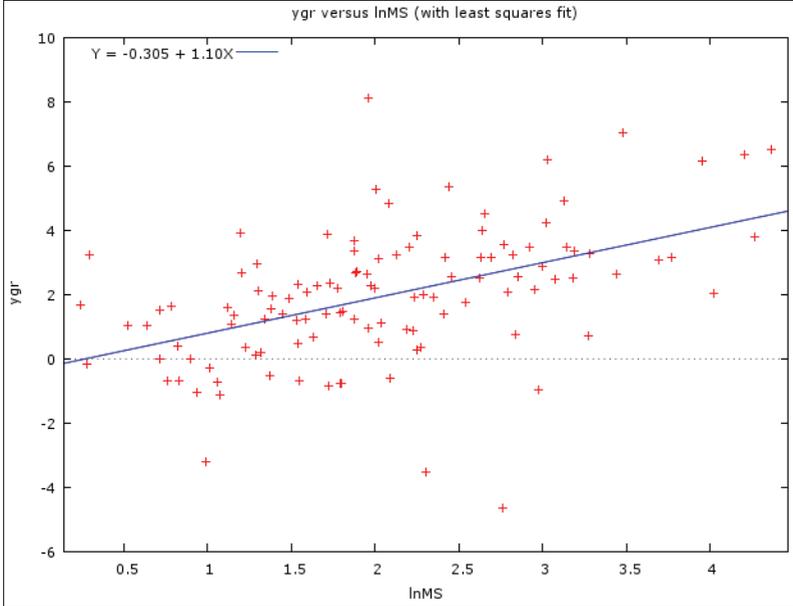
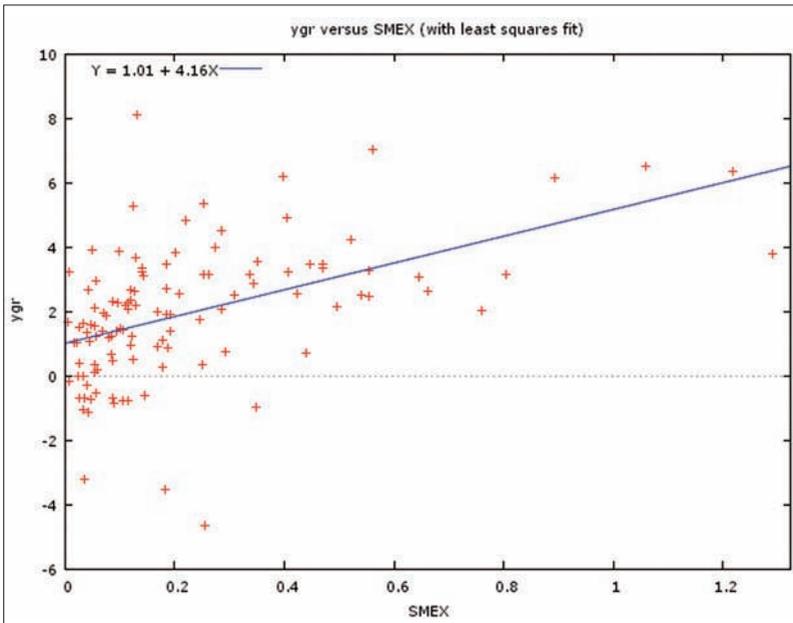


Fig. 4c: Growth vs. Social Market Economy Performance Index



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:

*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*