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”.¹ 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 economists² while the issue was foremost neglected by traditional ordoliberals.³ Even if the theory of path-dependence may be regarded as a somewhat fuzzy or “elastic” approach that may be challenged for several reasons⁴, 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. 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”. 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 of when there is an external shock.”

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 – “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”.

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 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.11 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 Germany12 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 Parliament13 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.14

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”15 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”.\textsuperscript{16} 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”.\textsuperscript{17}

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\textsuperscript{18} 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.\textsuperscript{19}

These developments left some of the pillars of the Social Market Economy\textsuperscript{20} 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.\textsuperscript{21} 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:\textsuperscript{22}

- 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”.

- 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. 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. 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. 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”⁹²⁷ 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 politically 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.²⁸

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.
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". 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. 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, 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. 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, 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”. However, the longer-term changes resulting from piecemeal “salami-slicing tactics”, 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”\textsuperscript{37} 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.\textsuperscript{38}

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”.\textsuperscript{39} 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.\textsuperscript{40}

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5. Funk (2002), for example, gives great detail on the theoretical background.
19. For an overview see Leonhard/Funk (2002).
23. All quotes from Kersbergen/Manow (2008), pp. 540-541.
29. For details on the reforms see Funk (2007).
34. Cf. for example Palier (2009), p. 392.
38. Cf. Funk (2009); see also the chapter by Gregosz in this book.