

The German Social Market Economy – (Still) a Model for the European Union?

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Abstract. *The model of a Social Market Economy (SME) defines a policy concept of economic order which is based on free markets but, at the same time, includes elements of social balancing. The term “Social Market Economy” can neither be found in the Treaty on European Union nor in the Treaty establishing the European Community. The documents only use the terms “open market economy” and “free competition”. The Commission has never made a clear statement whether its economic policy is guided by the principles of a SME. Because the SME-concept is not new and its value is not undisputed it is worth to reflect on it and to find out what it has to offer for the economic and social policy of the EU.*

Key words: social market economy; regulation; social policy; european model.

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1. Introduction

During the last decade average economic growth in the countries of the European Union has been lower compared to the United States, whereas unemployment has been higher. With the “Lisbon Strategy” initially launched in 2000 and revamped in 2005 the EU aims at becoming the leading economy of the world in terms of competitiveness, dynamics and social cohesion. But so far the agenda has not delivered the expected results. There are numerous papers which address the possible reasons for this failure.

One important line of argument is based on the claim that the apparent economic weakness of Europe is not a problem of Europe as whole: in some countries economic growth has been high

and unemployment low during the last decade whereas in other countries just the opposite is true. Following early suggestions of Esping-Anderson (1990) it is meanwhile quite common to partition the European welfare regimes into four groups which correspond with more or less solid geographic clusters:

- The Nordic (or Scandinavian) model (Denmark, Finland, Sweden, Netherlands) with a high level of social protection expenditures, social benefits, that are the same for everyone, “active” labor market policy, compressed wage structures, but comparatively weak employment protection legislation (EPL).

- The Anglo-Saxon model (Ireland, United Kingdom) with emphasis on social benefits only to those in greatest need, with increasing wage dispersion and a relatively large sector of low-pay employment (The Anglo-Saxon model is also called the Beveridge, the liberal, or the residual welfare model)
- The Continental model (Austria, Belgium, Germany, Luxembourg) with unemployment and pension schemes primarily based on insurance of those who are or have been on the labor market, with a high degree of EPL and (still) influential unions (The Continental model is also known as the Central European or the achievement oriented model).
- The Mediterranean model (Greece, Italy, Portugal, Spain) which is characterized by leaving the social responsibilities in a comparatively high degree with the family, by strict EPL and a strongly compressed wage structure.

A study of Boeri (2002) empirically compares the relative performance of these models with respect to their meeting of the most relevant objectives of social policy. Sapir (2005) concludes from this study that the Continental and Mediterranean models are not sustainable due to their lack of economic efficiency. This lack of efficiency generates an efficiency problem for the EU as a whole because the combined GDP of the countries belonging to these models accounts for about two-thirds of the EU-25 GDP. As a remedy it is suggested that the Continental/Mediterranean countries should undertake reforms of their welfare systems and their labor markets by moving their systems closer to the Nordic or the Anglo-Saxon models. However, there are doubts how efficient the Nordic model really is and whether the Anglo-Saxon model is acceptable to the societies of the Continental/Mediterranean countries. Recent political events in several European countries indicate that democratically elected governments have to fear the loss of power if they move too close to the Anglo-Saxon model because people oppose to the social imbalance they associate with a pure market economy. The outbreak of riots in French suburbs following an initiative to reform the EPL provides a notable example for this.

The model of a Social Market Economy (SME) tries to take care of this tension by combining the

efficiency of a free market economy with the adjustment of social imbalances. Although (or better: because) the SME-concept is not new and its value is not undisputed it is worth to reflect on it and to find out what it has to offer for the economic and social policy of the EU. In the first part of this contribution the basic principles of the SME-concept are recalled. The second part shows that the SME-model had a big impact on the two most important fields of the European economic policy and discusses some suggestions for reforms that can be derived from the SME-model.

2. Social Market Economy: Origins and Principles

SME defines a policy concept of economic order (“Ordnungspolitik”) which is based on free markets but, at the same time, includes elements of social balancing. Important contributions to this model were made by Müller-Armack, Eucken, Boehm, Roepke, Ruestow and, with regard to establishing the concept in practical economic policy, Ludwig Erhardt. The label “Soziale Marktwirtschaft” was coined by Müller-Armack to describe his own concept of a regulated market economy. However, in general, this term is used in a broader sense, covering not only the specific ideas of Müller-Armack but also those of the other researchers mentioned above.

There remains another ambiguity: The label SME is, on the one hand, attached to a theoretical, normative framework to guide economic policy, and, on the other hand, to the practical policy that has been and is still conducted in Germany. There is an ongoing debate between German economists how far the practical economic policy has deviated from the framework. Some economist even claim that practical policy had left it as early as 1957, when pensions were linked to the overall wage increase.

The question how deeply the practical economic policy in Germany is rooted in the concept of SME is of some relevance: Were the practical economic policy in Germany closely to follow the SME-concept one would have to doubt whether the SME is a convincing model because Germany performed economically not very well during the last decade. However, there is some evidence that this weakness cannot be attributed to the model. Partly it is due to the deviation of the practical policy from

the concept, but it is also the result of the way the German unification was conducted, and, certainly the conditions of entering into the European Monetary Union cannot be neglected⁽¹⁾.

Hence, the weakness of the *real* existing German social market economy does not provide evidence for the failure of the *concept*, and it is worthwhile to closer inspect the model.

The concept has several roots. The most important one is economic liberalism. Other roots are Christian social ethics and philosophical anthropology (Gutmann, 1998, p. 50). The liberal ideas found in the work of the researchers who contributed to the concept are modern variations of classical liberalism. Figure 1 follows a suggestion of Tuchtfeldt (1994) to classify these variations.

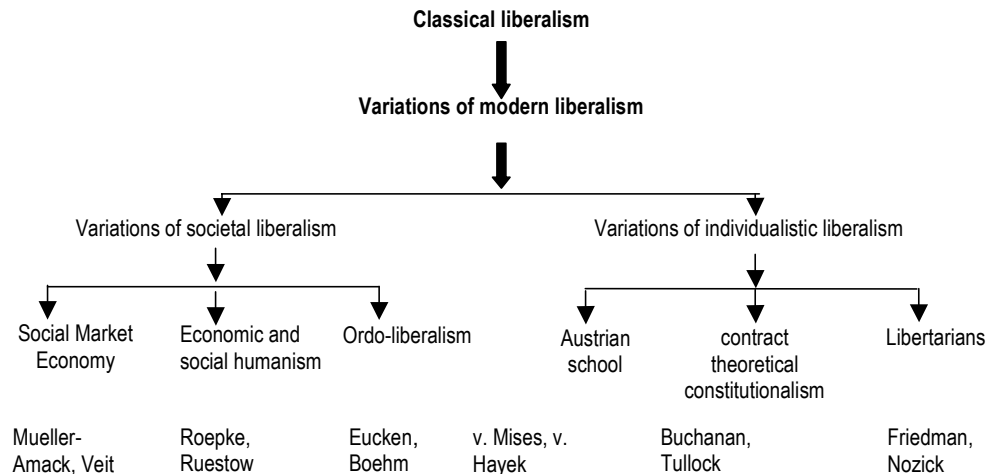


Figure 1. Modern variation classification of liberal ideas

The modern versions of liberalism are sometimes labeled “neo-liberalism”. Unfortunately, this definition is not unique. Tuchtfeldt makes a distinction between versions of neo-liberalism that are oriented towards the individual and versions that are oriented towards the society.

The first group consists of ordo-liberalism, economic and social humanism and of the SME in terms of Müller-Armack. Sometimes in the literature the label “German neo-liberalism” is used, to describe these schools. The second group consists of the Austrian school, contract theoretical constitutionalism and the so-called libertarians.

Since our topic - the SME (in the broader sense) - is linked to the schools of neo-liberalism which are oriented towards the individual and because of space considerations the second group will be only very briefly characterized. The basic approach of the second group lies in strict individualistic ethics. There is nothing like a “social end in itself” or a primary social interest. The society is defined by the individuals it consists of and the individuals act in their own interest. Because they have to interact with other individuals there might arise conflicts between different agents which in turn affect the individual sphere of freedom. To safeguard the

individual sphere of freedom from misuse by others the society has to organize “balancing justice” in form of general rules of conduct.

From the viewpoint of the individualistic versions of neo-liberalism one has to make a strict distinction between “balancing justice” and “distributive justice”. Distributive justice aims at bringing a specific individual (or a specific group of individuals) into a specific position. For individualistic neo-liberalism this is not acceptable for two reasons: First, by conducting “distributive justice” the state restricts the autonomy and the freedom of the individuals. Second, the meaning of “distributive justice” is not clear *per se*. The state has to specify norms of distribution, but this specification inevitably must be arbitrary. Hence, the state has to restrict itself to “balancing justice”.

In contrast, the versions of neo-liberalism which, in figure 1, are labeled “societal versions” and which contributed to the concept of SME not only allow for but also see the need for a certain extent of “distributive justice”. It should be mentioned here that the meaning of the phrase “certain extent of distributive justice” differs between the different versions of German neo-liberalism.

The most theoretically oriented and the most concise version of German neo-liberalism is the so called *ordo-liberalism* of the Freiburg-school. The most prominent representatives of *ordo-liberalism* are Walter Eucken and Franz Boehm⁽²⁾. The reasoning of Eucken and the other members of the Freiburg-school were shaped, on the one hand, by their critical view with respect to “laws of historical development” and, on the other hand, by the practical political evidence of their time.

The negation of “laws of historical development” aimed not only at Marxian ideas and at the ideas propagated by the German historical school, but also at the view of classical liberalism and its claim that societies automatically converge to the best economic and societal order (“natural order”) provided that economic freedom is granted (Eucken, 1990, pp. 200-225). From a more practical perspective they realized the restriction of economic freedom and self-determination of the individuals by a centrally planned economy – as it was the case in the Soviet Union – or a market economy which is dominated by conglomerates and cartels – as it was the case in the so called Weimar republic and in the Third Reich.

Especially Eucken, but to a certain extent also Müller-Armack, emphasized the importance of thinking about the economy in terms of public rules, stressing the interdependency between rules, parts of the system and reactions of agents. They used the term “Wirtschaftsordnungspolitik” or, briefly, “Ordnungspolitik” to describe an approach to economic policy which puts its main emphasis on the well considered and rationally guided building of the rules of the economic system. The argument here is that the impact of economic policy measures is not independent from the institutional framework because the framework influences the reactions and the behavior of economic agents. A well designed order will ensure not only a high degree of efficiency of the economic system but also minimize the need for regulating interventions.

To put this kind of reasoning in a modern system theory framework: The economic system comprises of many individual agents that interact in the context of public regulations. Due to the interdependences among the agents and their reactions to the regulations, the system is of a highly complex nature. That is why it is so hard to forecast the results of government interventions which can quite often have unforeseen and adverse ef-

fects⁽³⁾. From a systems thinker’s perspective the right approach is to consider carefully the structure of the system, to regard its positive and negative feedback loops, to take care of delays, etc. Due to the dynamics of complex systems it is wise not to introduce too often too strong regulations into the system because this may result in destabilization and overshooting or collapsing.

Eucken pointed out a number of principles or rules that are, from his point of view, necessary to make an economy sustainable because they ensure efficiency and flexibility. At the same time these principles allow the members of this society to live with a high degree of self determination.

Eucken distinguished between constitutive and regulating principles. He named seven constitutive and four regulating principles. The constitutive principles are (Eucken, 1990, pp. 254-291):

1. The basic principle of the economic order is the creation of a functioning price system. Such a system requires the absence of price manipulations by the government (such as price ceilings and price floors). It also requires institutions which impede the manipulation of prices by the private sector, i. e. by monopolies or cartels.

2. The primacy of monetary policy which aims at stabilizing the value of money.

3. Open markets, which allow potential suppliers to enter the market in order to increase the degree of competition in the respective market. This principle requires the government not to hamper the entering into a market by restrictive measures. As well it necessitates provisions to avoid private restrictions of entering into markets (e. g. cartels).

4. Private ownership of means of production. Decentralized planning and acting in a competitive order requires a decentralization of property rights. Private ownership of means of production can only lead to economically and socially acceptable results if the property rights are not concentrated in the hands of cartels or monopolies.

5. Freedom of contract. This principle ensures the mutual safeguarding of the agents in a decentralized economy. The freedom of contract finds its limits when it is used to constrict the freedom of contracts. An example for such a case would be the contract of a cartel.

6. The complete liability of property owners. The owners of means of production have to take the risk of wrong decisions regarding the use of their means by themselves. There should be no

legal form of a company which allows placing this risk on others.

7. Permanence and stability of economic policy. The dynamic development process of market economies is characterized by a high and unavoidable degree of uncertainty, which complicates the individual planning of suppliers and demanders. An erratic type of economic policy increases the amount of uncertainty by changing incentives and, potentially, destabilizing the economy. The higher uncertainty can be avoided by a steady economic policy that makes as little use of *ad hoc* measures as possible.

The constitutive principles are complemented by the regulating principles. Eucken believed that the constitutive principles are not sufficient to ensure the development of a practical competitive order which is free from flaws. Especially, he realized the possibility of the rise of monopolies. Beside this, he concedes that a competition order guided by the constitutive principles might lead to market results which are socially not acceptable. In Eucken's opinion the regulating principles create a framework for correcting dissatisfactory developments. The regulating principles are (Eucken, 1952, pp. 291-304):

1. Control of monopolies. The most important task of the state is to circumvent the formation of monopolies. If monopolies already exist they should, in general, be broken up. If this is not possible or advisable (as in the case of sub-additive cost structures) they have to be regulated by a monopoly control institution which should be a government independent organization.

2. Redistribution of income. The income distribution which is generated by the market process may have a higher degree of fairness than other possible distribution schemes but still it does not take care of the social needs of a society. It is the task of the state to redistribute income in a way that takes account of the social needs. Eucken recommends a progressive income tax. But, at the same time, he clearly points to the limits of redistribution because it tends to decrease investment and economic efficiency.

3. Regulation of externalities. The divergence between private and social costs gives reason for appropriate regulations by the state. As examples Eucken points out the use of natural resources, occupational health and safety, and working time regulations.

4. Price regulation in the case of non-normal reactions of labor supply (price floors).

Before now turning to the second origin of the SME it should be underlined once again that ordoliberalism, in contrast to the individualistic versions of neo-liberalism, makes a point for an assertive state. The state has the important task to constitute a competitive order, to guarantee its continued existence and to conduct regulatory measures if the market results of that competitive order are socially undesirable.

To understand the second origin of the SME one has to consider the ethical background of Müller-Armack's reasoning in a Christian and humanistic idea of man. Müller-Armack used the term "irenische Formel" to describe two aspects of his idea of SME. (The term "irenische Formel" means a peacemaking formula.) The first aspect is that he regards his concept as a way to bring such divergent ideas as socialism, catholic social doctrine and neo-liberalism together where they share common themes. The second aspect is to reconcile the "freedom of markets" with "adjustment of social imbalances".

The reconciliation of the freedom of individuals and markets, on the one hand, and the adjustment of social imbalances, on the other hand, is at the core of his program. In contrast to the protagonists of ordoliberalism, Müller-Armack did not believe that a consequent policy of economic order on its own is able to prevent socially undesirable market results. This is why, compared to Eucken and the ordoliberals, he assigns more regulating tasks of economic policy to the state⁽⁴⁾. There are six main "style-elements" of Müller-Armack's concept of SME (Tuchtfeldt, 2002, pp. 24-31):

1. Freedom of the individual. Freedom of the individual is important because it is a value in itself. With respect to economic freedom it is also the most important and indispensable incentive for the willingness to perform. Elements of economic freedom are: private ownership of the means of production, freedom of entering and leaving markets and freedom of contract. It is the obligation of the state to guarantee these elements of freedom.

2. Adjustment of social imbalances. Whereas the ordoliberals believe that a market economy in itself is basically "social", Müller-Armack sees the principles of "freedom" and "adjustment of social imbalances" in a complex relationship to

each other. In many cases this relationship will turn out to be a conflict. The market process can, at best, yield a distribution of income which reflects the efforts undertaken in the market. But this distribution does not take care of individuals that cannot participate in the market due to illness, disability or involuntary unemployment. For these and other reasons, Müller-Armack saw the necessity of a redistributive social policy albeit he conceded the tension to the incentives for the willingness to perform.

3. Business cycle policy, growth policy and structural policy. In contrast to Eucken, who was skeptical with respect to the necessity and the possibilities of business cycle policy, Müller-Armack doubted that market systems gravitate towards full employment equilibrium quickly. Hence, he regarded business cycle policy as an important style element of his concept. Unfortunately, from his writing it is not clear in which form and to what extent he believed business cycle policy, growth policy and structural policy to be useful and acceptable.

4. Criterion of market conformity. This last style element requires that all forms of market intervention should impair the allocation function of the markets as little as possible.

As we have seen, there are differences between the *ordo-liberal* concept and the concept of Müller-Armack. But both approaches emphasize the role of open and free markets, the importance of a stable value of money, and the need for competition policy. In addition, both strands acknowledge the need for a policy to adjust social imbalances. The promise to reconcile economic efficiency and distributive justice constitutes the attractiveness of the SME-concept. Today the SME-concept is accepted by all political parties and the German society.

In the following section I will briefly turn to the question which role the SME played in the development of the EU. In addition, I will point to some hints that can be derived from the SME-concept in order to guide the economic policy in Europe.

3. Social Market Economy and economic policy in Europe

The term “Social Market Economy” can neither be found in the Treaty on European Union nor in the Treaty establishing the European Com-

munity. The documents only use the terms “open market economy” and “free competition”. The Commission has never made a clear statement whether its economic policy is guided by the principles of a SME.

However, if we turn to the text of the Treaty establishing the European Community we will find several references to the concept. Two sections are especially noteworthy because they are at the core of the SME concept: The Rules on Competition (Articles 81 – 89) and the Articles on Monetary Policy (Articles 105 – 111).

Article 81 prohibits “all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market” and Article 82 prohibits “any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it”. Both articles may be traced back to nearly identical phrases found in the German competition law.

The independent “Deutsche Bundesbank” and its stability oriented monetary policy have always been seen as another building block of a practical implementation of the concept. And there is no doubt that the European Monetary Union was significantly influenced by the institutional structure and the monetary policy of the Deutsche Bundesbank.

On the other hand there are numerous articles in the treaty which are hardly compatible with the SME concept. To support this claim one can for instance refer to the articles on agriculture (Articles 32 – 38) and the articles on transport (Articles 70 – 80).

The examples stated above show that the concept of SME has left important marks in the economic constitution of the European Union. But certainly this economic constitution cannot be seen as the materialization of the concept.

Let me finally turn to some hints we can derive from the SME concept in order to improve the economic policy in Europe.

1. The interdependency between rules, parts of the system and reactions of agents is too often ignored by the countries of the EU. A prominent German example are the so-called Hartz laws which were meant to lower unemployment and to de-

crease the financial burden on the social security system, but in fact increased the burden sharply due to neglected reactions of the agents. The SME concept points to the importance of the rules of the game (“Ordnungspolitik”) the importance of market conformity and to the importance of permanence and stability of economic policy.

2. In many markets in Germany and the rest of Europe the degree of competition is still quite low. This is especially true for the energy markets and for agriculture. The European Commission has taken measures in the past which improved competition but according to the SME concept further measures are needed to make the EU internally and globally competitive.

3. The monetary policy of the European Central Bank is a good example for the successful implementation of a central element of the SME. Especially German economists articulated doubts regarding the stability orientation of the monetary

policy of the European Central Bank in the 1990s. As far as one can judge today, these doubts have proved to be unjustified. But it remains an important task for many countries in Europe to balance budgets and to decrease government debt in the long run in order to comply with a sustainable stability oriented monetary policy.

4. Finally, it is important to account for the principle of adjustment of social imbalances when policy measures are devised and implemented. There are numerous cases of policies which failed because politicians neglected this principle. One recent example is the attempt of the French government to reduce employment protection. The literature on the post World War II development in Germany suggests that the real existing social market economy was successful because the citizens took the term “social” as a promise of their economic order to ensure a fair participation in the growing wealth of the economy.

Notes

- (1) For an elaborate discussion of these issues see Sachverstaendigenrat (2002, pp. 205-215)
- (2) Other members of the school are Hans Grossmann-Doerth, Friedrich A. Lutz, Karl Friedrich Maier, Fritz W. Meyer, and Leonhard Miksch (see Klump 2001, p. 27).
- (3) There is a long list of examples of politic measures which showed adverse results in the history of Ger-

many: the increase in tax rates on tobacco, which yielded a lower, not a higher tax earning; the so called Hartz IV law, which was thought to lower expenditures on unemployment but, in effect, increased expenditures significantly, etc.

- (4) An early summary of his thoughts can be found in Müeller-Armack (1990), a reprint of his book „Wirtschaftslenkung und Marktwirtschaft”, first published in 1946.

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