

# Germany's Social Market Economy and the New Systems Competition\*

*Karl Farmer*  
*Department of Economics*  
*University of Graz*  
*Austria*

World championship in exporting manufactures notwithstanding, weak gross domestic product (GDP) growth and the largest number of unemployed since the 1930s have tarnished the splendor of Germany's once celebrated social market economy (SME). In search of the reasons for their country's present mediocrity, contemporary (ordo-) liberal German economists point to construction defects in the economic constitution that escaped the attention of the founders of the SME. This article reviews the legacy of the father of the SME as well as the liberal critique of the evolution of the SME in postwar Germany under the old systems competition (OSC) between capitalist West and communist East. The liberal white hope, that is the new systems competition (NSC), ensued by European integration and globalization, is presented as a mechanism for overcoming national policy blockades in reforming (labor) market institutions in accordance with the common socioeconomic preferences of all citizens.

## **Introduction**

Germany, once Europe's model economy, has fallen behind England and France in terms of economic growth. Even small European countries such as the Netherlands, Ireland, and Austria have overtaken Germany in terms of per-capita income. Five million unemployed, the highest figure since the 1930s, (half of whom are long-term unemployed)<sup>1</sup> is the clearest evidence of Germany's economic malaise. Conversely, over the past five years, German exports have grown more than three times faster than U.S. exports; thus, pushing Germany back into the position of world champion in exporting manufactures.

Germany is running a current-account surplus, while the United States has a huge deficit.

Hans-Werner Sinn<sup>2</sup> attributes weak gross domestic product (GDP) growth and the “German disease” of high long-term unemployment among less skilled workers to both internal and external factors.<sup>3</sup> Among the latter, the intensification of international competition on world commodities’ markets and the squeezing of Germany’s interest advantage after the creation of a common European capital market, figure prominently. Among the former, the comparatively strong increase of German wages and wage-related expenses, hindering job-creating investment, has predominated.<sup>4</sup> In addition, the expansion of the welfare state contributed significantly to the rise in labor costs by increasing minimum wages through the expansion of wage replacement payments and by extending the tax burden on labor. Last but not least, the economic mismanagement of German reunification explains—according to Sinn—a significant part of Germany’s weak economic growth.<sup>5</sup>

Wolfgang Kerber and Sandra Hartig trace the roots of Germany’s present economic difficulties back to the 1950s: Even then “a broad consensus existed about the need to integrate market-oriented economic policy with a highly distributive welfare state in a ‘social market economy.’”<sup>6</sup> While in the 1950s, the decade of the so-called German economic miracle, the *ordo-liberal* pillar of the SME predominated; in the late 1960s the social precepts gained the better of market orientation, with detrimental effects to Germany’s economy in the following decades.

Ulrich Witt associates the extension of corporatist, interventionist, and redistributionist policies beyond *ordo-liberal* principles with the social ethos that the founders of the SME had included in Germany’s economic constitution.<sup>7</sup> Witt claims that organized interest groups learned, over time, to exploit the vague notion of the social in their rent-seeking activities, while on labor markets, the social partners utilized their legally protected monopoly power to achieve wage increases and protection for the employed at the expense of the unemployed, the bankrupt firms, and the German taxpayers. Witt concludes “that the major objective of the fathers of the German economic constitution—to avoid mass unemployment and its consequent hardship—is reduced to absurdity.”<sup>8</sup>

Witt ends on a rather pessimistic tone. One of the main reasons for this is that his penetrating analysis focuses on the performance of the SME in the era of the old systems competition<sup>9</sup> (OSC) between capitalist West and communist East. Under the OSC, the rent-seeking activities of special interest groups and the quasimonopoly of the social partners on the labor markets were largely

unchallenged by globally mobile production factors. The fall of the Iron Curtain and South Asia's opening to the world markets marked the beginning of a new systems competition (NSC).<sup>10</sup> This enables national governments both to limit the scope for rent-seeking by particular interest groups and to discover reforms of the established economic constitution more in accordance with the common preferences of all citizens.<sup>11</sup>

Acknowledging the liberal white hope, that is, the overall beneficial role of the NSC, the present article reviews the legacy of Alfred Müller-Armack, the father of the SME, in section 2. The rise and fall of the German economic miracle over the past fifty years as portrayed by Kerber and Hartig are the subjects of section 3. Construction defects in the fundamental principles, policy failure in implementing the principles, and Witt's elaboration of the implementation dilemma of social security systems and of the collective dilemma of the corporatist labor-market order are presented in section 4. In section 5, it is argued that in contrast to the OSC the NSC enhances the capacity of the German government (1) to restrict privilege-seeking in social policy intervention and (2) to curtail the legal protection of the quasimonopoly on labor markets in accordance with the common socioeconomic preferences of all citizens. Section 6 concludes the article.

## The Legacy of the Father of the SME

Among the fathers of the SME (Alexander Rüstow, Wilhelm Röpke, Alfred Müller-Armack, and others) Müller-Armack is the most well known. In fact, he coined the term *social-market economy* and asserted that it combines “the principle of freedom in the marketplace with that of social balance.”<sup>12</sup> Müller-Armack claimed that a synthesis of these two contradicting societal principles is indeed possible<sup>13</sup> and can be implemented by a deliberate political design of a competitive economic order that respects principles of social justice.

Müller-Armack's SME builds on the *ordo-liberalism* of the Freiburg School of Law and Economics (Walter Eucken and Franz Böhm) and on a social philosophy that is closely connected with the personalism and solidarism of Catholic social teaching.<sup>14</sup> Like the *ordo-liberals*, Müller-Armack (and the other founding fathers) heavily criticized the *laissez-faire* of nineteenth-century paleo- (or old) liberalism, which in their mind did not take seriously the tendency of nineteenth-century capitalism toward cartelization and monopolization and, moreover, neglected the social question of the time—the ever-increasing impoverishment of the masses.

However, whereas the ordo-liberals were convinced that the best policy to solve the social question would be the enactment of legal institutions fostering competition on commodity markets (competition policy),<sup>15</sup> Müller-Armack, as well as Rüstow and Röpke, pleaded—to a different extent, though—for an extra social policy aiming at social balance and social progress in addition to the competition policy suggested by the Freiburg School. While Röpke’s vision of a social-market economy was certainly closest to the ordo-liberal school of thought, Müller-Armack stressed the need to correct and supplement market outcomes by the state. Measures such as compulsory old-age insurance; government aid in the case of unemployment, illness, accident, and prolonged disability to work; family and residential allowances; a free system of education at all levels; and a tax system for the redistribution of incomes and minimum wages were already suggested by Müller-Armack.<sup>16</sup> In his view, the market economy was merely an (efficient) instrument to achieve higher goals; for example, social peace. “The market economy is not like an automaton; it rather represents a semi-automaton, which occasionally needs to be repaired and even reconstructed.”<sup>17</sup> The limits to repairing and reconstructing the market system were defined by the principles of market conformity and of subsidiarity. However, as Reuter<sup>18</sup> observes, Müller-Armack remained rather vague concerning strict application of these principles to limit state intervention in market processes—an attitude that can be traced back to his philosophical-anthropological position.

Following the end of World War II, socialism, Catholic ordo-thinking, Protestant social ethics, and the agnostic neoliberalism strived for intellectual dominance in Germany.<sup>19</sup> In accordance with the German philosophical tradition (Hegel), Müller-Armack tried to balance these contradicting positions by fashioning an all-encompassing vision—the SME. Müller-Armack closely followed Scheler’s and Plessner’s philosophical anthropology, stressing that unity of mind and body is specific to humans. It is this unification of spiritual and physical needs that distinguishes man from animals, enabling him both to be free from animal instincts as well as to be free to create his own history.

Man is free to shape mankind’s history only jointly with others. An individual realizes his true nature and personality by meeting other individuals face to face.<sup>20</sup> Thus, the state as a human social organization embodies more than mere social rationality (in contrast to the theory of the *Contrat Sociale* and Public Choice) and has a value in itself. The representatives of the state are justified in and responsible for organizing and managing social peace and social progress.

The specific philosophical position and Müller-Armack's paternalistic view of the state<sup>21</sup> prepared the ground for the gradual overexpansion of the welfare state. The danger of such a development had already been recognized in the salad years of the SME experiment by Wilhelm Röpke, who largely shared Müller-Armack's philosophical and religious position but at the same time emphasized the importance of competition and of freedom and autonomy of the individual:

By its continuous expansion, the welfare state tries to cover more and more uncertainties of life and ever wider circles of the population, but it also tends to increase its burdens; and the reason why this is so dangerous is that while expansion is easy and tempting, any repeal of a measure later recognized as hasty is difficult and ultimately politically unfeasible.<sup>22</sup>

## The Rise and Fall of Germany's Economic Miracle

The currency reform of 1948 marks the beginning of the rise of Germany's economic miracle as well as of the SME. It was directly accompanied by the original decision of Ludwig Erhard, the director of the (United States and British) Bizonal Economic Administration and later minister of economic affairs under Chancellor Adenauer, "to abolish the system of central planning in the Bizone by lifting price controls on almost all manufactured goods and some foodstuffs, and by rescinding rationing and the central allocation of resources."<sup>23</sup> The successive transition to free competition on commodity markets, the wage restraint exercised by still-weak German trade unions, and a modest social security system instituted by the conservative Adenauer government initiated a period of a hitherto unseen economic recovery, provoking the term *economic miracle*, with average GNP-growth rates of 8.2 percent throughout the 1950s, steadily increasing mass incomes, a decline in the unemployment rate from 11 percent in 1950 to 1 percent in 1960 (in spite of an influx of nine million immigrants from former German areas), low inflation, a nearly balanced public budget, and a change from being an international net debtor to a net creditor within one decade.

For ordo-liberals, as well as for the fathers of the SME, the German economic miracle was a consequence of the economic constitution of the SME, which allowed freedom of private initiative in the marketplace within the public safeguards of private competition and within the predefined limits set by public social policy. The overwhelming economic success of the SME in the 1950s and early 1960s led to its growing acceptance among political parties, unions, churches, and the media. The SME figured prominently in the German

reunification contract of 1990 and even found its way into the draft of the European Union's (EU) constitution.

However, the broad acceptance of the SME inside and outside of Germany must not hide the fact that the model lost policy relevance as its acceptance within society increased. The principles of the SME were transformed to conform to the political aspirations of social groups rising in the late 1960s.

The decline of the SME in the policy arena started with Karl Schiller's policy of global demand management and sector-specific investment planning as well as a rapid expansion of the social security systems.<sup>24</sup> At the same time, the conservative coalition government of the Christian Democrats and of the liberal Free Democrats was first replaced by a coalition of the Christian and Social Democrats (1966) and finally by coalition governments of Social and Free Democrats under the chancellors Brandt and Schmidt.

These "red" chancellors signaled a change of the general political climate in West Germany.<sup>25</sup> The old socialist criticism of the perils of market competition experienced a revival, and the demand for more social justice in (re-) distributing the gains from economic growth gained broad social acceptance. In contrast to the 1950s, it was thought that the government should exert a much more active role in steering and controlling the German economy. Although prominent SME advocates, as already mentioned above, had insistently warned of the dangers of the welfare state, another principle was successively gaining the upper hand: "the spreading socialization of the use of income, resting on the leveling and state-idolizing theory that any expansion of social services for the masses is a milestone of progress."<sup>26</sup> Similarly, their warnings of the monopoly power of trade unions<sup>27</sup> were largely ignored.

The initial protection of laborers from arbitrary dismissal was gradually expanded to take on the form of general protection from almost any type of dismissal.<sup>28</sup> In 1976, the worker codetermination in larger firms was introduced. The quasimonopoly of industry-wide employer associations and trade unions in collective bargaining was enforced by legally prohibiting company wage bargains that led to wage levels lower than those centrally negotiated. Finally, the Work Promotion Law of 1969 brought a generous system of wage-replacement payments for unemployed workers.

As a consequence, the incentives for the labor market parties to externalize the costs of rapid wage growth strongly increased, thus allowing the social partners to pay less and less attention to the growing number of unemployed. Public measures against rising unemployment showed little real effect: Most of the means were spent on administrating the system of unemployment insurance in accordance with the principles of the German welfare state.<sup>29</sup>

The change to ordo-liberalism proclaimed by the coalition of Christian Democrats and Free Democrats under Chancellor Kohl in 1982 brought a shift toward supply-side policy à la Reagan and Thatcher. “The basic insight was that the economic problems of late twentieth-century Germany were a consequence of failing incentives on the supply side of markets caused by overregulation, state intervention, high taxes, and a welfare state that had been extended too far. The central problem was seen as state failure, not market failure.”<sup>30</sup> However, paying lip service to liberalism and supply-siders, “the new coalition fully participated in the broad social consensus around the need to maintain the German welfare state.... Corrections to the German system of social security were deemed necessary, but the government never planned major reforms.”<sup>31</sup> All in all, “the conservative-liberal reforms were too inconsequential to prepare Germany for the new and unprecedented challenges of the 1990s: German reunification, European integration, and globalization.”<sup>32</sup>

On July 1, 1990, East Germany's economy was incorporated into West Germany's SME through the German Economic, Monetary, and Social Union, followed by political integration in October 1990. However, the reunification did not end in a new economic miracle but brought, at best, mixed results. The conversion rate of 1:1 for rents and wages and the pressure of (West German) social partners for equal payment in East and West Germany irrespective of the low level of productivity prevailing in East Germany led to rapid wage increases and to a cost explosion for East German firms. As a consequence, most East German industries collapsed, and the subsequent privatization policy failed to reduce high unemployment, despite the large subsidies available for the maintenance and restructuring of companies. The German government tried to save East Germany by huge expenditure on public infrastructure and by tax exemption for capital investments in East Germany.

The average income of East German households rose from 30 percent of the West German level before unification to 80 percent after unification; in contrast, East Germany's unemployment rate has since risen to 20 percent. One and a half decades after reunification

the consumption of goods and services by private households, private investment and public expenditures in East Germany exceeds the East German production levels by a half. Every third Euro that is expended in East Germany comes from the West. Seventy-five cents of every Euro are transfers, twenty-five cents are financed by additional debt.... The new federal states have become a transfer economy that is unable to survive without West Germany's money.<sup>33</sup>

“Paying for reunification put great financial pressure on both the German budget and the social security system, dramatically aggravating the already existing problems. Taxes had to be increased and the public-sector share of GNP rose above 50 percent during the 1990s.”<sup>34</sup>

Obviously, Röpke’s (1960, 1998) statement<sup>35</sup> foreseeing the detrimental effects of an overexpansion of the welfare-state to growth and employment, had already become reality for Germany by the time of reunification and has turned out to be true afterward even more.

### **Manifestations of Germany’s Constitutional Dilemma<sup>36</sup> and the Bazaar Economy Effect<sup>37</sup>**

In their thorough review of the SME’s performance within the past fifty years, Cassel and Rauhut trace the fall of the German miracle since the 1970s back both to construction defects in the fundamental implementation principles of the SME and to policy failure in applying these principles in everyday politics.<sup>38</sup>

In regard to the construction defects, neither the principle of market conformity nor that of subsidiarity was unambiguously defined so that policy proposals could be dismissed because of contradiction to the principles. Moreover, the fathers of the SME interpreted the range of the principles differently. Once again, Müller-Armack went furthest in accepting even obviously incongruous market interventions (because of his conviction that the market economy could do with quite a bit of such measures without losing its very nature).<sup>39</sup> The definition of the principle of subsidiarity lost unambiguousness, too, as it was mixed up with the principle of solidarity by the advocates of Catholic social teaching.<sup>40</sup> Due to the vagueness of its decision rules, the whole concept of the SME has degenerated into a meaningless notion that has become irrelevant for everyday economic policy decisions.<sup>41</sup>

However, even if both principles had been clearly defined, policy failures would have prevented practical application. Adherence to the principles represents a public good with a much larger number of beneficiaries than discretionary interventions in favor of small-numbered special interest groups. Free-riding on a politics by principle induces self-interested politicians to offer privileges to well-organized interest groups in exchange for supporting votes in democratic elections. Discretionary politics is crowding out politics by principle. Cassel and Rauhut rightly observe that the fathers of the SME missed the chance to develop a competitive order of politics to take care of the implementation of the SME’s principles within mature democracies.<sup>42</sup>



Witt carries on with Cassel and Rauhut's line of argument in referring the incentives for demanding political privileges back to the social ethos within the German (economic) constitution. He diagnoses a constitutional dilemma, arguing that

interest groups have learned to exploit the vague notion of the "social" in their rent-seeking activities. Hiding their particular interests behind accusations of social injustice or appeals to establish social balance, they have increasingly pressed the government to grant all sorts of advantages to their members....<sup>43</sup>

The constitutional dilemma manifests itself in an implementation and a collective dilemma.<sup>44</sup>

The implementation dilemma arises because, in practice, "the pursuit of a social ethos cannot easily be aligned with economic efficiency and robust individual freedom."<sup>45</sup> In the face of the hardship and pain caused by mass unemployment during the Great Depression, the fathers of the SME argued for comprehensive social security in case of illness, unemployment, old age, and for means-tested public assistance to the poor. However, the "criteria for transfer claims can neither be easily made objective nor be kept from manipulation by potential beneficiaries.... Moreover, public assistance in the form of welfare payments practically invites moral hazard."<sup>46</sup> In contrast to traditional solidarity transfers from family members, granted or refused on the basis of profound knowledge of the individual circumstances, the modern administrators of social security and public assistance, lacking this personal information, have to use standardized assessment procedures that are quite arbitrary and provoke moral hazard. The resulting individual injustice and inefficiency could be overcome by extending the rights of the social bureaucracy to obtain information about the personal circumstances of all citizens.<sup>47</sup> However, this could only be done at the expense of infringing upon the privacy of the beneficiaries. Here, the horns of the implementation dilemma are encountered: The envisaged social balance of the SME attained by social insurance and public assistance is either inefficient or clashes with basic liberal rights of citizens.

The collective dilemma originates in the postwar constitutional and post-constitutional legal sanctioning of the so-called social partnership in German labor markets revitalizing the old corporatist idea of correcting competitive-market outcomes by means of central negotiations between employers' and employees' associations (trade unions). Compulsory industry-wide wage negotiations guarantee a bilateral monopoly to the social partners; thus, enabling their representatives to behave like vote-maximizing politicians taking account

of the interests of the median-member of the associations they represent and neglecting the preferences of the nonmembers.

The typical trade union median-member is a job owner and his or her main interest is a maximal increase in wages and/or in job security. Thus, union leaders interested in reelection strive to maximize wage increases and/or job protection for the employed workers, which in turn destroy the incentives for employers to reemploy the unemployed. Heavy legal protection against wrongful dismissals and the generous wage-replacement transfers from the welfare state reinforce these tendencies. The corporatist order of the labor market, once created to counteract employers' dominance over individual labor suppliers, ends up in a collective-bargaining dilemma: The benefits of an expansive wage policy are reaped privately by the representatives of the labor-market partners and their members, while the costs are borne collectively by the unemployed, by those firms that go out of business, and by the taxpayers.

In the short run, the owners of capital are forced to shoulder the social costs of the private benefits of the members of the labor-market associations. In the medium and long run, however, capital adapts elastically to quasi-rents foregone in the past by intensifying labor-saving technical progress and/or by shifting labor-intensive production processes into low-wage foreign countries.

The latter option became more attractive in the course of the 1980s as many countries adopted policies of liberalization of market transactions and as technical progress in transport and communication technologies reduced international transport and communication costs substantially. Major German industrial corporations such as Siemens, DaimlerChrysler, and Volkswagen soon shifted parts of their production sites into Southeast Asia, China, India, and since the mid-1990s, German mid-sized enterprises have also been heavily building up production capacities in Eastern Europe. A number of manufactured commodities are sold under well-known German brand names but are produced to an ever-greater extent<sup>48</sup> in Eastern Europe.

Such observations have made Hans-Werner Sinn claim that Germany is becoming more and more like a bazaar economy.<sup>49</sup> He substantiates his claim by observing that Germany's industrial production increased by 18.4 percent between 1995 and 2003, while the value added only increased by 5 percent.

Apparently, a growing share of German manufacturing production is due to a process of outsourcing to other sectors and countries and to off-shoring. In the light of these developments, it is not surprising that employment in the German manufacturing sector has been reduced by 8.3 percent.... Imported intermediate products have grown by 45 percent in the time period from

1995 to 2003, twice as fast as industrial production and about ten times as fast as value added.<sup>50</sup>

In particular, automobile producers seem to respond to the reduction in domestic quasi-rents by downsizing relatively costly home production sites and creating cheaper jobs abroad.

Such domestically unpleasant consequences of international-factor mobility could not arise in the age of the OSC between capitalist West and communist East before the fall of the Iron Curtain and the opening of China. At that time, governments and social-pressure groups in each hemisphere were able to design their policy strategies without having to consider the economic interests of investors and the impact on enterprises migrating between West and East or between North and South. However, if it is true that too much outsourcing and off-shoring<sup>51</sup> is indeed a late consequence of the power of the insiders, legally protected by the corporatist labor-market order that was well suited to a period of high GNP growth, to a small-sized North-South and West-East-trade, and to a period of structural change exerting only little impact on the less qualified, one may rightly question whether the institutions adapted to the OSC are a blessing under the new international division of labor.

## **The NSC and Reforms of the SME**

At least since the late 1980s the OSC between West and East has been replaced by the NSC among all states of the world.

Governments today must be aware of the effects that national institutions have on cross-border transfer of economic activities. Taxes, social transfers, public goods, regulatory systems, laws, and many other factors are just as influential in motivating the movement of people and production factors as wages and other economic fundamentals that are not influenced by government. No government can afford to frighten off mobile capital as a result of grossly inefficient institutions, just as no state can afford to be a magnet for the poor of this world. Like a private company, a state competes for good customers and tries to ward off the freeloaders.<sup>52</sup>

The state that offers a favorable tax-benefit package to internationally mobile factors and firms will attract foreign investment capital, generating production capacity and new labor employment and raising national tax revenues. Less-attractive states will lose capital and firms, as well as jobs and tax revenues.

Empirically, it is rather difficult to decide whether Germany's current tax-benefit package is favorable to international investors or not.<sup>53</sup> Assuming that Witt's theoretical diagnosis of the implementation and collective dilemma of the SME applies, the German government would be well advised to overcome these dilemmas by (post) constitutional reforms. However, this is easily demanded but difficult to implement given that three-quarters of the elected representatives of the Social Democratic Party in the former Bundestag (the German parliament) were members of trade unions and fiercely opposed any deterioration in entitlements currently provided by the established labor market order.<sup>54</sup>

In addition to the question of feasibility, it remains open as to which reforms of Germany's economic constitution would conform best to the common (constitutional)<sup>55</sup> interests of all citizens. Given apparent differences in the socioeconomic preferences<sup>56</sup> between Europeans and Americans,<sup>57</sup> it would be premature to imitate U.S. labor-market institutions simply because of their better economic performance. There is a need for a social mechanism that induces European governments to redesign (labor) market institutions in accordance with the socioeconomic preferences of their citizens.<sup>58</sup>

While the NSC is often accused of undermining the ability of democratic governments to act in the common interests of their citizens, Vanberg maintains that, on the contrary, the NSC can "enhance the capacity of democratic governments to serve the common interests of their constituents by limiting the scope for rent-seeking and by functioning as a discovery process."<sup>59</sup>

First, in contrast to a basic assumption of neoclassical welfare economics, democratic governments do not always serve the common interest of their citizens but are vulnerable to privilege- or rent-seeking by well-organized special interest groups. This is especially true under the OSC. Under the NSC, however, internationally mobile factory owners who do not agree with the domestic tax-benefit package utilize the exit option and vote with their feet. As an immediate consequence, domestic tax revenues and jobs are lost. The welfare of the unemployed diminishes and so does the propensity to vote for the ruling parties. Anticipating these consequences of the voting process, the ruling government becomes more reluctant to maintain privileges granted in the past and is more inclined than before to reevaluate the established economic constitution. In contrast to the conditions under the OSC, there is now an incentive for the national government to question legally protected privileges.

Second, it is one thing to design reform laws compatible with the established constitution and related legal norms, but it is quite another thing to

implement norms that both conform to the common socioeconomic preferences of the citizens and are also cost effective. In the real world, there is no perfect information. Politicians and their advisers just do not know enough about people's true preferences and about how economic agents will react to the new rules, so their real costs cannot be foreseen. In the absence of the pretence of knowledge<sup>60</sup> of political advisers and decision-makers, appropriate national reform laws that meet the above conditions have to be discovered by a process of trial and error. Exactly such a process is fostered by the NSC.<sup>61</sup> However, it must also be mentioned that the signals enunciated by the NSC are much more open to the interpretation of voters and politicians than are the signals of competition on traditional markets for demanders and suppliers.<sup>62</sup>

This general characterization of the overall beneficial role of the NSC can be illustrated by the fact that the past red-green German government succeeded in reforming the legislation regulating unemployment benefits against fierce opposition from trade unions (Hartz-IV reform).<sup>63</sup> Both the shortening of the length of the entitlement period and the curbing of the benefit level can be seen as a move by the German government to limit the scope for rent-seeking in social policy. The former conservative-liberal government was neither ready nor able to push through such a far-reaching reform because the pressure of the NSC in the late 1990s was felt much less urgently than half a decade later. By 2004, under changed conditions, even the parliamentary opposition was ready to support the Hartz-IV reform.

Up to now, though, none of the German governments has hitherto dared to proceed with reforms of the corporatist part of the labor market order as advocated by liberal German economists such as Hans-Werner Sinn and Nobert Berthold. For instance, Berthold and Stettes<sup>64</sup> had several years ago proposed legal opening clauses for collective wage agreements if a qualified majority of firm employees voted for smaller wage increases than those bargained for collectively. During the election campaign of 2005, the present chancellor Merkel had the abolition of comprehensive wage settlements on her agenda, but it was buried in the negotiations for a grand coalition. By voting against a black-yellow coalition of Christian and Free Democrats on the occasion of the last federal election, the majority of voters unwittingly strengthened the antagonists of reforms of the German labor market order. It seems that the electorate will not vote for a coalition of political parties ready to reform the corporatist labor market order in line with the proposals of liberal economists before the negative employment consequences of upholding the established order are felt by an even larger part of the employed voters. Only then, will more and more

voters be prepared to vote for politicians who propose painful reforms of the corporatist labor-market order. These foreseeable political developments exemplify the knowledge-creating function of the NSC for the German citizens.<sup>65</sup>

## Conclusion

The attribute social, that brought about such widespread acclaim for the competitive market order lying at the heart of West Germany's economic miracle in the 1950s, has proved to be one of the main factors that gradually led Germany's model economy into a stubborn crisis with persistent high unemployment among less-skilled workers (the so-called German disease). Alfred Müller-Armack, the father of the SME, in his zeal for a postwar social harmony extending beyond the ideologies of fascism and communism, seems to have unwittingly sowed the seeds of the decline of Germany's ordo-ideal, which began in the late 1960s.

Now, with the benefit of hindsight, the decline can be traced back to three main causes: construction defects in the principles of market conformity and subsidiarity, policy failures in applying these principles, and a constitutional dilemma arising from the inclusion of a social ethos in Germany's constitution. Faced with the hardship and personal pain caused by the mass unemployment of the Great Depression, the fathers of the SME argued for the promotion of freedom, efficiency, and security from life's pitfalls.

Protected by high international transportation and communication costs, by the Iron Curtain between West and East, and encouraged by growing average wealth, particular interest groups in Western Germany gradually learned to exploit the vague notion of the social in their rent-seeking activities. Since the late 1960s, German policymakers have to face both the implementation dilemma inherent in the provision of social security and public assistance and the collective dilemma of the corporatist labor-market order. As a consequence, the capacity of the German economy to adapt to external and internal shocks has decreased successively.

Under the OSC, the deterioration of the competitiveness of Germany's economic institutions remained largely undiscovered. Under the NSC, due to the falling cost of international mobility since the late 1980s, the social costs of the lobbies' rent-seeking activities and the quasimonopoly of centralized wage bargains have become more and more obvious. Foreign investors and large as well as mid-sized German firms, now exposed to fierce international competition, have started to react by outsourcing and by shifting parts of their production sites into low-wage countries.

The exit option for internationally mobile factors, which today is much more attractive than it was twenty years ago, imposes restrictions on the freedom of the German government to uphold the privileges granted to particular interest groups under the OSC. As seen in the case of the Hartz-IV reform package, the German government, with the support of the political opposition, has only recently been able to cut the overgenerous unemployment subsistence payments. Hitherto, abolishing the corporatist labor-market constitution of the SME had proved infeasible. However, the NSC will continue to provide incentives for German governments to limit the monopoly power of trade unions and industry-wide employer associations. It also functions as a discovery process for the citizens affected by negative consequences of upholding the established labor-market order. They will vote for (a coalition of) political parties proposing reforms of the SME's labor-market order that better conform to citizens' common interests in the face of the new challenges of European integration and globalization.

On the one hand, it must be admitted that the blessings of the NSC cannot be as easily traced as those of the competition of firms for customers in well-established markets. On the other hand, ever-present political ambitions to harmonize social, labor, and environmental standards on an international level are certainly detrimental to those who are said to be protected by them. Instead of doing away with the NSC, it seems more appropriate to ponder about the possibility of establishing a competitive order for the NSC within the EU and beyond.<sup>66</sup> As long as total government spending of many European states is between 50 percent and 60 percent of GNP there seems to be no real danger of a race to the bottom in which EU's governments give up their indispensable role as providers of social security and equity.

## Notes

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- 1. Due to short-run improvement in consumer and business sentiments and increasing cost-competitiveness of German business, the number of unemployed recently decreased to 4.5 million.
- 2. See Hans-Werner Sinn, *Ist Deutschland noch zu retten?* (München: Econ 2003, 2004).

3. Several authors have voiced similar diagnoses of the German malaise. For example, Horst Siebert, "Labor Market Rigidities: At the Root of Unemployment in Europe," *Journal of Economic Perspectives* 11 (1997): 37–54 and more recently, *The German Economy: Beyond the Social Market* (Princeton, N.J.: Princeton University Press 2005); Norbert Berthold, "Mehr Beschäftigung, weniger Arbeitslosigkeit: Setzt sich das ökonomische Gesetz gegen (verbands-) politische Macht durch?" *ORDO* 51 (2000): 231–59. Recently, Sinn claims that "[ex]port boom and weak domestic growth are not separate events, but are economically closely fitting parts of a development process which is caused by labor-market rigidities" (Hans-Werner Sinn, "The Pathological Export Boom and the Bazaar Effect: How to Solve the German Puzzle," CESifo Working Paper No. 1708, April 2006, 4).
4. Real hourly labor costs increased by more than 40 percent in western Germany between 1980 and 2000, while the rise in the United States was only about 8 percent over the same period. As a consequence, the number of working hours increased in the United States by more than 40 percent, while West Germany only managed an increase of about 5 percent.
5. Peter Bofinger, *Wir sind besser, als wir glauben. Wohlstand für alle* (München: Pearson Studium, 2005) recently criticized Sinn's supply-side diagnosis of the internal causes of Germany's present (macro) economic problems. Bofinger points out that Sinn neglects weak aggregate demand that explains low GDP growth rates over the past years much better than supposedly excessive wage claims. However, acknowledging sluggish aggregate demand as a reason for weak growth and high unemployment does not imply that the supply side might be neglected. On the contrary, Sinn's analysis remains relevant for the attempt to increase employment without an accelerating inflation rate.
6. Wolfgang Kerber and Sandra Hartig, "The Rise and Fall of the German Miracle," *Critical Review* 13 (1999): 337–58, 337.
7. Ulrich Witt, "Germany's 'Social Market Economy': Between Rent-Seeking and Social Ethos," *The Independent Review* 6, no. 3 (2002): 365–75.
8. *Ibid.*, 373.
9. Hans-Werner Sinn, "The New Systems Competition," *Perspektiven der Wirtschaftspolitik* 5, no. 1 (2004): 23–38, 23.
10. *Ibid.*, 23.
11. See Viktor Vanberg, "Globalization, Democracy, and Citizens' Sovereignty: Can Competition Among Governments Enhance Democracy?" *Constitutional Political Economy* 11 (2000): 87–112, 87.



12. Alfred Müller-Armack, "Soziale Marktwirtschaft," in *Handwörterbuch der Sozialwissenschaften* 9, 243–49, 243 (Stuttgart: Fischer 1956) [Witt's translation of the entry "Social Market Economy" in the *Handwörterbuch der Sozialwissenschaften* in "Germany's 'Social Market Economy': Between Rent-Seeking and Social Ethos," 367].
13. Alfred Müller-Armack, "Die Wirtschaftsordnung, sozial gesehen," in *Genealogie der Sozialen Marktwirtschaft*, ed. idem (Berne: Paul Haupt, 1947), 73–89, 85.
14. Gernot Gutmann, "Ideengeschichtliche Wurzeln der Konzeption der Sozialen Marktwirtschaft," in *50 Jahre Soziale Marktwirtschaft*, ed. Dieter Cassel (Stuttgart: Lucius & Lucius 1998), 49–66, 52.
15. See Walter Eucken (1952), cit. by Kerber and Hartig, "The Rise and Fall of the German Miracle," 343. Eucken expected in accordance with basic liberal thought that more competition would spur productivity growth leading to higher wage growth and wealth for everyone.
16. Alfred Müller-Armack, "Soziale Marktwirtschaft," 391.
17. Dieter Reuter, "Genese der Konzeption der Sozialen Marktwirtschaft," in *50 Jahre Soziale Marktwirtschaft*, 67–96, 91 (author's translation).
18. *Ibid.*, 92.
19. Gutmann, "Ideengeschichtliche Wurzeln der Konzeption der Sozialen Marktwirtschaft," 58.
20. *Ibid.*, 60.
21. While "Müller-Armack assigns to the state broad competences including the definition and realization of collective objectives, Eucken calls for a limited government in order to safeguard individual liberty" (Lange-von Kulesa and Andreas Renner, "Die Soziale Marktwirtschaft Alfred Müller-Armacks und der Ordoliberalismus der Freiburger Schule—Zur Unvereinbarkeit zweier Staatsauffassungen," *ORDO* 49 [1998]: 79–104, 104).
22. Wilhelm Röpke, *A Humane Economy*, 3d ed. (Wilmington, Del.: ISI Books, 1998), 162.
23. Giersch et al. (1992), cited by Kerber and Hartig, "The Rise and Fall of the German Miracle," 339.
24. Dieter Cassel and Siegfried Rauhut, "Soziale Marktwirtschaft: Eine wirtschaftspolitische Konzeption auf dem Prüfstand," in *50 Jahre Soziale Marktwirtschaft*, 3–34.
25. These paragraphs closely follow Kerber and Hartig, "The Rise and Fall of the German Miracle," 344–45.

26. Röpke, *A Humane Economy*, 158.
27. “The concentration of supply on the labor markets in centralized trade unions works with the whole arsenal of monopoly power and does not shrink from naked extortion. This monopoly is the most damaging of all because of its all-pervading effects, the most fatal of which is the inflationary pressure of our time” (Röpke, *A Humane Economy*, 31). See also Walter Eucken, *Grundsätze der Wirtschaftspolitik* (Tübingen: Mohr 1952), chap. 9.
28. Protection of employees from arbitrary dismissals was legalized in the Kündigungsschutzgesetz of 1951. Its amendment in 1969 brought the general protection from almost any dismissal.
29. The ratio of public social expenditures to GDP increased from 25 percent in 1970 to 30.4 percent in 1980 (32.2 percent in 2003, the most recent available figure). The ratio of expenditures for employment promotion and unemployment insurance to GDP went up from 2 percent in 1970 to 5.1 percent in 1980 (10.5 percent in 2003, including Eastern Germany).
30. *Ibid.*, 347.
31. *Ibid.*, 349.
32. *Ibid.*, 351.
33. Sinn, *Ist Deutschland noch zu retten?* 476–77 (author’s translation).
34. Kerber and Hartig, “The Rise and Fall of the German Miracle,” 352.
35. “A whole world divides a state that occasionally rescues some unfortunate individual from destitution from another state where, in the name of economic equality and to the accompaniment of the progressive blunting of individual responsibility, a sizable part of private income is constantly sucked into the pumping engine of the welfare state and diverted by it, with considerable friction losses. Everything into the same pot, everything out of the same pot—this is becoming the ideal” (Röpke, *A Humane Economy*, 157).
36. Witt, “Germany’s ‘Social Market Economy’: Between Rent-Seeking and Social Ethos,” 367.
37. EEAG (European Economic Advisory Group at CESifo), *Report on the European Economy 2005*, 39 (Munich: Ifo Institute for Economic Research, 2005), 39.
38. Cassel and Rauhut, “Soziale Marktwirtschaft: Eine wirtschaftspolitische Konzeption auf dem Prüfstand,” see 18, 20.
39. Alfred Müller-Armack, “Die Soziale Marktwirtschaft nach einem Jahrzehnt der Erprobung,” in *Wirtschaftsordnung und Wirtschaftspolitik*, ed. idem (Freiburg 1959), 251–65, 258.

40. See Oswald von Nell-Breuning, "Subsidiaritätsprinzip," in *Staatslexikon*, vol. 7, 6th ed., 826–32.
41. Cassel and Rauhut, "Soziale Marktwirtschaft: Eine wirtschaftspolitische Konzeption auf dem Prüfstand," 20.
42. *Ibid.*, 24.
43. Witt, "'Social Market Economy': Between Rent-Seeking and Social Ethos," 366–67.
44. *Ibid.*, 367.
45. *Ibid.*
46. *Ibid.*, 369.
47. The recent regulation of the German ministry of finance that (social) bureaucrats are allowed to get information about private bank accounts can be interpreted as a step in this direction.
48. An extreme example is a car such as the Porsche Cayenne, which appears to be produced in Leipzig (East Germany). However, Leipzig accounts for only 12 percent of the value of the Cayenne, while 88 percent of its value is produced in Bratislava (Slovakia). See EEAG, *Report on the European Economy 2005*, 39.
49. See Sinn, *Ist Deutschland noch zu retten?* 67. Bofinger, *Wir sind besser, als wir glauben*, 32–33 questions Sinn's notion of Germany as a bazaar economy by pointing out that although the proportion of domestic value added in exports has decreased since 1995 it still amounts to up to 60 percent of exports.
50. Cf. EEAG, *Report on the European Economy 2005*, 49.
51. In *Die Basar-Ökonomie Deutschland: Exportweltmeister oder Schlusslicht?* (München: Ulstein 2005) Hans-Werner Sinn speaks of "over-optimal outsourcing and off-shoring" due to the (downward) rigidity of Germany's wages.
52. See Hans-Werner Sinn, "The New Systems Competition," 24.
53. For Sinn, in *Ist Deutschland noch zu retten?* the exodus of well-known German corporations signals an unfavourable German tax-benefit package, while Bofinger (2005) points out that Germany's FDIs do not differ significantly from the FDI-levels of comparable countries.
54. Now, after the election of 2005, the Social Democratic Party is in a grand coalition with Christian Democrats. It does not seem that the political influence of trade unions has diminished.
55. Viktor Vanberg, "Rules and Choice in Economics and Sociology," in *Rules and Choice in Economics*, ed. idem (London: Routledge 1994), 11–24 diagnosed a divergence between constitutional (common) and individual interests in social

dilemma situations that can be overcome by public policies following the principles as elaborated by Walter Eucken, *Grundsätze der Wirtschaftspolitik* (Tübingen: Mohr 1952) and Friedrich August von Hayek, *The Constitution of Liberty* (London: Routledge 1960).

56. Citizens have preferences not only for more consumption of goods (economic preferences) but also prefer social security and equity (social preferences). Because the latter are not provided by private markets, these public goods are supplied by the political system in modern democracies. In principle, the supply conforms to the socioeconomic preferences of the median voter.
57. Oliver Blanchard, “The Economic Future of Europe,” *Journal of Economic Perspectives* 18, no. 4 (2004): 3–26, on page 4 argues that between 1970 and 2000 Europeans exhibited a higher preference for leisure over income than North Americans.
58. It is well known from public choice theory that due to policy failures national political competition does not bring forth a supply of public goods that corresponds to the socioeconomic preferences of the median voter.
59. Viktor Vanberg, “Globalization, Democracy, and Citizens’ Sovereignty,” 87.
60. See Friedrich August von Hayek, “Die Anmaßung von Wissen,” *ORDO* 26 (1975): 12–21.
61. See Friedrich August von Hayek, “Der Wettbewerb als Entdeckungsverfahren,” reprinted in *Freiburger Studien*, ed. idem (Tübingen: Mohr 1969), 249–65.
62. See Stefan Voigt, *Institutionenökonomik* (München: Wilhelm Fink Verlag, 2002), 202.
63. Called after the leader of the reform commission and former human resources manager of VW, Peter Hartz.
64. See Norbert Berthold and Oliver Stettes, “Der Flächentarifvertrag—vom Wegbereiter des Wirtschaftswunders zum Verursacher der Beschäftigungsmisere?” in *Ökonomische Analyse des Arbeitsrechts*, ed. C. Ott and H.-B. Schäfer (Tübingen: Mohr, 2001), 1–29.
65. The caveats mentioned by Voigt (see n. 53 above) apply here too.
66. See Wolfgang Kerber, “Zum Problem einer Wettbewerbsordnung für den Systemwettbewerb,” *Jahrbuch für Neue Politische Ökonomie* 17 (1998): 199–230.