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Between ideologies: the social market economy

Imagine a man starving in the streets of Stockholm and the reaction of the various economic ideologies to it. Capitalism – driven by denial of state-interference rooted in liberalism, or its radical form, libertarianism – would argue that the man would never starve, because there will always be somebody who opens his door to help. The welfare state – rooted in the traditional socialist believe in the strong state – would argue that the state would prevent such a situation happening, so that nobody has to open his door.

The economic debate in our times is very often stuck between the stubborn belief in an unrestricted market, careless of its effects on the individual, and the rigid fixation on a welfare state, mistrusting of the individual and disinclined to give him a chance to act. This tussle shows all the signs of an ideological confrontation. Ideologies are characterised by a self-contained conception of the world which refuses to be questioned and claims to have found the absolute truth.

Originally, the term “ideology” stood for the “science of ideas” and made its first appearance at the time of the French revolution, courtesy of the French philosopher and politician Antoine Louis Claude Destutt de Tracy (1754-1836). He claimed to have adapted it from philosophers such as John Locke, for whom all human knowledge was knowledge of ideas. Loosely defined, ideology meant any attempt to approach politics in the light of a system of ideas. In the stricter modern sense, ideology aspires to be a comprehensive theory of human experience. It sets out a political programme and conceives its realisation as emerging from a struggle. It seeks not merely to persuade, but to recruit loyal adherents willing to employ

violence. It addresses a wide public but may confer a leadership role onto intellectuals as a privileged avant-garde.

The Austrian philosopher Karl Popper (1902-1994) argued that ideology rests on a logical error, which is the notion that history can be transformed into science understood as a method of observation, hypothesis and confirmation. In contrast, Popper described the true method of science as one of trial and error (“falsification”), not one of confirmation. Popper’s fallibilism underlines that we make theoretical progress in science by deliberately subjecting our theories to critical scrutiny and abandoning those which have been falsified. He accuses ideology of being an attempt to find certainty in history and to produce predictions following a false notion of science as a method of self-affirmation.

The endless row between the proponents of capitalism and socialism shows, on both sides, the ideological signs of self-certainty and aversion to being scrutinised. Though impervious to their repeated historical failure, they were, however, seriously damaged by the global financial crisis.

New Challenges to Old Thinking

The fundamental crisis of the global financial system has shown what damage the unlimited welfare state can do to the individual by spending money it doesn’t have – as we saw in some European countries and in the United States. A debt management policy leads to constantly increased budget deficits and, as a natural consequence, to higher taxation and cuts in public services. The examples of Iceland, Greece, Ireland and Portugal illustrate why this, after all, is endangering personal freedom through a dependency on drastic economic and financial measures taken by the state if deficit policies cross a certain threshold.

Many refuse the politics of accumulation of debt as a morally unacceptable policy at the expense of future generations. As a result of the financial crisis, people understand better why the promise that welfare states seem to offer – of living beyond one’s means – may be attractive in the short term, but is dangerous in the long run. In the end, it is the middle class that has to pay for the ravages wrought by such policies through an ever-increasing fiscal gap.

At the same time, the financial crisis has shown what harm unregulated

markets can do, socialising economic losses while privatising profits. It became obvious, once again, that pure, unrestricted capitalism leads to a situation where the economic failure of a few is jeopardising the wealth of all.

Such a crisis is not only economically devastating but can easily translate into political instability. It is not surprising that in countries like France, Belgium, the Netherlands, Finland, Denmark or Sweden, political parties to have benefited are those that promote the revival of national isolation, boost fear of foreignness and are filled with incredulity about opening borders for human exchange and international trade. This creates a new instability, not only in these countries but also between them and their neighbours.

Therefore, it is not only economically but also politically of vital importance to overcome the ideologically originated mental blockade of a debate between this one-dimensional construct of a planned economy and the patronised individual on the one hand and the unlimited belief in free markets and the unconstrained individual on the other. Both ideologies lost further credibility through the global financial crisis. Against this background, it is not surprising that a new political debate has emerged about how to create a legitimate economic system for democracy.

The Social Market Economy as the Third Way

The oft-repeated failure of the welfare and laissez-faire state draws attention, once again, to the idea of the social market economy as a “third way” between the ideologies of socialism and capitalism. The reaction of the social market economy to the starving man on the streets of Stockholm reads: “Yes, it could happen. Let’s see whether somebody will open his door to help. If not – and that could well be the case – the state should be ready to help and has to be able to do so.”

The notion of Social Market Economy refers to the economic concept which has formed the West German economic policy since 1948. The term was introduced in 1946 by the German economist, Alfred Müller-Armack (1901-78), who designed a theoretical concept in contrast to the centrally controlled economy of national socialism and also to the familiar concepts of the free market economy. According to him, the point of the social market economy is “to combine the principle of a free market with that of social balancing”. It is a concept in which the basic values of

liberty and justice represent two sides of a relationship whose tensions have to be maintained and tolerated.

The way for this concept was paved by the “Freiburg School”, which was formed by a group of economists in the early 1930s at the University of Freiburg. They suffered savage persecution from the Nazis. Their common basic beliefs were known as “ordoliberalism”, which is a concept opposed to unbridled capitalism as well as the centrally planned economy. The main representatives of this group were Walter Eucken (1891-1950), Franz Böhm (1895-1977) and Wilhelm Röpke (1899-1966), who argued the case for an “economic and social humanism”.

It was Ludwig Erhard (1897-1977) who went on to tackle the practical, economic implementation of the concept of a socially-oriented market economy when he became Minister for Economic Affairs in the first government of the Federal Republic in 1949, holding this position until 1963, when he was elected Federal Chancellor. Erhard is generally hailed as the “father” of the social market economy.

The first phase of its implementation in Germany (1948-66) was characterised by the initially successful realisation of economic growth and social security. The so-called economic miracle of the 1950s led – with American support, through the Marshall Plan – to the technological modernisation of the production process and the rapidly rising standard of living of the population in West Germany. The second phase (1967-78) was dominated by a policy of demand management, along the lines of Keynesianism and interventionism. This entailed increasing restrictions of the markets. The third phase (1979-90) started off with the failure of the policy of demand management with increasing unemployment rates and was followed by a policy more focused on the stimulation of market processes when the government of Helmut Kohl took power. Reunification began the fourth phase, with a re-establishment of a balance between the economic and social dimension through institutional reforms of economic order, which were also necessary as a consequence of European integration.

The social market economy is not explicitly mentioned in the German constitution, though there are articles which contain important preconditions for it. In particular, Article 14 of German Basic Law guarantees private property and, at the same time, it postulates that this should serve the well-being of the general public. In

the process of unification, the treaty of 8th May, 1990, between the Federal Republic of Germany and the German Democratic Republic, establishing a monetary, economic and social union, formally declared the social market economy the common economic order of both contracting parties and thus it became the official scheme for a united Germany.

A Concept of Man

Because a legitimate political and economical order should not be used as coercion against individuals, but rather to enable them to live together according to their nature, it is essential to reveal its underlying concept of man. This concept of man is the benchmark, whether political and economical systems are serving humans, or the other way around.

The fundamental values of the social market economy are rooted in what one might call the Christian image of humanity. The concept of inalienable human dignity results directly from the essential structure of humans, which is immutable. The dignity of one individual cannot be placed over, or subordinated to, the dignity of another. For Christians, this results from the certainty that humans are creatures of God. But the formulation of human dignity can be derived from other traditions or religions too. Out of the establishment of human dignity for everyone arises the respect for the equality of all humans. It cannot be separated from an understanding of human individuality. No-one is identical to another. From this diversity, the decision to embrace pluralism in politics and society follows.

Finally, the Christian concept of man is cognisant of the indissoluble human incompleteness which nobody can deny for himself or others. If nobody claims perfection, human dignity is secured for everyone. Where one or some deny human dignity for others, the threat of dictatorship and totalitarianism arises.

Ethical Goals

The social market economy is committed to three main ethical goals, which are essential to allow people to live in human conditions. The first and most important of these is an optimal goods supply, which can be achieved only when economic agents enjoy the freedom that forms the basis of their economic creativity. The second goal is

the guarantee of decent conditions at the workplace through public legislation, while classical liberalism sees even the labour market as exclusively subject to the law of supply and demand. The third ethical goal is solidarity with the economically weak through a system of social security. In our times, a fourth ethical goal of ecological compatibility and global economical reasonableness should be added.

On this basis, the social market economy is an institutionally order-related programme based on the principles of a competition-oriented economy, linking free personal initiative with social progress, made possible through the economic effectiveness of a successful market. In order to be able to fulfill this function, the institutional order has to meet a number of constitutive conditions. The structural elements which need to be mentioned are: private property, freedom of production, freedom of action, freedom of trade, free choice of occupation, free choice of work and freedom to consume. As the main prerequisite for a free market, private property can be defined as the right of private actors to dispose goods and services. These private actors also have to accept the consequences of their own decisions by being liable – positively in the forms of profits, negatively in the form of losses.

But the social market economy does not leave it at that. Just as it provides room for success for everybody in the market, it takes responsibility for the losers in the marketplace. For that purpose, it establishes a system of social security to protect all members of society against poverty and hardship and to provide everyone with the potential to lead a dignified life. The intention of this concept is to enable the beneficiaries of these services to live independently of assistance where possible. Answering the question about which of these solidarity services are indispensable to protect human dignity and where state responsibility ends to give room for reasonable individual contributions, the social market economy follows the principle of subsidiarity.

Diversity or Uniformity?

The dilemma has a long history in political philosophy. Its roots reach back to Aristotle who advocated the guiding principle of variety to build a society, quite unlike his teacher Plato, who recommended the ideal of unity as the principle structure of a society. The dispute between these two concepts of society runs through

the history of political ideas. Particularly impressively, Karl Popper analysed this in his book, *The Open Society and Its Enemies* (1945). On the one side Plato, Rousseau and Karl Marx described the ideal state as one which places unity over everything and to which variety appeared disturbing. On the other side, Aristotle, Locke and Kant emphasised the fundamental purpose of the state as guaranteeing diversity. Their guideline was: as much freedom as possible, as much unity as necessary.

It was Jean Jacques Rousseau (1712-78) who advocated “Du contract social ou principes, du droit politique” and a mysterious “volonté générale”, because, for him, no society could exist without a condition in which all interests agree. Thus Rousseau understands the individual only as part of the community. His ideal was the homogeneity of the people and he considered diversity to be an indication of crisis: “The nearer opinion comes to unanimity, the greater is the dominance of the general will; whereas long debates, dissensions and tumult proclaim the domination by particular interests and the decline of the state.” By belittling differences of opinion as “quarrel” Rousseau justifies his struggle for homogeneity through general will.

Rousseau’s concept – which can be seen as one of the roots of modern totalitarianism – stands in sharp contrast to the ideas of John Locke (1632-1704). In his influential paper, “The Second Treatise of Government” (1690), Locke stated that all humans are free by nature and make themselves so through agreement with members of a political society. Therefore the state has to ensure variety. This concept of “agreeing to disagree” can be understood as the origin of the modern concept of pluralism. In his essay, “On the Old Saw: that may be right in theory, but it won’t work in practice” (1793), Immanuel Kant (1724-1804) followed this line by stating that public welfare cannot be used against everyone’s “undeniable right to find his blessedness in each way that suits him, if he does not harm the freedom of others.”

Such philosophical thoughts were translated into a political concept by no less a figure than Abraham Lincoln (1809-65) who, six years before he was elected to be the 16th President of the United States, wrote in his “Fragment on Government” (1854): “The legitimate object of government is to do for a community of people whatever they need to have done but cannot do at all, or cannot so well do for themselves in their separate and individual capacities. In all that the people can do as well for themselves, government ought not to interfere.”

Even so, the idea has been around long enough to develop its full strength as a grand theory and to be labelled with the brand “subsidiarity” in the Christian social doctrine of the 19th century.

Christian Social Doctrines

The concept of the social market economy was driven by critiques of historical economic and social orders, chiefly Smithian laissez-faire liberalism on the one hand and Marxian socialism on the other. The concept of a “social ethic” was a response to industrialisation and its “social question”. While a Protestant social ethic refers to the Bible, the Catholic church postulates a universally binding natural law and thus presupposes a social philosophy.

Protestant social ethics were born out of empirical social sciences. The Lutheran theologian, Alexander von Oettingen (1827-1905), was the first to use the term “social ethics” in the title of a book of 1867, by distancing himself from an exclusively mechanistic definition of the social process and also taking a stance against a one-sided view of ethics as referring only to individual and personal acts.

The starting point of a corresponding social and ethical reflection remains, for Protestant reformers, their commitment to the rule of Christ over the world and the community in this world and the next. Protestant social ethics demand that everyone takes responsibility for his or her own life. To that extent, the individual can’t escape the tension between freedom and responsibility as the two key concepts of Protestantism. Freedom can only be substantiated if individuals have a certain degree of property and adequate opportunities to participate in the form of meaningful paid work. Individual freedom is tied to cooperation with others. The logic behind this idea is a just society as a fair system of cooperation.

The contemporary Catholic social doctrine dates back to a time when Catholicism strove for an answer to the social question, while liberalism and socialism emerged as the two dominating economic theories. While liberalism predicted that free global markets would result in the “wealth of nations” (Adam Smith), socialism believed in the necessity of a “class struggle”, which would lead to communism as a “classless society” (Karl Marx).

In the first social encyclical (world circulars) of the Catholic church, *Rerum*

Novarum (“of new things”) of 1891, Pope Leo XIII dealt with massification and anonymity as consequences of industrialisation. He emphasised how significant it is to protect and strengthen the individual against these tendencies and levelled harsh criticism at the early capitalist class society of the time. While rejecting the idea of socialism, he demanded a national social policy for the workers. The encyclical described the possibility of combining the related concepts of liberty as a fundamental value and the institution of the market with the idea of social justice in such a way that they were in a state of equilibrium, which would be able to “carry” the economic system and thus to “tolerate” the tension between liberty and social equality.

In 1931, the second papal encyclical, *Quadragesimo Anno* (“in the 40th year”), by Pope Pius XI, explicitly picks up on that plea in the face of totalitarian movements and the arrival of ideologies as new threats to individuals and describes individuals, family and social structures as protection against a pervasive state. He stated that the “capitalist way of running the economy cannot be condemned as such” but it is necessary “to organise it properly”, because “unhampered competitive freedom” can easily lead to “the survival of the fittest, who all too often tend to be more brutal and lacking in conscience”.

Subsidiarity

The term subsidiarity – derived from the latin word *subsidium* (“help”) – has its roots in the encyclical, *Quadragesimo Anno*, where its classical definition may be found: “Just as it is gravely wrong to take from individuals what they can accomplish by their own initiative and industry and give it to the community, so also it is an injustice and, at the same time, a grave evil and disturbance of right order to assign to a greater and higher association what lesser and subordinate organisations can do. For every social activity ought, of its very nature, to furnish help to the members of the body social and never destroy and absorb them.”

The 1991 encyclical, *Centesimus Annus* (“hundredth year), by Pope John Paul II, refers to *Rerum Novarum* and forms a third chapter of the Catholic social doctrine, resulting in the idea of a social market economy. Although it did not use this specific term, it described the issue down to the finest details of ethical principals. While the terms “liberty” and “social justice” describe basic ethical values, the terms “market

mechanism” and “public control” describe the two fundamental organising elements of the social market economy.

The subsidiarity principle demands that the self-sufficiency of the individual be protected against state interference. Moreover, it has a dual core: “private before state” and “small before large”. Where a problem arises, the smallest unit should be given the first chance to solve it before huge structures can capture it. Priority in assuming responsibility should be given first to the individual, then to the family; the neighbourhood is permitted to interfere before the state; the order of priorities moves from local to regional to national to European to global.

The subsidiarity principle is a rule for distribution of the scope of authority. Its ranking is clear: self help before neighbourly help; neighbourly help before help from afar and governmental interference. It is therefore crucial how political and economic order will examine the question of its reach of competence. One cannot insinuate that subsidiarity advocates that the state should not take care of anything. It doesn't want government to be so powerful as to interfere everywhere, but it does want it to be powerful enough to act when needed. In addition to its decentralisation dynamics, the subsidiarity principle requires that the government institution which is assigned to solve a problem must be sufficiently equipped to complete these tasks.

In a sense, subsidiarity (“we should keep a sense of proportion”) is the sister of solidarity (“we are all in the same boat”). It promotes freedom and individual responsibility. It wants to avoid the dependency and paternalism of the welfare state as much as it promotes security for the individual, rather than the abandonment of the individual under capitalism.

Rules for the Market

With its emphasis on the principle of subsidiarity, the social market economy advocates that each individual not only has the right, but also the duty, to do what he or she is capable of doing. This applies to integration in the job market, the acquisition of knowledge and education, and the ability to accumulate assets and to make financial arrangements for retirements and times of need. Unlike the welfare state, it gives personal initiative priority over state action and stipulates the state to act bottom up instead of top down. Unlike the libertarian laissez-faire state, it does not

exclude state action as a last choice, if individual initiative is too weak to succeed.

The social market economy starts from the premise that the market economy requires a stable, legal-institutional framework, which the state can create by making provision for internal and external security, administration of justice and a suitable infrastructure. Government has responsibility for drawing a code of general rules for market participants. Markets do not always function smoothly. Open competition is only possible if anti-trust rules guarantee a minimum number of competitors and prevent monopolies from dominating the market.

In all free market systems there are a number of economic sectors that require special regulations because they deviate more or less strongly from general market principals. Such sectors – basic needs like agriculture and food, water supply or electricity, health care – are a feature of the social market economy, partly exempted from the laws of general competition. Instruments to be used are state regulations controlling market entry, prices, production and sales volume, investments and capacities, as well as quality and terms. This includes prohibition of cartels and price fixing, the ban of price recommendations and monitoring of abuse in cases of exclusivity commitments of costumers towards certain suppliers.

To safeguard free markets by implementing fair is a key purpose of the social market economy. Another is to make sure that human dignity is not only protected for those who participate in a free market, but for those who fail to survive there.

Social Security

A legitimate political and economic order allows for the fact that human beings have not only different interests, ideas and opinions, but also different gifts and abilities. There are the risks of non-income periods – unemployment, illness and retirement – against which a social security system should provide a basic safeguard. The social market economy organises for this through an insurance system which is compulsory for everybody because, otherwise, those who are reasonable enough to safeguard their money for difficult times would also have to support those who don't.

These compulsory insurances against times where there is no income are based on the concepts of solidarity and subsidiarity. They force everybody to show solidarity with himself by taking bad times into account when he enjoys the good

times. Without this imposed precaution, people would live at the expense of others when they are hit by personal financial crises. Viewed in this light, the protection of freedom for all is justification for the constraint of personal freedom, forcing individuals into an insurance system.

In Germany, unemployment insurance, health insurance, the pension system, care insurance and insurance against accidents at work are compulsory. The level of contributions (and benefits) to these compulsory insurances for times where there is no income is linked to the level of income when it is earned. The insurance premium is shared 50:50 by employers and employees.

At the time of writing, in 2011, these contributions stand at 19.9 per cent of wages for pension insurance, 15.5 per cent for health insurance, 3 per cent for unemployment insurance and 1.9 per cent for nursing care insurance. With his half of it, an employee pays a significant 20 per cent of his income as premiums for these social security insurances. This is about the same as the average tax rate.

While the insurance system is personalised – basically, you get what you pay – there is also a social security net which is funded by taxes and ensures a minimum standard of living when all other systems fail. In 2011, this minimum income system provides €364 per month for an adult and between €215-287 for children, depending on their age. In addition, beneficiaries are entitled to be reimbursed for their costs of an appropriate home.

With solidarity as one of its principles, the German social market economy is committed to a system of progressive income tax. Currently, its key points for the individual are a basic tax allowance of €8000 (plus €7000 per child), a starting tax rate of 14 per cent, higher rates of 42 per cent for annual incomes of €52,000 or more, and a rate of 45 per cent for incomes of more than €250,000.

In addition to certain benefits in the tax system – such as a tax split for family incomes – there is a special policy to support families. It includes child allowances (between €184-215 per child) and parents' money (€300-1800 Euro up to 14 months, depending on previous income, if you take a break to raise children). Time spent on childcare and education is taken into account in the calculation of old-age pensions through insurance contributions paid by the state. The term “family contribution compensation” used for this policy underlines that children do not represent a burden

on society, but that parents, through their investment of money and labour, are making an essential contribution to the continued existence of society. Family policy is also a part of the commitment of the social market economy to the principle of solidarity.

Compulsory Insurance

Right from the start of its conceptualisation, one of the fundamental pillars of the social market economy was to ensure that the aged can enjoy their retirement, adequately provided for and free from poverty. It is equally important that old-age pensions should not come across as charity, but as a rightful claim derived from contributions made during the acquisition phase. Pensions are rewards for performance. Therefore, Germany has a so-called contribution-financed pension system for each employee. The employer deposits a fixed percentage of earned income, from which pensioners draw during retirement in proportion to their contributions.

In Germany, for historical reasons, the deposited contributions are paid directly to the pensioners and not placed into interest-bearing investments to be paid out later to the respective contributor. In other words, the pension system works on a pay-as-you-go basis. Pension scheme revenues are based on the contribution average, multiplied by the numbers of employees. Expenditure is based on the average pension multiplied by the number of pensioners. If the number of pensioners rises, or the numbers of employees fall (or both), it follows that expenditure goes up or revenues go down (or both). Therefore, economic crises and demographic changes have a direct impact on the pension fund. If there is a deficit, it has to be covered by the tax-payer. Due to demographic development, these subsidies to the pension fund became the second largest item of expenditure in the national budget – after the interest rates on the state deficit. Lowered pay-outs, extended working ages and incentives for more private provisions for one's old age are the countermeasures which are taken by politics.

As a protective measure against health risks, people have to get health insurance. Up to a certain income, they belong to the statutory health insurance system. About ten per cent of the population are members of a private health insurance scheme. Both schemes are financed through contributions calculated in

order for contribution revenues to cover current expenditure. The contribution charged is a percentage of income. A free insurance coverage for family members without income is included. One of the most important rights for the patient, guaranteed by the system, is the free choice of a doctor.

In recent years, new medical technologies and new medicines and the growing number of senior citizens have sharply increased health costs. In order to counteract these developments, reform of the health service is an ongoing task. Measures include the exclusion of certain non-basic services and medicines from the service catalogue, the introduction of supplementary payments by the insured and so-called budgeting, which entails upper limits for the financing of services rendered or initiated by hospitals and physicians in private practice. But still the insurance contribution has risen.

Nursing care insurance functions like health insurance, but is dramatically confronted with higher costs as a consequence of demographic developments, people getting older and more of them depending on professional care. Statutory occupational accident insurance covers accidents at work, occupational diseases and work-related health hazards. Its contributions are paid by the employer only.

Unemployment insurance guarantees 60 per cent (or 67 per if you have children) of your last wage (confined to €5,500 per month) up to 24 months, depending on your age. After this time, one is entitled to claim basic social security. The primary purpose of this social security system is to reintegrate the unemployed into working life, while they are expected to show active participation. Basic social welfare – not the insurance benefits – can be cut if one does not seek a job.

This system of support and demand manifests the continuing ability of the social market economy to conciliate freedom and justice, while the old ideologies of capitalism and socialism remain stuck in the philosophy that you have to make a choice between these objectives.