PS OnPoint

Long Reads

Why the Social Market Economy Succeeds

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COLOGNE – The COVID-19 pandemic has intensified ongoing debates about the future of capitalism and the economic framework best suited to meet the post-pandemic world's long-term needs. Developed economies will, of course, need strong growth to offset the economic damage wrought by the virus, and to rise to the challenges posed by climate change and societal aging. And yet, across the developed world, the pace of economic growth has been slowing for decades, casting doubt on how these challenges will be met.
How should the gap between actual and necessary growth be closed? Should developed economies continue to focus on Keynesian demand management, thus risking the accumulation of ever more debt? Or should we shift to a longer-term, rules-based approach that anchors expectations and builds confidence, albeit at the expense of some policy discretion?

Such questions have become urgent, and yet are not being forthrightly addressed. Throughout the pandemic, the consensus has been that governments should intervene to boost aggregate demand through fiscal- and monetary-policy stimulus. Yet while a decisive crisis response was clearly necessary to avert an economic death spiral last spring, scant attention has been paid to the pitfalls of demand management – from the implications of massive government deficits to the potential for renewed inflation, lost business confidence, and future tax policies.

At the same time, rules-based policies have increasingly fallen out of favor. A strong tide is pushing against any measure that might inhibit the freewheeling monetary and fiscal experiments we have been witnessing. Structures such as the European Union's Stability and Growth Pact, which capped government fiscal deficits and debt at 3% and 60% of GDP, respectively, now seem to have been discredited as manifestations of “evil austerity.” Never mind that they delivered clear successes in Cyprus, Ireland, Portugal, and Spain in the 2010s.

Moreover, the singular emphasis on demand management has distracted policymakers from the fact that today’s challenges are structural, and not solely the result of the pandemic. Concerns about growing government interventionism have coincided with reduced overall investment. Despite this, many economists continue to demand even more state intervention, while glossing over questions of what expansive monetary and fiscal policies will mean for growth over the long term.

The Social Market Blueprint

While much of the West has been preoccupied with what the Nobel laureate novelist Saul Bellow called “sucking out the victories of the short run,” many Asian countries have adopted more of a strategic, long-term approach to their economic decision-making.

This is certainly true of China, which has systematically sought to learn from others’ experiences as it confronts its own development challenges. Specifically, Chinese leaders have been keen to understand how Germany managed to outperform most of its Western peers in the face of challenges ranging from the post-World War II reconstruction and the great inflation to reunification and the 2008 global financial crisis.

To that end, two of us (Feld and Jungen), together with Zhou Hong, former Director-General of the Chinese Academy of Social Sciences, and Zhu Min, former Deputy Managing Director of the International Monetary Fund, conducted a wide-ranging study to identify the essential elements of German post-war economic policymaking. This work culminated in *The Social Market Economy: Compatibility among Individuals, Markets, Society, and the State*, a book outlining the main features of the German model, the historic context that led to its creation, and the lessons it holds for our own time.

The book makes clear that Germany’s social market economy is not chained to circumstance. Rather, it is essentially a set of universal principles and rules for running an open economy. Although it advocates a strong state, it shares Adam Smith’s view that government’s proper role is to provide essential public goods and services, set the rules of the game, and then serve as a referee.

The “social” element of the social market economy, then, is not about state ownership or state direction, as under socialism. Instead, it refers to a rules-based economy in which social interests are properly accounted for.

A Model for Open Societies and Free Citizens

Although the social market economy was implemented under unique conditions – namely, out of the ruins of the most devastating and destructive period in human history – it is well suited for any country that is committed to pursuing patient, secure economic development. In the German context, the idea for a liberalizing reform package originated with the Freiburg School – so named for the picturesque town at the foot of the Black Forest, home to the University of Freiburg.

The social market economy's main protagonists were the economists Walter Eucken and Franz Böhm, and it was strongly influenced by the Austrian economist Friedrich von Hayek (then in exile in London). Henry Simons and Frank Knight of the University of Chicago also inspired the "ordoliberal" thinking underlying the approach.

The true "birth" of the Freiburg School of economics came in 1936, over a decade before Germany's currency reform, and at one of the darkest moments in the country's history. This was when Böhm, Eucken, and Hans Grossmann-Doerth published the "Ordo Manifesto," pushing back against the collectivist ideas that had come to seem triumphant with Stalin's disastrous five-year plans and the Nazis' increasingly interventionist and clientelist economic policies.

In the face of this, Böhm, Eucken, and Grossmann-Doerth saw the need for a systemic, principle-based view of the economy. Taking the perspective of lawyers as well as economists, their manifesto advanced the Hayekian notion of an "economic constitution" comprising special laws on bankruptcy, labor, real estate, and other relevant domains, all with the aim of providing for a well-functioning, competitive market-based system. At a time when the country was fully in Adolf Hitler's grip, the publication of such a manifesto was nothing if not courageous.

Once peace came and Germans began to govern themselves again, Ludwig Erhard, the minister for economic affairs, sought to put the "Ordo Manifesto" into practice. Erhard considered himself a liberal and was strongly influenced by ordoliberal ideas. But labels are important, so Alfred Müller-Armack, another "founding" ordoliberal and senior official under Erhard, coined the term "social market economy" in 1947 to serve as the public expression of "ordoliberalism."

A *Wirtschaftswunder* Is Born

The rudiments of the ordoliberal model were first put into practice three years after WWII, a time when Germany remained destitute, desperate, and nearly paralyzed. The country's economy was riddled with black marketeering and widespread economic controls that had been imposed by a massive bureaucracy comprising not only the remnants of the old German state but also the military administration of the occupying powers (the United States, the United Kingdom, and France). There were shortages of everything, and various forms of interventionism, state planning, and control prevailed. But Germany's nascent post-war leaders were preparing to embark on a different path.

A crucial moment came on June 20, 1948, when the Deutsche Mark was introduced as a new currency. This coincided with Erhard's decision to abolish the wartime and post-war systems of price administration. With these two seemingly simple steps, the foundation of a market economy was laid. Henceforth, the prices of most goods and services would be set by the free operation of markets. Soon enough, German shop windows were restocked with goods as the black market was absorbed into the official economy.

In liberalizing markets and strengthening competition, Erhard and his Freiburg School collaborators in Konrad Adenauer's government broke with Germany's long tradition of monopolies, cartels, and ad hoc government intervention. Consumption and production quickly aligned, as entrepreneurs reallocated labor and scarce capital to more productive uses. Investment and innovation took off. The postwar German *Wirtschaftswunder* (economic miracle) was born. By unleashing the market to revitalize a moribund economy, German policymakers pursued a course that may seem obvious today but certainly didn't at the time.

Ironically, those who were most skeptical of the ordoliberal reforms included representatives of the US, the world's leading market economy. Though what is apocryphal and real are now impossible to reconstruct, there is an anecdote that General Lucius D. Clay, the military governor of the US-controlled zone, summoned Erhard and told him that he must not alter the rules of price administration:

"Mr. General, I have not altered the rules, I have lifted them," Erhard replied.

"Professor Erhard, all my advisers tell me that a market economy in Germany will never work."

"Don't worry," Erhard assured him, "all my advisers are telling me the same."

In the event, it took the German people some time to warm to the new approach. Such hesitancy was understandable after the years of National Socialist dictatorship and virtual serfdom. Nonetheless, in 1949, Germans chose the Christian Democrat Adenauer, a longtime mayor of Cologne who had never supported Nazi rule, to serve as West Germany's first chancellor, and Adenauer put Erhard in charge of economic policy. The social market economy was the platform on which they would build a democratic Germany.

"At a turning point of German history," explains Alfred Mierzejewski, Erhard's biographer, Germany was "offered a real and moderate alternative to all the other political ideological extremes" then under discussion. Over time, as the economy delivered persistently strong growth, the social market economy became ever more popular. In the words of Jürgen Jeske, former editor of the *Frankfurter Allgemeine Zeitung*, it was "the visible hand of economic prosperity." In the following decades, West Germany became one of Europe's most successful economies. The social market economy and ordoliberalism have continued to serve as the country's guiding economic philosophy.

The Rules of the Game

Conceptually, the social market economy has the virtue of being straightforward and intuitive to ordinary citizens. Recognizing that modern economies are far too complex to be planned or engineered, ordoliberalism limits itself to governing the rules of the game, which in turn allows people to set their own expectations and act accordingly. To be effective, however, all of the rules and policies must "fit together"; good rules make for good games, in the economy as in sports.

The roots of ordoliberal thinking lay in classical economics, which placed great faith in free, responsible individuals interacting in markets. Ordoliberals shared Smith's view that, as the economist John Kay put it, a "successful market economy requires the legal, social, and economic infrastructure that only a strong state can provide." But "a strong state is tolerable only in an environment of pluralism, democracy, and mutual trust." Ordoliberals were similarly aware of how markets can go wrong or go too far. Like Smith, they knew that "markets function well only when embedded in strong and supportive social institutions." Again, in Kay's words, "there is no contradiction between Smith's *Theory of Moral Sentiments* and *The Wealth of Nations*."

Böhm argued along the same lines. Writing in 1966, he pointed out that the social market economy required the rule of law so as to abolish "all class prerogatives and privileges." In particular, "the administration of justice should be totally free from all powers of domination and representation." The result, in today's parlance, is a level playing field on which free citizens can pursue their own interests and thrive.

To that end, markets are crucial for aligning production with consumer preferences, by generating information about what is scarce and what is not. The price mechanism, as Eucken put it, is a "scarcity gauge." To function properly, however, markets need to be competitive, which has the added benefit of enhancing efficiency and innovation.

A competitive order provides opportunities for everyone, rather than just for the powerful, and the principle of individual responsibility ensures that people can reap the rewards of their successes without avoiding liability for their failures. Uncompetitive, power-driven behavior is therefore a threat to any market order. Because firms tend to collude, form cartels, and exploit their local labor-market powers, well-designed competition and labor laws are essential.

While pre-war Germany had a long history of labor law, it was more resistant to the idea of a competition policy. But with the Freiburg School's support, Erhard introduced the German Competition Act in the late 1950s.

Dignity Over Dependence

Erhard stressed that the social market economy was designed to support "the basic human instinct to better one's life." It was aligned with the "nature and dignity of human beings" that the Nazi regime had so grievously denied. The state, he and his contemporaries believed, should act as an impartial referee and not as a player, let alone a team manager.

It is this principled impartiality that puts the "social" in the social market economy. Because everyone has a natural drive to improve their situation, the provision of an efficient, innovative, equal-opportunity system is a paramount social good.

The social market economy is also social because it creates the wealth needed to provide welfare benefits, housing support, pensions, and other programs. Of course, as Müller-Armack stressed early on, such social policies should be designed to promote self-reliance and dignity rather than dependence.

More fundamentally, Eucken, Böhm, and other ordoliberals saw ad hoc government interventions in the economy as the greatest threat to a functioning economic order. Not only do government actions affect short-term outcomes, but they also introduce uncertainty, distortions, and disincentives that will frustrate the workings of the system over the long run.

Hence, Erhard warned of the "insolence" of "megalomaniacal bureaucrats." To be sure, he was no less scathing about well-organized private interests and "crony capitalists" who pursue every opportunity to secure privileges for themselves at the expense of everyone else. But because interventionism tended to benefit the well-connected rather than the innovative or the poor, the ordoliberal's default view was that it was, if anything, anti-social.

The Big Tent

As a direct intellectual descendant of the classical economists, ordoliberalism is not simply some peculiar German or Austrian invention. The social market economy and *Ordnungspolitik* have kindred spirits around the world. For example, with its emphasis on rules and the general interest (rather than special interests), the "constitutional economics" pioneered by the American Nobel laureate James M. Buchanan had much in common with ordoliberal thinking. Similarly, public choice theory, the economic analysis of politics and the role of government in the economy, relies on an approach very similar to that of the Freiburg School.

And, of course, ordoliberals have always sided with the rules-oriented-economics camp in the great "rules vs. discretion" debate in macroeconomics. Whereas rules foster intertemporal consistency and long-term optimality, discretionary policies ignore and even undermine these objectives. By the same token, there is strong cross-fertilization between ordoliberal views and the American debates over fiscal and monetary rulemaking, which touch on everything from most US states' balanced budget requirements to the famous Taylor rule in central banking.

Moreover, the social market economy and ordoliberal thinking remain dominant in many other parts of Europe. For example, ordoliberals have had a strong influence on the development of the EU's competition policy, which itself has followed a rules-based approach. Indeed, ordoliberalism's greatest international achievement is perhaps the EU's "four freedoms" framework, which provides for free movement of goods, services, capital, and people within the single market. When combined with clear and predictable competition rules, these freedoms keep countries economically fit, by encouraging them to develop an attractive, well-functioning market system at home, lest they lose out on trade, investment, and other commercial opportunities.

Ordoliberal thinking has also strongly influenced what one might call Europe's "financial constitution." It was the German Bundesbank that provided the model for the European Central Bank and other independent central banks across the Union. Likewise, the Maastricht deficit and debt rules that laid the foundation for the euro were a clear reflection of ordoliberal thinking. And the same can be said of the German deficit rule – the "debt brake" that allowed Germany to reduce its public debt after the global financial crisis and thus be well prepared to handle the fiscal challenges of the pandemic.

Ordoliberalism's central tenets also underpin the European Stability Mechanism – which adheres to the IMF's principle of conditional financial support to ensure solidarity within the EU – and the EU Treaty's requirement of "subsidiarity," or decentralized decision-making.

Finally, rules-based economic policymaking is strongly supported at the level of multilateral and global-governance institutions. This is not surprising: one country's trade protectionism, for example, damages the interests of not only its own consumers but also of many others abroad. Before a rules-based system was established under the General Agreement on Tariffs and Trade, and later the World Trade Organization, protectionism had long been a source of international tension and conflict.

Good Rules Make for Innovative Ideas

Building on Austrian economist Joseph Schumpeter's ideas, ordoliberals have long stressed the importance of openness, innovation, and economic dynamism. According to Herbert Giersch, one of the most prominent ordoliberals in the 1970s and 1980s, human capital and favorable institutions were the keys to Germany's escape from post-war misery. These factors helped Germany avoid the middle-income trap as it recovered from post-war impoverishment and achieve general prosperity, before ably tackling the challenge of reunification and then weathering the 2008 global financial crisis.

With its focus on predictable rules and open, reliable institutions, ordoliberalism has provided a powerful framework for driving innovation. Here, the state's role is limited to funding basic research and the appropriate infrastructure, so that entrepreneurs and inventors have a stable environment in which to turn knowledge into capital and bring new and innovative products to market.

Still, policymaking in Germany is not a perfect incarnation of ordoliberalism. Political compromises have had to be made in the face of diverging interests. The state's continued ownership stake in Volkswagen and a few other companies comes to mind. But these examples are exceptions to an otherwise private-sector-driven growth and innovation model.

Germany thus stands in stark contrast to countries that have engaged in "industrial policy," aiming to identify the most promising industries to promote.

This reflects the conviction that successful innovation policy does not pretend to know what the future will bring. Instead, it maintains institutional openness to ideas that no one today could even imagine. Indeed, no government could have foreseen that mRNA technology developed by a German startup (BioNTech) to fight cancer would be used to create a vaccine against the coronavirus in record-breaking time.

Finally, in fostering more green innovation, Europe has deployed rules- and market-based emissions trading schemes as the foundation of its decarbonization strategy. This, too, represents another win for ordoliberal thinking. It shows that the social market economy remains the framework for tackling our most pressing challenges today.

The social market economy model endures because it supports consumer interests before those of producers, just as it positions citizens, rather than the state, as the true sovereigns. At its heart is a commitment to constitutional and system-level thinking, not piecemeal, discretionary policymaking. This approach has proven to offer the most reliable foundation for a successful economy. Germany's record after 1945 speaks for itself.

This matters today because too many economists continue to view rules and boundaries as guidelines, not guardrails. Yet now more than ever, we need a reliable compass for navigating the challenges ahead. Consistency and predictability invariably build confidence, which is one of the main reasons why Germany became the economic anchor of the EU. The world's drifting advanced economies could do worse than to attach themselves to the same mooring.

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