

Social Market Economy and German Social Policy

– Focusing on a Desirable Social Policy

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1. Introduction

This paper considers the influence of the concept of the “Social Market Economy” (SME) (*Soziale Marktwirtschaft*) on German social policy after WW II.

SME is the basic principle underlying German economic and social policy, and it focuses on combining market freedom and social balance. Social balance (*Sozialer Ausgleich*) in the context of Germany may be interpreted as a social policy of the country that is manifested through low employment levels, good working conditions, insurance, healthcare, etc. However, there are different perceptions of what is considered to be a desirable social policy even among the founders of SME—Walter Eucken, Alfred Müller-Armack, and Ludwig Erhard.

In the following account, these different perceptions are classified into three types according to the three famous founders of SME: “Eucken type,” “Müller-Armack type,” and “Erhard type.” Thereafter, based on this classification, the transition of the German social policy in the postwar period is analyzed, and then a desirable social policy that is currently relevant will be considered.

2. The Concept of SME

The term SME was coined by Müller-Armack in 1947. According to him, “the concept of a social market economy may (...) be defined as a regulative policy which aims to combine, on the basis of a competitive economy, free initiative and social progress” (Müller-Armack 1956, 83). Further, “the idea behind the social market economy is that market freedom is combined with social balance” (Müller-Armack, *ibid*, 82). The concept of SME was created in Germany after WW II as a countervailing concept against both the state-controlled economy of the Nazis and the USSR and the principle of *laissez-faire* of the United Kingdom in the 19th century¹. The SME was established through Article 2 of the Lisbon Treaty² in December 2007; thus, it is currently being adopted as the basic principle for EU economies as well.

Theoretically, SME is based on the economic and political concept of ordoliberalism³, which is a kind of neoliberalism, and is also influenced by other theories such as the Christian social theory and neosocialism.

Walter Eucken is considered to be the father of ordoliberalism; this economic theory focuses on the creation of such an economic environment that promotes a healthy competition through market measures, thereby emphasizing a strong role of the state for constructing and maintaining the framework of economy. In other words, from the viewpoint of ordoliberalism, market freedom can be realized by “competitive order” (*Wettbewerbsordnung*), which is an economic order that approves of a

1 Thus, SME is often called “the third way.”

2 “The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.”

3 “Ordo” is the Latin word for “order.”

perfectly competitive economy. Moreover, a policy that generates and maintains competitive order is known as an “order policy” (*Ordnungspolitik*). According to Walter Eucken, order policy comprises constitutive and regulative principles. Policies that *establish* competitive order through a perfectly competitive economy, price stability, private ownership, and guarantee of liberty of contract are based on the former principle, and policies that *maintain* competitive order, such as the antitrust and income policies are based on the latter principle (Eucken 1952/1967, 345–411).

The concept of social balance implies the state’s response to social problems. According to the ordoliberal perspective, social balance can almost be brought about by realizing competitive order itself. However, there are several social problems that cannot be solved by competitive order alone. Thus, a complementary policy, in this context a social policy, is necessary to provide solutions to problems. However, social policy must be absolutely complementary to order policy. In other words, social policy must not hamper order policy; thus, social policy is manifested through subsidiarity (upper groups do not undertake what lower groups can do) and market conformity (there must be no obstruction in the functioning of the price mechanism).

The three objectives of SME are first, the generation and maintenance of a perfectly competitive economy, second, providing solutions for social problems such as mass unemployment and poverty through economic and social policies which are mutually complementary, and third, the promotion of self-help and freedom of individuals through a free market economy.

2-1. The Implication of Social Policy in SME: Three Types

The adjective “social” in the acronym SME is believed to have two implications. One is that the market economy itself is already social, and

the other is that the concept of SME includes social problems that cannot be avoided only by the establishment of a market economy and that the complementary role of social policy is indispensable (Nojiri 1995, 120–121).

These two implications are related to the description of social policy given by the three great SME theorists—Walter Eucken⁴, Ludwig Erhard⁵, and Alfred Müller-Armack⁶. The descriptions given by Eucken and Erhard emphasize the former implication, and that given by Müller-Armack emphasizes the latter implication of SME. More precisely, the perspectives of Eucken and Erhard can be distinguished according to content. The following account describes the three types of social policy; Eucken type, Erhard type, and Müller-Armack type.

Eucken Type

According to Eucken, the competitive order itself realizes social balance. Thus, from his viewpoint, competitive order implies social policy. In principle, he rejected the process policy (*Ablaufspolitik*; *Prozesspolitik*) that is defined as the policy through which the state exercises direct control over the economic process and included the control of foreign trade, regulation of credit accommodation, and the redistribution policy in the process policy. However, Eucken admitted

4 Walter Eucken (1891–1950) was an ordoliberal economist (ordoliberalist) who yielded great influence in Germany. He was a leading theorist of the Freiburger School (German neoliberals), and was a member of the Advisory Board of the Federal Republic's Ministry of Economics and of the Mont Pelerin Society. He established the Freiburger School, and founded the *ORDO* yearbook and was a member of the board of editors of the yearbook (Peacock and Willgerodt 1989, XV).

5 Ludwig Erhard (1897–1977) was an economist who held prominent positions such as Economics Minister (1949–1963) and Chancellor (1963–1966) in Germany.

6 Alfred Müller-Armack (1901–1978) is an economist and philosopher who held administrative vice economics minister under economics minister Erhard.

reluctantly that the redistribution policy (“special social policy”) (Eucken, *op.cit.*, 319; Schönwitz and Wünsche 1986, 184)⁷ be used to a certain extent because he recognized that certain social problems cannot be solved only by competitive order.

Müller–Armack Type

According to Müller–Armack, a certain amount of process policy in the form of a “special social policy” is necessary for solving social problems that cannot be solved by competitive order alone. However, he recommended that the process policy must include market conformity and subsidiarity in order to complement order policy. He believed that competitive order and social balance are different, but they can be made compatible through the concept of SME. The problems associated with this type of SME are first that the standard of market conformity was not clearly established (Kulesa and Renner 1998, 87), and second that the redistributive social policy can be easily promoted and expanded (Cassel and Rauhut 1998, 18) because Müller–Armack recommended the non-market-conforming policy as long as it was not detrimental to the market economy (Müller–Armack 1962, 303).

Erhard Type

Erhard believed that the market itself was social and recommended minimal social policy. He attempted to correlate economic and social policy (Schönwitz and Wünsche, *op.cit.*, 186–190). In contradiction to Eucken, who rejected process policy almost entirely, particularly the

⁷ Neoliberalists treat process policy in a negative manner. However, this does not necessarily imply that all process policies are rejected. For example, they recommended a regular monetary policy by the central bank; moreover, they believe that process policy such as preferential savings are also necessary for achieving the objectives of order policy (Adachi 1995, 73).

redistribution policy⁸, Erhard permitted existing process policy (social policy); however, he aimed at minimizing social policy, and utilizing social policy to promote the participation of recipients in the primary distribution of wealth (earning income directly) instead of redistribution. Through his social policy, he intended to provide people with jobs in an effort toward full-employment in order to secure a regular income for people. He emphasized that the state must limit its responsibility to the provision of basic social security⁹.

Erhard believed that the process policy must eventually be integrated with order policy. Further, his viewpoint may be interpreted as a halfway stand between Müller-Armack type and Eucken type of SME.

3. Development of the (West) German Postwar Social Policy

3-1. CDU/CSU Government (1949-1966)

After its defeat in WW II, Germany was taken over by the allied powers. The currency reform (*Währungsreform*) conducted by Erhard, the then Director of Economics, is considered as the first step toward establishment of SME. On June 21, 1948, the German Mark was established as the official currency of Germany. Thereafter, there was a drastic improvement in the German economy (“the economic miracle”). In May 1949, West Germany gained independence under chancellor Adenauer in the alliance of the CDU (Christian Democratic Union) and CSU (Christian Social Union); SME was officially adopted in the CDU guidelines (“Düsseldorf Guideline”) in July 1949.

8 However, he permitted a minimum social policy for poor people (Eucken 1952/1967, 422-437). Moreover, he included full employment and income policies as part of order policy (Eucken, *ibid.*, 405-407).

9 Thus, he opposed compulsory insurance with excessive benefits (Erhard 1957/2000, 253-255).

At this time, the traditional German social security system that was prevalent before the Nazi regime was recovered; moreover, various reforms were implemented such as the 1957 Pension Reform (1957) (introduction of earnings-related-pension under the pay-as-you-go system) and the First (1961) and Second (1965) Property Accumulation Law.

3-2. Grand Coalition (1966–1969) and the SPD Government (1969–1982)

During the regime of the Grand Coalition of CDU/CSU and SPD (Social Democratic Party of Germany) under chancellor Kiesinger and the rule of SPD government under chancellors Brandt and Schmidt, the concept of SME was redesigned and brought closer to Neosocialism, which was a principle of the SPD. Neosocialism rejects Marxism, prefers the mixed economy regime (Nojiri, op.cit., 128), and pursues mutual adjustment of market mechanism (competition) and planning (Adachi, op.cit., 102). Karl Schiller, the great neosocial theorist of the SPD, said “planning should be done in macro economic areas where developing, monitoring, and leading global quantities should be important problems. Competition, on the other hand, would find sufficient conditions in micro economic areas” (Schiller 1964, 26/ Adachi, op.cit., 103). He introduced the system of Global Regulation (*Globalsteuerung*), the planned derivation of German economy, and described this orientation as follows: “What is happening in Germany is a progressive synthesis and development of the theories of Keynes and Eucken” (Schiller 1967, 184).

Until the Oil Shock of 1973, the German economy was faring well, and some generous social policy reforms were introduced, such as the Law of Continuation of Paying Fee for the Case of Illness (*Gesetz über die Fortzahlung des Arbeitsentgelts in Krankheitsfälle*) (1969), Third Property Accumulation Law (1970), 1972 Pension Reform (1972), etc. With the reforms, there were redistributive extension and an increase in

benefits. The social policy of this time was rather similar to the Müller-Armack type with regard to these aspects. However, the economic situation worsened after the Oil Shock, and it became necessary to limit social policy under the financial pressure.

3-3. CDU/CSU (1982–1998)

Due to the low-growth economy, falling birthrate, and the aging population, it was necessary that the CDU/CSU government led by Chancellor Kohl reorient to the Eucken-Erhard types and promote supply-side economics in order to diminish the financial burden of social security finance. In the 1980s, there was a heated debate regarding the economic crisis and the new direction of the welfare state (“*Sozialstaat*” (social state)) and various reform plans of social policy were presented. However, no drastic reforms were implemented; thus, social policy expenses did not decrease¹⁰. Moreover, mass unemployment, which had emerged as a serious problem since the Oil Shock, was not remedied because of the downsizing of surplus manpower in the process of economic recovery, and an increase in the number of women in the labor market. Further, in the 1990s, the effects of the reunification of Germany (there was greater unemployment in former East Germany than former West Germany due to the lack of skills and financial problems encountered by former East German companies) also impeded the reduction of unemployment.

10 The reason was that German citizens had strong faith in the German social security system, and the objection from the people or groups with vested interests against the cutback of benefits was too intense to launch fundamental reforms. For example, the “Christian Democratic Worker Group” (CDA), which emphasized social policy, wielded strong influence within the CDU and intensely objected to the cutback of benefits (Frerich and Frey 1993, 161-163).

4. German Social Policy in the 21st Century.

The character of German social policy changed drastically in the 21st Century. Under Chancellor Schröder (1998-2005) the SPD changed the underlying principle of social policy explicitly from that of Neosocialism (similar to the Müller-Armack type) to the Erhard type. This is evident from the content of the 2001 Pension Reform (2001), and the “Hartz-reforms” implemented through “Hartz-laws (the First-Fourth Laws for Modernizing the Labour Market: Hartz I-IV),” which were enforced in 2003-2005 based on the final report of the “Hartz committee (the Committee for Modern Services in the Labor Market)¹¹” released in August 2002. Chancellor Schröder undertook a strong initiative for the fundamental reforms of social security institutions (Kondoh 2009, 111-118).

The 2001 Pension Reform stipulated to lower the pension benefit levels moderately (from 70% to 64% of take-home pay), and offset this reduction by promoting complementary private pension insurance through income credit and state subsidy (“Riester-Pension¹²”).

The Hartz-reforms were implemented in order to reform the existing labor market through Hartz-laws I-IV. Hartz I (enacted in January 2003) established PSAs (Personal Service Agencies) in nationwide job institutes (*Anstalt für Arbeit*); these PSAs undertake personal temporary staffing services, job-placement, and re-education. Hartz II (enacted in January 2003) stipulated prescriptions for marginal jobs such as Mini-Jobs and Midi-Jobs. Hartz III (enacted in January 2004) renamed job

11 The Hartz Committee was founded in February 22, 2002, and named after its head Peter Hartz, who was the Personnel Director of Volkswagen at the time.

12 This system of promoting private pension is known as “Riester-Pension (*Riester-Rente*),” named after Walter Riester (SPD), the Federal Labor Social Minister at that time.

institutes as job agencies (*Agentur für Arbeit*) and reorganized them, in order to promote rapid employment placement. The objective of these reforms was to make the labor market more flexible by promoting new types of employment and the “integration of public assistance and unemployment allowance.” The latter was introduced through Hartz IV, which was enacted in January 2005, after going through heavy dispute and criticism. Hartz IV eliminated previous unemployment benefit (*Arbeitslosenhilfe*), which was the benefit for the unemployed who were not eligible for unemployment allowance (*Arbeitslosengeld*) or whose qualification period for unemployment allowance had expired, and changed it to unemployment allowance II (*Arbeitslosengeld II: AG II*). Under unemployment allowance II or AG II, the amount of allowance was revised from a flat-ratio (53% or 57% of the take-home pay of the former job) to a flat sum (359 € per month as of July 2010¹³). Moreover, job assistance for the recipients of AG II was enhanced with the inclusion of measures such as job incorporation benefit (*Leistungen zur Eingliederung in Arbeit*) (individual consultation at job agency), incentive for work (working benefit and working deduction), sanction (benefit cutback) for irrational refusal of work applied for through a job agency, and job opportunity (*Arbeitsgelegenheit: AGH*)¹⁴.

13 This is the amount of regular benefit, and the amount is revised in July annually. Moreover, other benefits are also included under AG II, such as housing and heating expenses, and social allowance for persons who are incapacitated, in need, and in the same household as the recipient of unemployment assistance.

14 There are two types of “job opportunity.” One is called “job opportunity with income” (*AGH mit Entgelt*), and the other is “job opportunity with more expense compensation” (*AGH mit Mehraufwandsentschädigung: AGH-MAE*), which is commonly referred to as the “1-Euro-Job.” The former opportunity entails that the recipients work at a regular job with regular pay for half a year. They can also receive AG II in parallel as long as their income is below the fixed amount. The latter opportunity entails the provision of simple jobs with cheap pay (1-2 Euros per hour) (for example, weeding, and cleaning) for recipients who are unable to find suitable jobs. They may also receive AG II in parallel.

In the Grand Coalition (2005-2009) of CDU/CSU/SPD under chancellor Merkel (CDU), a reform related to compulsory medical insurance (*Gesetzliche Krankenversicherung: GKV*) was implemented. The reform promoted competition among health insurance funds (*Krankenkasse*). The Law of Reinforcement of Competition in Medical Insurance (*Gesetz zur Stärkung des Wettbewerbs in der Gesetzlichen Krankenversicherung*) has led to a drastic change in the system of GKV. Under this system, the contribution rate has been integrated, and the contribution is paid not to each health insurance fund, but to the newly established Health Fund (*Gesundheitskasse*). The Health Fund allocates resources to each health insurance fund, after taking into consideration the effect of the different risk structure of each health insurance fund. Therefore, it is easy for an insured person to judge whether his health insurance fund succeeds in reducing benefit cost by ensuring efficiency of benefits. Moreover, he/she can choose the health insurance fund that is successfully managed, thereby intensifying the competition among health insurance funds (Matsumoto 2008, 72-73).

Since September 2009, the coalition of CDU/CSU/FDP (Free Democratic Party) under chancellor Merkel has been in power. In the preface of the position paper of the coalition, “Growth, Education, Cohesion (Wachstum. Bildung. Zusammenhalt)”, there is a clear reference to SME: “We avow ourselves to the Social Market Economy as the order of the society and order of the economy (...). Our approach is the solidarity achievement society where anyone can show his ability and takes his responsibility (CDU/CSU/FDP 2009, 5)”. For example, in the latest development in social policy there is a dispute regarding the improvement of AG II due to the judgement of the federal constitutional court in February 2010 that stated that the amount allocation under AG II is not sufficient for appropriate child nurturing (BMAS 2010). Further,

due to the law related to minimum wages (Employee Delegation Law) (*Arbeitnehmer-Entsendegesetz*), enacted in April 2009, and Minimum Labor Condition Law (*Mindestarbeitsbedingungengesetz*), revised in April 2009, minimum wages have been fixed in several industrial sectors such as construction and electricity. Moreover, a method was also prescribed to fix minimum wages in sectors where the coverage rate of wage agreement (*Tarifvertrag*) is less than 50% or where there is no wage agreement.

5. Conclusion

It is evident from the above account that the Erhard type of SME has been pursued as a desirable social policy in Germany, particularly since the 21st century. It is revealed that there has been a decline in the redistributive social policy and the promotion of participating in and securing primary distribution.

It seems that the current social policy, in relation to cash benefit, is directed toward the reduction of benefits to subsistence level that is complemented by a self-sufficient (with regard to GRV: Riester-Pension; with regard to AG II: effort to work) and “service intensive¹⁵” workfare (with regard to AG II: job incorporation benefit), and in relation to benefit in kind, toward the promotion of competition among providers in GKV. The shift from simple redistribution to the redistribution for promotion of participation in primary distribution may be perceived as a departure from the Müller-Armack type of SME.

Currently, the economic and social circumstances are rather different from the time when SME was founded; thus, the manner in which the

15 “Service intensive” is a term classified by Miyamoto (2002); it implies a type of workfare that gives top priority to the active labor market policy and injects substantial public funds to job training (Miyamoto 2002, 131).

three typologies of SME should be applied in the current circumstances must also be changed in order to implement relevant reforms. In the current global economy, when depression in one country promptly influences the economy of another, the employment situation becomes more unstable. Therefore, currently, the Erhard type of SME appears to be more useful than the Eucken type because it respects not only order policy (economic policy) but also social policy.

Erhard indicated that the greater the success of the economic policy, the lesser is the necessity for social political intervention and remedial measures (Erhard 1956, 14). However, currently the opposite situation is emerging. Not all people can participate equally in primary distribution, and social problems such as social exclusion or low-income earners (“working poor”) are also rampant. Thus, in the future, a social policy that facilitates effective redistribution for the promotion of participation in primary distribution for all people at all levels of society is required. Thus, in Germany, the Erhard type of SME would be regarded as the most appropriate and desirable economic and social system.

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