What is a Social Market Economy?

THE UNP has appropriated "Social Market Economy" as the label for its economic programme. Its election manifesto referred to a knowledge-based, highly competitive social market economy. This is a "third way" between extreme capitalism and extreme socialism. It blends a free market economy with government intervention to protect vulnerable people and the environment. And it will deliver "economic democracy to the people".

These are vague political slogans, of course. Which begs the question: What is "social market economy"? What is it in theory? What does it look like in practice?

The terms "social market economy" and "third way" originated in Germany and are common in German and wider European political debate. As a graduate student, and then as a young professor, I spent much time in Germany reading about and discussing these ideas. I would like to take Daily FT readers on a little intellectual-historical excursion to give a sense of what these ideas mean – who came up with them, how they spread in the context of their time and place, what policies materialised, and what difference they made. That, I hope, will give us a better sense of what Social Market Economy means for Sri Lanka.

In the last decade the EU has drifted away from Ordnungspolitik, and European competitiveness has declined significantly

Social Market Economy: The conventional meaning

Most people who have heard about Social Market Economy think it means a mixed economy, combining the "efficiency" of the market with "social justice". The latter requires government intervention, especially to distribute the fruits of the market economy "fairly". This is the social-democratic version of Social Market Economy, strongly slanted towards "distributive justice". Philosophically, its lineage goes back to Aristotle, and forward to the Harvard philosopher John Rawls.

My View

Global Economics

By Razeen Sally

Alfred Müller-Armack, a German economist and sociologist, coined the term "social market economy" (soziale Marktwirtschaft) in 1945. He sought a "new synthesis" of market freedom and social protection. His conception of the market economy owes more to mechanical physics than biology: the policy-maker "engineers" the "free" market to produce the maximum of wealth, which can then be redistributed in the name of social justice. He allows for a range of government intervention, including subsidies for small businesses, worker participation in the management of companies, and Keynesian (counter-cyclical) policies to ensure full employment.

Müller-Armack's vision of the market is similar to that of John Stuart Mill in the nineteenth century. Mill, rather schizophrenically, believed that systems of production and distribution were separate and could operate under different laws. Government intervention in the wealth-creation process should be minimal – the laisser-faire principle; but it should be much more active to distribute the wealth created.

"Corporatism" came to be associated with Social Market Economy. Corporatism is the consensual management of the economy by hierarchically organised "social partners", especially business associations and trade unions. It has a long tradition in German thought, from Cameralism in the Middle Ages to the Historical School in the nineteenth and early twentieth centuries. And its roots are deep in German practice, before and after the Second World War.

This view of Social Market Economy became popular in West Germany from the late 1960s, when the Social Democratic Party entered government for the first time after the war. But the Christian Democrats, the main centre-right party, came to accept it as well. So Germany had – and still has – a strong political consensus supporting this version of Social Market Economy. And from Germany it spread elsewhere in Europe. It is seen as a genuine Third Way, avoiding the extremes of laisser-faire capitalism that excludes the vulnerable and weak, and socialism that stalls the market economy's productive engine. That is why Tony Blair, backed by his intellectual guru Tony Giddens, talked about the Third Way so much during New Labour's heyday in the UK.

Social Market Economy: The alternative meaning

But there is no single version of Social Market Economy. Indeed, from the 1940s to the '60s, a different view of it – more free-market, less distributive, more organic, less mechanical – held sway in West Germany. To the public, it was the economic philosophy and programme of Ludwig Erhard, the Federal Republic's Economics Minister from 1949-63, and Chancellor from 1963-66. Erhard is known as the father of West Germany's Wirtschaftswunder – its post-war "economic miracle". He had a distinctive view of Social Market Economy; and surrounding him were economists, lawyers and sociologists who provided intellectual ballast. They were "ordo-liberal" economists and lawyers from the Freiburg School, centred on Walter Eucken and Franz Böhm, and the more sociologically inclined Wilhelm Röpke (also an economist) and Alexander Rüstow.

Let's start with Freiburg School Ordoliberalism. It gestated in the turbulence of the 1930s and then wartime apocalypse. Its founders wanted a clean break with Germany's collectivist past; their philosophical foundation, rather, was the German Idealism of the eighteenth-century Enlightenment, combining individual freedom with the Rechtsstaat – the "rule of law". They saw the progressive concentration of power as the fundamental problem. From the late nineteenth century to the 1930s, governments and big corporations colluded to cartelise the economy; monopolies and oligopolies came to dominate it. That paved the way for Hitler to turn Germany into a full-blown command economy. Fused, centralised economic and political power destroyed the market economy and the rule of law. Individual freedom was smashed; a behemoth, the all-powerful state machine, crushed the individual into a pulp. Here there are echoes of F.A. Hayek's Road to Serfdom.

Out of wartime ashes, Ordoliberals wanted to see a new order rise in Germany – one that would lift people out of extreme deprivation and set them on the path to prosperity, and establish individual freedom under the rule of law. For both objectives, limited – but not minimal – government and free markets were indispensable. Power, including economic power, had to be decentralised radically; and that was impossible without a truly competitive market economy.

Eucken, the Freiburg School's founding economist, encourages us to think in terms of economic orders. Decision-makers, economists, and "armchair economists" among the public, think reflexively of policy interventions to fix this-or-that problem. But one intervention might contradict another, and a pile-up of ad hoc interventions has perverse consequences for the economic order as a whole. So all policy acts should be judged in terms of how they relate to the total economic process, i.e. the economic order.

Eucken then outlines a free-market order, constituted and regulated by a "policy of order" (Ordnungspolitik). Ordnungspolitik maintains the market economy's framework of rules, but it does not intervene in the economic process: price-setting and resource allocation are left to market participants. To use a classical-liberal analogy, from Adam Smith and David Hume to F.A. Hayek and Milton Friedman, the state should be the market's "umpire", but not one of its "players". As Eucken says: "State planning of forms – Yes; state planning and control of the economic process – No! The essential thing is to recognise the difference between form and process, and to act accordingly."

Ordnungspolitik should avoid interventions that impair freely forming prices, such as counter-cyclical policy, monopoly formation and exchange controls. Monetary and exchange-rate policies should guarantee price stability. West Germany's Bundesbank, with cast-iron independence, made sure that happened – until the European Central Bank and the Euro replaced it and the D-Mark. The state should uphold the freedom of contract and the freedom to trade; and it should avoid discriminatory interventions to favour particular sectors and firms. Economic policy should be "constant", steering clear of chops and changes that cause private actors to shun risk-taking and investment. Eucken also favours strong competition rules to prevent public and private restraints on trade.

Franz Böhm, Eucken's Freiburg University colleague, provides Ordoliberalism's legal foundation with his theory of the "private-law society". Private (civil) law protects the individual's property rights and his freedom to strike contracts with others. Without it market society would wither. But the twentieth-century state's legal expansion, through public administrative law, undermines the private-law society. All sorts of government intervention – subsidies, tax breaks, price-fixing, protection of monopolies, trade protectionism – favour "particular interests" – especially large businesses and trade unions – at the expense of the "general interest"; they make a mockery of the equality of all individuals before the law. Private law, unlike public administrative law, has general rules of conduct that protect the individual against the tyranny of both majorities and minority interests. In Böhm's view, it should be sacrosanct – above politics; rather than becoming a creature of the state, it should be a bulwark against the state's encroachment on individual liberty – including property rights and the freedom of contract.

With Wilhelm Röpke and Alexander Rüstow, the scene shifts from legal-economic constitutionalism to sociology and a piercing cultural critique. They are concerned with the non-economic foundations of a liberal society, including a free-market economy – "what lies beyond supply and demand", according to Röpke. What are the political, social and moral crutches of a market order? What are the sociological preconditions for successful market reforms? To Röpke and Rüstow, pure laisser-faire economists ignored these questions: they were "sociologically blind".

Röpke and Rüstow were also cultural romantics. They abhorred many of modernity's products, especially the "centralism" of big governments, big business and big cities; and they yearned for a return to small towns and villages full of small and medium-sized firms. These social microstructures, they believed, were best suited to combine individual freedom with decentralised citizen politics and the warmth of community.

This "small is beautiful" vision seems wistful and anachronistic in today's market society. But that aside, their social views resonate with the classical-liberal tradition. They regard the "social" as part of an organic whole, along with the rule of law and free markets – not a redistributive device to correct the iniquities of a mechanical market. Social cohesion emerges spontaneously "from below", nurtured by the traditions and conventions of evolved, grown institutions – the family, church, workplace, sports clubs and other voluntary associations. These foster bourgeois virtues of self-responsibility, self-help and civic-mindedness – the moral framework conditions that sustain a successful market economy. Social policy is first and foremost Ordnungspolitik, integrating as many people as possible into market society, with a basic safety net for those who fall by the wayside. Indeed Rüstow calls for a "strong state, a state above the economy, above the interests – there where it belongs in the interests of a liberal economic policy." He contrasts the "small but strong" state, which sticks to its Ordnungspolitik functions, with the "big but weak" state that intervenes left, right and centre. Ultimately, Röpke and Rüstow seek to combine the liberal principle of freedom with the conservative requirement of order. They must go together. Freedom without order leads to anarchy and libertinism. But freedom can easily be smothered in the name of preserving order. This, then, is a conservative-liberal view of Social Market Economy, not a social-democratic one. It has more in common with Edmund Burke and Alexis de Tocqueville, and indeed with Smith, Hume and Hayek, than it does with John Rawls, Tony Blair and Bill Clinton. And it was the Social Market Economy Ludwig Erhard believed in when he was in charge of West German economic policy.

What should Social Market Economy mean for Sri Lanka?

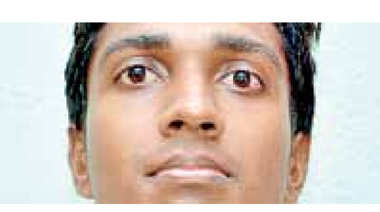
Should Sri Lanka opt for the social-democratic or liberal-conservative version of Social Market Economy? Politically, the former is more appealing. A Third Way between extremes, a blend of market efficiency and social protection, social justice for all: who would not want to embrace all that? It sounds as wonderful as mother's milk and apple pie. But it is political bromide, not a real cure for Sri Lanka's ailments. Besides, this kind of Social Market Economy has not worked well in Germany and Europe.

What competitiveness Germany has is a legacy of Erhard's Ordnungspolitik. His free-market reforms transformed the western, non-Communist half of Germany from wartime destruction – a mass of rubble with a starving population – into Europe's economic powerhouse and a world leader in industrial exports. Reforms in the early 2000s to make the labour market more flexible gave the economy an extra boost. But Germany carries the burden of half a century of post-Erhard "social" interventions; the result is high taxes, heavy regulation and a large welfare state. Today, Germany's real-world social market economy is ill-equipped to tackle big challenges such as an ageing population and the need for a more services-based economy.

It is worse in most other European countries, and in the European Union collectively. What success the EU has had is due to free trade among its members, a unified "single market" and openness to the outside world – a reflection of Ordnungspolitik in Germany and Thatcherite policies in the UK. But common policies on agriculture and heavy industry were collectivist from the start, rigging the market with subsidies, price controls, production targets and protection against imports. The EU's bureaucracy spread its tentacles into other policy areas.

In the last decade the EU has drifted away from Ordnungspolitik, and European competitiveness has declined significantly. European integrationists' biggest blunder was to charge ahead with monetary union when so many EU members – not only Greece – were clearly unsuited for it. A semi-permanent Euro crisis is the result. Germany lost its prized Ordnungspolitik in monetary and exchange-rate policy. The European Central Bank has torn Ordnungspolitik to shreds with open-ended bailouts to sick banks and sick governments. Meanwhile, costly EU and member-state regulations pile up in other areas. "Green" regulations, for example, have ratcheted up energy costs and other costs of doing business. Higher taxes, more regulation and a bigger welfare state are not the cure for Sri Lanka either. It has had too much of this medicine since independence. It suffers from chronic fiscal and monetary incontinence, unsustainable public debt, perennial balance-of-payments crises, a huge, unproductive public sector, a private sector choked in red tape, a rigid labour market, and welfare expenditure that goes to political vote banks rather than targeting those in desperate need.

If Sri Lanka needs a Social Market Economy model, it should look to the liberal-conservative version and Ludwig Erhard's example. There are valuable lessons from Erhard-style Ordnungspolitik: fiscal prudence, a stable currency, price stability, deregulation to promote competition, openness to international trade and investment, a flexible labour market, a limited – not outsize – public sector, and social policy for a basic safety net, not for a big welfare state. And Sri Lanka needs different institutions to support such policies: independent regulatory agencies, starting with an independent central bank; a strong foundation of private law to protect property rights and contracts; a smaller state that performs its core functions better – a state that is less of a "player" and more of an "umpire", that has less discretion and is more rule-bound. What is "social" in this mix? If policies and institutions move in this direction, the economy will grow faster, productivity will improve, and more Sri Lankans outside the elite will be integrated into market society. They will have better life choices and chances. A "smaller but stronger" state will leave more room for a spontaneous, bottom-up society. Individuals will be less reliant on the whims of surly, rapacious politicians and bureaucrats to get essential things done, and better cushioned by what Edmund Burke called society's "little platoons" – families and voluntary associations. Surely this would be a healthier, more "social" society than what Sri Lankans have now, or what they would have with even more collectivist policies.



Less risk, more reward

By Kulunu Jayamanne

BE it by the Atlantic on Wall Street or by the Indian Ocean at the Colombo Stock Exchange, eyes are fixed on giant screens intently tracking the volatile economic progress of humanity materialising in a language of numbers alien to many. A little further to the South by the beach in the Bahamas or the Maldives, the people who pull strings and call shots are thinking 'more risk, more reward'.

Waves of ideas drive growth. But we often forget that in a split second, a disaster could cause the wheels of growth to stop turning and both the ideas and the machinery could be buried under a pile of rubble. One could argue that disasters are like punctuation, reminders that it is not always smooth sailing.

There have been approximately 6,525 events classified as natural disasters around the world in the decade spanning 2004-2013. It is almost redundant to remind us Sri Lankans of the horrors of 26 December 2004. To some, reminders of personal experiences bring tears to their eyes. For others, there is a story to be told if a tsunami warning is sounded or each time Boxing Day swings by. It is a step in the right direction that disaster management has risen up the national agenda today. For generations past and many to come, people's livelihoods have been closely connected to nature. Natural disasters and the ways and means of dealing with them have had a direct impact on millions of lives. If human development is to be viewed through the lens of freedom, where people's capacities are enhanced such that they can make better choices, a robust national mechanism for disaster resilience serves as assurance of development prospects to communities.

Youth engagement

There's a tornado of buzzwords in our heads in the wake of the introduction of the SDGs to the world. It is extremely important as youth to make sense of any challenges in their adoption. In Sri Lanka's post-conflict era, it is necessary to remind ourselves of the huge development prospects ahead of us. Youth want to drive and reap the rewards of growth and do not want our good work derailed in the wake of a disaster. Hence, young people have both a massive stake and a role to play in reducing the risk of disasters.

THIS WEEK IN UNLOCKED

A common perception of youth, although sometimes not properly justified or illustrated, is that we bring fresh, innovative and demanding perspectives to the table. Ever wondered if there are any misguided interpretations of disasters that could potentially stunt the progress of communities? Here's one: a number of people may be of the view that natural hazards (or more precisely their increased frequency) are completely inevitable, or that managing disasters is a lost cause. It is important for communities to realise the value of collective efforts in achieving a desired level of disaster resilience. Youth have the power to spread the message that successful interventions can bring about change and reduce the risk of disasters significantly.

Disaster risk reduction

Disaster risk reduction is a key concern for youth civic engagement. According to the Sri Lanka National Human Development Report 2014 on Youth and Development: Towards a More Inclusive Future (NHDR), the National Youth Survey (NYS) 2013 identifies that many youth, at the mercy of top-down solutions, present themselves as passive recipients of development and feel that most systems and practices are not worth challenging since transformation appears to be impossible. In the wake of an increasing frequency of disasters and an ever-increasing need for action on climate change, the above trend is a dangerous one that needs to be reversed. Policies and practices need reorientation and adaptation, as static solutions may prove to be incapable of moving communities forward.

Disaster risk reduction has a strong connection to climate change adaptation. 'Climate change' is a buzzword that has bothered us for years. While youth may be eager to act on climate, we are often unable to translate such concerns into substantive action. Acting on disaster risk reduction represents tangible action on climate change.

The Minister of Disaster Management recently announced that the Government has already put in place comprehensive disaster management measures nationwide. The hope is that the Government has also considered creating space for youth to contribute towards such disaster risk reduction. Looking at the bigger picture, structural and indirect interventions can facilitate youth action on disaster risk reduction. For example, research and development and expertise are vital components for disaster preparedness and response. On that note, given the right environment, youth could come up with innovative solutions for disaster warning systems or a more responsive way to deploy relief assistance. Additionally, there are careers to be found in fields ranging from environment to humanitarian emergencies.

Mainstreaming youth into policy

When we were children, we were often referred to as tomorrow's leaders – that 'tomorrow' is today. For those of us who would like to contribute towards implementing the post-2015 development agenda, the Sendai Framework for Disaster Risk Reduction is the first major agreement that will come into effect!

The idea of 'mainstreaming youth into policy' might sound like a cliché, but this is what must happen. Disaster risk reduction is no different. What is it that they say about examinations? If you fail to prepare, you prepare to fail. Each day is an examination of our resilience towards disasters, a measure of our levels of empowerment in combatting those challenges. And finally to the buzzword of buzzwords – sustainability. Disaster risk reduction is a crucial component required to actually achieve sustainability. If youth want to become major stakeholders and call the shots in achieving sustainable development, the mantra we'll have to follow must be 'less risk, more reward'.

(UNLOCKED is a space for Sri Lankan youth to express their views and opinions on development with the aim of creating positive change in the world. The views expressed in the blogs are solely those of the authors. UNDP Sri Lanka and Daily FT does not represent or endorse the views expressed in these blogs. Read more about the UNLOCKED initiative www.lk.undp.org)