



**FRIEDRICH NAUMANN
STIFTUNG** Für die Freiheit.



SOCIAL MARKET ECONOMY

**The principles behind Germany's
economic success**

FOCUS

Imprint

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📺/FNFreiheit

Author

Justus Lenz, Policy Advisor Economics and Finance

Editor

Liberal Institute – Friedrich Naumann Foundation for Freedom
Justus Lenz, Policy Advisor Economics and Finance

Production

Luise Bofinger, Friedrich Naumann Foundation for Freedom

Contact

Telefon +49 30 220126-34

Telefax +49 30 690881-02

E-Mail service@freiheit.org

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	Applying the Social Market Economy’s guiding principles can help formulate good policy responses to our most pressing challenge including globalization, environmental protection, and the digital transformation.	

1 Ordoliberalism

Starting in the 1930s, a group of thinkers around Walter Eucken and Franz Böhm, an economist and a lawyer at the University of Freiburg, developed a new school of thought called “ordoliberalism”. Having just experienced the Great Depression and facing the rise of communism and fascism, they focused on reforming the existing capitalist order. Without institutional backguards, they feared, some market actors can accumulate too much power. Adam Smith, the founder of modern economics, already knew that entrepreneurs have strong incentives to restrict competition. Eucken and Böhm argued that these developments had a severe negative impact on consumers, e. g. higher prices, and on competitors who were pushed out business. They also feared that the accumulation of power can threaten democracy itself. To preserve free competition, the ordoliberals emphasized the need for institutions charged with protecting free markets.

Development of the Social Market Economy

In contrast to the proponents of laissez-faire capitalism and to those of a centrally planned economy, ordoliberals see the importance of state, market, and society. They believe that these orders are interdependent and are all vital for a free society. Based on these ideas, Eucken and other thinkers worked on a new economic order for the time after World War II. Their work became the foundation of the Social Market Economy, which was implemented by the liberal politician Ludwig Erhard. Ordoliberalism as such never gained much traction outside Germany, even though its ideas on anti-trust legislation were formative for the process of European Integration. Nonetheless, ordoliberalism can be placed into a wider intellectual context of constitutional and institutional economic research programs. For instance, there are striking similarities between ordoliberal ideas and the works of James Buchanan or Elinor Ostrom. Some scholars also argue that the Austrian economist Friedrich August von Hayek was strongly influenced by ordoliberalism.



FRANZ BÖHM

Source: by courtesy of publishing company Mohr Siebeck, Tübingen



WALTER EUCKEN

Source: Walter Eucken Institut

Recommended further reading:

- Dold, M., Krieger, T. 2020. Ordoliberalism and European Economic Policy: Between Realpolitik and Economic Utopia. Abingdon: Routledge.
- Eucken, W. 1950/1992. The Foundations of Economics: History and Theory in the Analysis of Economic Reality. Berlin: Springer-Verlag.
- Goldschmidt, N. & Wohlgemuth, M. 2008. Social Market Economy: Origins, Meanings and Interpretations. Constitutional Political Economy 19 (3), p. 261–276.
- Kolev, S., Goldschmidt, N. & Hesse, J.-O. 2020. Debating liberalism: Walter Eucken, F. A. Hayek and the early history of the Mont Pèlerin Society. The Review of Austrian Economics 4/2020, p. 433-463.
- Reinhoudt, J. & Audier, S. 2018. The Walter Lippmann Colloquium: The Birth of Neo-Liberalism. Cham: Palgrave Macmillan.
- Vanberg, V. J. 2004. The Freiburg School: Walter Eucken and Ordoliberalism. Freiburg Discussion Papers on Constitutional Economics 04/11, Freiburg.

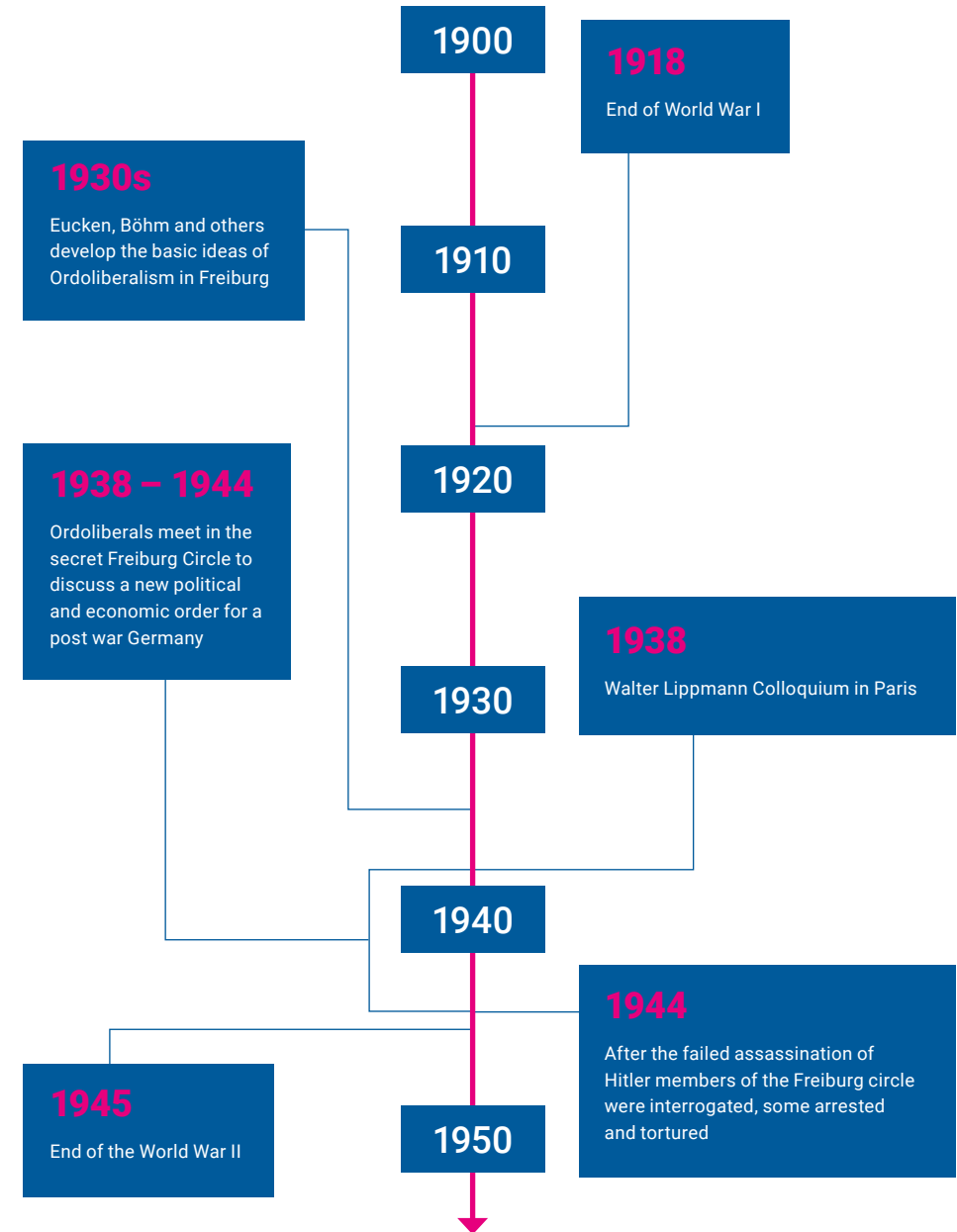
2 Ethical and intellectual foundations

In developing their ideas, the ordoliberals drew on well-established liberal conceptions developed in the 18th century. Many of their basic assumptions were already part of Adam Smith's work, the Scottish moral philosopher who founded modern economics. Examples are the eminent tendency of market actors to restrict free competition or the insight that the economic, political and moral order of a society are interconnected. One might argue that the ordoliberals drew on crucial elements of Adam Smith's thinking which were ignored by (some) laissez-faire economist in the 19th century. But Smith was certainly not the only source of inspiration for the ordoliberals. The development of ordoliberalisms was also part of wider reform movement.

Walter Lippmann Colloquium

Facing the failures of both laissez-faire capitalism and totalitarianism, a group of thinkers met 1938 in Paris with the goal to renew liberalism. This Walter Lippmann Colloquium, was attend by philosophers, political scientists, economists and businessmen from Europe and the United States. Here the term "neoliberalism" was coined, to define a new liberal program in contrast to laissez-faire liberalism. While the ideas of the participants varied, they all feared the failure of liberal democracies. And in contrast to a common misconceptions of "neoliberalism", the general agreement was that states play a crucial role in establishing and maintaining free markets. Eucken and Böhm did not attend. But Wilhelm Röpke and Alexander Rüstow who later helped to implement the Social Market Economy in Germany were part of the meeting in Paris, as well as Hayek. The Lippmann Colloquium shows that ordoliberal thinking about the interconnected nature of markets and states institutions was internationally widespread. Scholars in England, the USA and France also emphasized the importance of a competitive order (like the Social Market Economy) for well-functioning markets and free societies. England, the USA and France also emphasized the importance of a competitive order (like the Social Market Economy) for well-functioning markets and free societies.

Timeline: Development of Ordoliberalism



3 Social Market Economy

Germany's swift economic recovery after World War II looked like a "miracle". Yet, it was based on implementing an economic order that allowed entrepreneurs, innovators and workers the freedom to achieve their best. It guaranteed the rule of law and a high degree of political predictability and stability. This economic order, the Social Market Economy, was based on the ordoliberal idea that governments and markets both have essential roles to play in a modern, open society. The state sets general rules, oversees and enforces them. Within these rules, everybody is free to compete without state intervention. Therefore the state acts as a referee, observing the game and enforcing its rules, while abstaining from participating in the moves of the game.

Policies

West Germany significantly outperformed East Germany, where a communist government implemented a centrally planned economy. Freedom, private property, competition and the rule of law proved to be more successful than an all-controlling bureaucracy. Yet, state institutions did play vital roles in West Germany's economic system. For example, the Bundeskartellamt, the anti-trust authority, was founded in 1958 to safeguard free competition against cartels and other abusive practices. Another crucial institution was the Deutsche Bundesbank, the independent central bank, whose only goal was to preserve price stability. This monetary policy proved to be very effective for fostering long-term economic growth. Infrastructure and a quality-oriented public education system are further examples, as well as a social security system. The creators of the Social Market Economy believed that free markets are the most important part of social policy, as competition guarantees fairly-priced quality products as well as fair wages. This did not negate the need for additional social policies such as unemployment insurance. Nonetheless, all social policy programs were to be implemented in a form that did not hinder competition.

How does the social market economy work?

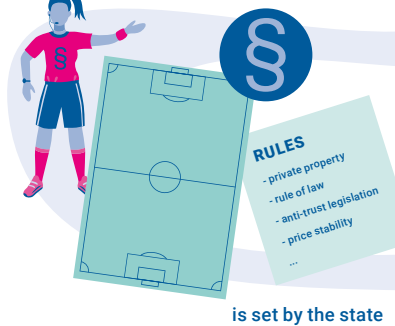
Companies compete in the market, the state acts as a referee



state ensures a fair level playing field

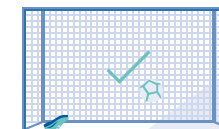
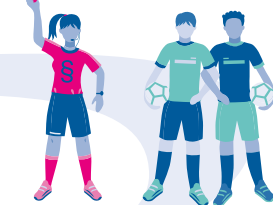


market framework

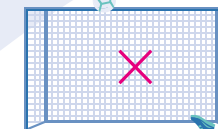


is set by the state

monopolies and oligopolies are forbidden



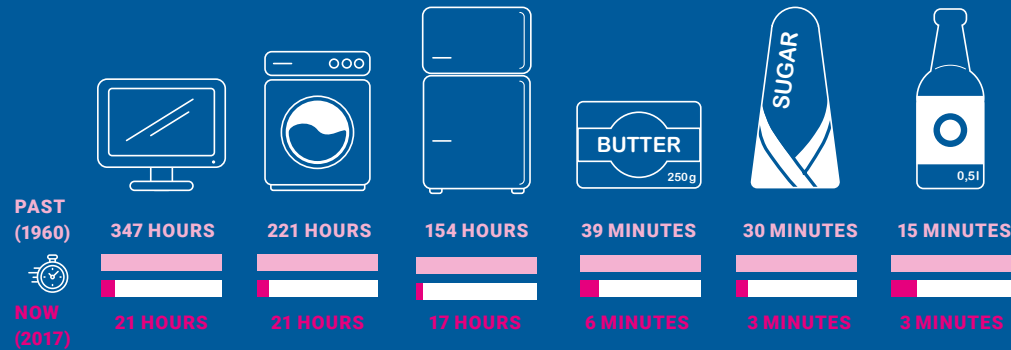
private companies bear chance of winning and risk of losing



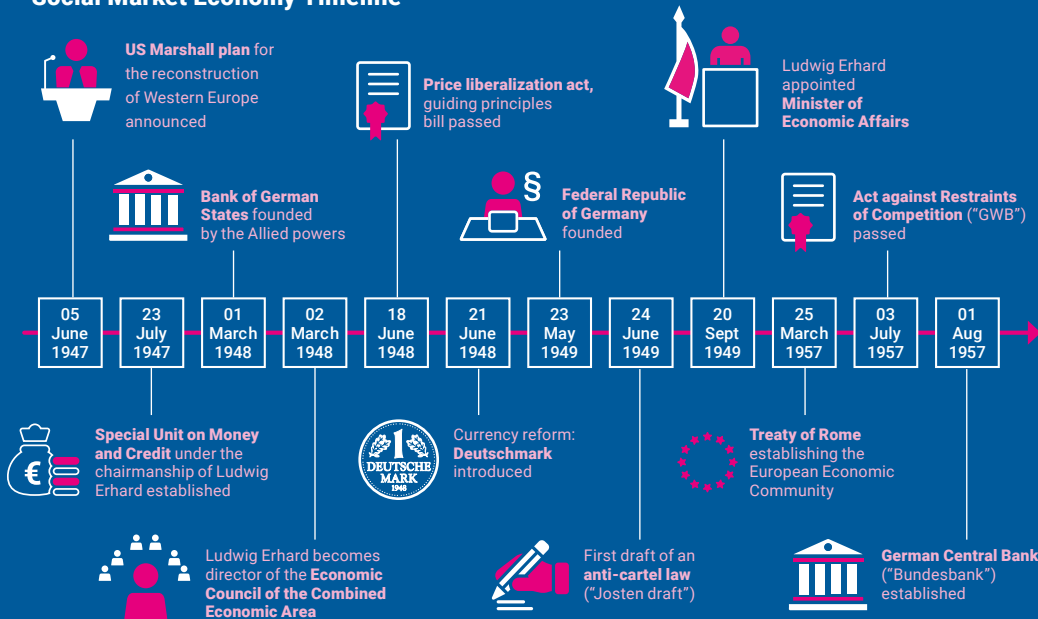
Germany's economic recovery

Development of purchasing power

Innovation and higher productivity allow a good standard of living doing less work. Average working hours which have to be worked to purchase consumer goods in West Germany.

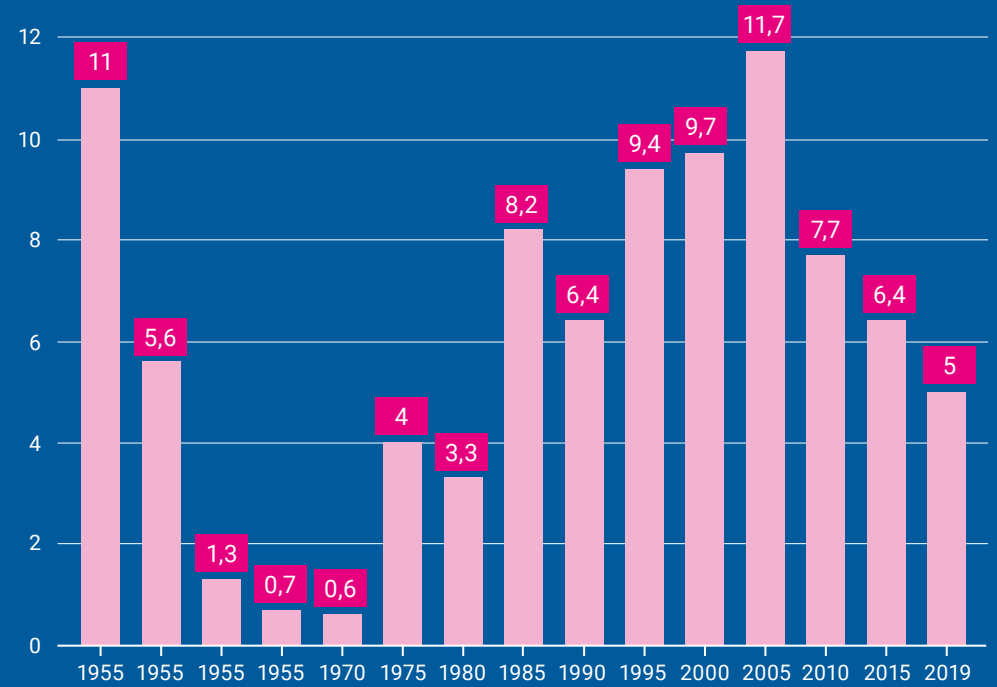


Social Market Economy Timeline



Development of unemployment rates

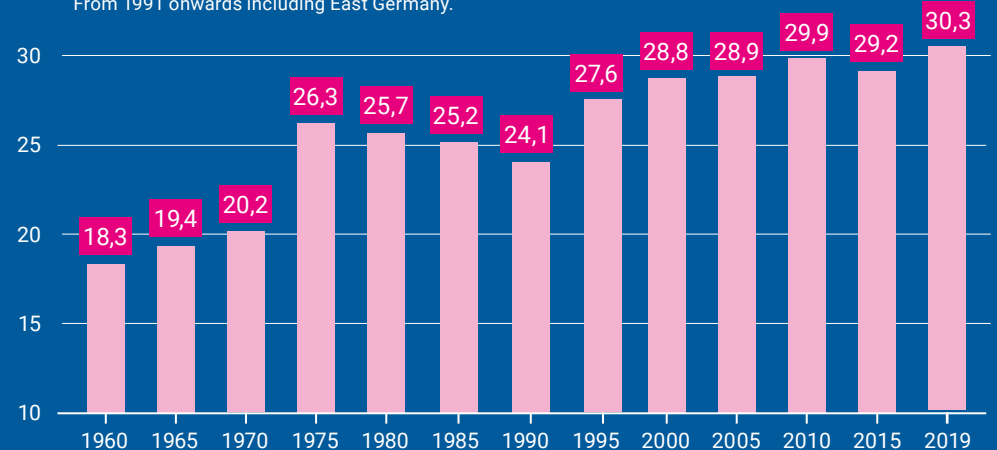
before 1995 only West Germany



Source: Deutsche Bundesbank

Development of the social benefit ratio

Share of government social expenditure in gross domestic product (social benefit ratio) in percent. From 1991 onwards including East Germany.



Source: Bundesministerium für Arbeit und Soziales

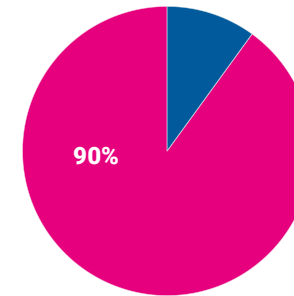
4 Family businesses and hidden champions

Family businesses play an essential role in Germany's economy. Regarded as the backbone of Germany's economic success, their defining characteristic is the controlling interest of one family, sometimes of only one or two members, sometimes of many hundreds. While most family businesses are small or medium-sized, some are multibillion-dollar companies. Irrespective of their size, they often belong to the most innovative companies. Some of these smaller companies are only known to experts, even though they are worldwide leaders in their market segment. Over 1300 of these companies – often termed “hidden champions” – exist in Germany. Family businesses are very popular employers, not least because many embody the spirit of the Social Market Economy. They combine a competitive nature and a drive for freedom with a strong sense of responsibility. Usually, especially in rural areas, they are deeply intertwined with their regional communities.

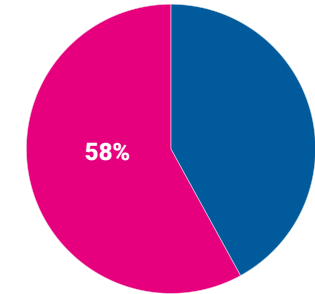
Framework for successful companies

Family business in Germany did not grow despite open and highly competitive markets – they are successful because of the ongoing competitive pressure to improve and adapt. Free markets and competition were key factors for the formation of smaller “hidden champions” because existing larger companies could not resort to unfair practices or cartels to hinder fledgeling new competitors. Yet, in order to be successful, family businesses need an internationally competitive framework consisting of the rule of law, good infrastructure and reliable state institutions. Family businesses are especially hard hit by unfavorable conditions such as excessive taxes or bad infrastructure since they tend to be very interconnected with their region. A critical factor for thriving family businesses is, of course, the inheritance tax system. A high inheritance tax is a prohibitive factor for the development of intergenerational family businesses and economic sustainability.

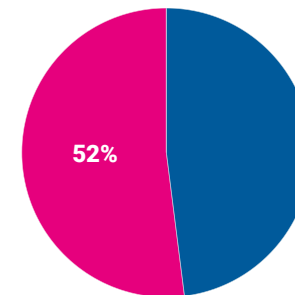
Family businesses in Germany



Share of family owned businesses
(percentage of all active businesses*)

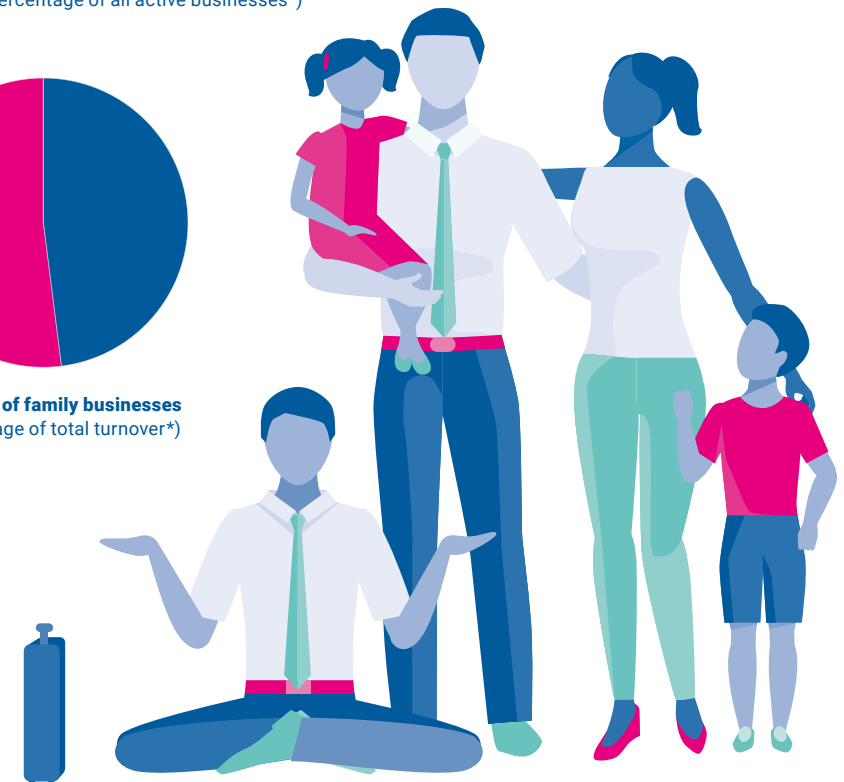


Employees in family owned businesses
(percentage of all employees in businesses*)



Turnover of family businesses
(percentage of total turnover*)

Graphics: macrovector - Freepik



* state controlled companies excluded

Source: ZEW, Stiftung Familienunternehmen 2019

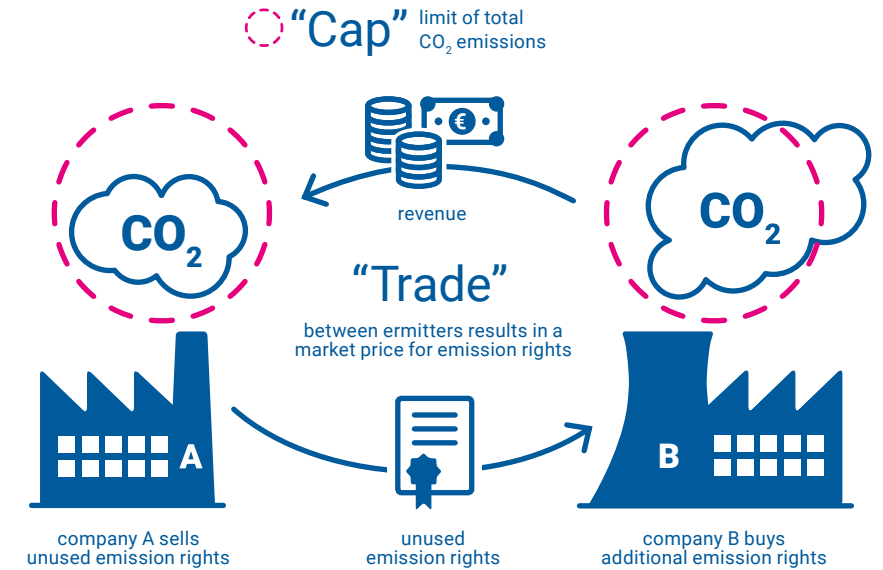
5 Social Market Economy in the 21st century

The Social Market Economy, as implemented in Germany, included a stronger degree of social policy and state intervention than intended by Eucken and his peers. This is an ongoing challenge. Too many interventions and too many ill-managed social spending programs threaten both the functionality of freedom and of competition. In a Social Market Economy, the state needs to be strong in order to uphold the rule of law, but it also needs to resist the temptation of direct market interventions, even though they can be widely popular (one example is the rescue of prominent/important businesses in trouble). This becomes more urgent in the 21st century because protectionism and nationalism are again on the rise. In addition, societies worldwide face pressing challenges such as climate change and digital transformation with increasing monopolistic structures of large platforms.

Ideas for the future of the Social Market Economy

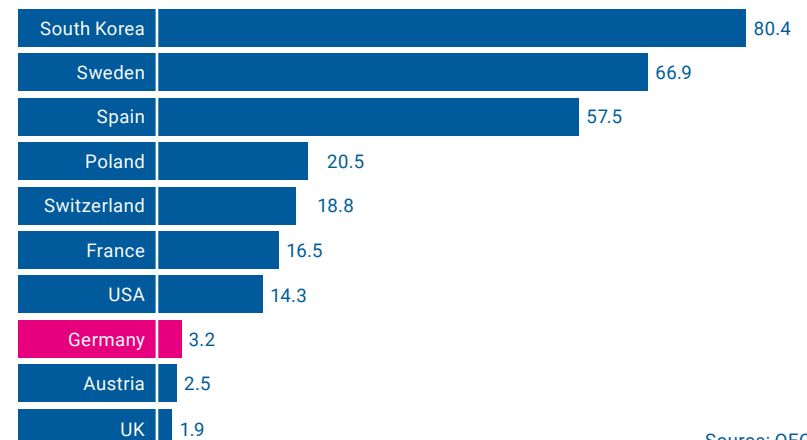
The basic principles of the Social Market Economy can be helpful guidelines for dealing with these challenges. For example, updating existing rules to be compatible with digital technologies or providing state of the art fibre connections are important parts of a modern market framework. Tackling climate change through direct interventions, e. g. by banning traditional light bulbs, did not deliver sound results. Introducing a carbon dioxide trading scheme is an efficient alternative. It could help harness the innovative potential of competition to deliver better CO₂ reduction results. As our economies and societies become more interconnected, we also need to start thinking about global sets of rules for transnational problems such as climate change. Developing the existing carbon dioxide trade systems into a global system might be the key to solving this problem. Adapting regulation and antitrust legislation to the platform economy will also be crucial for conserving competitive markets. In many ways, the 21st century will need a global market framework, at least for specific areas.

Carbon dioxide trading scheme explained



Source: Liberales Institut

Fiber glass connections in percentage of all broadband connections in selected countries



Source: OECD 2019

