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Karl Fasbender and Manfred Holthus*

The Social Market Economy: An Export for the Third World?

Long before the socialist industrialized nations began to call their centrally planned, or government controlled, economies into question, policymakers in many developing countries with dirigistic, interventionist systems, including capitalist oriented ones, had started to rethink their economic philosophies. Now that the former exporters of the concept of the centrally planned economy are themselves interested in importing free-enterprise ideas, reform in the Third World is likely to take on more momentum and interest in the social market economy will increase.

As the developing countries and their hybrid forms of centrally planned economy and market economy differ greatly, the reasons for the increased interest in the social market economy are many and varied and are of disparate relevance from case to case. Christa Luft, economist and former socialist Deputy Chairwoman of the Council of Ministers in East Germany, delivered the following judgement of the centralized, bureaucratically planned economy in her country, which also holds true of many developing countries: "... lacking in innovative power, unable to motivate people adequately, and hence inefficient, ecologically inadequate and of limited effectiveness in the social sphere."¹ The negative aspects of centrally planned economies were revealed most clearly by external shocks (such as the oil price crises and the drop in raw materials prices) and the impacts of growing foreign indebtedness.

Experience has shown that centrally planned economies cannot cope with the challenge of the continually increasing division of labour in national economies. Countries with market economies thus usually solve the problem of scarcity – the fundamental problem of all economic activity – more efficiently than those with a centrally administered economy,² which is why many developing countries are more amenable to a decentralized market system than before.

Many countries, however, harbour serious misgivings towards the pure market economy, understood as *laissez faire* capitalism. Of the many different reasons for this, a major one is that the trickle down and spread effects of

growth measures have often failed to meet expectations or have not taken effect at a politically acceptable pace.

In the search for models, increased interest is being shown in the social market economy, the economic order of the Federal Republic of Germany,³ whose achievements in post-war reconstruction, economic growth and social stability make it extremely attractive.⁴

The hallmark of the market component of the social market economy is that decision-making over the allocation of scarce resources is decentralized; decisions are taken by individual consumers, producers, those supplying and demanding capital, employers and employees. This multiplicity of individual planning decisions is coordinated on the goods and factor markets via the price mechanism and competition.

For example, if demand for a given good rises, its scarcity increases, as the supply cannot be enlarged immediately (supply is not infinitely elastic). Because the volume of demand exceeds that of supply the price of the good in question goes up. This shortage signal tells the producer that the manufacture of the good has become

C. Luft: *Marktwirtschaft als Chance zur Wettbewerbsfähigkeit*, in: *Handelsblatt*, No. 48, March 1990.

² Cf. among others A. J. Halbach, R. Osterkamp, H.-G. Braun, A. Gälli: *Wirtschaftsordnung, sozioökonomische Entwicklung und weltwirtschaftliche Integration in den Entwicklungsländern*, Bonn 1982.

³ Cf. A. Borrmann, K. Fasbender, H.-H. Härtel, M. Holthus: *Social Market Economy – Experiences in the Federal Republic of Germany and Considerations on its Transferability to Developing Countries*, Hamburg 1990.

⁴ On this and the following cf. K. Fasbender, M. Holthus: *Zur Übertragbarkeit der Sozialen Marktwirtschaft auf Entwicklungsländer*, in: *Aus Politik und Zeitgeschichte*, B 30-31/90, pp. 5 ff.

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more attractive. He will expand production until the surplus demand has been met. An equilibrium price is attained, where the price and quantity needs of sellers and buyers coincide and the market is cleared. The price mechanism informs the producers rapidly and reliably of the wishes of consumers and thus decides what is produced.

Competition means that producers of a good that operate less economically than other suppliers of the same good are ousted from the market in the long run because the price is under their long-term unit cost minimum and, hence, their profit (adequate rewards to the entrepreneur plus return on capital) is under the average for the branch or they even make a loss. Competition therefore decides how goods are produced and who produces them, namely the manufacturers with the cheapest production methods. This engenders a permanent incentive to offer new or improved products (product innovation) and promote technological progress in developing cheaper manufacturing methods (process innovation).

Further, the price mechanism and competition prevent scarce resources from being squandered, because producers are obliged to obtain their profit targets with as little input of resources as possible. Consumers, for their part, will allocate their limited income to various goods in such a way as to derive optimum utility from their consumption.

This system already possesses a social component in that the market economy with its highly developed mechanism of sanctions and incentives ensures the efficient allocation of the scarce factors of production and hence an optimum supply of goods and satisfaction of needs with the given resources. Its forces for development, its high adaptability to changing consumer needs, make it far superior to the centrally planned economy or dirigistic systems of a milder form. It has

afforded the common citizens a degree of prosperity which was unthinkable prior to its inception.

Arguably, the high level of production and its responsiveness to consumption is the most important social achievement of the market economy. This is social in a genuine sense because it is based on voluntary transactions, through which the free and mature persons involved expect to improve their situation. In addition, the efficiency of the social market economy creates the conditions for self-reliance.

Role of the State

Unlike systems of capitalist-style market economy, the social market economy and the related social contract (democracy) confer an active role on the state, primarily in four main areas:

□ *Establishment and securing of the legal order.* There will only be a readiness to provide goods and services and to take risks if certain individual rights and freedoms are guaranteed: the right to own and dispose over private property, private liability to the value of this property, freedom to choose a trade or profession, freedom of contract, freedom of association and free collective wage bargaining. The legal order must limit the exercise of these freedoms where they impinge on the rights and freedoms of others.

□ *Maintenance of effective competition.* The sanctioning effects of competition and the price mechanism provide an incentive for market participants to curb competition or even to do away with it by entering into an agreement with competitors or by their removal. The market economy system is thus in danger of disintegrating. The state is thus entrusted with the task of safeguarding effective competition by appropriate legislation, such as a ban on cartels, the setting up of a body to monitor possible abuse by market-dominating businesses and the vetting of mergers. This aim is also

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served by the keeping open of national borders for the free international movement of goods, services and capital.

□ *Correction of market failure.* The market economy cannot automatically satisfy all needs. This partial failure of the market must be remedied by government economic policy measures. Market failure occurs for example in the case of positive external effects, i. e. when it is more or less impossible to prevent the unpaid use of a good. It is then not manufactured at all or only in inadequate amounts. The state must attempt to offset these supply shortfalls by providing public goods such as internal and external security, transport infrastructure, education and basic research, etc. or by applying the principle of exclusion, such as in the case of patent law.

Market failure also occurs in the case of negative external effects, i. e. when resources such as the environment can be used without payment. This leads to macroeconomically inefficient overproduction and consumption. In these cases, the state must ensure that environmental damage is reflected in production and usage costs by setting standards and influencing price formation via taxation and levies.

Experience has also shown that economic development does not automatically proceed smoothly. Rather, inflation, unemployment, trade imbalances and downturns in growth recur. In the social market economy, the state is therefore required to take countermeasures in line with market principles, for example in stabilization and structural policy.

□ *Social Compensation.* In the social market economy, the state is entrusted with the task of providing social compensation to individuals in special circumstances in which they are unable, or only to a limited extent able, to take care of themselves, such as illness, invalidity, old age, unemployment, natural handicaps, etc. In the case of risks that can be covered via insurance, it usually suffices to introduce compulsory insurance. Only in those cases where provision for future contingencies by the individual concerned and insurance are not possible does the state have the duty to undertake welfare measures according to the principle of solidarity so as to ensure the subsistence of needier sections of the population.

Another welfare function of the state is to correct the distribution of income. The returns to the factors of production are regulated by the price mechanism and

competition on the factor markets but the distribution of income among individuals is heavily influenced by the distribution of wealth (i. e. the ownership of the means of production), which can alter greatly over time independently of the individual's own efforts (i. e. via inheritance). For the necessary correction of the distribution there is an extensive set of market-conforming instruments available, namely taxation, direct and indirect income transfers, capital accumulation schemes and educational measures to improve the individual's chances.

Overall, the principle of minimum government intervention holds: as much market as possible, as much state as necessary.

Alternative for the Third World?

The social market economy as outlined above exercises a growing attraction on development policymakers and economists in the Third World. We shall thus look at how far it or some of its components would be useful for individual countries. So as to pre-empt any misunderstanding, the analyses deal only with the basic suitability and transferability: the blanket transfer of a model order of whatever kind from one national economy to another, if at all possible, makes little sense. The given cultural, social and ethnic specifics must always be accounted for as well as the development conditions, which change over time. As the concrete form of the social market economy is not predetermined, it is able to meet the need for adaptability. A fundamental prerequisite, however, is the creation and maintenance of a market system.⁵

The basic preconditions for this are also given in developing countries, in the view of Alfred Müller-Armack and Ludwig Erhard, two of the founding fathers of the social market economy. In fact, because of its capacity for economic and social mobilization, the social market economy is particularly well suited to the countries of the Third World.

One argument in support of this is that all countries have the same basic problems regardless of the state of development of the economy. The economic task is always the same: to reduce efficiently the shortage of goods needed, to satisfy human needs. The "basic familiarity with market processes" as a major precondition for the introduction of this economic order may also be assumed, particularly in view of the fact that – looking at them historically – most developing countries were previously rudimentary market economies without a centralized government authority and mandatory economic planning.⁶

⁵ Cf. A. Borrmann, K. Fasbender, H.-H. Härtel, M. Holthus, op. cit.; W. Kraus: Marktwirtschaftliche Umorientierung in Entwicklungsländern, in: Orientierungen zur Wirtschafts- und Gesellschaftspolitik, Vol. 2 (1990), No. 44, pp. 39 ff.

⁶ Cf. L. Erhard, A. Müller-Armack: Soziale Marktwirtschaft, Frankfurt, Berlin, Vienna 1972, pp. 337 f.

The basic familiarity with market processes has now been verified in numerous developing countries and can very likely be assumed also in nations which have adopted a more centrally planned approach. Evidence of this is provided by the markets of the informal sector, which in many cases make a considerable contribution to supply but are not accounted for in the gross domestic product, and the black markets for capital, goods and services. There is today also little question that effective markets perform an incentive function in developing countries, in mobilizing private resources and in the introduction of new technologies, for example.

According to Clapham, the constitutions of most states in the Third World provide for the basic economic rights essential to a market economy such as "private property, freedom of labour ... freedom to choose and learn a trade or profession, freedom to set up a business, freedom of association, free movement of capital and labour, freedom of settlement and educational freedom".⁷ The "welfare state" is also foreseen in many constitutions. Embodiment in the constitution does not, however, always mean that these rights are safeguarded in practical reality.

Price and Income Relations

The postulate that the social market economy is basically capable of being transferred to advanced developing countries is largely undisputed, but its application to those countries with a comparatively low level of development is the subject of debate. Critics point above all to the constraints discussed in the following.⁸

One argument often levelled against the practicability of market-style economic systems in developing countries is that producers do not behave in accordance with market principles. In the case of favourable price and income expectations, for example, the market opportunities are not made use of by expanding production.

Such behaviour not in line with the market has been proved empirically for some – mostly geographically and/or ethnically limited – regions with largely subsistence economies, but it is not the rule. On the contrary, it has been empirically shown that the majority of small farmers, who are often cited as an example in this line of argument,

demonstrate positive price elasticity of production. Accordingly, the inadequate agricultural production in many developing countries is due not least to a policy of low prices – in favour of urban and industrial consumers. The reaction of producers to prices unrelated to shortage thus often poses a graver problem for planned economies than the non-response of entrepreneurs to price signals in market-style economic systems.

Lack of Dynamic Entrepreneurs

It is argued that in many countries there are no, or not enough, dynamic entrepreneurs, who can recognize market opportunities early on and exploit these by a more efficient use of resources, introducing new technologies and/or mobilizing additional resources at their own risk. Where such entrepreneurs exist, they are interested in short-term profit (bazaar capitalism), not in the long-term capital investment needed for development.

Empirical investigations, not only in market economy developing countries, however, prove that the shortage of entrepreneurs ought not as a rule to constitute the crucial obstacle. Lack of entrepreneurial initiative is due above all to a lack of the predictability of legal decisions, political instability and imperfect general conditions such as price distortions and restraints on competition. Entrepreneurs who under such conditions prefer short-term capital investments with prospects of a quick profit at low risk behave perfectly rationally.

In all, it can be said that there is a shortage of dynamic entrepreneurs, but the potential is there. The lack of entrepreneurial capacity is not the cause but the result of dirigistic market interventions and the lack of a suitable general framework. "Every entrepreneur and every manager must have means of production at his disposal and be in a position to deploy them where they will be most effective. As long as the means of production are not made available via markets such as factor markets, a market economy system cannot operate."⁹

Administrative Constraints

In a market economy and more so in a social market economy, the state is required to perform major tasks related to growth, stabilization, employment and social policy so as to assure that the economic system operates effectively. The sceptics argue that these functions could not be performed by most developing countries, particularly as regards financial, monetary and competition policy.

This argument ignores the fact that a centrally planned economy places much heavier demands on government

⁷ R. Clapham: *Marktwirtschaft in Entwicklungsländern*, Freiburg 1973, p. 37.

⁸ On this and the following cf. K. Fasbender: *Marktwirtschaft – Eine effizienz- und sozialorientierte Wirtschaftsordnung für die Dritte Welt?*, in: E. Kantzenbach, B. Molitor, O. G. Mayer (eds.): *Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik*, Vol. 35, Tübingen 1990.

⁹ W. Kraus, *op. cit.*, p. 40.

and administration than a market economy. In addition, substantial planning resources and highly qualified specialist workers are released and can be deployed in policy areas that are important to a market economy. The precondition for this is, however, a government able to implement policy. But this is essential in any economic order.

Problems arise in particular in curbing the arbitrary exercise of power by bureaucrats and functionaries. These groups of persons, which are responsible for putting the reforms into effect, fear losing power and income from corruption. They can substantially delay the transformation of the economy, which is one reason why the predictability of legal decisions is of particular importance.

Political Acceptance

In all, we can say that the constraints listed (whereby the list does not claim to be exhaustive) can impede progress towards more market economy, but it must be stressed that they are not insurmountable obstacles and can be mitigated by creating an adequate general framework and implementing suitable measures, especially in education and training.

More crucial than the impediments to the introduction of a market economy outlined above is probably, as with any change of the economic order, its acceptance by the political groupings of the given country. Without the willingness to bear responsibility for the new economic system, there is not enough motivation to raise performance and production and the necessary confidence in a consistent economic policy, particularly in the transitional phase. Apart from this, hardly any democratic government will wish, or be able, to impose successfully a new economic order against the will of the major social groups. Shams for example underscores the point with a view to reform prospects in Jamaica: "The crucial question for the future ... remains whether a political consensus on the economic order and the continuation of economic reforms to bring about and secure such an order can be achieved."¹⁰ Interests differ of course from country to country but certain generalizations may be made.

As a rule the rural populace, often the majority of the population, will benefit in the short and medium term from a decentralized economic order, for example from the reduction of price distortions commonly attendant on the introduction of a market economy and hence the departure from a low-price policy for agricultural produce.

In these cases the requisite acceptance may be assumed. The situation is different in those comparatively few states, such as Turkey, where the farming sector has been disproportionately subsidized.

The urban population, particularly the industrial workers, will only benefit from the positive impacts of a change in policy in the medium to long term. In the transition phase they can expect to forfeit real income due to the curtailment or abolition of subsidies for everyday goods. Another aspect is that as a result of structural adjustment in industry, workers will be made redundant, whereas the employment impacts of the new economic policy will only make themselves felt after an adjustment interval of differing duration. In these cases, the readiness of these frequently politically powerful social groups to accept the changes will largely depend on the form the structural adjustment takes and the related social buffers. The importance of this latter consideration is illustrated by the political unrest triggered in the urban centres of various Arab countries during the second half of the eighties by price rises for staple foods.

Most entrepreneurs stand to gain from the liberalization and deregulation associated with the market economy and from the incentives to enhance performance and mobilize additional resources for development. Apart from this common factor, though, interests are very disparate. Businesses geared to imports will lose from the depreciation of overvalued currencies, while those directed towards exports will benefit. Businesses largely shielded from domestic and/or foreign rivals will be increasingly exposed to competition from national market contenders and the "cool wind of free trade" (List). From an overall standpoint, an essential determinant of the level of acceptance by business will be the form that the regulative measures take.

Regulative legislation which is viewed by those affected as insufficient or misconceived can impede or even prevent necessary reform in important subsectors. The 1980 tax reform in Turkey, for example, was thwarted by the joint opposition of small and large farmers, self-employed and industrialists. Stabilization policy underwent a similar fate: it was resolutely fought by the unions. The example of Turkey also shows, however, that the knowledge and experience of the interest groups in a country can make a substantial contribution to the practical effectiveness and higher efficiency of development measures. The participation of important interest groups in the planning of regulative measures, for

¹⁰ R. Shams: Interessengruppen und Anpassungskonflikte in Entwicklungsländern, Fallstudie III: Jamaika, Hamburg 1990, p. 10.

¹¹ Cf. R. Shams: Interessengruppen und Anpassungskonflikte in Entwicklungsländern, Fallstudie I: Türkei, Hamburg 1989, pp. 39 ff.

example, converted the associations in farming, trade and industry from opponents to advocates of liberalization.¹¹

Closely linked with the problem of acceptance but of separate significance is the social component of the market economy, particularly in the transition phase. The correlation already described between efficiency and social security is not peculiar to highly developed industrialized countries. In the Third World, too, the money needed for social compensation has to be earned. "The best social policy cannot achieve any reasonable success if the productivity of human labour is low. The establishment of a working system to direct an economy based on the division of labour is thus the prime precondition for the solution of all social problems."¹²

Thus growth must be accorded particular attention in social policy. Within such a policy, target-group oriented

schemes can improve the opportunities of needier groups to take part in the development process and improve the results of their participation. A development policy geared to a closer integration of disadvantaged sections of the community into the economic process will in the medium and long term diminish poverty and raise the gross domestic product. The Regional Rural Development Programme is such a development concept.¹³ Even programmes of this kind are politically vulnerable, particularly in the socially difficult transition phase, because they often need several years to take full effect.

Though narrow, the scope for redistribution existing in most developing countries ought therefore to serve as a major flanking instrument of a social market economy. It is all the more important that the available financial possibilities directly benefit the poor sections of the

¹² W. Eucken: Grundsätze der Wirtschaftspolitik, Munich 1965, pp. 180.

¹³ Cf. Federal Ministry for Economic Cooperation and Deutsche Gesellschaft für Technische Zusammenarbeit: Regional Rural Development – Guiding Principles, Eschborn 1984.

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New Publication

**Axel Borrmann,
Karl Fasbender,
Hans-Hagen Härtel,
Manfred Holthus**

SOCIAL MARKET ECONOMY

Experiences in the Federal Republic of Germany and Considerations on its Transferability to Developing Countries

In many centrally planned developing countries the mechanisms of central control as applied in state run economies have reached their limits: factors of production can no longer be allocated efficiently, growth is inadequate and there is diminishing scope for the redistribution of income. In the search for models solving their economic problems, increased interest is being shown in the Federal Republic of Germany, the "social market economy". Its achievements in rebuilding its economy, its economic success and social stability enjoy considerable international prestige. Therefore the Federal Ministry for Economic Cooperation (BMZ) and the Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) commissioned the Hamburg Institute for Economic Research (HWWA) to compile a study on the theoretical principles of the "social market economy", the problems associated with its introduction and the experience gained with this economic system in the Federal Republic of Germany, and to examine aspects related to its transfer to developing countries.

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population. Successful models here are for example the Food for Work Programme or special programmes for mothers. As with a growth-oriented social policy, measures of this sort must be conceived for each country individually, in line with the market and within the individual financial leeway and administrative capabilities.

The Change to a Social Market Economy

For political and social reasons also, the concept for a change in the economic order is of great importance. Wherever vested interests such as acquired rights, preferential treatment, etc. are affected and those concerned see no prospect of benefitting at least in the medium or long term, political resistance can be reckoned with. The same applies to the poor in urban areas, especially as the social problem in many developing countries has another dimension to that in the industrialized countries. The mastery of the problems involved largely depends on the political will of a government genuinely in a position to implement reform, the participation possibilities of the groups concerned and the institutional arrangements for settling disputes.

The shaping of the economic order striven for and the pace of the transformation are essentially the prerogative of the state. Owing to the differing degrees of market economy and central planning in the different hybrid forms and to the divergent levels of development, it is also virtually impossible to devise a practical list of measures for general application.

For purely economic reasons, though, it can be generally asserted that a change of system should occur in a short period in the form of a kind of "shock therapy". This will produce sustainable positive impacts in the relatively short term. If for political or social reasons this cannot be effected, complex economic relations must be accounted for. If this is not done, the reform measures are in danger of dissipating or blocking one another, or their effectiveness will be inhibited by negative impacts on the implementation of other goals, as the following examples illustrate:¹⁴

- Realistic exchange rates are of little use if decontrol measures are not taken, or if inefficient or corrupt customs officers do not clear merchandise correctly.
- The liberalization of trade and capital transactions should be synchronized as closely as possible. If for political reasons this is not possible, trade should be

given precedence: "The strongest case for this ordering is based on the relationship between macroeconomic flows and the real exchange rate. The experience with destabilizing capital flows immediately following capital account liberalization has generally been negative ..."¹⁵

- Prior to the liberalization of international capital movements, the domestic financial market should be reformed to avert inflationary developments and capital flight. A precondition for this in turn is the control of budget deficits.
- Access to the domestic markets should be afforded to foreign competition gradually so as to give national producers the opportunity to make rationalization investments and take measures to raise productivity. Nursery duties for infant industries should be designed degressively from the outset so as to avoid further adjustment problems.
- Decontrol of retail prices and wages must be flanked by measures to enhance competition and financial discipline. Otherwise inflationary tendencies are likely. If the liberalization of prices and wages is attended by negative real interest rates, there is an increased danger of inflation and diminishing savings.¹⁶
- The privatization of most government enterprises is essential for many countries to avoid misallocation of public funds and increased indebtedness. Without effective competition – in the case of monopolies and oligopolies from foreign companies – this can lead to an undesirable effect on competition accompanied by inflationary trends.

Overall then, the basic conditions for the transition from a centrally planned economy to a decentralized and social market economy in developing countries may be assumed. Such change is also an imperative for a development policy geared to efficiency. The basic concept of a social market economy can therefore be exported, mediated by policy dialogue at all levels. The concrete form it has to take however, is not exportable, as the specifics in each nation have to be catered for. The decision on the changing of the economic order is the task of the government of the country concerned, and its alone. Once the decision has been taken – often in an economic crisis – support by the industrialized countries during the difficult transition phase, including the social cushioning of structural adjustment measures will be helpful, and in part also necessary. Such support is also called for by the efficiency imperative of sustainable economic cooperation.

¹⁴ K. Fasbender, *op. cit.*

¹⁵ S. Edwards: Sequencing Economic Liberalisation in Developing Countries, in: *Finance and Development*, Vol. 24 (1987), No. 1, p. 26.

¹⁶ Cf. T. A. Wolf: Reform, Inflation and Adjustment in Planned Economies, in: *Finance and Development*, Vol. 27 (1990), No. 1, p. 2.