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GERMANYS' SOCIAL MARKET ECONOMY:* THEORY AND PRACTICE

AT a time when India is seriously involved in reforming her industrial system, it might be of somewhat interest to learn about the German. economic system and the basic theoretical concepts that motivated economic action during the periods of Erhard (1948-1966) and Schiller.

It is common knowledge that this system has led to a phenomenal economic growth. In 1945 Germany's cities were piles of debris, its industries to a great extent destroyed or being dismantled, its transport system disrupted. The German economy had come to a virtually complete stop. Fifteen years later at the beginning of the sixties, the Federal Republic, comprising only half of the area of the former German Reich, had become the third economic power and the second largest trading country in the world, and the "Deutsche Mark" was emerging as one of the world's hardest currencies. The rapid growth of the German economy combined with a remarkable stability of prices appeared so extraordinary to many people that they became accustomed to calling it a miracle.

In order to "explain the miracle" we would have to analyse all the components of the German economic system. The dominant feature of this system has been the socially conscious free market economy. In the following pages an attempt has been made to analyse the foundations and tenets of such an economy.

WHAT "FREE MARKET ECONOMY" DOES NOT MEAN

There are quite a few misconceptions about what the term "free market economy" means in the German context. It does not mean, firstly, a laissez-faire economy of the 19th century type, in which the role of the state is virtually reduced to that of a night watchman, en-

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suring law and order. In modern conditions, the State inevitably has to exercise a direct and decisive role in an economy which can no longer be guided by Adam Smith's invisible hand, but only by the hand of the State. Even for the market economy the question, therefore, is no more whether or not the state has to steer the economy but rather *how* it has to steer it. And the answer the market economy gives to this question is that the State should guide the economy by *using* the market mechanisms rather than by *destroying* them. Or to say it in other words: The question is no more one of State intervention versus non-intervention, but one of the proper form and objective of intervention.

Secondly, the market economy is not identical with a system of exclusive private ownership of the means of production. In theory, if not in practice, one could well imagine a market economy in which the State owns the major part of the means of production. The question again is *how* the public enterprises are managed rather than whether or not there should be public enterprises. The public sector in Germany is, contrary to a widely held opinion, quite large. Apart from the so called natural monopolies of the past, the railways and the public utilities, public enterprises in 1960, for example, produced 25% of the coal extracted, 77% of the aluminium smelted and 50% of the automobiles built. But the publicly owned companies are, for all purposes, run on the same principles as private enterprises. The central or local government is represented on the Company board, but a greater part of the supervisory posts are held by personnel chosen from private industry and business. The emoluments of "Public Sector managers" are not tied to the salary system of the civil servants but are related to the salaries paid in private industry. Thus it is not abnormal at all that a manager directing a public enterprise may get a salary several times higher than that of a secretary of the State. The decisions, finally, of the companies on investment policy, pricing policy etc. are taken in a way comparable to those of private firms. There is a striking example of this independence of publicly owned enterprises. In 1964, Professor Nordhoff, the late General Manager of the Volkswagon Company, raised the price of the "people's car" at a moment politically most inconvenient to the Government. The then Chancellor Erhard protested strongly and called upon Nordhoff to rescind his decision. But in vain. Nordhoff stuck to the decision and the Volkswagon Company continued to make record profits as ever and to reinvest them in new plants.

THE THEORY OF THE "SOCIAL MARKET ECONOMY"

The theoretical founder of the social market economy was Walter Eucken, whose role in German post-war economic policy is comparable only to that of Keynes in British policy. Eucken's basic tenet was that, despite all the new problems arising in a modern economy, the plans of individual producers and consumers are still best coordinated by market mechanisms, and that the competitive market is still the most efficient means of allocating the scarce resources of the national economy. On the other hand, Eucken rejected not only cantralized planning of the Soviet type but—perhaps to an exaggerated extent—dismissed anything which was even remotely connected with planning. He did so for three reasons:

The first reason was political. Eucken developed his neoliberal theory during the Nazi time and with this theory protested against the dominant conditions of the time. These conditions were totalitarianism in the political field and centralized planning in the economic field. In Eucken's opinion, there could be no political freedom without economic freedom. Just as the system of a centrally administered economy belonged to dictatorship, the market-economy corresponded to democracy.

The *second* reason for rejecting planning was psychological. Planning in Eucken's view ran counter to ordinary human incentives and thus paralysed private initiative.

The *third* objection to planning was technical. Correct planning appeared to be a technical impossibility, for it would presuppose complete information about not only present but future conditions. In Germany's case, we are able to test this hypothesis by experience. In 1948 various expert groups set up long-term programmes based on the prediction that in 1952-53 industrial production would reach the 1936 level. In reality, however, industrial production in 1952-53 was 50% higher than in 1936. If the planners had their way, Germany's economy would have been kept in a strait jacket.

But rejection of planning did not mean a return to 19th century liberalism with its ideal of laissez—faire. On the contrary, Eucken recognized that a laissez-faire economy left to itself would not create a competitive market economy, but would lead, as past experience showed, to the formation of monopolies and thus end up in abolishing competiion. A competitive market, therefore, could only be created and preserved by active intervention of the State. A laissez-faire economy, secondly, was exposed to heavy cyclical fluctuations of economic activity and, thirdly, it tended to create intolerabe large inequalities of income The State again was called upon to counteract these tendencies. Eucken thus entrusted the State with most important economic functions: The State had, by its active policy, first to create and then to preserve a competitive market economy. Secondly, it had to secure price stability as a prior condition not only of the efficient working of the market system but of preserving social justice. Thirdly it had to maintain a high level of economic activity. And last but not least it had to prevent major inqualities of income. In short, the State had to establish a *socially conscious market economy* which would ensure both prosperity and just distribution of wealth.

THE "IMPLEMENTATION" UNDER ERHARD

From the Third Reich Germany had inherited a centrally administered economy. The first task to accomplish, therefore, was to create market economy by removing price and production controls. The Currency Reform in 1948 had enabled prices once again to perform their normal functions, and the freeing of the internal markets made rapid progress. The Currency Reform took place in June 1948; by the end of July price controls had been abolished for more than 90% of all commodities. It was a bold experiment if the fact that the economy hitherto had not been able to satisfy even the basic needs of the population was considered. No wonder that many observers thought Erhard's policy would directly lead to catastrophe. The then US High Commissioner, General Clay, is reported to have said to Erhard: "Herr Erhard, my economic advisers tell me, you are making a terrible mistake." Erhard replied: "Don't listen to them, my advisers tell me the same thing." And, indeed, there were critical moments for the market economy in the first months and on several occasions even later on. Prices began to rise dangerously. But in the end inflation was averted by the fantastic rise of production between June and December

1948. The industrial index went up by jumps; monthly rates of increase were achieved which later could be reached only as yearly rates.

The freeing of the markets, in fact, had changed the economic climate over night. There were extraordinary opportunities for imaginative enterpreneurs in the post-war period. Firms like Grundig starting on a shoe-string had chances to soar if they were ready to take them. In fact, the key figure of the German post-war economic scene was the entrepreneur. His drive for profit and wealth carried the economy forward. Germany's economic growth thus corresponds to Schumpeter's production-oriented growth model. According to this model the growth process in an economy is set in motion by the entrepreneur. It is he who grasps the possibilities offered by the markets and by new production techniques and who makes the investment required to exploit them. Investment thus grows—new workers are employed in the capital-goods industries and workers already employed there earn higher wages—the workers, in turn, spend their increased income on larger purchases of consumer goods, this calls for higher consumer-good's production, this again requires new investment and so on. In Schumpeter's theory the chain of causation thus runs from increases in capacity to higher output and income. In the interplay by which production and consumption reciprocally stimulate each other the initiating impulses come predominantly from the production side.

Having freed the markets, Prof. Erhard went on to ensure competition in these markets. Against considerable opposition from industry the "Law against Restraint of Competition" was enacted and a Central Office set up to control cartel agreements, mergers and dominant firms. The negative anti-monopoly legislation was supplemented by a positive policy aiming at fostering the middle stratum of the population. By the so-called "Middle Estate Policy" the small and medium-sized firms were deliberately strengthened to form a bulwark against monopolies.

Diffusion of economic power was further promoted by the denationlization of State-owned enterprises. From 1959-65 part of the shares of three giant public enterprises—among them Volkswagon, Germany's biggest company, were sold to the lower and middle income groups at a "social discount." This transaction created about three million holders of "people's shares." In addition, several other measures were taken to spread property ownership. Thus, to mention just a few, a "Savings Premium Act" provided for a premium to be paid on saving which—up to a certain amount—are invested for six years. An amendment to the Company Law in 1959 gave incentives to the management to acquire shares of their own company in order that they may offer them at privileged prices to their employees. Today, as an effect of this law, many of Germany's big joint-stock companies have tens of thousands of shareholders among their personnel.

The anti-trust legislation was enacted in 1958. At the same time Germany abolished what was left of exchange control and went on to a completely free convertibility of its currency. International trade had already been liberalized years before and had enhanced competition on the internal market. Now also international capital movements were liberalized. This coincided with the creation of the European Common Market which made Continental Europe and especially Germany attractive for foreign capital. Huge amounts, especially of US capital began to flow into Germany. The book value of US direct investments in Germany at present amounts to DM 16 billion, that is about the value of the total public sector investment in India. Competition in the internal market was again increased from outside, this time by the introduction into the German market of aggressive American management methods.

The incentives for expanding investment and production inherent in the competitive market were supplemented by a fiscal policy deliberately favouring capital formation. There were on the one hand highly progressive income taxes and, on the other hand, a great variety of tax privileges to firms and individuals willing to save and to invest. This very combination gave enormous incentives to capital formation. Firms and individuals had to decide whether to invest profits and other incomes or to pay the greater part of them to the tax collector. Naturally, they chose to save and to invest.

Stimulating capital formation by tax incentives, however, could not but effect another goal of the social market economy, the prevention of major inequalities of income. For the highly progressive tax system, designed for this purpose, was bound to lose much of its effect through these tax privileges. In fact, the first years after the introduction of the free market economy were marked by an extremely high degree of self-financing of investments and, consequently, by concentration of wealth on the side of the entrepreneurs. Tax deductions which were made under the various legal provisions favouring capital formation are estimated at DM 28 billion (Rs. 5600 crores) for the period 1949—57. The bulk of the benefits from these deductions accrued to higher income brackets.

The trade unions tolerated this development because they recognized that the then existing structural unemployment could be cured only by widening investment. In the longer run this policy, indeed, proved to have been also in the interest of the tax incentives, the economy was rapidly growing, and so was—if not at the same pace—the income of the worker. Also judged by his interest, it turned out to be more advantageous to distribute a big pie unequally than to share a small pie equally. Moreover, after full employment had been reached, the trend in income distribution was reversed: wages began to grow faster than productivity. Between 1958 and 1966 wages rose by 95%, per-capita production only by 65%. At the same time social security spending by the Government increased faster than the national income. Today the living standard of the German worker, is the highest in the EEC. The economy created by Prof. Erhard can rightly claim to be a socially conscious market economy.

1966: A SOCIAL DEMOCRAT BECOMES MINISTER OF ECONOMICS

Late in 1966 Prof. Erhard's Government was replaced by the "Grand Coalition" Government under Chancellor Kiesinger and for the first time since 1949 a Social Democrat, Prof. Schiller, became Minister of Economics. Does this mean that German economic policy is now moving in a different direction? The answer to this question is "no" and "yes".

The Social Democratic Party has been supporting the social market economy ever since the famous Godesberg Programme of 1959, No radical change was, therefore, to be expected when the "Grand Coalition" came to power. In fact, the new Minister of Economics in some ways has pursued neoliberal policies more energetically than his predecessor. He has totally freed interest rates in the banking sector from official regulation; he has taken vigorous measures to readapt the sick coal industry to competitive conditions; and he has introduced an added-value turnover tax, thereby replacing the old cumulative turnover tax which had encouraged vertical concentration and thus tended to diminish competition. Moreover, in the recent discussion on how to fend off imported inflation it was Prof. Schiller who voted for the solution conforming to the market economy, namely up-valuation of the German Mark, and it were members of Prof. Erhard's Party who advocated reducing the influx of foreign currency by restricting the free convertibility of foreign exchange into Deutsch Marks.

Professor Schiller has also made new attempts to tighten the anti-monopoly legislation. The fact that the recent years have seen a wave of mergers does not contradict this statement, for it indicates a change in situation rather than a change in policy. Today, after the Custom Union of the EEC has been completed, anti-monopoly policies are more and more transposed from the national to the EEC level. The question of monopolisation today has to be examined with a view to the larger market of the EEC rather than the German market alone.

The measures mentioned so far may be seen as a continuation of the policies of the Erhard period. In June 1967, however, a law of far reaching importance for future economic policy was enacted the "Law for Furthering Stability and Growth of the Economy."

The law prescribes longer-term budgetary planning and provides the Federal Government with the most modern legislation for applying Keynesian budgetary policies which any Government in the world has so far got. It also indicates the introduction of a voluntary incomes policy by providing that the Federal Government shall make known economic data to the states and municipalities, the workers' unions and entrepreneurs' associations with a view to enabling them to take concerted action in economic policy matters. In pursuance of this provision Government and both sides of industry have taken to coming together in regular meeting in order to discuss how to keep wage increases in line with productivity.

The "Stabilisation Law" had been already prepared under Erhard' Chancellorship. Thus at first sight it, too, may seem to be a continuation of the policies of the Erhard period. But the extent to which Prof. Schiller has since moved anti-cyclical budgetary spending and incomes policy by concerted action into the centre of economic policy proves this law to have been a new departure. The time of exclusive reliance on monetary policy has come to an end. The new economic policy attempts to achieve a synthesis between Eucken's compe itive order and the Keynesian concept of managing agggregate demand, and it adds to this synthesis a voluntary incomes policy.

Some observers have interpreted Schiller's introduction of Keynesian elements into neoliberal policy as a response to a new problem not foreseen by the neoliberal School, namely the problem of Germany's permanent balance of payments surpluses. In a world of creeping inflation Germany, by its very price stability, is achieving large export surpluses and attracting large inflows of speculative money. In such a situation, however, orthodox monetary policy alone cannot be expected to ensure stability of both the internal price level and the balance of payments. Neoliberal monetary policy, therefore, has to be supplemented by Keynesian fiscal policy.

This interpretation certainly shows an important aspect of the new policy, but it does not give the whole picture. In the last analysis, the new policy is a response to a more comprehensive problem: that of economic growth.

Growth has become a necessity for the "New Industrial Society". Inherent in this society is the urge to increase the standard of living and to compete with the other industrial nations for the highest growth rate. Constant and adequate growth, further-more, is the basic prerequisite of attaining the goals of the "magic triangle": full employment, price stability and balance of payments equilibrium. At the present stage of the German economy even stagnation, let alone recession, would involve a loss of DM 30—40 billion (Rs. 1600—8000 crores) in GNP and of DM 8—10 billion (Rs. 1600—2000 crores) in tax receipts. It would cause unemployment and social unrest, would bring about lack of governmental funds for financing the more and more rapidly increasing expenditure on education, infrastructure, research, development aid etc. and, last but not least, would mean falling behind in the race of technological progress.

The recognition of the social and political necessity of growth and the consequent emphasis on growthmanship goes far beyond the range of Erhard's neoliberal policy. It inevitably will further increase State influence on the economy. But there is no doubt that the basic principle of the market economy will remain intact. The Government will continue to pursue its goals by *using*, rather than by destroying the market mechanisms.