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## Economic Dynamism and the “Social Market Economy”: Are they Reconcilable?

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It is an honor to be invited to give the Erhard Lecture, especially on the 50<sup>th</sup> anniversary of Ludwig Erhard’s book *Wealth for All*. I have been invited here to discuss Germany’s economic system, called the Social Market Economy. Some serious questions are being raised about this system: Is it low in *economic dynamism* by international standards? In any case, are there reforms to the economy that would raise its dynamism substantially *without* altering its character? How much of the Social Market Economy would have to be dismantled or neutralized if *high* dynamism were to be achieved? I am grateful to the *Initiative* for giving me this opportunity to speak on the subject.

### **The Theory of Capitalism**

It is natural to look at the Social Market Economy from the perspective of some alternative economic system. I will tend to focus on the consequences for dynamism of those elements *present* in a Social Market Economy but missing in a capitalist economy and those elements present in a capitalist economy but *missing* in the Social Market Economy.

The preponderance of economists have not understood very well the embryonic theory of the desirability of a well-functioning capitalism – capitalism in countries where it can function well. What *passes* for such a theory among economists with a libertarian leaning is an argument for a *free-market economy* in the sense of an economy with a very small government. This argument is based on neoclassical theory, in which there is little for the government to do! In this view, all that is required for a well-functioning economy is the establishment of private property rights, including the right to own and manage capital and the “rule of law”; with these minimal institutions in operation, the economy will surely navigate the optimum path of intertemporal equilibrium. But this argument has nothing to do with capitalism. Capitalism is all about novelty, exploration, innovative ventures and discovery – features absent from neoclassical theory.

As I see it, two ways of justifying capitalism have been attempted in political economy. Friedrich Hayek contributed to both of them, which has caused

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some confusion. In his book *The Road to Serfdom* (and later in *The Constitution of Liberty*) Hayek's premise was that people ought to have economic freedoms as well as political freedoms – freedoms to start a firm and to close one, to introduce a new product or method, and so forth. Since a socialist system and a corporatist system deny people some of these individual freedoms, they are unjust. Hayek appears to assume that a country's people, when allowed these individual freedoms by the government, will evolve the institutions of the system called capitalism. But what if instead people in some countries evolved the institutions of a system of cooperatives – such as monasteries or kibbutzes – simply because that was familiar to them from their ancestral past, not because they had tried capitalism and liked it less. Would that system of cooperatives also be considered a good economy? In *The Road to Serfdom* there is nothing about entrepreneurial activity and innovation – as if the *consequences* of capitalism were immaterial to its justification. I would note that Ludwig Erhard did not advocate the social market economy on an argument that the Social Market Economy was the only system that offered people economic freedoms.

Another vulnerable point of this approach is that people might reasonably think that they ought to have the freedom to act through their communities to say no to a factory they all dislike or to subsidize the relocation to their area of a business they all do like. To argue persuasively that individual freedoms ought to be decisive in every case over community freedoms requires taking into account the *consequences* of community freedoms.

The *other* way of justifying capitalism has been to argue the benefits of its consequences – the benefits of the means, or processes, as well as the visible ends. For example, various American economists said in the 1950s that U.S. capitalism was justified by the rapid economic growth – in particular, the productivity growth – that it delivered; but these economists began to have doubts a decade later. Hayek could be said to have opened the way for that way of arguing for capitalism: In writings before *Serfdom* and after *The Constitution of Liberty*, he presented insights into the mechanisms of capitalism that, taken together, suggested the desirability of capitalism as an economic system – its desirability from the point of view of its *consequences*.

In the 1930s Hayek had the key insight that, in a market economy, each individual in the business sector has experience and observations that no one else has. He then argued that only people possessing this *private knowledge* are likely to have any idea of how this or that good could be produced and what goods might be remunerative to produce. The implication, which was none too sharply drawn by Hayek, was that these knowledge workers (to use the latter term by Drucker) were better able to judge what can be produced and what cannot be than some state bank or other state agency would be, since the latter would lack the specialized “know-how.” In the 1960s it is evident that Hayek came to see (if he had not seen it earlier) that out of the private knowledge possessed by someone may come an *original* idea – an idea that he or she could be pretty sure that no

one else has come up currently or in the near future. So capitalism, a bottom-up system of private initiative based on private knowledge, has the potential for creativity. In contrast, a top-down system directed by social institutions too remote from business to have the rich veins of private information possessed by the private individuals in business does not work.

A related theme of Hayek's was that the development and launch of an innovative product is a leap into an unknown where no one has been before. So the law of unanticipated consequences applies. In the terminology of Friedman and Goldberg, there is "imperfect knowledge" of how the economy will receive the novel product. In the terminology of Frank Knight there is uncertainty. The uncertainty is compounded when there are several, perhaps many, other new products and methods being launched around the same time. Capitalism is therefore a system of *disorder* – of guesses and huge surprise – alongside some elements of order. It becomes a serious question whether the right ones among the ideas for new products and methods will receive financing and whether they will receive the evaluation and try-out necessary to their widespread adoption. How can this system work?

These basic insights have opened the door to a more realistic view of capitalism. I like to use the word *dynamism* to mean innovativeness in profitable, thus commercially viable directions. I argue that a well-functioning capitalist system possesses a high degree of dynamism but that requires overcoming difficulties. High dynamism requires not only new commercial ideas. 1<sup>st</sup>, it requires an abundance of *entrepreneurs* with the *range* of abilities needed to push the development of a new idea in spite of unforeseeable hurdles. 2<sup>nd</sup>, high dynamism requires *financiers* – angel investors, venture capitalists and so forth – having a *diversity* of past experience so that many promising ideas are not rejected for lack of a financier with the background needed to understand it (to some extent) and so that the entrepreneur can have a mentor in each of the development stages. 3<sup>rd</sup>, high dynamism requires *managers* with the *vibrancy* to be alert to new methods and the *education* to evaluate them; and also *consumers* with the *venturesomeness* to give new products a look in the shopping mall and to take some of them home to give them a try.

It is clear, then, that a country's economic institutions and its economic culture – not just the rule of law and private property rights – impact on the actors in the innovation process and thus add to detract from an economy's dynamism. It is clear that the government has to stand ready to *step in* when things go awry – though it will not always know what would be useful to do.

But is this system *desirable*? In my view, one's first reaction has to be yes. First of all, high dynamism expands employment – it creates more jobs than it destroys – through the creation of jobs in development, in marketing and in managing. (This is rather clear in my book *Structural Slumps*.) My book *Rewarding Work* (1997, 2007) and in the introduction to the conference volume

*Designing Inclusion* (2003) points out that high dynamism has invaluable effects on the workplace experience – benefits consisting of the personal, or intellectual, development of employees as well as entrepreneurs.<sup>1</sup> In advanced economies at any rate, the mechanisms of innovation and of discovery largely shape that experience, such as the degree to which employees feel engaged in their jobs, and the rewards, such as job satisfaction, of participating in the workplace. Without such dynamism jobs would not offer much in the way of non-pecuniary rewards.

### **The Continent's Social Market Economy**

That was not the thinking that – in continental Europe – reached a peak in the 1920s and 1930s. It came to be thought the bourgeois entrepreneurs were not able or motivated to generate new commercial ideas and that a type of system that is more coordinated would be capable to generating faster economic growth. This impression invited the idea of that a better system would be a tripartite economy in which the government working with leaders in industry and in organized labor would set the main directions of the economy.

There was also a strand of equalitarianism – the idea that it is out of place for a person to do anything that would cause him or her to stand out from the group to which he or she belonged.

There was also a de-emphasis on material things. As Hans-Werner Sinn commented to me, A German would rather say that he had inherited his wealth than admit that he had made his fortune himself.

Finally, it was thought that industrial peace would be served by setting up institutions for collective bargaining between industries and unions, with the government acting as a mediator if necessary.

It is hard to say how well or badly such systems worked in the *Interwar* period. However, in the postwar period, capitalism in continental Europe continued to be an object of very extensive criticism.

With the emergence of Ludwig Erhard, Germany had the opportunity to strike out on a new course. The term Social Market Economy arose as a label for the newly emerging system or the main features of it.

Many observers still take the term Social Market Economy to mean a capitalist system alloyed to a welfare state consisting of some basic social insurance and social assistance programs. But capitalism never implied the omission of any or all such social insurance programs. (Hayek himself wanted to include some government programs.) Erhard commented that competition was social – it was in the interest of society – as if to say that no welfare state baggage

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<sup>1</sup> Phelps, *Rewarding Work: How to Build Participation and Self-Support to Free Enterprise* (Cambridge, Mass.: Harvard University Press, 1997, 2<sup>nd</sup> printing 2007); Phelps, *Designing Inclusion* (Cambridge, Mass., Cambridge University Press, 2003).

was indicated or required.

However, the Social Market Economy has come to mean an economic system with two new features: Co-determination of the management of corporations by the employees alongside the owners; and a variety of penalties on employers and rights conferred on employees. In short, ownership of capital came to be shared between employees and owners.

At the same time, there continue to be the strands of social thought mentioned above – the equalitarianism, the anti-materialism, and the idea of social partners.

Empirically, it is clear that where a well-functioning capitalism is feasible, or supportable, a well-functioning capitalism is better for the stimulation of new innovative ideas, their development and evaluation than either eastern European socialism or the western continental European system, whatever we call it. We mustn't repeat that debate for another century.

The remaining questions are two: Is capitalism just after all? And if so, how exactly might a country such as Germany move in that direction – what would be the best operational steps?

I argue that high dynamism is essential for the good life. It is paramount that our lives, much of which must be spent doing something, present us with mental stimulation, problem-solving, exploration and thus the means to our intellectual development and personal growth. The other considerations cannot have an equal priority. This line of thinking is in a line that starts with Aristotle and runs through the vitalists such as Cellini, Cervantes, William James and Henri Bergson and runs also through the pragmatists such as Virgil, John Dewey and Amartya Sen.

What then must be done to create more dynamism – and with it better lives? There is no magic bullet. Many initiatives must be taken. And we will never know for sure which initiatives were the most important.

There are some areas that I believe can be safely ignored in any program of fundamental reforms. I do not believe that modifying in either direction the duration or the size of the benefit paid to unemployed workers is a step that would transform the economy into one of high dynamism. In general, it is unfortunate that the political parties are so heavily occupied with moving back and forth certain standard policy levers, such as tax rates, the budgetary balance and trade policy. These moves tend to be cyclical, rather than one-way. And in any case they do not promise to raise dynamism appreciably.

The penalties under the Employment Protection Legislation tax a company when it downsizes its workforce while it does not subsidize a company when it invests in a larger workforce.

I recommend adoption of the idea of topping up the pay rates of low end workers. (I have long advocated low-wage employment subsidies.) To introduce statutory minimum wage rates is to put the car into reverse gear: it has the effect of increasing the cost of labor to employers and will tend in almost every case to decrease employment in the business sector.

But above all it is necessary to review German institutions in the area of corporate governance, particularly co-determination, bankruptcy law, and the structure and functioning of the entire financial sector.

With a big push toward an economic system with greatly increased dynamism Germany can look forward not only to more job satisfaction and employee engagement in the workplace but also to faster economic growth and something approaching “full” employment! A German economy that is healthy will be a benefit to the whole world.