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# Germany's “*Social Market Economy*”

## *Between Social Ethos and Rent Seeking*

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ULRICH WITT

The successful reconstruction of the West German economy after World War II and its spectacular rise to the leading position in Europe since then is undisputed. However, the persistently high unemployment rate of the past two decades and the stagnation in the New Laender since unification have tarnished the splendor. Among the reasons for both the early success and the later mediocrity, a most influential one lies in Germany's economic constitution. From this relationship a more general lesson may be drawn. A country's economic constitution reflects an unwritten social contract. In constructing a constitution, the framers may strive for a balance between the interests of the members of society. Yet such a balance may turn out to be infeasible in the actual operation of the economy. In the United States, the Founding Fathers of the U.S. Constitution noted this problem in their debates, and it influenced the choices they made (Hamilton, Madison, and Jay [1788] 1947). The experience with Germany's postwar economic constitution, manifested in its *social* market economy, differs. Still heavily influenced by their experience of the Great Depression and its mass unemployment and hardship, which had paved the way for the Nazis' rise to power, the framers of Germany's economic constitution considered a social ethos a moral imperative. In their decision to lay that ethos down in the constitution, they seem to have overlooked the dilemma

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inherent in the attempt to achieve simultaneously freedom, efficiency, and security from the pitfalls of life.

Both Germans and others often attribute Germany's postwar recovery to its social market economy (see, for example, Giersch, Paqué, and Schmieding 1993; Kerber and Hartig 1999). This type of political economy has on the one hand a basic free-trade orientation and on the other hand some "social" precepts that modify the outcome of the market process by redistributive and social security measures (for a broader portrayal, see Peacock and Willgerodt 1989). The blending of ideas from liberal thought, social welfarism, and corporatism in the conception of a social market economy may appear discordant to the non-German observer. It results from a politically motivated merger of two different approaches to economic order and policy-making, a merger popularized and politically implemented by Germany's great first minister of economic affairs, Ludwig Erhard (1897–1977). In some respects, this merger was the offspring of *ordoliberalism*, whose most prominent advocate was Walter Eucken, a professor of economics at the University of Freiburg and a liberal in the European sense. (Unfortunately, his influential manifesto [Eucken 1952], which anticipated many ideas of public-choice theory and constitutional political economy [Vanberg 1998], has not been translated into English.) In other respects, it was the realization of a socially conditioned market regime that its major proponent, Alfred Müller-Armack (1950), called *social irenic*, clearly indicating his indebtedness to the social doctrine of the Roman Catholic Church. (For a good survey of the beginnings of social market economics, see Watrin 1979.) The widespread acclaim that the social market economy soon came to receive from the German public may reflect only that everyone can associate the term *social* with whatever suits his own interests and ideology. Indeed, right after the war, when socialist ideals dominated all of Europe, making a concession to such expectations might have been the only way to ensure majority support for free markets in the young German democracy. As time went by, however, conditions changed.

Today, the social ethos of the social market economy continues to be widely regarded as legitimate. Moreover, many Germans—not least, the German Constitutional Court—still believe that active pursuit of that social ethos is compatible with reaping the benefits of free markets. Thus, the government is held responsible for providing protection against the pitfalls of life, including the consequences of too fierce competition in free markets, and the consequent government actions are not viewed as attenuating either the individual freedom to participate in markets or the efficiency of those markets. Yet, in practice, interest groups have learned to exploit the vague notion of the "social" in their rent-seeking activities. Hiding their particular interests behind accusations of social injustice or appeals to establish social balance, they have increasingly pressed the government to grant all sorts of advantages to their members. The consequences of their successful endeavors include the present heavy tax burden on the German economy as a whole as well as extensive economic regulations (Kerber and Hartig 1999). Moreover, the old corporatist idea of

"correcting" competitive market outcomes in bilaterally cartelized labor markets by means of central negotiations was soon brought under the social precepts of the social market economy, resulting in the legalization of a major departure from a competitive market regime.

Such a development is to be expected when a constitutional dilemma is preprogrammed, as it was in the German social market economy. In practice, I argue, the pursuit of a social ethos cannot easily be aligned with economic efficiency and robust individual freedom. I examine first the government's social policy interventions. Those, I maintain, may well be legitimate reflections of a fairness norm in a social contract, but their implementation tends to threaten either efficiency or liberty. Next, I discuss the corporative "correction" of the market process. In negotiations between cartelized employer groups and trade unions, the latter usually seek to obtain an income distribution different from the competitive outcome and, at the same time, to protect *employed* workers against layoffs and other job risks. This policy approach has been revived recently in the context of the so-called new corporatism (Giddens 1998; Streeck 1993) and has gained significant political influence after the recent establishment of social democratic governments in many European countries. This method of "socially" correcting free markets, however, also gives rise to a dilemma, one that casts doubt on whether the implementation of such a method has anything to do with the pursuit of social goals.

### **Social Contract, Social Policy, and the Implementation Dilemma**

The ambiguity of the social market economy derives from the very intention "to combine the principle of freedom in the market place with that of social balance" (Müller-Armack 1956, 243, my translation). Evidently the objective is to allow free competition in the markets (subject to legal regulations that exclude, for example, cartelization in the markets for goods and services) but not to accept the result of the competitive market process unless it results in a "social balance." If such a balance does not result from the actions of the competitors, the government should establish it by means of redistribution of income or cartelization of the labor market. Yet what, precisely, does "social balance" mean, and why is it desirable? The fathers of the German economic constitution have been very vague in answering this question. Let us reconsider it in the light of modern social contract theory (see Binmore 1997 and Rawls 1971).

In the abstract, all members of society have certain "entitlement rights" established by the ownership titles that everyone has acquired; these rights can be exchanged, including the right to dispose of one's own labor (Sen 1981). In turn, they determine the material welfare that individuals can potentially enjoy. Individual endowments and abilities vary, as do relative prices in the market place, favoring some more than others. As a result, entitlement rights can differ greatly, and for some members of

society they may sometimes fall short of what is necessary to subsist. Voluntary unilateral transfers can remedy this condition, but history has shown that, leaving aside transfers within families, voluntary transfers have occurred at only modest levels.<sup>1</sup> Certain distributions of entitlement rights may therefore oblige the government to effect a redistribution. This idea, we may conjecture, was the view of the fathers of the social market economy, who were keenly aware of the unemployment and hardship during the Great Depression.

In abstract social contract theory, such a redistribution of entitlement rights can be justified, à la Rawls (1971), by applying the voluntariness criterion not to actual choice behavior but to a hypothetical consent to the binding terms of a social contract. Assume that each member of society were to decide whether or not to agree to the social contract without knowing specifically who will be the future payer and who the future recipient (the “veil of ignorance” assumption). What kind of stipulations in the social contract concerning the conditions of the transfer payments might then be imagined to receive unanimous acceptance? As it turns out, any reasonable answer to this question implies a fairness norm. Such a norm may also be used to determine the meaning of “keeping a social balance”—that is, taking the redistributive measures within the framework of social policy that can be imagined to have gained (fictitiously) unanimous agreement in society.

Let us assume for the moment that general consent has been given to stipulations requiring the government (1) to make transfers to those members of society who can, according to objective criteria, claim to fall short of a minimum level of entitlement rights, perhaps because of illness, loss of employment, or old age;<sup>2</sup> and (2) to require contributions from those who are not needy in order to finance the transfer payments. The effect of these stipulations would be the same as that of a comprehensive insurance association—to which all members of society agree unanimously and participation in which can never be terminated. Notice that, on an entirely privately organized basis, such a comprehensive insurance association would not be feasible. Because of moral hazard problems and the practical difficulties involved in assessing the conditions for the claims, private life, health, pension, and occupational disability insurance schemes cover the risks selectively. It is no accident, therefore, that in Germany, as in all other European countries, an important part of the economic constitution is a compulsory social *insurance* that, for historical reasons, is in most countries operated by the government. Yet even this social insurance is selective and does not cover all life risks, excluding in particular the risks of long-term unemployment, long-term sickness, and

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1. This statement is true even for the extreme cases of great historical famines. As Amartya Sen (1981) has shown, many historical famines have developed because of a dramatic temporary deterioration of the entitlement rights of the poor. Charitable and philanthropic transfers were insufficient to prevent hunger, starvation, and death for millions.

2. Additional criteria for assessing the claims of the needy, such as the “no-fault” nature of the claim or the length of time during which transfers have already been received, may be worth considering and can often be observed in reality. Note that the minimum level of living of the needy is itself subject to general consent within society and thereby determines the size of the transfers.

poverty in youth or old age. To deal with these contingencies, social policy relies in a supplementary way on public assistance in the form of welfare payments.<sup>3</sup>

Hypothetical consent to the preceding stipulations (1) and (2), which I have presupposed, is, of course, a debatable assumption, given the related implementation problems. The criteria for transfer claims can neither be easily made objective nor be kept from manipulation by potential beneficiaries. A state-run, compulsory insurance scheme does not solve these problems, which inhibit private insurance of many of the related risks. Moreover, public assistance in the form of welfare payments practically invites moral hazard. Can the stipulations of a social contract be considered generally agreeable if they are to have such consequences? To put this question into perspective, it is useful to recall how society dealt with all such life risks in history before social policy and the concept of insurance had been conceived.

In those days, the victims of misfortune relied for the most part on solidarity transfers based on family bonds and, to a lesser extent, on solidarity action within neighborhood and religious communities. Unlike participants in a formal insurance scheme, however, the beneficiaries could not simply assert their claims for transfers. Response to such claims rested on custom and on charitable and philanthropic motives. These sources of obligation allowed the transfers to be refused or limited when the people from whom solidarity required action had doubts about whether a need really existed or whether solidarity claims were justified. Such doubts might have been well founded because these people usually had intimate knowledge of the individual's circumstances, and they took into consideration the extent of the recipient's responsibility (if any) for the misfortune, the duration of the transfers, and the use made of them, among other things. At a time when income per capita was much lower than it is today, this institutional arrangement served to limit the individual solidarity burden caused by moral hazard and false claims of actual neediness. On the other hand, of course, it forced people in need to adopt the bitter role of supplicants asking alms of their more fortunate fellows.

With respect to the preservation of human dignity, it is therefore, perhaps, an achievement when society as a whole deals with individual misfortune by means of social insurance and public assistance based on legal claims on the welfare state—at least, behind the "veil of ignorance" such an arrangement may well appeal to many members of society. However, unlike the extended family or the solidarity community, the administrators of social insurance and public assistance cannot rely on personal information and monitoring to curtail the moral hazards. In an anonymous administration, lacking intimate knowledge of personal circumstances, the standardized

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3. At least in Germany, social policy regulations and transfers carried out today go far beyond social insurance and public assistance. For some of the measures, such as youth protection and child allowances, a hypothetical legitimation may be imaginable, but in most cases—including the subsidies paid for housing, education, and private savings of low-income groups—such legitimation is extremely doubtful. The respective interest groups, of course, claim that the concept of the social market economy justifies these measures as well.

bureaucratic assessment procedures can be quite arbitrary and incapable of doing justice to every individual case. Inefficiencies increase, and the extent of moral hazard may become enormous, placing a heavy burden on the citizens who are not in need, notwithstanding the higher income per capita of the modern welfare state.

The practical difficulties of implementing a social contract based on stipulations (1) and (2) might be reduced, though not eliminated, if the welfare bureaucracy were given extensive rights to obtain information about the personal circumstances of all citizens (because all are potential future claimants). Such administrative rights to information about the citizens' private lives, however, would be incompatible with liberal principles. Therefore, an implementation dilemma seems unavoidable. The transition from supplication and receipt of charity to legal claims on the welfare state entails that either the "social balance" attained by social insurance and public assistance is not efficient (and thus not able to prevent moral hazard), or it cannot be combined with liberal ideas about protecting the private sphere of the members of society. The implementation dilemma may be assessed differently in different societies with regard to reaching a hypothetical consensus about a social contract containing the stipulations (1) and (2). In general, despite the cost-driving implementation dilemma, Germans seem to favor the government's conduct of a noninquisitory redistributive social policy.<sup>4</sup> The social market economy was, after all, a concept that originated in the economic tradition of German-speaking people. Costly as it is, the welfare state seems to meet with approval in other European countries as well. In contrast, in the United States the implementation dilemma appears to preclude the reaching of such a general consensus.

### **"Social Partnership," Unemployment, and the Collective Dilemma**

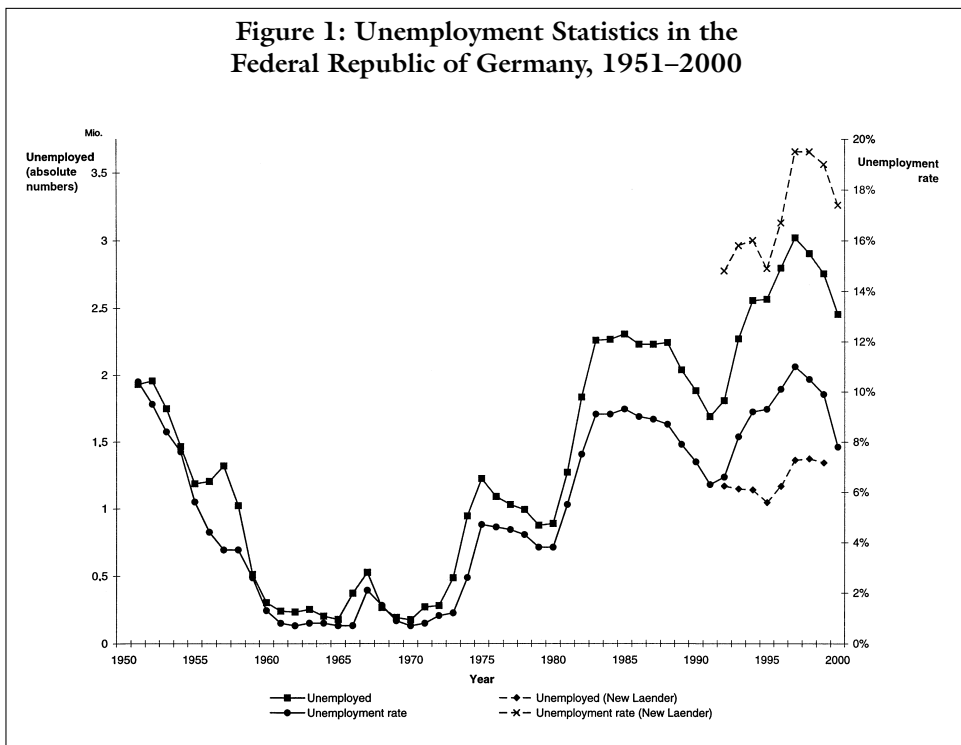
In the 1940s, the mass unemployment experienced during the Great Depression was still a traumatic memory, and it led many thinkers, including some leading liberals (Röpke 1950, Eucken 1952), to consider social problems more closely, especially unemployment. "Our social conscience forbids us to tolerate mass unemployment," wrote Eucken (1952, chap. 9, my translation). As a liberal, however, he argued against Keynesian employment policy, which he regarded as unwise because of its side effects, and against the establishment of a corporatist arrangement for setting wages. Such an arrangement, he argued, would not prevent unemployment, but it would give rise to monopolistic market structures. However, owing to postwar Germany's legal sanctioning of the freedom to form coalitions and the right to autonomy in centralized

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4. In 1998 (the latest year for which data are available in Federal Statistical Office 2000), compulsory social security payments—a kind of earmarked tax—reached a share of roughly 19 percent and taxes a share of 40 percent of gross domestic product (GDP). On top of this high burden, public debt has constantly been growing at an accelerated pace since the German unification. Total public debt as a share of GDP in 1998 was at an unprecedented value of 60 percent.

wage determinations by trade unions and employer associations, there did develop a corporatist order of the sort Eucken opposed. Indeed, this special arrangement appears to have contributed greatly to the willingness of the German trade unions to make their peace with the German economic constitution, even though their socialist position initially led them to oppose the social market economy. The arrangement remains in operation today, and, under the name *social partnership* it has become part of the theory and practice of the contemporary social market economy.

In the context of the peculiar institutional mixture of free competition in the product markets, the welfare-state coverage of the life risks (including those resulting from that competition), *and* the corporatist order of the labor markets, it has proved impossible to prevent the recurrence of mass unemployment (see figure 1). Contrary to what many adherents of the German social partnership believe, its combination with the social policy institutions previously discussed creates an incentive structure that gives rise to a collective dilemma.<sup>5</sup> The centralized wage negotiations, based on a legally enforced bilateral cartelization in the labor markets, guarantee a quasi-monopolistic position to the trade unions, which gives them the ability to legitimate themselves in the eyes of their members by negotiating "social" benefits in the skeleton wage agreements that would be far more limited, if obtainable at all, without the



5. The inability to induce a high rate of economic growth—a *Wirtschaftswunder*—in the New Laender and the disastrous employment effects after unification (see figure 1) are additional indications of the conflicting nature of this combination of institutional arrangements, though they cannot be discussed here in detail.



negotiating monopoly. (In the rhetoric of the trade unions, this power prevents “social havoc” and “discrimination against the employees in the course of economic progress.”) The main goal of trade union strategy, however, has been to increase wage incomes overall and to change the wage structure by means of more than proportional increases of low-wage incomes. (Again, “social” motives are usually cited.)

The problem associated with collective, centralized bargaining between trade unions and employer associations is that although every decision is reached by mutual agreement, this agreement is made by the representatives of the associations and not by the individual parties bound by the wage contract. The majority opinion within the employer associations determines their judgment about the acceptability of an agreement. Experience suggests that this opinion is based on whether the resulting cost increases (direct wages and salaries plus nonwage labor costs) of different grades of labor can be recouped without loss of profitability in the industry. It is doubtful, however, whether the majority opinion, especially under the pressure of actual or potential strike, takes sufficient account of the variance in the profitability of all member firms. Because the member firms are not allowed to pay less than the union rate, firms at the lower end of the profitability distribution are forced to reduce employment or even to go out of business when wages and nonwage labor costs rise. This outcome occurs even where the employees of these firms are willing to work under conditions worse than those specified in the centralized agreement, such workers’ interests having been ignored in their union’s opinion-formation process.

As long as profitably expanding industries and new firms in the economy can absorb the workforce laid off elsewhere, the trade unions are tempted to pursue what has been called an “expansive wage policy.” Following such a policy, trade unions push for contracts that result in large increases of wages and other benefits and that drive up labor costs, consciously accelerating the reduction of employment in the less-profitable sectors and firms despite the effort, migration, and possible retraining required of the employees who lose their jobs. During recent decades, in collective-bargaining rounds, the German labor unions have adopted a strategy of seeking increases of the real wage and other benefits at least equal to the estimated *average* annual gain in labor productivity. Although this strategy has brought about permanent increases in the real income of those employed, German unemployment has been worsening since the 1970s (figure 1). The risk of losing a job and of being unable to find a new, equally attractive one quickly—a risk borne by the individual employee—has increased sharply during the past thirty years. Trade union officials have never acknowledged a connection between the job losses and the wage-and-salary increases or the improved benefits, which drive up nonwage labor costs, in the contracts they have negotiated.<sup>6</sup>

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6. According to the economic research institute of the German Employers’ Association, nonwage labor costs in the industrial sector in Germany in 1995 amounted to an 82 percent addition to the money wages paid—compared to 42 percent in U.S. industry in that year—and they have increased since then (see Institut der Deutschen Wirtschaft 1996, table 148).

In a sense, these officials do not have to accept responsibility for those ill effects of their contracts because in the social market economy the individual unemployment risk is covered by state-run social insurance and public assistance. Here the collective dilemma entailed by the institutional set-up of the social market economy comes starkly into view: the benefits of an expansive wage policy are reaped privately, but its costs are borne by the solidarity community and the taxpayer. Like all voluntary associations, trade unions must justify themselves to their members by providing individual benefits of membership. Under the German economic constitution, with its corporatist order in the labor markets, trade unions can serve their members by using their monopolistic power to negotiate agreements that result in high wage-and-benefit cost increases. Aware that social insurance and public assistance exist, the trade union officials, in defining their strategy, need not—and surely do not—take fully into account the effects of increased labor costs in raising the rate of unemployment.

For union members, themselves potential future victims of unemployment, the negative consequences of such wage-increase agreements are less threatening because of the welfare-state protection they enjoy. Their net wage-and-salary increases are, of course, reduced by increased social security payments and tax increases related to the rising unemployment. However, they share the burden of those increases with people who do not participate in the labor force, and the burden is usually imposed only after a significant delay. Absurdly, such increases are often advanced as a reason for demanding further increases in the next round of wage negotiations.

The continuing growth of the union wage-and-benefits rate (in real terms), on the one hand, and the ongoing increase of unemployment, on the other, signify the operation of socially inappropriate incentives. These incentives arise from the combination of welfare-state institutions and the corporatist order of the labor markets, and they lead straight to a collective dilemma. In the previous section, I diagnosed the incentives encouraging an *individual* exploitation of the German social market economy (moral hazard). Here we are faced with a different form of antisocial incentives: those inviting an indirect *collective* exploitation of the social impetus of the social market economy. As individuals and organizations respond to these incentives, the major objective of the fathers of the German economic constitution—to avoid mass unemployment and its consequent hardships—is reduced to absurdity.

## Conclusion

Any attempt to determine more precisely the meaning of what F. A. Hayek called the “weasel word ‘social’” (1988, chap. 7) comes up against a complex set of problems. The many contradictions that can be identified in the design and actual practice of Germany’s social market economy reflect the interests, ideologies, and institutions prevailing in German society after World War II. The social policy that the fathers of the German economic constitution had in mind can, in principle, be legitimized from the point of view of modern liberal social contract theory. However, the more relevant

question has turned out to be whether the concept of the social market economy can be implemented, and if so, how. The answer to this question depends on the institutional framework within which the *practice* of the welfare state evolves. In Germany, the historical situation in which social policy has operated and still operates has given rise to a practical implementation dilemma associated with familiar individual moral hazard problems.

Besides the welfare-state elements in the concept of the social market economy, a corporatist element has greatly affected the practical implementation of the concept in Germany. This element expresses the old corporatist idea of pressing for “social” corrections of the competitive market outcome—that is, for income redistribution—effected by the operation of bilateral labor-market cartels. Indeed, soon after the establishment of the Federal Republic, the freedom of trade unions and employer associations to form coalitions with the right to autonomy in centralized wage negotiations was sanctioned under constitutional law. The consequence was a cartelization of the labor markets in remarkable coexistence with free competition in the product markets and with a welfare-state public-assistance guarantee. Such an institutional arrangement can be expected to and in fact did produce a different, collective dilemma. In the negotiation process, the trade unions have no incentive to take fully into account the effects of their wage policies on employment. As a result, rapidly increasing real wages and other employee benefits, which drive up labor costs, have been accompanied by increasing unemployment. Contrary to the trade union rhetoric, the current corporatist practice within the tradition of the social market economy does not promote genuine social security but rather exploits its institutional safeguards.

Unlike the Founding Fathers of the United States, the founders of the German economic constitution seem to have been enticed by their social ethos to ignore the dilemmas they would create by laying down in that constitution the commitment for society to provide security from the pitfalls of life to all its members. Although this commitment may well be a constitutional desideratum, in practice it cannot easily be aligned with economic efficiency and robust individual freedom. Whereas the corporatist practice fails to qualify as an implementation of that constitutional desideratum altogether, the redistributive social policy may achieve that goal. In doing so, however, it creates an implementation dilemma that entails high costs—too high, perhaps, to be acceptable in many other societies.

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