Internationale Politikanalyse
International Policy Analysis

Anke Hassel

Reconsidering the Social Contract after the Crisis

Market and State in European Social Democracy

■ Capitalism in the process of radical change: The profound politicial, social and economic transformation taking place in modern societies presents social democracy with the major challenge of redefining the relationship of politics to the market economy. This challenge has been further accentuated by the financial crisis. In a basic policy paper, Anke Hassel analyses the underlying conditions and possibilities for evolving a market model that combines social justice and solidarity with economic dynamism and the modernisation of society. With this publication the Friedrich-Ebert-Stiftung would like to make a contribution to the debate on the relationship between market and state from a social democratic perspective. It will be followed by papers outlining the European and international perspectives of the social democrats.

■ The financial crisis has shown the limits of globalisation and spelled the end of economic liberalisation. Nevertheless, a turn away from liberalisation cannot mean a return to conservative social structures. Instead, it will be necessary to take the modernisation agenda in a direction that constrains liberal markets while allowing space for social development.

■ This will require social inequality to be curbed, both through egalitarian education and social policies and by reducing national, European and international economic imbalances. To do this we will need a new form of cooperation between civil society, the private sector and policy-makers founded on the principle of embedding the market economy firmly in a social and political framework.

SEPTEMBER 2009

FRIEDRICH EBERT STIFTUNG

Content

1 Today's Challenges*

As liberal societies undergo a profound political, social and economic transformation, social democracy faces the major challenge of redefining the relationship of modern politics to the market economy. This challenge has been further accentuated by the financial crisis, which has forced many of those involved to readdress fundamental issues concerning the relationship between market and state. Nevertheless, this challenge would exist even without the crisis, since social and economic structures had already changed radically even before it began.

To state it bluntly, social democracy faces a dilemma. To qualify for the responsibility of government (which in our globalised world means being flexible enough to understand and respond to the requirements of economic and social change), it must forge ahead with modernisation programmes and continue to adapt social institutions to changed conditions. Yet, at the same time it must also respond to the need of the lower middle classes, in particular for greater protection from the harshness of the market. Within the party spectrum, the social democratic tradition has its roots in the struggle of wage-earners for emancipation during the late nineteenth and twentieth centuries. Today it must continue to fulfil this function and tradition in a new context and under changed conditions.

Globalisation and liberalism have led to social dislocation, particularly in the lower half of society. This dislocation and the accompanying economic uncertainty have led traditional social democratic voters to cling to the tried-and-tested forms of the welfare state of the past. They have resisted, for good reasons, modernisation in the form of increasing globalisation and economic liberalisation, fearing that it may threaten the material basis of their existence. This creates a tension between espousing liberalisation if social democracy is to continue to play an active role in politics in a global world and continuing to represent the interests of traditional social democratic voters. This tension was already an issue in the Agenda 2010 and it has reappeared on the political agenda since the onset of the financial crisis.

Reconciling the need for modernisation with policies representing the interests of all citizens was at the centre of the Third Way espoused by the British Labour Party and, in a more moderate form, also by its German and European offshoots in the late 1990s. In practice, the policy was often to take an offensive approach to liberalisation instruments in the hope that by actively engaging with the market mechanisms and proceeding with economic and state liberalisation, benefits would ultimately emerge even for weaker market players – either directly in the form of employment or indirectly via growth. In Britain, where the »first-past-the-post« voting system institutionally perpetuates a two-party system, the Third Way allowed Labour to successfully occupy the centre of the political spectrum. In Continental Europe, by contrast, where governments are elected via proportional representation, the social democrats' modernisation policies regularly produced electoral gains for parliamentary parties at the extreme ends of the political spectrum, as well as competition from socialist parties. Yet even in these countries, the social democrats were forced to admit that modernisation was unavoidable. They recognised that there could be no return to the world dominated by trade union-organised industrial enterprises – for even where these enterprises still exist, corporate and social practice is now a far cry from the practice that still gave meaning to social democratic politics in the 1970s.

Social democracy is therefore now left with no alternative but to come up with answers to legitimate questions about how social justice can be preserved under changed conditions, and it will need to draw the answers from a new political base of like-minded people, alliances and partners. Whether it succeeds or fails will determine the survival of social democracy in the twenty-first century. If it fails, there is a great danger that social-democratic parties will slowly be squeezed out between the socialist periphery and the conservative centre of the political spectrum.

There has been very little effort to address the challenges; indeed, there has not even been a systematic discussion of the issues. Instead, there is an intellectual vacuum with little to fill it.

This applies both to the immediate handling of the financial crisis and to the challenges that lie beyond. The far-reaching measures taken to revitalise the banking sector, to regulate financial markets and to reformulate industrial and trade policies have far-reaching implications both for the relationship between market and state and for the effect of

Prof. Dr. Anke Hassel is Professor of Public Policy at the Hertie School of Governance, Berlin, and currently Senior Visiting Fellow at the European Institute, London School of Economics.

* This paper benefited greatly from the suggestions and comments articulated in two expert workshops as organised by the Friedrich-Ebert-Stiftung. The participants were Matthes Buhbe, Pia Bungarten, Dr. Marius Busemeyer, Dr. Michael Dauderstädt, Prof. Dr. Sebastian Dullien, Cilia Ebert-Libeskind, Prof. Prof. Dr. Hansjörg Herr, Dr. Ernst Hillebrand, Ulrich Hörning, Dr. Christian Kellermann, Prof. Jürgen Kocka, Kristin Linke, Dr. Gero Maaß, Dr. Uwe Optenhögel, Dr. Alfred Pfaller, Christoph Pohlmann, Karl-Heinz Spiegel and Lothar Witte. With this publication, the Friedrich-Ebert-Stiftung aims to encourage a European debate and develop an international position on the future of capitalism from a social democratic perspective.

distribution between states, between citizens and the state, between generations and within society. This applies first and foremost to the issue of government debt. The economic growth of the last thirty years has been accompanied by steadily rising state debt. And as national governments incur massive new debts in the wake of the financial crisis, their fiscal latitude becomes further constrained. Passing on today's problems to future generations is not a sustainable option in the long term.

While the liberalisation of the world economy over the last thirty years has generated enormous growth in many regions, in certain countries it has also produced major social disequilibrium. This disequilibrium has been much more marked in countries that espouse neo-liberalism than in continental Europe. Whether this trend will change once the crisis has been overcome remains to be seen.

In the long term, the dilemma for social democrats to reconcile the need of modernisation and social protection will become more acute. Can politics and society be modernised without economic liberalisation? Should we return to less liberal forms of the market economy? Are there socially balanced forms of liberalisation that would benefit everyone? Is it possible to return to the old tradition of the social market economy? What indeed is the meaning of the social market in a globalised economy? In attempting to answer these questions, old, unresolved problems re-emerge alongside new ones. It became necessary to modernise the »old« social market economy not primarily to remain competitive in global markets but to overcome its inherently conservative features that discriminated against women, foreigners and part-time employees. The issue of limits to liberalisation raised by the financial crisis cannot be equated with the question of what constitutes a modern society. Instead, new responses are required to the economic and social changes engendered by the policy of liberalisation. The Third Way will no longer help us here, given its one-sided emphasis on the positive aspects of liberalisation. Instead, we need to find a new path that goes beyond both liberalisation and a »business as usual« return to the old social market economy.

2 The Financial Crisis

The impact of the financial crisis on both national economies and the world economy has increased pressure on politicians to come up with new conceptual ideas. As we have seen in recent months, unregulated financial markets and inadequate control mechanisms pose a threat of massive global economic destabilisation. This has forced the state to intervene in corporate decision-making and hence to assume responsibility not only for fundamental economic parameters but also for business decisions. Having rejected a role for the state as a macroeconomic player in the Godesberg manifesto in 1959 and having consistently defended this principle against criticism from the Left, German social democracy must now reconsider the relationship between market and state.

Although it is unlikely that the financial crisis will result in across-the-board nationalisation in the long run, it will certainly challenge many of the steps taken in the direction of liberalisation – steps that particularly in the last decade were accepted and supported by European social democrats as necessary modernisation measures. If the comprehensive liberalisation of global financial markets proves to have been a mistake, will anyone still be able to credibly defend the positive effects of the liberalisation of other markets – e.g. liberalisation of the infrastructure, the health and education sectors and the labour market? The radical ideology of neo-liberalism that has dominated the western world and the countries engaged in post-communist transformation over the past twenty years will be toned down. The belief that market failure is the exception and state failure the rule can no longer be justified, albeit without precisely defining the criteria for distinguishing between them. Should the pendulum begin to swing back in the other direction, we will need to start asking what mix of market, regulation and intervention we should strive for.

We thus seem to have reached a turning point in a particular form of liberalisation of the global economy which over the past three decades increasingly decoupled economic and financial dynamics from social structures. The political and ideological victory of the advocates of neo-liberalism in the 1980s and 1990s had led to a systematic suppression of market-constraining regulations and institutions, unleashing a powerful dynamic of economic development. Although this helped to produce high rates of economic growth worldwide, it also massively strengthened the financial sector and the position of investors at the expense of the real economy. Ownership of companies was now primarily not about production or the provision of goods and services but about buying and selling shares, with short-term leaps in share prices that were disproportionate to the added value generated by productivity increases. One particularly radical form of neo-liberal ideology was based on the idea that markets could regulate and stabilise themselves autonomously without any state intervention. Accordingly, the role of governments was reduced to formulating a loose monetary policy. This was all made possible by the industrialisation of the emerging economies, which led to a constant and steady demand for dollars.

At the level of the nation state, property bubbles were mistaken for solutions to the problem of cyclical economic fluctuations. The property market explosion in Britain over the past ten years was heralded by the former Chancellor of the Exchequer and current Prime Minister Gordon Brown as the end of »boom and bust«. In the USA, credit and hence the money supply were artificially inflated to generate consumer demand without most people's real wages increasing. In many small European countries both private households and governments ran up debts with foreign banks.

When the financial bubble burst it revealed the limitations of this economic model and rightly raised fundamental questions not only about the liberal approach to financial markets but about the entire Anglo-American version of economic and social liberalisation of the past four decades. The implications of these questions for the future reform of developed welfare states in modern industrial societies are enormous. They concern the extent and future of globalisation; and they ask what measure of liberalisation is desirable, tolerable or indeed necessary, and hence how social democracy should proceed with modernisation.

3 Limits to Globalisation

The question of where the limits of globalisation lie has arisen earlier and more quickly than globalisation critics expected. It is expressed most clearly in the huge imbalances in world trade. At the global level, the structural debt of developed countries has been financed by the huge trade surpluses of China and other creditor states. While China lived below its means, the Americans financed both their standard of living and their international military activities with foreign money.

Currently, these regional and financial imbalances still exist. But one of the tasks of the new ordering of the world economy occasioned by the financial crisis will be to reduce them, hopefully in a way that will cushion the impact for the economies and currency regimes concerned. The adjustment of exchange rates and the accompanying relative loss in prosperity that this will entail will affect all countries, albeit to different degrees. Creditor states will have to write off part of the money owed them, while debtor countries will have to curb their consumption. As a strongly export-oriented economy with a foreign-trade surplus, Germany is one of the creditor countries that have financed the debt of others. The world economy has now become so closely interconnected that, in open international markets, this process of adjustment is taking place in the sectors where each country has its competitive strengths: in Germany in the car industry, in Britain in the banking sector and in China in the mass production of clothing and toys.

Nevertheless, it is likely (and in terms of restoring regional economic balances also to some extent desirable) that the global division of labour will be reduced without resorting to protectionist measures. As the financial sector shrinks worldwide, manufacturing industry in strongly de-industrialised liberal countries will once again come to play a greater role. Industrial production in China will become more strongly oriented towards the domestic market and the markets of other threshold countries and less towards exporting to the USA. Germany, too, will have to reduce its trade surplus, which will mean job losses in its export-oriented industries. At the same time, although the integrated value chains of global enterprises will continue to exploit location advantages worldwide, currency adjustments and currency uncertainties will reduce the opportunities for »arbitrage«. While technological advances have led to a huge increase in mobility, increasing use of the Internet will make some of this physical mobility unnecessary. In short, globalisation of production and financial markets will lose some of its impetus even if governments do not actively resort to protectionist measures but simply seek to stabilise their economic locations in the interests of employees.

The financial crisis has exposed the extreme vulnerability of open and highly specialised national economies to economic fluctuations. The increase in speculative bubbles over the past two decades and the tremendous effect of these bubbles on the real economy cast doubt on the sustainability of unbalanced growth.

With the slowdown of the globalisation process there is a danger in the short-term that states will adopt protectionist measures and compete with each other in providing ever greater government grants to shore up their national industries. In the global balancing act that we now face, the greatest challenge will be to strike a balance between national efforts to overcome the crisis in the interest of saving jobs and the effects of reducing global imbalances. The paradox is that if governments use the instruments at their disposal to protect their national industries and financial locations in the long term, this will tend to work against a coordinated response to the crisis. The governments of consumption-dependent economies emphasise the demand side more strongly than those of countries with heavily export-oriented industries, the latter tending to favour direct intervention. These diverging interests are already apparent in the inability of European governments to agree on a comprehensive common strategy. Such a strategy would tie the hands of national governments too strongly and would not reflect their national interests, at least not fully. Yet in the interests of maintaining an open global economy, the EU as a whole should be making a greater effort to find a strategic response to economic imbalances both in the euro zone and in Central and Eastern Europe.

In the interests of stabilising world trade, part of such a response would be for countries with balance of payments surpluses to assume responsibility for the disequilibrium that these surpluses cause. This would not necessarily mean reducing exports but rather make an active contribution to restoring the balance in the form of private or public demand for foreign products. In other words, if globalisation is not radically curtailed, countries with a trade surplus will have to convert more of their surplus into demand for foreign products or else use it to support endangered debtor countries.

In the long-term, a slowdown in the globalisation process may fundamentally call into question the German export model. Surplus capacity in the German automobile industry has already become unacceptable on account of climate change. In the future, the role of mechanical engineering in global industrialisation will also decline in importance. While highly efficient specialised industries will continue to play an important role for the German economy as an industrial location, their role for the German domestic economy will diminish in the global division of labour.

4 The End of Economic Liberalisation

The last three decades have been decades of economic liberalisation. Since the late 1970s in western OECD countries and from the early 1990s in post-socialist countries, deregulation, liberalisation and privatisation came to be accepted and actively supported by the majority of political players as fundamental components of a worldwide growth strategy. From the 1990s, this was also true for the majority of social democratic parties. Led by New Labour and driven by the decline of macroeconomic demand-side policies, the need for an intelligent supply-side policy stood at the forefront of political concepts. Received opinion was that such a policy would improve economic conditions for the private sector, make public administration more efficient and activate labour markets.

Germany, too, pursued strategies of privatising major state-owned enterprises and globalising and deregulating Germany's financial centre and its corporate management. Legislation to promote capital markets globalised Germany's financial location and brought its regulation into line with US standards. The abolition of capital gains tax made possible the break-up of corporate networks, and the accounting practices of major companies were adjusted to international standards. German railways and the German postal system were restructured and given new private legal forms, though they have not yet actually been privatised.

Liberalisation of the labour market and the welfare state followed a decade later. The challenges of reunification were met for the most part using traditional instruments of the conservative welfare state. These included public work schemes, a high level of long-term unemployment in eastern Germany with relatively good benefits for the unemployed, and early retirement schemes. However, this traditional labour market set-aside policy only aggravated the problems, since it was associated with a high level of inactivity and high costs.

The first major step in the direction of liberalisation was taken by the coalition of the SPD and the Green Party (known as the Red-Green coalition), particularly during its second term in office after 2002. Labour markets were opened to low-wage and temporary work, transfer payments were reduced and labour practices began to resemble those of the countries espousing economic liberalism. At the same time, a central aim of Red-Green labour policy was getting the long-term unemployed back into work.

Liberalisation of the labour market yielded both winners and losers. One of its main achievements was to put a stop to the practice of taking people out of regular employment by means of early retirement, job creation schemes and employment promotion companies and to send the important message that structural change did not just pose the threat of job losses but also offered new chances. In the past five years, the long-term unemployed in particular have been given many new opportunities to re-enter the labour market that they previously did not have.

At the same time liberalisation has helped to produce social inequality and income uncertainty. The market is blind where redistribution of wealth is concerned. The liberalisation of collective bargaining policy leads to wage differentials, while the integration of unskilled long-term unemployed in the labour market leads to very low incomes and the legalisation of temporary work to insecure employment conditions. The partial privatisation of regional rail networks and the restructuring of Deutsche Bahn have brought about massive reductions in wages and salaries in the transport sector. At the same time, liberal management practices have not only become possible but been positively welcomed, while directors' salaries have risen enormously. In the name of economic dynamism, the principles of social cohesion previously espoused by both of Germany's mainstream political parties have been consigned to the background.

The financial crisis has enabled, and indeed forced, all political players to adopt new positions vis-à-vis further social reform. And it has added issues to the political agenda associated with the liberal variant of the market economy, such as economic uncertainty and social inequality.

5 The Scandinavian Model?

The end of economic liberalisation also means taking a critical look at the Third Way – a variant of modern social democracy that lies between the state and the market. In Britain, the reality of a primarily liberal welfare state with few social democratic traits has led to disillusionment. On the Continent, where New Labour was never really a viable option for parties wishing to be elected, pressure from Leftist parties and criticism of the liberal variant of social democracy is becoming stronger. What remains is a major vacuum. The Third Way was an attempt to actively engage with the new economic policy of the 1990s; yet in many European countries this attempt was never even made.

Some experience, however, already exists, in addition to New Labour's, of introducing liberalisation while maintaining the social equilibrium – namely, the Scandinavian model. Particularly in recent years, as the downside of increasing social inequality began to become visible in Britain, New Labour itself turned to the Scandinavian model. In the EU too, it was Scandinavia that sparked the debate about *flexicurity*. In many countries, however, *flexicurity* has primarily been interpreted as a call for deregulation and further liberalisation, while the important component on the other side of the equation – social security – has fallen victim to budget cuts and the pursuit of labour market activation.

Scandinavia has shown that increasing income inequality and income uncertainty have less to do with globalisation and the need for a low-wage sector than with taking liberalisation forward. These countries have engaged in trade union-steered collective bargaining, pursued an activating employment policy and made major and equally distributed investments in education; they have a well-developed public sector for social services, a high level of employment and strong trade unions; and they have achieved a form of modern market economy in globalisation that combines social equilibrium and competitiveness.

To the extent that public investment can and indeed must now be used to achieve economic stabilisation and that trade unions are needed to help overcome the crisis, social democrats and trade unions in Germany will have a new opportunity to readdress thorny unresolved issues together with employers and thereby promote a social democratic agenda geared towards the Scandinavian model. Protecting skilled employees in a phase of economic destabilisation by introducing short-time working and offering new possibilities for further qualification are certainly two elements in such an approach. The Agenda 2010 has already taken a first step in a Scandinavian direction by raising the employment rate and integrating many long-term unemployed in the labour market.

In tackling the current crisis, policymakers should try to ensure that public investment in education, vocational training and social services follows the Scandinavian model of high employment, good childcare, little social inequality and high educational standards. The long overdue modernisation of the education system at all levels – pre-school, primary, secondary and tertiary – can only be accomplished via macroeconomic stabilisation measures. With regard to training, care should be taken to ensure that companies continue to invest in basic vocational training. In addition, investment in education should also include the modernisation and upgrading of school and company-based training concepts, and closer links should be established between company training and tertiary education.

The need for comprehensive economic stabilisation programmes and the turn away from liberal capitalism offer an opportunity to carry out reforms that follow an activating but social democratic market model in the Scandinavian sense. A return to instruments used in the past need not be a mistake if it is combined with a modernisation of the German model and is able to boost competitiveness and to curb economic uncertainty and inequality.

Although the Scandinavian model may be regarded as a desirable general direction, the possibilities for simply transferring it to Germany are limited. Differences in historical paradigms, the structure of the welfare state and the ability of the taxation system to finance a large public sector are simply too great for that. In any case, the Scandinavian countries themselves are coming under increasing pressure. The financial crisis has raised the level of state debt everywhere, so that the industrialised countries will come under enormous fiscal pressure in the medium term.

6 Europe as a Driver of Economic Liberalisation

The European Union, as a political and economic integration project, is affected by the financial crisis in a special way. Although the core of European identity is based on the European social model of a well developed welfare state and on what, by world standards, are relatively low levels of social inequality and high living and social standards, the deepening of European integration over the past twenty years has followed a path of economic liberalism. Beginning with the introduction of the single European market in the mid-1980s, European integration has been characterised largely by free trade and the free movement of capital and the establishment of standard conditions of competition in EU member-states. Economic and monetary union, limits on state aid, and pressure to make national protection of certain industries, codetermination and employee rights uniform EU-wide have tended to result in a dismantling of social protection mechanisms. The EU's eastward enlargement brought the post-socialist transformation countries of Europe – most of which were liberally oriented – into the community of states, and these tended to view the legacy of an extensive welfare state as a burden on their struggling economies rather than as a benefit.

European social and employment policy has done little to counter this trend. Although (in keeping with Jacques Delors' vision of an internal market with a social dimension) the rhetoric of the Lisbon Agenda bracketed economic dynamism and social cohesion together, in practice EU employment policy has followed the liberal growth model of New Labour, which seeks to achieve economic dynamism by stimulating and activating the labour market, raising employment quotas and investing more in education and research. Recent rulings of the European Court have fundamentally questioned the legitimacy of institutions of nation-states concerned with protecting trade unions and labour regulation. As a result, the fundament of European welfare states threatens to erode.

The European context of economic liberalism is a further obstacle to social democratic renewal. While the citizens of the EU value the security offered by the welfare state that was built on the foundations of the European social model, the EU's market integration often goes in the direction of economic liberalism. This contradiction undermines popular approval for the European project.

What is more, Europe has failed to come up with a coordinated strategy to tackle the crisis. Each nation-state's economic stabilisation programmes have followed different approaches, each aiming to protect its own economic base. National responses to the crisis are putting the principles of the economic and monetary union to the test – particularly with regard to such issues as how much debt governments can be allowed to incur, how much state aid is permissible and the need for a European financial supervisory authority – without offering an alternative form of political coordination. The need for European coordination has become more pressing than the willingness of EU member-states to assume economic responsibility for each other.

7 Social Democracy and the Social Market Economy

The social market economy is the German variant of a liberal market economy. As we know, neither the term nor the concept have much to do with the social dimension of a market economy. It was a term coined by German ordo-liberal economists to win political legitimacy and justification for the establishment of liberal markets in the capitalism-critical climate of post-war Germany. Today, it is used in the political debate to denote a concept that expressly recognises the limits of the market and thus defines the relationship between market and state as a state of affairs, whereby liberal markets are embedded in a fundamental social order. While the economy functions via markets, the state is responsible for regulating those markets and for shaping the underlying social order. Defined in this way, the term social market economy receives widespread approval from both the entire spectrum of political parties and the general public, since – at least superficially – it emphasises the need for a welfare state.

If one takes the term out of its political context and applies it empirically to the German market economy, it describes – in a similar way as terms like the German model or Rhenish capitalism – the special features of the non-liberal form of German capitalism, which is characterised primarily by a strongly organised civil society and an extensive welfare state. Unlike the liberal countries, in which the organisation of civil society is decentralised and takes the form of local welfare associations and in which the welfare state is also organised along liberal principles, both trade unions and employers and other economic and political players such as welfare and industrial federations are highly organised in Germany. In the past, this strong civil society has replaced market mechanisms with other forms of coordination, as evidenced, for example, by the regulation of wages via collective bargaining. The welfare state brings together conservative, status-oriented principles and a far-reaching responsibility of the state for its citizens in the form of a social safety net.

It would, however, be wrong to believe that the regulation of markets, in particular of financial markets, is an inherent part of the institutions of the social market economy and that it has therefore protected us from the financial bubble. There are several reasons why this did not happen. First, neither the German social market economy nor the existing German banking sector regulators were able to stop German credit institutions from participating in the global finance market in a rather Anglo-American fashion. Second, it was not able to counter either the fast increase of German managers' salaries or the shareholder value orientation of major German companies. Despite trade union representation on the supervisory boards of large German companies, the salaries of these companies' directors have followed American practices. Third, the German social market economy has not been any less affected by the financial crisis than the economies of other countries. Fourth, the social market economy has in itself not curbed liberalisation but, on the contrary, appeals have been made in its name for even greater liberalisation. Fifth, the social market economy also faces the fundamental challenge of reconciling globalisation, deindustrialisation and preservation of the welfare state.

Therefore if we are to orient the market economy to the needs of society – and not the other way round – the term social market economy remains of fundamental significance, for it has the power to appeal to broad political circles and to harness public opinion beyond social democracy to propagate the importance of preserving social security, of renewing the European social model and of a just distribution of wealth. Given the continuing popularity of this concept in the German political public sphere, it would seem to make little sense to mobilise political forces against it or to propagate a counter-concept in the political discourse.

Nevertheless, beyond pointing the way in a general direction, the concept is not a roadmap for adapting the social market economy (or its German model) to the new economic and social situation following the financial crisis or for meeting the challenges of globalisation or the service-based economy. The market economy must once again become embedded in the social order; this includes adapting to modern society and the knowledge economy, curbing social inequality and introducing new forms of monitoring business activity. However, the concept of the social market economy provides no clues as to how this should happen or what the underlying principles should be.

8 Modern Society

Social realities at the end of the period of economic liberalisation are quite different from what they were when it began, and are at least in part the result of that liberalisation. At the same time, a process of modernisation has been going on in society since the late 1960s that is independent of political and economic developments.

In fact, few things have changed the world of work in Germany so much over the last thirty years as the pluralisation of the labour market and the redefinition of the family. The key development here has been the entry of women into all fields of work, which has radically changed their role both in the labour market and in the family. Nowadays, gender equality at schools and universities is rightly taken for granted. Yet the promise of gender equality has still to be fully realised, as wage inequality and the much greater proportion of mothers to fathers in part-time work testifies, as does the relatively small number of women holding top positions.

The reason for this lies in the discrepancy between the abstract assertion of gender equality and the practicalities of family life, the labour market and social policy, which is only just beginning to address the needs of modern families. Not for nothing does comparative literature label the German welfare state a conservative one based on the traditional allocation of roles in the family which favours the single breadwinner model. While it is now possible for a woman with school-aged children to become a minister, she can only do so under very specific conditions. In reality, only very few families manage an equal division of labour between fathers and mothers – primarily because the arrangements of the German welfare state do not tune to their needs. The joint taxation of married couples, half-day schools as the norm, the lack of day-care for small children and employers who are not family-friendly continue to deny families the flexibility that working parents require. As a compromise, many highly qualified mothers still end up in part-time jobs with no chance of career advancement.

In fact, women's increasing role in the work force is both a cause and a consequence of the liberalisation and employment activation policy of recent years, which has departed from some aspects of the conservative model. Women receiving social security (Hartz IV) are now expected to work, the surviving dependant's pension has been cut, and alimony payments have been drastically reduced; and while the period of entitlement to parental benefit has been cut back to a year, primary school hours have become more reliable and there are now more all-day schools. But there is still a long way to go. Women are now expected to do more to support themselves but the conditions for doing so are not optimal. Too many couples still have to decide when the first child is born, who will be the main breadwinner in the long term, and there are too few mothers who end up in this position. In the event of divorce, women who have stayed at home to raise families come off particularly badly under the new divorce laws.

The inequalities and tensions in the life plans of young families will continue to drive forward the modernisation of the welfare state. Liberalisation policies – such as getting single mothers back into the labour market, the new divorce and surviving dependents laws and the new family policy – will continue to exert pressure on the way companies and labour markets operate. In other words, some aspects of modernisation and liberalisation are now so much part of modern society that they will not be reversed even in the »post-liberalisation« era. The rejection of economic liberalisation does not spell a return to conservative and traditional social structures but rather the continuation of a modernisation agenda, which, while curbing liberal markets, leaves room for social development.

9 Curbing Social Inequality

Peter Mandelson, one of the founders of the Third Way, said in the early stages of the New Labour government that the new British social democracy was »intensely relaxed about people becoming filthy rich as long as they pay their taxes«. Today, this policy is seen as increasingly problematic for a number of reasons. Not only are the »filthy rich« to a great degree responsible for the global economy now facing the deepest recession since the Great Depression of the 1930s, but one of the main reasons why they have become so wealthy is that they pay much less in taxes than the rich previously did. As a result of global pressures, top tax rates were continually reduced and international tax havens were actively created and supported by the British Labour government. Parallel to this, the incomes of low-earners stagnated as they were forced to compete for jobs with people in the newly industrialising countries. The proportion of GDP accounted for by wage income is now at an historic low.

The result has been an enormous increase in social inequality over the past two decades, particularly in the liberal and post-socialist transformation countries. In the USA, the effects of this were cushioned by a policy of cheap credit and the promise of permanently rising property prices. The financial crisis places a big question mark next to this policy, although it has yet to be seen what impact the economic stabilisation packages will have on the distribution of wealth. Income distribution is important, contrary to what Peter Mandelson might think.

In the political debate, the just distribution of wealth is often set against equality of opportunity. The argument goes that if everyone has equal opportunities for social advancement, unequal income distribution poses more of an incentive than a danger. In fact, the just distribution of wealth and equality of opportunity are closely linked, for social mobility is actually greatest in the most egalitarian societies. Scandinavia offers many more opportunities for social mobility than liberal, unequal societies do. Hence, equality of opportunity through just distribution is worth fighting for.

We also know that social inequality correlates with a whole series of other social phenomena: countries with a high level of social inequality are also the countries with large prison populations, lower life expectancy and worse education systems.

Probably one of the greatest flaws in the reasoning of the Third Way was to confuse the issue of social inequality with the classic issue of combating poverty. In a socially homogeneous society, the decoupling of managers' salaries from the level of average wages as experienced in recent years would not be possible. The idea that poverty could be fought by creating extreme wealth – the dream of the Third Way – could not be realised in reality. Over the past three decades, the liberalisation policies of Margaret Thatcher and Tony Blair have made Britain one of the most unequal countries in the OECD. And in terms of the level of directors' salaries, Germany now occupies second place in the EU. The reform of the German system of unemployment and social security benefits and the lack of a minimum wage have led to a radical reduction in wages in certain sectors.

To curb social inequality we must think systematically about a whole range of equality-oriented measures – from education and family policy to equal opportunities. In particular, the current opportunity could be used to persuade employers to return to the German tradition of collective bargaining, which has declined considerably in the past twenty years, and to give works councils and trade unions a more active role in the new fields of further education and lifelong learning. These measures would send important signals to employees about income security and continuing qualification.

10 New Forms of Corporate Governance

Even Jack Welch, the former CEO of GE and as such the founder of the shareholder value approach, now claims that the one-sided emphasis on short-term returns and shareholder value is a »stupid idea« (*Financial Times,* 13.03.2009). Instead, he believes, shareholder value should be the result, not the strategy, and short-term profits should be linked to a long-term increase in the value of a company. For European economic policymakers, such admissions confirm the value of traditional company management, which has increasingly had to defend itself against the shareholder value movement proclaimed by none other than Jack Welch in 1981.

Questions must now be asked about the role of managers and management practices. One of the hallmarks of modernisation and liberalisation was the advent of the professional manager. Whereas in the past, key decisions about corporate and sectoral development were made by experts and professionals, the wave of modernisation allowed managers – in later phases financial managers – to gain the upper hand. Liberalisation went hand in hand with the rise of management consultants and directors who understood a lot about figures but little about a company's actual business. In other words, the managing directors of major German companies were no longer engineers but business graduates trained in finance. Corporate finance and financial returns became more important than the actual products. In the wake of the crisis, the injection of large sums of public money in a bid to save jobs has resulted in a renewed focus on market share rather than on obtaining high returns for shareholders, and the role of managers has hence been undermined. Government policy is now determined principally by its impact on the labour market, while for companies and for the shaping of markets, shareholder returns are a secondary consideration.

For all that, the end of shareholder value still does not solve the problem of control or future corporate strategy, even if there are signs of a greater degree of corporate ethical commitment. Instead, new ways need to be found of controlling global firms whose sales exceed the GDP of many countries. So far, neither liberal nor non-liberal countries have been able to come up with suitable answers.

With the end of shareholder value, modern companies are rediscovering stakeholder concepts. Discussions about the social and political responsibility of companies under the heading of *Corporate Social Responsibility* (CSR) and debates about sustainability, companies and human rights, corporate responsibility for supply chains etc. all point in the direction of increased corporate responsibility, accountability and transparency. The right of civil society to information about and control over corporate behaviour must be strengthened. The German practice of employee co-determination is a good starting point for strengthening stakeholder management in German companies. It should be supplemented by greater involvement of other civil society players, including a stronger demand for transparency and a corporate obligation to provide information to stakeholders with regard to social and environmental standards.

11 High-quality Services

There is currently a major discrepancy in the German economic model between the great success of high-quality industrial products in global markets and the chronically underfinanced and hence lower-quality domestic service sectors. This applies particularly to social services and education. These sectors are not only an important engine for employment in an increasingly de-industrialised economy but also a factor underpinning further development of the German industry's comparative advantages. In recent years, the majority of new jobs have been created in the service sector, yet the salaries paid and levels of qualification in this sector are well below those in industry. Except for the health sector, spending in Germany on social services, education and research is well below that of the USA and in many cases below the OECD average.

In the interests of human capital formation, it will be important in the long term to guarantee high-quality education and social services, and for this a much higher level of investment will be required, both public and private. The state will have a key role, for example in using its power to reduce costs in personnel-intensive service sectors mainly by reducing social insurance contributions. As the main provider of education, the state can also use financial and other incentives to encourage private investment in education and social services.

The continuing transformation of the German economy from an industry-based export economy to an integrated, more service-oriented one will require a quality offensive in the service sectors. This will entail a new, more positive evaluation of the people-related services provided by the caring professions and by education. Quality standards must be developed and funding found to achieve them. The financial crisis offers an opportunity to step up investment in this sphere, even if in the medium term budget consolidation will mean that much of that investment will have to be private.

12 Political Alliances

Political support for re-embedding the market economy can come from three sources: from the political demand for more social equality and for greater economic security for a broad middle class; from a renewal of the social partnership; and from a new understanding and new recognition of corporate responsibility for social prosperity. In the interests of a new social contract, these three sources can and should be tapped.

While the losers of both liberalisation and the financial crisis are unskilled workers and people excluded from the labour market, in the past the political alliance supporting the welfare state came from a coalition within the middle class. Comprehensive welfare states not only care for the poor but also provide benefits to the majority of voters. Therefore, the middle-class electorate will only be prepared to go on supporting the welfare state if it stands to benefit from doing so. This political support concerns especially infrastructure benefits in education and health, in childcare and in care of the elderly.

A social democratic policy of renewal must therefore address middle-class concerns about employment prospects, the education of their children and their social and economic security. Here it is largely eduation and employment prospects that shape perceptions of security. Education is hence highly relevant as a source of security for the unskilled but also for those with a medium level of education. Even today, almost sixty percent of a cohort go on to do some kind of apprenticeship or in-company training when they leave school. A policy of re-embedding the social market economy should therefore address the security concerns of precisely this social group. This is also the group that needs to be taken into account in handling the financial crisis and the job losses involved in company restructuring. In formulating policies to tackle the crisis, social democrats should keep the interests of the mid-level educated middle-class electorate in mind.

Above and beyond this, the development of the European welfare state relied to a large extent in the past on the regulatory power of employers' and employees' organisations. The self-regulation of labour markets via collective bargaining led in the countries where it functioned well – notably in Scandinavia – to smaller income inequalities than in the countries espousing economic liberalism. Trade unions and employers' associations were key players in the organisation of the vocational training system and important pillars in the process of economic restructuring. Works councils were the hinges that held economic restructuring, qualification of the workforce and socially acceptable employment conditions together. Today, however, the German trade unions, especially in large parts of the services sector, have lost much of their former influence as well as their members.

The relationship between policymakers and social partners should be reconsidered. Trade unions should be encouraged to modernise and to adapt themselves to the new employment conditions in a service economy, while policymakers should support their social partners during this process. Labour market regulation and job protection should be considered from the perspective of new fields of employment and no longer exclusively from that of export-oriented industries. Measures to combat low wages and poor working conditions in the private service sector could provide the starting point for launching a badly needed quality offensive. New civil society players and organisations in areas like development aid and environmental protection should receive active support and be involved in shaping strategy.

Finally, in a broader sense, companies are also partners in developing a new sense of responsibility towards society. Major German groups are among the most globalised companies in the world. They therefore not only have a major influence on the value chain worldwide, but at home too are increasingly involved in a process of examining how social expectations can be met in practice. This applies not only to companies with a reputation for taking social responsibility or for companies whose future, following the financial crisis, depends on political decisions. Rather, for many companies, their role as »corporate citizens« is a central part of their business strategy. At the same time it is companies and their managers who have suffered the greatest loss of credibility as a result of the crisis.

What role companies play in Germany's future economic model depends in no little measure on how they define their political and social responsibility in the wake of the crisis. Policymakers can use new »corporate responsibility strategies« for their own ends, formulating expectations about corporate behaviour with respect to issues such as training, consumer protection and relocations without seeking to engage in confrontation. Companies can be made responsible for the employability of their employees, as well as for the performance of school-leavers in the communities in which they invest. And they can be subjected to critical questioning about issues like the compatibility of low-wage policies with the values of fairness and quality.

The task of overcoming the financial crisis offers a chance to use the newly mobilised elite consensus to redefine the social contract between civil society, the private sector and policymakers. This discussion, which must include all stakeholders – civil society, trade unions, employers and policymakers – should recognise the new social and economic realities and proceed from the principle of a strong social and political embedding of the market economy. Specific political responses, such as a modern family and education policy, instruments for a fairer distribution of wealth or new forms of corporate governance have yet to emerge. It would be naive to believe that these are easy to formulate or implement. Better education and childcare alone do not constitute a strategy for implementing badly needed modernisation and social justice. On the contrary, the dialogue about the future modernisation of society is far from concluded. It is only just beginning.

Imprint
Friedrich-Ebert-Stiftung
International Policy Analysis
Division for International Dialogue
D-10785 Berlin

www.fes.de/ipa
E-Mail: info.ipa@fes.de

ISBN 978-3-86872-155-3

Orders
Friedrich-Ebert-Stiftung
International Policy Analysis
Nora Neye
D-10785 Berlin

E-Mail: info.ipa@fes.de
Fax: +49 (30) 2 69 35-92 48

All texts are available online:
www.fes.de/ipa