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The Social Market Economy

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1 INTRODUCTION

The most hopeful political development of recent years is revival of belief in the market system. It has become worldwide, uniting rich and poor, capitalist and socialist countries in a common language and the beginnings of a common practice. In Russia, China, and Eastern Europe, the monoliths of state socialism have started to crumble; in the West the army of officials is in retreat. New Vistas of freedom and peace have opened up as the world starts to converge on the ideals of political and economic liberty.

This global turnabout has already had an immense effect on the thinking of the Left. But there is a world of difference between "coming to terms with" market mechanisms or accepting their use where "appropriate", and commitment to market economy as a social institution. The use of the phrase "social market economy" signifies a choice in favour of market economy. It means that we turn to the market as a first resort and the government as a last resort, not the other way round. It means that our first instinct is to use the market, not to override it; and that we are not afraid to apply the logic of this to matters of thought, expression and behaviour, which most governments, not least Mrs Thatcher's, have an incurable urge to control.

Having said this, there remains a substantial role for government. Adding the word "social" to "market economy" is not just a political flourish. Its object is to draw attention to the elements of statesmanship and design necessary to sustain a market order. Market exchange may have developed spontaneously. But the market system is not a culmination of spontaneous social evolution, as Hayek believes. Despite its powerful intellectual supports, and practical achievements, it remains a fragile institution, not much loved; the Utopia of some intellectuals, but the villain of others; feared by most producers, taken for granted by most consumers. At all stages its relationship with the state has been crucial for its development. The state has encouraged it, but also shackled and distorted it; has protected it, and protected people from it.

Those who value the market as an institution must be concerned to keep its support system in good repair. The state's role is essentially threefold: (a) to create and maintain an appropriate legal framework for market exchange; (b) to limit and supplement the market where necessary; and (c) to ensure that the market is politically acceptable. A social market economy is, above all, one which is embedded in social arrangements regarded as "fair". These matters will form the main topic of this essay. But before developing the argument, a historical retrospect is in order.

2 RETREAT AND REVIVAL OF THE MARKET

History never repeats itself. But there may be long cycles in attitudes towards states and markets. In 1922, the economist Hubert Henderson wrote:

> When a century and a half ago, the foundations were being laid ... of systematic economic theory, the public attention was much occupied ... with the failings of Governments. The keynote of the economists' conclusions was that Governments were doing immense mischief by meddling with a great many matters, which they would have done better to leave alone ... Let Governments preserve law and order; and leave the economic sphere alone... An ideal of perfect competition became an idol to which much human flesh and blood were sacrificed.[1]

By the 1870s the pendulum had started to swing the other way, and the "age of collectivism" had begun. Existing economic arrangements were castigated for failing (a) to shift the poverty of a large minority of the population; (b) to protect or compensate the victims of change; (c) to provide regularity of employment; (d) to protect domestic industries against "unfair" foreign competition; (e) to prevent the rise of monopoly power; (f) to provide adequate standards of education and health care.

Collectivism came in both mild and virulent forms. Social reformers - the advanced liberals and social democrats of that time - wanted to redistribute wealth and income, provide compulsory insurance against unemployment, sickness, and old age, and extend public provision. They started the Welfare State before the first world war. Although they understood the need to make the economy more "social", they had little specific appreciation of the market as a social institution. For socialists, Adam Smith's "invisible hand" was a recipe for anarchy and the exploitation of workers by capitalists. Their remedy for both (at least in the Fabian version) was public ownership of the instruments of production, which was itself seen as redistributory, and making for production according to need rather than profit. By redefining freedom as power ("positive" freedom), collectivists of both persuasions were able to claim, contrary to historical experience, that freedom was expanded by increasing rather than reducing state power. We will return to this confusion in Section Five.

The potency which these collectivist criticisms acquired can be explained by a number of background factors. The most obvious was the growth of democracy which brought the "social question" into the centre of politics. For the first time in history, a majority of the electors consisted of the propertyless, with party competition geared to winning their support. The second factor was the rise of the social sciences. The promise here was that "collective" knowledge and intelligence could be brought to bear on social and economic problems, the contrast being with the "anarchy" of the market. A third factor was a growing confidence in government. Governments, it was assumed, could be relied upon to act more wisely than in Adam Smith's day. The civil service had greatly improved in knowledge, capacity, and integrity. Governments were more accountable to the people, less to "vested interests", than they had been in the 18th century. Fourth, there was the growth of social conscience of the better-off. Whereas previously the misfortunes of the poor tended to be blamed on their character defects (eg., drink caused poverty), now they tended to be blamed on a bad environment (poverty causes drink). Improvements in social arrangements - particularly in education and health-care - were the key to improved characters and, hence, life-chances. This fitted the mood of late Victorian evangelicalism. Fifth, there was the problem of unemployment, widely identified as the most costly example of "market failure". Mass unemployment was often linked to a sixth factor – the replacement of competition by private monopoly in many sectors, which seemed to open a wide field for government regulation, or even public ownership. The era of producer- group politics seemed to have arrived, giving government a much greater role as guardian of the "public interest". Finally, we must not underestimate the importance of the two world wars and the attraction of the war model to many on both right and left: a unity of purpose underwritten by high rates of taxes, "fair shares", authoritative allocation of resources dictated by social needs, and promises of a better life for the poor. If the government could commandeer resources for producing munitions, why not houses, hospitals, schools?

Twentieth century collectivism established itself in a variety of forms, ranging from the totalitarian, centrally-planned economies of Soviet Russia and Nazi Germany, to the milder forms favoured by the democracies. The common features of democratic collectivism were: (a) the public ownership of "basic industries" (mainly, but not exclusively, public utilities); (b) a great extension of non-market (government) provision of services like education, health, and housing; (c) an indifference to competition, exemplified by high levels of protection and encouragement of concentration of production in large units and centralised wage bargaining as facilitating "planning" of production and incomes; (d) a severe curtailment of international capital markets; (e) the use (particularly in Britain) of discretionary fiscal policy to "balance" the economy at full employment.

The overall effect of these measures was to limit the scope of "market economy" and to regulate it more tightly and "correct" its malfunctions more actively. Indeed, the phrase "market economy" dropped out of use. The political debate was between defenders of "free" or "private" enterprise and "the profit motive" and those who wanted more public ownership and more planning. There was some liberalisation in the 1950s, when governments of the right were generally in power, but the collectivist mindset remained in place, and was strengthened in the 1960s when planning for growth and incomes policy were added to the collectivist repertoire. The strongest reaction against democratic collectivism came from those who had experienced, or were connected by background with its totalitarian forms. Friedrich Hayek's *The Road to Serfdom* was published in 1944 and followed by his more profound *Constitution of Liberty* in I960. More important in the present context was the German concept of the "social market economy" which was born in the rubble of the Third Reich. This marked an explicit revival of the market philosophy; but also an understanding of the need to create secure social foundations for market exchange.

The social market economy was seen as a means of dispersing economic and political power. Ludwig Erhard, one of its architects, who later presided over Germany's "economic miracle", attributed the collapse of the Weimar Republic not just to political events, but to its "impossible economic system, which was a fateful mixture of socialism, cartellization, and old-fashioned capitalism". [2] What was distinctive about the German conception was the close attention given to its legal and social foundations; "deproletarianisation" was as important as decentralisation. The social market was adopted as an organising principle by the CDU (Christian Democrats) in 1949, and was subsequently endorsed by the SPD (Social Democrats) in 1959.

The main features of the German model were as follows:

Competition. One way the social market theorists aimed to keep the market social was by eliminating all aspects of monopoly. According to Franz Bohm: "Competition is the greatest and most congenial way of reducing power in history. You only need to invoke it and it does the rest of the work by itself."[3] For Wilhelm Ropke, the social market represented a choice "in favour of the small and medium-sized firm". Erhard laid chief stress on the need for international competition. Only under competitive conditions would prices be determined by the market.[4]

A sound currency. This was always a crucial background condition: "... a pre-condition for successful wealth formation is a relatively strict policy of financial stability."[5] The German Bundesbank has a legal obligation to safeguard the value of the currency.

Equality of Opportunity. According to Von Rustow, the only justifiable inequalities were those which arose from inequalities of accomplishment or the conditions of competition. "Most unjust of all are those inequalities in the conditions existing at the start of economic life, derived in part from unequal inheritance, which depend on how carefully one chooses one's parents. This being the case, we are led to demand ... just initial conditions for all." [6]

Co-determination. A leading aim of the Dusseldorf Principles of the CDU (1949) was to involve “representatives of the workforce at factory level and in national supervision of economic life in order to achieve the essential trust of all strata".

These principles determined a role for the state. Its main economic functions were to sustain competitive conditions; promote a more equal distribution of assets and skills, together with a system of industrial power-sharing; and maintain sound money.

The German model had the great advantage of concentrating attention on the legal, social, and technical conditions required to make a market economy work well. Such clarity was never achieved in Britain, where old-fashioned capitalism, socialism, the Welfare State, and Keynesian macro-economics were wrapped in an ill- assorted package labelled the "mixed economy". The consensus which sustained this mixture proved to be highly vulnerable, because it concealed a basic ambivalence about the justification of markets, and indeed about the private enterprise system itself.

The German model is thus a useful reference point, but it should not be accepted uncritically. First, it assumed that the only important cause of market malfunction was lack of competition, and thus ignored other causes of malfunction which might have important implications for policy (these are discussed in Section Four). Second, "co-determination", designed to win workers' consent to market forces, can easily become a force for resisting them. The lustre of the German system started to fade in the 1980s as dynamism gave way to stagnation.

The German model had little influence in Britain until the 1970s, when the failures of our own mixed economy became too gross to ignore. I have suggested elsewhere[7] that it was the attempt to plan both growth and incomes in the context of a divided politics and an adversarial system of industrial relations which brought Britain to its knees in the 1970s. The important point is that neither of the two main political parties believed in the market economy by 1975. The Labour Party's revisionism of the 1950s has been much misunderstood. Anthony Crosland in *The Future of Socialism* (1956) accepted capitalism precisely because, in his view, it was no longer tied to market competition: his model of the economy was corporatist, not competitive. Edward Heath was, at heart, and increasingly in practice as Prime Minister, a corporatist. His outlook was that of a manager of big blocs of business and union power. Revival of interest in the market as a social mechanism dates from the early 1970s. It owed a great deal to the powerful advocacy of economists like Hayek, Friedman, and Samuel Brittan, and think-tanks like the Institute of Economic Affairs. The left contributed little to this revival until the SDP was founded in 1981.

To succeed, ideas need the help of circumstances. Four circumstances contributed to a revived belief in the market.

- There was the progressive failure of Keynesian macro-economics to secure the internal and external balance of the economy. The trade-offs between inflation, unemployment, and a healthy balance of payments all worsened in the 1970s. It was taking more and more inflation to achieve a high level of employment; and more and more unemployment to prevent inflation from rising and the external value of the pound from falling. Although the problem, arguably, lay in the inflationary management of the macro-economy, the only solution the Keynesians had was "incomes policy" which aimed at controlling costs. What such policy achieved was a great increase in union power without, except for short periods, bringing the promised relief in the form of lower wage demands. By the end of the 1970s there was no credible alternative but to stop inflationary government finance and to allow unemployment to rise to whatever levels necessary to bring prices under control. This painful process revealed, for the first time, the true decline in British competitiveness: the extent of the misallocation of resources, mismatch between jobs and skills, and disincentives to save, invest, and work which had built up in the "Keynesian" years; in brief, the extent to which Britain had ceased to function as a "market economy".

- The second factor was the growing power of the unions, and the public revulsion against it. By the end of the 1970s employers, workers, and governments could do almost nothing without the permission of the trade union bosses, themselves often subject to the pressure of militant minorities. Trade union power rested on a simple absence of legal restraint on any of the unions' coercive activities, it being hallowed doctrine that the law had no part to play in industrial relations. Britain suffered heavily from inattention to the legal foundations of a market order.

- Thirdly, the 1970s brought an increasing public and intellectual appreciation of the problem of "government failure". In the heyday of collectivism all the attention was focussed on "market failure". Little thought was given to the question of how well governments could perform the tasks markets were failing to do, or were doing badly; and it was assumed, without too much question, that some sacrifice of freedom was a small price to pay for the social and economic advantages which governments might directly bring about. But gradually the evidence of government failure mounted up. Keynesian policy stopped working. The taxation system, geared to social and economic objectives, lost any contact with concepts of simplicity, equity, or neutrality and became a field of plunder for vested interests, and armies of lawyers and accountants. Public services seemed to exist more to serve those who worked in them than their customers. Governments seemed to be getting bigger and costlier and more incompetent and ineffective at the same time. A powerful reaction to all this was "less government and more market".

- The recent era of turbulent technology, heralded by the microchip/computer revolution has been market-friendly in a way the older technologies were not. What seems to have happened is that the new technologies, combined with the recession of the early 1980s, have removed "barriers to entry" in a number of occupations by reducing the advantages of "economies of scale". The newspaper industry is a notable example: the new computer-operated photo-composition methods should reduce the relative advantage of large circulation papers, making possible a proliferation of new titles. Another notable effect of the new technology has been felt in financial markets. Data, especially for this country, are very hard to obtain, but the idea that we are moving from a "Fordist" or mass production/mass consumption era into one in which smaller firms will cater to increasingly segmented markets appears to have some substance. Not only have large firms been decentralising their operations and dispersing their plant so that most workers now work in units of under 200 employees, but there has been a striking growth in the number of small manufacturing and service establishments, together with an increase of over one million in the number of self-employed persons between 1979 and 1988. The British economy is becoming more miniaturised, spacially dispersed, and organisationally decentralised; on the other hand, the very largest companies seem to be getting bigger, because more international. Much more research is needed into this whole question. What is apparent is that the old pluralist and corporatist view, which took for granted the need for bargained relationships between large blocs of economic power, may need to be drastically revised.

Thus the movement of ideas in favour of a more decentralised, competitive and entrepreneurial economy seems to have behind it not just the failures of the old system but the force of the new technology. The concept of the "social market economy" is a positive way of responding to these challenges. It recognises the instrumental efficiency of decentralised decision-making, as well as its connection with freedom, while setting market processes in a social democratic value system.

3 THE MARKET AS A SOCIAL GOOD

The most important shift in political economy between the first and second halves of the 20th century has been the move from indifference or hostility to the market to explicit recognition of the market as a social good. This shift has now become world-wide. It runs all the way from Thatcher to Gorbachev. It has affected rich and poor countries alike; it has transformed the disciplines of economics and economic history; about how we think and act about the problems of the poor, whether these be poor countries, or poor groups within rich countries. It marks an intellectual and political watershed. That is why the older languages of the Left which concentrated exclusively on collective goods and collective action are no longer appropriate.

The case for the market rests positively on its contributions to freedom, efficiency, and dynamism and, negatively, on the inferiority of planned systems in all these respects.

The most powerful argument for the market economy is that it decentralises decision making and makes possible the uncoerced co-operation of people for their mutual benefit. It achieves this not by relying on altruism, which is in short supply, but by making the pursuit of individual plans the means for satisfying the plans of others. It was Adam Smith who first fully saw in the mechanism of market exchange the basis of a spontaneous social order. The individual is "led by an invisible hand to promote an end which was no part of his intention. By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it."[8] The conditions for free exchange in markets are the same as, though less extensive than, the conditions of freedom generally: freedom of movement and choice of job; freedom of contract; properly defined and enforced property rights. The market system thus provides a powerful protection for political and civil liberty, because it minimises concentrated political power and disperses power in general. Furthermore, the market system provides a wider basis for co-operation than the political system, because it transcends national frontiers. It is thus an international system of liberty. In addition, the impersonal nature of its interpersonal relationships makes it both colour and gender blind: it is the best safeguard in the long run against racial and sexual discrimination.

If these conditions are maintained, the market can also be shown to be efficient in coordinating individual plans. Under very strong assumptions (perfect competition, perfect information, perfect rationality, etc.) it can be shown to be perfectly efficient at doing this. A state of perfect efficiency is said to exist if everyone's choices, given his resources, are perfectly satisfied by the existing allocation of goods and services. The conditions for perfect allocation are, of course, never realised so it is a matter of relative efficiency of want satisfaction compared to other systems. It is important to note that the market does not guarantee that everyone is perfectly, or even moderately, satisfied with the resources he "brings to market". It is the task of the "social" side of the market to address this problem.

Hayek and Schumpeter have enabled us to appreciate anew the creative role of markets - creating new wealth, new tastes, new possibilities or living. This is the function of the entrepreneur, the creator of the unforeseen and unpredictable. "It is because every individual knows so little and, in particular, because we rarely know which of us knows best that we trust the independent and competitive efforts of many to induce the emergence of what we shall want when we see it."[9]

The fact that every planned system necessarily violates some condition of freedom, efficiency, and creativity is well understood now, and need not be elaborated further. Less well understood is the connection between the three goods of a market economy and the right to private property in the means of production (capitalism). The recognition of what Hayek calls "private or several" property automatically limits state, and disperses private, power.[10] Efficiency in allocating resources requires that the factors of production Gand, capital, and labour) are allowed to move to their most valued uses. How, for example, is the state to calculate the optimal rate of saving and investment - one that accurately reflects individuals' time preferences and the uses to which they wish to put their saved

resources? Finally, the chance to gain wealth is a strong incentive to risk-taking and innovation. No comparable bureaucratic motives for risk-taking have been discovered.
To say that the market is efficient in satisfying wants is to say that it is an accountability mechanism. The way the market is accountable to the consumer is through the right of "exit". If consumers are not satisfied with one supplier they can switch to another. This requires a number of firms which compete with each other for the consumer's custom. The main accountability condition is that no single seller controls the price or quantity of a product. A firm's ability to enter a trade is therefore essential to maintain the customer's right of exit. To maintain not just the right of entry, but conditions in which entry is not too costly, is thus the object of competition policy.

Genuine though the difficulties are in maintaining competitive conditions, there is no equivalent accountability mechanism for statutory monopolies, or public services which the majority of people are constrained to use through lack of resources. It is clear that financial accountability of such services to governments and local authorities ("value for public money") is not the same as accountability to the customer. The Left has tried to develop an accountability model based on "voice". This is, more familiarly, a voting or participation model. Voters decide between different allocations of public money (taxes). Channels or institutions are created for users of public services to make suggestions for improving delivery, or to take part in forming policy.

The trouble is that it is extremely difficult to secure adequate accountability once the direct nexus between contribution (payment) and benefit (good) is broken. Voting notoriously fails to achieve outcomes which are clearly related to individual preferences. Nor do other "voice" models help much. Monopoly providers of services are notoriously insensitive to customer complaint or interference. And most public services are run by professionals who "know best". The Left's traditional answer has been to abolish the right of exit, for example, the right to private education or health-care, in order to lock the articulate into public systems. Not only is this an infringement of liberty, but the assumption that the articulate are representative of the majority is quite unfounded; they are more likely to form a special interest of their own. Latterly, more emphasis has been placed on decentralisation of delivery down to Burke's "small platoons" beloved of David Marquand. But such small platoons can be more oppressive than large battalions, as the medieval *charivari* demonstrate. A plausible story of accountability through "voice" has yet to be told.

This makes it all the more important not just to maintain rights of exit from all public services, but to create as far as possible "internal markets" within them. David Owen has advocated giving a patient the right to be referred for treatment to another District Health Authority's hospital, or even privately, when the waiting time for a particular type of treatment exceeded a certain period, his own DHA paying the cost in both cases.[11] The Conservative government has given parents a limited right of choice of school. Beyond this, Arthur Seldon has advocated charging for separable benefits in publicly provided goods like health-care and education, with consumer-patients or consumer-parents "empowered" by being issued with vouchers of lower or higher value (depending on means) to be spent on doctors, hospitals, and schools of their choice.[12] Ultimately, it is the feebleness of accountability under conditions of "social choice" which constitutes the chief argument for relying on "market choice".

4 THE STATE AND THE MARKET

Historically, the state has played a crucial role in determining the scope, and conditions, of market production and exchange. We can leave to one side the question of whether the state or markets came first.[13] The topics we take up in this chapter are the legal foundations of a market system and the state's role in correcting market failures.

Legal Foundations. The main tasks of the legal order are to specify and protect property rights; to enforce voluntary contracts; to guarantee freedom of movement and free choice of occupation, and to prevent and punish physical harms and fraud. However much trade we may imagine to take place in a "state of nature", the state is, for practical purposes, a necessary condition for a market *system.* Only the state can guarantee a non-coercive environment for market exchange. However, the state is also the greatest danger to the market system. Hence the constitutional order must be such as to limit the coercive power of the state "to instances where it is required to prevent coercion by private individuals."[14] The market economy thus depends on a general environment of freedom, which it reinforces.

The second point follows directly from this. The state's "duty" to the market is not limited to maintaining what economists call "efficiency conditions" (as described in the first part of Section Three). It must also maintain the conditions of freedom and creativity. Thus, in order to justify a measure of state intervention, it is not enough to show that the market fails to supply some good efficiently. It is necessary to show, or at least argue, that government intervention will produce a better outcome - not just in efficiency terms, but in terms of the other social goods of a market. (We can easily imagine a situation where intervention will increase efficiency in allocating given resources, but weaken the incentives to create new resources.) But the argument pulls in the opposite direction as well: certain market outcomes may be efficient and yet be socially unacceptable, and thus weaken the system which produces them. The only safe rule is to discount arguments for both intervention and non-intervention which do not show an awareness of the full range of social costs and benefits involved.

The general causes of market "failure" can be grouped under three heads: (a) absence or vagueness of property rights; (b) imperfections of information, important for insurance, employment, and capital markets; and (c) government and other interference, relevant to monopoly and also employment. An identifiable failure (unemployment) may have several causes. Also, depending on which cause for a failure is being claimed, government action may take the form of interference, or withdrawing from interference.

The various types of failure may be listed as: monopoly, public goods, externalities, insurance, and unemployment. Each will be briefly considered in turn.

Monopoly. Monopolistic tendencies exist whenever the producer can influence the price of his product. Defined in this general way, such tendencies are clearly pervasive, and can never be entirely eliminated. What can be influenced is the degree, extent and duration of monopoly. Arguments against monopoly have to do with freedom, efficiency, and innovation. Freedom of choice can be restricted when there are too few suppliers. Monopolistic conditions can diminish efficiency and the incentive to innovate. Maintenance by government of the conditions of competition is, therefore, an indispensable duty in a market economy which is to be social. This requires both free trade and anti-monopoly laws, with adequate machinery for their enforcement.

It cannot be stated too often that support for the market economy does not commit a government to the interests of big business. If anything, it commits it to medium-sized and small business. The Marxist equation of market economy with "monopoly capitalism" was always a confusion.

Nevertheless, it is true that governments have often weakened competition themselves. They have rushed to the defence of "essential" industries which "need" to be kept going, or kept under national control. They have imposed protective tariffs. They have instituted tax regimes and legislation which discriminate against small firms. Regulatory agencies designed to control or prevent private monopolies have often colluded with vested business interests. Governments have illegitimately widened the scope of the "natural" monopoly argument. There *are* "natural" monopolies, where competition would be wasteful. But these are much more limited than is often claimed. Roads are a "natural" monopoly (but not cars); the electricity grid (but not electrical appliances); the railway tracks (but not the carriages or catering); the gas pipes (but not the gas appliances); telephone lines (but not telephones); water pipes; the broadcasting network. These could either be publicly owned or regulated private monopolies. The advantages of the latter are freedom to borrow on the capital market, and the possibility of much stronger regulation than public monopolies are subject to, OFTEL being an example.

Many economists argue that the dangers of monopoly are exaggerated. The crucial efficiency condition is freedom of entry and exit. Thus the actual number of suppliers in a market may have little to do with the exercise of monopoly power. Even a market with only one producer (as in the "natural" monopoly case) will behave like a competitive one if the costs of entry to potential entrants are fairly low, so that the market can be easily contested. The ease of potential entry may be therefore sufficient to keep many a natural monopoly efficient. This is the basis for much of the recent changes in anti-trust laws and deregulation in America, though clearly the privatisation of British Telecom while restricting entry into the industry shows that this lesson has not been learnt in Britain. There is little agreement at present as to how much government intervention is needed, and of what kind, to maintain competitive conditions.

Public Goods. It has long been accepted that public goods have to be provided by the state. The essence of a public good is that no private property right can be established in its consumption. If it is provided, no one can be excluded from consuming (using) it. And if one person consumes (uses) it, this does not diminish the total amount available for others. Neither of these characteristics is true of private goods like butter or apples. It follows that, in the pure case, the good will not be provided by trade or voluntary agreement, even if it is desired by all. Therefore, it has to be provided by the state through a compulsory levy - taxation. The classic examples of "pure" public goods are defence and law and order. No citizen can "opt out" of his country's defence system; and the defence of one citizen is not at the expense of another's.

The existence of public goods may explain the origins of the state; but it offers an imperfect guide to policy, for three main reasons. The first is that, owing to the lack of connection between individual payment and benefit, there is no accurate way of telling how much of a public good is wanted. In former times, this was decided by the Prince. Now it is determined in a rough and ready way through the voting system. But this is not an accurate measure of individual preferences. Many people regard a defence system based on nuclear weapons as a public bad, not a public good. They have to pay their taxes nonetheless. From their point of view the good is oversupplied. On the other hand, there is some evidence to show that people would voluntarily spend more of their incomes on healthcare and education than they are compelled to pay through taxation. These are simply illustrations of the "social choice" dilemmas described above. The important point is that public provision, collectively financed, does not necessarily solve the problem of undersupply of some goods; and it may well lead to oversupply of others.

Secondly, outside the "pure" cases of defence, law and order, and a sound currency, most public goods are only partially public. In practically all cases, some degree of exclusion is possible; and sooner or later, "congestion" sets in, leading, in the absence of prices, to queuing. Congestion is endemic in public services, like roads and hospitals, suggesting that some rationing by price is both feasible and necessary.

Finally, government and commercial enterprise are not the only possible suppliers of such goods. There is also philanthropy. Many public goods in the past were supplied by this means, notably Victorian municipal buildings, but also schools and hospitals. Many of the arts are supported by private giving, more so in the United States than in Britain.

These conundrums are abstract, but they should influence thinking about policy. There are many possible mixes of public, voluntary, and commercial effort which can be used to supply goods which have some degree of publicness about them, such as education and health-care. Given the difficulty of making public services accountable to consumers, there is a strong case for inserting an element of individual payment into the financing of many so-called public goods.

Externalities. Externalities are unpriced spillover effects of some economic activity, harmful or beneficial. A harmful externality is when effluent is dumped in a river; a beneficial one when the river is cleaned. They arise when property rights (in this case in the river) are not defined and hence no trade is possible between the creator of the externality and his victims or beneficiaries. The theory predicts that a market economy, left "uncorrected", will over-produce neighbourhood harms and under-produce neighbourhood benefits. These benefits and harms provide grounds for state intervention of various kinds; prohibition or regulation; supplying or subsidising the amenity; taxing the polluter either to reduce the volume of his activity by increasing his costs, or to compensate those who suffer, or both.

This principle is mainly relevant to "green issues". But it is hard to translate into policy. For one thing, the government itself is an important source of harmful externalities. It has polluted air and water, crashed roads through attractive countryside, and put up hideous buildings. Secondly, how does one calculate the appropriate tax or subsidy? How is the balance (particularly the inter-generational balance) to be struck between the benefits of the clean air and the good or service the polluter produces? Thirdly, it may be that some of the missing property rights can be created by law, producing markets in externalities. Samuel Brittan sums up carefully as follows:

> Most economists would favour taxes and subsidies (and perhaps a few out-and-out prohibitions), when there are large and obvious spillover effects, and would support cost-benefit studies ... when large projects with obvious environmental effects are being considered. But to go beyond this and advocate discretionary state intervention in every private sector activity involves all of at least the three following empirical judgements: (a) that the unpriced spillover effects are likely to be large in relation to the costs of intervention; (b) that officials will have enough knowledge of cost conditions and individual preferences, now and in the future; and (c), and most important of all, that the Government action will not in practice be largely influenced by local, political and industrial pressures (or prestige considerations) which would lead to a worse result than that of the unaided market.[15]

Insurance Markets. Private insurance against ill-health, unemployment, and old-age may fail because suppliers of insurance may not have enough information to calculate the risk. The familiar examples are asymmetric information (where the insurer knows less than his customer) and moral hazard (where being insured makes the insured's behaviour less prudent than it would otherwise have been). In such cases actuarial calculation of risk is impossible or very difficult. Nicholas Barr further suggests that , since inflation is an uninsurable risk, it will not be in the interests of private insurers to offer index-linked pensions, thus reducing the supply of insurance below the demand. This is doubtful. But even if true, the failure here is not in the insurance market but in the state's failure to provide a credible guarantee of the value of money. Stable money, we recall, is one of the conditions of a social market economy.[16] [Similarly it does not seem right to regard the failure of the chronically or congenially sick to get insurance as a failure of insurance markets. The premium in such cases would be so close to the cost of actual treatment that there are no advantages in insurance.]

Compulsory insurance increases the efficiency of insurance markets by pooling high and low risks and charging everyone the same premium. The more important argument for compulsory insurance is to prevent the external "bads" which non-insurance can impose on the rest of the community (in the form of a spread of disease, or starvation). But there is little point in forcing people to take out insurance against life's hazards if they cannot afford the premiums; in practice, every compulsory insurance scheme involves cash assistance to the poor. In the case of health-care, there is an argument not just for compulsory insurance but for public provision, as a way of keeping costs under control. If a health service is publicly funded but privately provided, doctors are not faced with a budget constraint. The cost of maintaining such a service is, therefore, likely to escalate out of control. This is a strong argument for the National Health Service. The fact that we spend a smaller percentage of GNP on health than the United States or other West European countries may simply be because we are more efficient at providing it. However, it may also be that it is being seriously under-supplied.

Unemployment. The main charge against the market economy is that it fails to maintain continuous full employment. But there is currently no agreement as to why this should be. Two positions may be identified.

The first is that wages are prevented from falling to their market-clearing rate by government and other interferences. Monopoly pricing by unions, minimum wage legislation, unemployment benefits set at inappropriate levels and given under too easy conditions are all blamed. Unemployment is not a fault of an unaided market economy, but of government which has failed to keep labour markets efficient and actively contributed to making them inefficient. This is often coupled with the view that, except when government engineers or allows a collapse of the money supply, there is no involuntary unemployment over the normal course of the business cycle.

The alternative, Keynesian, view is that unemployment is inherent in an unaided market economy. Keynes suggested many reasons for this; one was the pervasiveness of ignorance and uncertainty. Keynes's work can form the basis of an explanation of mass unemployment in terms of the failure of co-ordination between markets.

These two views impose different duties on government. The first is "supply side" policy to reduce the "natural" rate of unemployment, coupled with maintaining stable money. The Keynesian duty is to maintain enough aggregate demand in the economy to employ all those seeking work. In fact, the two are not incompatible, and should rather be regarded as complementary. These are clearly matters on which much more hard thinking needs to be done.

Of all the market failures we have discussed, the existence of mass unemployment impinges most seriously on the *social promise* of the market. In Hayek's own terms, full employment is one of the most important guarantees of a free (non-coercive) environment. Hayek writes: "The essential fact is that in a competitive society the employed is not at the mercy of a particular employer, except in periods of extensive unemployment."[17] The right to employment is thus the modern equivalent of Locke's right to property, which he derives from the right of everyone to "property in his own labour". Failure to preserve this right thus amounts to a denial of the freedom from coercion which is a central justification of market economy. This denial is particularly palpable, and tragic, in the case of the long-term unemployed who are, in effect, debarred from the labour market. Unemployment is one of a number of interlocking problems which a market economy which aims to be "social" is bound to address.

5 THE MARKET ECONOMY AND SOCIAL DEMOCRACY

I have suggested that certain types of state intervention may be appropriate to improve the efficiency of the market economy, but that the costs of such interventions should always be carefully weighed against their claimed benefits. This fixes certain parameters of debate between the interventionists and the non-interventionists. But beyond this the market economy must be part of social arrangements seen to be "fair". It is in this area that social democracy makes its distinctive contribution.

The concept of the "social market" brings together two leading political ideas: freedom and power. Freedom describes the absence of coercion by others; it has to do with the availability of choice, the existence of a private domain exempt from collective or arbitrary decision. As Locke puts it, freedom is "not to be subject to the inconstant, uncertain, unknown Arbitrary will of another man." Power denotes a capacity to act; it has to do with the exercise of choice, with achievement. A person lacks freedom if he is forced to carry out someone else's plan; he lacks power if he is unable to carry out his own plan. The two things are clearly different. A person may be free to own property, but lack the power (resources) to buy it. Freedom of speech can co-exist with enormous inequalities in the effective exercise of that right, due to inequalities in wealth and education. Freedom has to do with the constitutional and legal order; power with the distribution of resources. [In his *Constitution of Liberty (1960)* Hayek distinguished between being "coerced by individuals" and "compelled by circumstances". Only the first, in his view, constitutes a state of unfreedom.]

Power to achieve one's aims depends on the resources, human and material, one can bring to that task. Lack of power is not the same as lack of freedom; but it lessens the value of freedom, and creates resentments against a free society. Social democracy's distinctive aim has been to reduce the inequality of power; or to put it another way, to "enable" people who need it to realise their aims.

The question is: why should enablement be the subject of special political concern? The answer is that whereas the market economy is one of the main guarantors of freedom, subject always to the full employment condition, its rewards are skewed in favour of those who start with advantages of birth. This has long been recognised, and that is why liberals and social democrats have added to their traditional demand for "formal" equality of opportunity (careers open to talent) the requirement of "fair" equality of opportunity (equalising initial conditions). Social democrats have further pointed out that even if full employment is maintained, the market value of the work of the low paid may be too low to secure them the minimum resources needed for self-respect and autonomy (which include supporting families and contributing as citizens to the community). The policy implications of these principles include: (a) steps to disperse personal wealth through inheritance taxes, in order to secure a fair value of equal liberties; (b) targeting educational resources on the least-advantaged; and (c) guaranteeing a basic minimum income. To these must be added the goal of full employment already mentioned.

The requirements of a "social market economy" outlined above are very close to John Rawls's principles of a "just" or "fair" society. These are arrived at by means of a thought experiment in which we are asked to imagine what social arrangements individuals would agree to set up if they had no knowledge of their particular circumstances or identities. Behind this "veil of ignorance", Rawls argues that individuals will accept two principles of a just society: (a) that each person is to have an equal right to the most extensive basic liberty compatible with similar liberty for others; and (b) that social and economic inequalities are to be arranged so that they are reasonably expected to benefit the least advantaged, and are attached to positions and offices open to all under conditions of fair equality of opportunity. The first principle is "lexically" prior: liberty can be limited only for the sake of liberty. A market economy is "social" if it is consistent with equal liberties for all, fair equality of opportunity, and assured access to resources sufficient not just forlife, but for autonomy and self-respect.[18]

Before arguing for what I have called the social democratic view, I would like to consider three other approaches to the issue of "fairness": those of the New Right, modern liberalism, and socialism.

The New Right takes the initial distribution of endowments, or resources, as given. In the well-known argument by Robert Nozick, property is justly held if justly acquired or transferred. For a market system to be just the only requirement is absence of coercion. Coercion may be used only to prevent or punish physical harm, theft, and fraud, and to enforce voluntary contracts. Setting aside rectification for past injustices, Nozick excludes any compulsory redistribution of justly acquired property.[19] Hayek concedes that both the state and private individuals, have a charitable duty to the "indigent, unfortunate, and disabled". However, like Nozick, he rejects any compulsory redistribution of wealth. The simplest objection to the Nozick-Hayek statement of the sufficient condition of Justice in exchange is empirical: it has not been so perceived. The main chink in the formidable intellectual armoury of the New Right is that it has never been able to give a satisfactory historical account of the "revolt against the market". Clearly freedom of exchange has not been the only demand societies have made of the market economy. This, of course, has been recognised by Mrs Thatcher's governments, which have done more to create a popular base for a privately-owned economy through their policies of council house and public asset sales than any Conservative government this century.

Modern Liberalism has tried to correct for inequality in inherited social position by insisting on "just initial conditions". This is equivalent to Rawls's "fair equality of opportunity". Rawls writes: "The thought here is that positions are to be not only open in a formal sense, but that all should have a fair chance to attain them ... we might say that those with similar abilities and skills should have similar life chances." Central to such an aim are legal and social arrangements which prevent "excessive accumulations of property and wealth" and maintain "equal opportunities of education for all".[20]

Socialism has claimed that even if there was fair equality of opportunity, so that market outcomes reflected only innate differences of ability and not social inheritance, any result other than equality of incomes would be unjust. The thought here is that innate inheritance is just as much the result of a lottery as social inheritance and confers no ethical claim to superior reward. The principle of reward according to market-valued skills is replaced by the principle of "to each according to his needs". There is a further assumption that needs do not vary much between individuals. The market system should be replaced by a system of centralised allocation which gives everyone an equal share of the national product. Few socialists have held these views with the dogmatic simplicity just described. But equal outcomes is the result to which socialist thought tends. The crucial weakness in the "pure" socialist position is that it entirely ignores the requirements for liberty as well as efficiency. Since social democrats give absolute priority to liberty, they cannot accept equality of result as the legitimate goal of a just society.

Social Democracy builds onto the liberal goal of "fair equality of opportunity" the aim of securing for all "reasonable economic conditions of well-being, the bases of self-respect and personal self-development, irrespective of the individual's market position".[21] This does suggest some modification of market outcomes for the least-advantaged. What the market economy promises is that workers are paid what they are worth to those who hire them - no more, no less. It does not guarantee even a wage sufficient to maintain a household, much less the material bases of self-worth and self-respect.
The social democratic view of the requirements of an acceptable system of market economy can be summed up as follows: (a) maintenance of the system of natural liberty, or, as I would call it, the accountability of economic arrangements to individual wants; (b) achievement of fair equality of opportunity through the educational system and a wide dispersal of property; and (c) a guarantee of a basic income to the least-advantaged sufficient to maintain the material bases of self-respect. Social democrats would argue that these principles are compatible with long-run market efficiency, if the social costs of an acute sense of unfairness are taken into account.

These aims would, I believe, be widely accepted. There is some advantage though, in avoiding certain types of language in advocating them. Some people on the Left distinguish between "negative" and "positive" freedom, the first corresponding to what I have called freedom, or liberty, and the second to what I have called "power". I think only a confusion results from using the same word to describe these two things and a dangerous one, since it suggests the possibility of a trade leading to an enhancement of freedom overall. It is important to insist that freedom and power are not the same and that freedom can be limited only for the sake of freedom.

A second recently fashionable language is that of citizenship. Raymond Plant, for example, distinguishes between "basic rights" of citizens, concerned with civil and political liberty, and their "social rights" which are "rights to resources such as income, health, social security and education".[22] One problem about this language is that it suggests that both sets of rights are confined to "citizens", whereas we would surely wish many, if not most, to apply to aliens resident in Britain. Further, the language of citizenship inhibits the targeting of benefits on the least well-off: it suggests universal provision, when what is required for some purposes is selective provision. Finally, when one talks about the rights of citizens, it is impossible not to go on to talk about their duties as well, as Plant recognises. What this leads to was spelt out by Beatrice Webb in language more brutal that would be allowed today: "the obligation of each individual to serve the state, in return getting a maintenance". Should a right to a basic income carry with it an obligation to work? This was certainly the idea of citizenship which underlay the Beveridge Plan, in which compulsory insurance against contingencies was linked directly to the labour market through the deducted national insurance contribution.

The debate is an old one which cannot be summarised in a few words. We need here only contrast two traditions: the Judaic-Christian idea of the duty to labour as a punishment for Adam's transgression, and the Greek idea of labour as being fit only for slaves. Without deciding between these two views it would seem more appropriate to talk about the rights of individuals than the rights of citizens. This carries the suggestion that freedom rather than necessity is the goal we aim for.

6 AGENDA FOR RESEARCH

The arguments above have the following implications. First, market economy is a primary social good. Second, this being so, market failure does not in itself justify state intervention. Such intervention should be attempted only when the failure is massive, and there are good grounds for believing that the outcome of intervention will be better than the existing state of affairs. Employment, health and the environment are prime candidates for intervention. The state must also maintain a substantial role in education because of the link between education and both the job market and the public good of knowledge. Third, the state - or more broadly statemanship - must not only maintain appropriate legal foundations for a market order, but must at all times concern itself with securing the social acceptability of the market system. This involves working towards "fair equality of opportunity", a wider dispersal of property, and a basic income guarantee.

Issues for further investigation can be grouped under eight heads.

Accountability. There is an urgent need for a plausible accountability model for the public services. The basic question is: how are these services to be made accountable to their customers and not just the government? Questions to consider are: to what extent can the delivery of public services be made competitive? Can democratic or "voice" models be developed, and what is their application? What do we need to do to ensure reliability of delivery? Can industrial action, which is acceptable under conditions of competitive supply, be allowed when there is, in effect, only a single supplier? The greatest weakness of contemporary liberalism is that, in its excessive reliance on the "voice" model, it ignores all the "social choice" dilemmas described earlier.

Industrial Relations. What is a modern role for the trade union movement? If they are thought of as suppliers of services to employees, what sort of services should they be supplying? What have been the main trends in trade unionism over the past decade? Are any further changes in the law needed? On a related matter: can more be done to make employers accountable to their workforce within firms? Has "co-determination" or "co- partnership" got a future in this country? It is time for a hard look, with case studies.

Technology and Competition Policy. What is the best form of competition policy? What limits are set by technological conditions? According to the German model, the decision for the social market was a decision for the "small or medium-sized firm". Are such firms efficient? In what areas? How concentrated is British industry? What have the recent trends been? Marxists talk of "post-Fordism", but data for this country are extraordinarily hard to come by.

Externalities. What should be the respective roles of state and market in dealing with environmental hazards, whose full costs will only be paid by future generations?

Education. The theory of the social market suggests a policy of positive discrimination in favour of the least-advantaged children. This is an important implication of the principle of fair equal opportunity. As John Rawls puts it: "The principle of redress holds that in order ... to provide genuine equality of opportunity, society must give more attention to those with fewer native assets and to those born into the less favourable social positions."[23] It is important to note that, in applying this principle to children, we are not aiming at equality of result. We need to consider seriously what would be entailed by targetting educational resources on the least advantaged. What would be the costs and benefits of (a) widening access to private education through differential vouchers or more Assisted Places; (b) concentrating resources on least-advantaged neighbourhoods; or (c) basing education to a much greater extent than presently on technical and vocational training? What priority ought we to give in our social policy to enhancing "human capital"?

Taxation. The resources for achieving the "social" aims of the social market must come largely from the proceeds of taxation. What is to be the design of a tax system which promotes our social aims? Can, for example, the social aims be achieved within the framework of a low, uniform tax rate? There is a great confusion between progression and redistribution. Redistribution does not require progression in the tax rate, simply a decision on how to use resources. Progression is not generally accepted: the evidence being that much of its effect is avoided by tax reliefs in respect of borrowing for house purchase and occupational pension plans and by holding money abroad. How do we work towards a wider dispersal of wealth? Vertical redistribution from the state has virtually run its course, with the main chance being missed. Would it be possible to earmark the proceeds of inheritance or capital taxes for widening share ownership?

Economic Policy. The crucial question is how to reconcile the goals of stable money, full employment, and external balance. If the only acceptable rate of inflation is a zero rate (as I believe it to be), how do we get it? This government has abandoned the goal. By joining the EMS and buying the credibility of the Bundesbank? How exactly would this work? How are we to sort out the Keynesian and non-Keynesian positions on unemployment policy? How much further than the Chancellor can we go in indexing part of workers' pay to company profits? What commitment ought we to make to the long-term unemployed, and under what conditions of reciprocity? For example, it has been suggested that they be given an "employment voucher" to enhance their chance of re-employment. Is this feasible?[24]

External Affairs. The main external issue looming for the social market economy is the opening up of the EEC in 1992. To what extent are our principles consistent with the aims of the EEC? What line should we be taking, from a social market perspective, on Mrs Thatcher's Bruges speech? How can we promote the spread of market principles, and the freedoms attached to them, to other areas of the world?

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