

Markets and Constitutions: Lessons from Weimar Germany

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This is a paper about failure. Bad constitutions will lead not only to political malaise but also to market collapses. In turn big economic catastrophes destroy polities and tear constitutions apart. What do I mean by bad? When a constitution departs from general and universally applicable principles, and starts to announce partial and limited laws, exemptions or privileges, that are intended to distort economic and social relations, it carries the seed of its own demise.

The Weimar Republic was and also continues to be the testing place of social and legal theories: not only of constitutional design, but also of a concept of legally enforceable social rights, as well as of the question of whether a “third way” was possible between market capitalism and the planned economy. Weimar was a pioneering experiment. The makers of the constitution included Germany’s most distinguished social scientists, Max Weber and Hugo Preuss. They set out to make a framework that went well beyond traditional constitutional theory, and which included a blueprint for a better society. It was intended to be the world’s best constitution, and some of the jurists who worked with it, including makers of the Israeli constitution, held onto the conviction of its role as a universal model. But by that time, after the tragedies of the Nazi dictatorship and the Second World War, the debate about Weimar and its legacy had produced a contrasting and possibly even more influential interpretation: that Weimar was and is a model of what a constitution should not try to do.

In particular, the question of social rights and their enforceability is central to the debate about Weimar and its problematic legacy. The fifth section of the Weimar constitution treated “economic life”, and began with a broad declaration of principle (Art. 151): “The order of economic life must correspond to the principles of justice with the goal of securing a basis of existence that encompasses human dignity. Within these

limits, the economic freedom of the individual is to be secured.” Art. 153 explicitly allowed expropriation on the basis of law if it was required “for the general good,” and provided for compensation “unless otherwise specified by an Imperial law”. A series of articles guaranteed labor rights, and Art. 165 provided for company and regional workers’ councils, which would “equally” with employers work on the regulation of wage and working conditions, and coordinate “the complete economic development of productive forces”.

These articles would prove highly corrosive of any liberal order. First, the principle of the organized participation of labor representatives in wage negotiations and wage arbitration led to a wage push, which led to the deterioration of the investment climate in 1920s Germany, and – as the distinguished German economic historian Knut Borchardt has shown almost thirty years ago – played a significant part in the story of the Great Depression. In particular, the expectation that the state should play a role in the process of wage determination led to a politicization of wages, and an over-burdening of a fragile democratic system with expectations of what politics might do. Wage earners expected the state to deliver higher pay, while employers began to blame the state for their low profitability.

Because of its claims to be able to solve a broad range of social and economic problems, the state was drawn into the arena of social and distributional conflict which in turn paralyzed and eventually destroyed the state. Farmers and business leaders expected subsidies from the government. Civil servants wanted jobs and higher pay. Workers wanted higher wages. Perhaps the most striking example of the new world view is the formulation in the mid-1920s by the leading socialist theoretician in Germany, the Austrian Rudolf Hilferding, of the doctrine of the “political wage”. He explained how wages were set not by the market, but by the power of labor through the ballot box, because a socialist ministry could shape the process of arbitration of labor disputes and the determination of wage settlements under the collectivist arrangements of the Weimar Republic. The SPD presented this argument as a reason for workers to elect socialist deputies in order to shape government policy. Many employers began to feel that democracy was being abused, and consequently turned against the democratic process. Governments believed they were obliged to set prices: not only that of labor, but also for

a whole range of goods, and also, after 1931, the price of money (the interest rate) which was fixed by presidential decree. In consequence, as the economy deteriorated, every discontent was focused on the government.

In a much more dramatic and sinister fashion, the expropriation provisions “in the general interest” were intended to meet postwar calls from the left for the socialization of enterprises, but they could also be used to justify expropriations in very different circumstances in Nazi Germany.

The most extensive as well as the most influential critical reflection on the failure of Weimar’s ambitious constitutionalism was provided by the Austrian economist Friedrich Hayek in *The Road to Serfdom* (1944) and later in the more general *Constitution of Liberty* (1960). *Road to Serfdom* is clearly a piece of its time, a reflection of the central European experience of the interwar years, and the failure of liberalism and democracy. It is much less an examination of what went on in totalitarian regimes, either of the German or the Soviet variety, which are hardly treated in any depth. It also addressed a very acute problem about the postwar period, but also for today: what sort of reconstruction was or is required in order to rebuild a liberal society?

At an early stage, Hayek had been fascinated by Walther Rathenau, a central figure in the early years of Weimar, and in particular by his vision of planned politics and society in which there existed a middle way between capitalism and socialism (he later said that Rathenau’s writings had “very much contributed to my interest in economics”: Ebenstein, 41). In practice, the search for a third way was deeply flawed.

Democracy in interwar Austria or Germany became unworkable because of the way particular interests were articulated politically on the basis of rights that were anchored in the new constitutional provisions. The result was conflict of such intensity that the usual mechanisms of arbitration and resolution became overstrained. It was impossible to formulate any kind of vision of an over-arching interest. Hayek accurately identified that the interventionist approach of the Weimar Republic (which had had its origins in wartime planning of *Kriegssozialismus*) created a sort of path dependency, in which the answer to failure was not an abandonment of the approach, but rather a more radical version. Partial controls looked ineffective, so the Nazis wanted a more extensive and more radically enforced control. As Hayek put it: “Both competition and central

direction become poor and inefficient tools if they are incomplete; they are alternative principles used to solve the same problem, and a mixture of the two means that neither will really work and that the result will be worse than if either system had been consistently relied upon.” (31)

The eruption of a massive economic crisis, which had sprung out of the social arrangements of Weimar, made the enforceability of social rights especially problematic and divisive. A widespread response to the great financial crash of 1931 was the imposition of capital controls, which brought the state further into the micro-management of economic activity. Economic planning, as Hayek saw it, was inherently discriminatory: “It cannot tie itself down in advance to general and formal rules which prevent arbitrariness.... It must constantly decide questions which cannot be answered by formal principles only, and in making these decisions it must set up distinctions of merit between the needs of different people.” (55)

The issue of arbitrariness applies in a particular way to the actual implementation of capital controls. They were implemented in both Austria and Germany from 1931, i.e. before the onset of the political dictatorship (Hitler came to power in January 1933, and in 1934 Austrian conservatives created the conservative *Ständestaat*). But the dictatorship gave more means of enforcing controls. Hayek cites the German liberal Wilhelm Röpke, to the effect that “while the last resort of a competitive economy is the bailiff, the ultimate sanction of the planned economy is the hangman.” (94). He could actually, if he had at the time known Hitler’s table talk, have cited the dictator himself: “Inflation does not arise when money enters circulation, but only when the individual demands more money for the same service. Here we must intervene. That is what I had to explain to Schacht, that the first cause of the stability of our currency is the concentration camp.” (James, 353)

The decision on who should benefit from the allocation of foreign exchange became political and arbitrary. The institution invited a political process of rent-seeking, and it was those who could develop the closest contacts with the regime who benefited most. The allocation of scarce raw materials was in fact the basis of Nazi economic planning, as Hayek recognized: “The controller of the supply of such raw material as

petrol or timber, rubber or tin, would be the master of the fate of whole industries and countries.” (170)

Arbitrary too was the decision on who should be investigated for breaches of foreign exchange regulations. In 1931, the German government imposed taxes and penalties on capital flight (the *Reichsfluchtsteuer*). They were ineffective, and were progressively tightened, with increasing penalties (including a death penalty, after 1938). But until the end of 1938, these regulations were not – in their formulation – formally discriminatory, and they applied to all Germans. On the other hand, as they were applied after 1933, they were used as an instrument especially against an ethnic minority, Germany’s small Jewish minority, in accordance with the Nazis’ anti-Semitic program. The stereotypes and the behavior of the vulnerable minorities reinforced one another. Faced by mounting anti-Semitism, Jews tried to move their capital out of many Central European countries; and as they fell foul of new legislation to control speculation, they reinforced the stereotype of the "Jewish" speculator. For instance, in Hungary, in the year *before* the introduction of anti-Semitic legislation in 1938, 112 out of 187 currency offenses were committed by Jews. (Junz)

A recent and quite influential book by Amy Chua makes the case that liberal economics and globalization promote upsurges in ethnic tensions, and in particular a turning against what she terms “market-dominant minorities”, Chinese in Indonesia or Malaysia, Lebanese in West Africa, Indians in East Africa, or Jews in Russia. But she is really describing eruptions of discontent and the attempts to control capital and capitalism. It is not the market economy that produces the backlash against ethnic groups identified with successful entrepreneurship, but instead rather the idea that the market is harmful and needs to be controlled by some radical (and discriminatory) means. Hayek’s description of the phenomenon of the association of discrimination and anti-Semitism with anti-capitalism is more historically sensitive than Chua’s. “In Germany and Austria the Jew had come to be regarded as the representative of capitalism because a traditional dislike of large classes of the population for commercial pursuits had left these more readily accessible to a group that was practically excluded from the more highly esteemed occupations.” (104)

Hayek wanted to interpret the central European experience for Britain, which he thought of as having embarked on the slippery path of control since 1931 (the turn to protection and to currency depreciation). He had, by coincidence, left Vienna to take up his chair at LSE on the weekend of September 20, 1931, when the Bank of England announced the suspension of gold convertibility. But it was also a more general warning for the postwar world. It was echoed by the German liberals like Wilhelm Röpke and “ordo-liberals” such as Walter Eucken and Alfred Müller-Armack. The new German concern was reflected in a much more limited constitutional ambition in the case of the Federal Republic. Indeed, Germans in 1949 took modesty so seriously that they even termed their constitutional arrangements a “basic law”.

What did these lessons mean for the task of building a postwar world? In the 1920s, Austria and Germany had frequently responded to their own problems with democracy by trying to pass on the blame to some external agent. Thus, in the aftermath of the Austrian hyperinflation, it was the League of Nations which was charged with a stabilization plan that involved the dismissal of some 100,000 civil servants. In the depression, the League was called in again to sort out public finances. In Germany, the era of inflation and hyper-inflation was ended under the terms of the Dawes Plan (1924) by passing over substantial elements of sovereignty to an Agent-General for Reparations Payments. After the Second World War, some measure of Allied control would clearly be necessary: but Hayek believed it to be crucial to make this control a liberal one in the sense that it should be based on general principles and laws, and not intervene in a specific and necessarily partial way.

In 1945, Germany clearly needed a profound reordering. But there were clear limits to the extent to which this could be done from the outside, in Hayek’s view, even though the constitutional and political reordering might reflect the notion of a better or higher morality. “Though there are no doubt many people who honestly believe that if they were allowed to handle the job they would be able to settle all these problems justly and impartially, and who would be genuinely surprised to find suspicion and hatred turning against them, they would probably be the first to apply force when those whom they mean to benefit prove recalcitrant, and to show themselves quite ruthless in coercing people in what is supposed to be their own interests. What these dangerous idealists do

not see is that where the assumption of a moral responsibility involves that one's own moral views should by force be made to prevail over those dominant in other communities, the assumption of such responsibility may place one in a position in which it becomes impossible to act morally. To impose such an impossible moral task on the victorious nations is a certain way morally to corrupt and discredit them." (169)

We might also easily find other more recent cases in which the extension of constitutional rights produced politicization, the extension of claims, and legal and political chaos. The 1988 Brazilian constitution, drawn up in a similar setting of attempting a transition from autocracy (in this case military rule) to democracy, in the course of 250 articles and 83 transitional provisions, greatly expanded the range of constitutional rights to include a plethora of social and economic guarantees. When many Brazilians used the new constitution as a basis for legal action, the courts were flooded so as to become unoperational (Prillaman; Dam).

Germans applied the liberal legal philosophy in debates about a new European order in the 1950s. It was Röpke who suggested to Ludwig Erhard that the German delegation to negotiate the European Economic Community should be led by the liberal Walter Hallstein. They saw the process of integration as created by a customs union that would unleash competition, and in their view the maintenance of competition policy should be the core competence of the new EEC institutions and in particular of the Commission. Röpke saw this approach as dramatically contrasting with what he called a "perfumed planned economy on a French model." (Nicholls) The social parts of the 1957 Treaty of Rome (Arts. 117-122) were limited and very modest, and confined to an affirmation of "the need to provide improved working conditions and an improved standard of living for workers". But this would come "from the functioning of the common market" as well as from the procedures provided in the Treaty "and from the approximation of provisions laid down by law, regulation or administrative action."

But the debate about a more ambitious constitutionalism flared up again after 1989, when most central European reformers rejected "reform socialism" and came to the conclusion that the "third way" was a way to the "Third World". It has also resurfaced in tensions in the European draft constitutional treaty between provisions that appear to endorse and those that appear to restrict market principles and limit what Jacques Chirac

memorably termed the “new communism” of ultra-liberalism. The new Treaty is replete with invocations of ways of controlling and regulating and harnessing the market. The objectives of the Union, spelt out before the “fundamental freedoms” in Article I-3, include not only (paragraph 2) “an internal market where competition is free and undistorted”, but also (paragraph 3) that “The Union shall work for sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment, and social progress, and with a high level of protection and improvement of the quality of the environment. It shall promote scientific and technical advance.”

The institutions which enable a free determination of prices as a basis for choice, and hence a free society, are not easily shaped to a specific form. Micro-management from the outside (as opposed to the formulation of general principles about competition) will look partial – whether it is a case of post-1945 Germany, or post-Soviet Central Europe, or the formulation of IMF programs, or the principles on which postwar Iraq should be reconstructed. In that sense, Hayek’s work contains a powerful critique of the kind of policies implemented to deal with Asian crisis in 1997-8 or with Iraq in the aftermath of the 2003 war. But micro-management via the extension of constitutional rights to a large range of social and economic issues can be equally problematic. This is an area in which the makers of a new Europe learnt from Weimar’s doomed experiment in the 1950s, and might learn from it again. The major lesson is constitutional restraint and constitutional modesty.

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