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**Article**

## Ten years after: German unification revisited

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# TEN YEARS AFTER: GERMAN UNIFICATION REVISITED

Conference organised by Rüdiger Dornbusch, MIT, and Hans-Werner Sinn, CESifo, in co-operation with the German Economic Review.

Exactly ten years after German unification, Rüdiger Dornbusch and Hans-Werner Sinn held their jointly organised conference not far from the Berlin *Reichstag*. The panel of experts, which also included Georg Milbradt, the Saxon state minister of finance, and Karel Dyba, the former Czech minister of economics, discussed the following questions: Would we do it the same way again? Was the transformation of the east German economy a success? What went wrong?

**Hans-Werner Sinn** opened the discussion by looking at the enormous improvement in the standard of living in east Germany. According to recent estimates, it has risen, in real terms, by a factor of three. Real average income is now 90% of west Germany's, the level of nominal wages is 74%, and pensions are even higher than in the west. Sinn characterised this development as phenomenal, beset only by the problem that this success was and is financed by west Germany to a degree which is simply not sustainable. Every third D-Mark which is spent in east Germany still comes from the west: Whereas annual absorption in east Germany is DM 655 billion, its GDP is only DM436 billion. The difference is financed, on the one hand, by a net transfer of private capital of DM 78 billion, which is appropriate; on the other hand, DM141 billion, or 4.5% of west German GDP, is provided by west German government budgets. Accumulated over the entire period, the public net transfer adds up to DM1,200 billion. Because most of it was financed by borrowing, the public debt rose from DM900 billion to DM2,300 billion. That implies a large burden on future generations, especially in view of the severe demographic problems facing Germany in the longer run.

Hans-Werner Sinn emphasised the need to move to a situation where the east Germans will finance themselves. Such a move is expected to provoke resistance, however. Thus Sinn expects a severe

crisis when the current transfer system expires in 2004 and the west German side refuses to continue the large payments of the past. This is the major remaining problem of German transformation policy.

Would it have been possible to avoid this dramatic development? Of course, considering all political constraints at the time, Hans-Werner Sinn argued, only the things that happened could have happened. But as economists we should critically examine these constraints. Sinn mentioned two main problems which could have been avoided:

- The first is the wage policy pursued in east Germany as a result of which nominal wages rose from 7% of the west German level in 1989 to almost 75% today. For Sinn this is the result of a special situation: The strategy of quickly adjusting east German wages to the western level was negotiated before east German privatisation. This meant that no true representatives of east German trade unions and employers sat at the negotiating table but basically only west Germans. They quickly agreed not to have lower wages in east Germany for any length of time. Of course, the east German people welcomed this policy, which also meant higher unemployment benefits!
- The second is the introduction of the west German welfare system into east Germany at the time of economic union in July 1990 when the transformation process started. Instead of some regional differentiation, social welfare in the east started at the west German level. This worked as a barrier to lower wages. Had east German wages been kept at a lower level for a couple of years, then, combined with the improved infrastructure and the legal framework freshly imported from west Germany, this would have provided the best conditions for private investment in east Germany, higher economic growth, more jobs, and later-on higher wages, too. Hans-Werner Sinn emphasised that the 1:1 currency conversion was appropriate but believed that another wage policy would have

Wage policy and welfare system caused major problems

been possible because at the start of the reunification process *everything* would have been possible!

**Rüdiger Dornbusch** emphasised different causes of the wage increase. He agreed that the wage increase resulting from the 1:1 conversion rate was unavoidable. Even if it had been possible to start with a more appropriate exchange rate making east Germany a lower-wage country, things would not have developed any better because at a lower conversion rate there simply would have been a faster rate of wage inflation. However, in his opinion, the root of the problems has to be sought in west Germany rather than east Germany. “Unification meant that everybody got not only the benefits of the west German economic institutions but also all the disastrously negative institutions: unions, overpaid unemployment, excessive job security, and pervasive regulation. If west Germany, in the face of unification, had rolled back all these limitations to the free play of markets, creating a competitive business environment, the economic costs would have been far lower. East and west Germany would be closer to full employment.” Thus, for Dornbusch the good news is that unification did take place, the bad news is that east Germany became an even worse economy than the west! For him the lesson is quite clear: West Germany is responsible for the unaffordable costs. Dornbusch also argued that cheap labour is not a sufficient condition for attracting private investment. Otherwise the Czech Republic or other transformation countries would be overrun by foreign investment. If, however, you ask – so Dornbusch – why the transition to a market economy failed in Russia, some experts set great store in the failure to establish institutions before letting market forces take their course. “That surely cannot be the argument in east Germany – institutions came overnight with world class German law, property rights and courts, public administration, banks and capital markets and west German money.” The problem really was that with the good institutions the bad ones came, too.

Despite all the problems, unification will remain, and therefore west Germany must change or pay more and more. Ultimately there may be a hard landing and the money cut off which also would result in rising unemployment in west Germany because the public transfer to the east is connected with demand effects for the west like foreign aid.

In order to achieve a soft landing, Dornbusch recommended phasing out the excessively costly welfare state. In the effort, in east Germany, of whittling down wages in bargaining at the firm level and getting away from industry-wide settlements, he recognised a first helpful sign.

**Georg Milbradt** presented the views of a west German professor of economics who went to Saxony nine years ago and was able to influence economic developments there as a politician, as minister of finance. For him the quick *political* unification was very successful. “Neither the huge political and administrative problems nor the economic and financial questions could have been solved had east Germany remained a separate state.” In this context, the early introduction of the D-Mark together with the economic union was also a correct decision, although some people blame the exchange rate for the well-known economic difficulties. “There was no acceptable way to maintain a floating east German currency and a separate economic area. You could not keep an economic border within Germany or especially here in Berlin after the wall had come down. And nobody wanted it!” Furthermore, the exchange rate prevented the east German population from experiencing a considerable devaluation of their savings, their main form of wealth. Thus it was “a sort of gift of the west to the eastern compatriots”.

What went wrong nevertheless? According to Milbradt, financing nearly all economic measures by debt in the early years of unification reflects a lack of economic realism and political courage. The economic differences between western and eastern Germany, the necessary transformation period and the financial and economic dimensions of the process were underestimated; the self-healing forces and especially the positive effects of transferring the western system were overestimated.” It was soon evident that basic elements of the west German system were only partially suitable for reconstructing east Germany. But the need to reform the west German system in different aspects – corresponding to Dornbusch’s arguments – was hardly recognised. Thus there was an overemphasis on distribution policy, a preference for a *status quo* policy and a neglect of allocation strategies.

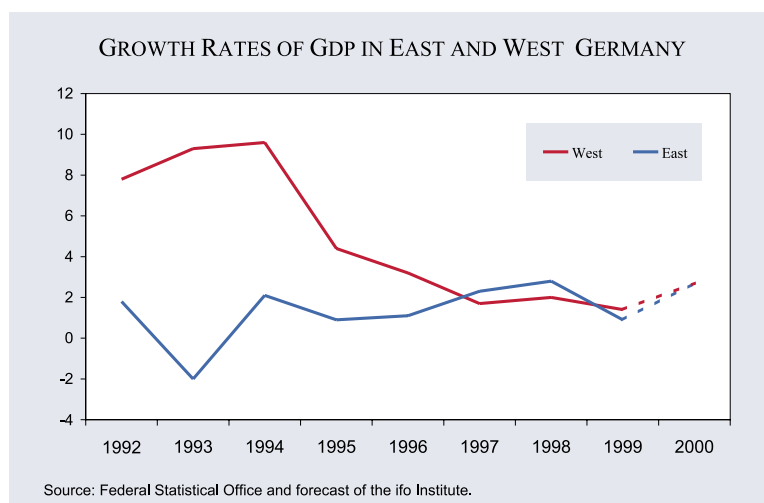
Minister Milbradt also emphasised the role of wage policy. “It was falsely regarded as a suitable instru-

The root of the problems must be sought in west Germany

ment for adjusting living standards. Since wage compensation payments – especially unemployment compensation – were dependent on the level of wages, it was completely rational, from the point of view of east German employees, to press for higher wages. Instead of a productivity-oriented wage policy, a policy of giving extensive public investment assistance was pursued. The result was a rapid, shock-like and expensive restructuring of the entire economy in the direction of the western economic structure with ensuing high unemployment. In the east, legal entitlements were created, based on the western social system that could not be met by the local economy and which of necessity led to consumption-oriented west-east transfers.”

Milbradt therefore advocated a more moderate wage policy, a stronger differentiation of wages between individual firms and regions, a process which has started already as 70% of east German companies are not or no longer members of employers’ associations: a clear reaction of market forces to inappropriate general wage settlements. In addition, financial support to private investment and for improving the infrastructure in many areas will still be necessary in coming years. At present, the share of the “new Länder” in total German tax revenue is only 8% with 19% of the population! “The adjustment process is not a sprint but a marathon.” Positive signs can be observed, although the east German growth rate has declined remarkably since 1997 (see Fig. 1). To a large extent this was due to a normalisation of activity in the construction sector, whereas the growth rate of output in the manufacturing sector has been rising in recent years (see Fig. 2). Finally, if the east German development after ten years is compared with the regional differences in Italy, for example, then a large part of the marathon is

Fig. 1

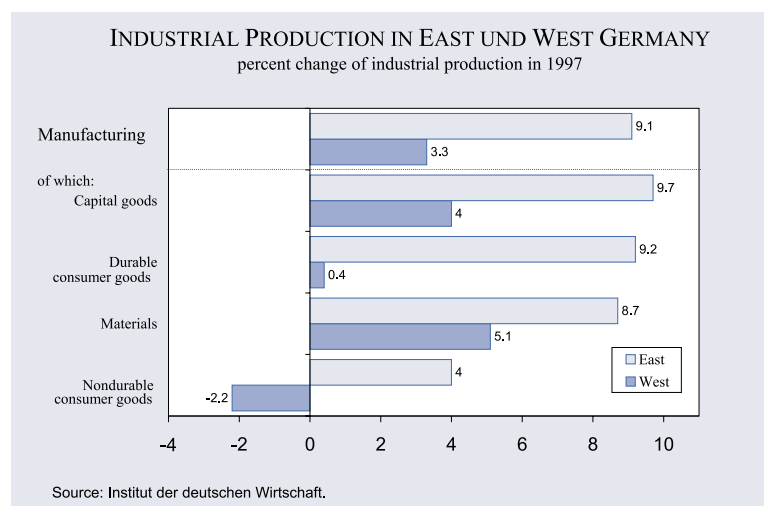


already behind us. Thus Milbradt was more optimistic than Dornbusch with respect to a happy end.

What about the economic situation in the Czech Republic, one of the top candidates for EU enlargement, which is experiencing a cyclical decline with negative growth rates in 1998 and 1999? Unlike some other people, **Karel Dyba** did not explain this by referring to incorrect concepts of transformation and neglect of microeconomic policies and/or institutions. In his view, the current economic recession was caused by excessively tight macroeconomic policies applied to an economy at a stage of unfinished transformation, lacking any recession experience. “Mastering macroeconomic policies in a market economy is a learning-by-doing exercise which cannot be imported.” Referring to the stage of the transformation process, he stated that presently 80% of output is produced by the private sector and

Productivity-oriented wages instead of investment subsidies

Fig. 2



No Wirtschaftswunder but a lot of progress in the Czech Republic

about 70% of foreign trade is with EU countries, more than half of it with Germany. "These results are irreversible." Even though Karel Dyba is slightly disappointed because he had expected a kind of "Wirtschaftswunder" for the Czech Republic, which did not happen, he consoles himself with the fact that he erred together "with some big names in the profession". Nevertheless, a lot has been achieved in the last ten years. "I do not think I would do many things differently."

What should be done in Germany? Concluding the panel session, **Hans-Werner Sinn** formulated a reform decalogue:

1. The infrastructure in east Germany needs further improvement and west Germany should pay for it.
2. The current system of investment subsidies, which is to end in 2004 because of its deficiencies, should not be prolonged.
3. The system of collective wage bargaining must be abandoned in east and west Germany. Wages should be negotiated at the firm level.
4. To make more employment possible one should think about forms of ownership participation which provide incentives for insiders to accept lower wages.
5. There is still too much public housing property in east Germany. Its privatisation could help to moderate wage policy.
6. The system of social welfare should be abandoned in its current form, which is a subsidy for doing nothing, in favour of a system of workfare.
7. The time pattern of unemployment benefits is too generous, inducing people to accept jobs only at high wages in east and west Germany.
8. The social welfare system should be regionalised in order to reflect regional productivity and wage differences .
9. Public sector wages in east Germany should be better adapted to regional productivity.
10. East German pensions should be reduced to those in the west.

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