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Germany: Fifteen years after unification

Fifteen years after: East Germany revisited

Joachim Ragnitz*

Assessing the German economy fifteen years after unification, we can hardly say that it has been a success story. This is especially true for east Germany that is still suffering from slow growth and high unemployment. But the west German economy, too, is still depressed by unsolved problems following a number of wrong decisions in the process of unification.

Persisting weak performance of the East German economy

After extraordinary growth rates in the early 1990s, reflecting primarily the process of rebuilding the infrastructure and a resurgence of production in privatised or newly established firms, economic growth in east Germany slowed down after 1995. From 1995 to 2004, real GDP growth averaged only 1.24 percent, nearly the same as in West Germany (1.26 percent). Today, it is only the manufacturing sector that is expanding in a satisfactory way, but with a share in aggregate output of only 17.5 percent (west Germany: 22 percent), manufacturing is too small to move the whole economy onto a higher growth path. Another reason for low aggregate growth is the continuing contraction of the construction sector whose size has halved since 1995. Nevertheless, this sector is still nearly double the size of west German construction (42 compared to 24 employees per 1,000 inhabitants), indicating further contraction in this sector in the years to come. Because of slow growth, the labour market has not improved at all in recent years. In 2005, the unemployment rate (including hidden unemployment) was still as high as 22 percent, reflecting the lack of more than two million jobs in the east German states. Bad labor market conditions are one reason for the persistently high migration from east Germany, as especially younger and better qualified people try to find jobs in west Germany. Though individually rational, this further reduces the chances for a higher growth path, as human capital is becoming a scarce production factor in east Germany.

The weak performance of the east Germany economy is best shown by looking at per capita figures in comparison with west Germany. At present, GDP per capita reaches only 64 percent of the west German level, labour productivity hovers at only 72 percent, and tax revenues generated at the state and communal levels are only about 40 percent of west German levels. On the other hand, household incomes (in west German prices) have risen to 86 percent, and investment per capita to even 95 percent of west German levels. Moreover, government expenditures of the east German states and their municipalities exceed those of the poorer west German states by 20 percent, the major reason being high government consumption and an excessive stock of personnel in the public sector. Thus, there is a significant gap between self-generated economic strength and realized living standards of the population. This is only made possible by enormous transfer payments from west to east Germany, amounting to about 83 billion euros per annum (4 percent of west German GDP, but around 30 percent of east German GDP). Without these transfers, demand in East Germany would be 25 percent lower, and estimates suggest that the real economic performance (GDP per capita) would not be 64 percent, but only 55 percent of west German levels.[1]

Slow growth, high unemployment and transfers from the west

The problem is, however, that financing these transfers weakens the growth prospects of the west German economy. Since unification, public debt as a share of GDP has increased from 41.8 percent (1989, west Germany only) to 66.4 percent (2004), implying high interest payments and a reduced scope for action in the public budgets. And secondly, because unification issues dominated policies in the 1990s, structural reforms of goods and factor

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[1] Lehmann, H./Ludwig, U./Ragnitz, J., "Originäre Wirtschaftskraft der neuen Länder noch schwächer als bislang angenommen," *Wirtschaft im Wandel,* No. 5/2005, pp. 134–145.

markets were postponed, diminishing the competitiveness of Germany as a location for investment and production. As a consequence, growth rates in Germany have been the lowest in the European Union for several years. This again hampers the development of the east German economy, as west Germany has become an important market for manufactured products from the eastern states and as more than half of private investment in the east is done by west German firms.

The reasons for the weak performance of the east German economy are manifold. Most important in this respect seem to be structural deficits in the business sector, like the small size of most firms causing difficulties with R&D, finance and exports. Furthermore, as economies of scale cannot be sufficiently exploited, productivity is depressed further. Estimates suggest that about 75 percent of the productivity gap in the manufacturing sector is due to the specific size structure of the east German economy. This structure is the result of the fact that most firms were founded only after 1990, but it has also been brought about by the reluctance of west German firms to invest in east Germany: only 9 percent of all firms in east Germany are subsidiaries of west German companies, and only 30 of the 757 firms with more than 1,000 employees are located in the eastern part of the country. Of course, no one could expect west German firms to move from west to east; nevertheless, these path dependencies were not recognised early enough, causing privatisation decisions of the Treuhand Agency that did not prove to be wise in every single case.

Small company size in the east

The size structure is accompanied by a lack of human-capital intensive managerial functions such as marketing, research or other business services, resulting in a high share of less productive activities in east German firms. This again results in lower productivity and – as wages are roughly in line with productivity now – in lower disposable income. This special human capital structure therefore merely reflects the size structure of the East German economy, as smaller firms often do not need these entrepreneurial skills (or cannot afford them). Additionally, in most cases west German subsidiaries are located in east Germany only for production purposes while the more productive parts of the value-added chain stayed at headquarters in west Germany. As structural characteristics of an economy normally change in the long run only, it is difficult (or even impossible) to reach West German levels of productivity and thus of income in a few years only.

Turned another way: low aggregate productivity is not caused by bad location conditions in east Germany, such as infrastructure deficits or poorly qualified workers – external firms investing in east Germany can therefore reach productivity levels that are not substantially different from those in other industrialised countries. Nevertheless, as internal demand as well as individual migration decisions depend on aggregate productivity levels, location disadvantages persist, leading to an ongoing reluctance of firms to invest in the eastern states.

Large regional differences

In the past fifteen years, a considerable regional differentiation has emerged in east Germany. Some regions have developed rather well, and they can be considered growth poles for the surrounding areas. These (effective or potential) growth centres are mainly the big agglomerations like Berlin, Dresden, Chemnitz, Leipzig, Halle, Jena and Erfurt, maybe also Rostock. The positive factors in these regions have been high population density (leading to agglomeration advantages), the existence of universities or other research institutions, favourable infrastructure conditions or simply historical coincidences (like the existence of big firms). Although even these cities still exhibit a number of transformation-induced problems (like high unemployment or an underdeveloped service sector), convergence to comparable West German agglomerations is proceeding. Unfortunately, the number of these agglomerations is rather low, and they are concentrated in the southern part of east Germany, limiting potential spillover effects on the east German economy as a whole.

Besides these potential growth poles, there are plenty of regions where economic progress has come to a halt in recent years. These are mainly rural areas, often located on the periphery of the east German states, but also locations of industrial complexes which might have been competitive under socialist conditions but not under market conditions and integrated world markets. The real problem is the large number of these regions. In some of them, a vicious circle has evolved: low economic activity results in high unemployment and in the emigration of younger people, leading to an even lower attrac-

tiveness for investment, promoting further emigration and so on. It is hard to see how these developments could be reversed. They are causing severe distortions in regional policy that tries to level out regional differences.

Unfavourable prospects

While the present problems of east Germany are difficult enough, there is even less cause for optimism with respect to the future. In particular, foreseeable demographic changes and fiscal consolidation needs will dampen economic growth.

With reference to the latter, east German states and municipalities will see a "normalisation" of their budgets: While presently taxes and transfers by the federal government result in per capita revenues of 120 percent of west German low-income states, in 2020 the figures will be nearly the same in east and west Germany. This is made possible by the so called "Solidarity Pact II" that will decline from 10.5 billion euros a year in 2005 to zero transfers in 2020. Together with a reduction of transfers in the so-called "Laenderfinanzausgleich" (fiscal equalization among the states that guarantees minimum public per capita incomes in all German states) because of lower population figures, most east German states will experience a reduction of their revenues by about 30 to 40 percent by 2020. Obviously, this will lead to severe demand pressures as expenditures will have to be reduced in a similar extent.

Even more dramatic are the foreseeable demographic developments. Already today, east Germany is characterised by a rapidly shrinking population. Since 1989 the population size has fallen by around 1.7 million persons, and by 2020 the number of people living in the former GDR (without Berlin) will further decline from 13.5 million in 2004 to only 12.2 million, that is by more than 10 percent. The major reason for this is a lack of births. Since following German unification, birth rates temporarily fell to 0.8 children[2] per woman, there will be a substantial lack of potential parents in coming years. A second reason is, of course, net migration from east to west Germany, which is still as high as 50,000 persons a year. Though this does not seem very much compared to the whole population, the growth implications might be enormous, as mainly younger and well qualified persons are leaving east Germany to find better jobs elsewhere.

Demographics will not only result in a lower population but also – and even more so – in a declining potential workforce (persons aged 15 to 64). This age group will shrink by about 20 percent in the next 15 years – and this will bring about severe economic consequences, especially a lowering of potential growth rates due to a smaller supply of labour. At given productivity levels and given participation rates, potential output will decrease by the same factor as the available workforce. Further, as the labour force is declining faster than the population as a whole, there will be a dampening effect on per capita GDP. Pure arithmetic suggests that per capita GDP will remain constant only if productivity grows by at least 0.6 percent per annum.

Shrinking population due to low birth rates and migration

Of course, it seems quite realistic that productivity growth of this magnitude can be achieved. In the past 15 years, the trend growth rate of labour productivity was around 1.5 percent p.a., and in east Germany productivity growth has been substantially higher (1.94 percent) even after 1995 because of the ongoing adjustment processes. Nevertheless, productivity growth itself is negatively influenced by future demographic developments, as aging could lead to a worsening of the human-capital base and to lower innovation rates. Therefore, it is not very likely that future productivity growth will be very much higher than in the past. Simulations under perhaps too optimistic assumptions regarding productivity growth (2.25 percent p.a.) and labour participation rates (+ 0.3 percentage points p.a.) result in a GDP growth rate of only 1 percent p.a. from 2004 to 2020. This in turn allows a growth rate of per capita GDP of 1.5 percent, resulting in a level of GDP per capita of 70 percent of west German levels in 2020. In this scenario, unemployment might be reduced to a rate of about 8 percent. However, while highly qualified labour will become scarce in the years to come, unemployment of low-skilled labour will still be high then.

Again, these figures hold only on average; especially in some rural regions on the periphery of the eastern states, population and the workforce will decline even more, leading to even lower growth rates. On the other hand, east German agglomeration centres might expect a nearly stable population, due to migration from the periphery to the centres. It does

[2] This merely reflects an adaptation of west German attitudes, as the total fertility rate in east Germany and west Germany is nearly the same (1.3 children per woman) today, though too low to guarantee a stable population.

not seem likely therefore that the goal of "equal living standards" all over Germany, which has determined German policies since unification, can be achieved in the years to come, and a new interpretation of the corresponding principle will become necessary: In the regions with a progressively declining population, public policy will only be able to guarantee limited standards with respect to infrastructure, school systems or even health care. These public services will have to be concentrated in the agglomeration centres, deepening the (economic and social) differences between centre and periphery. While other countries (like the United States or Canada, but also France and Spain) have already had experiences like this, in Germany the image of depopulating desolated areas is quite unknown and therefore neither policy nor the public is prepared for this. Nevertheless, it is hard to see how this development can be avoided. It is therefore necessary to find policy instruments to deal with it.

Needed: Privatization of services, more focussed support, and growth policies

The main task will be to develop a new division of labour between the public and the private sectors. In Germany, many tasks have been transferred to public institutions, tasks that can be equally well or even better managed by private actors – for example education, health care, infrastructure services. Publicly provided services of this kind will no longer be affordable, however, due to financial constraints on the government accompanying the demographic change. Of course, privatisation will result in different prices for these services according to supply and demand conditions, but there is no reason why prices for publicly supplied goods should be identical as long as the level and structure of costs differ across regions.

Secondly, economic policy (which in east Germany consists mainly of support for firms) must be concentrated according to regional strengths. At present, this is not the case, as many instruments of firm support in east Germany do not differentiate between weak and strong regions or sectors. This, in turn, leads to inefficient policies, i.e. subsidisation of pure prestige projects (like computer technologies in regions without an adequate technological base or competing biotechnology centres in neighbouring regions). As long as the states retain responsibility for economic policies, stricter controls by the federal government seems to be in order.

Thirdly, more pronounced growth policies have to be pursued in Germany as a whole, as the east is still dependent on growth dynamics in the west: As long as demand is supported by transfer payments in the present extent, as long as more than half of industrial investment is financed by west German firms and as long as more than 40 percent of manufacturing production is sold in west Germany, east Germany cannot achieve higher growth than west Germany. It is only reasonable, therefore, that the newly elected federal government put pan-German economic policies at the centre of its agenda.

Concluding remarks

As described above, the economic situation in east Germany fifteen years after unification is far worse than is indicated by most official judgements. Unemployment is unacceptably high, slow growth does not seem to be just a temporary phenomenon, and continuing regional differentiation might lead to severe social and economic problems. The prospects for the next fifteen years are not very favorable as demographic developments and fiscal consolidation needs will dampen economic dynamics.

It appears that pessimistic forecasts[3] of the duration of the east German convergence process from the beginning of the unification process were not wrong. Although the adjustment mechanisms are not those of the classical convergence model, the final result – a convergence speed of about 2 percent a year – seems to be the best that can be achieved. Unfortunately, there seem to be no policy options left to speed up this process. But looking at indicators of individual happiness (which are not very much different in east and west Germany), one may doubt that confining the assessment to purely economically defined indicators of individual prosperity is appropriate. This however, is a question that cannot be discussed here.

[3] Cf. Barro, R./X. Sala-i-Martin, "Convergence across States and Regions," *Brookings Papers on Economic Activity* I/1992, pp. 107–182; Hughes Hallet, A./ Y. Ma, "East Germany, West Germany and their Mezzogiorno Problem, A Parable for European Economic Integration," *Economic Journal,* 103, p. 416–428.