The Lack of Government Success in Reducing East German Unemployment: Analysis and Explanations

Tamara Polyakova

Introduction

Germany is one of the world's highly developed industrial nations and the third largest economy after the United States and Japan.[1] One of the founding members of what today has become the European Union (EU), it is currently the Union's most important market.[2] With an export volume equaling one third of its gross domestic product (GDP), Germany is the biggest exporter of goods worldwide.[3] In 2004, industry accounted for 84 percent of its national exports, making Germany one of the world's largest and most technologically advanced producers of iron, steel, coal, cement, chemicals, machinery, vehicles, and electronics.[4] Successful fiscal and monetary policies ensure a stable and low inflation rate, which has been key to attracting foreign investment.[5] Overall, it is hard to overestimate Germany's role in the world trade and economy.

For the last two decades, however, the unusually high and persistent unemployment levels have been a major obstacle to Germany's superior economic performance.[6] Unemployment is not uniform; in fact, there exists a clear distinction between eastern and western Germany. Since the Federal Republic of Germany (FRG) and the German Democratic Republic (GDR) reunited on October 3, 1990, unemployment in the east has been about twice as high as in the western part of Germany – an average of about 8 percent in the west compared to 18 to 20 percent in the new Bundesländer .[7,8] High levels of unemployment have caused a number of negative consequences for unified Germany – from political and economic to social. The rise and strengthening of both right- and left-wing political parties, the impoverishment of the population, and the persistent economic gap between eastern and western Germany are just a few of such consequences.

Unemployment has slowed down the economic performance, affected national elections, and conditioned the persistence of the rift between capitalist west and formerly socialist east.[9] Why has eastern German unemployment remained persistently high? Why are there no visible results of the eastern and western labor markets' integration with respect to unemployment, even almost twenty years after unification? And most importantly, why has the government of Germany not solved the problem of high unemployment through policies such as job creation, job training, implementation of an earlier retirement age, or others? This paper will suggest answers to these questions through the following structure. First, I will describe the expectations of eastern Germany's post-unification economic transformation and outline the general process of transition from planned to market economy, experienced in different degrees of intensity by all former members of the socialist bloc. I will then contrast the labor markets of the GDR and the FRG and describe the structure of unemployment in eastern Germany. The next section will focus on the effects of unemployment on the nation's economy, politics, and society, and compare East German labor market transformation to that of other socialist economies. Finally, I will outline some of the causes that could have contributed with different intensity to the condition of East German unemployment and conclude with a suggestion as to why the government of the unified Germany has not been successful in reducing unemployment in eastern Germany.

Unified Labor Market: Expectations and Reality

The expectations of economic returns from German unification were high.[10] Both the FRG and the GDR had played an important role in their respective economic environments – West Germany's economic system was considered one of the most respected in Europe and the

1 "Total GDP 2005," World Development Indicators Database, World Bank, July 1, 2006, http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf.

2 Thomas Straubhaar, "Germany as an Economic Hub," in *Facts About Germany*, http://www.tatsachen-ueber-deutschland.de/index.php?L=1.

3 Straubhaar, www.tatsachen-ueber-deutschland.de.

4 "Germany," in *The World Factbook,* https://www.cia.gov/cia/publications/factbook/geos/gm.html.

5 Straubhaar, www.tatsachen-ueber-deutschland.de.

6 Thomas Lange and J.R. Shackleton, "The Labor Market in Post-Unification Eastern Germany," in *The Political Economy of German Unification*, ed. Thomas Lange and J.R. Shackleton (Oxford: Berghahn Books, 1998), 95.

7 Bundesland (plural Bundesländer), German federal units.

8 *Statistisches Jahrbuch* (Statistisches Bundesamt Deutschland, 2006), 91.

9 See, for example Hermann Kurthen and Michael Minkenberg, "Germany in Transition: Immigration, Racism and the Extreme Right," *Nations and Nationalism* 1 (1995).

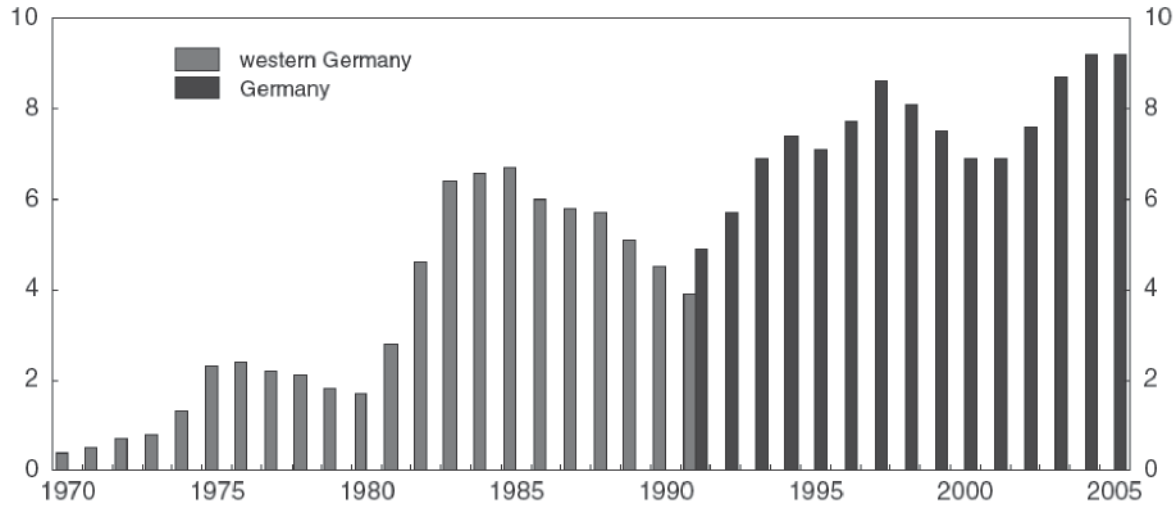
10 See, for example, Jerald Schiff et al., *Labor Market Performance in Transition* (International Monetary Fund: Washington, D.C., 2006).

world, and East Germany was the main supplier of advanced industrial equipment to the COMECON[11] markets.[12] A bright economic future seemed to be waiting ahead, which led the Chancellor of the unified Germany, Helmut Kohl, to proclaim in a speech to the Bundestag in 1990: "Only the unification will give us the chance to turn Mecklenburg-Vorpommern, Sachsen-Anhalt, Thüringen, Brandenburg and Sachsen[13] into blooming landscapes, where it is worthwhile to live and work."[14]

An initial rise of unemployment had been predicted, but then the quick, market-driven reallocation of resources was expected to lead to a rapid decline in unemployment and a sharp surge in productivity.[15] The following three-stage development of unemployment in transition has been suggested by the International Monetary Fund economists: (1) initial period of declining employment due to job destruction in the public sector; (2) further falling of employment, compensated by a rise in productivity signifying the expansion of the private sector; and (3) the rise of employment due to job creation in the public sector.[16] Overall, therefore, East German citizens were prepared for some economic stagnation, but they expected it to be temporary and soon overcome by fast economic growth.

However, the actual effect of the German unification has been very different from the one that was expected. Employment diminished dramatically – from 1989 to 1991 the workforce declined by almost three million people,[17] partially due to the emergence of previously hidden unemployment, but most significantly due to early retirement and discouragement resulting from the inability to find work.[18] Unemployment, on the other hand, rose to 43 percent by some accounts – a value almost unprecedented in developed nations.[19] Furthermore, the output declined dramatically – production of goods dropped to 46 percent of its pre-unification level,[20] and industrial sector jobs were cut by half.[21] These labor market developments, coupled with a sharp rise in consumer prices,[22] caused strong public dissatisfaction with the effects of unification.[23]

Figure 1: The Development of Unemployment in West and the United Germany
(Unemployment as Percent of Labour Force)



Source: "Germany," *OECD Economic Survey*, Volume 2006/8, May 2006, 29.

[11] Council for Mutual Economic Assistance, established in January 1949 to facilitate and coordinate the economic development of the eastern European countries belonging to the socialist bloc. Comecon's members were the Soviet Union, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, Albania, German Democratic Republic, Mongolian People's Republic, Yugoslavia, Cuba, and Vietnam. For more information, see, for example, "COMECON," *Encyclopædia Britannica Online*, http://www.britannica.com/eb/article-9054503/Comecon. [12] "Germany," *Encyclopædia Britannica Online*, http://search.eb.com/eb/article-233610.

[13] East German federal units, the new Bundesländer.

[14] Blühende Landschaften oder Zukunft Ost heißt Urwald," MDR, May 4, 2004, http://www.mdr.de/artour/archiv/1326250.html.

[15] Schiff et al., 1.

[16] Schiff et al., 30-31.

[17] Conny Wunsch, "Labour Market Policy in Germany: Institutions, Instruments and Reforms since Unification," Discussion paper no. 2005-06 (St. Gallen: University of St. Gallen, 2005) 6.

[18] Jürgen von Hagen, "East Germany," in *Going Global. Transition from Plan to Market in the World Economy*, ed. Padma Desai (Cambridge: MIT Press, 1997), 194, 197.

[19] K.H. Domeday, "Privatization in the New Bundesländer: A Critical Assessment of the Treuhand," in *The Political Economy of German Unification*, ed. Thomas Lange and J.R. Shackleton (Oxford: Berghahn Books, 1998), 54.

[20] Wunsch, 6.

[21] Lange and Shackleton, "The Labor Market," 89.

[22] von Hagen, 190.

[23] von Hagen, 186

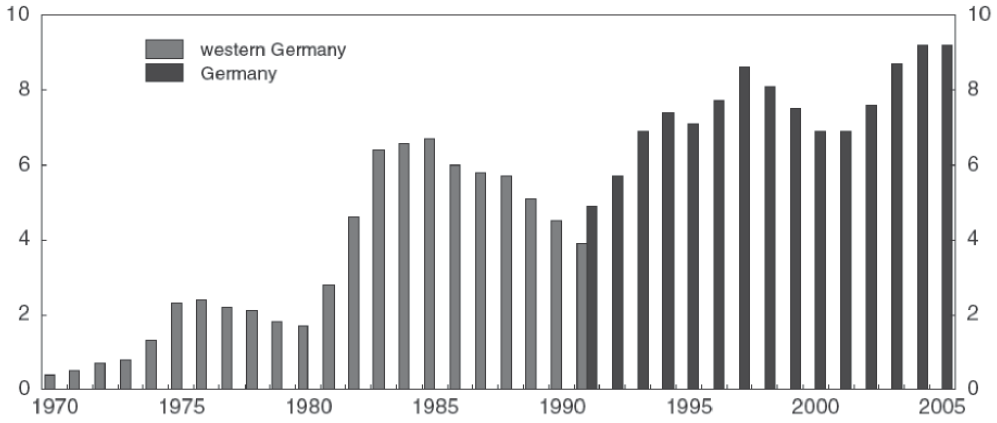
To understand why these labor market shocks occurred, we need to understand the differences between employment structures in the two countries. In the GDR, just as in anymember of the socialist bloc, employment was guaranteed in the nation's constitution.[24] Unemployment was therefore nonexistent, which created a certain stability for the population – it was almost impossible to be fired, and even if that happened, a new job would have been found by the system. Of course, this approach created great inefficiencies in the market, such as reduced competitiveness.[25] By contrast, the labor market of western Germany was much like a western labor market of today – competition and productivity were oriented and judged by market criteria rather than social demands. West Germany's unemployment rate before unification fluctuated between 4 and 6 percent (see Figure 1) – a value that can be considered a market's natural unemployment rate.[26]

Due to these distinct differences between the structure of east and west labor markets, there was a significant personnel problem in the east. In the GDR, there were skilled workers and technicians, but few entrepreneurs, managers, and lawyers – professions that are highly demanded in a market economy.[27] Furthermore, the socialist management structure disintegrated speedily after the unification; no industrial plans were created by the government, and no one in the east was able to fill these management positions.[28] The absence of such important institutions as social insurance, employment exchanges, and trade unions all pointed to the necessity of wholesale adoption of the Federal Republic model.[29] This was the determining factor for the decision to transform the East German territory politically, economically, and socially in conformity with the West German standard.[30]

The Key Characteristics of German Unemployment

Regional differentiation of unemployment is evident – only one western Bundesland (Bremen) has a higher level of unemployment than the average national. Within the regions, there also exists some differentiation: in the former FRG, unemployment is higher in the north than in the south; in the GDR, unemployment is higher in the rural areas and lower in the urban zones and in territories that border on western Germany.

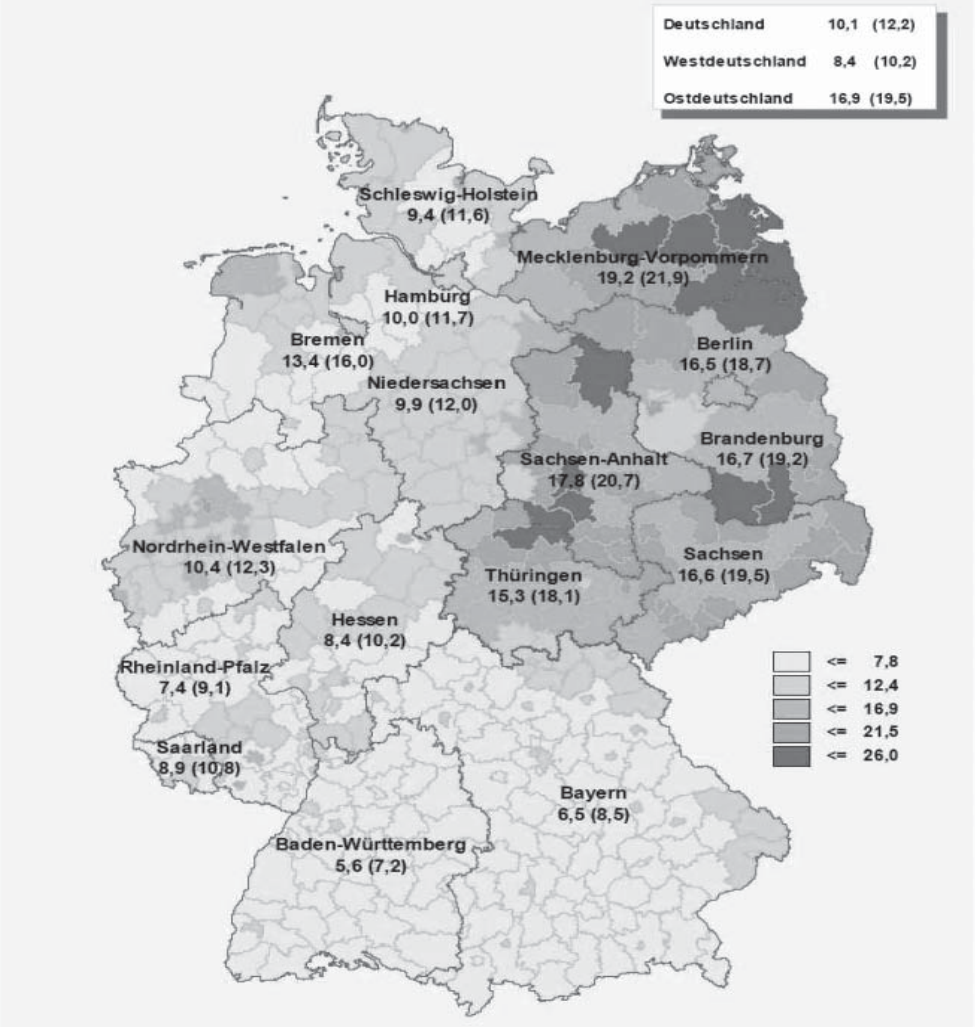
Figure 2: Unemployment Rates, 2004, by Bundesländer



Source: "Germany 2005," *Statistisches Bundesamt Deutschland*, May 2005, http://www.destatis.de/download/e/veroe/germany.pdf, (accessed on April 23, 2007).

[24] Lange and Shackleton, "The Labor Market," 90.
[25] Heinz Fassmann, "Are The Two Things That Belong Together Coming Together? Labor Markets and Jobs in the New and Old Länder," in *Germany Ten Years After Unification*, ed. Alois Mayr and Wolfgang Taubmann (Leipzig: Institut für Landeskunde, 2000), 148.
[26] A natural unemployment rate is not caused by the economic recessions, but rather consists of workers in transit between two jobs or in training. For more information, see, for example, Campbell R. McConnell and Stanley L. Brue, *Macroeconomics: Principles, Problems, and Policies* (Boston: McGraw-Hill, 2005), 137.
[27] Martin Geiling, "Germany's Changing Political Landscape," in *The Political Economy of German Unification*, ed. Thomas Lange and J.R. Shackleton (Oxford: Berghahn Books, 1998), 35.
[28] Geiling, 35.
[29] Lange and Shackleton, "The Labor Market," 91.
[30] Domeday, 45.

Figure 3: Unemployment in March 2007, by Länder and Regions



Source: "The Labor Market in February 2007," *Bundesagentur für Arbeit*, February 2007, http://www.pub.arbeitsamt.de/hst/services/statistik/000000/html/start/monat/Arbeitsmarktbericht-engl/2007/0207.pdf, (accessed April 23, 2007).

The long-term unemployment pattern follows the general unemployment pattern – it is higher in the north and in areas further from urban centers.[31] It has been pointed out that the German labor market is exhibiting clear tendencies toward being "sealed"; those on the inside of the employment system are increasingly protecting themselves from outsiders, rendering job searches for recent graduates or women returning from maternity leave fruitless.[32]

The group that has arguably suffered the most from the persistent unemployment in East Germany is women. Traditionally, labor force participation rates of East German women were much higher than those of their West German counterparts - in 1991, 78 percent compared to 58 percent in the West.[33] East German women also enjoyed a higher level of education (see Table 1) and thus could potentially take on higher level jobs than women in West Germany. After the unification, women of East Germany were faced with discrimination in obtaining and retaining employment; it was more difficult for a woman to find a job, and when firing decisions were made, women were the first ones to go.[34] A large number of East German women who in 1989 occupied senior social and professional positions were forced to accept lower levels of responsibility and pay.[35] Despite the higher level of education of East German women, their employment levels have converged with those in West Germany (see Figure 4).

[31] Fassmann, 152.
[32] Fassmann, 152.
[33] Wunsch, 8.
[34] Anneliese, Braun ,"Women in the New Germany," in *The Political Economy of German Unification*, ed. Thomas Lange and J.R. Shackleton (Oxford: Berghahn Books, 1998), 105.
[35] Braun, 106.

Table 1: Qualification Structures of Employed in Germany (in percent)

Qualification level	Western Germany 1989-90		Eastern Germany 1991	
	Women	Men	Women	Men
No skills*	27.2	17.2	8.6	7.2
Intermediate Skills	60.1	58.7	51.2	57.3
In 'high level' professions**	12.7	24.1	40.2	35.5

* Including partly-skilled workers
** As a result of attending trade schools, technical schools or college/university education

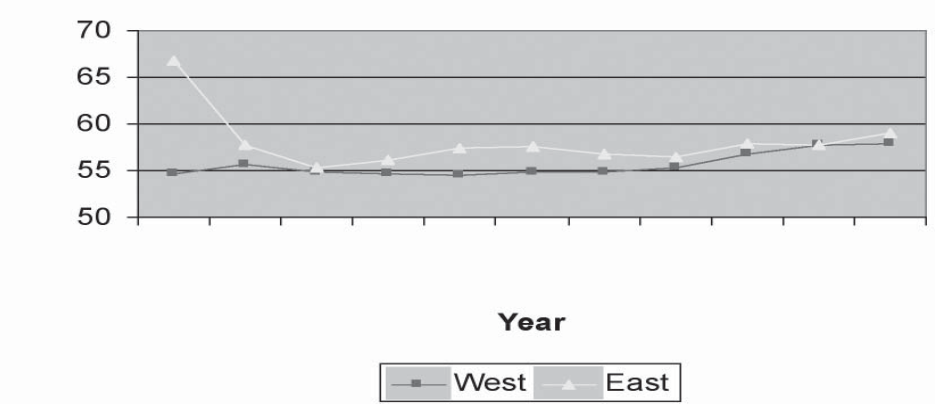
Source: Anneliese Braun, "Women in the New Germany," in *The Political Economy of German Unification*, ed. Thomas Lange and J.R. Shackleton (Oxford: Berghahn Books, 1998), 110.

Significance and Implications of High Unemployment

High unemployment arguably has had a strong effect on German national politics. Discouraged by employment insecurity, many east Germans have turned to the Party of Democratic Socialism (PDS, now Die Linke), the restructured successor of the Socialist Unity Party (SED), which was the sole political party of East Germany before the unification.[36] There exists a significant difference in the voting patterns of eastern and western Germany, with much stronger support for the populist PDS in the east. Such political differentiation between east and west Germany can potentially transform national politics into a battle of two camps: the market-oriented western and the socialist eastern, arguably reducing the effectiveness of the German political system.

A dangerous trend that could have been caused by high unemployment in the east is the rise of right-wing extremism.[37] The younger generations are unable to gain employment and become increasingly xenophobic, thinking that it is the foreigners who are taking their jobs.[38],[39] The high unemployment and xenophobic population tendencies have led some analysts to compare post-unification eastern Germany with the weak democracy of the Weimar Republic.[40] It is argued that an increase in employment possibilities can solve the problem of xenophobia because "violence in eastern Germany is bound to subside eventually as economic conditions improve and youth gain employment and a sense of self-worth."[41]

Figure 4: Female Unemployment in East and West Germany, 1991-2001



Source: "10 Jahre Erwebsleben in Deutschland," *Statistisches Bundesamt Deutschland*, 2002, http://www.destatis.de/download/d/veroe/d_erwerbsl.pdf.

[36] Geiling, 38-40.
[37] Geiling, 42.
[38] Partially this view is supported by the fact that there exists very little unemployment of foreigners in East Germany (see Fassmann, 148). However, this can be explained by the fact that very few foreigners were invited to East Germany to work (especially when compared with West German national policies of invitation of guest workers); therefore, there is no unemployment of foreigners because of lack of foreigners.
[39] Thomas Lange and J.R. Shackleton, "Germany in Transition: An Introduction," in *The Political Economy of German Unification*, ed. Thomas Lange and J.R. Shackleton (Oxford: Berghahn Books, 1998), 5.
[40] See, for example, Jan Herman Brinks, *Children of a New Fatherland: Germany's Post-War Right Wing Policies* (New York: I.B. Tauris, 2000).
[41] Geiling, 42.

Unemployment has negative economic consequences – the potential contribution of the unemployed to the growth of the economy is lost, and unemployment expands the ranks of people who collect welfare.[42] High long-term unemployment has potentially important policy implications, as this group may find their job skills eroding, increasing the long-run equilibrium unemployment rate, and they may find themselves ineligible for unemployment insurance and fall into poverty.[43]

Unemployment, especially long-term unemployment, may have negative social and psychological consequences; it may affect self-esteem, dignity, and social status of the jobless. Chronic unemployment gives the people a feeling that they are unneeded and not a part of the society. Because it is such a new phenomenon in the formerly socialist countries, the shocks of unemployment have been even stronger there.[44] Overall, high unemployment has a negative effect on the economy and the society of a nation, and all necessary policies should be implemented to reduce it to its natural level.[45]

The assessment of unemployment in eastern Germany in the context of the European Union's labor market difficulties is beyond the scope of this paper. As a result of Germany's importance in the economy of the EU, however, any domestic policies are bound to resonate internationally. The stagnation of German economy has certain effects on European economic growth. Therefore, reduction in the unemployment of eastern Germany is a task important not only for the domestic but also for the regional and international economies.

Unemployment and the Transition from Planned Economy

The pattern of unemployment exhibited in eastern Germany is not unlike that seen in other transition economies of Eastern Europe. All of these transforming countries experienced an initial sharp contraction in output; deep recession and fundamental structural changes both had a profound effect on the labor market.[46] In the initial years of transition, employment declined sharply as job shedding in government and state-owned enterprises more than offset job creation in the private sector.[47] It has been pointed out that in the short run, privatization of the formerly state-owned enterprises raises unemployment, reduces demand and thus contributes to the economic recession.[48] The most prevalent view on the source of this unemployment surge is that it has been caused by the transformation strategy – the shift from agriculture and manufacturing to services.[49] In the process of this transition, the authorities did not account for possible market failures, leaving it to the forces of supply and demand to furnish goods such as employment to the population.[50] This shift, designed to promote greater efficiency, has nonetheless decreased the power of the economy by creating high unemployment in all formerly socialist countries of the Eastern Europe.

Another similarity that existed between all the transition economies was the lack of accurate information about their economic state. In the bringing together of the two Germanys, accurate statistical data from both the GDR and the FRG was very important, because often it was the only indication of the correspondence between the two. Based on this data, the economists planned the union, deciding on such issues as the conversion rate between the two currencies and the taxation levels for the new states. However, the economic growth of the GDR is very difficult to determine statistically, due to a bias in the data. The official reporting was constantly revalued because of frequent changes in the statistical definitions, continual plan revisions, overvaluation of new products, omission of important comparative information, and the conscious veiling of inflationary tendencies.[51]

Detailed statistics on economic developments at the sector level were published increasingly infrequently since the middle of the 1970s.[52] These statistical adjustments were used to conceal the arising fundamental weaknesses of the GDR's development from the outside world.[53] In the end, these methods proved effective, and by 1989 no one could be sure about the level of the GDR's development. The two countries were in reality much more different economically than was assumed during the Unification, which arguably caused many unexpected difficulties during the merge.

---

[42] Jan Adam, *Social Costs of Transformation to a Market Economy in Post-Socialist Countries* (New York: St. Martin's Press, Inc., 1999), 97.
[43] Schiff et al., 9.
[44] Adam, 97.
[45] For the definition of the natural unemployment level, see footnote 27.
[46] Schiff et al., 3.
[47] Schiff et al., 8.
[48] Adam, 17.
[49] Adam, 14.
[50] Adam, 17.
[51] Manfred Melzer, et al. "The GDR Before 1989," in *German Unification – an Example for Korea?* Ed. Heiner Flassbeck and Gustav Horn (A. Aldershot: Dartmouth, 1996), 9-10.
[52] Wolfgang Scheremet and Manfred Melzer, "The Turning Point," in *German Unification – an Example for Korea?* Ed. Heiner Flassbeck and Gustav Horn (A. Aldershot: Dartmouth, 1996), 37.
[53] Heiner Flassbeck and Gustav A. Horn, "Introduction," in *German Unification – an Example for Korea?* Ed. Heiner Flassbeck and Gustav Horn (A. Aldershot: Dartmouth, 1996), 1.

The Causes of High and Persistent Unemployment in Eastern Germany

There exist seven possible reasons that have been cited as having caused or contributed to the high unemployment in eastern Germany and lack of convergence of the eastern and western German labor markets. They are as follows: the bad state of the GDR's infrastructure and economy, the failure of the unification policies, the collapse of eastern Germany's traditional markets, the Europe-wide recession, the frictional and structural unemployment resulting from the restructuring of the economy, the convergence of wages, and the inefficiencies of the German social insurance system. Some of the causes listed above could not have had a decisive effect on the labor market; however, they could have influenced it and worsened the existing situation. All of these causes are assessed in greater detail below.

The bad state of the East German economy and infrastructure, not obvious at first due to the lack of statistical data described above, has been seen by some economic analysts as the decisive reason for the high unemployment in eastern Germany after unification, unemployment being the price that had to be paid in order to develop the former GDR into an internationally competitive region.[54] In 1989, the eastern German economy was characterized by a capital stock – machines and production technologies - that were largely obsolete by Western standards: almost 55 per cent of the GDR's industry equipment was older than 10 years and more than 21 percent older than 20 years.[55] In the late 1980s, economic growth in the GDR was low, productivity was falling, and trade declined.[56] In the first year following unification, east German regions accounted for 20 percent of Germany's population but only 8 percent of its GDP.[57] The economy was severely distorted – wages were completely incompatible with productivity.[58] Overall, the efficiency of the economy was so low that it would take East Germany a long time to catch up with its western counterpart.

Unification policies are another cause often blamed for high east German unemployment. Monetary, economic and social unification had to be implemented swiftly in order to prevent migration from east to west, which had become a significant problem – 2.3 percent of East Germany's population migrated to West Germany in 1989 alone.[59] Furthermore, it was believed that a faster transition progress would allow employment to rise more rapidly.[60]

On the other hand, the swift transition, with the slogan "one German deserves as much as another" embodied in it, have been interpreted as a means to avoid the cost of acknowledging the complexity of the unification process.[61] The privatization of state-owned enterprises implied in the transition to a market economy needs to be elaborated in depth. The process was organized by Treuhandanstalt, a trust fund holding ownership of formerly state-owned East German companies and authorized to sell them to the public, restructure them, or liquidate them.[62] The work of the Treuhandanstalt was characterized by a significant transfer of power.[63] West Germans dominated the supervisory board of the trust fund, which secured a transfer of 'know-how' to the east, at the expense, however, of eastern entrepreneurs' self-determination.[64] The initial aim of privatization in the former GDR was "to transform public ownership into private ownership to be held, as far as possible, by East German citizens."[65] However, this goal has not been met: 75 percent of the privatized firms went to West German entrepreneurs, 6 percent to foreigners, and only 19 percent to East German entrepreneurs.[66] It had been planned that the privatization and dismantling of the Treuhandanstalt was to take place in 1994, so because of time constraints, not much industrial restructuring of east German enterprises was undertaken.[67] Instead, the Treuhandanstalt approach to privatization focused on selling downsized firms to investors without taking into account employment targets. On average, the new ownership of east German firms reduced employment by 20 to 30 percent.[68] As put by an economic analyst,

> the productive potential, the preservation of a qualified labor force, research and development facilities and training resources, the creation of new products, marketing and reconstruction of competitive firms before selling them to the private sector at decent prices were never at the heart of Treuhandanstalt activities.[69]

Although it is argued by some that Treuhandanstalt did indeed successfully accomplish rapid privatization

[54] Thomas Lange and Geoff Pugh, "The Treuhand: A Positive Account," in *The Political Economy of German Unification*, ed. Thomas Lange and J.R. Shackleton (Oxford: Berghahn Books, 1998), 62.
[55] Wunsch, 5.
[56] von Hagen, 177-8.
[57] Lange and Shackleton, "The Labor Market," 93.
[58] Lange and Pugh, 60.
[59] von Hagen, 174.
[60] Schiff et al., 36-7.
[61] Geiling, 34.
[62] von Hagen, 186.
[64] Lange and Pugh, 70.
[65] Domeday, 49.
[66] von Hagen, 187.
[67] Lange and Pugh, 69.
[68] Domeday, 53.

that facilitated the GDR's transition from socialism to capitalism,[70] the process of privatization has also often been dubbed "the sell-off" of East German economy.[71] There were also many advocates of alternatives to privatization, such as distribution of property vouchers to previous owners, issues of free stock market shares to workers in previously state-owned commercial properties, and the transformation of state-owned small and medium-sized enterprises into cooperative holdings, which could arguably diminish the negative effects of the transition on the labor market.[72]

The monetary unification, that is, the introduction of the Deutschmark (DM) in East Germany, was also a significant aspect of the unification policies, the effects of which on unemployment are often debated. The economic unification, implemented on July 1, 1990, introduced the Deutschmark in the GDR, eliminated all trade, capital and labour movement barriers between Eastern and Western Germany, and harmonized their legal, tax, and social insurance systems.[73] The actual monetary union provided for the conversion of the GDR Mark in the following manner: all stocks in the Ost Marks[74] of cash, assets, and liabilities were converted at the ratio Ost Mark 2 : DM 1, with the main exception that for each private person, a certain amount of Ost Marks was converted into DM at the ratio of 1 : 1. The size of the amount depended on the age of the person. Overall, almost 65 billion Marks were thus converted at the ratio 1 : 1.[75] In addition to the conversion of financial assets and liabilities, it was also necessary to convert flow values, such as wages and pensions. In the case of pensions, the aim was to increase the living standards of pensioners, so the pensions were also converted at the ratio of 1 : 1 and increased by a supplement. In the case of wage conversion, the situation was more difficult. The aim was not only to meet social criteria but also to ensure the cost-competitiveness of East German industry in order to promote the recovery of East German economy and to keep the migration from the East to the West to a minimum. However, it was important not to set the real wages too high, because that would cause the shutdown of many firms, higher unemployment, greater disparity between the rich and the poor, and an increasing flow of migration to the West. Based on these observations, the conversion rate for the wages was also set at the ratio of 1 : 1.[76]

The result of this conversion was the overvaluation of the Ost Mark by four or five times that eventually exposed the bankruptcy of the East German economy,[77] making the collapse of the export sector of the East German economy all but inevitable.[78] Such strong overvaluation made West German or foreign goods preferable to the lower quality but higher priced East German goods, decreasing aggregate demand and stagnating production. Firms were then forced to reduce output and fire workers, sharply increasing unemployment in the new Bundesländer. A contrasting example taken from another transition economy is that of the Czech Republic. Because of the starkly devaluated national currency, the foreign demand for Czech products was high and stimulated the economy. In the short term, this measure helped to keep unemployment low.[79] Perhaps a monetary policy that would devaluate the Ost Mark would have helped eastern Germany's economy and labor market.

Monetary transfers to the east were conceived as a part of the unification process that would help rebuild the GDR's outdated infrastructure. These government transfers are still flowing at an astounding annual rate of €83 billion (about 4 percent of total German GDP and 22 percent of eastern Germany's consumption).[80] This financing is often directed toward defunct firms that carry out only low-value activities or produce solely for the local market and in a way these transfers only hinder the efficiency-oriented restructuring of the economy. It is these transfers that are blamed for the inability of the east German economy to become self-sustaining and produce jobs.[81]

The collapse of the traditional east German trade patterns and a following decrease in aggregate demand have also contributed to the rise in unemployment.[82] Most of the GDR goods were produced for the sheltered COMECON markets – trade with members of the socialist bloc was largely uncompetitive. Due to the overvaluation of prices of east German goods after the unification and the collapse of the COMECON market, new buyers for east German products were hard to find, which reduced demand, output, and employment.[83] Although the collapse of trade patterns alone could not have caused the drastic unemployment surge, it could potentially have had a significant contribution to it.

---

[69] Domeday, 53-54.
[70] Lange and Pugh, 71. [71] Geiling, 33.
[72] Domeday, 48.
[73] Wunsch, 5.
[74] Currency of the GDR, "East Mark."
[75] Volker Meinhardt, et. al., "Institutional Reforms," in *German Unification – an Example for Korea?* Ed. Heiner Flassbeck and Gustav Horn (A. Aldershot: Dartmouth, 1996), 68.
[76] Meinhardt, et al., 72.
[77] Lange and Shackleton, "Germany in Transition," 5.
[78] Meinhardt, et al., 73.
[79] Markus Scheuer and Robert J. Gitter, "The Rise in Czech Unemployment," *Monthly Labor Review*, May 2001.
[80] "Getting back together is so hard," *The Economist,* September 18, 2004.
[81] Meinhardt, et al., 73.
[82] Lange and Shackleton, "The Labor Market," 93.
[83] Wunsch, 6.

Another explanation for high east German unemployment could be the world-wide recession of the late 1980s-early 1990s. Indeed, this recession is considered the most protracted since the end of the Second World War and has severely affected the aggregate demand for any outputs, including those of eastern Germany.[84] The resulting shocks to the national system of labor demand and supply can be seen as causes of the rise in unemployment.[85]

It had been predicted that the sectoral restructuring that is implicit in a transition from plan to market would also temporarily reduce employment.[86] The decline in agriculture and the increase in the service industries implied a necessary reeducation of the work force, which would create temporary structural unemployment.[87] Another path of restructuring should have reflected eastern Germany's comparative advantages, such as the high level of education. However, this specialization never occurred, which no doubt also decreased the potential of the transitioning economy.[88] Although this structural unemployment should have subsided after seventeen years of transition, initially it could also have contributed to the poor performance of the east German labor market.

Aggressive wage policies implemented in the east after the unification have also been seen as a cause of unusually high unemployment.[89] A certain correlation between wages and worker productivity has been long noticed by economists – as productivity increases, wages must increase as well.[90] In the following table we can clearly see that the convergence of east and west German wages was not followed at the same pace by the convergence of their productivity. Thus, west German goods became relatively easier to produce and took the same time to produce as east German goods, causing the aggregate demand in the east to fall. East German workers were thus "priced out of the market" into unemployment.[91]

Finally, the last cause of high east German unemployment named by economists is the entire German economic system. Germany's economic arrangement is described as the "social market economy" (*Soziale Marktwirtschaft*), which involves a highly regulated labor market buttressed by generous welfare provisions. This model is said to encourage long-term commitment and trust between firms and workers, leading to high levels of investment in human capital and associated productivity gains.[92] Recently, however, questions have been raised as to whether Germany will be able to support its welfare system on the scale to which its people have become accustomed. Germany has Europe's oldest students and youngest pensioners; Germans work shorter hours and have longer holidays than British, Japanese, or American workers. Labor market regulations protect the workers, making it costly for employers to hire or fire labor.[93] All these factors present a significant cost to the economy, providing excellent working conditions at the expense of the overall efficiency of the economy. The graph below demonstrates the level of replacement rates for the workers of OECD member states.

Table 2: Selected Economic Indicators for Germany (in percent), 1991-2004

Year	GDP Growth		Unemployment Rates		Productivity	Gross Wages
	West	East	West	East	East/West	East/West
1991	5.0	-19.2	6.2	10.2	32.9	57.5
1992	1.7	6.2	6.4	14.4	35.5	67.7
1993	-2.6	8.7	8.0	15.4	39.0	74.2
1994	1.4	8.1	9.0	15.7	41.4	77.1
1995	1.4	3.5	9.1	14.8	42.5	79.1
1996	0.6	1.6	9.9	16.6	43.4	79.5
1997	1.5	0.5	10.8	19.1	44.6	79.8
1998	2.3	0.2	10.3	19.2	66.9	80.1
1999	2.1	1.8	9.6	18.7	67.7	80.9
2000	3.1	1.3	8.4	18.5	68.5	81.3
2001	1.1	-0.5	8.0	18.8	69.1	81.2
2002	0.2	-0.2	8.5	19.2	69.9	81.2
2003	-0.1	-0.2	9.3	20.1	NA	81.2
2004	1.7	1.2	9.4	20.1	NA	NA

Source: Conny Wunsch, "Labour Market Policy in Germany: Institutions, Instruments and Reforms since Unification," Discussion paper no. 2005-06 (St. Gallen: University of St. Gallen, 2005).

[84] Garther Dale, "More Shock Than Therapy: Why There Has Been No "Miracle" in Eastern Germany," Socialism and Democracy Online 42, http://www.sdonline.org/32/shock_therapy.htm.
[85] Gerd Hansen, "The German Labor Market and the Unification Shock," *Economic Modeling* 17 (2000), 339-440.
[86] Schiff et al., 1.
[87] Lange and Shackleton, "The Labor Market," 90.
[88] von Hagen, 192.
[89] See, for example, von Hagen.
[90] Stephen Golub, "Does Trade with Low-Wage Countries Hurt American Workers?" *Business Review*, Federal Reserve Bank of Philadelphia, March/April, 1998.
[91] von Hagen, 195.
[92] Lange and Shackleton, "Germany in Transition," 2-3. [93] Lange and Shackleton, "Germany in Transition," 2-3.

Replacement rate is the percent of the original income an unemployed person receives. As can be seen from the graph, the German workers lose only a little less than 70 percent of their income while receiving unemployment benefits. Such high benefits reduce a worker's incentive to accept a job and keep him or her unemployed longer.[94]

The policies of benefit reduction recently undertaken by the German government address precisely this problem. In 2005, Germany's chancellor, Gerhard Schroeder, has implemented a program entitled Agenda 2010, whose main goal is to combat the constantly rising long-term unemployment.[95] Hartz IV, a part of this program, consists of a set of measures that, among other things, seeks to curb unemployment benefits for people who remain out of work for extended periods. Specifically, the plan calls for merging Germany's welfare and long-term unemployment benefits.[96]

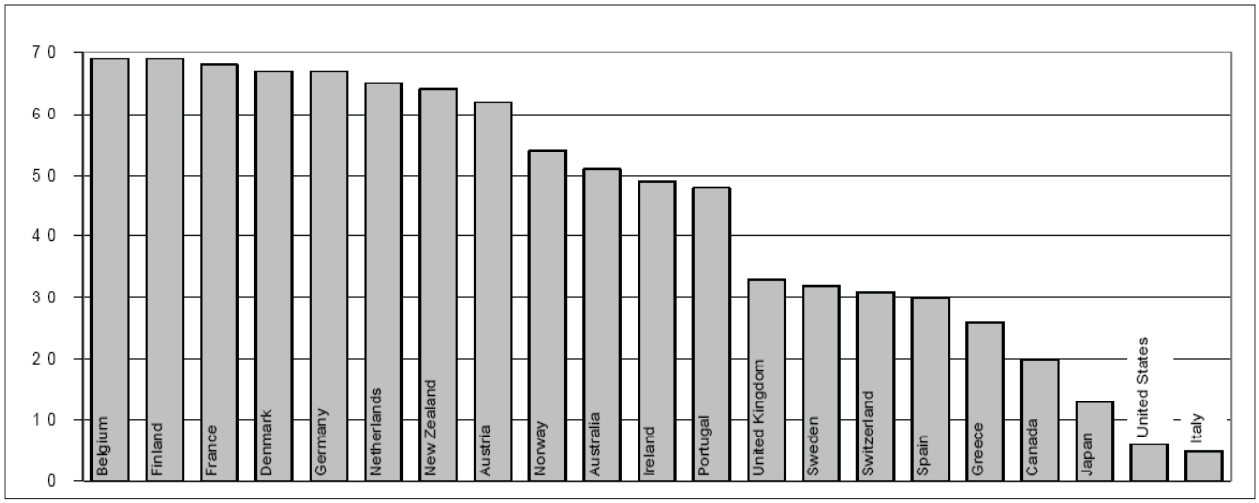
Currently, out-of-work Germans are well protected. People who lose their jobs get unemployment benefits of 60% of their previous earnings (or 67% if they have children) for up to 32 months. After that, payments drop to between 53% and 57% but have no time limit. By this stage, payments are known as *Arbeitslosenhilfe*, or unemployment aid. This generous financial support, as well as family and housing benefits, cause many workers with few skills—making up over half the unemployed – to eschew badly paid jobs.

To change this, Hartz IV will shorten the period of unemployment benefit to 12 months (or 18 months for those over 55) and do away with the second phase of unemployment aid. Instead, the long-term unemployed will receive a flat-rate benefit, means-tested and paid only to those who seek work seriously.[97] Hartz IV allows unemployed persons to continue receiving benefits equivalent to just under 60% of what they earned while working even after the period during which they are officially entitled to them has expired. Benefits for individuals with substantial savings or other assets, as well as for those who refuse to accept job offers, will be reduced to encourage people remaining out of work and dependent on unemployment insurance to accept the offered jobs.[98]

After two years, it is still unclear if this policy has been successful in reducing unemployment. It has, however, already raised much criticism. As put by a prominent Polish-American economist,

> the reduction [in unemployment benefits] is felt by the unemployed, and rightly so, as a punishment for something for which they are not responsible. Only extreme individualists can argue that the core of the unemployed are responsible for their own plight. It is sad enough that some people are exposed to unemployment, but the authorities add to their plight by giving them low benefits which throw a great proportion of the unemployed into the rank of paupers.[99]

Figure 5: Average Replacement Rates for 21 OECD Countries in 2002



Source: Conny Wunsch, "Labour Market Policy in Germany: Institutions, Instruments and Reforms since Unification," Discussion paper no. 2005-06 (St. Gallen: University of St. Gallen, 2005).

[94] Schiff et al., 38.
[95] "German chancellor defends his reform policy," *BBC Worldwide Monitoring*, September 8, 2004.
[96] Jo Kawakami and Mikio Sugeno, "Schroeder firmly committed to Agenda 2010 reform program," *The Nikkei Weekly*, October 25, 2004.
[97] "It's those people, all over again," *The Economist*, August 12, 2004.
[98] Kawakami and Sugeno.
[99] Adam, 99.

Although in eastern Germany the situation is not as extreme as in some other Eastern European transition economies, reducing benefits without increasing the effectiveness of job search can lead to dramatic social consequences.

The economic progress of the former GDR since the German reunification has been remarkable - growth in the east measured 2.8% in 2006 or just above the west's rate and, in the second quarter of 2007, is predicted to rise to 4.5% while that in the "old states" will be only 2.8%.[100] Despite this fact, unemployment levels have not diminished since the early 1990s – paradoxically, economic growth has few or no noticeable long-term effects on the labor market.

Conclusion

Twenty years after the reunification of Germany, the problem of labor market convergence between east and west still persists. The high unemployment rates in eastern Germany have a strong negative effect on the politics, economy and society of the united Germany. However, it seems that hardly any measures have been undertaken by the German government to ameliorate the problem, and even those that were implemented failed to decrease the level of east German unemployment. In this paper, I have attempted to explain this apparently paradoxical situation.

A key to the solution of a problem lies in its causes. I have therefore looked at the possible causes of high unemployment in eastern Germany and outlined seven of them in the paper: the bad state of GDR's infrastructure and economy, the failure of the unification policies, the collapse of eastern Germany's traditional markets, the Europe-wide recession, the frictional and structural unemployment resulting from the restructuring of the economy, the convergence of wages, and the inefficiencies of the German social insurance system. Some of these causes, such as the world-wide recession of the early 1990s, could not alone have caused the drastic difference in unemployment levels between Germany's east and west regions. Others, such as the inefficiency of the German economic system, are forcefully debated by economists and politicians of the world. Some of the outlined causes have nothing in common, such as the deficiencies of eastern German infrastructure and the social market economy of the united Germany. Others, on the other hand, have a clear connection, such as the unification policies and the stagnation of the transitioning economy. Overall, however, it is unclear what index of importance to assign to each of these reasons. Is the main cause of high unemployment the much too rapid privatization or is it the inefficiency of the German social protection system? Can unemployment be explained by the natural transition from planned economy and opening of the economy to the world markets, or is the pressure from labor unions for wage convergence to blame for the persistent problem? The answers to these questions are still unclear, as indicated by the ongoing debate between German and world economists and social scientists.

Any policies undertaken by the German government to reduce the unemployment are therefore bound to attack the symptoms and not the causes of the problem. This is illustrated by Schroeder's Hartz IV, the main focus of which is the reduction of unemployment benefits – this policy forces people to take jobs that they prefer to avoid and does not actually facilitate the creation of jobs or reform the labor market. Without the knowledge of the true causes of the east German unemployment, no measures can be undertaken to directly counter the problem. The high levels of East German unemployment could not have been the effect of a single cause, such as the failure of privatization in the early 1990s. Therefore, much more comparative research should be directed toward the solution of this problem, contrasting the case of Germany with the cases of other economies in transition, as well as with Germany's geographical neighbors. Only through detailed investigation of the problem can the accurate solution be found, and later implemented in government policies.

[100] David Gow, "Germany no Longer the Sick Man of Europe," *The Guardian*, April 4, 2007.

SELECTED BIBLIOGRAPHY

- "10 Jahre Erwebsleben in Deutschland." *Statistisches Bundesamt Deutschland*. 2002. http://www.destatis.de/download/d/veroe/d_erwerbsl.pdf (accessed April 23, 2007).
- Adam, Jan. *Social Costs of Transformation to a Market Economy in Post-Socialist Countries*. New York: St. Martin's Press, Inc., 1999.
- Blühende Landschaften oder Zukunft Ost heißt Urwald." MDR. May 4, 2004. http://www.mdr.de/artour/archiv/1326250.html (accessed April 23, 2004).
- Braun, Anneliese. "Women in the New Germany." *The Political Economy of German Unification*. ed. Thomas Lange and J.R. Shackleton. Oxford: Berghahn Books, 1998.
- Brinks, Jan Herman. *Children of a New Fatherland: Germany's Post-War Right Wing Policies.* New York: I.B. Tauris, 2000.
- "COMECON." *Encyclopædia Britannica Online*. http://www.britannica.com/eb/article-9054503/Comecon(accessed April 23, 2007).
- Dale, Garther. "More Shock Than Therapy: Why There Has Been No 'Miracle' in Eastern Germany." Socialism and Democracy Online 42. http://www.sdonline.org/32/shock_therapy.htm (accessed April 23, 2007).
- Domeday, K.H. "Privatization in the New Bundesländer: A Critical Assessment of the Treuhand." *The Political Economy of German Unification*. ed. Thomas Lange and J.R. Shackleton. Oxford: Berghahn Books, 1998.
- Fassmann, Heinz. "Are The Two Things That Belong Together Coming Together? Labor Markets and Jobs in the New and Old Länder." *Germany Ten Years After Unification*, ed. Alois Mayr and Wolfgang Taubmann. Leipzig: Institut für Landeskunde, 2000.
- Flassbeck, Heiner and Gustav A. Horn. "Introduction." *German Unification – an Example for Korea?* ed. Heiner Flassbeck and Gustav Horn. A. Aldershot: Dartmouth, 1996.
- Geiling, Martin. "Germany's Changing Political Landscape." *The Political Economy of German Unification*. ed. Thomas Lange and J.R. Shackleton. Oxford: Berghahn Books, 1998.
- "German chancellor defends his reform policy." *BBC Worldwide Monitoring*. September 8, 2004.
- "Germany." *Encyclopædia Britannica Online*. http://search.eb.com/eb/article-233609 (accessed April 23, 2007).
- "Germany." in *The World Factbook.* https://www.cia.gov/cia/publications/factbook/geos/gm.html (accessed April 23, 2007).
- "Germany." *OECD Economic Survey*. Volume 2006/8. May 2006, 29.
- Golub, Stephen. "Does Trade with Low-Wage Countries Hurt American Workers?" *Business Review*. Federal Reserve Bank of Philadelphia. March/April. 1998.
- Gow, David. "Germany no Longer the Sick Man of Europe." *The Guardian*. April 4, 2007.
- Hagen, Jürgen von. "East Germany." *Going Global. Transition from Plan to Market in the World Economy*. ed. Padma Desai, 173-207. Cambridge, Massachusetts: The MIT Press, 1997.
- Hansen, Gerd. "The German Labor Market and the Unification Shock." *Economic Modeling* 17. (2000).
- "It's those people, all over again." *The Economist*. August 12, 2004.
- Kawakami, Jo and Mikio Sugeno. "Schroeder firmly committed to Agenda 2010 reform program." *The Nikkei Weekly*. October 25, 2004.
- Kurthen, Hermann and Michael Minkenberg. "Germany in Transition: Immigration, Racism and the Extreme Right." *Nations and Nationalism* 1. (1995).
- Lange, Thomas and Geoff Pugh. "The Treuhand: A Positive Account." *The Political Economy of German Unification*. ed. Thomas Lange and J.R. Shackleton. Oxford: Berghahn Books, 1998.
- Lange, Thomas and J.R. Shackleton. "The Labor Market in Post-Unification Eastern Germany." *The Political Economy of German Unification*. ed. Thomas Lange and J.R. Shackleton. Oxford: Berghahn Books, 1998.
- ----------. "Germany in Transition: An Introduction." *The Political Economy of German Unification*. ed. Thomas Lange and J.R. Shackleton. Oxford: Berghahn Books, 1998.
- McConnell, Campbell R. and Stanley L. Brue. *Macroeconomics. Principles, Problems, and Policies.* Boston: McGraw-Hill, 2005.
- Meinhardt, Volker et. al. "Institutional Reforms." *German Unification – an Example for Korea?* ed. Heiner Flassbeck and Gustav Horn. A. Aldershot: Dartmouth, 1996.
- Melzer, Manfred et al. "The GDR Before 1989." *German Unification – an Example for Korea?* ed. Heiner Flassbeck and Gustav Horn. A. Aldershot: Dartmouth, 1996.

- Scheremet, Wolfgang and Manfred Melzer. "The Turning Point." *German Unification – an Example for Korea?* ed. Heiner Flassbeck and Gustav Horn. A. Aldershot: Dartmouth, 1996.
- Scheuer, Markus and Robert J. Gitter. "The Rise in Czech Unemployment." *Monthly Labor Review*. May 2001.
- Schiff, Jerald et al. *Labor Market Performance in Transition.* International Monetary Fund: Washington, D.C., 2006.
- *Statistisches Jahrbuch*. Statistisches Bundesamt Deutschland. 2006.
- Straubhaar, Thomas. "Germany as an Economic Hub." in *Facts About Germany*. http://www.tatsachen-ueber-deutschland.de/index.php?L=1 (accessed April 24, 2007).
- "The Labor Market in February 2007." *Bundesagentur für* Arbeit. February 2007. http://www.pub.arbeitsamt.de/hst/services/statistik/000000/html/start/monat/Arbeitsmarktbericht-engl/2007/0207.pdf (accessed April 23, 2007).
- "Total GDP 2005." World Development Indicators Database. World Bank. July 1, 2006. http://siteresources.worldbank.org/DATASTATISTICS/Resources/GDP.pdf (accessed April 24, 2007).
- Wunsch, Conny. "Labour Market Policy in Germany: Institutions, Instruments and Reforms since Unification." Discussion paper no. 2005-06. St. Gallen: University of St. Gallen, 2005.