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Thirty Years after the Berlin Wall Came Down: Economic Transition Completed, but Structural Deficit Remains

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Thirty years ago, in November 1989, the Berlin Wall was opened and the political experiment of a socialist state “on German soil” ended quite abruptly. The political system of the German Democratic Republic (GDR) collapsed, about 40 years after its founding; East Germany “came in from the cold.”[1] The breakdown was a nearly complete one: only a few months later, in July 1990, the economic system of West Germany was transferred to the still existing GDR, and political unity was restored on October 3 with the accession of the newly founded eastern German states to the Federal Republic of Germany. In this respect, German unity was from the very beginning not an equal partnership between two independent states, but the subordination of the East to the West, which had been considered the place of longing for most East Germans since the division of Germany after the Second World War. Nevertheless, collective memory talks of a “peaceful revolution,” which attributes the demonstrations of GDR citizens mainly to the desire for individual freedom: besides the first demonstrations in Leipzig and elsewhere that were carried out by a small minority of civil rights activists, the motivation for the ongoing mass protests in late autumn 1989, the electoral success of the unity supporters in the parliamentary elections of March 1990, and, finally, the rapid accession of the GDR to the Federal Republic of Germany was a primarily economic one – namely, participation in the West German level of prosperity. It was in reality a shock therapy, as it was widely accepted that a stepwise approach would be the riskier one on the road to re-unification. The unavoidable consequences – namely, the far-reaching collapse of the East German economy – were at least taken into account, presumably: they were widely accepted because most people expected a renewal of the economy in a short period of time, the so-called “flourishing landscapes” chancellor Helmut Kohl promised. So, reunification by accession happened in accordance with the wishes of the majority of the East German population.

Due to the form of the GDR’s accession to the Federal Republic of Germany (FRG), institutionally, with unification, apart from a few temporary exceptions, the legal framework that had developed in West Germany during the long years of division was introduced in eastern Germany “in a jiffy.” Institutions – which does not primarily mean the organizational or administrative structures of a country, but rather the applicable laws and their expression in administrative provisions – represent the framework within which economic action must fit. It was certainly not clear for most people in East Germany (neither for those in West Germany) what this meant in everyday life: Germany is characterized by a dense and sometimes complicated regulatory system that covers almost all areas of life and society. The reason for this is probably a specifically German desire for order, but also the fact that the Federal Government, the states, and the municipalities, on the one hand, but also different political majorities, on the other, have always wanted to realize their own ideas for shaping economic and social framework conditions has led to a bulk of regulations over time. The existing legal framework is therefore almost all-encompassing, though not always without contradictions (which repeatedly give rise to legal disputes), and it is characterized by high complexity. Even if, in principle, a wide set of regulations can increase legal certainty, it is at the same time hardly possible for an individual to know all relevant regulations even approximately. This was all the more true for the citizens of East Germany who as a result of German reunification were suddenly exposed to a legal framework that they did not know at all. At least in the beginning, this led to increased uncertainty among people in eastern Germany. Not only did they have to deal with the fact that some Westerners came to the East trying to take advantage of the inexperience of East Germans (meaning not just people but enterprises and public administrations as well), this uncertainty also induced a higher risk aversion in the population and proved to be a burden when reconstructing the economic and political system.

Making the situation worse still, some of the new institutional regulations created to promote the process of reconstruction in eastern Germany did not always satisfy the requirements of a transformation economy, but rather corresponded to West German legal understanding. This was especially true for the concept that property expropriated under the GDR should be returned to its former owners, leading to severe obstacles to investment. It took some time until this deficiency was recognized, and an agreement reached on financial compensation instead. Other specific regulations, for example the de facto occupational ban for former collaborators of the GDR secret service (“Stasi”), might also have impeded the reconstruction of the East German economy at least in the beginning. This again shows that East and West were not equal partners, as West German perceptions dominated not only the public debate but also the policy actions that were taken, even in the eastern German Länder themselves; in most states, government members and higher administrative staff were “imported” from

[1] Akerlof, G., H. Hessenius, A. Rose and J. Yellen (1991) “East Germany In from the Cold: The Economic Aftermath of Currency Union”, *Brookings Papers on Economic Activity* 23(1), 1–105.

the West, shaping policies and structures in a Western style without knowing much about the specific circumstances of an economy in transition.

So, the transfer of West German institutional regulations must be regarded as a disadvantage for the rebuilding of eastern Germany ("Aufbau Ost") that must not be underestimated. Positively, the transfer of West German law to eastern Germany prevented the emergence of lawless areas, as was the case in some transition countries in Central and Eastern Europe in the early 1990s, which in part contributed to undesirable developments there. Negatively, however, in view of the lack of familiarity of citizens and companies with the new institutional conditions and the necessity of having to find "unconventional" solutions to new problems, the adoption of the West German legal system in all its complexity was a burden on economic development in the East. This may have contributed to the fact that the economic upswing did not progress as quickly as the people in East Germany had expected and as politicians had pledged. From today's perspective, it would certainly have made sense to find appropriate (meaning at least less comprehensive) regulations for the eastern German Länder, at least for the transformation phase. The fact that this did not happen probably represents the most serious political shortcoming during the process of unification,[2] which ultimately contributed to the fact that eastern Germany is still lagging behind the western half of the country in important indicators and that transfer payments were necessary to a far greater extent than originally expected to compensate for the effects of unfavorable initial conditions.

The main reason that the difficulties of the transformation process in East Germany were underestimated was probably the widespread misconception that the GDR was one of the most advanced industrial nations in the world; this impression ultimately turned out to be the result of massive falsifications of official statistics on the part of the GDR. However, it also included the illusion that the introduction of market-based incentive systems, the free movement of capital, and the granting of freedom of trade would trigger a growth process similar to the West German "economic miracle" in the 1950s.[3] Under these assumptions, the adoption of the West German regulatory framework appeared to be not only viable, but also helpful on the way to rapid convergence. One cannot blame those acting at that time for this, but one can blame them for the fact that they hesitated for a long time to allow deviating regulations of any noticeable magnitude at all. When this finally happened, it was often too late to stop the incipient deindustrialization of the eastern German states and to accelerate the rebuilding of industrial structures.

In fact, after the introduction of the market economy, the East German economy collapsed to a large extent because the existing enterprises were hopelessly backward due to suppressed investment during GDR times and the impossibility of gaining access to Western technology.[4] In addition, they suffered from massive overstaffing, as the GDR economy had to apply labor-intensive production technologies in order to compensate for the lack of capital and technology. While the introduction of the D-Mark in East Germany at an exchange rate of 1 Mark of the GDR to 1 DM meant an appreciation of the GDR currency in foreign trade of about 400 percent, the companies lost their markets in West Germany and abroad, aggravated by the simultaneous collapse of the other socialist states in Central and Eastern Europe, which had until then been the main recipients of East German export products. The massive collapse of industrial production in East Germany even in the second half of 1990 was mainly caused by these factors – and not, as is sometimes claimed today, by the bad intentions of West German politicians and enterprises who wanted to prevent the emergence of competition in their own country. In short: the economy of the GDR was not at all viable under the changed conditions of free markets, and any attempt to keep it alive with state aid would have led to immeasurably high long-term consequential costs.

Only in retrospect does it become clear how all-embracing the collapse of the East German economy was and how quickly it took place. In 1988, the level of industrialization in the GDR was about 35.5 percent (measured in terms of employed persons), far more so than in West Germany at the same time (28.5 percent). Due to the GDR's desire for self-sufficiency, it maintained strong representation even for those sectors that in western industrialized countries had already shrunk sharply under the globalization pressures of the 1970s and 1980s and had no chance of survival in a high-wage country such as East Germany was soon to become. In just a short period of time until 1991, the number of people employed in the manufacturing sector fell by about 50 percent because the existing companies, organized in completely oversized structures, were in no way able to cope with competitive pressures after the opening of their markets. Even though the non-trading sectors of the GDR economy were less affected by the reduction in production, they also had to make significant cuts in personnel. While full employment prevailed in the GDR, underemployment rose to around two million people (official unemployment and short-time work) even before political unification in October 1990. It is important to emphasize this because it makes it clear that it was not the circumstances of the further transformation process that drove the East German economy down, but rather

[2] For a more detailled analysis see: Ragnitz, J. (2009), "East Germany today: Successes and failures" *CESifo DICE Report* 7 (4), 53–58.

[3] Among others: Willgerodt, H. (1990), "Vorteile der wirtschaftlichen Einheit Deutschlands [Advantages of economic unity in Germany]", Institut für Wirtschaftspolitik an der Universität zu Köln, Cologne, Germany.

[4] Schürer, G., A. Schalck, E. Höfner, and A. Donda (1989), "Analyse der ökonomischen Lage der DDR mit Schlussfolgerungen, Vorlage für das Politbüro des Zentralkomitees der SED, 30. Oktober 1989", mimeo, Berlin .

the suppressed structural change and the foregoing failure to modernize enterprises during GDR times.

While the collapse was rapid (even faster than in other Central and Eastern European countries, which were not equally exposed to the competitive pressure of a superior economy), the establishment of new structures required more time. Nevertheless, a fast growth process began in 1991, albeit starting from a low level of economic activity. This was driven on the one hand by the founding of new companies by the local population and on the other by external investors from western Germany and abroad who set up new production facilities in the eastern German states. In the initial phase, the latter was less a result of new developments (which were hindered by the lack of suitable land, for example) than of the takeover of existing production plants, which had previously been state-owned and now had to be transferred to private ownership in accordance with the principles of a market economy. This task was transferred to a specially founded institution, the "Treuhandanstalt," which saw its major task as being the rapid privatization of existing GDR companies. Only in cases where this was not feasible were plants closed; the restructuring of existing companies with fundamentally good prospects for the future or a structurally determining importance receded into the background. The task of the Treuhandanstalt was almost immeasurable: the existing 432 combines were split into privatizable units, and over time around 12,000 companies emerged, for which private investors had to be found within a very short period of time. Contrary to what was initially assumed, the Treuhandanstalt's business was therefore not the "sale of national assets" but the "purchase of investors" – one reason why the Treuhandanstalt closed its operating business after only four years with a loss of around EUR 120 billion. Alternative proposals, such as the issue of tradable share certificates to the East German population, had no chance of realization in view of this order from the outset; they probably would not have led to private investors for the East German companies to the required extent. In this respect, the Treuhandanstalt's activities may have been criticized, but its task of privatizing the East German economy (despite the frictions that arose in detail) has been properly fulfilled: by the end of 1994, 7,850 enterprises and parts of enterprises had been handed over to new private owners; only in 3,700 cases did privatization fail, so that the liquidation of the enterprises concerned had to be initiated. The few remaining state-owned companies – obviously the cases that were most difficult to sell – were then privatized, mostly in subsequent years, with further financial concessions.

In retrospect, it seems wise to transfer the privatization process to an institution outside the political sphere, because the Treuhandanstalt took on the role of "scapegoat," leaving politics unaffected. With the closure of the Treuhandanstalt in 1994, for the public the bogeyman disappeared from the scene. However, the mental harm to the population caused by the Treuhandanstalt's activities was probably underestimated. In any case, there is no other explanation for the fact that today, 25 years after its dissolution, there is an increasing number of political voices calling for a review of this chapter of transformation history and, in particular, claiming that the liquidation of supposedly competitive companies was the main cause of the continuing backwardness of the eastern German economy vis-à-vis the West. It is therefore all the more important to point out that it was not the Treuhandanstalt policy, but rather failures in GDR times that were the real reason that these enterprises were unable to survive.

Even though the transfer of the East German enterprises into private ownership was quickly achieved, this does not mean that there was no need to carry out further, often painful restructuring measures in the enterprises concerned. Overstaffing was still an issue and, in addition, the purchasers of existing companies had to redesign their production technology and market orientation, meaning personnel had to be reduced for a second time. Employment particularly in industry therefore continued to shrink; as a result, in the mid-1990s, only a quarter of the former industrial workforce remained. On the other hand, the construction industry, which benefited in particular from the need to catch up and renovate residential, commercial, and infrastructure buildings, and the services sector both expanded. Apart from the transformation-induced and ultimately only temporary upswing in the construction industry, the eastern German economy quickly pursued the structural change that had shaped West Germany over the preceding decades, but had been suppressed in the GDR due to its lack of integration into the global division of labor. As a result, at least on an aggregated level, an economic structure emerged that was largely similar to that in the West – even if there are some considerable differences in detail. Thus, regionally oriented, often less technology-intensive branches of the economy continue to dominate, and the state sector is still of greater importance in eastern Germany than it is in the western half of the country.

The dismissal of personnel no longer needed, but also the modernization of the capital stock led to rapid increases in productivity in the first years after the introduction of the market economy. Gross domestic product per person employed, which in the GDR had been only about one-third of the level in West Germany, rose to just under 60 percent of the western level by the mid-1990s. In contrast, the underemployment rate, which includes registered unemployed persons as well as persons in job-creation measures or in state-subsidized advanced training courses, continued to rise, peaking in the early 2000s at almost a quarter of the total labor force, in some regions even significantly more. However, it must also be borne in mind that the participation rate of women in eastern Germany in particular was historically exceptional and therefore required significantly more jobs per inhabitant than in western Germany – which is hardly to be expected, however, with the same institutional framework and the same wages in the future.

In addition to the privatization activities of the Treuhandanstalt, the transformation of the East German economy into a market economy was characterized by the instantaneous opening of the East German market to the outside world. With unification, the eastern German states not only became part of the West German economic area, but also part of the European internal market. Initially, this meant above all increased competition from western German and foreign companies on the eastern German regional markets, which intensified the collapse of the existing GDR companies. This was accelerated by the fact that eastern German consumers initially preferred western German products to eastern German goods. In the medium term, however, the free movement of goods also enabled eastern German companies to gain access to western markets. Even though it took some time for this advantage to be exploited – not least because of the policy of the large trading groups, which preferred proven products to eastern German brands unknown to consumers – this should not be underestimated. The disadvantage of the complete integration of eastern Germany into the common economic area, however, was that labor migration was now unhindered: due to the higher wages in the West, but also due to the unfavorable labor market situation in the eastern German states, there was massive migration from eastern to western Germany. In the years 1989–1991 alone, the migration loss amounted to 810,000 persons. Even if emigration has clearly slowed down since then, eastern Germany has lost about 1.1 million persons to the West to date. Even though this relieved the tense labor market in eastern Germany, it is likely to have had a negative impact on economic development, as especially younger, well-qualified workers have moved to western Germany. Together with the massive drop in the birth rate after reunification – the birth rate fell from 1.57 in 1989 to only 0.7 children per woman within just a few years and increased to around 1.5 children per woman only in the further course of time – this contributed to the fact that eastern Germany had to accept a massive population shrinkage, which is likely to shape further economic development in the medium term due to the resulting shortage of labor.

Finally, one of the institutional peculiarities of the eastern reconstruction was the massive support granted by the federal government, but also by the EU. After it had initially been assumed that a rapid economic upturn would start simply as a result of the introduction of market-based incentive systems, it was soon recognized – in the spring of 1991 – that more specific interventions were needed to support economic development. In addition to the rapid expansion of infrastructures, the focus was on investment incentives for companies in the form of special tax depreciation allowances, large-scale investment subsidies as well as low-interest loans, especially for newly founded firms. In favorable cases these reached a considerable level – of up to 50 percent of the investment sum; often this was what made investment in the eastern German Länder profitable at all. The positive effect on investment activity should not be underestimated; however, this also encouraged investments that were either profitable on their own or that were realized only because they were strongly subsidized. The first case therefore concerns deadweight effects, the second case the promotion of bad investments. However, since it was not possible for politicians to make appropriate selections, this lack of precision had to be accepted at least for some time. It was only gradually that attempts were made to make investment promotion more efficient by limiting the set of beneficiaries, lowering the subsidy rates, and finally thinning out the entire range of subsidy instruments. All in all, however, expenditure on the federal government's funding policy in the 1990s alone is likely to have amounted to almost EUR 100 billion. It cannot be ruled out that subsidies led to habituation effects lowering the effectiveness of funding policies over time.

The rebuilding of the economy was finally supplemented by large-scale programs to provide social support for the transformation process. Although the eastern German unemployed were in principle entitled to unemployment benefits in accordance with the current legal situation, a whole series of measures were also implemented to create jobs (primarily in the clearing of industrial sites, later also in the reconstruction of infrastructures) and to retrain in supposedly more marketable occupations. However, most of these programs were not successful with respect to "building a bridge" to the regular labor market. Rather, many evaluation studies show that participants' labor market opportunities in fact often deteriorated because participation in such programs led to negative stigmatization effects; furthermore, in many cases, individual efforts to find a regular job diminished. It was not until many years later – towards the end of the 1990s – that these measures were curtailed due to a lack of success and were subsequently discontinued completely. In the end, they relieved the labor market temporarily, but were unable to solve the fundamental problem of an immense lack of jobs in the regular labor market. The funds spent on this were then lacking elsewhere, namely in designing more growth-oriented locational conditions in eastern Germany.

All in all, the institutional conditions under which the transformation of the East German economy into a market economy took place were not necessarily favorable. In particular, the excessive exchange rate in the course of monetary, economic, and social union and the transfer of the entire West German legal system to East Germany, which took place with the Unification Treaty, must be viewed critically. The almost complete collapse of GDR economic structures would not have been avoidable under other conditions, since it was pri-

Table 1

Economic Indicators for Eastern Germany

	in % of western Germany		1991=100
	1991	current	current
GDP per capita, in 2018 prices (2018)	38.9	69.2	234.2
GDP per unit of labor, in 2018 prices (2018)	41.0	79.7	226.7
Wages per employee, nominal (2017)	50.7	81.6	258.3
Unit labor costs, nominal (2017)	143.2	101.8	68.8
Disposable income per capita, in 2018 prices (2017)	62.9	85.8	161.5
Gross investment per capita, current prices (2016)	61.6	72.6	179.4
	Absolute figures		1991=100
Employment per capita (2018)	46.4	47.9	88.7b
Unemployment rate (2018)	10.2	7.6	56.9b
Current account balance in % of GDP (2016)	-75.4	-12.9	55.3c
Population (millions) (2018)	14,624.7	12,550.7	85.8

[a] Eastern Germany without Berlin, western Germany with Berlin – [b] Change in employment and unemployment in absolute terms, 1991=100 – [c] Change in the current account deficit in absolute terms, 1991=100.
Source: AK VGR der Länder, Bundesagentur für Arbeit; author's calculations.

marily caused by the failure to modernize in GDR times. In addition, facts were created during the initial period of transformation that still have an impact today and are partly responsible for the fact that the eastern German economy has not yet reached the level of performance of the western German economy. The “price” for a policy that did not fit the needs of an economy in transition were high transfer payments from western Germany to eastern Germany: to date, these may add up to EUR 2 trillion.[5]

Looking at key economic figures, eastern Germany still lags considerably behind in terms of gross domestic product per capita (69.2 percent of the western German level in 2018) and gross domestic product per person employed (79.7 percent) (see Table 1). There is also still a considerable discrepancy between the derived figures such as wages and incomes to those of the western half of the country. This is mainly due to the structural peculiarities of eastern Germany, which in turn have their actual cause in the path dependencies created in the early 1990s: there are hardly any large enterprises in eastern Germany that show productivity advantages through the exploitation of economies of scale in production or through research and development opportunities. In addition, almost all industrial enterprises in eastern Germany are subsidiaries of western German or foreign corporations and therefore pure production sites (“extended workbenches”) with low value-added intensity and low own competencies. All in all, the eastern German economy has specialized in more regionally oriented, often less technology-intensive sectors that have neither great productivity potential nor great growth potential. Finally, there is the loss of well-qualified population groups due to emigration, which leads to a lack of dynamic, more productive workers in many sectors and regions. And it should not be neglected that the economy in western Germany has grown strongly over the past 30 years, thus representing a “moving target” for the equalization of living conditions: whereas the economic performance in eastern Germany in 1991 was 30 years behind that of West Germany in 1960, it has now reached the level of the mid-1980s – the time lag in development has thus remained roughly the same despite the temporary rapid growth in eastern Germany. Path dependencies and increasing economies of scale in production are favoring development in western Germany: another reason that it is difficult for the eastern German economy to catch up with the West.

In addition, clusters and networks, which are generally regarded as a basic condition for technologically driven economic development, are weaker in eastern Germany than in western Germany. On the one hand, the fact that existing network structures were frequently destroyed as a result of the Treuhandanstalt’s activities has had a negative effect here, since the privatization of state-owned enterprises made their unbundling necessary. In addition, both privatized and newly founded companies were often unstable and therefore not necessarily regarded as suitable cooperation partners – especially as many of these companies did not survive the structural upheavals of the 1990s and withdrew from the market again. Structures that have grown over many years, as they characterize western German regions, therefore do not exist in eastern Germany – and attempts by politicians to establish them through political intervention have failed in most cases. It can be shown that this might lead to subsequent divergence instead of convergence between regions.[6]

Empirical estimates indicate that it will probably not be possible to reduce the economic backwardness of the eastern German states in the coming years either, because demographic trends, the mirror of the birth failure in the 1990s, and strong migration until 2005 will lead to a serious shortage of labor in all sectors in the near future. Many companies will not be able to fill jobs that become vacant as a result of age, and employment-intensive growth is ruled out anyway. If it is not possible to make do with fewer workers, i.e., to substitute capital for labor through rationalization and digitalization, then production will also grow more slowly, or it might even decline in some remote areas. Among the five eastern German states, only Saxony can be expected to catch up noticeably with the western German level, while Mecklenburg-Western Pomerania and

[5] Lehmann, R. and J.Ragnitz, “Die Transferleistungen zugunsten der ostdeutschen Bundesländer – Status quo und Ausblick”, *ifo Schnelldienst* 65 (3), 25–30.

[6] Uhlig, H. (2008), “The Slow Decline of East Germany”, *Journal of Comparative Economics*, 36 (4),517–541.

Saxony-Anhalt are indeed likely to fall back relative to western Germany. If one continues to see the goal as an "equalization of living conditions," this will not be achieved across the board even by 2035. However, this does not mean that the "rebuilding of the East" has failed completely, but merely that the original goals were too ambitious. In western Germany, too, there are considerable differences in economic strength between different federal states and regions and, derived from this, in the regional level of prosperity, despite a largely similar institutional framework. It would be astonishing if eastern Germany, characterized by a particular lack of agglomeration centers and 40 years of neglect of economic efficiency aspects, were to achieve something in only 30 years that Schleswig-Holstein or Rhineland-Palatinate have not achieved in more than 70 years.