



## GOOD INSTITUTIONS ARE NOT ENOUGH: ONGOING CHALLENGES OF EASTERN GERMAN DEVELOPMENT<sup>1</sup>

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The two decades following the fall of communism have provided economists with a remarkable opportunity to study the consequences of radical changes in economic institutions, i.e., in the rules of the game and norms that underpin economic interaction. Transition has proved more protracted than anticipated – a rapid catch-up by the central and eastern European transition economies to European Union levels of productivity has not occurred. A useful standard of comparison is with the phase of rapid catch-up by the southern European economies that began following the liberalisation reforms around 1960.

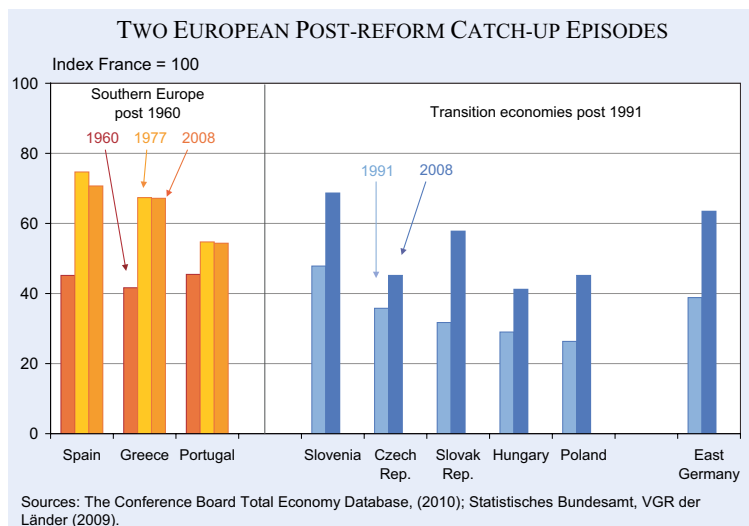
Figure 1 presents PPP data on value added per employed worker, a broad measure of economy-wide labour productivity. It takes France as the comparator for two exercises: first for the catch-up of the southern economies from 1960 and second, for the post-communist catch-up from 1991. Several points emerge from the comparison. First, with the exception of Slovenia, the eastern European countries were further behind France in 1991 than were the southern countries behind France in 1960 at the beginning of their catch-up. Second, the southern catch-up in the subsequent 17 years was mostly more rapid than that in the

17 post-transition years. Third, the southern productivity catch-up had virtually stopped by 1977 – in the subsequent 31 years, the labour productivity gap with France scarcely changed. Against the performance of its eastern European comparators, eastern Germany’s performance was reasonably good and its catch-up to France was similar to that achieved by Greece from 1960 to 1977.

A substantial research effort has attempted to discover why well-educated labour forces with good levels of physical infrastructure in an era of financial globalisation and trade integration were unable to take advantage of the apparently “low-hanging fruit” available by introducing existing technologies and to reap the reward of rapid catch up. Much of this research has pointed to the neglect at the outset of the transitional period of market economy institutions.

The eastern German transition provides a useful comparative case study. Unlike other transition economies, eastern Germany acquired high quality and credible market institutions by virtue of unification. Yet its performance was in many ways similar to that of its central and eastern European comparators: a transitional recession followed by slow convergence. eastern Germany’s experience of transition highlights the limited extent to which good institutions alone can overcome 40 years of missing market ex-

Figure 1



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perience, especially during a period of increasingly integrated global markets.

**What was the binding constraint on catch-up?**

The framework of growth diagnostics proposed by Hausmann, Rodrik and Velasco (2006) can be used to analyze the reasons for a slow catch-up in the transitional period. The initial distinction is between a situation in which the growth of private investment and entrepreneurship are inhibited by (a) too low a rate of return on private investment and (b) too high a cost of finance. If there is evidence of an abundance of profitable projects but the high cost of finance prevents them from being undertaken, the question arises of whether it is poor access to international finance or poor local finance that is at fault. In the case of poor local finance, this could be due to weak intermediation or because of low savings.

In the left-hand side of the tree (Figure 2), the availability of finance is not binding – rather, it is the low rate of return on investment that is the problem. This could be because of the effect of poor complementary factors such as unfavourable geography, inadequate physical infrastructure or weak human capital in reducing expected private returns. Alternatively, government failures could be responsible by raising micro or macroeconomic risk. The final branch points to market failures and the associated lack of good projects.

It is difficult to argue that the catch-up speed of transition economies was hampered by lack of access to finance. On the contrary, a striking feature of transition was that unlike typical developing countries, the

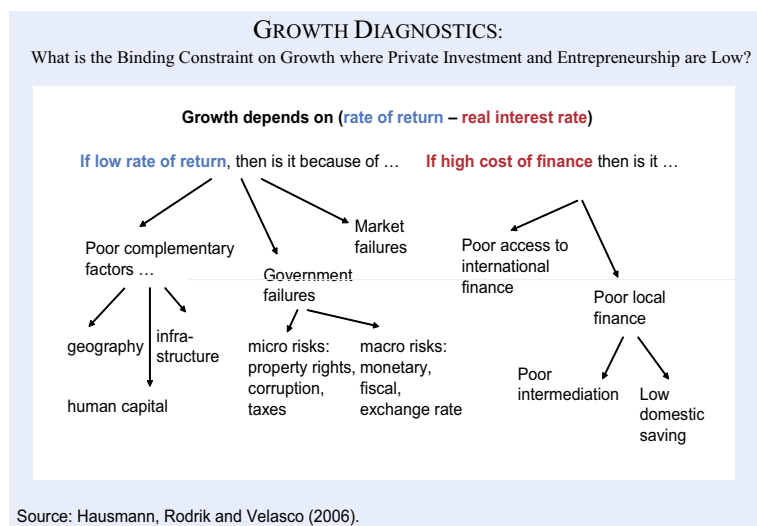
CEEC transition economies defied the so-called Lucas Paradox: capital flowed to these economies and they did not have repeated balance of payments crises (e.g., Prasad et al. 2007). Moreover international banks largely took over local banking networks, providing expertise and access to international capital markets. For the CEECs and eastern Germany, it seems reasonable to presume that we are in the left-hand part of the decision tree: the rate of return, not the cost of or access to finance was the problem.

We can also rule out poor complementary factors – these countries were situated contiguous to the European Union market and a positive legacy of communism was to leave levels of human capital and skills, and physical infrastructure higher than those of the market economy benchmark at similar levels of GDP per capita (e.g., Mitra et al. 2010, chapter 5).

A large body of research literature has emerged in the past decade arguing that it was institutional weakness (government failure) that hampered the rapid catch up of the CEECs (e.g., Rodrik 2006). Effective legal systems, reliable and predictable tax and customs administration, norms and rules to control corruption, and so on were not created overnight. New owners had to be found for large enterprises and it became clear that privatisation in the absence of adequate corporate governance failed to lift the performance of privatised enterprises above that of state owned ones (Estrin et al. 2009). Foreign owned firms performed notably better than those privatised to domestic owners.

Recent evidence suggests that political integration in the European Union helps explain why the CEECs defied the Lucas paradox (Friedrich et al. 2010). A plausible channel is that by creating expectations among foreign investors of a commitment to institutional reform, political integration facilitated the positive role of financial integration in promoting catch-up. If government failure or institutional weakness was a likely cause of slow catch-ups in the CEECs, it was prima facie less plausible as a binding constraint in eastern Germany because of the transfer of western German institutions. Eastern Germany is at the extreme end of the political integration contin-

Figure 2



uum. However, institutions do not only involve “rules on the books” but also norms, and recreating market economy norms was not immediate even in eastern Germany. Alesina and Fuchs-Schuendeln (2007) showed that eastern Germans continued to have different attitudes to state intervention than western Germans, and argued that such differences were likely to persist for another generation.

It is also possible that western German – as compared with generic – market institutions were mismatched with the needs of the transitional eastern German economy (e.g., Carlin 1998). The core export-oriented sector of the western German economy is characterised by a number of specialised institutional arrangements involving among others unions, employers’ associations, works councils, the commitment to transferable skills training by companies, technology transfer institutions and various state-, quasi-state and private organisations at the federal, Land and local level. For example, it is argued that unions, employers’ associations and works councils play important roles in delivering wage compression and employer commitment to training that lie behind the high-skills “equilibrium” of the western German core economy (e.g., Hall and Soskice 2001).

The most well-known example of institutional transfer to eastern Germany was the recruitment of eastern German workers by western German unions, and the participation of the *Treuhandanstalt* in wage-setting. Combined with the extension of social security entitlements, this placed a high floor under wages. This rendered unprofitable much of the capital stock, producing the rapid deindustrialisation of eastern Germany and raised the bar for the required productivity level of new projects if they were to be profitable. Once western German companies rapidly revised downwards their initial expectations of accessing buoyant markets in the former Soviet bloc via the expansion of production facilities in eastern Germany, it proved impossible to replicate the western German core economy and its institutional context in the new *Bundesländer*. Eastern Germany was left with the cost burden of the wage-setting and social security system without its micro-institutional benefits.

The federal government was forced to step in to deal with problems arising from the failure of the western German model to operate in the east. Combined with the associated fiscal burdens, this led to important changes in policy and institutions in the Federal

Republic as a whole, culminating in the Hartz IV welfare reforms. Nevertheless, the export-oriented core of the western German economy retained its self-organizing capacity (as reflected in the substantial restructuring and real depreciation achieved over the post 2000 period; Carlin and Soskice 2009). Yet in spite of the formal transfer of institutions, the export-oriented core did not extend its scale through replication in eastern Germany. The experience of eastern Germany over the past two decades was one of institutional adaptation – most obviously in the low membership of eastern German companies in employers’ associations and the associated limited coverage of collective wage agreements in eastern Germany (Paqué 2009).

In spite of these caveats, institutional quality, in the sense of the credibility and efficiency of the core market economy institutions of a functioning legal system, control of crime and corruption, and the efficient administration of taxes and customs were established quickly in eastern Germany. We are therefore led to turn to the final branch in the diagnostic tree diagram – market failures – in order to pin down the binding constraint on eastern German growth.

Hausmann et al. (2006) explained the “market failure” problem in a less advanced economy as follows: “The development process is largely about structural change: it can be characterised as one in which an economy finds out – self-discovers – what it can be good at, out of the many products and processes that already exist” (p. 18). In eastern Germany’s case, this problem was compounded because the floor on real wages set by the political settlement (including the need to prevent mass migration to western Germany) meant it needed to “self-discover” at a point much closer to the technology frontier than typical for a developing or transition country. New ideas for tradeables were required in order to replace the old activities rendered unprofitable by the real exchange rate and by openness to international competition. Opening up to international trade and capital flows does not automatically generate knowledge of profitable niches. Self-discovery is inhibited by learning and coordination externalities. In the core of the western German economy, a complex institutional matrix promotes the spillover of technological and marketing information and the coordination of lumpy upstream and downstream investments. But as noted above, this was not reproduced in the east.

Moreover, eastern Germany faced problems of self-discovery even in non-tradeables. Normally in the sheltered sector, domestic firms have the opportunity to benefit from monopolistic innovation rents. But even in non-tradeables, the first-mover advantages for local suppliers in eastern Germany were often taken by western German firms – eastern German firms immediately faced “foreign” suppliers and hence lower profits from “innovation” in such markets.

### What is the scale of the problem still faced by eastern Germany? The evolution of the “export base”

Transition economies left the planning era with oversized industrial sectors relative to a market economy benchmark. Eastern Germany’s rapid deindustrialisation following unification led it to overshoot the market economy benchmark. One reflection of this is its very low employment rate in industry. Figure 3 compares employment rates in industry (excluding construction) in eastern Germany with a number of transition economies, and with western Germany.

There is a scarcity in eastern Germany of “export-base” jobs: these jobs are involved directly or indirectly in the production of goods and services sold beyond the region. A lagging region lacks sufficient jobs of this kind and is characterised by dependence on the central government to support living standards. Support arises from benefit payments and from the financing of government employment, where pay scales are set nationally. In principle there are two ways to eliminate such regional economic weakness – potential workers move to the other region, i.e., to western Germany and/or new jobs are created in eastern Germany.

For political reasons, it is implausible for the entire adjustment to take place through the movement of population, and for economic reasons, it is infeasible for it to take place through the creation of new export base jobs. A satisfactory adjustment path would therefore be likely to involve both processes (Rowthorn 2000). What is an unsatisfactory outcome? An unsatisfactory outcome is a Mezzogiorno scenario where excess population remains in the lagging region and local economic development is too weak to absorb it: productivity fails to converge and living standards are sustained by federal transfers. After a brief burst of adjustment in the 1960s, the Italian south was characterised by the Mezzogiorno scenario (Boltho et al. 1997).

Using regional data for Germany, it is possible to make a crude calculation of the development of employment in tradeables, private non-tradeables and the government (i.e., non-market non-tradeable) sector. Employment in tradeables is defined by employment in agriculture, mining and manufacturing plus “extra” employment in finance and business services. For each year, the region in Germany with the lowest ratio of employment in finance and business services to population was used to define the share of employment in this sector that could be viewed as non-tradeable, i.e., producing services required to support the local population. The remainder of employment in finance and business services in each region was defined as part of the “tradeable” sector. Employment in the government sector was defined as that in “public administration, defence and social security”. The results highlight the differences in the deployment of resources in eastern and western Germany – the employment rate deficit of eastern Germany is large in tradeables at some 8 percentage points. The employment rate in private non-tradeables is also markedly lower in eastern Germany.

Using 1991 as the base year, Figure 4 plots the evolution of the working-age population and employment in eastern Germany relative to Germany as a whole. The working-age population in eastern Germany fell by 5 percent relative to Germany over the period. The chart makes clear that employment fell by much more. Following the end of the con-

Figure 3

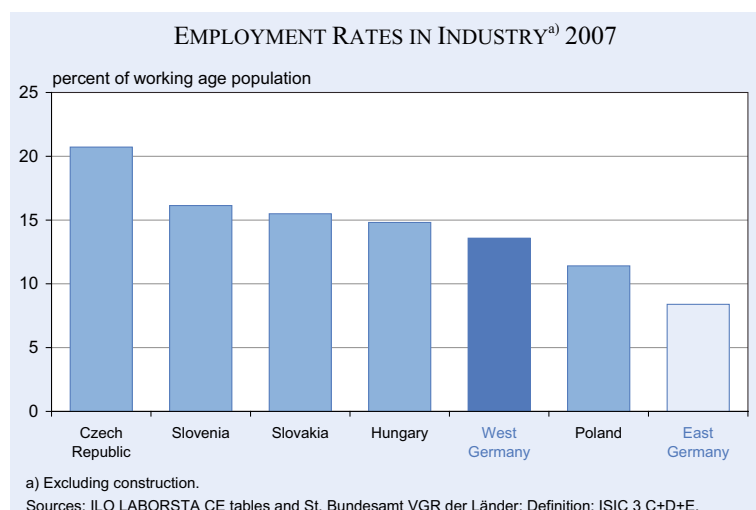
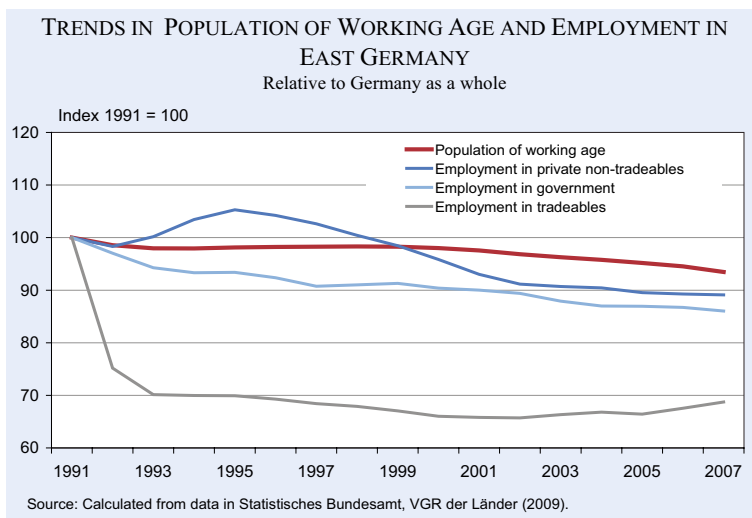


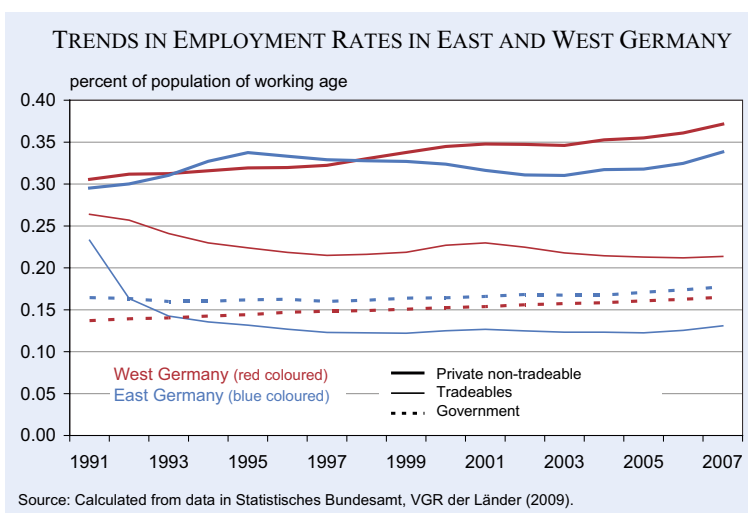
Figure 4



struction boom (reflected in the bulge in eastern Germany's share of employment in private non-tradeables), relative employment growth in both the government and in private non-tradeables evolved in line with relative population. This is what would be expected since employment in non-tradeables serves the local population. The normalisation of the eastern German economy would involve bringing the employment in tradeables and population lines closer together: either by population draining from eastern Germany and/or by rising employment in tradeables, which would tend to stabilise the working age population and the associated non-tradeables employment. Given the loss of "export base" jobs in the initial phase of the eastern German transition, this remains a substantial task. Nevertheless, Figure 4 indicates that both adjustment processes discussed above were present in eastern Germany from around the year 2000.

Figure 5 presents the employment rates in eastern and western Germany for tradeables and the two components of non-tradeables. In western Germany the rising overall employment rate was driven by private non-tradeables and a steady rise in the employment rate in the government sector. The upturn in eastern Germany's employment rate over recent years was the result of the recovery of the employment rate in private non-tradeables to a level similar to the peak achieved dur-

Figure 5



ing the post-unification construction boom, the stabilisation and slight upturn in tradeables, and the continued rise in the employment rate in the government sector.

A similar exercise can be conducted for each Land (Carlin 2010). The clearest contributions to the amelioration of the regional problem are in Thüringen and Sachsen where employment rates in tradeables are rising toward the western German norm. However, Mecklenburg-Vorpommern appears to have the emerging characteristics of a Mezzogiorno

region with little sign of closure of the huge employment rate gap in tradeables. It would appear that emigration is too weak to remove the surplus labour, and local economic development is too weak to absorb the "stayers". The high employment rate in the government sector in this region is consistent with the decline of the region and its dependence on transfers.

Although the employment rate gaps in tradeables remain large, the achievements of eastern German development are tangible and suggest that designating eastern Germany as a whole as trapped in a Mezzogiorno scenario may be premature. Nevertheless, the challenges to creating an adequate export base remain substantial.

Buch and Toubal (2009) provide evidence of persistent differences between eastern and western



Germany in their integration in international trade. They show that eastern German Länder trade much less with the rest of the world than western German ones, had fewer parents of multinational companies and a lower share of inward FDI. Buch and Toubal (2009) showed that there was only a slow convergence of eastern to western German levels. The methodology is well-designed to show a causal effect from lower openness to lower GDP per capita, highlighting the consequences of eastern Germany's limited success in discovering its sources of comparative advantage.

In the absence of policy instruments directly able to remove the market failures inhibiting the development of eastern Germany's export base, real depreciation is essential. Figure 6 shows that nominal wage restraint and more rapid hourly productivity growth both contributed to eastern Germany's improved

competitiveness in manufacturing since 2000. It is productivity catch-up that made the greater contribution. The chart also makes clear that productivity improvement was accompanied by the stabilisation of hours worked in manufacturing in eastern Germany. Money wage growth was below but close to that in western German manufacturing – reflecting the outcome in wage-setting of the conflicting pressures of a persistently weaker labour market in eastern Germany and the much more rapid growth of relative productivity.

The success of eastern Germany in achieving a substantial real depreciation vis-à-vis western Germany is all the more notable in the light of Germany's improved competitiveness versus other members of the eurozone since 1999. Figure 7 shows the evolution of real exchange rates among the EU-27 countries. Germany's real depreciation is evident both as compared with southern European eurozone members in the left panel and as compared with central and eastern European transition economies in the right panel.

The difficulty of achieving lower unit cost increases without the help of nominal depreciation is reflected in the cumulative competitiveness gaps (and associated widening of trade deficits) that now exist in a number of eurozone countries. The adaptation of the wage-setting system and productivity improvements achieved in eastern Germany are a notable success.

Figure 6

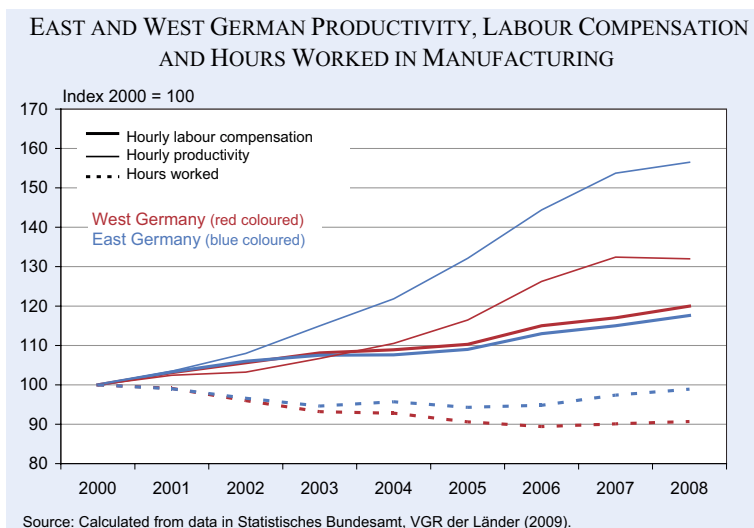
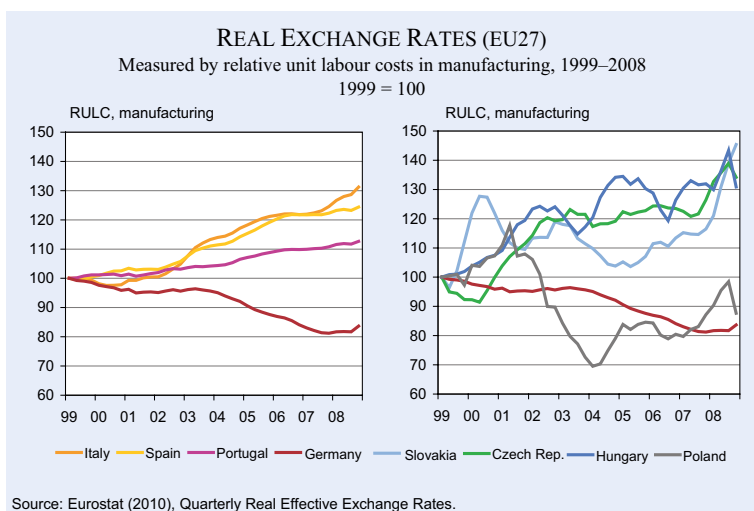


Figure 7



Conclusions

Eastern Germany's experience of transition highlights the limited extent to which good institutions alone can overcome 40 years of missing market experience, especially during a period of increasingly integrated global markets. The eastern German case brings to the fore the problem of finding a niche in the international division of labour. However, there are signs of slow improvement in eastern German performance. For the region as a whole, it does

not seem that the Mezzogiorno scenario is an appropriate characterisation.

Setting eastern Germany's performance within a broader context highlights the contrast between its success in raising competitiveness and the erosion of competitiveness among a number of southern eurozone members. However, the speed of catch-up of eastern Germany is very slow and its continuation depends on the steady growth of its small poles of tradeables success. Given the evidence that agglomeration and networks are important, well-designed industrial policy to foster investment and job creation in the nodes of development that have established themselves is more likely to be successful than the application of "watering can" support to the region as a whole.

Finally, eastern German catch-up would be assisted by a more balanced pattern of growth in western Germany than was characteristic of the 2000s before the global economic crisis. A shift toward growth less reliant on net exports in western Germany associated with stronger growth of real wages, consumption and investment would help reduce tensions and constraints on growth in the eurozone (where 40 percent of Germany's exports are sold). If the decoupling of eastern Germany's wage-setting system is successfully maintained, the region could gain in such a scenario from a further boost to its competitiveness and from more buoyant growth of markets in Germany and in the eurozone more broadly.

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