

## The Awakening of the East: Economic Development in the Eastern Federal States

By Klaus Deutsch and Sascha Brok

What structural reforms have helped shape the economy in the eastern states?

How is the financial crisis impacting state budgets?

### What is the Situation in the East?

#### *The Rush to Unification...*

Autumn 1989: Weekly Monday demonstrations in Leipzig, Dresden, and in other cities; an unhinged, leaderless GDR in a state of dissolution; in March 1990, the first free elections in the *Volkskammer*; Chancellor Helmut Kohl's and East German Prime Minister Lothar de Maizière's state treaty for economic, social, and currency union, which came into effect on 7 July 1990; the political gallop to unification through accession on 3 October 1990; the Agency for Privatization (*Treuhandanstalt*); rebuilding infrastructure, consumption, and institutions with billions (of Deutsch Marks and later euros); and the creation of five new *Bundesländer*.

#### *... is critically evaluated.*

And today? Twenty years of unity. Twenty years of "Reconstructing the East"—the span of an entire generation. Five new federal states. Blooming landscapes between Rügen and the Erzgebirge? A "German Mezzogiorno without a Mafia?" "A super-Gau?"<sup>1</sup> A success-story? Germany has evidently achieved unity—or has it? Everyone is in the same boat during the current crisis of the century: East Germans and West Germans alike. Do the distinctions east and west really have any meaning or significance in political and economic reality anymore?

#### *Reconstruction of the East*

In light of the historical drama, uproar about the "reconstruction of the east" (*Aufbau Ost*) has become astonishingly quiet: the *Aufbau Ost* has been administered by knowledgeable state and communal governments with the help of the federal government; eastern Germany is politically represented in high positions in federal German politics (besides the Chancellor herself, the vice president of the German Bundestag has eastern German origins); and a majority of prime ministers of eastern German states now have local roots. The *Aufbau Ost* is hardly noticed economically outside the five new states and gives almost no reason for special political programs or civic society interest now. Is this depiction deceptive? We think so.

The twentieth anniversary of the fall of the Berlin Wall provides an opportunity to look at the development of the eastern states. This currently occurs quite frequently through contemporary historical, biographical, and journalistic examination. A precise analysis of the economic development, however, combined with an evaluation of the current economic state and the outlook for the medium term, is rather rare. This is surprising. After all, the standard of living has vastly improved in the former GDR since 1989. Per capita income in the GDR in 1989 was just one-third of per capita income in West Germany, productivity in the East was only about 13 to 20 percent of West German productivity, and the average household net income about half of the West German value; whereas, today, the per capita income in the east is about 68 percent and the consumption rate about 80 percent of levels in the west.<sup>2</sup> Even so, the unemployment rate in the east remains very high. Many eastern Germans are commuting to work in the west; according to surveys, satisfaction with the quality of

life leaves much to be desired;<sup>3</sup> and the equalization process between the east and west has stagnated for more than half a decade. What has become of the reconstruction of the east? What is the outlook? What has happened in the past five years since our last review of the situation? None of these questions has a simple answer.

**Economic Development 2004-2009**

The eastern German economy underwent a fundamental structural change, a total transformation in the past twenty years. As we emphasized five years ago, the eastern German economy was relatively smooth sailing after clearing the initial rapids of privatization, building up investment assistance, and securing existing and constructing new sites for industry production. For about a decade, the new states have witnessed a structural change, which includes a reindustrialization shaped by medium-sized businesses, a few heavy industry parks, and a gradually developing service sector industry servicing primarily businesses. Those developments were countered by the need to bring the construction sector within normal levels by 2005 and the reduction of the size of the public sector to western German standards. Domestic demand-oriented businesses and the private service sector (trade, commerce, craft) posted disappointing results. Overall, though, the structural adjustment policy is on the politically desired track, and, in terms of the public sector, also within politically-desired as well as economically-feasible parameters.

**Table 1**  
GDP in the eastern states  
(in millions of euros)

|      | Brandenburg | Mecklenburg-<br>Western<br>Pomerania | Saxony | Saxony-<br>Anhalt | Thuringia | Berlin | Germany   |
|------|-------------|--------------------------------------|--------|-------------------|-----------|--------|-----------|
| 2004 | 48,291      | 31,837                               | 85,608 | 47,158            | 44,647    | 77,624 | 2,210,900 |
| 2005 | 49,024      | 32,116                               | 85,509 | 47,271            | 44,876    | 79,234 | 2,243,200 |
| 2006 | 50,888      | 32,957                               | 88,962 | 49,184            | 46,634    | 81,675 | 2,321,500 |
| 2007 | 53,173      | 34,782                               | 92,747 | 51,617            | 48,555    | 84,757 | 2,422,900 |
| 2008 | 54,947      | 35,867                               | 95,119 | 53,788            | 49,833    | 87,519 | 2,492,000 |

Source: *Volkswirtschaftliche Gesamtrechnungen der Länder*

**Table 2**  
Per capita income  
(in euros)

|      | Brandenburg | Mecklenburg-<br>Western<br>Pomerania | Saxony | Saxony-<br>Anhalt | Thuringia | Berlin | Germany |
|------|-------------|--------------------------------------|--------|-------------------|-----------|--------|---------|
| 2004 | 18,796      | 18,449                               | 19,873 | 18,790            | 18,883    | 22,914 | 26,798  |
| 2005 | 19,132      | 18,750                               | 19,960 | 19,042            | 19,136    | 23,361 | 27,202  |
| 2006 | 19,935      | 19,383                               | 20,875 | 20,028            | 20,076    | 24,023 | 28,185  |
| 2007 | 20,921      | 20,621                               | 21,903 | 21,262            | 21,110    | 24,873 | 29,453  |
| 2008 | 21,721      | 21,439                               | 22,620 | 22,427            | 21,875    | 25,554 | 30,343  |

Source: *Volkswirtschaftliche Gesamtrechnungen der Länder*

Little debate continues as to whether the basic obstacles for infrastructure were eliminated. Although some of the federal and municipal transportation plans have not yet been realized—some Autobahn connectors or some traffic routes—by and large the eastern German states have an effective infrastructure in transportation and telecommunications, in governance and justice, schools that are partly successful

above average, a substantial private and public science and research community, and altogether a clearly defined position profile (more on that below).

To look at overall economic results, the outcomes show the following:<sup>4</sup> The 5.7 million people in the labor force in eastern Germany (of the 13.1 million eastern Germans, which accounts for about 16 percent of the German population), produced about 12 percent of the German economic performance (including Berlin, 20 percent of the population and 15 percent of the economic performance).

The per capita income, the simplest measure of the standard of living, has dramatically risen in the east during the past twenty years, and lies between €21,700 in Mecklenburg-Western Pomerania and €22,620 in Saxony. That corresponds to a margin of 66 to 68 percent of the average of the western German states in 2008. The past few years have been marked by a very slow convergence toward the western levels.

The gross income and wages of each worker have remained at around 80 percent of western standards during the past few years; hourly wages are at a slightly wider margin, about 76 percent. Nevertheless, even in eastern Germany, incomes rose in the years 2007 and 2008 by more than 3 percent. Income of self-employed and investment income also rose rather strongly and social benefits decreased slightly. Overall, however, mass purchasing power has not developed positively.

The growth in the past few years overwhelmingly came from the manufacturing industry and from service sectors servicing businesses such as finance, lease, and enterprise services. Other sectors, such as forestry and agriculture construction since 2007, commerce, the hotel and restaurant industry, and transportation, also performed well some years.

The manufacturing industry now accounts for about one-fifth of added value and generates about €50 billion annually. The average business size increased to 164 employees. About 16 percent of the labor force works in this industry.

**Table 3**  
General indicators

|                             | Brandenburg | Mecklenburg<br>-Western<br>Pomerania | Saxony        | Saxony-<br>Anhalt | Thuringia | Berlin    | Germany    |
|-----------------------------|-------------|--------------------------------------|---------------|-------------------|-----------|-----------|------------|
| Area<br>(km) sq*            | 29,480.33   | 23,185.40                            | 18,418.<br>04 | 20,447.05         | 16,172.10 | 891.02    | 357,104.07 |
| Pop*                        | 2,535,737   | 1,679,682                            | 4,220,2<br>00 | 2,412,472         | 2,289,219 | 3,416,255 | 82,217,837 |
| Pop/sq<br>Km*               | 86          | 72                                   | 229           | 118               | 142       | 3,834     | 230        |
| Labor<br>force<br>(1000s)** | 1,203       | 757                                  | 1,913         | 1,083             | 1,067     | 1,504     | 38,163     |
| Un-emp.<br>%***             | 11.0        | 11.8                                 | 11.6          | 12.2              | 10.1      | 13.6      | 7.7        |

\*21 December 2007

\*\*Year average 2007

\*\*\*October 2009, drawn from the full civilian labor force

Source: *Statistische Ämter des Bundes und der Länder, Bundesagentur für Arbeit*

The capital stock per labor unit in eastern Germany was valued at 84 percent of the western value. All in all, however, the gross fixed investments in the east are disappointing. Only investments in new machinery rose in 2004 and 2006, but slacked again after that. Intermediate input and capital equipment industries surpassed the average.

The industrial production reflected this, as also in this sector electronics, metal industry, machine tools, automobile manufacturing, and chemical production saw the highest growth. They rode the cyclical economic boom in 2006/2007 and were competitive with their western counterparts due to lower unit labor costs (in 2007 by 13 percentage points). But already in the summer of 2008, a shadow cast over the economic landscape.<sup>5</sup> Reductions in new orders followed promptly. While the turnover in 2008 for three-fourths of businesses and profits for two-thirds of businesses in 2008 were satisfactory, business prospects for intermediate input and capital equipment industries were already collapsing. Domestic-oriented businesses remained level.

A rise in exports was observable in all of the new federal states. Eastern German products are mainly exported to western Germany, the EU, and the Gulf Region. While the production type and product quality is beginning to closely resemble western German models, regional structural differences still exist. The average export turnover varies widely among the eastern states: Brandenburg is at the low end of the range with an export quota of 25.5 percent and Saxony with mining and manufacturing industries at the high end with 36.9 percent.

The productivity of the overall economy in the east, measured in gross value added per working person, rose by 13 percent since 2000, compared with only 9 percent in the west; and especially in the past five years, the pace of productivity increased faster in the east than in the west, at a rate of 2.4 percent per year versus 2.0 percent per year. At the same time, a 22 percent gap remains between the total economies of the former west and east.

Despite shrinking population levels, and sinking employment provisions due to a falling birth rate and an increasing number of retirees, the size of the labor force increased moderately in all the states in 2006. Nevertheless, the number of people commuting from east to west remained relatively high, at about 400,000 people. The unemployment statistics in the east thus went down from over 1.3 million in 2004 to about 900,000 in the summer of 2008, and only began to rise again in the winter of 2008-09. Even so, in October 2009, unemployment figures hovered between 10.1 percent (Thuringia) and 13.6 percent (Berlin) of the civil work force, still well above the western German average of 7.7 percent.

Employment ratios in eastern Germany remain unsatisfactory. According to calculations, in 2007, about 1.8 million jobs were lacking for 7.4 million potential laborers. Nearly 5.7 million workers from the eligible labor force were working in eastern Germany, 400,000 commuted to work in western Germany,<sup>6</sup> 1,000,000 reported unemployed, and another 390,000 were underemployed or unreported. Despite a number of cyclical boom years, this weak point could not be improved.

A comparative study of the quality of life in eastern Germany by the IFO Institute found that legal structures, infrastructure, cost of capital, salary flexibility, local purchasing power, research and development, and personal security in eastern Germany are overall good to very good in comparison to similar regions (in terms of productivity and factor endowment); although eastern Germany displays high labor costs and is viewed critically in terms of the availability of qualified workers.<sup>7</sup> Even so, as an area for foreign investors, eastern Germany retains certain advantages from their point of view,

which can be confirmed by international companies locating business divisions in eastern Germany.

In its annual report,<sup>8</sup> the federal government also indicated that there are now a number of efficient, mostly mid-sized businesses that are internationally competitive and produce high-quality technical products. Besides the automobile industry, micro-electronics, and chemical production industries, these certainly also include optics, air and space technologies, solar power, and branches of the medical industry. We indicated in our report five years ago—as have other researchers—that to prosper, these economic sectors required an expanded targeted political program, beyond the programs to encourage settlement in the east, such as the creation of business parks and incentives for investment. Such policies should also include a qualified workforce in the long run, despite rising school drop-out rates, increased public-supported research and development programs (at universities and research institutes), as well as focusing state politics on providing a good framework for these rapidly growing industries. That has been implemented in all five states despite the diverse industrial structures. Additionally, the latest studies show that in Jena, Dresden, Greifswald, and Potsdam, as well as in some other areas to a lesser extent, there is a great regional potential for innovation.<sup>9</sup>

There has been much progress in this regard in the last five years. Even though some structural deficits—including many small and medium-sized businesses with barriers to entry into the international markets and financing difficulties, insufficient research and development capacities within the companies themselves, and outmoded assembly structures in manufacturing—cannot be undone, there is a core of middle-size businesses that are internally and loan financed, technologically advanced, more represented on international markets, and more robust. The economic boom contributed to this in many sectors.

Important parts of the service sector, in contrast, remain weak. Productivity remains 20 percent below western standards as well as the growth projections. The public administration employs still more people in the eastern states than in their western counterparts. The state governments are thus systematically reducing the public workforce. Although retail and ordinary business increasingly imitate the western model, a gap remains in the more sophisticated business-oriented service sector. In the finance industry, wholesale trade, information technology, legal and economic consulting, advertisement, and the lack of corporate headquarters is most remarkable. The DIW determined that, among the 700 most profitable firms in Germany, only 5 percent were located in the eastern part, and among those, some were subsidiaries. The DIW believes there is a great growth potential in business-related service sectors and moderate growth in household-related businesses. Much depends on whether medium-sized businesses can continue to thrive, since one cannot expect that corporate headquarters will choose to locate in the east or large establishments of well-known businesses will take place in the east. In most federal states, new business developments open with about eighty employees, in other words, veritable mid-sized businesses.

The reconstruction of the east was supported from the beginning by substantial financing from the German federal government, the EU, and the financial equalization scheme between the federal government and the *Länder*. In addition, several transfers from west to east were undertaken through the social security system. That development until 2004 was treated fully in our first report. In it we showed that, in spite of more than €300 billion worth of investment promotion, no overall economic self-sustaining investment dynamic could be developed, and the peaks from the year 2000 had mostly declined again. In the past five years, little has changed in the overall promotion scheme, but one should list the following: An agreement on the exact

outline for the use of funds from the Basket II of the Solidarity Pact II (*Korb II des Solidarpakts II*) until 2019, amounting to €51 billion; the extension of the investment promotion will continue through 2013; and funding for the Joint Agreement on the Improvement of Regional Economic Structures (*Aufstockung der Mittel für die Gemeinschaftsaufgabe*) will be increased by €200 million for the Stimulus Package I (*Konjunkturpaket I*), of which €100 million will go to the eastern states. For the east, €18 billion have been earmarked from EU structural funds (2007-2013), and another €4.7 billion in the framework of the second pillar of the Common Agricultural Policy, which amounts to €3.2 billion per capita.<sup>10</sup>

The investment promotion is universally regarded as having especially contributed to capital spending, the creation and retention of jobs, and the development of mid-sized businesses. The generous investment promotion policy was possibly also very important for the establishment of certain capital-intensive new industries, for example, solar plants. Even after 2013, most eastern states will most likely continue to be able to request high allocations. Nevertheless, the allocations in the Solidarity Pact II package are less. This outlook has already led to a forward-looking adjustment by the states, who have switched from subsidies to credits.

The federal grants encompass, above all, the normal support of businesses through common tasks such as transportation infrastructure, innovation and technology-promotion through federal competitions, financing for business networks, future conferences about industries with future potential, and attracting research groups with federal funding in the east. Among the successful achievements, one can name some of the projects undertaken under the second Stimulus Package, credit and bond programs for small and medium-sized businesses, and also some initiatives for mid- and high technology promotions.

As Deutsche Bank argued five years ago, programs at the federal but especially at the state level that aim to improve the long-term attractiveness for investment in areas, especially by improving the quality of the shrinking labor force, improving education and training by closely linking the state and economy and the greater support of industry-specific research and development, would be much more effective than purely pouring capital into economic sectors.

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<sup>1</sup> Uwe Müller, *Supergau Deutsche Einheit* (Hamburg, 2006).

<sup>2</sup> Klaus Schröder, *Die veränderte Republik. Deutschland nach der Wiedervereinigung* (Berlin and Munich: Verlag Ernst Vögel, 2006); Institut für Wirtschaftsforschung Halle, "Auslaufen der Solidarpaktmittel: sind die Neuen Länder ausreichend vorbereitet?" *Wirtschaft im Wandel* 3/2009 (2008); Ifo Dresden, "Konjunkturprognose Ostdeutschland und Sachsen 2008/2009: Abschwung und Rezession," *Ifo Dresden berichtet* 1 (2009): 3-11.

<sup>3</sup> Stefan Bergheim, "Deutschland zum Wohlfühlen. Viele Gemeinsamkeiten in den glücklichen Regionen," *Aktuelle Themen* Nr. 401, DB Research (2007).

<sup>4</sup> The data were collected from Volkswirtschaftlichen Gesamtrechnungender Länder (VGR d L); Bundesministerium für Verkehr, Bau, und Stadtentwicklung, *Jahresbericht der Bundesregierung zum Stand der deutschen Einheit 2008*, [www.bmvbs.de](http://www.bmvbs.de); and Institut für Wirtschaftsforschung Halle, "Auslaufen der Solidarpaktmittel: sind die Neuen Länder ausreichend vorbereitet?" *Wirtschaft im Wandel* 3/2009 (2008).

<sup>5</sup> Institut für Wirtschaftsforschung Halle, "IWH-Industrienumfrage in Ostdeutschland zum Jahresauftakt 2009: Im Abwärtssog," *Wirtschaft im Wandel* 3 (2009): 140-144.

<sup>6</sup> Calculations of the IWH (2008). The employed are also comprised of people participating in job-creation schemes, as well as work-creating infrastructure measures, short-time work, part-time retired employees and people working in one-euro jobs. All data for eastern Germany without Berlin.

<sup>7</sup> Ifo-Dresden, "Konjunkturprognose Ostdeutschland und Sachsen 2008/2009: Abschwung und Rezession," *Ifo Dresden berichtet* 1 (2009): 3-11.

<sup>8</sup> See most recently Bundesministerium für Verkehr, Bau, und Stadtentwicklung, *Jahresberichte der Bundesregierung zum Stand der deutschen Einheit 2009 and 2008*.

<sup>9</sup> Institut für Wirtschaftsforschung Halle, "Innovationspotenzial ostdeutscher Regionen: Erfindergeist night nur in urbanen Zentren zu Hause," *Wirtschaft im Wandel* 4: 181-192 (2009).

<sup>10</sup> Bundesministerium für Verkehr, Bau, und Stadtentwicklung, *Jahresbericht zum Stand der deutschen Einheit: Berlin*, [www.bmvbs.de](http://www.bmvbs.de) (2009).

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