Weak Foundations Under East German Reconstruction

In terms of living standards, East Germans are the clear winners of communism’s collapse. Since rapid privatization decimated the local industrial base, however, they remain heavily dependent on transfers of Western wealth.

by JEFFREY KOPSTEIN

While the economic policies of other ex-communist countries shift back and forth between marketization and social protection, and as politicians and populations learn to discard ideological formulas in favor of pragmatic solutions to problems of marketization, German largesse sustained radical economic reform in the former East Germany over an extended period, despite significant social costs.

The five new Länder of federal Germany that were formed from the extinct German Democratic Republic have had far more external assistance than any other former communist country: in the five years since the 3 October 1990 unification of Germany, nearly DM 1 trillion of public money has flowed from the West to the East. In relative terms, the support given to East Germany after unification exceeds that given to any Western European country under the Marshall Plan after World War II. But while clear progress has been made in raising standards of living and laying the basic infrastructure for development, the East German industrial sector collapsed and little progress has been made toward rebuilding or replacing it. In a sense, the East German economy has become little more than a market for West German firms subsidized by large governmental transfers of wealth.

The German experience in the East suggests that, even under the most favorable conditions, constructing capitalist institutions of self-sustained growth from scratch is an experiment in many ways as ambitious as the communist one that just failed. The lesson of that experiment may be obvious, but it reinforces what has been maintained by theorists of economic modernization: success in economic development is not primarily dependent on the amount of capital available to an economy, but rather on the economic institutions it has in place to utilize that capital. Capital and other resources may be transferred relatively quickly, especially in the 1990s, but the institutions and social structures designed to absorb and use them do not lend themselves to rapid transfer.

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<td>1,358</td>
<td>1,309</td>
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<td>Total</td>
<td>9,766</td>
<td>7,339</td>
<td>6,261</td>
<td>5,933</td>
<td>6,017</td>
<td></td>
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October 1995, federal Economics Minister Guenter Rexrodt announced that no one could say when the East German economy would reach the level of the West. "We are saying that five years after German unity and the introduction of the social market economy, great progress has been made. But we’re only halfway there. There is still the second half of the way, and that will also be a difficult road."

The results are certainly impressive, especially if one considers the counterfactual: what would East Germany have looked like without unification? Since 1992, the economy in the new German states has grown between 7 and 10 percent per year, making Germany’s East the fastest-growing region in Europe. Rudimentary economic infrastructure in the new states, such as roads, rail links, and telephone communications, has been vastly improved by a steady stream of government investment.
investment. In 1988, only 17 percent of East German households had telephones, corresponding to the level of Crete. Between 1990 and 1993, 2.3 million new lines were installed, and it is expected that the West German level will be attained by 1997.

Such overt signs of progress, however, do not tell the whole story. For one thing, they mask very low starting points. Quite apart from the dismal state of the East German economy before 1990, the immediate impact of unification was to unleash a depression in the East, the magnitude of which surpassed all expectations. Currency union resulted overnight in a fourfold increase in the costs for East German goods and services. Unable to compete with the West and subject to rapid privatization, East German industry collapsed. Two out of three jobs in manufacturing, which employs more people than any other sector in East Germany, have been lost since 1990 (see Table 1).

Aggregate unemployment rates started to bottom out only in the first half of 1994, well after the economy started to turn around (see Table 2). On the fifth anniversary of unification, official unemployment in the East hovered at approximately 14 percent, with significant regional variation. Government-funded retraining programs, make-work programs, part-time work, and early retirements would bring the number closer to 30 percent.

The existence of rapid economic growth in a stagnating — or even collapsing — industrial labor market suggests that the stabilization and turnaround of the East German economy has had little to do with sustained, “domestically” driven growth. The East German economy continues to be heavily dependent on the West. In 1995, the estimated DM 158 billion in transfers East Germany will receive from the federal government, other Laender, the European Union, and social security will amount to more than 25 percent of the resources available in East Germany for consumption and investment.

Whereas East German demand for goods will reach about DM 610 billion in 1995, only DM 380 billion of goods will be produced there. Trade flows tell a similar tale. In 1994, East Germany bought DM 255 billion of goods from West Germany, while selling a mere DM 45 billion in return. There is not one major East German product that has a market throughout the federal republic; producers that have managed to survive rely on regional markets. Despite high-level commitments of major German producers to “buy East,” only about 10 percent of East German production is sold in the West and even less makes its way onto world markets.

INDUSTRIAL COLLAPSE

Besides consumption, one of the main uses of the capital flowing into East Germany has been construction (see Table 1). A wave of residential and commercial construction is driving the East German recovery. According to one expert, however, the region simply does not require much of what is being built. For example, between 1990 and 1995, DM 50 billion was invested in metropolitan Leipzig, mostly in large shopping centers and other commercial spaces. Meanwhile, 17 percent of commercial real estate remains empty.

The rapid growth in the service sector after unification corrected what had been a typical weakness of a command economy. Further growth in that sector will depend on demand for services from industrial enterprises in the regions and on the willingness of Western firms investing in the East to use local-

ly based service providers rather than relying solely on their tried and tested partners from the West. The head of a market research firm in Rostock complained that “since almost all large investment comes from the West, breaking into market research depends on developing connections with Western firms that, in all honesty, have no need for new partners in the East. The fact of the matter is that West Germany and Europe produce more than enough to cover demand in East Germany, and for that reason our situation is completely unlike that in the West after World War II.”

The central problem in the new German states is that the de-industrialization that took place in the first years after unification has not been overcome. Measured against Western standards, East Germany was overindustrialized before unification; now it is clearly underindustrialized.

Given the absence of large capital holders in the five new states, industrial investment will necessarily come from Western Germany and other developed capitalist countries. Much of East Germany’s future will thus depend on how attractive it is as an investment site. In comparison with other former communist countries, East Germany enjoys a highly stable political and institutional environment for investors. However, the investment record since unification is mixed. While some areas, such as Dresden and Leipzig, have been successful, others have not.

Labor costs are one problem. Fearing downward pressure


4Interview with head of market research firm, Rostock, September 1995.
on wages from cheaper Eastern workers, West German trade unions quickly dominated the Eastern landscape and have consistently put upward pressure on wage settlements there. But while Eastern wages have risen rapidly to the level of the West, disparities in labor productivity have persisted, rendering unit labor costs even more threatening for potential investors than in West Germany. German economist Fred Klinger characterized the impact of high East German wages in the context of a globalized labor market dramatically: "Worldwide there is, by far, no more comparable production location that is simultaneously so expensive, so productively weak, and infrastructuraly so weakly equipped." Thus, despite a good start after unification, productive investment has begun to lose pace.

### Table 2: Unemployment in Eastern Germany

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<th>Year</th>
<th>Thousands</th>
<th>Percent</th>
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<tr>
<td>1991 1st half</td>
<td>843</td>
<td>9.5</td>
</tr>
<tr>
<td>1991 2nd half</td>
<td>1,038</td>
<td>11.8</td>
</tr>
<tr>
<td>1992</td>
<td>1,170</td>
<td>14.8</td>
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<td>1993</td>
<td>1,149</td>
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<td>1994</td>
<td>1,142</td>
<td>16.0</td>
</tr>
<tr>
<td>March 1995</td>
<td>1,061</td>
<td>15.1</td>
</tr>
<tr>
<td>August 1995</td>
<td>1,035</td>
<td>14.7</td>
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High unit labor costs not only deter large corporate investors, they also make it difficult for small and medium-sized businesses to stay afloat. The wave of new medium-sized firms that sprouted up after unification is currently undergoing a crisis of solvency. The majority are going bankrupt, a phenomenon not unusual in itself but alarming when one considers just how small the East German Mittelstand is compared to that of the West. As subsidies and tax breaks from the federal government intended to promote enterprise in the East run out over the next few years, the bankruptcy rate can be expected to increase substantially.

A year after the German privatization agency, Treuhand, finished its work, a growing number of Germans suspect that despite impressive gains in construction, infrastructure, and consumption, a base of productive industry will not be reestablished in the East without some sort of regional economic policy. Such a policy would provide subsidies and protected markets to "core" industries throughout the East and ultimately would require sustained assistance from the West. This is slowly becoming the consensus at both the federal and the state level. Yet even with such a consensus, it is not clear whether Germany has either the political will or the economic capacity to continue to pour resources into the East at the rate of the past five years.

Unification has not only created new problems, it has also brought old ones to a head more quickly than expected. Postwar West Germany tried to even out regional economic differences through administratively intricate financial transfers, a policy that worked well among regions with economies at roughly the same level of development. Extending the policy eastward after 1990 has put a severe strain on the German budget that, if continued, will necessitate either higher taxes or significantly lower social benefits for Germans today and in the future. The German welfare state, a staple of national integration since Bismarck's time, will most likely continue to be downsized in the coming years, as the federal government searches for ways to defray the costs of high unemployment, industrial restructuring, and an aging population.

At the same time, most economists predict, levels of development in the East will be far more differentiated than in pre-unification West Germany. As the economist Albert Hirschnanz argued more than a generation ago, small differences in levels of development quickly accumulate into large advantages, reinforcing the backwardness of the backward region and the advantage of the advanced region. The contours of that differentiation are already visible. Whereas in Dresden, unemployment levels are below those in such crisis-ridden Western cities as Bremen and Wilhelmshaven, such traditionally backward regions of East Germany as Mecklenburg-Western Pomerania and Brandenburg, which the former communist regime tried to industrialize, will probably return to their former status as sparsely populated and poor areas.

**REGIONAL IDENTITIES PERSIST**

In 1990, most East Germans wanted unification for a very simple reason. Whether measured in terms of living standards or political and social freedoms, socialism was a failed experiment. Amalgamation with prosperous West Germany simply made sense as the best and most painless route to prosperity and freedom. Thus, whereas other Central and East Europeans used nationalism as a tool for the exit from communism, Germans exited from communism not by asserting a distinctive East German political identity, but in large measure by denying it. Yet in the five years since unification, the politics of identity have returned to East Germany. Regional identities in Germany, at least temporarily, have taken on many of the traits of an ethnic political divide.

In the federal and numerous state and local elections held in 1994, the largest divergence between East and West Germany was in the performance of the Party of Democratic Socialism (PDS), the successor to the East German Communist Party. While receiving a paltry 0.9 percent of the Western vote, the PDS consistently garnered nearly 20 percent of the East German vote at both the state and federal levels (and 34.7 percent in East Berlin). In addition to unanticipated strong support among young people, 27 percent of white-collar workers and 35 percent of civil servants in East Germany voted for the PDS. Those results suggest that party loyalty

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create undue expectations of an already overburdened government’s ability to sort out conflicting claims.

As retroactive justice, Estonia’s restitution policy is at best partial redress. On the other hand, that may be the most any government could hope to accomplish in the transition from communism.19 Restitution has clearly played an important role in Estonia in a broader process of cultural de-sovietization and the restora-


tion of civil society. But it is now also serving to divide society among the winners and losers in property reform. That might be a healthy and stabilizing trend for democracy, as cleavages become more “cross-cutting” and Estonians promote their economic interests across ethnic lines. It could also prove destabilizing, as groups appeal to the state to mediate among conflicting economic interests that might otherwise be sorted out in the marketplace.

The state may well succeed in muting those conflicts in the interim, until the restitution winners are satisfied with their gains and the losers have other chances to improve their lot. But in any case, conflicts over property rights will be one more way in which this and subsequent governments, as they move closer to an extensive market system, will continue to deal with the long shadow of Soviet rule.

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runs deeper than expected, even among those East Germans who successfully negotiated the transition. Such a nostalgic outlook (or as Germans now call it, Ostalgie) may pass as conditions in the East improve, but it is more likely to be a matter of time, as a new generation comes to accept the new Germany as inevitable and natural.

According to a poll published by the Berlin daily Tagespiegel on the eve of unity day 1995, the majority of East Germans — 57 percent — feel that they have profited from unification.12 The number who thought of themselves as winners had increased from the 32 percent in 1993 and 38 percent in 1994 registered in similar polls. But 21 percent still considered themselves to be the “losers” of unification, only a small improvement from the 1994 figure of 23 percent. Those polls seem to point to a polarization in attitudes.

Purely in terms of living standards, East Germans are the clear winners of communism’s collapse. But even though East Germans are eating better food, receiving better health care, buying more consumer durables, living in better apartments, traveling abroad more frequently and to pricier destinations, and breathing better air at home, many still complain that the skills and communal habits acquired under socialism have been devalued by the transition to capitalism and that Western culture belittles the lives lived during East Germany’s 40-year history. This is true even for the vast majority of East Germans who continue to say that unification was both a good idea and a necessary step.

East Germans are also reacting to the sudden and almost complete commodification of the economy. The idea that such fundamental areas of human life as housing, schooling, and day care, as well as food and other staples, should be subject to cost-benefit calculation and the vagaries of the market does not sit well with most East Germans, regardless of political orientation. Somehow the market, understood in this sense, offends their sensibilities even as they participate in it, understand that there is no practical alternative to it, and are prepared to do little to change it. What might be characterized as an egalitarian “moral economy” of communist society appears to have persisted well into the transition period.

Ultimately, unification’s success will depend on the patience and sensitivity that the numerically greater and economically stronger West Germans bring to the process. Helmut Kohl, in his televised address to the German nation on 3 October, expressed confidence that within the foreseeable future, “the material problems [of unification] will be mastered,” while drawing his audience to the more amorphous cultural divide: “In the long run, getting along with each other in Germany is the largest task for all of us. For that, we need patience, good will, and the readiness to listen to each other.” The most important lesson of the German experiment may be that nation-building has as much to do with cultural transformation as it does with economic development.

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12Press summaries prepared for German Embassy personnel.