Micro- and Macroeconomic Adjustment Processes in Eastern Germany – Nineteenth Report

by the German Institute for Economic Research, Berlin (DIW), the Institute for the World Economy at the University of Kiel (IfW) and the Institute for Economic Research Halle (IWH)

At the end of 1989, almost ten years ago, the socialist system in the GDR collapsed. This paved the way for the establishment of a liberal democratic system based on the social market economy. A year later the two German states were reunified.

Economic reconstruction in eastern Germany has proved more difficult than had been expected, however. The change of system pitilessly revealed the deficiencies of the socialist planned economy. The economic base collapsed like a house of cards, and had to be rebuilt from scratch. Although the response to this challenge has been vigorous, it is a process that will take considerable time.

The German Institute for Economic Research, Berlin (DIW), the Institute for the World Economy, Kiel (IW) and the Institute for Economic Research, Halle (IWH) have accompanied the reconstruction process in eastern Germany from the outset, within the framework of a research project entitled 'Macroeconomic land Microeconomic Adjustment Processes in Eastern Germany', commissioned by the then Federal Economics Ministry. So far they have published 18 reports, which constitute, in their continuity, a unique documentation of a piece of German economic history.

This, the 19th, report sets the keystone on the entire project.[1] It covers the entire period from the peaceful revolution in 1989 to the present day. It describes the distance covered by the east German economy so far, and attempts to determine where it now stands compared with the west German economy. It also provides information on the changes in the living conditions of the population.

The report reveals that, even after almost ten years, the two parts of Germany do not yet constitute an economic unity. Reducing the gap in economic performance thus remains the prime task. This cannot be achieved by pumping large amounts of public money into the East of the country. What is decisive is that private investors put their money into the region. Economic policy must set the appropriate parameters for this to occur.

From the socialist planned economy to the social market economy

It must not be forgotten in just how poor a state the economy of the GDR found itself at the end of the 1980s:

- Much of its capital stock was worn out and technologically obsolete. There were shortages of raw materials and intermediary goods. Together this led to frequent production stoppages due to breakdowns and shortages of material.
- Many of the products were unsatisfactory in terms of their utility characteristics, their quality and their appearance. Most of them could only be sold on western markets, if at all, at prices that were below cost.
- Production was inefficiently organised in many areas. The size and form of the industrial combines and the state-owned enterprises were often excessive and inappropriate to the economic framework: the production programme was often far from optimal, and there was little division of labour between enterprises.
- The specific consumption factors of production was high. Comparatively large quantities of materials and energy were consumed and labour was often deployed inefficiently. According to western standards production was thus costly, and productivity correspondingly low.

Official propaganda constantly pointed to the economic successes achieved, but the picture painted by the statistics – according to which 'produced national income' rose by an annual average of 4% during the 1980s, prices remained stable, and the government budget was balanced – was far too rosy. In a confidential document presented to the Central Committee of the ruling SED in May 1989, the Chairman of the State Planning Commission was forced to admit that the GDR was finished economically. In order to avoid state bankruptcy, he recommended drastically reducing popular consumption. This amounted to an admission that the strategy of a 'unified economic and social policy' pursued by the SED leadership had failed.

Given this objective situation, no-one could be under any illusion about the consequences of economic, monetary and social union. Even so, the pace and extent of the economic decline came as a surprise. The index of

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[1] The previous reports have also appeared in the *Economic Bulletin*. This is an abridged version of the shortened version of the report that appeared in the DIW's *Wochenbericht* no. 23/99. The full report was published in German in the IW's *Kieler Diskussionsbeiträge* no. 346/347 and in the IWH's *Forschungsreihe* no. 5/99.

Table 1

East-West Comparison of Key Economic Indicators

West Germany = 100[1]

	1991	1992	1993	1994	1995	1996	1997	1998
GDP per capita	31.3	38.9	47.7	52.3	55.4	56.8	56.7	56.1
Final domestic expenditure	49.1	72.1	82.5	87.6	.	.	.	.
Investment in machinery and equipment per capita	63.6	75.3	99.5	111.5	110.2	111.3	102.1	.
Construction investment per capita	67.2	100.9	130.8	163.7	174.5	178.4	175.4	164.3
Private consumption per capita	50.0	58.7	64.1	67.1	69.6	71.2	72.6	.
Gross wage and salary income per employee	46.7	60.7	67.9	70.5	72.5	73.6	74.4	73.9
Net income per employee	54.7	67.7	75.6	78.3	82.4	84.3	85.4	.
GDP per employed person	31.0	43.5	53.1	56.0	57.3	59.4	60.4	59.5
Unit labour costs	150.6	139.4	128.0	126.0	126.5	124.0	123.2	124.0

1 All figures at current prices. — 2 Gross wage and salary income per employee divided by GDP per employed person.
Sources: Federal Statistics Office; ifo; DIW.

industrial goods output, which continued to be determined according to GDR statistical conventions until the end of 1990, fell by about half in the immediate wake of the introduction of the D-Mark in the GDR. A further decline was initially cushioned through the provision of massive state aid, in particular by financing so-called transfer rouble transactions with the central and eastern European reform states. Yet as these measures were wound down, the contraction continued. The index of net manufacturing output, as calculated by the Federal Statistical Office from mid-1990, fell by around a further quarter during the first half of 1991.

The nature of the transition to the market economy, it must be said, also contributed to the collapse of the GDR economy, although it was not the causal factor. Problems here included the procedures used in currency conversion and the rapid rise in wage costs even prior to the establishment of economic, monetary and social union. Both factors meant that the vast majority of enterprises were insolvent within a short space of time. This explains why, with few exceptions, the economic collapse affected all sectors.

Economic policy makers, too, initially underestimated the gravity of the situation. They focused largely on limiting the damage. Firms were provided with generous liquidity credits and export assistance, and short-time working was financed. In addition, a series of support programmes were set up in order to boost investment. Last but not least, central government and the west German states provided start-up financing for state and local government in eastern Germany and the social insurance funds. Initially, economic policy relied on things taking a turn for the better relatively quickly. Yet the hoped-for upturn failed to materialise. Investment from the West developed only sluggishly, and, moreover, was focused largely on developing sales markets in the region. As the bad news reports piled up at the start of 1991, however, economic policy responded vigorously: the restructuring and privatisation of state-owned enterprises was stepped up, the barriers to investment deriving from a lack of clarity on ownership rights were removed as far as was possible, public support for investment was increased, progress was made in developing the infrastructure, and planning and approval procedures were simplified and speeded up. Gradually people realised that the reconstruction of eastern Germany was going to take time, and that it would require active support from the West.

Macroeconomic developments can be divided up into three phases:

– the decline phase, from around the middle of 1990 to mid-1991,
– a marked recovery, which lasted until the end of 1994,
– a renewed slow-down, which persists until this day.

These phases can be identified from the quarterly rates of change of total output.

Yet it is important to consider what lies behind these statistics. The high and rising rates of growth between 1992 and 1994 partly reflect the collapse of output in the preceding years. GDP was able to rise rapidly, from a depressed level, as a growing number of firms began to

Table 2

State Support for Eastern Germany

	1991	1992	1993	1994	1995	1996	1997	1998[1]	total 1991 to 1998
Total support	139	15	167	169	185	187	183	189	1370
of which:									
Central government	75	88	114	114	135	138	131	139	934
West German state and local government	5	5	10	14	10	11	11	11	77
'German Unity' Fund	31	24	15	5	–	–	–	–	75
European Union	4	5	5	6	7	7	7	7	48
Social insurance funds[2]	24	29	23	30	33	31	34	32	236
of which:									
Social benefits	56	68	77	74	79	84	81	84	603
Subsidies	8	10	11	17	18	15	14	16	109
Investment	22	23	26	26	34	33	32	33	229
General financial support (unclassifiable)	53	50	53	52	54	55	56	56	429
Central government revenue in eastern Germany	–33	–37	–39	–43	–45	–47	–47	–48	339
Net support, total	106	114	128	126	140	140	136	141	1 031
memo item:									
Treuhandanstalt deficit	9	14	24	24	–	–	–	–	–

1 Estimates on the basis of planning figures. — 2 Unemployment insurance and pension insurance funds.
Source: Bundesbank.

expand output, and a declining number continued to cut output. In addition, the figures also reflect the demand and output effects of the pump-priming finance provided in the form of massive transfers from the West. The low and declining rates in subsequent years, on the other hand, are not so easily explained. To some extent they reflect a normalisation of construction activity. Partly, though, they are evidence that the internal dynamic of the east German economy is still inadequate.

The core problem of the region's economy is its inadequate output-generating capacity: GDP per inhabitant is only around half that of the west German economy. Indeed, since the mid-1990s the region has scarcely been able to close the gap, and last year it even fell back slightly.

In marked contrast to the level of output are the comparatively high absorption figures. According to the last figures made available by the Federal Statistical Office, by 1994 the final domestic consumption of goods (per capita) had reached almost 90% of the level in west Germany. The gap between output and absorption had opened up as early as the second half of 1990, when expenditure on private consumption, public consumption and investment expanded strongly, whereas GDP contracted not less strongly. Between 1991 and 1994, on average less than two-thirds of absorption was met by domestic output; the remaining third – as it were, the negative net exports of the new *Länder* – were financed by transfers and capital imports.

It seems that this gap has not been significantly closed in recent years.[2] Although estimates by the Institutes suggest that private consumption has expanded only slightly, and investment has actually declined, the growth of output, too, has remained modest. Hence the regional economy remains dependent on a substantial inflow of resources; on balance they probably amounted to the order of DM 200 billion in 1998. Of this around three quarters consists of public transfers.

The continued need to transfer financial resources to the new *Länder* has two very different causes. It must

2 Official data on the expenditure side of GDP are not available for the years since 1994; the only figures published relate to construction investment.

Table 3
Sectoral Structure of Fixed Capital (1991 and 1995) and of Fixed Capital Formation (1995 - 1998) in East and West Germany
in %

	E = east W = west	Gross fixed capital		Gross fixed capital formation			
		1991	1995	1995	1996	1997	1998
Agriculture, forstry and fisheries	E	5.2	4.0	0.6	0.6	0.6	0.7
	W	3.0	2.6	2.0	2.0	1.9	...
Electricity, gas and water supply and mining	E	11.7	9.6	8.3	7.4	7.5	7.9
	W	4.9	4.2	3.4	3.9	4.1	...
Manufacturing industry	E	14.9	13.4	12.7	12.6	12.5	12.6
	W	12.1	11.0	15.3	15.9	16.4	...
Construction	E	1.4	1.7	1.5	1.2	1.0	1.0
	W	0.8	0.7	1.9	1.5	1.2	...
Trade, transport and telecommunication	E	9.7	12.3	15.7	15.7	16.3	16.2
	W	9.5	9.1	11.7	11.7	...	...
Services (excl. housing rental)	E	4.7	7.9	17.9	17.5	16.3	16.4
	W	10.6	12.2	23.5	23.6	...	...
Housing rental	E	34.0	32.2	27.6	29.5	30.5	29.4
	W	39.4	41.0	30.9	30.7	30.0	...
State, private organisations	E	18.4	18.9	15.7	15.5	15.2	15.9
	W	19.6	19.1	11.3	10.6	9.8	...
memo item:							
Enterprises (excl. housing rental)	E	47.7	48.9	56.7	55.0	54.3	54.7
	W	41.0	39.8	57.8	58.7	60.2	...

1 At replacement prices, beginning of the year. — 2 New plant at current prices.
Sources: Federal Statistical Office; ifo; IfW calculations.

therefore be considered in a differentiated way, just as with a country's current account deficit.

- In part – the larger part – it results from the rapid equalisation of incomes. East German incomes now represent around 75% of the level in western Germany. This, in turn, reflects the strong wage growth in the years immediately following unification, which has also served to drag up income from social transfers. Consumer spending differentials have narrowed correspondingly. The consumptive components of the current account deficit must be financed from income transfers from western Germany. Thus it is difficult to argue that they make a contribution to establishing a self-sustaining economic base in the new *Länder*.
- To a lesser extent it reflects the strong investment activity. For some years now per capita investment has been significantly higher in eastern than in western Germany. A current account deficit that is due to imports of capital goods is normally financed by the market in the form of capital imports. Resources to finance investment are, however, also provided by the public sector. This can be justified with reference to the substantial locational disadvantages of producing in eastern Germany, which reduce the propensity to invest. However, the argument that support must be provided to offset disadvantages is losing its credibility. This increases the danger that incentives will be given for uneconomic investment.

To the extent that a decline in the growth dynamic is due to a stagnation of transfer-financed private consumption or a decline in wrongly subsidised investment, it is not a cause for concern. What is important is that – profitable – investment continues is maintained. For in the longer run it is such investment alone that determines the trajectory along which output can grow.

The east German economy has made considerable progress in developing a modern, high-performance capital stock. Between 1991 and 1998 around DM 1.3 trillion was invested in new plant, according to estimates by the ifo Institute. By virtue of such investment, the stock of gross fixed assets, decimated by the removal from production of plant and buildings that were no longer viable, has grown strongly once more; rough estimates suggest at an annual rate of around 7%, more than twice as fast as in the west German economy (2½%). The average age of the plant in use in eastern Germany has been reduced to a correspondingly substantial degree: according to the last calculations made by the Federal Statistical Office, which relate to 1994, the average age was 25.3

Table 4

Capital Endowment per Worker[1] in the East German Business Sector, 1991 to 1997

	1991	1994	1997[2]
Total			
absolute (DM 1000)	103	155	197
as a % of west Germany	46	62	73
Equipment			
absolute (DM 1 000)	29	47	.
as a % of west Germany	29	14	.
Buildings			
absolute (DM 1 000)	74	101	.
as a % of west Germany	60	73	.

1 Gross fixed assets at 1991 prices per person in employment. — 2 Estimated.
Sources: Federal Statistical Office; IfW calculations.

years, compared with 32.6 years in 1991. The comparable figure for west Germany in 1994 was 21.3 years. By now the gap can be expected to have narrowed to virtually zero. Indeed, the 'degree of modernity' of the capital stock, a variable calculated by dividing the capital stock that has not yet been fully depreciated by the total stock, is almost certainly significantly higher in eastern than in western Germany. The rejuvenation applies above all else to the stock of machinery and equipment, which has by now been almost entirely replaced.

The capital stock in the GDR was not only technically obsolete, it also exhibited a different structure than that in the Federal Republic. The goods-producing sector was of far greater relative importance. In this respect, too, there have since been major changes. First, it was particularly in the goods-producing sector that the transition to the market economy rendered large parts of the capital stock obsolete. Second, investment activity has focused on those areas that had previously been neglected. Around three-fifths of total investment in the business sector (excluding housing rental) occurred in trade, transport and the service sector.

In spite of the strength of investment activity, the volume of real capital per employee is still far below that in the west of the country: in the business sector (excluding housing rental) the average capital intensity in 1997 – based on an extrapolation of the calculations by the Federal Statistical Office, which are available for the period up to the start of 1995 – was still more than one-quarter below the west German figure. Moreover, there is much to support the view that even this figure is exaggerated. This implies that investment must be maintained at a high level in order to raise the capital intensity of production in the region to an appropriate level.

Although average capital intensity is markedly lower in eastern than in western germany, this fact offers only a partial explanation for the major difference in labour productivity. Experts point to a whole range of additional factors, such as deficiencies in technology management, inadequate plan organisation, difficulties in gaining market access and integrating into supply networks, and the mistakes made in specialisation. All these factors mean that in many cases the existing plant is not being fully utilised. This indicates the need for measures that ensure higher capacity utilisation levels. These include, in particular, sharpening the profile of the product range, optimising production processes and plant-level organisation, and intensifying marketing activities.

The transition to the market economy also mapped out the course for the structural renewal of the east German economy. For unlike in a socialist centrally planned economy, in which production targets and production conditions are set by the state authorities, business activities had to be geared to prices on goods and factor markets that are largely dictated by market forces. Although socialist economic calculations were also based on prices, which served as a guideline for state-owned enterprises, the price structure in a centrally planned economy was very different from that in a market economy. Hence, the transition from one economic system to the other was sometimes interpreted in terms of a price shock.

It came as no surprise that, in the wake of transition, it was primarily the producers of industrial goods that

Table 5

Structure of Gross Value Added[1] by Economic Sector in the GDR/New *Länder*

in %

	1990		1991	1997	memo item: western Germany
	1st half[2]	2nd half			1997
Agriculture, forestry and fisheries	7.1	3.3	1.7	.	.
Goods-producing sector	53.1	41.6	34.1	35.7	34.0
of which: Manufacturing industry	.	.	17.7	16.4	26.8
Construction	.	.	12.5	15.0	4.6
Trade and transport	13.3	18.0	16.7	13.2	15.5
Service companies	8.5	16.9	23.8	32.3	39.9
Government, private households, private non-profit organisations	18.0	20.2	23.7	20.5	13.9
All sectors	100.0	100.0	100.0	100.0	100.0

1 At current prices. – 2 In GDR Marks.
Source: Federal Statistical Office.

came under severe adjustment pressure, particularly where the nature of the goods was such that they were easily tradable on supra-regional markets, or could be easily substituted by other goods. Producers of services, on the other hand, faced more favourable initial conditions, for a number of reasons:

– they were able to enter the gaps left open by the centrally planned economy; the supply of services to the population was in many respects inadequate.
– they did not immediately have to face competitive pressure from western firms, as it took some time for them to set up their own branches and subsidiaries. Even in the trade sector, where western companies quickly occupied the field, enough niche markets initially remained.
– They were able to benefit from the rapid rise in incomes, which created the scope for strong growth of demand for services. In this way they were able to push through the price adjustments necessitated by the transition to the market economy.

In the intervening years the economic structure of the region has changed markedly. The goods-producing sector has declined significantly in relative importance, with a corresponding increase in the weight of the service industries, considered in abroad sense. Within these two major areas of the economy, however, there is in each case an important difference compared with the structure of the west German economy. In east Germany manufacturing industry is of relatively minor importance, whereas the weight of the construction industry is correspondingly large. This reflects, on the one hand, the enormous adjustment pressure encumbering the industrial sector and, on the other, the high level of construction activity, from which the local construction industry has profited. Yet it appears that these structural distortions are in the process of being reversed. Industry is now growing strongly, whereas the construction industry is contracting. Structural patterns in services, too, differ from those in the west of the country: consumer services are relatively more important, producer services less so than in west Germany. Last but not least, the public sector also remains relatively large. East German state and local governments have so far failed to delegate tasks to private service-providers to a sufficient degree.

In the longer run the economic structure in eastern Germany will come to broadly resemble that in the West. Given identical production conditions, the division of labour between the two regions can realistically only be substitutive, as opposed to complementary.

The fundamental restructuring and modernisation process was not possible without swingeing job losses; by western standards enterprises and the public authorities were seriously overmanned. Since the start of transition around two-fifths of all jobs in eastern Germany have been shed. It was therefore necessary to cushion the effects. The main burden in this respect was borne by labour market policy and by social policy. Initially,

Table 6
Development of the East German Labour Market
in 1 000 persons

	1989	1990	1991	1994	1998
Domestic economically active population	9 858	9 164	8 503	7 798	7 757
Registered unemployment	0	241	913	1 142	1 375
Employment (residents)	9 858	8 923	7 590	6 659	6 382
Self-employed and family workers	187	252	371	501	545
Wage and salary earners	9 671	8 671	7 219	6 155	5 837
Net cross-border commuters	2	-68	-269	-326	-327
Employment (domestic concept)	9 860	8 855	7 321	6 330	6 055
memo item:					
Impact of labour market and social policy measures	0	543	1 881	1 873	982

1 Full-time equivalents.
Sources: Federal Statistical Office; Federal Labour Office.

labour market policy makers attempted to spread job losses over an extended period, in the hope that recovery would soon commence in other areas. Labour market policy measures thus initially functioned as a 'waiting-room' for many of the unemployed. Amongst other things, a number of enterprises set up so-called 'employment companies' (*Beschäftigungsgesellschaften*), financed by the public employment service (Federal Labour Office). In addition, in most cases the Treuhandanstalt, the state privatisation agency, negotiated employment commitments with new investors, in return for compensation in the form of reductions in the sale price of companies. This helped to save jobs, albeit usually only for a limited period. Finally, a large number of people participated in training courses, while elderly workers were sent into early retirement. By these means up to two million people were removed from the labour market in the early years. At the height of the employment crisis, at the end of 1992/start of 1993, almost 900 000 people were drawing state early retirement allowances (*Vorruhestandsgeld* or *Altersübergangsgeld*). According to the results of the Federal Labour Office's Labour Market Monitor, the vast majority of those aged between 55 and 65 who lost their job did not return to working life, but subsequently entered normal retirement.

Even now, labour market policy measures continue to play an important role in easing the pressure on the labour market. Last year almost one million people were involved in various measures who would otherwise have swelled the ranks of the registered unemployed. This must not be allowed to conceal the fact that almost 2½ million jobs are still lacking on the primary labour market.

The persistently high level of unemployment in eastern Germany results not so much from an inadequate demand for labour as from the fact that labour supply is at a high level; this reflects not least the far higher participation rates of married women than in western Germany. It will prove difficult to absorb this potential labour supply on the market. This would require greater wage differentiation and the removal of the regulatory mechanisms that are hampering employment. In this respect eastern Germany is, it is true, a few steps ahead of western Germany, but it will take a considerable time for this to be reflected in an adequate number of jobs.

Economic policy considerations: strengthening regional development potential

The picture of the economic situation in the new German *Länder* painted by this report is a mixture of darkness and light:

- What is immediately striking is the substantial progress that has been made in economic reconstruction. There are a substantial number of firms that are now standing on their own feet and are holding their own in a competitive environment. Communications links are now state of the art. Considerable progress has also been made in modernising the transport infrastructure, repairing and modernising the housing stock, and dealing with environmental damage.
- Yet what must not be overlooked is that a large number of companies are still anything but safe in

the saddle and are still in danger of being driven out of the market. Moreover, the very high level of underemployment is becoming increasingly entrenched, as no additional jobs are being created on the primary labour market.

Hence, one must not allow oneself to be guided by illusions. The road along which the east German economy still has to travel is long.

From the very outset, the three Institutes voiced their opposition to the view that the huge gap between the two regions could be closed in just a few years and with the help of substantial transfers. Accordingly, they recommended that economic policy adopt a longer-term perspective. The aim should be to establish favourable conditions for entrepreneurial activities, by supporting investment and business start-ups, and by improving the infrastructural endowment. The rationale behind this strategy was to help the new *Länder* to develop an independent, competitive economic base. Today, it must be admitted that this aim has so far been only partially realised.

Developments to date have repeatedly been taken as grounds for placing a question-mark over the effectiveness of the policies adopted. Such criticism has focused on the special economic assistance provided to the new *Länder* and the funds made available to state governments to compensate them for the lack of tax revenue. The motives behind such criticism vary, as do the proposals that have been made. Some observers want to increase the level of support, and supplement it with new instruments geared towards the specific problems of companies that are 'in difficulty although their prospects are good'. On this view, support should focus primarily on overcoming supposed 'weaknesses'. Others, by contrast, want to cut back support as quickly as possible, or even terminate it altogether. The Institutes take the view, however, that neither of these positions can be convincingly justified. They recommend maintaining economic support, as planned, in its current form until the end of 2004.

At the same time, it is important to recollect that the special support offered to eastern Germany is supposed primarily to offset locational disadvantages. In addition, it is to cushion the greater susceptibility to risk of companies in the region, to the extent that they have not yet established a firm position on the market. In this respect there is no disagreement between academic economists and policy makers. Both emphasise the need for substantial 'start-up financing'.

It is in the logic of this concept, though, that the support provided is seen as 'help towards self-help'. Accordingly, it should be subject to a time limit and should be degressive in nature. On this there is some disagreement between academe and politics. The Institutes draw attention to the fact that sooner or later the support system for the entire region will have to be converted into a more selective regional support policy, because not all regions in the east of the country are developing equally. Moreover, economic support becomes, in the longer run, less and less effective in terms of strengthening firms' competitiveness; indeed, actors may grow accustomed to the provision of support. With this is mind, it must be asked how long the present concept should be retained, and in what ways should it be adapted to the changing circumstances. An answer to this question must be found in the near future. In the following the Institutes provide some assistance in weighing up this matter.

Attention should focus on two facts. First, although eastern Germany as a whole continues to suffer from locational disadvantages and a dearth of well-established companies, these disadvantages are increasingly receding into the background. Second, it is becoming increasingly inappropriate to view eastern Germany as a uniform economic area. Economic developments are highly differentiated, with the result that some regions in eastern Germany are better off than some in western Germany. In the light of these facts, the following approach should be adopted with regard to the special support provided for eastern Germany (the *Sonderförderung-Ost*, which includes, alongside support for investment and other forms of equity and external capital support, part of the supplementary central government grants):

– No changes should be made in the special support for the entire region for the formation of productive capital in the form of the 'investment supplement' (*Investitionszulage*) until the current regulations expire at the end of 2004. This is required not least by considerations of maintaining trust in announced government policies. It should then be wound up – and a credible announcement to this effect should soon be made. The justification for allowing the special support to expire is that the marginal returns to the support measures are evidently declining. Moreover, there is a growing danger of a 'subsidy mentality' gaining hold and that inappropriate investment projects will be induced; the effects of a measure that is introduced provisionally may change if the measure is perceived as permanent. It should be replaced by a regional support policy applying to Germany as a whole, based primarily on the joint central-state government task (*Gemeinschaftsaufgabe*) 'Improving regional economic structures', and EU structural policies, especially in the context of the structural funds and the Community Initiatives. Moreover, steps should finally be taken to improve coordination between the various support measures; little has been done in this respect, in spite of repeated expert recommendations. For instance, broad-based support for small and medium-sized enterprises and support for business start-ups should be brought together in a single programme.

- State aid for companies encountering difficulties should, wherever possible, no longer be provided. Restructuring such companies is the responsibility of the banks, not of the successor to the *Treuhandanstalt* (the BvS) or individual state governments. There is little to support the view that companies that have not been successfully refloated after – in the extreme case – ten years of permanent subsidisation will ever become viable. Sooner or later they will become an unbearable burden on taxpayers. The funds devoted to this purpose could be deployed elsewhere to greater effect, not least in terms of jobs.
- Modernisation of the transport infrastructure, on the other hand, should continue to receive high priority. Considerable deficiencies remain in this area, particularly at regional and local level. To a greater extent than has been the case so far, the distribution of such funding should be geared to regional development potential: for the time being the Institutes consider it better to focus funding on so-called growth nodes than on rural areas. The resources required should be provided jointly by central and state government within the framework of the supplementary central government grants, fiscal compensation between state governments and the 'joint task' (*Gemeinschaftsaufgabe*) set out in Article 104 of the German Constitution. The precise procedures for providing such support should be clarified as soon as possible, in order to given local and regional authorities a reliable basis for their planning. In this area the planning horizon should extend beyond 2004.

To the extent that the disadvantages in terms of 'hard' competitive factors decline in importance, resources should be redeployed to overcome deficiencies in 'soft' locational factors. These include, above all, the quality of the living environment, leisure opportunities and environmental conditions. Such 'soft' factors constitute an important component of the development potential of a region. Indeed, in terms of attracting new companies they can be of decisive importance, for example if skilled workers are needed who must, along with their families, be attracted from elsewhere. 'Soft' factors of this type can best be influenced at a decentralised level. This is conditional on the regional and local public authorities having the corresponding financial resources at their disposal, and their deploying them to improve the conditions for production in the locality.

The debate on the special support for eastern Germany cannot be held in isolation from another crucial topic, that of the future of Germany's intra-governmental fiscal redistribution systems, particularly the system for redistributing tax revenue between state governments (*Länderfinanzausgleich*). Some of the provisions currently in force expired at the end of 1994. The current antagonisms between central and state government, between west and east German state government, and between the net contributors and net recipients among west German state governments indicate that the lines of conflict in this matter are highly complex.

The aim of the overall fiscal compensation system is to ensure that each federal state, proportional to its population, enjoys a broadly equal financial endowment. This is currently ensured by means of a complicated, four-stage, vertical redistribution procedure. The new *Länder* benefit not only from fiscal compensation between the states, but also from supplementary central government grants (under Article 107 (2), iii) of the constitution. They will receive DM 14 billion p.a. of such grants until the end of 2004 for the removal of 'special burdens' emanating from the division of the country and to offset their weak tax-raising potential. For this reason the east German *Länder* are actually better off than their west German counterparts.

The contributor-states complain that their incentives to improve their own economic situation are weakened, because the benefits are largely externalised. The recipient-states, on the other hand, argue that they would lag behind even further if the financial support were reduced. Their position is that they must first be put in a position to take effective initiatives of their own.

The Institutes cannot make recommendations in the context of this report as to how best to sever this Gordian Knot. There is no lack of models for reform, the advantages and disadvantages of which have been discussed in detail in the scientific literature. One remark should be made, however: the Institutes consider it vital that the east German states benefit from financial solidarity beyond the year 2004. Whatever the conflicts of interest, that should not be a matter of dispute, and indeed this does not appear to be the case. Of course, east German authorities can only expect solidarity provided they deploy the resources channelled towards them to improve their economic potential in a sustained fashion. This is not always the case.

The prime task of economic policy is to bolster the forces for economic growth. Among other things, this involves removing barriers to growth in the form of superfluous regulations. The east German states could assume a pioneering role in this respect, for instance in liberalising shop opening hours. By contrast, it would be counter-productive to exempt eastern Germany from the liberalisation of the electricity market.

Last but not least, the parties to collective wage bargaining need to be reminded of their responsibility.

They must take steps to ease the cost burden on east German firms. Given that there is little realistic prospect of cutting collectively agreed wage rates, attention should focus on measures to render working hours more flexible, in order to increase the efficiency of labour deployment. The scope for limiting cash pay increases by increasing the use of share options as part of remuneration packages should be considered. This would enable firms to acquire long-term means of finance that they often find difficult to obtain on the capital market.

If such measures enabled labour costs to be reduced, more jobs would be created. Recruitment would be increased, and that would in turn ease the burden on labour market policy. In any case, labour market policy in its present form must be reconsidered, in view of its limited effectiveness. Job-creation measures, in particular, often merely provide a pathway to (early) retirement. This is a classical form of social policy, and this fact should be visible in terms of the division of institutional responsibility: such measures should in no way form part of the spectrum of instruments deployed by the Federal Labour Office, and should be financed out of general tax revenue. As far as labour promotion measures are concerned, 'special support for eastern Germany' should be terminated at once: there is no reason why the new *Länder* should be placed at an advantage compared with structurally weak regions in western Germany.

Summarising all that has been said, in the longer run a change of strategy is required. Gradually, responsibility for the reconstruction process in eastern Germany should be transferred from central government to the east German state and local authorities, who would then have to define their priority tasks and develop the appropriate solutions themselves. Central government influence would then largely be restricted to implementing supra-regional infrastructure projects. It would, however, retain an important responsibility, along with west German states, for bolstering the fiscal base of state and local authorities in the East, so that they can perform their tasks. How this is to be brought about in detail must be determined politically, that is by negotiation. What is important, though, is that the east German *Länder* perceive such a change of strategy as a great opportunity for themselves, and that they do not waste it by making inappropriate demands on central and west German government.