Mikhail Gorbachev had set in motion a process of reform that affected the Soviet Union and the rest of Eastern Europe. However, in the former GDR (German Democratic Republic), the Socialist Unity Party of Germany (SED) resisted all attempts at change. This had its own impact on its citizens. Meanwhile, events in Eastern Europe began to gather momentum. In September 1989, Hungary opened its borders to Austria. This led to an exodus of citizens from GDR via Austria into the FRG. After this, there was no looking back. The Berlin wall fell in 1989 leading to several questions regarding the future of Germany. Interestingly, German unification was never immediately on the agenda as several sources revealed. Helmut Kohl (the then Chancellor of the former FRG) put forth his *Ten Point Programme* on November 28, 1989. It envisaged a path to a confederal, unified Germany through several stages. This included economic aid to the GDR on condition that there would be a fundamental change in the political and economic system of the GDR, a contractual community and confederal structures. Hans Modrow (head of state of the GDR) also advocated a *contractual relationship* and close cooperation between the two German states.

Public enthusiasm overrode all skepticism and soon the thought of German unity began to take shape. The changing international environment also helped in developing the idea of a unified Germany. The Four Powers (the USA, the USSR, France and Britain) were clearly divided over this issue. While the USA was overwhelmingly supportive, France was ambivalent; USSR and Britain vehemently opposed German unification. USA succeeded in convincing Britain and France.

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75 See Appendix II for details of Ten Point Programme.
The July 1990 Zheleznovodsk agreement between Kohl and Gorbachev overrode the latter’s objections.\textsuperscript{77} Then followed a series of treaties – the Two plus Four Treaty (between the two Germanies and the Four Allies), which defined the borders of Germany, a treaty with Poland (November 1990) and the Treaty on the Establishment of German Unity (August 1990). Earlier, the two German states had formed an economic, monetary and social union (July 1990).\textsuperscript{78} This abolished the East German Mark and the Deutsch Mark of the Federal Republic was introduced in the East. The savings of East German citizens were exchanged at the rate of 1:1; larger amounts were exchanged at 1:2.\textsuperscript{79} (The rate would be 1:1 for wages and savings up to 5000 Marks; thereafter, the exchange rate would be 1 Deutsch Mark for 2 East Marks).

Unification (October 3, 1990) took place at two levels: political and economic. Politically, the GDR states (see Map 4) of Brandenburg, Mecklenburg, Western Pomerania, Saxony, Saxony-Anhalt and Thuringia became states of the Federal Republic of Germany (FRG). Berlin was made the capital in 1999. The Basic Law, after suitable amendments, was introduced in the territory of the former GDR as well. While political unification took place smoothly, economic and social integration proved to be a daunting task. The obvious problem was the integration of a centrally planned economy into a social market economy. Since World War II, Germany had rejected both the \textit{laissez-faire} doctrine as well as government intervention in business and investment decisions. Instead, the state plays a regulatory role and creates the general conditions for market processes. It must be noted that this task of integration is a unique one without any historical precedent. The states of the former USSR are still in the process of \textit{converting} into a market economy. In the case

\textsuperscript{78} See Appendix I for chronology of events.
\textsuperscript{79} Joachim Nawrocki, \textit{Op.Cit.}.
of The People’s Republic of China, it is a single integrated economy that has undergone changes (after 1980). For Germany, it is a process of integrating two different and opposing systems.

The restructuring of a highly unprofitable economy into one with competitive operational structures required immense efforts on the part of all involved – the business community, the government and especially the people of the former GDR. After the initial euphoria over unification ended, it became clear that the economic situation in the East was critical. Unlike widely publicized notions, it was found that the ex-GDR was not one of the ten major industrialized states. Its firms were uncompetitive and their methods of calculating production were all wrong. It was new for the ex-GDR people to adopt modern methods of marketing and public relations. Small and medium sized businesses (Mittelstand), formerly the driving force of the economy, had been almost totally eliminated. Creativity and initiative had to a great extent been paralyzed. A large proportion of the goods produced there were not competitive in the global market. Production had been tailored to the needs of the states of the former Communist bloc. Compared with the Western levels, productivity was extremely low (about 30% of the levels in West Germany) while wage levels in the former GDR were 70-80% of the FRG. Therefore, a policy had to be formulated which would enable the people in the new Federal States to enjoy moderate progress during the period of restructuring. Hence the aim was to bring about certain long-term changes (integration) as well as a few short-term developments.

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80 Thomas Zielke, Ministry of Economics, Division for Cooperation with the New Federal States, Bonn/Berlin, personal notes of Prof. Dr. J. Banerjee, Official German Government invitee, 24/06/1996.
81 Ibid.
This Chapter will first examine some of the programmes and steps initiated by the Federal Government towards developing the new states. Secondly, a brief analysis of their impact will follow. Thirdly, certain tentative conclusions will be drawn.

**Programmes introduced to revive the East German Länder:**

*Upswing East (1990 and early 1991)*: Its key aim was to create the preconditions for self-sustaining, steady and dynamic economic development.\(^{82}\)

The basic elements of this strategy include:

- Promotion of both private investments and the establishment of new private businesses – this was to be done through extensive investment assistance
- Elimination of obstacles to investment
- Construction and expansion of the infrastructure
- Improvement of marketing conditions for East German firms
- Privatisation, reprivatisation and reorganization of firms by the *Treuhandanstalt* (Trust Agency-established in 1990) and its successor organizations
- Utilization of labour market policy instruments to cushion the social repercussions of unavoidable, radical, structural change and to complement regional policies during the adjustments process.\(^{83}\)

*Treuhandanstalt (Trust Agency, set up in 1990)*: The first version of the Treuhand was created in June 1990, by the only democratically elected *Volkskammer*. The law was based on the premise that the command economic model had to be abandoned and created an agency that would regroup all

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\(^{83}\) *Ibid.*
of the GDR’s industrial and other holdings and then attempt to sell them off to private investors.\textsuperscript{84} After unification, the control of the Treuhand was vested in the Federal Government, which meant that West Germans were put in all the Treuhand’s important positions. It was a public privatization agency. Its task was to privatize, reorganize and, if necessary, wind up industries of the former GDR by the end of 1994. Besides, it had to make companies competitive and make land available for industrial and commercial purposes. It was replaced, as planned, by the Federal Agency for Special Tasks Arising from Unification (1994). It had the following companies under it:

- Treuhand Real Estate Company (dealt with privatization of properties)
- Participation Management Company (further development and privatization of remaining companies)
- Soil utilization and Administration Company (took care of farming and forest area of the former GDR)
- DV Information Systems, Organization and Service Limited (services in the electronic processing section)\textsuperscript{85}

All these worked under the purview of the Federal Ministry of Finance.

\textit{German Unity Fund (1990)}: Germany has a Federal system. Here, tax revenues which are mostly raises by the Federal Government are shared by the center and the state governments. Both derive the majority of their funds from this shared taxes, income and corporate taxes and VAT (value added tax). Since some governments are richer and so derive more from local taxes, the Equalization Law (\textit{Länderfinanzausgleich}) lays down redistribution between them so as to ensure


\textsuperscript{85} Zewdzky Karl, \textit{From a Planned to a Market Economy}, Inter Nationes, Bonn, 1995, pp.8, 10.
that no Land ends up with more than five percent above or below the Federal average. In 1990, equalization was suspended as it applies to the Eastern Länder as, given the economic situation of the new states, it would have put too much of a burden on the Western Länder. Instead a German Unity Fund was set up. It was a joint effort between the Federal Government and the States. Up to 1995, it was fed with 115 billion DM to finance the process of unification. Of this, the Federal Government paid 20 billion DM into it from savings gained from unification. The balance of 95 billion DM was borrowed. 86

**Solidarity Pact I (1993):** It is an agreement between the Federal Government and East German states and is included in the Federal States equalization scheme. Federal States and the Federal Government support the reduction of special burdens of East German states as a result of unification. Solidarity Pact I replaced the German Unity Fund.

**Alliance For Jobs, Training and Competitiveness (1998):** It is a partnership based on understanding and cooperation aimed at providing additional support for investment, innovation and research. 87

**Future of the East 2000 (1999):** The basic tenets include:

- Stabilizing the labour market policy at the then existing level and creating additional training places
- Increasing public assistance under the Medium Term Assistance Strategy (1997). This was to continue until 2004. The focus was on expanding the equity capital base of the

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Mittelstand and encouraging ecological innovation to boost the sale of products from Germany.

- Strengthening the industrial base by promoting the transition to service-oriented, knowledge-based, information society
- Proceeding with the German unity transport projects. This is an infrastructure project for improving long distance transport links and modernizing municipal infrastructure. The latter included the construction of bypasses to relieve traffic congestion in cities and towns.\(^{88}\)

*The Inno Reggio Project (1999)*: It aimed to create 25 model regions in Germany. Half a million dollars were provided for this purpose. It included projects that outlined a regional development perspective and aimed to create networks that bring together public authorities, private companies and institutions of higher education and research establishments. They are spread throughout Germany and cover diverse industries ranging from conventional to ecology and tourism. New technology and businesses were encouraged. These included biotechnology, information technology, microelectronics etc. The Project also focused on developing the research landscape of Germany by linking up academic training and entrepreneurship.\(^{89}\) A total of DM 500 million was allocated for this till 2005.\(^{90}\)

*German Equalization Bank’s Programs*: It included the Business Start-up Program and EXIST Program for university graduates. The university graduates were to be provided assistance on

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\(^{89}\) *The Reform Package*, Deutschland, Societäts Verlag, in cooperation with the Press and Information Office, Frankfurt/main, 4/2000, pp.16.17.

\(^{90}\) *Annual Report 1999 On The Status of German Unity*, www.bundesregierung.de accessed on 12/12/00 at 2100 hrs (henceforth, bundesre.de) (every year the federal Government presents an annual report on German unification. It contains assessments of the economy as well as future plans to revive the economy among other things.)
starting their own businesses as well as developing the *Mittelstand* in the new Länder. It also included the Pro Net Program, which tried to link up industry and research. The bank was to be expanded into the Federal Government’s Bank for start-ups and small businesses.\(^91\)

*EU Reconstruction Aid*: The European Union (EU) has made substantial contribution towards rebuilding the new states. Agenda 2000 (adopted in the European Council in March 1999) established important pre-requisites for deepening and enlarging the EU integration process. It increased payments from its Structural Fund to the new states (20 billion DM additionally) and the latter continued to be its Objective I area.\(^92\) This would continue till 2006.\(^93\)

*Aufbau Ost (Reconstruction East 1999)*: Its objective was to rebuild the economy of the Eastern states to such an extent as to bring living standards there in line with those of the Western states.

*Tax Reforms (2001)*: It included reforming corporation taxation, which was to be reduced by 25% from 2001. The maximum tax burden on corporations including trade tax will be 38%. Investing in Germany will be made attractive through the half income method than by taxing dividends. Income tax was reduced at the top level from 51% to 42% and at the lower level from 22.9% to 15% by the year 2005.

\(^{91}\) *Ibid.*


The tax-free basic allowance was raised from DM 13,499 to DM 15,011. This, in turn, has reduced the tax burden by DM 90 billion.\textsuperscript{94} Income tax rates have been reduced again as of January 1, 2005 resulting in a further € 6.8 billion in tax relief for individuals and businesses. Priority importance will be attached to investments that are aimed at bringing about innovation. The Federal government will use money currently being paid out in the form of home ownership subsidies to help increase spending on research and education. This will amount to around € 3 billion by 2008. After the summer break, the cabinet presented a bill in parliament aimed at eliminating home ownership subsidies. The money freed up by this means will be used in the framework of the government’s innovation initiative to fund university and research activities as well as to increase the number of all day schools. The innovation initiative is an example of efforts being undertaken.

\textit{Agenda 2010 (March 2003):}\textsuperscript{95} It constitutes a series of reforms planned and executed by the Government to modernize the German social system and the labour market. The declared aim is to improve economic growth and reduce unemployment. Three main areas were targeted – economy, social security and Germany’s position in the world market. Steps included tax cuts targeted against the well to do as well as big cuts in the cost absorption for medical treatment, cuts in unemployment benefits as well as cuts in pension benefits etc. This was in response to the Lisbon Strategy 2010.\textsuperscript{96} Thus, the task of this package was three fold, make labour market more flexible by reducing job protection, lowering social security contribution for certain part time jobs or mini jobs,


\textsuperscript{95} \textit{Chancellor Schröder Sets Out Agenda 2010}, www.german-embassy.org.uk/schroeder calls on Germans tos.html 14/3/03 accessed on 24/5/04 at 13.00 hrs.

reform the Federal Employment Agency (*Bundesagentur für Arbeit* or the *B.A.*), equip it with better tools and to encourage the long term unemployed to look for work by introducing a new flat rate benefit.\(^97\)

**Hartz Concept:** This refers to the recommendations resulting from a commission\(^98\) on reforms relating to the German labour market that was set up in 2002. It went on to become part of the German Government’s Agenda 2010. It has come out with four reform packages – Hartz I, II and III (effective from January 2003-2004) and IV (January 2005).

**Hartz I** called for the establishment of the Personal Services Agencies (PSAs), support for vocational education from the Job Agencies and subsistence payments by Job Agencies. The PSA will employ jobless people who are on the dole for a specified period of time and hire them out to private firms as temporary workers. They will be selected from the Job Agencies. For the first six months, the wages of a PSA temporary will be the same as his unemployment benefit. After that, he would get the going trade union rate for his type of work.\(^99\)

**Hartz II:** The salient features are:-

- It created new types of employment – Mini-jobs and Midi-jobs with lower and gradually increasing taxes and insurance payments.
- Provided a grant for entrepreneurs and set up *Ich AG* (Me Inc or one person businesses).

Through this, *moonlighters* are to be helped to become entrepreneurs and then receive

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\(^97\) *Squaring The circle,* Survey on Germany, The Economist, Feb 11-17, Vol: 378, No 8464, London, pp.9, 10, 11.  
\(^98\) Commission for Modern Services in the Labour Market, chaired by Peter Hartz, personnel director, Volkswagen  
The millions who work illegally are thus to turn over some € 300 billion a year (15% of the GDP). They are to get tax incentives, earn up to € 25,000 a year, be taxed at a nominal rate of 10% a year, and receive unemployment benefit for three years but pay welfare contributions.\textsuperscript{101}

- It increased the number of Job Agencies.

\textit{Hartz III} is aimed at restructuring and reorganizing the Job Agencies. It planned to have more agents to help the unemployed find jobs. The Federal Labour Institute became The Federal Labour Agency.

\textit{Hartz IV} brought together unemployment benefits and social security benefits leaving them both at a lower level than what the claimants received earlier.\textsuperscript{102} Prior to 2005, 12-32 months of full unemployment pay (60-70% of previous net salary based on claimants age and work history) was followed by unemployment benefits (53-57% of net salary). From 2005 onwards, receipt of full Unemployment Pay I (\textit{Arbeitslosengeld I}) is restricted to 12-18 months for those over 55. This is followed by Unemployment Pay II (\textit{Arbeitslosengeld II}) if the claimant is eligible. A claimant becomes eligible when his savings, life insurance, income of spouse etc. is fully used up. Such claimants will then receive € 350 as compensation. This, in turn, will reduce the eligibility for benefits by half.\textsuperscript{103}

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\textsuperscript{100} Ibid.p.8.
National Pact for Training Young Skilled Workers (2004): The business community made a binding commitment to create 90,000 new trainee posts and 75,000 qualified to enter in the next three years. Politicians and Companies have undertaken to offer every young person who is able and willing to train, a training place or a suitable qualification course.

Economic Reforms under the Merkel Government: The new government’s economic policy is based on a threefold programme – reorganization/reform, investment and consolidation. The slogan of the Merkel Government reads as Economic rehabilitation, Reform and Investment in March 2006; the government identified eight areas for this. They include:

- Federalism Reform
- Reducing the Bureaucracy
- Research and Innovation
- Energy policy
- Financial policy (including tax reform)
- Family Policy
- Labour market reforms
- Health care reforms

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106 The Second Stage Begins, www.bundesre.de, 30/3/06 accessed same date, at 23.30 hrs.
A diagrammatic representation of the reform policy of the new government is shown.\textsuperscript{107}

![Diagram of the Federal Government's Reform Strategy](source: Federal Ministry of Economics)

**Figure 1: The Federal Government’s Reform Strategy**

The social market economy model will continue to be adhered to. The stress will be on *flexible economic structures and unbureaucratic procedures*.\textsuperscript{108} The new government aims to return the economy to a path of economic growth as it feels that German economy is characterized by weakness in economic growth when compared to other countries.

\textsuperscript{107} www.bmwi.de (Federal Ministry of Economics), accessed on 10/10/07 at 1600hrs  
A new thrust towards growth would overcome the country’s current economic and fiscal problems. To this effect the new government has introduced several schemes.

By 2009, a ‘future fund’ will enable investments in key areas—traffic infrastructure, education, research, technology etc. This will be flanked by a drive to promote SMEs (small and medium sized enterprises) and those setting up businesses particularly cutting edge technologies like nanotechnology and biotechnology. Moderate changes to labour laws, e.g. probationary periods will be extended from six months to twenty four months, in order to make the labour market more flexible.

Source: Federal Ministry of Economics

**Figure 2: A Comparison of Average Annual Real GDP Growth Rates in Selected Countries in percent**

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Labour market and employment: The Federal Government will optimize the Hartz IV process by a more precise definition of the group in need, setting new trends in the free assets allowance to provide for old age and review the handling of common law partnerships.\textsuperscript{109}

In reducing unemployment, the new government has split those unemployed into two broad categories. The first category maybe seen as those under the age of twenty five (or the youth) and the second category includes those between fifty five and sixty four or the older workers. The government has come up with programs accordingly.

Schemes for the Youth:

The aim of reducing youth unemployment further is receiving full attention from the German government. The National Pact for Training is being continued. In order to improve the chances of finding a place for the young unemployed, the Federal Employment Agency (FEA) is systematizing and improving its consultation, orientation and placement work in new \textit{U25} teams set up in employment agencies. A system of basic security for job seekers, which includes, training, a broad spectrum of placement support, auxiliary aids to training, financing vocational training and aid for the handicapped and disadvantaged has been introduced. The system will also focus on activating young people who are employable and need financial assistance. They will be assigned a \textit{personal contact partner} who will be in charge of seventy five such individuals.\textsuperscript{110}

\textsuperscript{109} Ibid, p.47.
\textsuperscript{110} Ibid, pp.47, 48.
The cabinet has approved the extension of a special program intended to provide initial qualifications for young people (EQJ) and is expanding it to finance 40,000 internships. Monitoring studies have shown that 57% of the young people who obtain initial qualifications in the workplace go on to full-fledged career training. The desired entry effect has occurred to a large extent and the program is seen as a major success.\textsuperscript{111} The EQJ program provides access to long-term internships in the workplace. It is an opportunity for young people whose prospects of finding a training job would otherwise be limited. The results have shown that both employers and prospective trainees have responded well to the program.

A total of 17,763 EQJ internships were provided in the first year of the program (2004/2005). 25,000 internships were pledged for 2005/2006 but this number was exceeded, reaching a total of 31,718. For the new training year just starting, the government will provide the funding needed to take care of 40,000 internships.\textsuperscript{112}

The government created the program with partners in industry in the framework of a national training pact in June 2004, in light of the large number of young people who were looking for training jobs but unable to find any. These long-term internships in the workplace are intended to serve interested young people as a point of entry for finding career training opportunities. The program reaches out to young people under the age of twenty five who are looking for a training job and have not yet been placed by September 30, 2006. It also reaches out to young people who are not yet fully prepared for career training. Under the EQJ program employers have an opportunity to get to know the young people placed in their care and can then make better

\textsuperscript{111} From Internship to Training, www.bundesre.de 27/09/06 accessed same date at 11.00 hrs
\textsuperscript{112} Ibid.
judgments with regard to their aptitudes than they would ever have been able to do only on the basis of school certificates. A young person training in the context of an EQJ internship is paid around € 200 a month plus € 100 to cover social security costs. Both items are covered by the program.113

Schemes for the Older Workers:
It is seen that Germany has a relatively low share of fifty five to sixty four year olds in employment by international standards – around 42%. About half of the companies in the country do not have employees above the age of 50. This reveals clearly that this sector remains relatively underutilized. The Federal Government aims to meet the target of the European employment strategy in this area by 2010, i.e. 50%.114

To improve the employment situation for older people, measures will be taken and pursued in three areas of action. They are, stabilizing employment by reducing disincentives, improving integration prospects with active promotion and introducing fundamental change in attitudes. In addition, employment is to be stimulated for and by the private sector, through talks with business associations and the trade unions on employment promotion instruments for older workers. Other measures will bring the regulations on time limits for older workers in line with EU law and make security against insolvency for workers with long time working accounts statutory. In view of the difficult labour market situation, especially for older recipients of benefits who have been out of work for a long time the possibilities for publicly funded employment need to be utilized.115

113 Ibid.
115 Ibid.
Accordingly, on September 13, 2006, the cabinet approved the "50 Plus Initiative”, the core elements of which include a combination wage scheme, integration subsidies, as well as increased funding of supplementary training opportunities. The objective is to increase employment opportunities for older members of the workforce and to improve their employability. It is hoped that this will help older workers keep their jobs longer and give older, unemployed persons a chance to find work again. The government has taken measures aimed at significantly reducing incentives for early retirement. The period of eligibility for unemployment compensation has been shortened and the statutory retirement age has been raised, starting in 2012. The early retirement option currently available to persons 58 and older will end in 2007.\(^\text{116}\)

The "50 Plus Initiative" consists of a combination of government measures as well as an effort to work together with labour and management organizations. It pursues four specific objectives: increasing the employment rate for persons above the age of 50 to 55% by 2010; significantly lowering the rate of early retirement among persons 55 and older; improving the reemployment rate for older unemployed workers by means of a "combination wage" and new "integration subsidies"; significantly increasing enrollment in supplementary training programs to help people develop the skills they need to match rising qualification requirements on the labour market.\(^\text{117}\)

The government is introducing a "combination wage" for older members of the workforce, meaning that a partial compensation will be paid if an unemployed person agrees to take a job that


\(^{117}\) Ibid.
pays less than he or she earned before becoming unemployed. During the first year of reemployment, the government will provide a subsidy making up 50% of the difference between the former net salary and the new net salary. During the second year the subsidy will amount to 30% of the difference.\textsuperscript{118}

Ninety percent of pension contributions will be paid for a period of two years. After a start-up phase, as many as 30,000 older members of the workforce per year are to be assisted under the combination wage program. A further element is wage subsidies for employers who provide jobs to older workers. These so-called "integration subsidies" will be offered for at least one year and cover at least 30% of wage costs. The limits will be a maximum duration of three years and a maximum amount of 50%. The jobs in question must be provided for at least one year. The objective is to provide support for the employment of between 50,000 and 70,000 older workers annually. At the same time, restrictions will be eased on limiting the duration of employment for workers who are 52 or older, thus making it more attractive for companies to hire older workers.\textsuperscript{119}

Existing projects are to be continued. The Federal Government will finance 30,000 jobs for workers 58 and older for a period of three years. In addition, it will support 62 regional projects for the reemployment of workers 50 and older. Measures aimed at promoting supplementary training for older workers are also to be expanded under this initiative. Workers 45 and older at companies with less than 250 employees (previously 50 and older and up to 100 employees) will be eligible for supplementary training assistance in the form of vouchers for certified courses. The government calls upon labour and management to step up their efforts to promote supplementary training for

\textsuperscript{118} \textit{Ibid.}
\textsuperscript{119} \textit{Ibid.}
employees. Achieving these objectives will require a considerable joint effort on the part of
government as well as labour and management organizations.\textsuperscript{120}

In short, the measures to increase the employment of older workers include the following:

- Promoting further training of workers aged over fifty
- Securing remuneration for workers over fifty
- Utilizing the imaginative planning and creativity of the regions by promoting 62 selected
  model projects for the occupational integration of older long-term unemployed workers to a
  volume of around € 250 million in 2006 and 2007
- Joint measures by the Federal Government and the State Governments through promotion
  of initially 30,000 jobs (since July 2005), for three years, with reimbursement of additional
  expenditure by the employer for long term unemployed persons in the last phase of their
  working lives (58 years) who can no longer be integrated in the labour market\textsuperscript{121}

\textit{Schemes for the Low Skilled:}

Nearly two million of the unemployed or 39\% of the unemployed in Germany are low skilled.
Their chances of finding a job at a wage that matches their productivity are limited. To meet this
situation, this group is already receiving assistance through various programmes. These range from
provisions for supplementary child allowances to income supplements. A working group has been
set up to look into this.\textsuperscript{122}

\textsuperscript{120} Ibid.
\textsuperscript{121} Ibid., p.50
\textsuperscript{122} Ibid.
In view of the labour market situation, the number of foreign seasonal workers is to be reduced to create scope for domestic job seekers. At the same time, agricultural workers must be able to meet their need for seasonal workers at harvest time. To meet both the demands, the admission of foreign seasonal workers is to be limited to a maximum of 90% of the approvals given in 2005.\footnote{Ibid.}

\textit{Reconstruction of the East:}

Investment incentive programs are being kept in place, e.g. the extension of the investment subsidy program until the end of 2009.

The EU leaders agreed on a new budget in December 2005, guaranteeing that the new programming period for the European Regional Development Fund will be able to start on schedule.

A total of €13.4 billion in regional development funding will be available to the eastern states, particularly for investment assistance and improvement of infrastructures. Closely associated with this is a continued entitlement to EU regional aid. With this support the German government will be able to continue its numerous programs aimed at promoting the development of eastern Germany and not have to make any cutbacks.

Efforts are being stepped up to attract foreign investors. The Industrial Investment Council, an investor recruitment organization for the eastern states, and Invest in Germany, an organization that carries out the same function for the Federal Government, are to be merged as of January 2007 and their budget is to be expanded considerably.
Work on Berlin-Brandenburg International Airport (BBI) has begun. It is the largest and most ambitious infrastructure project under construction in the Eastern States.

**Targeted strategy**

The Federal government would like to help promote economic growth and employment in the eastern states by revising its funding strategy. There will be a continued need for flexible and wide-ranging financial support. The latter can be provided under the Regional Economic Structure Improvement program as well as a number of programs aimed at promoting innovation and SME development. These and other instruments can be used to help promote emerging strengths and potentials. This could include support for clusters and production chains as well as measures aimed at improving regional growth potentials.

In implementing the labour market reforms, particular attention will be paid to the specific problems of East Germany. The core areas of the Federal Government’s promotional policy in the East include:

- Targeted use of investment and SME promotion in order to broaden the industrial base in the new states and create jobs.
- Even stronger focus on research and innovation, by networking research and industry, and shortening the way from the innovative idea to the marketable product.
- Directing infrastructure promotion to closing gaps in the transport system and making all areas accessible: making the towns and cities more attractive places to live and work in.
• Directing rural development to possibilities for earning and employment outside agriculture with professional regional management; working out integrated development concepts. All these programs are subjected to constant evaluation.124

Apart from these general guidelines, specific policies have also been adopted. These include:
• An over-proportionate share of the scheme to integrate the unemployed into working life will go to the new states.
• The monthly standard benefits paid as Unemployment Benefit II will be increased in East Germany and made uniform on the West German level of € 345. The funds needed would be provided by the Solidarity Pact II.
• These funds are to be used to target specific potentials in eastern Germany to ensure that every Euro provided is put to optimum use. The new states will receive supplementary Federal grants for special needs to a total of € 105 billion between 2005 and 2019 (Basket I Funds).
• The Federal Government has also undertaken to make further over-proportional payments to a target amount of € 51 billion (Basket II Funds), between 2005 and 2019.125

Basket I Funds are to be used mainly to reduce the backlogs in the infrastructure projects arising as a result of the division of Germany. They will augment the funds provided under the Solidarity Pact. The new states present reports annually on the use of the funds provided under Solidarity Pact. The reports from 2002 to 2004 have revealed that the funds are not being used as intended.

125 Ibid. p.63.
Hence, the government has stated that funds from Basket II will be reduced if funds are misused from Basket I.\textsuperscript{126}

\textit{Basket II Funds} can be used for any measure that will promote growth and employment, reduce old debts, and help to compensate structural deficits as a result of division of Germany. The Federal Government will consult the new states before disbursing these funds. However, the new states will have to present a report on the utilization of the same every year (since 2006).\textsuperscript{127}

On the basis of several policies initiated earlier dynamic economic centers have developed in East Germany and these centers are to receive further support under new schemes introduced by this government. Economic clusters\textsuperscript{128} are to be formed on the basis of geographical proximity and these are to network with each other in areas of research, innovations etc. Cooperation between research and business is being actively encouraged. The Federal Government has introduced programmes like \textit{The Enterprise Region} to promote clusters, \textit{NEMO (Network Management East)} to promote network management activities and \textit{The Joint Task for the Improvement of the Regional Economic Structure}, which provides funds for technology centers, new business centers and cooperation between the regional clusters.\textsuperscript{129} The latter also promotes commercial investment to create new jobs and secure existing jobs. Business related infrastructure will be supported to improve location conditions and make Germany more attractive as a business location. Regions will be evaluated and identified according to their potential and aided by the government for the period between 2007

\textsuperscript{126} \textit{Ibid.} p. 64
\textsuperscript{127} \textit{Ibid.}
\textsuperscript{128} A critical mass of companies located in close proximity to one another is referred to as a cluster. It is a network of manufacturers, suppliers, and research institutes created along one and the same value added chain.
\textsuperscript{129} \textit{Annual Report}, 2006, pp. 64, 65.
and 2013. The entire process will be supported by sectoral conferences which will be held in cooperation with the firms in the private sector.\footnote{Ibid.}

\textit{Promotion of Enterprises in East Germany:}

According to the government figures, East German industry has registered a growth rate of 6% since mid 1990. To further stimulate this growth rate, the Federal government has introduced the following programs:

- Investment Grant to be continued beyond 2006.
- Economic development in the structurally weak areas of East Germany will be promoted through \textit{The Joint Task for the Improvement of the Regional Economic Structure}.
- Federal promotion of SMEs and new business ventures will be developed further flexibly in accordance with the needs of firms and changes in the economy; preference will be given to the new states.
- Special emphasis will be laid on attracting investors.
- The load of the bureaucracy will be eased for the SMEs.\footnote{Ibid.}

\textit{EU Structural Policy:}

The EU Structural Fund makes an important contribution to economic development particularly in the areas of investment and infrastructure. Germany has received around € 29 billion from this. The main focus of the EU Structural Policy is East Germany; however West Germany will also be aided to support their regional economic development.\footnote{In the negotiations in the European Council on 15/16 December 2005, 0.37\% of the EU’s gross national income or € 307.6 is to be made available to the EU Structural Fund.} Germany is to receive an additional € 225
million for the new Federal States, and an increase of € 75 million for areas of Bavaria adjoining the Czech Republic. In all, Germany will receive more than € 23 billion in the period 2007-2013. The areas to receive aid from the EU have been designated as Target I areas or the new Federal States, Target II areas or the old Federal States and the Target III areas or areas under the European territorial cooperation arrangements.\textsuperscript{133}

\textit{Public Private Partnerships or PPP:} The scheme has been in operation since the last five years and more than three hundred PPPs have started operations in areas like, construction, transport etc. The total investment amount is more than € 7 billion. The present government is continuing with this as the number of contracts signed between the public and the private concerns has doubled between 2004 and 2005. The aim of this plan is to offer an opportunity to perform public tasks better and in conjunction with companies in the private sector. The PPPs can help to modernize the state and make companies more internationally competitive as they gain experience with projects within Germany. The present government has introduced a new law—\textit{The PPP Acceleration Law} which will play a significant role in reducing obstacles, increasing efficiency and legal facilities for the enterprises. The law clarifies questions relating to the budget, the award of public contracts, taxation and changes thus creating more flexibility and legal certainty for the PPPs.\textsuperscript{134}

To make labour costs cheaper, non-wage costs are to be cut down from 41\% to 40\% and unemployment insurance contribution is to be lowered from 6.5\% to 4.5\%. In July 2006, the Cabinet approved a corporate tax reform. The basic features of this include, replacing the current form of corporate tax by a corresponding local tax on corporate profits, the current trade tax by a

\textsuperscript{133} \textit{Ibid.} p.66.  
\textsuperscript{134} \textit{Ibid.} pp.68,69.
local tax. The revenues from the Federal tax will be divided between the Federal and state
governments and those from local taxes will go to the local governments. Both will have a uniform
basis of assessment. As of January 2008, the tax on corporate profits will drop below 30% (current
level is 38.65%). The Government has proposed two models – tax reliefs for formation of reserves
to be used for investment and general tax break on earnings. In addition, the fixed tax on interest
earnings which would be withheld by banks and paid directly to the tax administrators need not be
listed as savings on tax returns. The government has also announced a tax relief to the next
generation if they kept the business going; this is to avoid the flight of capital.\textsuperscript{135} The aim is to
make Germany more attractive in terms of tax in comparison to other countries and replace current
different taxation levels for partnerships and joint stock corporations with uniform tax laws. There
are also aims to balance the budget by increasing VAT from 16% to 19% by 2007.\textsuperscript{136} The
government also plans to spend some € 25 billion over the next four years on infrastructure and
education.\textsuperscript{137}

In the 2006 budget, as much as € 25 billion was earmarked for investment and employment. The
areas covered include:

\begin{itemize}
  \item Promotion of research and development - € 6 billion.
  \item Economic revitalization and promotion of SMEs - € 9.4 billion.
  \item Improvement of transport and infrastructure - € 4.3 billion.
  \item Promotion of families - € 3 billion.
  \item Employment at home - € 2.5 billion.
\end{itemize}

\textsuperscript{135} Main Points of Tax Reforms Approved, www.bundesre.de 12/7/06. Accessed on 23/7/06 at 18.50hrs
\textsuperscript{136} Facts About Germany, www.taatsachen-ueber-deutschland.de/en/economy.html accessed on 23/7/06 at 14.00hrs
By 2009, allowances and special deductions worth €19 billion are to be eliminated. This in turn will reduce the cost to public budget by €117 billion by 2009. Also, traditional Christmas bonuses will be halved for Federal officials, which will result in savings worth €1 billion. Social insurance exemption on wages paid for work carried out on Sundays and holidays has been limited to €25/hour.\(^{138}\)

In August, 2006, the Cabinet approved a new high technology strategy for Germany. This is a broad based national program that will make innovation policy a key focus, bringing to bear the combined efforts of the government, scientists, industry and the civil society. The Government has set aside some €15 billion to fund innovative technology and cooperation between science and industry up to 2009. Seventeen key areas have been identified for this. They include health care, energy production, nanotechnology, bio technology, information and communication technology, education and research etc.\(^{139}\)

**SME:** The German economy is characterized by 3.4 million small and medium sized enterprises, self employed and independent professions. 37.4% of these developed after 1995. In fact, around 99.7% of all companies are such SMEs. These are firms with annual sales below €50 million and a payroll of less than 500. 70% of those employed work in SMEs and 82% of apprenticeships are provided by them. 48% of these are service providers, 31.4% manufacturing and 19.7% commerce. These realize marketable products, have an international focus and a high degree of specialized

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\(^{138}\) *German Budget on Consolidation Course*, www.budesre.de, 22/2/06.accessed on same date at 1200 hrs

\(^{139}\) *Innovation, High Technology Strategy: Growth through Innovation*, www.bundesre.de, 30/8/06. Accessed same date at 1800hrs
The government has put together an SME Initiative for promote growth and employment in this sector the key features include:

I. Greater independence by

- Creating a single consultancy partner for new enterprises.
- Exemption from statistical obligations.
- Raising the turnover threshold for bookkeeping from € 350,000 to € 500,000.
- Reducing bureaucracy etc.

II. Better Financing through

- More favorable depreciation conditions.
- Promotion from the ERP (European Recovery fund).
- Increase the supply of equity capital and mezzanine capital (similar to equity capital).
- Reforming inheritance tax.

III. Mobilizing Venture Capital for Innovations

- More attractive framework conditions.
- Increasing the Fund for New Entrepreneurs and Young Technology-Based firms.

IV. Improving Vocational Training

- Continuing the Training Pact.
- Widening the range of occupations offered.
- Modernizing skilled occupations to meet practical requirements.
- Actively helping to design European cooperation in vocational training.

V. SME Friendly Framework Conditions,

- Promoting household related services.

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- Shaping the law on the award of contracts to suit SMEs.
- Greater support in opening up foreign markets.\textsuperscript{141}

In the light of their importance to the economy the government has introduced a *Small Company’s Act* as of July 2006.\textsuperscript{142} The purpose of this Act is to give them more leeway, facilitate business, reduce bureaucracy and make the legal process easy.

*Solidarity Pact II (2001):* This will finance most of the development projects in the new Federal States. Financial support was to be continued initially up to 2004 but will now be extended until 2020. A total of €156 billion will aid advancement and special promotion of East Germany till 2019.\textsuperscript{143}

*Kombilohn: A combination of low market wage and government subsidy.*\textsuperscript{144}

*Reform of the Bureaucracy:* The German cabinet has approved a programme called *Bureaucratic Reduction and Better Legislation* in April, 2006. It aims to introduce a comprehensive programme to slash unnecessary red tape as bureaucratic procedures cost the economy billions every year. To this effect an *Office of Bureaucratic Red Tape and Better Legislation* has been established with Hildegard Müller as Federal Coordinator. The aim is to create greater freedom for companies and increase public acceptance of government measures. It will also establish an *Independent legislation and Oversight Council*, which will assess prospective bills and legislations for cost

\textsuperscript{142} www.bmwi.de (Federal Ministry for Economics and Technology), 19/7/2006. Accessed same date at 1800hrs.
\textsuperscript{143} www.taatsachen-ueber-deutschland.de, Ibid.
\textsuperscript{144} Survey, Ibid.
impact. Suggestions for improvement, determining costs of legislation and establishing a time frame for carrying out cost reduction will also be some of its tasks. The Bureaucratic costs will be measured according to an international standard cost model in place in the UK and the Netherlands.145

Individual measures to consolidate the Public Budget

- The annual expenditure by the public administration will be cut by € 1 billion.
- Specific savings, rising to around € 1.4 billion a year, will be made in some areas of promotion (agriculture etc.).
- The implementation of basic security for job seekers will be optimized. From 2007, this will amount to about € 4 billion.
- The grants from the Federal budget for the statutory health insurance institutes will be reduced to € 1.4 billion in 2007. It will be discontinued altogether in 2007.
- No further Federal grant for the Federal Labour Agency is envisaged.
- Grants from the Federal budget to the statutory pensions insurance will be stopped.
- The social insurance institutes will be relieved of expenditure amounting to € 1 billion a year. This is to be done by limiting exemption from social insurance contributions on Sunday, public holiday and night shift work to a basic hourly wage of € 25 and raising the general charge on mini-jobs in trade and industry to a total of 30%.
- Around € 19 billion will be gained by reducing tax concessions and special tax regulations.

The standard rate of turnover tax (value added tax), and insurance tax will be raised by three percentage points to 19% by 2007. The lower rate of value added tax of 7% will not be changed.

From 2007 the rate of income tax on particularly high income from non business sources (above € 250,000/500,000) will be raised to 45%.146

Federalism Reform

The Federalism reform (Stage 1) set down in the Coalition Agreement was to cover the following main areas:

- Reform of the rights of approval of the Upper House by removing the requirement for approval under Art. 84, Para. 1, Basic Law and introducing new cases where Federal laws require approval as considerable costs are involved (Art. 104a, Para. 3a Basic Law, new version),

- In future the Federal legislature is to be able to regulate the establishment of authorities and the administrative procedure for the execution of Federal laws by the states as a matter within its own competence without requiring the approval of the Upper House. This replaces the responsibility for the majority of the laws requiring approval held hitherto by the Upper House. In return the states will on principle be given the right to set regulations that deviate from these requirements.

- Reform of legislative competences by abolishing framework legislation and redrawing the list of competing legislation, with reduction of the area of application of the clause on

requirements in Art. 72, Para. 2 Basic Law and introducing divergent legislation in certain areas of law.

- The following matters will be transferred into the competence of the Federal States: the laws on shop opening hours, catering establishments, gaming halls/exhibition of persons, trade fairs, exhibitions and markets; the laws on assemblies, remuneration and pensions and the laws on the careers of state officials and judges, most of the university legislation with the exception of university registration and university degrees, and the general legal position of the press.

- In future, the Federal Government will have exclusive competence for the laws on weapons and explosives, nuclear power, reporting and identification, and the protection of German culture from migration abroad. The other matters that have so far come under the framework legislation will be transferred to the competing legislation and (with some areas of exception) will be subject to the new divergent legislation, which will enable the states to issue regulations that deviate from Federal law.

- A clearer assignment of financial responsibility by removing mixed financing (the Joint Task for University Construction in accordance with Art. 91 a, Para. 1, No. 1 Basic Law (new version), More stringent conditions for financial assistance (Art. 104 a Basic Law new version)

- Greater regional autonomy in taxation (property acquisition tax, Art. 105, Para 2 a Basic Law new version)

- Firmly fixing the national Stability Pact (Art. 109, Para. 5 Basic Law new version)
• Clarifying the bases for the assignment of responsibility to the Federal Government and the Federal States for infringing supranational and international obligations and the Maastricht criteria (Art. 104 a, Para. 6, Art. 109, Para. 5 Basic Law new version).  

The largest constitutional reform since the present constitution went into effect in 1949 has been enacted by the German Parliament on 30th June 2006. It is intended to make interaction between Federal and state government authorities more effective and to define respective responsibilities more clearly. It will make Germany more capable of taking effective action and better able to compete internationally.

Speaking in Parliament, Chancellor Angela Merkel said today is a good day for Germany, for Federal, state, and local governments. She said the Federal system had stood the test of time but that over the sixty years of its existence, an imbalance had developed. Complicated decision-making processes had resulted in a lack of clarity with regard to ultimate responsibilities. This reform clearly sets out who is responsible for what.

For some time now there has been general agreement on the need to modernize the Federal system. In 2004, a joint commission made up of members of the upper and lower houses of Parliament formulated proposals for Federal reform.

147 Annual Report, 2006, pp.21, 22.
148 Successful Modernization of the Federal System, www.bundesre.de 30/6/06, accessed same date at 1200hrs. Also Bundestag passes Bumper Reform, www.dw-world.de/dw/article/0,2144,2074389,00 30/6/06, accessed same date at 1900hrs. Also, Germans Back Major Federal Reform, www.news.bbc.co.uk/2/hi/europe/5158428.shtml, 7/7/06 accessed on 9/7/06 at 1600hrs
149 Ibid
The Grand Coalition included this reform objective in its coalition agreement. A total of 25 articles of the constitution were amended with a view to reapportionment of responsibilities: 22, 23, 33, 52, 72, 73, 74, 74a, 75, 84, 85, 87c, 91a, 91b, 93, 98, 104a, 104b, 105, 107, 109, 125a, 125b, 125c, 143c. In addition, 21 Federal laws were amended.\textsuperscript{150}

There are three objectives of Federal reform. They include :-

(a) Improvement of the capacity for effective decision-making and action. Over the decades, legislative processes had become increasingly cumbersome. Long, drawn-out negotiations with numerous different players were required before bills could be passed. This was, not least of all, a result of the fact that an increasingly large number of bills could be passed only with the approval of the Upper House of Parliament, where the state governments are represented. There was a recurrent danger of blockades whenever the two houses of parliament were under the control of different parties. The reform reduces the number of bills requiring upper house approval from around 60 percent to somewhere between 35 and 40 percent.

(b) Clearer apportionment of government responsibilities: Government credibility presupposes transparency. People need to be able to see more clearly who is responsible for what.

(c) The interweaving of upper and lower house responsibilities as well as negotiations conducted in the mediation committee have frequently been a hindrance thus far. Improved effectiveness and expediency of executive government. In European matters, in particular, it is necessary that Germany speak with one voice. In the future, state government leaders will be able to speak for Germany as a whole only on matters of education, radio/television, and culture when exclusively state government interests are involved. The compatibility of the German constitution with the European Union has been strengthened by adding a new liability rule in connection with EU

\textsuperscript{150} \textit{Ibid.}
sanctions. The National Stability Pact for the first time subjects Federal and state governments to joint budget discipline. It clearly stipulates that state governments will also be liable if and when EU sanctions are imposed. The cumbersome instrument of mixed Federal and state government financing will be systematically phased out. It is believed that this reform will make the country more competitive and parliamentary decisions more transparent.

In September 2006, the government approved yet another law that will allow new parents to take temporary leave. This is to increase the problems faced by the German population, i.e. low birth rate (1.36 children/women - lowest in Europe) and an ageing population. Parents of children born after January 1, 2007, who have stopped working, receive 67% of their net salary up to a ceiling of €1,800 a month for a year. This would be extended to fourteen months if fathers also undertake childcare for at least two months. If both parents want to be of work simultaneously, they can each receive payment for seven months. Parents will also benefit if they work for less than thirty hours a month. Payments increased by 10% for each additional child under five years in the household. This will cost the government €3.9 billion a year.\(^{151}\)

*Health Care reform (October 2006)*

German healthcare needed a complete overhauling as, given the ageing population, the costs on public health care under the present system will go up. The system consists of some 252 public health insurance companies covering 90% of the population. The rest 10% are covered by private insurance companies. The system is funded by contributions from employers and employees who pay just under 14% of their salaries into it. This contribution is to be raised by 0.5%. A new health

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\(^{151}\) *Germany To Pay Parents To Stay At Home*, www.dw-world.de/dw/article/0,2189401,00.html/mac=maca=en-bulletin-433-html 29/9/06 accessed on 1/10/06 at 1200 hrs.
fund has been put off to 2009 (here, the contributions paid into it and tax revenues with € 1.5 billion also contributions by the Federal government will be put in. The fund will pay out a flat fee to every individual person insured under the public insurance schemes.)

Thus, it is the professed aim of Chancellor Angela Merkel to return the economy to a path of economic growth. Primarily reforms and investment are to strengthen innovation and growth and secure Germany’s long-term competitive edge. To this end, by 2009, a future fund will enable investments in key areas such as traffic infrastructure, education, research, technology, as well as family promotion. This is to be flanked by a drive to promote SMEs and those setting up in business. In particular, cutting-edge technologies such as nano and biotechnology will be supported. In addition, moderate changes to labour laws, for example extending probationary periods from the current six months to 24 months, are aimed at making the labour market more flexible. In order to make labour cheaper, non-wage costs are set to be cut from the current 41% to less than 40%: Thus the unemployment insurance contribution (which employers and employees share) is to be lowered from 6.5 to 4.5%. A corporate tax reform scheduled for 2008 is geared to making Germany more attractive in terms of tax in comparison with other countries. This will involve replacing the current different taxation levels for partnerships and joint stock corporations with uniform tax laws. In addition to boosting the economy, one of the Federal Government’s major goals is to balance the budget – among other things by abolishing tax subsidies and increasing VAT as of 2007 (19%).

152 German Health Care Reform: Mission Impossible, www.dw-world-de/dw/article/0,2144,2117345,00html 3/8/06 accessed same date at 1300 hrs. Also, A Stillborn Health Care Reform, www.spiegel.de/international/0,1518441170,00.html 6/10/06 accessed same date at 1600 hrs. Merkel Announces A Deal Averts a Crisis, www.spiegel.de/international/0,1518,440924,00html 6/10/06 accessed same date 1630hrs
Potsdam Initiative (December 2006): A concrete action plan to make Germany an attractive location for ICT business The government will invest € 1.2 billion in the ICT sector by 2009. This was a follow up to the ICT 2020 Research for Innovation launched at the Cebit\textsuperscript{154} \textit{in} 2005. The commitment by the government has been prompted by the fact that the ICT sector generated € 74 billion into the economy in 2005. It also has a workforce of 800,000 people, one of the largest in Germany.\textsuperscript{155}

Assessment and Impact of Reform Packages

The conditions under which the Trust agency took up work were daunting. There was no model for guiding an entire economic system through the transition to a social market economy. Neither an opening balance sheet nor realistic asset valuations were available. It was not until the work of the Trust Agency got underway, was the extent to which the assets of the GDR’s economy had been depleted discovered. The last GDR Government had valued the GDR’s state assets at DM 1,300 billion. By the Trust Agency’s assessment, it stood at DM 210 billion.\textsuperscript{156}

It was seen that only 8\% of the jobs in the enterprises taken over by the Trust Agency were profitable and that productivity of labour in the former GDR, as noted earlier, had been about 30\% of the level in Western Germany. Production plants and machinery were obsolete and energy

\textsuperscript{154} Cebit is the largest trade fair for information and technology held every year in March since 1986.
\textsuperscript{155} www.cebit.de/homepage_e> www.bmbf.de/en/1321.php and www.bundesre.de,26/8/06 14/3/07 accessed on 18/6/07 at 1200hrs
consumption was twice as high as the West.\textsuperscript{157} Five characteristics could be seen in the work of the Trust Agency:-

- A multidimensional target: This included hiving off companies, restructuring the East German economy, creating a base of small and medium sized businesses (Mittelstand), job security, developing core industries, etc.
- Decisions to be taken on a case-by-case basis: There was no fixed pattern in the way companies were to be broken, reorganized, hived off, etc. Only small-scale privatizations were carried out according to a standardized set of rules.
- Sale of companies was to be accompanied by investment and employment pledges by the buyer.
- Limited budget restraint: From 1991-93, it received funds amounting to DM 120 billion.
- Its work was subject to the decisions of the policy makers.\textsuperscript{158}

The work of the Trust Agency fell under three phases. The first lasted till mid-1991 when it focused only on selling state owned enterprises of the ex-GDR. The second phase was till mid-1992 wherein the aim was preliminary reorganization prior to privatization. The third phase went on till 1994, when active reorganization work was carried out. The state became an entrepreneur. This was seen in the release of investment funds, formation of Management KGs\textsuperscript{159}, cooperation with the Federal States on several projects, etc.\textsuperscript{160}

\textsuperscript{157} Ibid. pp. 231, 232.
\textsuperscript{158} Lichtblau,Karl An Attempt to Take Stock, The work of the Treuhand Agency, German Comments, Osnabrück, Germany, April 1994, p. 67.
\textsuperscript{159} KG or Kommanditgesellschaft is similar to the limited partnerships in the USA.
\textsuperscript{160} Ibid, p.68.
A Management KG is a legal structure that allows the Treuhand to transfer the management and restructuring responsibilities of seven to fifteen selected Treuhand companies to an outside management company run by well known private business persons, who will also contribute capital with the aim of restructuring and ultimately selling the companies. A Management KG is set up by first incorporating a GmbH\textsuperscript{161} which is designed to carry out the management functions of the KG. The private manager chosen for this task owns 96% of the shares in the corporation while the Treuhand owns 4%. The purpose of the KG is to restructure the companies in its portfolio and to privatize them within a stipulated time frame (usually three years), though it may do so earlier if a buyer is interested.\textsuperscript{162}

The criteria for admitting a company into the Management KG were:

- Recognition by the Treuhand as being fundamentally capable of being restructured;
- A pressing need to be restructured;
- No foreseeable short term chance of being privatized;
- Have at least 250 employees.\textsuperscript{163}

The Management KG’s were structured in such a manner that private investors can cash out on the back end. In other words, they are entitled to a share of the sale proceeds when the companies in the portfolios were privatized. This provided them with the incentive to do a proper job in restructuring the companies entrusted to them.

\textsuperscript{161} Gesselschaft mit beschraenkt Haftung or limited liability Company similar to a closely held corporation.


\textsuperscript{163} Ibid.
Achievements of the Trust Agency

- In the course of re-privatisation, many companies that had been expropriated were returned to their original owners. Nearly one-fifth of all privatized firms were taken over by their own management (purchased from the Trust Agency through MBOs (Management Buy-Outs). Currently, these constitute the successful Mittelstand in Eastern Germany.

- A number of firms, however, were so run down that they could not be organized. They had to be closed down. New businesses were established, which provided jobs to about 30% of the defunct firms’ employees.  

- By December 1994, 14,000 firms were privatized, 4,500 re-privatized, 25,000 mini privatizations of shops, hotels, and other small businesses were completed, 40,000 individual contracts were concluded, sale proceeds of DM 65 billion yielded commitments for 1.5 million jobs and investment pledges of DM 20.7 were received. Approximately 40,000 tracts of land were sold.

- Debts amounting to DM 270 billion remained. This was to be folded into a fund for retirement and, together with the GDR’s housing construction debt, would be paid off. Federal expenditure for this fund began at DM 370 billion in 1994 and has been on the rise since then.

- Removed monopolies in the former GDR’s economy.

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165 Ibid. p.233.
166 Ibid.
Expenditure for the modernization of the ex-GDR companies totaled DM 153 billion; expenditure towards de-contaminating polluted land and controlling, overcoming environmental damage came to DM 44 billion.\textsuperscript{167}

The opinions regarding the work of the \textit{Treuhand} are mixed, and fall into two broad categories - eastern and western. According to the eastern view, it has destroyed more than it has created, laying off thousands of workers from companies capable of producing perfectly acceptable goods. It had deliberately withheld cash and made no serious attempts to restructure the GDR economy. Mass unemployment, de-industrialization of the world’s tenth largest industrial economy etc, are some of the charges against the \textit{Treuhand}. ‘Deceived and sold out’ is the claim in the former GDR.\textsuperscript{168}

The western views can be classified according to the party affiliations. Those sympathetic to the CDU and the CSU said that the goal of the \textit{Treuhand} was to privatize the GDR’s economy quickly. In this regard it has been successful. Those sympathizing with the SPD feel that the quick privatization approach is fundamentally wrong.\textsuperscript{169} It should have made a greater effort to restructure the existing enterprises and preserved their value. It must be remembered however, that no one has tried to privatize an entire economy and no one had an idea about the actual state of the former GDR’s economy before the \textit{Treuhand} undertook its task. Other factors contributed to the high cost of restructuring the GDR’s economy included, the collapse of the COMECON trading system, and world wide recession in certain key industries like the steel, ship building and coal mining.

\textsuperscript{167} Peiner Wolfgang, \textit{The East German Economy can catch up, Ten Suggestions, Upswing East, German Comments, October 1996, Op.Cit.} p.68.
\textsuperscript{169} \textit{Ibid.}
Objectively assessing the *Treuhand’s* work, it may be said that the general track record of the Trust Agency is good but not perfect. There were a few flaws in its strategy. Reorganization of economic sectors has not been equal e.g. mining, chemicals, leather, textiles, etc. lagged behind in the privatization process. In the restructuring work, companies concerned did not participate sufficiently. Hence, they were unable to cope and could not comprehend the new structures that emanated. The Agency was also overburdened as a result of excess centralization. This affected its efficiency. Privatization meant selling the state owned companies of the ex-GDR. The buyers were mostly from the Western part of the country. As a result, there were too few independent companies in the new *Länder* and too few headquarters as well. Most of the mergers were horizontal. Companies in the West bought additional capacities in the same branches of industry. Lastly, its work was expensive as the accumulated debt (mentioned earlier) revealed.

A brief assessment after seventeen years of unification reveals that:

- Some 11,000 km of Federal highways and Federal trunk roads and 5,300 km of railway track had been newly constructed or thoroughly modernized. More than half the investment in rail and road has gone to the former GDR. Until 2009, some € 40 billion will be invested in modernizing transport routes.\(^{170}\)

- Deutsche Telekom AG has installed about 5.2 million new telephone accesses. Digitalization of the entire network was completed at the end of 1997; since then, Germany has had a more modern telephone network than Western Germany.

- In the area of housing construction, more than 3.8 million housing units – over half of the number of units that existed in 1990 – have been renovated or newly built.

• Considerable progress has been made in the restructuring of farm enterprises as well.\(^{171}\)

• Over 50,000 new companies have been created. Special programs for education were instituted. This resulted in the complete overhauling of the education system (content wise).\(^{172}\)

• East German states are better off when compared to the other states of the Eastern bloc. The economic strength (without Berlin) of the states of Eastern Germany is three times that of Hungary or the Czech Republic, the last two being economically strong countries.\(^{173}\)

• In 1991, there were 4000 private companies. At the time of this writing, there are more than a quarter of a million. Leipzig heads the list of entrepreneurial cities in Europe. Dresden has the world’s most modern microchip factory. Jena is today known for housing the maximum number of scientists. Mecklenburg is a major tourist attraction. Saxony is home to the automobile industry and is dubbed auto land Saxony.\(^{174}\)

• Foreign investments have come in steadily - a new BMW plant in Leipzig, AMD’s (American microchip giant) third factory in Dresden to name a few.\(^{175}\)

• The automobile boom has created a new industry that supplies automobile components. Saxony has a turnover share of more than 20% and an export quota of 40% in this.\(^{176}\)

• The serious environmental damage in the ex-GDR states has been remedied bringing about a visible improvement in the region. The air, water and soil pose far less risks than before. More than DM 50 billion has been spent on modernizing energy production. New production profiles, closing down of environmental offenders, improved wastewater and sewage treatment plants

\(^{172}\) Thomas Zielke, Op.Cit.
\(^{174}\) Ibid.
\(^{175}\) Ibid.
\(^{176}\) Ibid.
have all resulted in a decline in pollution. Clean up operations in the various mining regions was continued through 2005 and to date DM 6.2 billion has been invested in this.\textsuperscript{177}

- Construction of buildings in the tertiary education sector i.e. investments in universities has been achieved to a large extent. Since 1998, spending on education has gone up by 30%. A further € 1.5 billion will be spent by 2010.\textsuperscript{178}

- Economic recovery in Germany also depends on a well functioning legal system and efficient state and municipal administration, all of which could be established within a brief period of time as a result of the extensive assistance of administrators from the Western states. The process of creating a public administration in the East, which conforms to that existing in the West, has been completed.

In the words of former US president, Bill Clinton, Kohl has reunified Germany funneling massive sums of money from West to East to lift the incomes of those who had made far less under the communism. When he visited Germany in 1994, he commented that Berlin was booming, full of construction cranes as the city began to resume its role as the capital of united Germany\textsuperscript{179}.

Never before in European history has a region’s infrastructure undergone this degree of modernization. The conversion of a very marginal economy into a competitive one with modern infrastructure is not an easy task. There are a few problems that need to be looked into.


\textsuperscript{179} Clinton, Bill My Life, Alfred A. Knopf, N.Y. 2004, pp.527, 608.609
The East German economy grew at an average rate of 8% a year in the first half of the 1990s. Since 1997, it has grown at less than half the rate of the Western states. In 2001, it went into recession shrinking by 0.5%. In fact between 1993 and 1999, economic growth fell at the rate of 1.5% annually. Wages are still one third below those in the West. Unemployment in the East is, as of now, in certain areas of the new states as high as 20%, and on an average 15.2% (twice that of the Western States), while the growth rate is only 5.5%.

The various labour market reforms have not been completely successful. In fact, when Hartz IV was introduced, it evoked mixed reactions. The political parties reacted differently. The CDU and the FDP received it well. On the other hand, there was a major disagreement within the SPD and several members resigned. The PDS and the Greens opposed it. Later, 80% of the SPD and 90% of the Greens agreed. This left the PDS the sole opponent. The German Trade Union Federation opposed it initially but later, after a meeting with Schröder, in August 2004 accepted it. Public response was seen in the large-scale demonstrations over summer 2004. One of the outcomes of this was the creation of a new party – WASG or the Workers and Social Justice Party (PDS leader Gysi and Oskar Lafontaine’s breakaway group joined hands to form this party).

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181 www.bundesbank.de.
183 Ibid.
184 Eastern Germany Gets Pep Talk on Wasting Money, www.dw-world.de
186 www.derspiegel.de.
Few Economic Realities

- After eight years of steady economic growth, an economic downturn began in 1992. Since 1992, Germany has seen an annual average rate of growth of only 1.5%. 2006 has been the best year in terms of the economy. This year saw a growth rate of 2.7%. 187

- In 2006, rate of unemployment dropped to 9.8% nationwide. However, unemployment rate in the former states of East Germany was 17.3%. 188 Some States of the East have an unemployment rate of even 20%.

- Germany’s six leading economic institutes expected the country’s economic growth as of October 2004 to slow down further. 189 East German states have the highest rates of unemployment as mentioned earlier. Unemployment in the West is half of the East. Government transfers support 850,000 of the jobs in the East.

- Since unification, support from the Federal Government has amounted to € 1.25 billion. An additional € 156 billion will be given through 2019. 190

- Rebuilding East Germany has cost the Federal Government € 1.5 trillion ($ 2.1 trillion) so far. 191

- Annual expenditure by the Federal Government on the ex-East German states is about € 90 billion. 192 (Official sources say € 80 billion) 193 The net result is stagnation in the West and no

187 Background Notes, (country wise), www.state.gov accessed regularly. Last accessed on 21/10/07 at 2300hrs.
188 Ibid.
189 Germany’s Economic Woes, www.dw-world.de/dw/article/0,2144,1367797,00html 21/10/04 accessed same date at 1200hrs, Gloom Deepens Over East German Economy www.dw-world.de/dw/article/0,2144,1365124,00html 19/10/04 accessed on 21/10/04 at 2200hrs
192 Has Reviving The East Failed, www.dw-world.de/dw/article/0,15641163753,00html, 6/4/2004 accessed on 10/4/04 at 1300 hrs. The Economy and Transport Ministry commissioned this report. It is the result of an analysis by a panel of thirteen economic experts, headed by former Hamburg Mayor, Klaus Von Dohnanyi.
revival in the East. The new government plans to spend more than the 3% of the GDP, next year however it plans to cut subsidies, other spending and increase VAT from 16% to 19%. This took effect from January 1, 2007. At the time of this writing the government spends around 4% of its annual GDP on East Germany.

- EU enlargement has resulted in competition for investments and jobs. The new members offer low wages and low costs of production.
- High rate of unemployment in the new states has led to the migration of the young and the educated. In 1989, there were 16.7 million people in the ex-GDR states. As of 2007, the population has gone down by 1.3 million. Added to this, birth rates have fallen due to economic insecurity. It is predicted that the population will fall in East Germany by 7.7% by 2020.
- Wages in East Germany is 23% lower than the West.
- Inflation is set to rise.
- Five Think Tanks – Ifo (Munich), HWWA (Hamburg), RWI (Essex), Ifw (Kiel) and IWH (Halle) – predicted a 1.5% growth rate for 2005. Official sources predicted a growth rate of

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195 In A Bind, Ibid.
196 Annual Report 2007, accessed online from the German Ministry of Economic affairs, on 13/9/07 at 2300hrs IST.
200 Ibid.
1.7%. The same Think Tanks have recently forecast that the German GDP will rise at 2.4% (one point higher than in 2006) in 2007 and 2008.

- Skills crunch will cost the nation more than € 20 billion annually this year (2007).

An American artist spent a month traveling through Germany, asking Germans to write down their thoughts on Germany. A resident of Leipzig wrote... the people marching on the streets in 1989 had no idea what the changes they were seeking would mean economically. The Wall had to come down, but it will take generations for the economy to recover. In most of the cities she visited (Berlin, Hamburg, Cologne, Munich and Leipzig), unemployment was the main concern. Hope has turned to complacency, resentment and despair, she writes.

Hartz IV was initially not an unqualified success. It added around € 8 billion to the costs of the government. It also got its incentives wrong. The state calculates benefits on the basis of a Bedarfsgemeinschaft (Household in which the jobless person lives). A single person in West Germany gets € 345/month, while in the East he gets € 331/month. Added to this are benefits like health insurance, rent and utilities which are paid by the state. The government expected some 2.6 million Bedarfsgemeinschaft, today there are 3.7 million of them. While it has not created too many new jobs, yet the number of self-employed has increased from 4 million in 2001 to 4.4

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201 Gloom Deepens Over East German Economy, www.dw-world.de/ dw/article/0, 2144, 1367797, 00html, 19/10/2004 accessed same date at 2200hrs .
203 Skills shortage Could Dent German Economic Study Warns, www.dw-world.de/dw/article/0,2144,2745130,00html,20/8/07 accessed same date at 2100hrs IST also see Facing Reality, Europe Moves to Lure Skilled Immigrants, www.dw-world.de/ dw/article/0,2144,2658224,00html, 21/7/07 accessed on 20/8/07 at 2135hrs.
million in 2004. Mini jobs costing € 400 a month are very popular with students. More than 30% of the German workforce is employed in part time or temporary jobs. In July 2005, unemployment fell marginally. Big companies reported healthy profits. They have restructured, cut their bloated cost base, which has resulted in the unit labour costs coming down. This is a positive development for the German economy as it has helped exports to pick up. German exports were € 63.4 billion and imports were € 51.9 billion (as of August 2005). This is an increase of 13.4% (exports) and 15.3% (imports) over the last year. Exports rose to € 77.6 billion in February 2007, imports to € 63.4 billion resulting in a trade surplus of € 14.2 billion. ‘The Economist’ thus feels that the German economy is no longer sick. The country has won a new competitive edge over other countries like France, the Netherlands etc. It may very well make a strong comeback.

Perhaps the country is not on the brink of an economic disaster. The US Investment Bank, Goldman Sachs, had made similar predictions at the beginning of 2005. The latter spoke of a possible surprise with respect to the German market. However, it is clear that the key steps in this regard have been taken by the companies and not by the politicians. The small but perceptible changes could be due to a delayed impact of the reforms. Perhaps it is an indication that the reforms ought to continue.

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207 Ibid.
208 www.bundesre.de.
210 The Economist, Aug 20-26, Op.Cit.. Also see, Crossland, David, Merkel Sitting Pretty Two Years Into Term www.spiegel.de/international/germany/01518,501117,00html, 22/8/07 accessed on 23/8/07 at1800hrs,
212 Die Welt, 19-08-2005, Ibid.
213 Süddeutsche Zeitung, 20-8-2005, Ibid.
214 Rheinische Post, 19-8-2005, Ibid.
The country is the world’s leading exporter selling goods worth € 733 billion a year. Exports amounted to nearly US $ 1 trillion in 2005. In fact, Germany sells more goods in the world market than any other. It accounts for 10.6% of high tech global trade and is in second position after the USA and ahead of China, Great Britain Japan and France. In fact, exports accounted for 0.7% of the overall economic growth in Germany in 2006. Profits in the big companies are looking up. Business confidence has improved. Yet, the economy was the main issue in the last election campaigns. As the election results reveal, the voters could not decide whom to vote for. The reality is that East Germany and unemployment are the country’s two major problems. In 2005, unemployment reached a post war record of 5.2 million According to the opposition, 1000 jobs disappear everyday. No doubt, over the last few months, unemployment rates have fallen slightly, yet in some states of the ex-GDR, as mentioned earlier, unemployment continues to remain high. Unemployment is hitting both the consumers’ confidence as well as their purchasing power. Savings in Germany have reached 11%. This, in turn, has reduced domestic demand, which has hit the Mittelstand badly. The latter do not have the profit margins, the legal teams or the means to relocate to another country. The current export boom has failed to trigger a higher rate of investment. This, together with the Euro zone stability rules, has starved the Federal Government of much needed funds. The EU had set Germany an ultimatum. It will have to rein in its deficit by 2007 or face sanctions. Recently the EU has expressed its satisfaction at the German government’s efforts to deal with this problem.

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216 www.taatsachen-ueber-deutschland.de also see Germany Once Again The World’s Leading Exporter, www.bundesre.de 2/1/07, accessed on 21/5/07 at 2150 hrs IST.
217 Ibid.
219 Hans-Werner Sinn, President of the Ifo Institute for Economic Research, Ibid.
220 Minister Says Germany Off The Hook In Budget Deficit Affair, www.dw-world.de/dw/article/0,2144,2168895,00html 9/9/06 accessed same date on 1500hrs . Minister, Germany To meet EU Deficit rules in 2007, , www.dw-world.de/dw/article/0,2144,2164909,00html 5/9/06 accessed on 9/9/06 at 1500hrs
Germany is setting new export records but no new jobs have been created. Factories are so efficient that no new personnel are required.\textsuperscript{221} H. Uhlig, Director of Economic Policy Institute, Humboldt University, Berlin made a telling comment on the economic situation in Germany. He said … the Germans were sitting in a car whose engine is running, it’s rattling and clattering, it’s dark and they do not know whether they are coming or going. He admitted that the Schröder government has done a lot of things ignored by the Kohl government. The picture is not so rosy and simple.\textsuperscript{222} A resident of Berlin wrote … the gap between the rich and the poor is getting wider. We do not want the same ratio as the USA or China. We want a world that is more just, where no one is allowed to starve or go without medical care.\textsuperscript{223} This sums up the sentiments prevailing in Germany at the moment.

It is not as if the government is not doing anything. The IMF, in fact, praised the efforts of the German Government, as did the World Bank.\textsuperscript{224} The IMF has predicted a 4.9% growth in the world economy in 2007-2008. It has referred to Germany as the principle locomotive in the Euro Zone and feels that the country’s economic growth will be around 1.8% in 2007. It has also predicted that unemployment will drop by 0.3% points in 2007 and a further 0.2% points in 2008.\textsuperscript{225} The Wall Street Journal pointed out that of the €190 billion collected through tax revenues, €80 billion is passed on to the state pension system, €30 billion to unemployment benefits, and €40 billion to

\footnotesize{IST, German Parliament Approves 2006 Budget, www.dw-world.de/dw/article/0,2144,2065607,00html same date accessed on 9/9/06 same time, Federal Deficit Projected At 2.6% of GDP, EU On Tuesday To Suspend Disciplinary proceedings Against Berlin, www.dw-world.de/dw/article/0,2144,2200253,00html 10/10/06 accessed on 12/10/06 at 2100hrs.\textsuperscript{221} Tagesspiegel. 20-08-2005.\textsuperscript{222} Harold Uhlig, Handelsblatt, 23-08-2005.\textsuperscript{223} Postcards For The Chancellor, Op.Cit.\textsuperscript{224} Unemployment Compensation II, Op.Cit., also, Germany-Info.org\textsuperscript{225} The Economy, Robust Growth In Germany And Worldwide, www.bundesre.de 13/4/07 accessed on 15/4/07 at 1900hrs.Also see, www.imf.org/external/pubs/ft/weo/2007/01/pdf/text.pdf> accessed same date.}
banks to service debts. The Federal budget (2005) amounted to € 260 billion and the income from taxes could go up by € 20 billion if the economy picks up. But there was also the deficit of € 50 billion that needed to be met. The country’s economic situation after years of economic stagnation appears to be unstable. An interesting question is ‘why this cycle of rise and fall in economic development?’ One can identify both internal and external causes for this.

**Internal Causes:** At the time of unification, the extent of effort that would be required to integrate a command economy into a social market economy was not anticipated. There was a lack of coherency in the programs as well as in the awareness regarding the preconditions to be fulfilled. The currency exchange of 1:1 / 1:2 was more a political decision than an economic one. The feeling that any other rate would have alienated the voters in the East fuelled it. Given the low productivity of the GDR economy, this caused an increase in the cost of products resulting in the loss of competitiveness. Many industries of the GDR were damaged beyond repair and its capital stock became useless overnight. Added to this were the cases of the misuse of funds, senseless investments and personal enrichment by the officials concerned. The Trust Agency had worked to a plan i.e. privatization and closedown of industries where not viable. Not only were most of the buyers from the Western states, but also the Trust Agency itself was viewed as a Western Institution – one that destroyed the jobs in the East.

The biggest trouble faced by the East is the collapse of the building industry. Fuelled by fat subsidies, this was the main motor of Eastern growth in the 1990s, at one time employing a third of the work force. But, as of 2002, around one million houses and offices lie empty, the builders’

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227 Süddeutsche Zeitung, in Fishwrap, Ibid.
228 Financial Times Deutschland, in Fishwrap, Ibid.
productivity has plummeted and their woes look set to continue for sometime. Another problem in
the East has been the exodus of many of its brightest and best – some 80,000 Easterners flooded
West over the newly opened borders in search of a better life! Since 1991, a further one million
have left tempted by better opportunities and wages in the West. Most of those who left were young
and well trained. Some have returned since but they mostly are the old or the less successful. This
is one reason for the continuing discrepancy in productivity between the East and the West.

From the very beginning, efforts to move from a state controlled planned economy with an ailing
infrastructure, a non-existent Mittelstand and lack of marketing skills, faced enormous problems.
East German Industry was literally bankrupt.229 Added to this was the lack of a global market. Sale
of goods was exclusively to the former Communist States. This was in the form of goods exchange
agreements between the concerned states. There was also a high level of hidden unemployment due
to labour-intensive production.

After unification, there was an abrupt de-industrialization of the ex-GDR. Several scholars feel that,
it would have been better to bring about a step-by-step process of economic integration rather than
the sudden, overnight change. However, this would not have been feasible even if attempted, given
the emotional situation at that time.

Slow introduction of West German investment in the East also hindered development. Where joint
agreements between firms in the two Germanies had promised quick upgrading, a close
examination shows setting up new factories rather than upgrading old ones would have been more
cost effective. Further, property titles were not clear and free in the former GDR. The decision to

establish a procedure to allow past owners to demonstrate ownership slowed down the process of development.\textsuperscript{230}

The proportion of foreign investment was relatively small at the beginning. Had this been activated right at the beginning, perhaps the ex-GDR states could have had access to an international market and centers of economic competence could have been established. The expectation was that privatization would lead to a shift in the entrepreneurial ability from the West to the East. In reality, the East German companies were taken over by the West German ones to acquire market shares rather than production. So much so, when recession struck, these companies were closed down without any hesitation. This, in turn, caused widespread unemployment. The collapse of the large industrial combines also left noticeable gaps in industrial production which new firms are finding difficult to bridge.

Further, the East German market was flooded with consumer goods from the West. The latter saw the former as a market for selling its goods and not as a new source of production. Retail trade organizations were taken over by the companies of West Germany. This resulted in a reduction of the East German companies’ chances of distribution and sale. Thus, lack of adequate jobs in the manufacturing sector and business decision making centres in the ex-GDR states caused the dependence on transfers from the West (this continues even today). During the first few years of unification, there was a sudden rise in the demand for consumer goods. This caused growth rates to grow up resulting in an improved job scenario in the West particularly in the manufacturing and service industries. These were the very jobs that the East lost out on.

The lack of headquarters of the big firms in the ex-GDR is responsible for the lack of economic elite there. Of the large 190 firms in Germany none have a permanent seat in the former GDR.  

The one-way flow of goods from West to East has boosted the economy of West Germany while depleting that of East Germany. Alexander von Witzleber, boss of Jenoptik (a Thuringian Company), has pointed to a lack of focus in the spread of investments. Infrastructures have been set up where not required. The result is a patchwork economy with certain states like Saxony and Thuringia being highly developed while others lag behind. These two states concentrated on developing their *Mittelstand* rather than their large companies. In 1995-96, the economy in the FRG was stifled by a combination of DM appreciation, misguided wage policy, cyclical contraction and unfavorable supply side conditions.

It must be mentioned here that the unit cost of production is very high in Germany – in Britain it is € 19.90/hour, in the USA it is €18.80/hour, in the Western states of Germany it is € 27.60/hour, in the Eastern states it is € 17.20/hour while in central Europe it is less than € 5/hour.  

As a result, companies are willing to shift wherever labour and capital costs are low. Continental, a tyre manufacturer, has located its production abroad although it employs 32,000 people in Germany and keeps its headquarters there. Many other companies are doing the same. Cities and states in Western Germany that are facing the problem of flight of industrial capital have shifted from production to the service sector – finance, banking, consultancy, insurance etc.  

Excessively high wage costs and costs additional to wages are particularly burdensome on those firms which are still

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in the restructuring phase and have yet to gain access to the world’s markets. Germany today is seriously considering a ceiling on minimum wage.

Added to this is the fact that wages are set by national peak level bargaining. IG Metall Union (the biggest and strongest trade union), would negotiate a pay rise in one of its strongholds which would then be adopted by unions and employed in other sectors. At the same time, wages at the lower end of the scale tended to rise disproportionately fast, making unskilled labour increasingly unattractive to employ. The effect on labour costs was magnified by the way the country finances its welfare state: through payroll tax with matching contributions from individuals and employers. Unemployment and early retirement programs pushed up these contributions from individuals and the cost of labour with them. The country keeps losing full time jobs and their attendant social security contributions which now add up to over 40% of the gross income, compared to 27.6% in 1970.234

Unification aggravated this vicious circle. The cost of integrating the East German economy was to a large extent placed on the social security systems as it was politically easier than raising taxes. Also, German Unions and Employers Associations (both dominated by westerners) agreed to raise wages in the East to the level of the West. The idea was to prevent skilled workers from the East from moving to the West. This only succeeded in pricing many low skilled easterners from the market. To this must be added the de facto minimum wage set by welfare benefits along with strong protection against dismissal which only compounds the problem.235

235 Ibid. pp.9,10.
Denis Snower, president of the Kiel Institute for World Economics has put forth an *insider-outsider* theory. The insiders are those possessing jobs while the outsiders are the long term unemployed (who account for more than half of Germany’s unemployed). The insiders are interested in maintaining a high level of labour-turnover costs (all costs associated with firing an employee and hiring a new one). This is because the higher they rise, the lower the probability that they will be incurred. Hence, there will always be a huge gap between the insiders and the outsiders.\textsuperscript{236}

There are cultural reasons as to why low paid services are under developed in Germany compared to other countries. Many Germans dislike the idea of working in services, thinking them demeaning. Women are still underrepresented in the work force, tend to do their own housework rather than outsource it while many men are *do it yourself* enthusiasts.\textsuperscript{237}

Recently, there has emerged growing concerns about the misuse of funds in the states of East Germany. The ministers concerned were pulled up for alleged waste of Solidarity Pact Funds. The Federal Finance Ministry alleged that only 39\% of the € 8.5 billion allotted were spent on infrastructure.\textsuperscript{238} As of this writing the Federal Government has transferred €1.3 trillion to the new *Länder*. The Social Democrat Government in Brandenburg claimed to have spent 89\% of the € 1.5 billion received in 2005 on reconstruction projects, while the Halle Institute for Economic Research (IHW) points out that that only 59\% was used for reconstruction purposes. In the case of Saxony Anhalt, the government claimed to have utilized 59\% of the allotted € 1.7 billion for reconstruction

\textsuperscript{236} Ibid.p.10.  
\textsuperscript{237} Ibid.  
\textsuperscript{238} *Eastern German States Get Pep Talk On Wasting Money*, Op.Cit.
while the IHW says only 12% was so used. Only Saxony used its allotted 2.8 billion Euros towards reconstruction. Most of the States used the allotted funds to fill budget holes.239

The new states have a brand new infra structure, they look so nice. But a lot of jobs have been lost and have not been replaced to the extent required. Unemployment is high. The former GDR had an outdated industrial structure. It was a barter economy inside the Soviet bloc. After unification, the East Germans became uncompetitive externally and internally. Externally, their products were far inferior to the standards of the West. Internally, they wanted to buy goods as in West Germany, those who bought stopped producing. As a result income fell. A lot of money has been pumped in. In fact, the percentage of the GDP spent on the East in Germany is equal to the share of GDP that USA spends on its defense.240

External Causes: Germany is battling the consequences of several economic shocks. These are:-

- Globalization, wherein an economic disaster in one part of the world will affect another.
- Enlargement of the EU resulting in the Opening of Central and Eastern Europe – this, in turn, is responsible for firms moving out of Germany to areas of low costs of production.
- Introduction of the Euro – if GDP falls in any of the states in the Euro area, all others get affected (e.g. when the GDP in the Euro area fell in the last quarter of 2001 by 0.8%, output fell in all the big three economies – Germany, France and Italy). The EU stability and Growth Pact prevents the member countries from borrowing out of trouble.

239 German East Accused of Misappropriation, www.dw-world.de/dw/article/0,2144,1723658,00html 28/9/2005 accessed on 1/10/05 at 0600hrs.
240 Günter Wehmann, Consul General of Germany in Kolkata, in an interview with the author, on 23/10/06 at the consulate premises.
• The 9/11 attacks have caused economic shockwaves throughout the world. The German economy is no exception.

• Global slow down of economic growth.

• High price of crude oil.

East Germany had to familiarize itself with a new situation overnight – a new constitution, a new social and economic system, etc. It is not easy to overhaul a forty year old identity overnight. The Russian philosopher, Vladimir Solovyov, points to a gap between life and happiness that cannot be bridged.\(^{241}\) Unification had brought with it high expectations of happiness in the ex-GDR – happiness related to prosperity and an exalted status in the world. None of these materialized. In fact, it would not be wrong to say that the ex-GDR citizens welcomed unification in anticipation of this happiness. What they forgot is that West German prosperity is the result of several years of a social market system, with modern infrastructures in place and a strong D-Mark. In the case of the ex-GDR it is only 17 years of change. It will take time for the economy to catch up with that of the West. This has caused social tensions between the two resulting in separate identities – the *Ossies* (East Germans) and the *Wessies* (West Germans). They smoke different brands of cigarettes, drink different wines and read different newspapers. The Wall continues to exist invisibly in their minds. Most West Germans were prepared to make sacrifices in 1990. But, as the government pumped more than US $100 million/year into the East German states they started to experience an economic crisis accompanied by the highest unemployment rate in Germany’s history. Many in the West began to resent the fact that they were forced to carry the growing burden for rebuilding the East,

while their own plants were being shut down.\textsuperscript{242} Herr Wehmann adds \textit{this resentment is of the losers; those East Germans who are successful will not resent the success of the West Germans.}\textsuperscript{243}

On the other hand, the massive transfers from the west were never regarded by the east as a matter of goodwill or routine fiscal equalization between rich and poor states. The Easterners treated it as a moral obligation to rectify past injustices. The latter felt that they had paid disproportionately for Hitler. The fate of geography had placed them in the Soviet occupational zone. The occupiers of their land dismantled and transferred to Russia, whatever was left of East Germany’s industrial plants. Altogether Russia had extracted more than 50 billion Marks in reparations from this region. In contrast, West Germany had received generous American Marshall Plan Aid, rebuilt its infrastructure and laid the foundations of an economic miracle. The West Germans did not buy any of these arguments and blamed the East German mentality for the differences in the standard of living between the East and the West.\textsuperscript{244}

Many East Germans are more dissatisfied with democracy than the West Germans are. West of the Elbe, 28\% of the population believes that the German society is unjust; east of the Elbe the figure is 40\%. Radical extremism is rearing its ugly head (in the 2004 \textit{Länder} elections, the extreme right wing party, NPD, won 9.2\% of the votes) and the West Germans resent the amount that has been transferred to the East. They feel that this has been done at the cost of development in the West. The Easterners accuse the Westerners of being arrogant, of having taken over their economy, of destroying all their structures under the guise of unification. Whole industrial plants were sold for a

\textsuperscript{243} Consul General, \textit{Interview, Op.Cit.}  
\textsuperscript{244} \textit{Ibid.}
symbolic mark, factories were stripped of their assets, millions unemployed, etc. Thus, as the economic state of the GDR became apparent the ‘dear sisters and brothers became tiresome poor relatives’. The Westerners, on the other hand, accuse the Easterners of being dissatisfied, having too many expectations despite the sacrifices made by them. The issue is thus one of Western arrogance versus eastern hyper sensitivity.

“What we know of one another is often too superficial, too laden with prejudice. East and West Germans will, for a long time, have to explain themselves to one another without having to immediately justify themselves,” said Chancellor Schröder in the policy statement he gave on 19th April 1999. Both East and West Germans must undergo the German-German learning process. Internal unity, overcoming the “wall in people’s minds”, is proving to be much more difficult than rebuilding the East German economy.

Representative surveys of people living in Eastern and Western Germany during the tenth anniversary of unification in 2000 revealed how the unification process is perceived and judged. Today, most East Germans are reportedly better off than before the fall of the Wall. Only about one tenth of the respondents stated that they consider their personal situation to be worse. However, only about one in every ten unemployed persons in Eastern Germany stated that they benefited from unification; nearly one out of every two unemployed persons affirmed that unification meant a definite loss for them. Recently, a poll conducted by the Emnid Research Institute for N24 TV revealed that 19% of Germany wanted the Berlin Wall back while 75% was glad it was gone. In the

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246 Ibid.
247 *Tenth Anniversary Of German Unification, A Review Of The Progress Made Bringing the Eastern Section With The West*, www.bundesre.de. Accessed on 13/10/00 at 2100 hrs.
former states of East Germany 21% wanted the Wall back while 74% still felt like second class citizens.\(^{248}\)

A closer look at this personal balance-taking reveals that East Germans view the improvements in the goods on offer, in their travel opportunities, in the ownership of electrical appliances, in the media on offer, in their travel opportunities, in the possibility of expressing one’s opinion freely as positive developments. On the other hand, most East Germans bemoan the fact that there is less cohesion between people. When surveyed, a large percentage of East Germans agree with the statements that East and West Germans are still strangers despite German unification, and that the unification process has not taken the interests of the people (who were formerly citizens of the GDR) sufficiently into account.

This shows very clearly that despite all attempts at developing a pan-German Identity, there has developed a sub-National Identity of the Easterners. In the recent polls, the WASG, the successor to the PDS, gained 8.5% votes in the East. Though it has also gained 3.8% in the West and the SPD and the CDU/CSU have lost votes all over, this author reads in it the beginning of a political and economic sub National Identity. The enlargement of the EU had introduced fears of swelling crime rates, illegal employment, wage dumping etc. While the fears are not unwanted, recent trends reveal that the location of East Germany between the poor states of Central and Eastern Europe and the rich West German states has proven to be advantageous. The total imports have increased (from the accession states) to 32.3% from 25.2% since 2002 while exports fell from 12.5% to 11.4% in

\(^{248}\) Merkel Says Rebuilding East Germany Still Priority
the same period. To this must be added the fact that the unit cost of production in the ex-GDR States is less by € 11 which gives it a distinct advantage over the states of the West. Also, cheaper living costs, a brand new infrastructure, well qualified personnel etc. are inviting to a potential investor. For the East to catch up with the West, it may take eternity. Today the East is not interested in copying the West but in forging ahead in its own chosen path.

The states of East Germany may well create their own special economic zone by taking advantage of this situation though official sources rule out this possibility. Plans to make the Eastern states a “special economic zone” have not been greeted by all politicians with such enthusiasm. “That is a completely unrealistic perspective that we should quickly bury,” said leader of the Greens, Reinhard Batikofer, and others see major legal difficulties in implementing a special zone since there would be conflicts with both German and EU labour and tax codes.

Conclusion

An honest assessment leads us to the following conclusion regarding the challenges that Germany faces today:-

Economically: high pensions, relatively generous welfare, high levels of unemployment (60% of East Germany capable of employment is employed), lack of funds to pay for unemployment provisions; migration of the young and talented and a low birth rate. Economic aid for the East is dragging down the West. Will this result in a total economic disaster?

249 East Germany Profits From EU Enlargement, FAZ Weekly, Internet edition, Ibid.
250 see footnote 182.
252 www.DIW.de
Socially: a cleavage has developed between the East and the West.

Suggestions

- Germany’s new states need pinpointed, concrete assistance in those areas that will be decisive for the region’s future. The objective should be to promote the development of competitive economic structures that will make the ex-GDR states independent of transfers from the West. This would go a long way in removing fractured identities and could foster a pan-German Identity. (The author however feels that imposing such an identity may prove disastrous in the long run.) The sense of dependence and the idea of being the beneficiaries of the West’s largesse would be removed as far as the East goes. The West, in turn, will no longer feel resentful of carrying on the burden of an economically weak East at the cost of its own development.

- Programs should be created to provide greater employment opportunities for the young.

- Since 1998, promotion of industrialization was mainly focused on the manufacturing sector. Other industries must be focused on. Instead of spreading investment and Federal aid all over, focus should be on small clusters. Medium sized businesses must be further developed; existing companies are too small and short on capital. The new government is doing this and the benefits of the same are being felt slowly. In 2006 the East German economy grew at the rate of 3% according to official sources. And East German states are expected to outstrip the states of the West in terms of economic growth in 2008.²⁵³

²⁵³ Joint Economic Forecast, Ibid.
• Taxes must be trimmed and the state expenditure further curtailed. The government has made a beginning in this regard. The share of state expenditure in the GDP fell to its lowest since unification—46.8% of nominal GDP.  

• Subsidies should be reduced further (social security and healthcare amounts to 42% of the wage bill).

• With these, it will be a slow start. The internal situation can be controlled to some extent through new policies, stringent measures etc. (The new Chancellor’s suggestion to cut the social security taxes, make up the shortfall by raising the VAT by 2% has been put off). The external causes cannot be controlled. A hike in oil prices, a volatile Euro, or a global economic crisis can slow down the economy further. The internal efforts, however, must be continued.

(At the time of this writing the new government has taken important steps in this direction, but it still has a long way to go.)

The Federal Finance Ministry has made a *Projection of the Overall Economic Trend in Germany until 2010* as shown in Figure 3.

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In 2006, the GDP will rise at the rate of 1 1/2% (in real terms) and 1.4% in arithmetic terms. After adjustment for calendar effects this is a rise of 1.6%. In 2006 the GDP actually grew at the rate of 2.5%. It is expected that the GDP will rise in 2007 by 1%. The figures at the time of this writing say that in 2007 the GDP will rise at the rate of 1 ¾ % (in real terms) and 1.7% in arithmetic terms. The number of unemployed will decline by 480,000. There will therefore an annual increase in the number of persons employed by 300,000. The annual economic growth rate will be around 1.5% to 2%.

**Figure 3: Projection of the Overall Economic Trend in Germany until 2010**

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• There will be an increase of 6% in the share of nominal GDP accrued by balance of imports and exports of goods and services.

• Macro-economic inflation rate of 1% is expected.258

• For the first time in six years there will be a slight rise in real building investment of around ½%.

• However, this is subject to certain conditions. The Federal Finance Ministry categorizes these into conditions for stronger growth, potential risk conditions and technical assumptions.

**The Conditions for Stronger growth:**

These include:

• Improvement in Global adjustment processes and strengthening markets at the G8 framework.

• Guarantee of smooth interaction of financial, wage and monetary policy at the national and EU level.

• Rapid full implementation of the Lisbon Strategy.

• Strength of education, research, development, and innovative activity.

• Strength of incentives to take up work, flexible labour markets, removal of barriers to employment put by labour and social statutes.

• Bureaucratic reduction.

• Reforms in the field of social insurance.

• Ensuring sustainability and quality of public finance.259

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258 *Projection of the Overall Economic Trend in Germany up to 2010*, www.bmwi.de pp. 1, 6.
Potential Risks: These include:

- Economic shocks leading to significant appreciation of the Euro.
- Further rise in oil prices.
- Inadequate internal vitality in the Euro Zone.
- Continued and renewed increases in inflation in the Euro Zone.\textsuperscript{260}

Technical Assumptions: These include:

- Fundamental conditions for a robust trend in the global economy will be in place. Growth in the world economy will increase in 2006 at about 4.25\%.\textsuperscript{261}
- Global trade will rise at the rate of 7.5\% to 8\%.\textsuperscript{262}
- Global exports will rise at an annual rate of 6\%.
- Commodities available will be sufficient.
- Price of crude oil will not drop below $ 65/barrel.
- European Central Bank’s (ECB) monetary policy will remain oriented to price stabilization. Also, there will be no further changes in the interest rates set by the ECB.
- Exchange rate of the Dollar vs. the Euro will be 1.20.
- Inflation within the Euro Zone will remain below 2\%.\textsuperscript{263}

At the time of this writing, the latest available statistics reveal that the German recovery is set to continue, according to a number of economic research institutes. This finding is corroborated by figures published by the Federal Ministry of Economics in Berlin. Manufacturing production has grown by around 1.9\% compared with August ‘06. In this general upturn, industrial production

\textsuperscript{259} Projection, Op.Cit. pp. 1, 2.
\textsuperscript{260} Ibid.p3.
\textsuperscript{261} Annual Report, 2006,p.93.
\textsuperscript{262} Ibid.
\textsuperscript{263} Ibid.
leads the way with growth of 2.3%. In construction, too, the recovery accelerated with growth of 1.2%. In energy, on the other hand, growth slowed, falling to around 1.9%.  

According to the Institut der deutschen Wirtschaft (IW German Institute for Economic Research), this upward trend will be maintained in 2007. The Frankfurter Allgemeine Zeitung business forecast and EU Chief Economist Klaus Gretschmann have come to similar conclusions. The Federal Ministry of Economics is therefore expecting production to continue at a similar level over the coming months. In this, Germany's external trade is a decisive motor of growth. Germany is profiting from an upturn in the world economy, and exports increased by 9.6% over August ‘06. Five leading economic research institutes predicted the following; the GDP will rise at the rate of 2.4% in 2007 and 2008, which is one point more than 2006. Unemployment will fall by 700,000 to around 3.75 million or 8.7% which is 1.6 points below 2006. This trend will continue to 2008, wherein unemployment will drop below 3.5 million.

Growing production is also having its effects on the labour market. According to the IW, growth in manufacturing is having a beneficial impact on jobs. Furthermore, services in Germany are also doing more business, as reported by the Handelsblatt on 5th October, 2006. For the year 2006, the IW forecasted an increase in employment of 270,000 and in 2007, unemployment could fall beneath 4 million.

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264 Improved Economic Conditions In Manufacturing, www.bundesre.de 10/10/06, accessed same date.
265 Ibid.
267 Ibid.
This growth also includes a strong performance by producers of intermediate goods, which may point to somewhat higher demand in the coming months, as also to an increase in consumption in response to the rise in VAT in January 2007. The upturn also continues at the European level, and the Handelsblatt European business forecast published on 5th October, 2006 predicted economic growth of 2.5% for the Euro zone in 2007.268 Under the circumstances, as mentioned earlier, it is expected that Germany will meet the EU deficit criteria.

The recovery process depends on various factors which are particularly relevant in the current scenario. The Grand coalition comprises the CDU/CSU and the SPD, who are traditional political rivals. Each tries to come up best, trying to upstage the other. All attempts to reform are therefore the result of hard bargaining, sometimes resulting in compromises and even delays which have affected the system. A strong Federal system proved to be an impediment, with reforms it is expected that this problem has been addressed. At the same time, since, the state elections are round the corner (at the time of this writing), the state leaders tend to look at every development from the perspective of electoral gains. Ultimately, the economy works according to the business cycle. Employment goes up or down because of it. The government provides the legal framework in which the employers and employees work. It will make the system easier or complicated. One can lower taxes for businesses hoping they would invest more, can reduce the non wage parts of the labour costs hoping they would employ more, but if they think , they can sell goods and services, then only will they employ more.269

268 Ibid.
269 Interview with Günter Wehmann on 23/20/06 , Consul general of Germany in Kolkata.
The economic and societal balance sheet after more than a decade of unification reveals the effort that has been put in. It has been possible to bring living standards in the Eastern states, to some extent, in line with those in the Western states. A small but efficient industrial sector has developed in various high tech centers called ‘beacon regions’ in the five new Federal States particularly cities like Dresden, Jena, Leipzig, Leuna and Berlin/Brandenburg. The Manufacturing Industry has established itself as a new powerhouse.\textsuperscript{270} But, it appears there are two \textit{Easts} in Germany. The \textit{booming East and the declining East} as a news site reports quoting a respected German newspaper. Cities like Leipzig and Jena are part of the booming east while cities like Ankalam are part of the declining East.\textsuperscript{271}

Long-term assistance measures have started eliminating continued deficiencies, particularly with respect to the East German labour market. It is, however, also obvious that differences and misunderstandings must be overcome in order to realize internal unity.\textsuperscript{272} Perhaps it would be a wise idea to carve out an identity within a broad National Identity in order to stabilize the process of economic unification. Learning from the Indian scenario, the problems in the North-East in particular, it would not be a good move to impose a pan-German Identity. It may spark off tendencies resulting in the two halves parting ways once again. Already, a sense of alienation (or

\textsuperscript{270} \url{www.bmw.de}
\textsuperscript{271} There Are Two Easts In Germany, \url{www.dw-world.de/dw/article/0,2144,2191981,00html} 3/10/06 accessed same date at 1700 hrs.
\textsuperscript{272} Hyde, Rob \textit{History Still Haunts The Former East And West}, \url{www.telegraph.co.uk/news/main-jhtml?xml=/global/2003/12/29, 29/12/03}, accessed on 24/1/04 at 1300 hrs. Also, Nicola, Steven, \textit{Analysis Of Germany At 16}, \url{www.upi.com/International Intelligence/view.php} 3/10/06 accessed on same date at 1200hrs, \textit{Merkel Urges Germany To Recapture Optimism On The 16th Anniversary of Reunification}, 3/10/06, \url{www.iht.com/articles/ap/2006/10/03/europe/EU_Germany Unity_Day.php} accessed same date at 2000hrs, \textit{Merkel Calls For Germany To take Up With the Optimism Of Reunification}, \url{http://nouvelabs.reverso.net/wl/absResult.asp?directions=65544&template=Default&autotranslate=17url=http://permanent.nouvelabs.com/Europe/20061003.FAP5762e.html} 3/10/06 accessed same date at 2100hrs.
what is called Ostalgie) exists\(^{273}\). The creation of a separate economic zone for the states of the former GDR may create a sense of internal unity, foster social cohesiveness and remove the sense of alienation. A watered down version of this is the creation of beacon regions in the five new Federal States. These include the areas around Jena, Dresden, Leipzig, Leuna and Berlin/Brandenburg. These are industrial sectors that have developed in various high tech centers. Once more, it may prove to be an impetus for separation. However, the chances of the two parting ways appears impossible at this moment, given the fact that a long cherished wish of the Germans has been fulfilled. Germany divided will again bring into focus the problems of international security. Strengthening social cohesion and mutual respect and recognizing the efforts made are, therefore, important stepping stones in Germany’s way to bringing unity to culmination. This process demands patience, much mutual understanding and time – probably the period of an entire generation as well as certain hard and revolutionary decisions. It remains to be seen whether this materializes in the long run.