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The new German transfer problem

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Abstract

During the past ten years, Germany has gone a painful downward slope from an economy ahead of most of its European partners in terms of growth to the lowlands of EU's weak economies league. Not coincidentally, unification has been at the beginning of the decline. Instead of generating an economic powerhouse, Germany does not seem to cope with the unification challenges. This paper argues that fundamental constructional flaws in the design of German economic unification which we label the new German transfer problem explain most of the current problems. Based on the analysis we propose a policy shift towards a more active economic policy and argue that the recent EU enlargement process may benefit from the German experiences in that the worst mistakes may be avoided.

JEL classification: P27, P35, E61, E62

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1 Introduction

In the first half of 1990 German unification (henceforth GU) became a more and more realistic perspective. At that time it was widely held that the joint forces of the probably most advanced economies of the Western and Eastern European hemispheres respectively would generate an economic powerhouse hardly be seen before. At the same time the costs of transforming the East German centrally planned economy into a market economy were significantly underestimated. In particular, those who were politically responsible propagated this task to be almost self-financing while the then chancellor Helmut Kohl stated to pay the extra expenditures with petty cash.[1]

As we all know, the overly optimistic assessments were not only mainly politically motivated but also proved to be almost entirely wrong ex-post. After a sharp initial decline of about 50% in 1990 it took the East German economy one more year before it started to grow.[2] During 1992–1995 the recovery had been very fast at about 3–11% annually before the growth rate of gross domestic product (GDP) dropped below the West German rate.[3] This implies that in 1997 the catch-up process of East Germany effectively came to a standstill.

Even worse, nowadays not only the East German economy faces tremendous growth deficits, but the West German economy too has approached the bottom of income growth in the EU. The prevailing view on the causes is a mixture of omitted structural economic and social reforms in the early nineties and of too high costs of productions mainly caused by high wages. In this paper we offer a partly substitutional and partly complementary line of argument that focusses on what has turned out to be remarkably stable during all the very volatile years of unified Germany. This has been the need for almost always rising (gross) transfers from West to East Germany of about 141–227 billion Deutschmark

(€72 – €116 billion) a year. In principle, these transfers are meant to improve the East German economic potential and to bring East German incomes closer to West German levels. Unfortunately, so far the objective has not been met by these means and we maintain it will probably hardly ever do.

Two basic mechanisms drive the results. First, the transfers create an intra-German trade balance that explains why East German production does not develop as was once hoped. The main argument is borrowed from Ohlin (1929) who argued that transfers must not be regarded a one-way issue. On the contrary, the effects of transfers must be judged including their feedback originating at the receiving end. The second argument looks at short-term adverse incentives of transfer payments and thus sheds light on the difficulties of how to return to a long-run sound economic policy. This incentive scheme reminds to the vicious circle due to Myrdal (1957) claiming that causes may have malicious effects wich turn into their own causes again.

To our best knowledge, this kind of arguments is very rarely seen in the literature and political discussion alike. Commonly, the cost structure of the industrial and service sectors are focussed on. Therefore, our policy conclusions differ to a sizeable extent from standard views. Moreover, some similarities of German unification to the EU enlargement as of 2004 give rise to hints that may help avoiding some of the mistakes made in the unification process.

In the remainder of the paper we first repeat in greater detail the argument by Ohlin (1929) and the following discussion. We then apply them to the German situation by providing a thorough account of structure and dimension of the West-East German transfers. Next, the adverse incentives of the transfer mechanism at the short horizon are discussed and confronted with the long-run consequences which seem to take effect now. The German situation is then compared to the EU enlargement and finally, conclusions will be drawn.

2 The German transfer problem revisited

In the aftermath of World War I the defeated Germany was made to pay the victorious allied reparations in terms of money and commodities. According to the Dawes plan the amount due was 1 billion Reichsmark in 1924 rising to an annual 2.5 billion Reichsmark until 1928. Following the account given by Keynes (1929) the Dawes commission divided the problem of the transfer payments into the problem of how to extract "the necessary sums of money out of the pockets of the German people" on the one hand and into the transfer problem of "converting the German money ... into foreign currency" (cf. Keynes, 1929, p. 1) on the other. Keynes pointed out that these two problems may not be regarded independent of one another but that they have to be looked at in terms of an optimal allocation of productive resources.

Keynes' main conclusion was that the reparations could only be paid if there was a sufficient increase in the competitiveness of the German economy compared to the rest of the world. As a result export revenues would rise and Germany would be able to fulfill its obligations. A simple back-of-the-envelope calculation led him to notice that the implied decrease in wages necessary for expanding exports would be so significant that he questioned whether this was "politically and humanly feasible" (cf. Keynes, 1929, p.7).

Counter to Keynes's argument Ohlin (1929) held that Germany would well be able to raise the money by exports without extraordinary wage reduction. The key argument is set in a two-country model where some country A (in Ohlin's example: borrows) receives from country B (playing the role of Germany) the sum of 100 (million marks). Owed to the usual home bias, 80 percent of the sum may be spent on products specific to country A which are not subject to imported rivals. The remaining 20 percent are used to buy goods from abroad, that is, from country B. As a consequence, the trade balance of country A would decline, while it would increase in country B, the donor country. In both countries the corresponding industries will expand at the expense of the remaining trades. That is, in country A the domestic sector will increase and hence command a larger share of resources, while it is the export sector in country B which grows. These two effects will further increase the export opportunities for B going beyond the initial 20 million marks.

Ohlin goes on supposing that price rises for country A's non-traded goods may even magnify the demand for B's products. Taken together, Ohlin concludes "B need not offer its goods on cheaper terms of exchange to induce A to take a greater quantity of them" (op. cit. p. 175). Hence, relating back to Germany, Ohlin held that the "humanly" infeasible decrease in wages which Keynes deemed to be necessary was not at all a prerequisite of Germany's indemnity payments.

Many years after the Keynes–Ohlin dispute Bhagwati, Brecher and Hatta (1983) have shown that the argument of the donor country benefitting from its donation can be taken to the extreme situation where transfers may even turn out immiserising for the receiving country. The mechanism essentially builds on what is known as the terms of trade effect which Ohlin (1929) has already alluded to. Two factors are particularly important for obtaining this result. The first condition requires that a very large share of the receiving country's import demand is satisfied by the donating country's output. More technically speaking, the lower the marginal propensity to consume the export good in the donating country (that is its own goods) compared to the marginal propensity of consumption of the same good in the receiving country the larger will be the positive terms of trade effect for the donor. Second, unless the receiving country does use the donation to develop competitive production structures, it will not reduce its dependence on the donations.

Thus, applying the arguments to the case of GU we may observe that West Germany is in the position of the donating country while East Germany absorbs the transfers. Ohlin argued that Germany in the 1920ies being an international debtor used foreign credits to build up productive capital. These credits even exceeded the annual reparation payments to an extent that Germany in effect run a trade balance deficit. Therefore, Ohlin argued, Germany had plenty of means of production for generating exports and the German transfer problem could in fact become a problem of the receiving countries because demand for German production was created by the reparation payments. At the same time, there was no guaranteed market for the allied countries production. Hence, positive employment and income effects could be expected in Germany, but not as much in the victorious countries.

In a way, German unification was supposed to parallel the situation in that capital imports were meant to increase the East German production capacities. In the light of the 1920ies discussion one natural question therefore is, how the transfer money is spent nowadays.

3 The new German transfer problem

In the following we take a closer look at the structure of the West-East German transfers. Doing so we have in mind that on the EU level intra EU transfers appear to be among the most important issues which have repeatedly to be decided upon. Therefore, the German experience might tell a lesson about what, and maybe even more important, about what not to do.

3.1 Definition of transfers

In what follows the term transfer is used to characterise the sum of resources that is provided by an governmental entity to a receiving entity without compensation. In the context of GU the term transfer has underwent a semantic augmentation that now includes the "indiscriminate summation of all payment flows from the federal government to the East German regions".[4] This augmentation has the unpleasant effect that statistics and figures get blurred in the sense that almost every payment the new Länder receive through the federal budget can be labelled a transfer. This habit makes it very difficult to distinguish between the transfers which are due to unification and those which would also be made under completely different circumstances (see e.g. Burda and Busch (2001)). It is therefore necessary to decompose the gross transfers appropriately.

We will do this in two distinct ways. The first looks at a mainly political aspect. It has to do with the question what part of transfers can be understood as extraordinary aid of the West to the East as compared to the ordinary government activity. The second distinguishes between the principal uses of the transfer. This second approach will then be used to asses some aspects of the effects the transfers have.

3.2 Transfers by motivation

The standard headline figures of gross transfers from West to East Germany are presented in table 1.[5] If anything, these figures demonstrate that the level of payments is not negligible. In terms of German GDP they turn out to represent roughly 4% throughout the 1990ies. Taking these figure at their face value would, however, highly overestimate the government budgets' contribution to overcoming the East-West German disparities.

This is because table 1 lists the gross transfers as the sum of what can be called general and special transfers respectively. General transfers are the share that is due to the larger geographical area and increased population after unification. They would, in principle, also be paid to the old Länder in line with legal requirements and simply represent the normal activities and tasks allotted to the government and its agencies. For example, road building and maintenance, administration costs, defence, border control, etc. belong to this category. In other words, these expenses are not subject to a discrete choice of the federal government unless unification would be reversed.

The same applies in principle to yet another and even more important category of general transfers which run under the heading social security provision.[6] They are necessary to cover the federal deficits of the unemployment insurance, health insurances, pension funds.

Table 1 about here.

These general transfers have to be distinguished from those which are especially designated to promote East Germany. The Halle Institute for Economic Research (IWH) has exemplarily calculated the size of these payments for the years 1997 and 1999. Three principles have been applied. First, the gross transfers within the federal budget were analyzed if they were due to legislation only introduced for East German issues. This applied to approximately one third of the expenditures given in the fourth row of table 1. In the next step, each position within line four was set in relation to its total in the budget and then judged according to the share of East Germany on the total population. Here, more than one half turned out to be over-proportional, while one fifth was under-proportional. The first group was mainly made up of funds made available to early retirement schemes while the latter included positions like promotion of research. In the last step it was checked whether the results of step two are based on (non-legislative) measures especially taken for East Germany or not. This way, investment in road construction or waterway development and house building dropped out because they belong to the normal federal activities which just happen to be currently exercised in East Germany more heavily.

In effect, the volume of the thereby identified special transfers are far lower than the general transfers. These two figures show that the political discussions very often focus on misleading information when it comes to the calculation of the unification costs. The results are even worse, when the transfers are broken down in those components which are not generally assigned to raise East Germany's well being, but also in those which improve the economic potentials. Therefore, we will shed some light on this aspect next.

3.3 Transfers by utilisation

During the catch-up period, the East German economy would have to generate a much larger per capita income growth compared to West German growth if it was to approach a self-sustained standard of living close to the West German levels. Therefore, the speed of the catch-up will also decide about the necessary levels of aid and support. Ideally, the structure of the running transfers should therefore aim at accelerating economic performance in the first place. Unfortunately, this cannot be observed.

The previous section held that the lion's share of transfers cannot be considered especially designated to East Germany. The immediate (almost) complete integration of East Germany in the legal, federal political and social systems of Western Germany has to be considered responsible for this apparent defect. The same reason leads to the observation that despite the huge headline figures there is only little leeway for actual investment in the East German economy. In other words, the source of transfers determines their final utilisation.

Zooming in on the separate transfer positions gives the following picture. The largest share of approximately 50% can be considered "social transfers". They include direct subsidies for rents, child raising, unemployment benefits, social benefits, balance payments for social security systems, etc. The second largest portion are the so-called uncommitted transfers. Unlike their label suggests, the communities which are at the receiving end, cannot freely decide about their use. Instead, these payments are thought to balance the local budgets which are under-funded due to poor economic performance. Thus, the local administration and part of the infrastructure are their main beneficiaries. A more detailed account cannot be given. The category ranking third is the economic infrastructure in a narrow definition. It comprises construction and improvement of streets and motor-ways, railways, company access points to motor-ways and railways, communication lines, waterways and similar items. Finally, business development in a general sense make up the last major group to be named. They encompass subsidies for research and technology, equity capital, establishing companies. Further payments cannot be sorted in either of the positions due to insufficient information.

Table 2 puts the several categories in relation to the total gross transfers. Judging by the weight of their share, it is clear that the means which directly aim at closing the economic gap between East and West Germany are rather small. In fact, most of the transfers are directly supporting consumption but not the build-up of the economy. Instead, only roughly 20% (about €14 – €20 billion) serve the latter purpose.

Table 2 about here.

3.4 Determinants of level and duration of transfers

It should be recalled, that the transfers were intended to promote the fast adjustment of the living conditions of the East German population to West German standards. Thus, three parameters determine the transfers necessary. These are the initial relative positions, the desired degree of convergence and the desired speed of adjustment. If anything, in the case of Germany only the first of these was exogenous in 1989.[7] After unification in October 1990, the second parameter was fixed by the constitution and regarded more or less 100%. Finally, the threat of migration from East to West implied that the speed of adjustment would have to be as fast as possible. Closing the income gap was considered most effective for restricting migration.

To achieve the latter the government aims at providing sufficient income transfers. This is the ultimate reason for the large share of social benefits transfers reported in table 2. For example, in 1991 the difference between gross domestic product and national expenditure amounted to more than €80 billion. This figure increased to €107 billion in 1995 and remained at this level until the end of the last century. This production gap was closed by state transfers and capital imports. Obviously, a less ambitious objective in terms of speed of adjustment would have left more leeway for investments in business development. On the other hand, a less ambitious objective would have called for less generous political promises during the run-up to federal elections and a slower path for the unification strategy. Both of them were difficult to accomplish considering a very mobile East German population and given the political decision process.[8]

Looking at the results so far, it appears that the need for transfers has not decreased nor can it be expected that it will decrease. It wont do so because the economic catch-up process has come to a standstill and recent statistics even indicate a widening gap between

East and West German economic performance during 1998 – 2004. In the following we are going to provide arguments that try to establish that the transfer problem is at the core of the poor East German economic performance.

3.5 The *circulus vitiosus*

So far, we have seen that quite contrary to what one would have found advisable, the use of transfers has mainly been for consumption purposes. We now establish that on top of that a significant share of the transfers are used to consume the donator country's output.

Estimating the dependence of East Germany on West German products is not an easy task since no proper statistics exist. The only feasible way is therefore an indirect one which uses national account data for approximating the relevant figures. We combine the information of the export-import statistic of East Germany with national (i.e. East German) expenditures. As noted before, ever since unification East German 'national' expenditures have exceeded its GDP. This gap has constantly been filled mainly by transfer payments. We are now interested in the origin of products which have been consumed in excess of domestic value added. Therefore, we discount from this gap the number of imports and add the amount of exports. This figure equals the sum of all goods and services dissipated in East Germany which cannot be of East German origin. Since goods from abroad are subtracted, this figure is a lower bound for West German products being consumed in East Germany. It can only be a lower bound, since further goods can be bought in West Germany in exchange for East German products. Setting this number in relation to the gross transfers gives thus a rough estimate of the propensity to consume West German products for a unit change in transfer income.

Looking at actual data of 2003 figures, net imports to East Germany from abroad were €-8.7 bill. (all East German data excluding Berlin) and gross transfers were €116 bill. The trade balance deficit of East Germany versus West Germany can be given as the difference between national expenditures and net import. National expenditures were €-68.77 bill. and hence the intra–German trade deficit was about €77.5 bill. Setting this figure in relation to the gross transfers implies a propensity to import from West Germany of 2/3. In 1991, the year for which earliest possible data is available the ratio was 1.2 and it fell below one in 1999 for the first time ever since unification.[9]

By any standards two-thirds still is a very high number implying that more than sixty cent of every Euro which is transferred from West to East Germany is spent on West German products. The number would even be in line with the possibility that the terms of trade effects of the transfers may be even positive from the West German point of view. While one plausible explanation is certainly taste, it is hard to imagine that this explanation suffices. Therefore, we try to give some tentative, structural reasoning.

First, even before unification took place the privatisation agency managed to sell the (monopolistic) state-owned retail chain to a few West German retail companies such as REWE, Tengelmann and others thereby essentially also granting local monopolies. This ensured uncontested, immediate and full access for West German companies to the East German market. The same could not (and partly still cannot) be observed for the opposite direction. Second, one result of the privatisation was that only roughly 5% of the productive capital remained under East German control, approximately the same amount was sold to foreign companies, the vast majority, however, went into West German hands.[10] In this situation, the decision about how to satisfy transfer financed demand was to either increase capacity utilisation in the West, or to install new and to improve existing capacity in the East. To too large an extent the first option appeared more profitable. It did so due to speedy wage increases to up to 86% in terms of the West German levels until 1998.

We can thus conclude that on the one hand transfer payments are mainly used not for investment purposes but for consumption and that on the other a significant share of the donations is channelled back to the donors. This feedback triggers positive employment and income effects. Hence, the larger the transfers the longer they will have to be paid and the more funds are available to finance them. Moreover, there exist ceteris paribus positive incentives to maintain the transfer mechanism because it enhances consumption and hence welfare in East *and* West.

In a nutshell, transfers have to be paid because there are transfers paid and transfers are paid because they benefit both, donor *and* receiver. Such a situation where the cause has an effect that is its own cause has been characterised by Myrdal (1957) (among others) as a *circulus vitiosus*. In the case of Germany, the large transfer means led to a jump in output, number of jobs and firm profits in West Germany.[11] This additional income raised tax revenues and thereby generated the means for further transfers. Initially, according to Müller (2000) the extra West German income can even be considered larger than the necessary transfers. This mechanism of cause and effect with the effect turning into its own cause works until today. The transfer payments still depend on the additional income in West Germany which is at least partly generated through the transfer regime. Thus, the circle is closed.

Referring back to the Keynes-Ohlin debate in the 1920ies, Ohlin claimed that Germany was not only a donating country that partly created the market it needed for financing its transfers, it had also been a market for the capital products of the countries it was transferring money to. Those capital imports further improved Germany's production and marketing opportunities and contributed to lifting the reparations' burden. The contrast to the current situation could hardly been any stronger. West Germany does not serve as a market for East German products to any reasonable extent, while East Germany satisfies its demand by West German products. Further, transfers serve mainly consumption but not the improvement of East German production and marketing opportunities. Taken together, the current transfer mechanism does not lift the transfer burden, it does contribute to its perpetuation instead. This is what we call the New German Transfer Problem.

In the context of EU enlargement, it has to be made sure that such a situation should be avoided. The German experience might help to succeed in that.

3.6 Problem alleviation

The logic of the *circulus vitiosus* also paves the way to its destruction. The first type of measures we propose is concerned with the parameters of the determinants of the transfer volumes. The second relates to the mechanism of the cycle.

Although the exogenous factors such as privatisation policy, propriety structure of productive capital and distribution channels cannot easily be changed in Germany, one should keep their role in mind with respect to implications for EU enlargement. In the German case a more diverse, international and hence more competitive ownership structure in East Germany would it make more likely that the link between transfers and profits is provided through production in East Germany. The appendix shows in a simple and static model framework that there is an immanent incentive not to let East German consumption be satisfied other than by West German production payed for by transfers. Diversity in the origin of consumed, or rather purchased goods in East Germany would help overcoming these incentives.

Further, the desired degree of adjustment of the East German standard of living to the West German level could be lowered. As it has been argued before, this question touches very delicate issues. For example, the then West German government with chancellor Kohl managed not only to be elected and re-elected in 1990 and 1994 respectively promising to keep this parameter at its 100% maximum level. It also managed to neutralise any appreciable East German self representation with the argument that only West German proficiency and expert knowledge could ensure fast adjustment.[12] However, irrespective of the distribution of political power and other aspects, migration poses a permanent threat to any significant deviation from the 100% benchmark or slow-down of the adjustment process which renders this approach rather infeasible.

Responding to the rising budget deficit and federal debts, every government since 1990 has chosen to redesign the social security network (eligibility for unemployment benefits, health care, social benefits). This can be understood as a general reduction of the standard of living which also reduces the absolute amount necessary to establish equality between East and West (see also Busch (2002b) on the shifts in policy objective due to the failure of economic policy). Our results suggest, however, that lower wages and social security provisions while stimulating investment and raising incentives to supply labour, might be less efficient tools than commonly thought (see e.g. Sinn and Ochel (2003)).

The second type of solutions is therefore related to the mechanisms of the *circulus vitiosus*. This vicious circle can probably not be considered an infinitely self-sustaining mechanism. This is because not all West German extra income generated by the transfers to the East can be recovered as taxes. In fact, the recent decrease of the propensity to import West German products will temporarily magnify the budgetary problem because it implies that given higher productivity in the West the tax base on which transfers are raised deteriorates.

Second, as research implies, Keynesian-style politics such as the transfer mechanism may only be effective in the short-run anyway. In the medium to long–run rational individuals will expect higher tax rates and thus counter extra government spending by higher savings. On the contrary, some case studies on fiscal consolidation in western European countries even find positive long-run effects of sound fiscal politics on the growth rate (see Giudice, Turrini and in t' Veld, 2003).

Looking for another road to a solution leads back to the composition of the transfers reported in section 3.3. It was shown that only 20% are used for the improvement of the economic potential in East Germany. Available means could be redirected from infrastructure investments to supporting industrial R&D, for example. A recent survey has shown that the East German potential in that area where government programs seem to be effective has not been tapped at all. The research intensity reaches only 3/1000 employees compared to a 9.5/1000 employees in the West (figures for 2001 by Ragnitz, Ammon, Brenke, Komar, Pfankuch, Schneider and Stierwald, 2004, p. 24).

Nevertheless, as long as the value added in the East remains below national expenditures, the need for transfers remains. It appears natural to consider radical measure which go beyond what has already been tried. For example the system of taxation could locally be changed and simplified. This opportunity was missed during unification, because it affects constitutional issues. Formal, maybe even legal rules could require private companies as well as government agents to purchase East German products when they represent a reasonable substitutes for West German ones. Second, federal debt rules might be suspended provided that there is some assurance that the means are used successfully. Thirdly, as theory and experiences elsewhere suggest, a credible fiscal policy approach of either kind should be implemented in order to restore consumer confidence and expenditure planning reliability. This way the pronounced weakness of consumption in Germany can possibly be overcome. A likewise legally and politically challenging means to this end could be the use of elements of direct democracy for decisions with strong budgetary and hence taxation effects. This has proven very efficient in countries like Switzerland, for example. Finally, the new market opportunities in the enlarged EU should be seized to reduce the production gap.

In the next section we are going to outline, why some of the trouble Germany has been facing might be on the agenda of EU enlargement.

4 German unification and EU enlargement

The usual way to calculate the number of EU enlargements is to sum the steps in 1973 (Denmark, Ireland and Great Britain), 1981 (Greece), 1986 (Portugal and Spain) and 1995 (Austria, Finland and Sweden). None of these can, however, be compared to the year 2004's move. The simple reason is that none of these countries compares to the ten new members in terms of size and population, none of them has belonged to the former Soviet block, neither has any of them experienced the transformation from a centrally planned economy to a market economy. It might therefore appear self-evident that there has been no comparable situation so far. This however, could also be regarded a misapprehension since in 1990 the two Germanies became one country again. This implied not only an extension of the EU area but also the need to integrate a former planned economy into the (West German) market economy.

Apart from some historical common features of East Germany and Eastern Europe, a few more similarities can be recognised. For example, quite like in the case of German unification the new members join a federal structure, the proportion of the population of the new and the previous members is in the same range of 28% (GU) and 20% respectively, the standard of living in the then German Democratic Republic was approximately 40–50% that of West Germany and it is in the range of 27% (Latvia) to 68% (Slovenia) in the new EU member states compared to the EU-15 countries.[13] Furthermore, the same principal hopes and fears are attached to the enlargement processes. On the one hand the accession countries look forward to a fast catch-up in terms of economic power and eventually standard of living while the previous members fear competition on labour markets, and an increase of their contributions to the EU budget.[14] On the other hand, the prospect of conquering new markets for the products of the EU-15 economies is met with some degree of reservation on part of the accession countries since full access to the EU-15 market is not granted from the very beginning. The same could be observed after GU where access of East German producers to West German markets was aggravated by the existing market structures in West Germany and technical barriers to trade.

There are, however, also a number of distinct characteristics. For example, in contrast to GU, the transformation into a market economy has already taken place in the accession countries before they join the EU. Also, the degree of autonomy of the new EU members is much higher than it was for the German new Länder, which ensures a forceful representation of their self-interests. Moreover, while the East German federal states, the Länder, were immediately more or less fully integrated in the legal, social and political system of West Germany, a similar degree of integration is not intended with EU-enlargement. Likewise, the composition of the EU is culturally much more heterogenous (within and between the EU-15 and the accession countries) than it was within Germany. This will have implications for the readiness to share the costs and benefits of EU enlargement and for labour mobility alike. Finally, unlike in the GU case, the EU is faced with a hard budget constraint that sets an upper limit to all extra expenditures due to enlargement.

4.1 Implications for the EU enlargement

The dissection of the German version of the *circulus vitiosus* leads directly to the implications for EU enlargement. In the light of the German experience, the factors that might becloude the prospects of a successful integration of the accession countries are:

1. Asymmetric market access: The established EU member states do not grant full access to their markets for agricultural goods. At the same time, the new EU member states do have to adopt EU standards for technical goods and processed food. Where this adaptation has not yet been accomplished Eastern European companies cannot export to community members.

2. Regionally unbalanced FDI: Foreign direct investment by EU enterprises in industry and service companies of the new EU members may shadow the pattern which has been observed in East Germany. If so, the likelihood increases that demand may be satisfied by imports from the investor's country of origin production.

3. Exclusive trade links between EU-15 and accession countries: Entering EU reduced trade barriers to the fellow EU member states but raised or increased barriers to non-EU members. This may result in loss of traditional markets.

We would like to add the following comments. The seizure of the markets is a pre-condition for optimising the production capacity portfolio. Even if the less developed region has comparative advantages in terms of for example labour costs, there is no need to build up production in those regions if sales remain satisfactory.[15] Moreover, as explained the accession countries unfortunately have only restricted access to the EU-15 countries' markets.[16] Therefore, the new members will necessarily have fewer opportunities to generate income. One year after the EU enlargement it seems that at least in terms of trade figures the GU history may repeat itself. During this first year the aggregate current account balance of the new member countries vis-á-vis the EU has turned significantly negative. In 2002 the deficit was €2'324 million turning positive in 2003 (€1'352 million) before bouncing back to an impressive €8'024 million deficit according to Gabriesch and Kämpfe (2005). Of course, the optimistic interpretation is that these countries catch up with respect to production capital and are going to use the newly installed equipment for later production. However, only time will tell whether this is actually true or if the other EU countries simply use the new markets for selling their stocks of final goods.

The second and third arguments in the list could appear surprising. However, as has been argued before, the more control the EU-15 members have about production and distribution in the accession countries the more efficiently they can channel the transfers into their own balance sheets. The more, however, non-EU members benefit from possible transfer financed consumption the less successful this mechanism will be.

Further, there are factors that have the potential to limit the need for transfers in general.

1. No overly optimistic expectations about speed, degree and hardships of adjustment

2. Restriction of migration

3. EU aid if there was any being (almost) exclusively directed at business development. Compensation in form of guaranteed purchases or property transfer must not be allowed.

With respect to the first rule, in the run-up to EU-enlargement referenda promises have been made which sometimes remind to German unification. In particular, potentially negative effects have hardly been seriously discussed. The second should make sure that the threat of migration does not force transfers for consumption. Third, financial support must be provided only to support economic growth in the accession countries. The benefits arising from the division of labour and larger markets should be considered sufficient for the EU-15 member states. Moreover, it should be remembered that Germany stumbled into a long lasting recession after the initial unification boom. By now, the burden of the unpleasant effects are felt in the whole of Germany. Growth rates are among the lowest in Europe, unemployment is at record levels and the public deficit is rising. Therefore, it is in the best interest of the whole EU-25 not to get trapped in the *circulus vitiosus*.

5 Conclusion

German unification can be considered an informative experiment for integrating an economically less developed country into a modern Western economy. In the course of unification expectations were pitched at too high a level and the difficulties were not only under-estimated but even amplified by the integration policy. This led to a situation were huge transfers from West to East became not only imperative but even turned into the cause for their continued necessity. In contrast to the only seemingly parallelling experience of the 1920ies we call the current troubles the New German Transfer Problem.

An answer to its challenges is not easily given. It appears very likely that it may invoke fundamental transformations of the legal, social and political system in Germany than it is likely to maintain the status quo with only minor changes. The German government might be well advised in temporarily promoting East German products and marketing chains even if this may be at odds with text book standards. Further, significant investment in R&D be it at the expense of infrastructure expenditures or even higher budget deficits appears to be advisable. In addition the sooner a coherent approach is implemented the sooner consumer confidence will return and help to improve economic performance at large.

The situation of the EU accession countries can at least partly be compared to East Germany before unification. This raises the question of how to avoid the adverse effects of a well-meant transfer strategy. The answer is to call for a business development oriented aid policy, the complete opening of the West European markets, restrictions on East-West migration, realistic expectations about the duration of the adjustment and a competitive, diversified propriety structure of the East European means of production and distribution channels.

Wherever the EU administration or the accession countries still have the opportunities to move in these directions, they should seize it. It should provide a good chance to avoid the German mistakes to the benefits of the whole EU.

A Appendix: A model for static comparison

The following exercise shows that under reasonable assumptions and for a limited time horizon incentives exist which promote the desire for keeping up the level of West-East transfers. It can be concluded that these incentives are larger the larger the share of East German consumption is satisfied with West German production. In the longer run however, the transfers cannot be paid without increases in the government debt which very well reflects the current situation and likely invokes a fundamental change in policy. Thus, the following must not be confused with a fully grown rational expectations model that captures as many aspects of an economy as possible. Instead, it is only designed to highlight a single aspect of the transfer problem.

We use the following definitions for our model. Let Y be the West German output, C_E and C_W the consumption in East and West Germany respectively, T is the sum of transfers, τ the tax rate, γ the macro-economic multiplier and α is the share of C_E which is satisfied by Y. We thus have the following system of equations.

$$Y = Y(0) + (1+\gamma)\alpha C_E \tag{1}$$

$$C_E = T = \tau Y + B \tag{2}$$

$$C_W = (1-\tau)Y \tag{3}$$

where $Y(0)$ denotes the autonomous production in West Germany that would occur without transfer payments and B are government bonds.

After re-arranging the terms in (1) to (3) we find

$$\begin{aligned}
Y &= \frac{1}{1-(1+\gamma)\alpha\tau}Y(0) + \frac{\alpha(1+\gamma)}{1-(1+\gamma)\alpha\tau}B \\
C_E &= \frac{\tau}{1-(1+\gamma)\alpha\tau}Y(0) + \frac{1}{1-(1+\gamma)\alpha\tau}B \\
C_W &= \frac{1-\tau}{1-(1+\gamma)\alpha\tau}Y(0) + \frac{\alpha(1-\tau)(1+\gamma)}{1-(1+\gamma)\alpha\tau}B
\end{aligned}$$

which for $\tau \leq 1$ and $\alpha \leq 1$ only requires $(1+\gamma)\alpha\tau < 1$ and implies[17],

$$\begin{aligned}
\frac{\partial Y}{\partial \alpha} &= \frac{(1+\gamma)\tau}{(1-\alpha(1+\gamma)\tau)^2}Y(0) + \frac{(1+\gamma)}{(1-\alpha(1+\gamma)\tau)^2}B > 0 \\
\frac{\partial Y}{\partial \tau} &= \frac{(1+\gamma)\alpha}{(1-\alpha(1+\gamma)\tau)^2}Y(0) + \frac{\alpha^2(1+\gamma)^2}{(1-\alpha(1+\gamma)\tau)^2}B > 0 \\
\frac{\partial C_E}{\partial \tau} &= \frac{(1+\gamma)\tau^2}{(1-\alpha(1+\gamma)\tau)^2}Y(0) + \frac{(1+\gamma)\tau}{(1-\alpha(1+\gamma)\tau)^2}B > 0 \\
\frac{\partial C_E}{\partial \tau} &= \frac{1}{(1-\alpha(1+\gamma)\tau)^2}Y(0) + \frac{\alpha(1+\gamma)}{(1-\alpha(1+\gamma)\tau)^2}B > 0 \\
\frac{\partial C_W}{\partial \alpha} &= \frac{(1-\tau)(1+\gamma)\tau}{(1-\alpha(1+\gamma)\tau)^2}Y(0) + \frac{(1-\tau)(1+\gamma)}{(1-\alpha(1+\gamma)\tau)^2}B > 0 \\
\frac{\partial C_W}{\partial \tau} &= \frac{\alpha(1+\gamma)-1}{(1-\alpha(1+\gamma)\tau)^2}Y(0) + \frac{\alpha(1+\gamma)(\alpha(1+\gamma)-1)}{(1-\alpha(1+\gamma)\tau)^2}B < 0.
\end{aligned}$$

Thus, quite reasonably taxation hurts West German consumption while it enhances West German output and East German consumption. In contrast, the effect of α is unambiguous. The more East German consumption is satisfied by West German production the higher are C_W, Y and C_E. Moreover, a politician would have an incentive to establish a larger α at the expense of τ in order to raise East German support without loosing West German voters. On the other hand, for $\alpha = 0$, nothing extra would be gained by West Germans that a simple tax financed Keynesian stimulus would not yield anyways.

What is missing though in this analysis is the feedback from East German production. The most likely effect certainly is some kind of crowding out meaning that East German products are displaced by West German products. However, given that the most important decisions are taken in the West this feedback can be considered irrelevant at least in the short-run. Finally, since our model is static, no conclusions can be drawn for the situation in the long-run. It seems plausible however, that over a longer horizon financing this Keynesian style politics will be impaired by price rises, windfall gains, the Lucas critique, and too large a government debt. In sum, although our small toy model cannot capture every aspect, it shows that there are arguments counter to the simple view that transfers are supporting East Germany in the first place and need to be reduced quickly.

Notes

[1]The unification spared expenditures which were used to cushion the effects of the division e.g. in the West-East border regions.

[2]On the reasons for the decline see e.g. Sinn and Sinn (1992).

[3]See Busch (2002a), Table 4.1-1.

[4]Federal government: Annual report of the federal government on the state of German unity 1999, Berlin 1999: Bundesregierung (1999)

[5]This section and the following is largely based on Busch (2002a).

[6]It does so in principle only because the payments could only be reduced if provisions were lowered in East and West Germany jointly.

[7]The introduction of the Deutschmark in July 1990 implied a 300–400% appreciation of the local currency. This and the start of the privatisation led the East German output to decrease even further from an initial level of about 50-60% of West German per capita figures.

[8]Despite all efforts, more than 2 million people moved from East to West Germany between 1990–1999. Approximately 1 million migrated from West to East.

[9]Very recently, Lehmann, Ludwig and Ragnitz (2005) put the *extra* production in East Germany induced by transfers to roughly 58 percent of (their measure of net) transfers which corresponds to 35 percent of gross transfers.

[10]Statement of the federal government in Bundestagsdrucksache 14/2622, 31 December 2000, p.1.

[11]See e.g. Müller (1996), Busch (1998).

[12]Ironically, one argument to prove this proposition was the migration of East Germans to the West which could not be stopped by the East German government. In 1998 net migration to the West started to rise again.

[13]source: European Union: http://europa.eu.int/comm/publications/booklets/eu_glance/14/txt_en.pdf (Europe in Figures).

[14]Süddeutsche Zeitung, December 17, 2003: Prodi: Wer anschafft muss auch zahlen.

[15]New plants require investments which could be saved if competition is not a threat.

[16]Even worse, this applies especially to those products where the accession countries typically have an comparative advantage, like unprocessed food.

[17]For example, let $\tau = .04$ be the share of GDP income transferred to the East, then the limiting α ($\gamma = 0$) would be around 25%. Thus, at least one fourth of East German consumption would need to be satisfied by transfers.

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Table 1: Gross general and special West-East German transfers 1991–2003 (bill. €)

year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
gross[1)]	70.66	85.28	95.41	96.12	91.78	92.70	90.65	89.63	100.0	102.0	105.0	110.0	116.0
% of GDP	3.62	4.15	4.61	4.40	4.02	3.98	3.74	3.57	3.71	3.69	3.86	3.89	3.90
fed. gov.[2)]	38.19	45.71	58.75	58.75	69.43	71.12	67.03	67.54	74.1	75.0	80.0	82.0	83.0
special[3)]	n.a	n.a.	n.a.	n.a.	n.a.	n.a.	21.27	n.a.	24.03	25.0	24.0	24.0	24.0

Sources: Federal ministry of finance, Federal ministry for economic affairs, Halle Institute for Economic Research (IWH) Press Release 21/2003, Deutsche Bundesbank, other, own calculations.

1) including transfers by social security system (health insurance, pension), by West German Länder and communities. For 1991-1994 also including budget of East German industry holding (privatisation agency) Treuhandanstalt and fund "German Unity", excluding EU payments.

2) Federal government: general transfers without revenues raised in the East German Länder

3) special transfers corrected for items not especially assigned to promote East Germany

Table 2: Transfer utilisation 1991–2003 (shares) [1)]

year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000 – 2002	2003
infrastructure[2)]	12.3	9.9	8.6	10.0	13.1	13.1	13.1	12.8	12.5	n.a	13.0
business development	2.5	4.8	7.6	7.5	8.0	6.9	6.3	6.3	5.8	n.a	9.0
social benefits	45.4	54.0	54.0	53.8	49.4	50.3	50.0	49.4	51.7	n.a	45.0
u.c. transfers[3)]	28.1	22.4	20.1	19.5	23.8	24.3	24.8	25.6	24.4	n.a	21.0
other[4)]	11.7	9.0	9.6	9.2	5.7	5.4	5.8	5.8	5.6	n.a	12.0
sum	100	100	100	100	100	100	100	100	100	n.a	100

1) total including EU payments (appr. €2.5-3.5 billion), sources: Federal ministry of finance, Federal ministry for economic affairs, Halle Institute for Economic Research (Ragnitz, Dreger, Komar and Müller (2000)), IWH Press Release 21/2003, own calculations.

2) businesses relevant infrastructure

3) Uncommitted transfers: payments for unrestricted use by the receiver.

4) Transfers for whose use only insufficient information is available.

Table 3: Annual percentage change of real GDP in East and West Germany 1993 – 2004

year	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
East Germany	11.9	11.4	4.5	3.2	1.6	0.4	2.6	1.3	-.3	.7	0.2	1.5
West Germany[1)]	-2.3	1.3	1.4	0.5	1.4	2.2	2.0	3.1	1.0	0.0	-.2	1.6

Source: Federal Statistical Office, August 2004, February 2005.

1) Including Berlin