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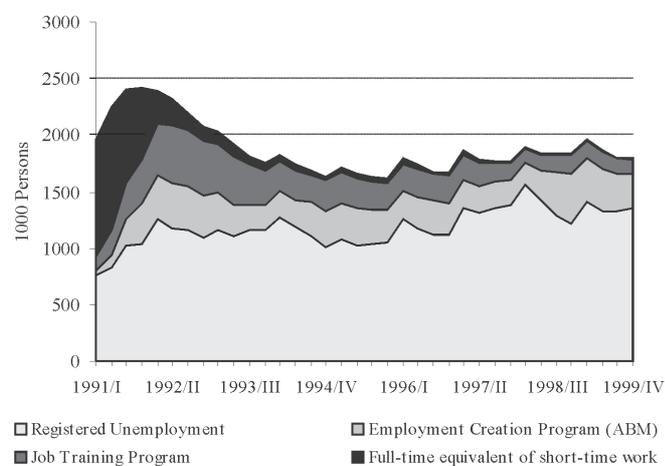
CONSIDERING THE FUTURE OF LABOR

## Ten Years after Unification – Lessons for the East-German Labor Market

A decade after unification, Germany is still struggling with the integration of the former eastern command economy into the social market-led economy. Hopes that the economic transformation could be completed fast and smoothly were soon disproved as overly optimistic. One of the most striking features of the eastern economy is the persistence of very high levels of unemployment. Since the economic catch-up process has slowed down in recent years, an employment upswing seems unlikely in the medium-term future. A current IZA study surveys the emergence and persistence of unemployment in East Germany and discusses whether there are promising policies to reduce what appears to many as an intolerably high number of displaced workers. For a detailed account see: Holger Bonin/Klaus F. Zimmermann, *The Post-Unification German Labor Market*, IZA Discussion Paper No. 185 (forthcoming in: R. T. Riphahn/D. J. Snower/K. F. Zimmermann, *Employment Policy in Transition: The Lessons of German Integration for the Labour Market*, Heidelberg 2000).

The transformation of the eastern command economy has by necessity affected the level of employment negatively. The artificial full employment policy of the GDR made state-owned companies and public administration overstuffed. The monetary union at parity forced the eastern economy into competition with the world market at a high real exchange rate, leaving many East Germans in economically non-viable jobs. Immediately after unification, a complete collapse of employment was avoided only with substantial financial transfers from the west. As soon as the eastern economy entered into the recovery phase of the output j-curve, the contraction of employment slowed down. However, when Germany as a whole entered into a recession, eastern unemployment went up again. The recent economic upswing has not relieved the eastern labor market. The rectification of structural distortions has rather shortened employment opportunities further. By the end of 1999, registered unemployment in the east exceeded 19 percent of the labor force.

The Structure of Unemployment in East Germany, Period 1991 - 1999



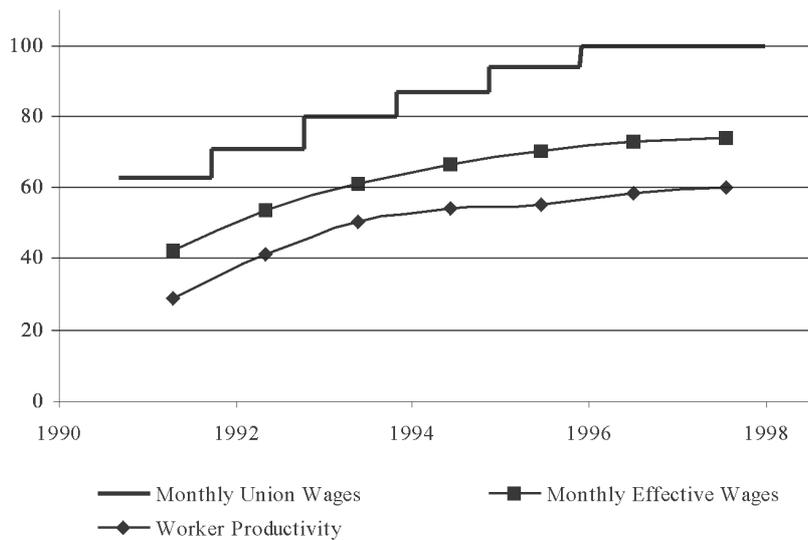
Source: Sachverständigenrat, Yearly Report, various issues.

The formidable level of unemployment was a traumatic experience for many East Germans. To avoid social tensions, extensive work creation measures were introduced. In the first period after unification, when creation of fresh employment was expected to start before long, policies aimed at stretching out the reduction of obsolete jobs. The *Treuhandanstalt*, the central privatization agency, often negotiated job guarantees with private investors, which ensured at least temporary job stability. In the first half of 1991, government authorities subsidized up to 2 million workers on short-time work. When most of the short-term workers became unemployed soon after, the emphasis of labor market policy shifted to job creation programs (ABM) and training schemes. Although the eastern labor force was seen to exhibit a high level of formal qualification, western-style retraining was expected to boost labor market opportunities. When the demand for specific qualification declined, the share of those unemployed involved in training programs in the east gradually converged to the western level. Publicly financed work programs, by contrast, remain a popular policy to cut registered

unemployment. In 1999, 18.9 percent of the unemployed in the east benefited from ABM, compared to only 2.7 percent in the west.

Empirical studies have not reached a unanimous answer to the question whether active labor market policy has been effective in promoting regular employment in the east. In general, schooling programs seem to have supported reemployment more successfully than job creation programs. One standard explanation is that participants search less intensively for regular employment. In addition, ABM measures, which often support labor-intensive types of work, do not always meet with the demand on the labor market. Therefore, participation in ABM may give a negative signal to potential employers. The weak impact of public job creation programs on individual employment performance casts doubt on their role as the central tool of active labor market policy in the eastern states. This does not say that ABM is not justified for social reasons. In fact, it appears that in the eastern states active labor market programs are used as a social policy instrument to cushion the burdens

**Union Wages, Effective Wages and Labor Productivity in East Germany  
(Index West Germany = 100)**



Notes: Productivity measured by gross product per worker in the production sector. Monthly effective wages in the production sector. Monthly union wages in the metal and electrical industry.

Sources: *Sachverständigenrat*, Yearly Report, various issues; German Statistical Yearbook, various issues, Boje/Schneider (1995).

of long-term unemployment. In Germany, the long-term unemployed typically descend on the transfer income ladder, from unemployment support to unemployment assistance to social welfare. This process is slowed down in East Germany by using active labor market policy to perforate the unemployment period. Since the interruption of unemployment establishes new claims on unemployment benefits, the perforation strategy postpones the gradual decline in unemployment transfer levels for the long-term unemployed.

In view of the importance of short-time work and training and employment creation programs in the east, the officially published unemployment figures cover the actual size of the employment problem only vaguely. In 1999, considering unemployment hidden by active labor market policies, actual joblessness in the east was 40 percent higher than registered unemployment. Besides, commuters, out-migrants, and early pensioners driven out of the labor force have relieved the eastern working-age labor force by 1.3 million persons. Thus, shortage of employment in the east has affected more than 35 percent of the working-age population.

While the level of unemployment seems to be stabilizing on a stubbornly high level, the structure of employment in the east continues to differ significantly from that in the west. The economically backward GDR had maintained the structure

of an advanced industrial society, so that the employment share of agriculture and the government and producing sectors was larger, that of trade, transportation, and services smaller than that in the west. After unification, the share of agriculture and the producing sector declined rapidly (the latter below the West German level), while the service sector started to catch up to western standards. Still, convergence with western sector patterns is far from complete. The eastern government sector, which is not exposed to competition, remains overstaffed. What seems more worrying with regard to the future employment outlook is the fact that both the trade and transportation sector and the service sector have not caught up to the west. Thus there appears to be little evidence that the eastern states will be able to leave West Germany behind as a modern service economy after completion of the transformation process.

With regard to the occupational position of the gainfully employed, there is little evidence as well that employment patterns are going to converge soon. Two trends may be particularly relevant for the eastern employment prospect. First, self-employment, which started from a very low level when the GDR command economy collapsed, is substantially less frequent than in the west. It seems that the transformation process did not open up sufficient opportunities for private enterprise that could promote dependent employment. Secondly, part-time employment, which has been increasing

in Germany as a whole over the last decade, is rather uncommon on the eastern labor market. In 1998, for each three part-time workers in the west there was only one in the east. This hints at unexploited opportunities for increased flexibility of labor.

In order to explain what causes the labor market crisis in East Germany, many analysts have argued that high wages are a major source of unemployment and insufficient investment. After unification, trade unions successfully pressed for rapid convergence of wages. Given the low labor productivity after the breakdown of the socialist command economy, wage setting certainly did not follow the logic of neoclassical equilibrium theory. Nevertheless, the relevance of wage policy has probably been overrated. Since the wage drift has been substantial, the focus on union wages exaggerates the differential between wage costs and labor productivity. Effective wages have been approaching western standards more slowly than union wages for several reasons. First, payment above the union rate, frequent in the west, is very rare practice in the eastern states. Secondly, eastern workers often do not receive certain extra payments (*Urlaubsgeld*, *Weihnachtsgeld*) that are quite standard in West Germany. Finally, standard wages frequently did not prevail on the labor market. In 1998, 79 percent of the companies in the producing sector did not participate in collective wage bargaining. Many of them paid wages below union rates. Furthermore, in many firms that take part in the collective bargaining process formally, internal agreements have been reached to pay less than standard wages. The adaptation of the wage setting process to the transformation crisis has been preventing wage convergence. Effective wages in the east had reached about three quarters of the western level in 1997 when eastern output per worker was close to 60 percent of that in the west. The relative wedge between effective wages and labor productivity has decreased in the course of the transformation process.

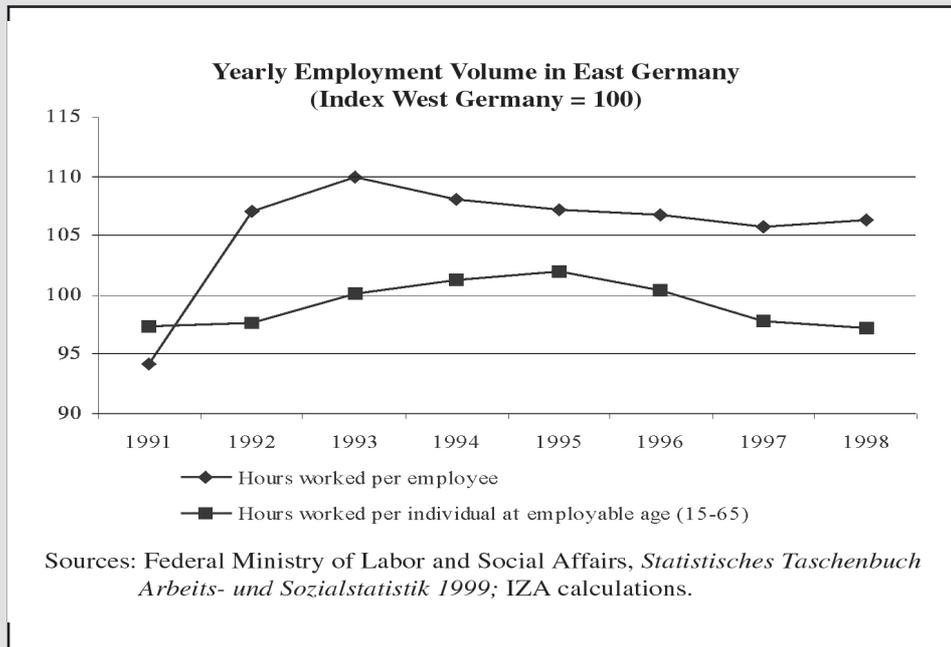
The argument that inadequate wage policy is fundamental to the high level of eastern unemployment can be challenged also for theoretical reasons. Certainly, wages should follow productivity in an equilibrium state. However, it is less certain that the equilibrium concept would provide a valuable answer to the problems of the East German economy during transformation. When the capital stock of the GDR became obsolete, most East German goods would not have sold at any level of socially acceptable real wages. Higher wages, however, should be no problem for a capital stock that is newly built up. Modern technology can pay high wages. In this perspective, the initial rapid wage increase in the east set

incentives for creative destruction. A low wage policy in East Germany would have resulted in a low productivity capital stock associated with very slow convergence to the west, which was not a politically feasible strategy.

standard, shortage of employment opportunities is clearly less substantial. This is even more evident considering the effective volume of eastern employment. If measured in terms of yearly working hours per gainfully employed, labor vol-

Ten years after unification, there is little doubt that the big bang approach of fast economic integration was without alternative. Still, it seems that some opportunities were missed. A major political mistake was to underestimate the economic costs associated with the transition. Due to the political myth of smooth economic integration, the challenge of transforming the eastern socialist economy was not perceived as an opportunity for re-thinking the political and economic system in Germany as a whole. A frequent attitude was that the reunited Germany should become an enlarged Federal Republic. However, many of the institutions expanded to the eastern states had been impeding economic progress also in the west. Not surprisingly, the systemic problems aggravated when the transition crisis called for greater flexibility. Lack of institutional innovation during the transformation process imposed serious obstacles to economic recovery in the east. Public administration, for example, was largely rebuilt after western examples. Hence the opportunity was missed to install flexible techniques of governmental management that could have provided the necessary flexibility for coping with the problems during the transformation process. Ineffective government slowed down the reconstruction of the outdated eastern infrastructure. Regional disparities in public infrastructure remain substantial. The difficult conditions of local administration and the lack of public infrastructure may explain why the generous investment incentives that were introduced to promote capital formation were only a partial success.

A second example of inadequate convergence is the initially unqualified adaptation to pre-existing labor market institutions. Universal collective bargaining exerted decisive influence on the rapid increase of eastern labor costs during the first period after unification. In addition, the acceptance of the highly regulated working conditions in the west was incompatible with the need for more flexible labor organization acute on the eastern labor market in transition. The mass unemployment in East Germany detected the inflexibilities of traditional German labor market institutions all too cruelly. Fortunately, there are some signs that the deep transformation crisis in East Germany also fosters institutional renewal. The progressive loss of membership in unions and employers' associations and the establishment of bargaining practices at plant level ignoring industry guidelines demonstrate that the eastern society is capable to independent initiative.



Shortage of employment is a relative phenomenon. The high unemployment rates reported for East Germany also reflect specific patterns of labor market participation and working hours. Labor force participation in the former GDR, where politics set strong incentives to work, was traditionally higher than in the West German states. In contrast to what many observers of the transformation process expected, marked differences in labor supply have been persistent. In 1998, labor force presence of East Germans was some 8 percent higher than that of westerners. In particular, the propensity of East German women to take up a job has not converged to western standards, despite rising obstacles to find employment. In view of the comparatively low eastern wage levels, one reason for this behavior appears to be the necessity to maintain family income. This may explain why labor force participation of married females is particularly high.

With strong disparities in labor supply persisting, a reduction of eastern unemployment to the western level cannot be expected. Furthermore, the focus on regional disparities of unemployment rates probably exaggerates the severity of the employment crisis. To assess the actual size of the employment problem, it is also important to what extent potential labor is being used. In 1998, the eastern employment rate was 56.4 percent of the working-age population, some 5 percentage points below the rate for West Germany. In this perspective, although the effective employment levels in the east have stabilized below the western stan-

ume per worker in the east has consistently surpassed that in the west and has been converging only slowly to western standards. In 1998, eastern workers were occupied 6 percent longer than western workers. The regional differences of individual employment volume are only partially due to the less generous wage agreements. They also reflect the considerable shortage of part-time occupations on the East German labor market. Had working hours in the east been distributed according to western standards, the size of gainful employment in 1998 could have been some 390,000 persons higher. Then the effective employment quota would have been as high as 60 percent, compared to 61.7 percent in the west. Given the volume of working hours relative to the size of the population at employable age, there also appears to be no substantial shortage of employment opportunities in the east. In fact, the effective eastern employment volume even exceeded that in the west during parts of the transformation process. In 1998, it was less than three percentage points below the western rate. To avoid misunderstandings, it is important to note that this type of calculation does not imply that the large size of unemployment in East Germany is not a real social problem. Nevertheless, it must be emphasized that a remarkable adjustment of the overall employment volume has already taken place in the east. Given that wages and labor productivity are converging to western standards, it is unlikely that the overall employment volume in the east will stabilize above the western level and absorb the more ample eastern labor supply.

## New book release: Lessons learned from ten years of market economy in former East Germany - Renowned economists analyze the eastern

A historically unique experiment is about to enter its second decade – German unification. Early hopes for a rapid and smooth economic transformation soon turned out to be overly optimistic. Despite massive financial transfers, the political promise of a “blooming landscape” remains a vision. Actual developments have left deep scars on the labor market, and the effects will be felt for decades to come.

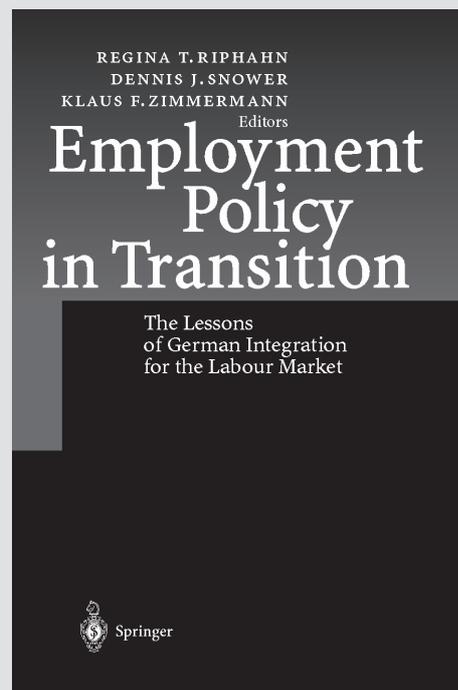
Was this outcome to be expected, perhaps even inevitable? What went wrong, and what were the available options? Or is the current state of the eastern German labor market in fact better than is commonly assumed? To answer these questions, the internationally renowned authors of this volume examine different stages of the labor market development in eastern Germany. The relevant facts are certainly diverse: While the rate of unemployment in the “new Laender” is substantially higher than in the west, the actual amount of work done per labor

force participant is about the same in both parts of the country. Moreover, real wage convergence has been much slower than originally predicted.

After an introduction to the subject and an overview of labor market developments in eastern Germany, part 1 of this volume will turn to specific issues of adjustment: wage trends, business start-ups, and early retirement. Part 2 reviews the policy options available in the transformation process and their labor market implications: wage subsidies, profit sharing, invested pay, further education, and various forms of active labor market policy. The final chapter draws parallels with the experience of other transition economies.

This book will be released in October, 2000.

*R. T. Riphahn/D. J. Snower/K. F. Zimmermann, Employment Policy in Transition: The Lessons of German Integration for the Labour Market, Heidelberg 2000; ISBN 3-540-41166-6.*



### **Employment Policy in Transition: The Lessons of German Integration for the Labour Market** *edited by R. T. Riphahn, D. J. Snower, and K. F. Zimmermann*

#### **Introduction**

##### **1. Introduction**

*Regina T. Riphahn* (University of Munich, IZA/Bonn, and CEPR/London)  
*Dennis J. Snower* (Birkbeck College/London, IZA/Bonn, and CEPR/London)  
*Klaus F. Zimmermann* (Bonn University, IZA/Bonn, DIW/Berlin, and CEPR/London)

##### **2. The Post-Unification German Labour Market**

*Holger Bonin* (IZA/Bonn)  
*Klaus F. Zimmermann* (Bonn University, IZA/Bonn, DIW/Berlin, and CEPR/London)

#### **Part I: Analysis of the German Labour Market Problem**

##### **1. Wages and Structural Adjustment in the New German States**

*Michael Burda* (Humboldt University Berlin, IZA/Bonn, and CEPR/London)  
*Michael Funke* (University of Hamburg)

##### **2. East/West-Wage Rigidity in United Germany**

*Karl-Heinz Paqué* (University of Magdeburg)

##### **3. Early Retirement in East and West Germany**

*Axel H. Börsch-Supan* (University of Mannheim and NBER/Cambridge)  
*Peter Schmidt* (University of Bremen)

##### **4. Employment Effects of Newly Founded Businesses in East Germany**

*Thomas Hinz* (University of Munich)  
*Rolf Ziegler* (University of Munich)

##### **5. Earning Dynamics in the East German Transition Process**

*Johannes Schwarze* (University of Bamberg and IZA/Bonn)  
*Gert G. Wagner* (University of Frankfurt/Oder, DIW/Berlin, and IZA/Bonn)

#### **Part II: Policy Options**

##### **1. Eastern Germany Since Unification: Wage Subsidies Remain a Better Way**

*David Begg* (Birkbeck College/London and CEPR/London)  
*Richard Portes* (London Business School and CEPR/London)

##### **2. Economic Efficiency and Social Acceptance of Wage Subsidies**

*Henning Klodt* (Kiel Institute of World Economics)

##### **3. Revenue-Sharing Subsidies as Employment Policy: Reducing the Cost of Stimulating East German Employment**

*Dennis J. Snower* (Birkbeck College/London, IZA/Bonn, and CEPR/London)

##### **4. Investment Wages and Capital Market Imperfections**

*Gerhard Illing* (University of Frankfurt/Main)

##### **5. Public Sector Sponsored Continuous Vocational Training in East Germany: Institutional Arrangements, Participants, and Results of Empirical Evaluations**

*Martin Eichler* (University of Mannheim)  
*Michael Lechner* (University of St. Gallen and IZA/Bonn)

##### **6. Active Labour Market Policies in Central Europe: First Lessons**

*Hartmut Lehmann* (University of Dublin, Trinity College, and IZA)

# Shaping Working Hours – The Case of the Netherlands

Last year the Dutch parliament accepted legislation on the right of employees to adjust their contractual working hours upward or downward under certain conditions. By July 1, 2000, this legislation entered into force. Its goal is to increase the possibilities to combine work and private life for both men and women, particularly to stimulate the economic independence of women. The legislation is part of a much more comprehensive legislation on work and family care that is still in development.

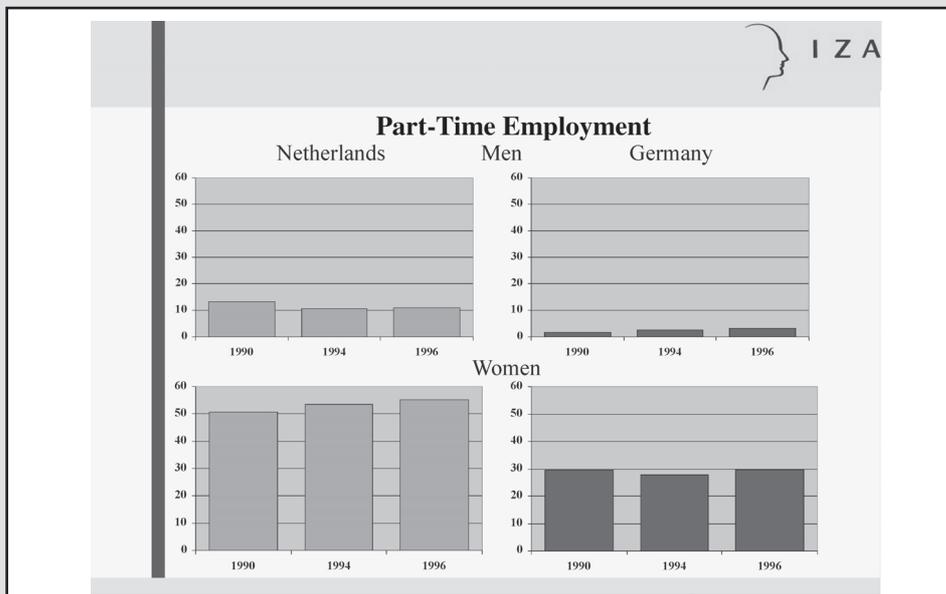
Only in the last two decades has the Dutch government been quite active in shaping the conditions of combining work and care. Before the 1980s the need was not prevalent. At that time, female labor force participation was low compared to other countries. But since the early 1980s, female labor participation has been increasing strongly and has almost caught up with the situation in Germany. Accordingly, the need for shaping the conditions of combining work and care increased. The solution of the Dutch government to handle this problem was to stimulate part-time work. In the beginning of the 1990s the Dutch parliament passed several acts that forbid employers to treat employees unequally with regard to the conditions under which an employee contract is initiated, prolonged or ended, solely based on a difference in the number of working hours. Thus the act awards part-time employees an explicit right to equal treatment concerning wages, paid leave and holiday entitlements, overtime payment, bonuses and training. It is unclear to what extent this really contributed to the success of part-time work in the Netherlands, but one result is that the proportion of both men and women working part-time is high in the Netherlands.

Although the new law gives a lot of rights to employees, there are some clauses to protect the employers. First of all, the law does not hold for firms with less than 10 employees. Secondly, the legislation gives firms the possibility to reject the wishes of employees if they can show that otherwise they would face considerable problems. Examples for that are a lack of work or the reverse, a lack of personnel. The employees do not need to give arguments for their wishes, but the firms have to come up with arguments in case they do not want to fulfill the employees' wishes.

It is an open question why such a rigorous legislation would be needed in the Netherlands. Part-time employment is quite common, and the Dutch labor market seems flexible in terms of working hours. Obviously, even in such a labor market the actual number of working hours does not seem to fit the preferences, as previous IZA research has shown (see Rob Euwals/Arthur van Soest, *Desired and Actual Labor Supply of Unmarried Men and Women in the Netherlands*, *Labour Economics* 6 (1999), pp. 95-118

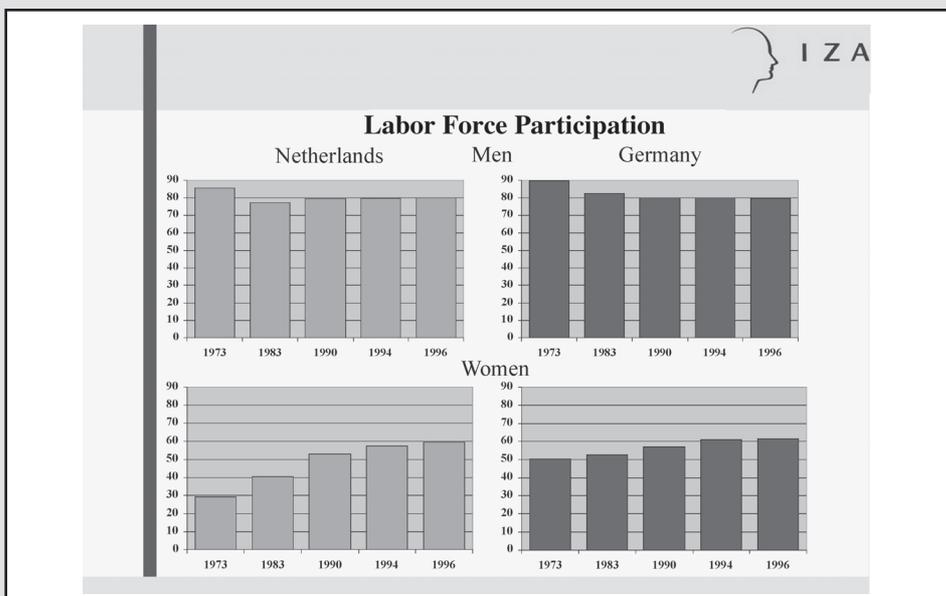
and Rob Euwals, *Female Labor Supply, Flexibility of Working Hours, and Job Mobility in the Netherlands*, IZA Discussion Paper No. 83). Studying labor supply and employment behavior of unmarried men and women in the

be shown that within a job (with the same employer) working hours on average adjust about 15 percent into the preferred direction. Thus, if a woman changes her preferences on working hours because of chang-



Netherlands, it has become evident that even in the Dutch labor market it is substantially more difficult to find a part-time job than a fulltime job. For an individual with an average education living in the west of the country (where the largest cities are), the probability to get a job-offer for a fulltime job is about 90 percent, while the probabil-

ing family circumstances (if, for instance, children leave the household, parents become sick, or her partner's income changes), it is actually difficult to change her working hours within the job accordingly. In other words: even in a labor market where part-time employment is quite common it is not easy to match the actual



ity to get a job-offer for a part-time job is about 45 percent.

The restrictions work in both directions: many individuals who work fulltime want to work part-time but also some would prefer to work fulltime instead of part-time. Furthermore, studying labor supply and employment behavior of Dutch women, it can

working hours with the preferred working hours and to combine work and care. It is doubtful whether the restrictive legislation of the Dutch parliament will be able to influence the situation. IZA continues to follow developments in the Netherlands and to analyze implications for working time policy in other European countries.

## ESPE annual conference gives new impetus to research in population and labor economics

### IZA hosts meeting of top experts

IZA organized and hosted this year's annual conference of the European Society for Population Economics (ESPE). The meeting, which took place at the Wissenschaftszentrum (Research Center) in Bonn, June 15-17, 2000, was an opportunity for more than 200 population economists to discuss questions of great relevance to the present situation.

### Mothers, Fathers and Children after Divorce

In her presidential address, ESPE President *Daniela Del Boca* (University of Turin, Italy) lectured on the impact of divorces on the children's welfare and the economic consequences for both parents. Until recently this issue has been widely neglected. But since the number of divorces, especially in the United States and Britain, has risen significantly and caused substantial welfare effects, the topic has finally received increased attention.

Del Boca pointed out the serious consequences of a divorce for the future development of the affected children. These consequences extend beyond the social implications and also affect human capital accumulation and labor market pros-



Daniela Del Boca

pects. Close cooperation between both parents, Del Boca argued, is therefore an essential – albeit only moderately realistic – precondition for the children's welfare and job prospects.

Del Boca further elaborated on the question why a divorce often has an asymmetric effect on the parents. This is due to the fact that fathers usually earn a higher

income, while in most cases mothers are granted custody of the child, which limits their employment possibilities. After a divorce, families no longer benefit from the economies of scale inherent in shared households. Therefore, it is often vital that the financially stronger partner remain employed in order to support the divorced spouse and the children in accordance with the law. With increased female participation in the workforce and better representation of women in high-salary jobs, however, this situation may change. It is likely that in the future more and more fathers will receive custody of their children.

Notwithstanding this development, the central goal from an economic point of view should be a fair balance of interests. Benefits from regular child visitation, for instance, are not just confined to the interpersonal aspect. Visitation has positive effects on the child and possibly on the payment morale of the supporting parent, which would ultimately contribute to the child's welfare.

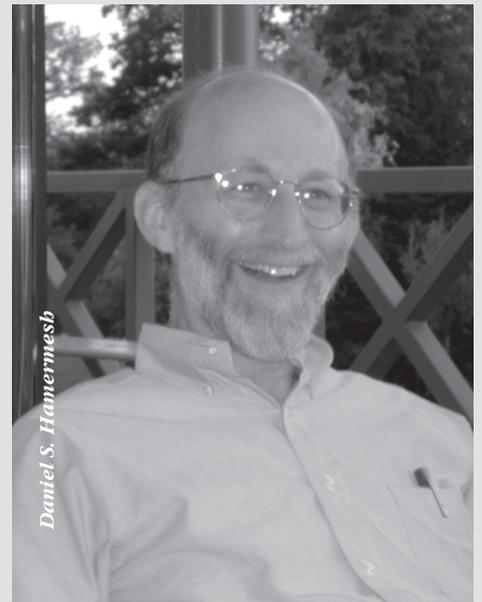


### Evaluation of Official Labor Market Programs

*Gerard J. van den Berg* (Free University of Amsterdam, Netherlands) gave a presentation on the scientific evaluation of the effectiveness and efficiency of official labor market programs. The purpose of this assessment is to measure the benefits, for instance, from participation in further training, and to weigh these benefits against the economic costs incurred in the process. The question of potential negative incentives in the form of higher taxes that are necessary to finance such programs is not answered in this context.

The fundamental problem of this type of evaluation is the scarcity of information about participants of government programs. An unfavorable evaluation could result from the fact that participants showed little motivation because unemployment benefits were conditional on participation in the program. The opposite case – participants with exceptionally strong motivation – would also be conceivable and could distort the evaluation.

It is therefore necessary, van den Berg explained, to give close attention to the amount of time each participant spends in the program. Highly motivated participants can generally be expected to finish the program earlier than those who participate involuntarily. Van den Berg's research of labor market programs in the Netherlands showed that they had a strongly positive effect. He pointed out, however, that further research is needed to weigh these benefits against the costs borne by the economy.



Daniel S. Hamermesh

### The Timing of Work and Leisure

*Daniel S. Hamermesh* (University of Texas at Austin, USA) analyzed the timing of work and leisure among family households and unmarried couples. Contrary to the predominant approach, his analysis concentrates on the leisure side. Based on U.S. data, Hamermesh showed that partners indeed manage to coordinate their labor market activities. It is necessary, however, to differentiate between couples with and without children, because parents of young children also have to coordinate their working hours with the schedules for child care and babysitting. In this case, mothers usually carry the burden of adjustment.

According to Hamermesh, the changes in working hours during the past decades have substantially improved the possibilities of timing work and leisure. As requested by employees, working hours are now increasingly concentrated, creating new opportunities for leisure activities. With better education and higher salary, selection between work and leisure generally becomes easier. This leads to the conclusion that preferred working hours apparently have to be bought with forgone wage payments. Consequently, the welfare gap between highly trained and less trained workers must be wider than is apparent from the existing wage differentials alone.

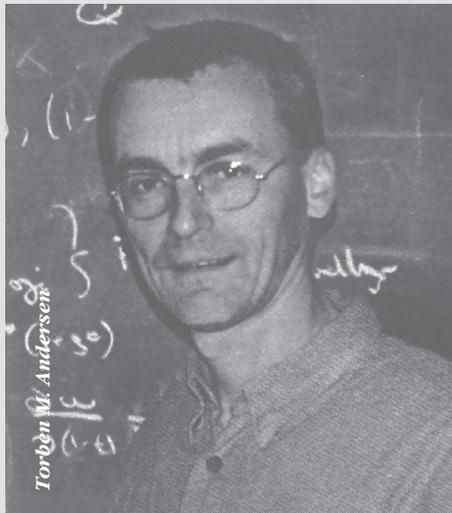
### European Integration and the Welfare State

Torben M. Andersen (University of Aarhus, Denmark) talked about the consequences of European integration on the welfare state in current and future EU member countries. For quantitative reasons alone, this is a highly relevant topic because European welfare budgets have played an ever more important role since the 1950s.

Financing the welfare state while integrating the economies poses a great challenge to the members of the European Union. Inasmuch as international integration encourages spatial mobility, the tax base will become more mobile and migrate to the countries with the best tax conditions. This could lead to an inefficient competition in tax policy. As a consequence, immobile factors, which already carry most of the burden of financing the welfare state, would have to bear an even heavier weight.

But, according to Andersen, even if labor remains relatively immobile and continues to serve as the main source for the funding of welfare payments, the commodity markets will become increasingly competitive as a result of integration. On

the one hand, this would weaken the position of labor unions because with diminishing monopolist's profits the opportunities of distribution will shrink. On the other hand, higher wages would induce firms to move their operations abroad. Unless wages and social security contributions are adjusted in each country, higher unemployment would be the inevitable consequence.



Future social security requirements, Andersen explained, would depend on collective risks for which insurance remains necessary. The impact of integration on insurable individual risks would therefore play a major role. Andersen assumes that a larger economic area is better equipped to cover risks than a small area. Consequently, the future need for collective social security insurance would in all likelihood be lower than today.

### Pension Reform and Intergenerational Redistribution

Another highly relevant issue discussed at ESPE 2000 is the problem of pension funding. The experts stressed the fact

that the German system of intergenerational redistribution depends largely on the size of the workforce and thus on the number of contributors. Since families play a major role in sustaining the current pension system, it seems reasonable to compensate them for part of the costs, possibly in the form of pension entitlements. Participants of the conference also underscored the relevance of redistributive effects. The younger generations should not – as the widely discussed models in the German debate about pension reform suggest – carry a disproportionately high costs. Today's observations already show that older generations can still increase their per capita consumption, while younger and future generations will face substantially reduced consumption opportunities. Prudent reforms are necessary to counteract this economically unhealthy trend.

### Outlook

In summary, ESPE 2000 was conducted on an exceptionally high academic level. It demonstrated once again the great importance of population economics in finding answers to compelling questions of demography, social security, and labor market policy. IZA Director Klaus F. Zimmermann remarked at the end of the conference: "Population economics is more than ever at the center of public attention. Key issues that will shape our future, such as the aging of western societies, coping with immigration, reform of the welfare states, and creating the right incentives for more employment are calling for convincing political concepts. Policymakers should embrace the answers that population economists offer: We need a systematic control of immigration, incentives for individual initiative, and a social safety net that concentrates on need rather than redistribution. ESPE 2000 has given science and politics an important impetus."



## Measuring the Cost of Unemployment

The following contribution is to a large extent based on a publication by Liliana Winkelmann and IZA program director Rainer Winkelmann, "Why are the unemployed so unhappy? Evidence from panel data", published in *Economica* 65 (1998), pp. 1-15. This publication received in 2000 the "Friends of the DIW Prize for the Best Paper 1984-1998/99 using the German Socio-Economic Panel (Second Prize)".

The achievement of full employment is one of the undisputed goals of economic policy, because unemployment always

implies the reduction of a country's well-being. Attempts to quantify the cost of unemployment for the economy as a whole remain controversial, however. The traditional economist's view holds that the main cost of unemployment is the loss of production, which is possibly corrected by an estimate of the value the unemployed receive from time spent on alternative non-market activities. The empirical cornerstone of this approach is Okun's law, according to which a 3 percent increase in GDP is associated with a 1 percent reduction of the unemployment

rate. In principle, the shortfall in GDP associated with a given unemployment rate can thus be computed.

This approach has come under criticism from various sides. First, the stability and validity of the empirical law has been questioned in subsequent research. Results differ depending on country and time period under consideration, but the general impression is that Okun's law substantially overestimates the size of the trade-off between unemployment and output. The issue is complicated further

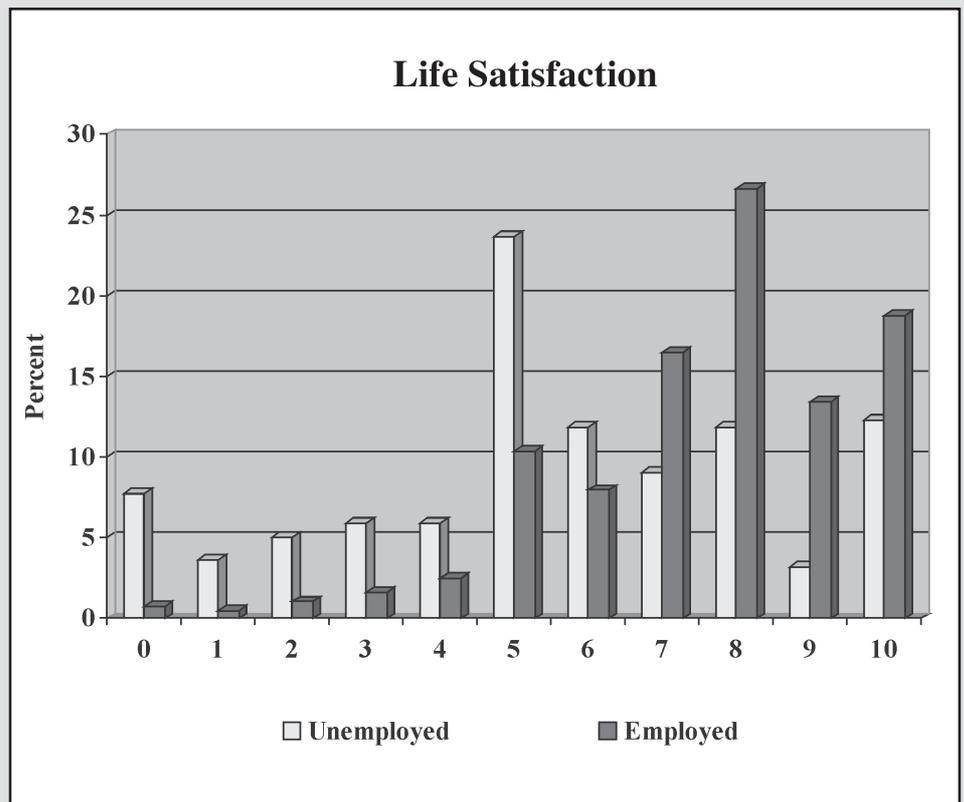
by the fact that, strictly speaking, Okun's law applies only to cyclical unemployment, while a large part of current unemployment in Western Europe and elsewhere is considered to be structural.

More importantly, lost production – even if measured properly – is too narrow a measure of the cost of unemployment to be meaningful and applicable. The unemployed are not just an “idle factor of production”. They are deprived of an important source of social relationships, identity and individual self-esteem. If employment was just a source of income, the social safety net with its – in the case of Germany - relatively high replacement rates would be more successful in mitigating the adverse effect of unemployment on the individual. However, there is widespread evidence that this is not the case in general. Individuals are negatively affected by unemployment in ways that go well beyond the pure pecuniary effect.

This finding is not entirely new, of course. Psychologists have developed models and provided explanations for the harmful effect of unemployment on the psychological well-being of the individual. For instance, they point to a lack of control, security, and sense of belonging that is observed among the unemployed. What is new is that there is now a substantial body of evidence based on large-scale survey data that provides a firm empirical basis for the previous conjectures and produces some startling results.

### Why are the unemployed so unhappy?

The most direct evidence on the non-pecuniary cost of unemployment is obtained by asking people how satisfied they are with their present life in general. Then the responses of employed and unemployed persons can be compared. The German Socio-Economic Panel (SOEP), a household survey conducted annually by the German Institute for Economic Research (DIW), regularly includes a question on general satisfaction with life on a scale from 0 (= completely dissatisfied) to 10 (= completely satisfied). In 1984, the first year of the survey, the average response of employed persons to this question was 7.6 on the scale from 0 to 10, whereas the average response of unemployed persons was 5.6. This is a considerable gap in general satisfaction with life. Similarly, only 5 percent of the employed were dissatisfied whereas 27 percent of the unemployed were dissatisfied. In other words, unemployed persons were more than five times as likely to report general dissatisfaction with their life than employed persons. Qualitatively similar patterns are found throughout the 1980's and the 1990's. There is systematic evidence that the unemployed are more dissatisfied with their lives compared to people who have a job.



In a different type of analysis, the longitudinal aspect of the SOEP is used to follow a person who was employed in one year but unemployed in the next. Then the change in the response to the life satisfaction question between the two years is computed for each person. On average, satisfaction goes down by one unit (on the 0-10 scale) in this case. Conversely, satisfaction goes up by one unit for people who become reemployed. Moreover, the strong negative association between unemployment and life satisfaction remains intact also when a whole array of other potential influences is accounted for. This includes a person's health, marital status, and income. The data from the German Socio-Economic Panel shows that particularly for men employment is the most important contributor to general life satisfaction. It is a lot more important than income, which has a small positive effect on satisfaction.

The transition from employment to unemployment has two aspects. First, the person loses income depending on the applicable replacement ratio, and hence becomes less satisfied. Secondly, the person becomes less satisfied for non-pecuniary reasons. These two factors combined constitute the total cost. Based on estimates from the German-Socio Economic Panel for men between 1984 and 1989, some rough calculations show that only 10 percent of the total costs of unemployment are pecuniary, whereas 90 percent are non-pecuniary. While this estimate may be at the upper end of the spectrum, other data sources show qualitatively similar results, among them the British Household Panel Survey and the

International Social Survey Program data set, which covers twelve different countries and other time periods.

### Externalities

So far only the effect of individual unemployment on the life satisfaction of the unemployed person was considered. To calculate the total social cost, however, it must be taken into account that individual unemployment can affect other people's life satisfaction as well, which is described by the term “externality”. For example, data from the SOEP has been used to show that the life satisfaction of a woman drops significantly when her husband is unemployed. This is a negative externality. But positive externalities can exist as well: part of the psychological cost of unemployment arise since it excludes people from society and deprives them of contact possibilities. This effect will be weaker the more people in a person's social reference group are unemployed. Indeed, there is strong empirical evidence that high unemployment in the reference group, for example a neighborhood or a profession, reduces the adverse psychological effect of unemployment at the individual level. In contrast to the large negative “internal” effect of unemployment, it is still uncertain whether the positive or the negative effects dominate on the external side.

### Implications for welfare policy

The existence of negative effects of unemployment on life satisfaction has a number of implications. It shows that unemployment is hardly “voluntary”. This is not surprising to the layperson, but it is a

contentious issue within the economics discipline. Indeed, the finding shows that on average the unemployed put a remarkably low value on their leisure. For instance, when offered the choice between working and being unemployed, a person would presumably choose to work in order to increase her life satisfaction, even in the hypothetical case when income is left unchanged. This is due to the pure non-pecuniary or psychological benefits of employment. Based on this evidence, the often-heard argument that unemployment compensation ought to be reduced in order to increase work incentives and thereby employment is inappropriate. The non-pecuniary benefits of employment already provide a massive incentive for taking up work, and the fact that people are still unemployed shows that unemployment results from an insufficient demand for certain types of workers, rather than being supply-driven.

### Reduced life satisfaction and persistent unemployment

Research on the connection between unemployment and life satisfaction has been refined in a number of ways. Among the hypotheses tested are those of scarring and habituation. For instance, it has

been shown that past unemployment has a permanent negative effect on psychological well-being. At the same time, it seems that people get used to being unemployed: The negative effect of unemployment on satisfaction is weaker for those who have been unemployed more often in the past. Furthermore, these subjective well-being measures can be used to explain economic behavior. For example, the habituation effect could mean that the long-term unemployed “dislike” their situation less and less, give up, and abandon search. Empirical research shows that those who experience greater reductions in well-being at the beginning of their being unemployed are more likely to become reemployed soon. An alternative view of the unemployment problem is based on the notion of psychological capital. Psychological capital, as well as human capital, is reduced during unemployment episodes, making reemployment less likely and causing self-perpetuation and hysteresis.

### Conclusion

The use of life satisfaction data for studying the non-pecuniary cost of unemployment has generally been a successful research program that has produced a

number of interesting and robust findings. Still, some people may not feel at ease with the subjective nature of life satisfaction data and with the whole concept of measuring utility and preferences directly. Economists in particular tend to defend their position vigorously: They study what people do and infer preferences indirectly, rather than studying what people think – or say they think – their preferences are. However, parallel research has studied the association between unemployment and a number of directly observable “objective” outcome measures such as mental illness, divorce, crime, suicide and mortality. These outcomes are all indicators of various aspects of the social or non-pecuniary cost of unemployment. The general evidence corroborates the results of the life satisfaction approach: Unemployment has negative effects on observed outcomes, and it is safe to conclude that the social costs of unemployment are far greater than the cost of lost production.

## SHORT REPORTS

### +++ Third IZA European Summer School a Grand Success+++

The third annual IZA European Summer School in Labor Economics was held from May 29 to June 4, 2000. In the relaxed atmosphere at the conference center of the Deutsche Post World Net (German Postal Service) in Buch at the

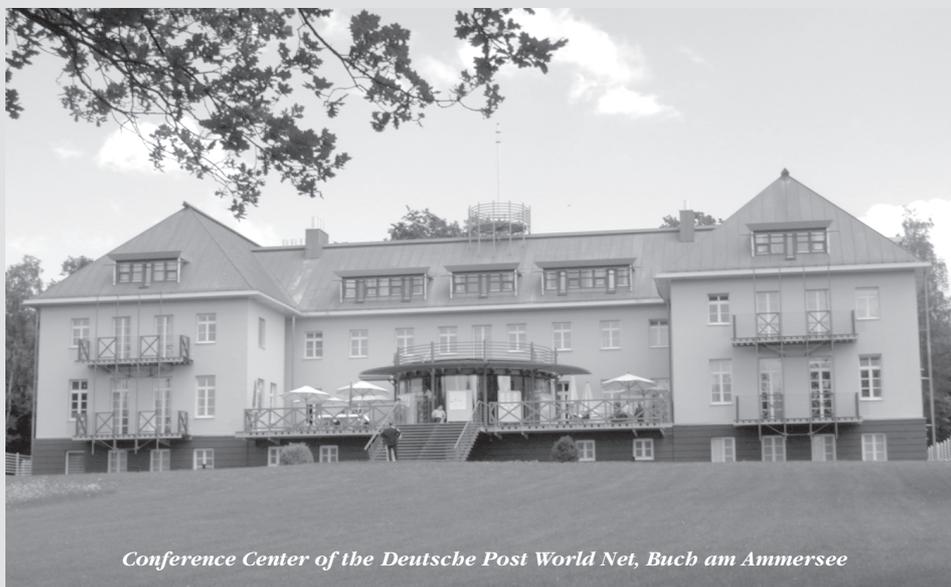
lake of Ammersee, Bavaria, Germany, the summer school once again brought together a group of highly talented Ph.D. students with distinguished scholars to study new areas in labor economics. The participants, selected by a committee out of 130 applicants, came from a wide range of European countries, creating a very productive international environ-

ment. During the course of the week, the students were given the opportunity to present their research ideas either through giving a formal presentation or through explaining their work in poster sessions. These presentations framed the setting for many open and lively discussions, leaving students with numerous helpful comments from both their colleagues and the established researchers. In addition, the students had the opportunity to attend lectures given by *Daniel S. Hamermesh* (University of Texas at Austin) on “Labor Demand” and *Gerard J. van den Berg* (Free University of Amsterdam) on “Duration Models and Search Models in Labor Economics.” The fourth IZA Summer School in Labor Economics will take place from September 10 to 16, 2001. Details on the application procedure and the program of next year’s Summer School will soon be available on the IZA homepage.



### +++ IZA Workshop “Welfare Transitions”, October 7-8, 2000 +++

IZA is organizing an international workshop on welfare transitions. The aim of the workshop is to learn more about the



Conference Center of the Deutsche Post World Net, Buch am Ammersee

determinants of the flows in and out-of welfare, in particular from a public policy perspective. The impact of labor market conditions and the generosity of social assistance on the transitions from welfare to work will be discussed. Special attention will be paid to immigrants and minorities. The workshop will bring together academics from a variety of countries to learn more about the different institutional settings of the countries considered. This will also allow assessments of the effects of welfare reforms. More details on this forthcoming event are available on the IZA homepage ([www.iza.org](http://www.iza.org)).



### +++ IZA Program Director Rainer Winkelmann Co-Winner of SOEP Award 2000 +++

Since 1984, data from the German Socio-economic Panel (SOEP) has appeared in over 2,000 academic publications. At the fourth international SOEP user conference, which took place on June 7, 2000, at the Social Science Research Center in Berlin, the best publications on the basis

of SOEP data for the first time received an award. Among the prize-winning works was the essay entitled "Why are the unemployed so unhappy? Evidence from panel data" by Liliana Winkelmann and IZA program director Rainer Winkelmann. This article, published in *Economica* 65 (1998), received the "Friends of the DIW Prize for the Best Paper 1984-1998/99 using the German Socio-Economic Panel (Second Prize)". For a summary of the key research results, see pages 7-9 of this issue of IZA compact.



### +++ IZA makes JSTOR available +++

Since last April, IZA researchers have been able to access the electronic database JSTOR. This makes IZA the fourth German institution to grant its employees access to one of the most efficient American journal databases. The three other institutions are the Bavarian State Library, Munich, Georg August University, Göttingen, and Johann Wolfgang Goethe University, Frankfurt/Main. JSTOR currently offers access to full-text articles

from more than 100 academic journals in such disciplines as economics, demography, political science, mathematics, and statistics. With JSTOR, IZA researchers benefit from a modern, efficient research instrument, which facilitates the retrieval of academic information and substantially accelerates progress in research.



### +++ IZA moves into second building in Bonn +++

IZA is expanding. The growing number of employees reflects this development. In June 2000, with support of the Deutsche Post Foundation, IZA was able to move into a second office building in the immediate vicinity of the IZA "headquarters". The institute now enjoys a perfect work environment in the heart of Bonn, a profitable research location. Since several guests can be accommodated in adequate offices at the same time, IZA visiting scholars certainly benefit from the new situation as well.



## IZA VISITORS PROGRAM

From March until July 2000 a number of renowned economists stayed at IZA to discuss issues of labor market research and policy:

*Lennart Flood*

(Gothenberg University, Sweden)

*Christian Dustmann*

(University College London, UK)

*Christoph M. Schmidt*

(University of Heidelberg, Germany)

*John Haisken-DeNew*

(DIW, Berlin, Germany)

*Michael Shields*

(University of Leicester, UK)

*Robert Wright*

(University of Stirling, Scotland))

*Scott M. Fuess*

(University of Nebraska, USA)

*Adriaan Kalwij*

(University of Oxford, UK)

*Kai Konrad*

(Free University of Berlin, Germany)

*Horst Entorf*

(University of Würzburg, Germany)

*Ekkehart Schlicht*

(University of Munich, Germany)

*Dennis Snower*

(Birkbeck College, London, UK)

*Maria Karanassou*

(Birkbeck College, London, UK)

*Hessel Oosterbeek*

(University of Amsterdam, Niederlande)

*Rebecca Blank*

(University of Michigan, USA)

*Christian Belzil*

(Concordia University, Montreal, Canada)

*Peder Pedersen*

(University of Aarhus, Denmark)

*Andrew Newell*

(University of Sussex, UK)

*Uwe Blien*

(IAB Nürnberg, Germany)

*T. Paul Schultz*

(Yale University, USA)

*Marc Regets*

(National Science Foundation, USA)

*Alessandro Cigno*

(University of Florence, Italy)

*Etienne Wasmer*

(Université Libre de Bruxelles, Belgium)

*Yves Zenou*

(University of Southampton, UK)

*Wayne A. Cornelius*

(University of California, San Diego, USA)

*Junsen Zhang*

(Chinese University of Hong Kong)

*Dan Hamermesh*

(University of Texas at Austin, USA)

*Barry R. Chiswick*

(University of Illinois, Chicago, USA)

*David Jaeger*

(Princeton University, USA)

*Anders Klevmarken*

(Uppsala University, Sweden)

*Jörn-Steffen Pischke*

(MIT, USA)

*Erik Plug*

(University of Amsterdam, Niederlande)

*Joop Hartog*

(University of Amsterdam, Niederlande)

*Wim Vijverberg*

(University of Texas at Dallas, USA)

*Stefan Bender*

(IAB, Nürnberg, Germany)

*Ira N. Gang*

(Rutgers University, New Brunswick, USA)

*Olaf Hübler*

(University of Hannover, Germany)

*Gil Epstein*

(Bar-Ilan University, Ramat-Gan, Israel)

## NEW IZA DISCUSSION PAPERS

A complete list of IZA Discussion Papers is available on our homepage at [www.iza.org](http://www.iza.org)  
Most papers are downloadable.

- 97 A. Barrett**  
Irish Migration: Characteristics, Causes and Con-sequences
- 98 J.P. Haisken-DeNew, C. M. Schmidt**  
Industry Wage Differentials Revisited: A Longitudinal Comparison of Germany and USA
- 99 R. T. Riphahn**  
Residential Location and Youth Unemployment: The Economic Geography of School-to-Work-Transitions
- 100 J. Hansen, M. Lofstrom**  
Immigrant Assimilation and Welfare Participation: Do Immigrants Assimilate Into or Out-of Welfare?
- 101 L. Husted, H. S. Nielsen, M. Rosholm, N. Smith**  
Employment and Wage Assimilation of Male First Generation Immigrants in Denmark
- 102 B. van der Klaauw, J. C. van Ours**  
Labor Supply and Matching Rates for Welfare Recipients: An Analysis Using Neighborhood Characteristics
- 103 K. Brännäs**  
Estimation in a Duration Model for Evaluating Educational Programs
- 104 S. Kohns**  
Different Skill Levels and Firing Costs in a Matching Model with Uncertainty – An Extension of Mortensen and Pissarides
- 105 G. Brunello, C. Graziano, B. Parigi**  
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- 110 D. DeVoretz, C. Werner**  
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- 111 V. Sorm, K. Terrell**  
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- 114 G. Brunello, A. Medio**  
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- 115 A. Cigno, F. C. Rosati**  
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## O P I N I O N

## The Labor Market and Ten Years of German Unification



German reunification, originally hailed as a once-in-a-lifetime gift, now looks more like a Danaens' present to many observers. It was supposed to pull eastern Germany's economic wagon on the journey toward a "blooming landscape" – after an unprepared cold or "jump start". But the wagon got stuck in the mud shortly after the journey began. Even if the level of transfer payments to eastern Germany remains as high as it is today, it would take at least another thirty years to complete the east-west convergence process in such areas as public infrastructure.

It is often concluded that eastern Germany is slow to catch up because it was headed in the wrong economic direction from the outset of unification. But there is no point in blaming politicians alone for all the undesirable developments. Economists must just as well admit to their own errors. The metaphor of a cold or "jump start", alluding to the extemporary transposition of the West German social market economy into the "new Laender", is misleading. After all, a warm-up lap certainly wouldn't have helped the East German "Trabbi" automobile to take the pole position. What

the car really needed was a new engine – and we might as well have given it a whole new body, too.

At the heart of this misunderstanding lies a flawed interpretation of the role of wage costs in explaining the desolate employment situation in eastern Germany. It is simply wrong to attribute the unemployment problem mainly to the high and rapidly rising wages after the new currency was introduced at a one-to-one exchange rate. We must keep in mind that the entire product range of former East Germany had become hard to sell – even in Eastern Europe.

As a consequence, the effective rate of unemployment, which includes both registered and hidden unemployment, still remains at over 30 percent in eastern Germany today. According to a back of the envelope calculation, neglecting all the relevant structural aspects, wages would have to fall by more than 80 percent in order to achieve full employment in the "new Laender". The suggestion to concentrate on the wage factor is therefore far from reality, just like the assumption that the eastern German labor market functions according to neo-liberal textbook economic principles.

The extent to which wages in east and west have converged is often overestimated since a comparison of union wages is easily misleading. In the west, union wages are often much lower than actual wages. In the east, most companies do not bother to participate in collective wage bargaining. Therefore, collectively agreed wages often do not apply, or they are simply ignored. Fringe benefits, such as vacation or Christmas premiums, are still substantially lower in the eastern part of the country. From this perspective, the eastern German labor market is much better than its reputation with regard to creativity and flexibility.

Therefore, the effective wages of east Germans, compared to their compatriots in the west, are not as far apart from productivity as is commonly alleged in the

public debate. But a general comparison of productivity always tends to be deceptive: It only works for sectors with interregional trade of goods, not for areas that are dependent on the public sector or on local purchasing power.

It is safe to assume that the labor market in the east will continue for a long time to play by different rules than the west. Despite high unemployment, the average number of hours worked per potential worker in the "new Laender" is almost at the same level today as in the rest of the country. Another example is the above-average education level, which – in contrast to the west – does not effectively protect workers in the east from losing their jobs.

Nonetheless, active labor market policy in its current form has no future. Regardless of its function as a social stabilizer, it has failed economically (with the exception of a few individual programs for further education). The political quarrel about this kind of policy will undoubtedly remain until we manage to establish an independent scientific evaluation of labor market policies as it has long been common practice in other countries.

Notwithstanding the progress made, overemployment in the public sector and an underdeveloped service sector still reflect the structural deficits of the eastern German economy. Rapid economic transformation has unleashed the potential for a modern service economy meeting the challenges of the information age. But this potential has not been fully realized. The lack of export orientation is yet another enormous structural deficit. EU eastward enlargement, which is already looming on the horizon, may be a promising opportunity to do some catching up. Nothing will be gained, however, without a consistent improvement of public infrastructure. This will remain an important task for support from the federal government.

*K. F. Zimmermann*



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