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The slow decline of East Germany[☆]

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ABSTRACT

Uhlig, Harald—The slow decline of East Germany

Fifteen years after German reunification, the facts about slow regional convergence have born out the prediction of Barro [Barro, Robert J., 1991. Eastern Germany's long haul. The Wall Street Journal, Dow Jones and Company, May 3], except that migration out of East Germany has not slowed down. I document that in particular the 18–29 year old are leaving East Germany, and that the emigration has accelerated in recent years. I document that low wages, high unemployment and increasing reliance on social security persist across wide regions of East Germany together with these migration patterns. To understand these patterns, I use an extension of the standard labor search model introduced in Uhlig [Uhlig, Harald, 2006. Regional labor markets, network externalities and migration: The case of German reunification. American Economic Review, Papers and Proceedings 96 (2), 383–387; Uhlig, Harald, 2008. A labor-search model of regional unemployment and migration. Draft, University of Chicago] by allowing for migration and network externalities. In that theory, two equilibria can result: one with a high networking rate, high average labor productivity, low unemployment and no emigration (“West Germany”) and one with a low networking rate, low average labor productivity, high unemployment and a constant rate of emigration (“East Germany”). The model does not imply any obviously sound policies to move from the weakly networked equilibrium to the highly networked equilibrium. *Journal of Comparative Economics* 36 (4) (2008) 517–541. University of Chicago, NBER and CEPR CentER, Deutsche Bundesbank.

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1. German reunification: 15 years later

Germany was divided into three parts: West Germany, East Germany and Berlin. These three parts have been united together on October 3rd, 1990. 15 years later, it is time to take stock of what has happened since. Fiscal transfers into East Germany have been massive. According to Busch (2002) for 1991 to 1999, own calculations for 2003, and a linear interpolation for 2000 to 2002, a total net transfer of 940 billion Euros has been paid from West to East Germany for the time span from 1991 to 2003. Fig. 2 shows that the transfers have been more than one-third of East German GDP on average: indeed, the absolute amount of the transfers has been steadily rising or barely falling for most of these years. While approximately 20% of the (gross) transfers have been used to pay for subsidies to firms as well as to building infrastructure,

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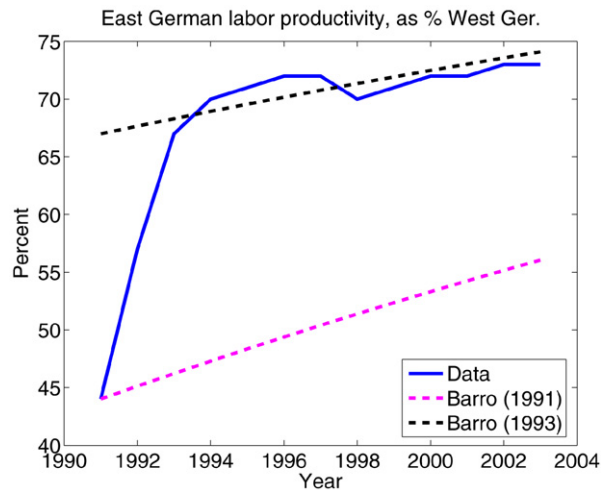


Fig. 1. Productivity convergence, compared to the 2% convergence prediction of Barro. Productivity convergence appears to have been fast from 1991 to 1993, so the prediction based on the 1991 numbers is far from the facts. Applying the prediction on the basis of the numbers for 1993, however, works surprisingly well. The data is from Burda (2006).

approximately 50% have taken the form of direct transfers for socio-political reasons. Due to the East–West transfers, the per-resident fiscal budget of the East German Bundesländer is approximately 15% higher than in the West. These transfers have been financed mostly with an increase in debt. Additionally, a “solidarity tax” has raised a total of nearly 90 billion Euros from 1991 to 2000.

Despite (or, possibly, because) of these transfers, convergence of conditions in East Germany to those in the West have been slow. Indeed, Canova and Ravn (2000) have shown, that reunification is tantamount to a mass migration of low-skilled agents holding no capital into a foreign country. Using an extension of standard neoclassical growth theory, they show how this should have led to an investment boom in the absence of a welfare state, but a prolonged recession in its presence. Thus, the anemic growth in Germany and many of the reunification problems may possibly find their cause rather than their remedy in these massive transfers to the East. This also echoes the warning of Sinn and Sinn (1992), reiterated in Sinn (2002), against raising the wages in East Germany too quickly to West German levels.

The slow rate of convergence between regions is another matter, however. Germany is not unusual in this respect. For disparate regions in a country, the slow convergence process has been documented e.g. by Barro and Sala-i-Martin in a series of papers, summarized in their book (1995). Based on this research, Barro (1991) warned against too much optimism regarding the speed at which East Germany will catch up with West Germany in a Wall Street Journal op-ed piece. He stated then that “there are substantial variations in estimates of East German productivity in 1990; a reasonable range is from one-third to one-half the West German figure. An extrapolation of the U.S. experience to the eastern regions of unified Germany implies that per-capita growth in the East would be initially 1 1/2 to 2 percentage points per year higher than in the West. This growth advantage... means that it will take about 15 years to eliminate one-half of the gap.... If so, the East would eventually catch up to the West, but in a couple of generations rather than a couple of years or a couple of decades.” Barro’s forecast turns out to be close to the current facts. 10 to 15 years after reunification, average labor productivity in East Germany (without Berlin) for 2001 to 2003 is at approximately two thirds the average labor productivity of West Germany (without Berlin), and therefore pretty much exactly where Barro predicted it would be. Likewise, the productivity growth rate differential between East Germany (without Berlin) and West Germany (without Berlin) for 1999 to 2003 is 1.6%, in line with Barro’s prediction.

The prediction in the Wall Street Journal appears to be a slight misprint, however. Given a convergence rate of 2% annually, one finds that $\exp(-0.02n) = 0.75$ is solved by $n = 14.4$ and $\exp(-0.02n) = 0.5$ is solved by $n = 34.7$; i.e., in 15 years, only a quarter of the productivity gap should have been eliminated, and it would take 35 years to eliminate half of it. This indeed is the (corrected) statement in Barro (1996, p. 14), with an update of the analysis in Barro (2002). Compared to that calculation, productivity convergence appears to be faster, at first blush. Fig. 1 provides greater detail, using the numbers from Burda (2006). Productivity convergence appears to have been fast from 1991 to 1993, so the prediction based on the 1991 numbers is far from the facts. Applying the prediction on the basis of the numbers for 1993, however, works surprisingly well. Whether the fast productivity growth in 1993 is due to mismeasurement prior to that date, whether this is due to low-productivity enterprises having simply been shut down, or whether there really has been a rather dramatic catchup in productivity in 1991 to 1993 might be an interesting subject of further research. My guess is that the former two explanations are far more likely than the latter. I conclude from this, tentatively, that the productivity convergence prediction by Barro was right, subject to a productivity jump between 1991 and 1993, probably due to some data revision or firm-closing.

His other prediction—the slowdown of migration—did not (yet) pan out, though, see Fig. 3. Barro stated that “the flow of migrants will... decline over time for two reasons: first, the East’s per-capita income will rise, if slowly, relative to the West’s; and

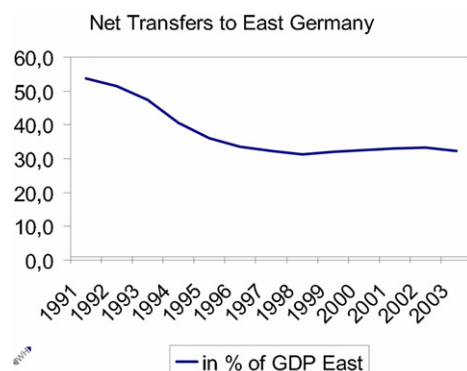


Fig. 2. Fiscal transfers from West to East Germany.

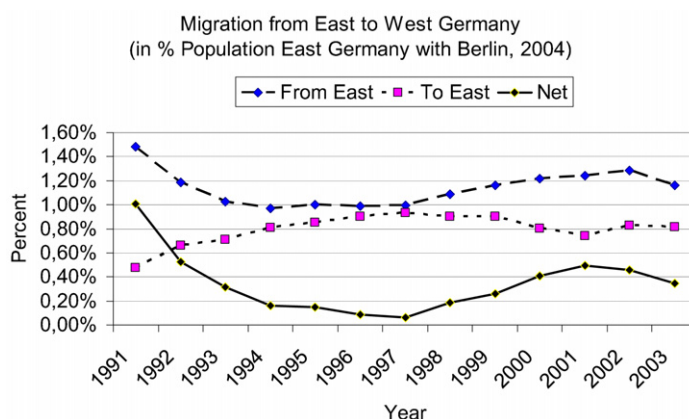


Fig. 3. Migration pattern for Germany.

second, cumulated migration will cause the West's population density to rise relative to the East's, thereby making the West relatively less attractive. The combination of these two forces implies that the annual number of net migrants will fall to a range of 140,000–230,000 by the year 2001; the projected cumulative number of migrants for the period 1991–2001 is 1.7 to 2.8 million.” Migration from East to West Germany was never quite as high: the total was approximately 0.7 million from 1991–2001, and the average migration rate for 2001–2003 of approximately 70 thousand is close to the average of the preceding ten years. One interpretation is that East Germans were initially “bribed” with the huge transfers to stay where they are, and that we now witness residual pent-up migration, as these transfers are scheduled to be gradually phased out. Another possibility is that migration from East to West Germany will continue to persist, turning East Germany into a deserted wasteland, except for a few industrial core regions. Since these migratory pattern differ from those predicted by Barro, I shall investigate them more closely in Section 2.1. I find that migration is particularly strong for the age group of 18 to 29 year old, and it is particularly strong from the country side and small cities, and much stronger than the corresponding pattern for West Germany. It appears that East Germany is slowly but surely gentrifying and dying.

In light of the analyses of Barro and Sala-i-Martin, one may be tempted to explain this pattern within the context of standard endogenous growth theories, in line with the usual explanation of slow regional convergence.

But something is amiss. The disparity between East and West Germany is not the result of many years of a gradual drifting-apart—as it is the case for the disparate regions in West Germany, the United States or Japan, which Barro and Sala-i-Martin have analyzed. Rather, here are two parts of the same country, one of which has been held back artificially during the postwar years.¹

The regions are homogeneous in many ways—the same climate, the same legal system, the same language and a similar level of general education. Technologies and blueprints can easily be transferred, capital can easily be moved. The slow rate of convergence of East to West Germany strikes me as more surprising than usual. In sum, what is needed is a theory consistent with the following stylized facts:

¹ This is similar to the distinction between risk-averse agents self-selecting into civil service job in West Germany and former East Germans being given a civil service job in East Germany, a distinction exploited by Fuchs-Schündeln and Schündeln (2005) to calculate the impact of risk aversion on occupational choice.

1. There is persistent migration from East to West Germany, in particular by the age group 18 to 29.
2. Unemployment in East Germany is higher than in West Germany.
3. Wages are lower in East Germany.
4. Average labor productivity is lower in East Germany, while education levels are similar or even higher.
5. The welfare system provides for comparable benefits in East and West Germany to short- and long-term unemployed workers.
6. There have been and continue to be sizeable fiscal transfers from West to East Germany.
7. East and West Germany operate subject to the same federal law. Regional differences in the legal system and regulations are minor.
8. Regional differences in the educational system are minor.
9. Real estate is cheaper in East Germany.

It certainly is the case that the job-specific skills and training of the workers in the East were not suitable to the new capitalist world of the West. However, the current generation of 18 to 29 year old, which are leaving East Germany in large numbers, were small children or at most teenagers by the time German reunification happened: their education and job-specific training should be on par with that of their age-compatriots in the West. It is conceivable, that the only way for them to receive apprenticeship training is to move to westwards—but then again, why do firms not move eastwards, exploiting the cost advantage of lower real estate prices, lower wages and compensation?

In Uhlig (2006, 2008), I have therefore sketched a theory of two otherwise identical regions, but where one region has higher unemployment and lower average productivity than the other, and where there is continuous, unceasing migration from the low-productivity to the high-productivity region. A standard labor search model would predict that the initially higher unemployment in the East should attract relatively more vacancy creation than in the West. Extending such a model to a two-region world with migration between them would add another valve for releasing the pressure of inequality and would eventually simply result in an equalization of the conditions in both regions. Furthermore, a reasonable parameterization would imply that this convergence happens quickly. Something more is required to make the differences persist.

To thwart this convergence, the model in Uhlig (2006, 2008) features network externality between producing firms. While firms can produce in isolation, selling their products on some anonymous market, they can often be more productive by specialization as part of a larger network of firms. A hotel can outsource many of its services like cleaning or repairs, provided such services are available from specialized firms close by. A machine or car manufacturer may outsource the production of specialized parts.

In Section 3, I discuss this model with respect to German reunification. The model has two equilibria. The “highly networked” equilibrium is the equilibrium, in which unemployment is low and average labor productivity is high, characterizing the destination region (“West Germany,” “vibrant city,” “industrial core”) for migrants. The “weakly networked equilibrium” by contrast is characterized by high unemployment and persistent emigration. The possibility to emigrate weakens job creation further, as the option value of emigration acts like an added unemployment benefit. One may want to think of this equilibrium as characterizing “East Germany”. Emigration in this model never stops, eventually turning a dying region into a wasteland.

2. Myth and facts about East Germany

2.1. Facts on inner-German migration

The general pattern of migration from East to West Germany since 1991 is shown in Fig. 3. The data counts East Berlin as part of East Germany before 2000, and all of Berlin from 2000 onwards. What is remarkable about this picture is that migration from East to West Germany has not come to rest after the initial post-unification wave. Rather, and since 1997, net emigration from East Germany has increased again. Slowly, but gradually, East Germany is shrinking in population, compared to the West.

Further investigations of East–West-German migration and commuting is presented in Hunt (2006) and Fuchs-Schündeln and Izem (2006). Here, in order to examine the issue of inner-German migration further, I have examined regional data available from the “Statistische Ämter des Bundes und der Länder,” available per <https://www.regionalstatistik.de/genesis/online/logon>. Germany is divided into 439 “Kreise” or regions, including the city states Berlin and Hamburg. For each Kreis, each year from 1995 to 2003 and several age groups, data is available on emigration and immigration, i.e., reallocations crossing the border of the Kreis. Furthermore, for 2003, detailed population data is available. The data lists the names for each Kreis. Whenever it contained the word “Stadt,” the German word for city, I have categorized the Kreis as a city, otherwise as countryside. Obviously, the “countryside” should properly be regarded also as serving as an extended suburb. Given modern possibilities for commuting, the distinction is blurred, certainly in a densely populated country such as Germany. Following the usual convention, I have categorized cities with a total population in 2003 of more than 100,000 as a large city and below that as a small city. The distribution across the various categories can be seen in Table 1.

Fig. 4 shows the distribution of the city sizes in East and West, plotting the log of the fraction of cities above a certain size versus the log of that size. As is well known as Zipf’s law, one often obtains a fairly straight line, see e.g. Krugman (1996) or Gabaix and Ioannides (2004): the same is true here.

Table 1
Distribution of the population in Germany

	All	East	West
	<i>Total population</i>		
Number of “Kreise”	439	113	326
Popul. in % of total	100	20	80
	<i>Large cities</i>		
Number of “Kreise”	70	12	58
Popul. in % of region	28	35	27
	<i>...without Berlin, Hamburg</i>		
Number of “Kreise”	68	11	57
Popul. in % of region	22	15	24
	<i>Small cities</i>		
Number of “Kreise”	46	15	31
Popul. in % of region	3	6	3
	<i>Countryside</i>		
Number of “Kreise”	323	86	237
Popul. in % of region	68	59	71

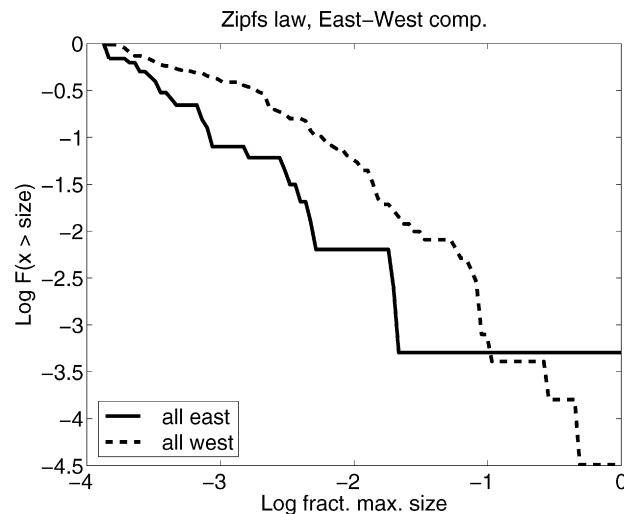


Fig. 4. Comparing the distribution of city sizes in East and West Germany.

Next, I calculate the migration rates of subpopulations within each of these categories and for various age groups, expressed in percent of the 2003 population. Fig. 7 shows a key pattern: the future work force of East Germany, i.e., the population aged 18 to 29 years, is leaving East Germany in large numbers. While there is considerable “churning,” i.e., while gross flows are considerably larger than net flows, there is little doubt that gradually and persistently, East Germany is shrinking in the relevant working-age population. This is also corroborated by Fig. 5: essentially, only people above age 50 stay in East Germany, all others gradually leave. Note also, that the migration pattern of people below 17 is nearly identical to the migration pattern of the group aged 30–49, since the former are the children of the latter. I therefore do not plot this age group in the other figures.

In Fig. 5, migrants crossing the German border are included. This makes a substantial difference, as a visual comparison to 3 already shows. While the latter shows persistent emigration from East to West Germany, 5 seems to indicate that there was net positive immigration until about 1997. Thus, Fig. 6 shows only the numbers for inner-German migration. The numbers now look bleaker, as it excludes a fairly large number of immigrants to East Germany from foreign countries. Since both types of numbers shed different light on the phenomenon, I included both throughout. For example, Fig. 8 is the companion figure to Fig. 7.

The fact that East Germans are leaving East Germany is particularly true for the countryside. Fig. 9 compares the migration patterns for various regions and age groups in East and West Germany. Fig. 10 concentrates on inner-German migrants, i.e., excludes migration crossing the German border. While the countryside provides a stable or even growing environment in West Germany, there is an exodus of young people in rural East Germany. Cities are generally attractive to young people, but more so in the West, while people above 30 and their young children (not shown) leave East German city at a faster rate than in the West. Figs. 11 and 12 (for only inner-German migration) focus on the migration pattern of

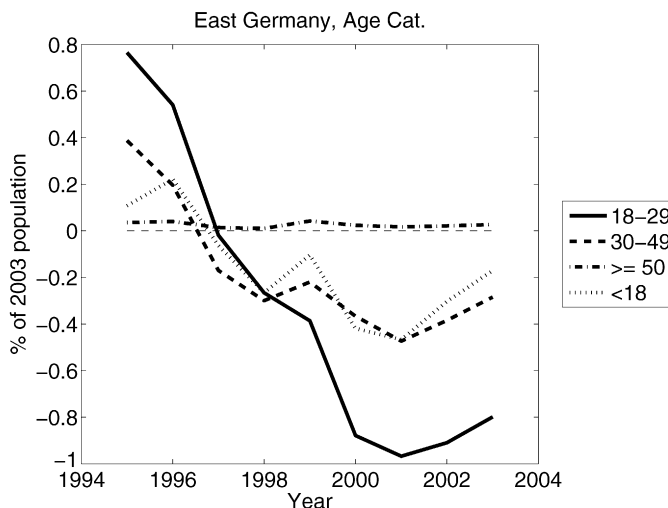


Fig. 5. Net migration rates for various age groups, East Germany. Only people above age 50 stay in East Germany, all others gradually leave.

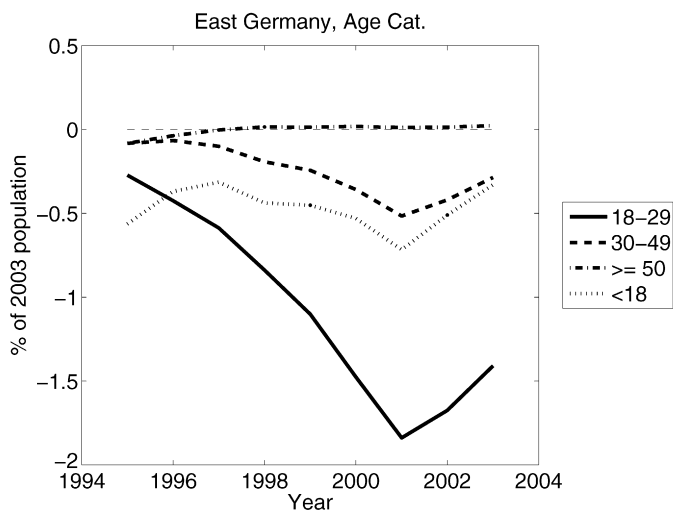


Fig. 6. Net migration rates for various age groups, East Germany, calculated for inner-German migrants, i.e., excluding migration crossing the German border.

people at age 18 to 29, showing both the rates (in percent of the 2003 population) as well as the cumulative effect. The cumulative effect needs to be taken with the caveat, that people age, i.e., the group of 18–29 year old is replenished by young children, as they age, etc. Nonetheless, the implied changes in the population of East Germany, in particular, rural East Germany, and the generational composition of this population is shifting dramatically and continues to do so, 15 years after reunification.

A comparison of Figs. 13 and 14 shows the migration pattern of the 18–30 year old population as a map of Germany, comparing 1995 to 2003. The colors code migration from net migration rate of less than -3% (dark red) to more than $+3\%$ (dark green). The difference between 1995 and 2003 is stark: the net exit from East Germany has accelerated as an area-wide phenomenon, except for a few small patches, corresponding to the large cities.

One may not notice the ongoing exodus of the young population in East Germany, when taking just a snapshot of the population distribution. Fig. 15 shows the 18–30 year old per 1000 in 2003 across Germany, with dark red showing low numbers mostly prevalent in northern, western and far southern Germany—but not Eastern Germany. However, the comfort in these numbers is only apparent. Fig. 16 shows the ratio of the 18–30 year old in 2003 to the 10–20 year old in 1995, as a (somewhat rough) measure of whether young people stay or not. Now, East Germany is the area deeply colored in red, denoting particularly low ratios between 67 and 101. What is happening is simple to explain. Before reunification, East Germany had a larger birth rate than West Germany: while the children still grew up in East Germany, they now choose to migrate to the cities and the West. Thus, with young families and their children lacking in the future, the population in East Germany appears to be aging and declining ever further.

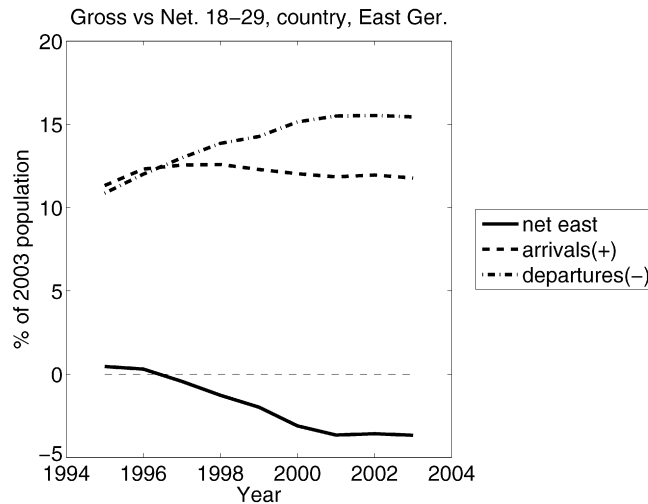


Fig. 7. Gross and net migration of people, aged 18–29, into East Germany, in percent of the 2003 population of that age group.

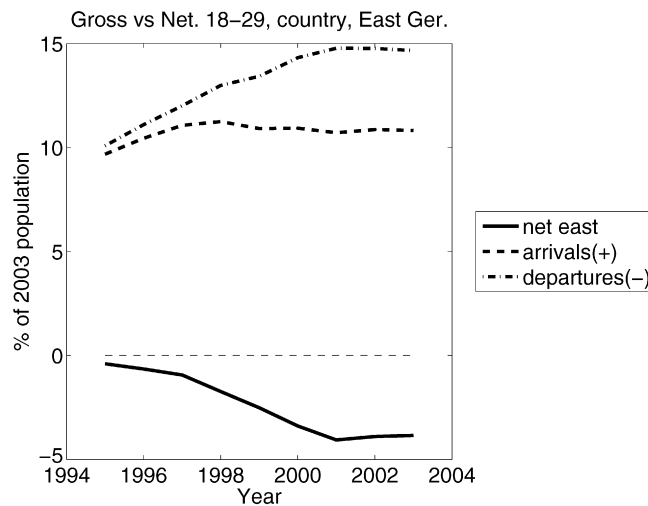


Fig. 8. Gross and net migration of people, aged 18–29, into East Germany, in percent of the 2003 population of that age group. Here, only inner-German migration is shown.

Fig. 17 shows that young women lead the way in the exodus: there are particularly few young women per 1000 in the 18–30 year old population in East Germany. One should be cautious in overinterpreting these numbers: for the entire map, they range from 426 (light red) to 551 (dark red), still giving reasonable matching odds for the males in the lighter areas in East Germany. One interpretation may be, that females seek out regions populated by employed and higher-earning males and thus migrate. If so, then these ratios would return to their normal balance, if East Germany were to prosper just as much as West Germany. That, however, seems unlikely.

2.2. Employment characteristics

Fig. 18 shows that earnings² are considerably lower in East Germany: the white areas indicate earnings of under 2249 Euros per month per employed worker, whereas the dark red areas correspond to 2790 Euro per month and more for 2002. Despite labor being cheap in East Germany, unemployment is high, as Fig. 19 shows for 2004. Moreover, the unemployment statistics have gradually worsened over time in East Germany. Fig. 20 shows increases of 3% or more for most of East Germany over the years 1995 to 2004, while matters remained unchanged or even improved in much of West Germany during the same time. These statistics are mirrored in the facts on the fraction of the population receiving social security (“Sozialhilfe”).

² The figures for all the following graphs are obtained from the INKAR CD ROM 2006 by the Bundesamt für Bauwesen und Raumordnung.

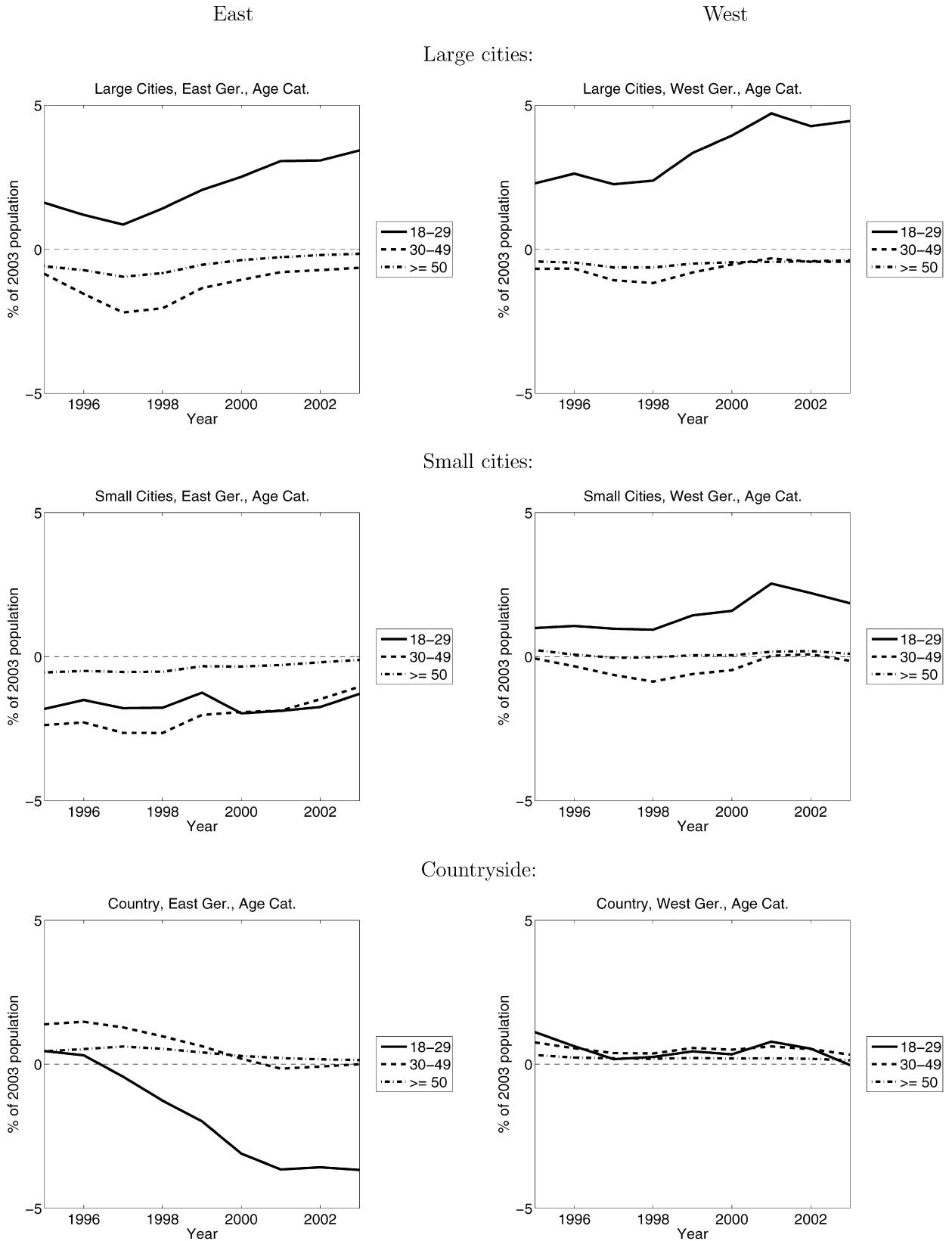


Fig. 9. Net migration rates for various age groups and regions, comparing East and West Germany.

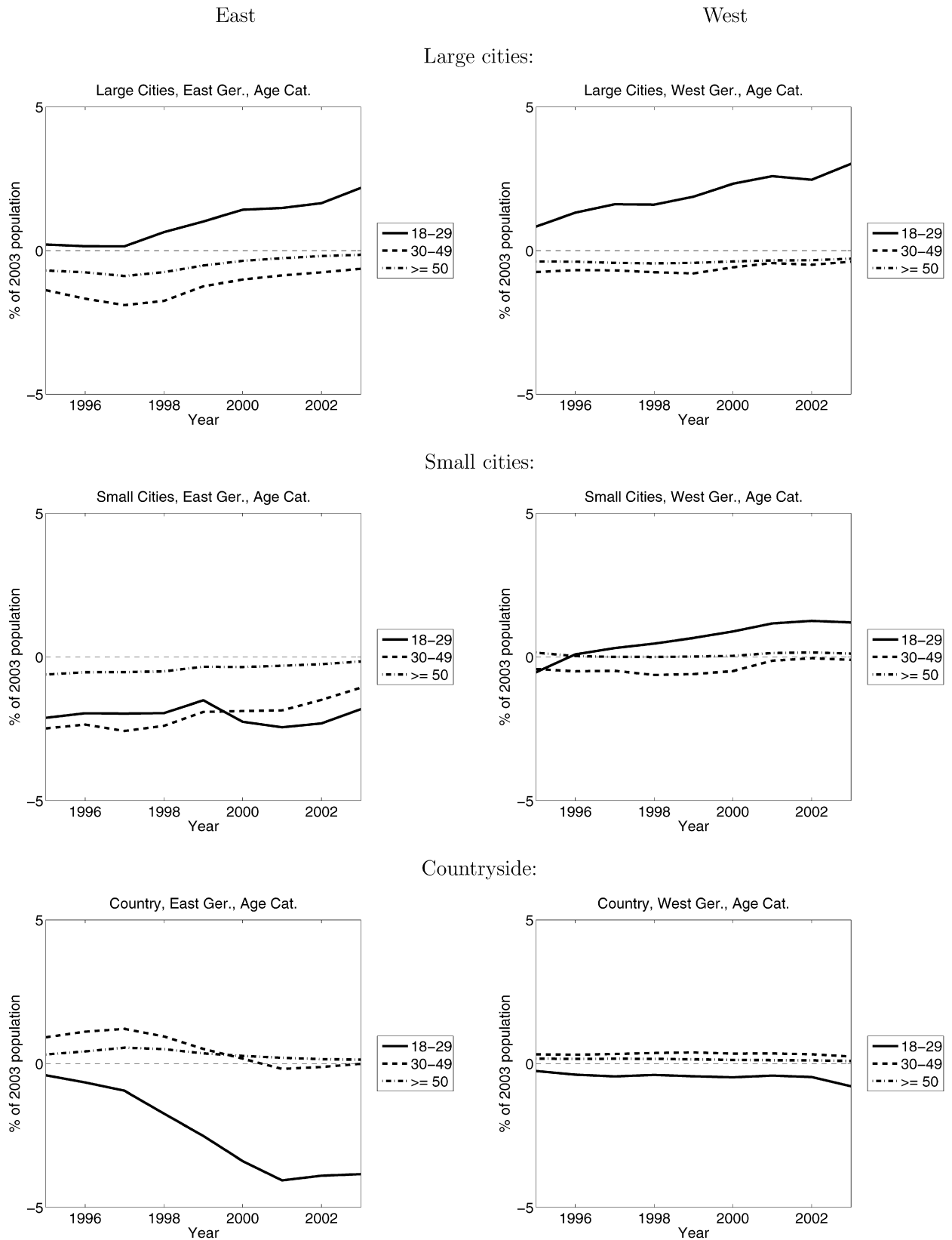


Fig. 10. Net migration rates for various age groups and regions, comparing East and West Germany, inner-German migration only.

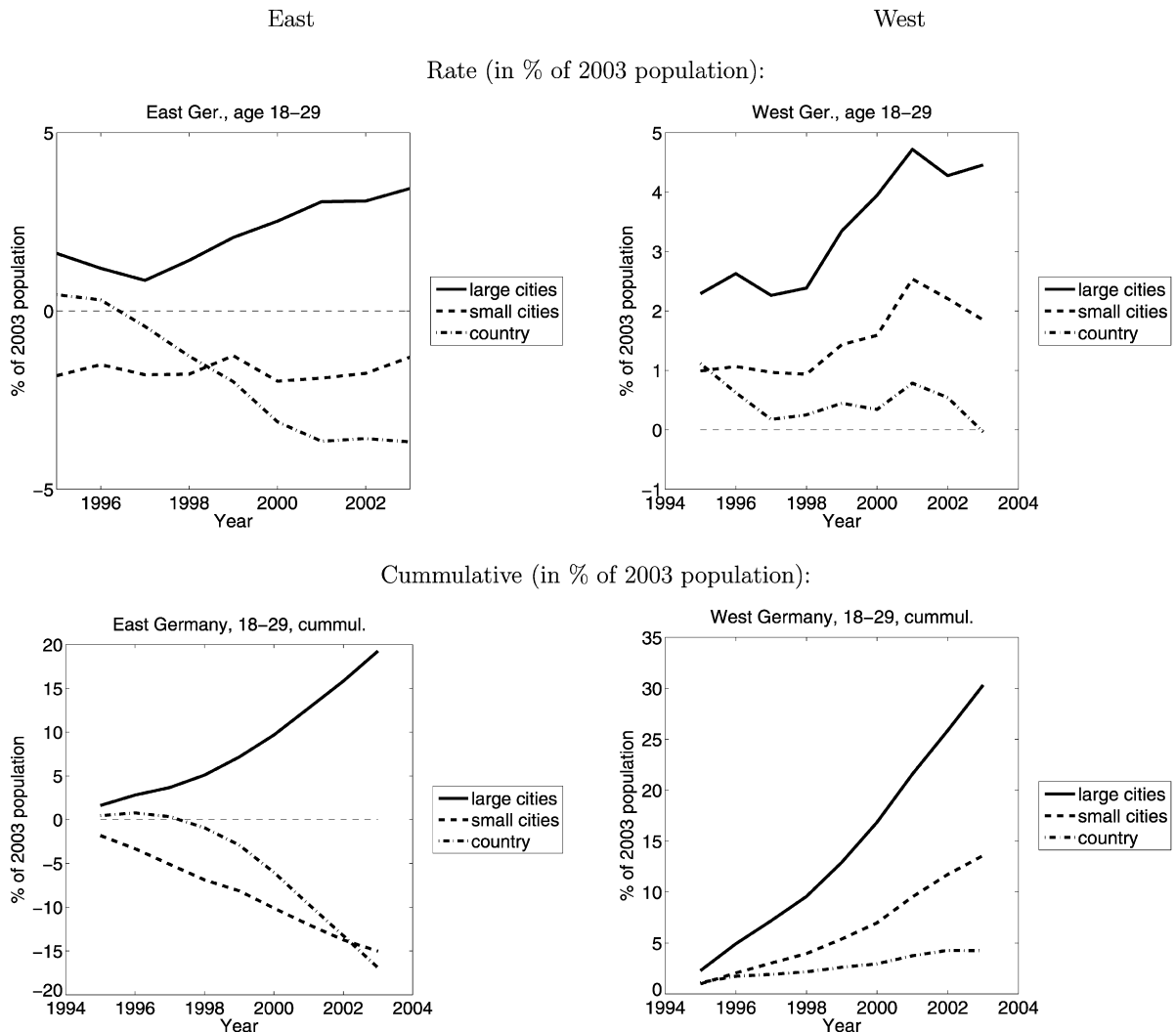


Fig. 11. Migration patterns of 18–29 year old.

These ratios were particularly high in particular in the north and east of Germany, often exceeding even 38% as a regional average, see Fig. 21, and rising in particular in East Germany, but falling in West Germany, see Fig. 22.

A few caveats are in order, though. It is not the case that unemployment affects young people in particular in East Germany. Fig. 23 shows that youth unemployment, i.e. the fraction of unemployed, who are under the age of 25, is not particularly high in East Germany and appears to be highest in Southern Germany (which has low levels of unemployment rates to begin with, however). Also, the employment ratio in East Germany is not unusually low, as Fig. 24 shows for 2003 (with light areas denoting low employment ratios). This is due to a comparatively high female employment ratio in East Germany, often exceeding 46% of all employed, as Fig. 25 shows.

One may be tempted to believe that high unemployment and low wages in East Germany may be due to low levels of education and training. While this would be hard to square with the observed migration patterns, it also is not born out by the facts. Fig. 26 shows that the ratio of employed workers recorded to have “high qualifications” is particularly high in East Germany, with ratios often exceeding 7.2%, while Fig. 27 shows that the fraction of pupils attending the highest of the three German high school tracts, the so-called Gymnasium, is typically particularly high in East Germany, with ratios often exceeding 26%.

3. Applying a model of labor search, migration and network externalities to German reunification

3.1. The model

To shed light on these phenomena, I have provided an extension of the standard labor search model in Uhlig (2008), a sketch of which has been provided previously in Uhlig (2006). Surely, market distortions and policy interference in East

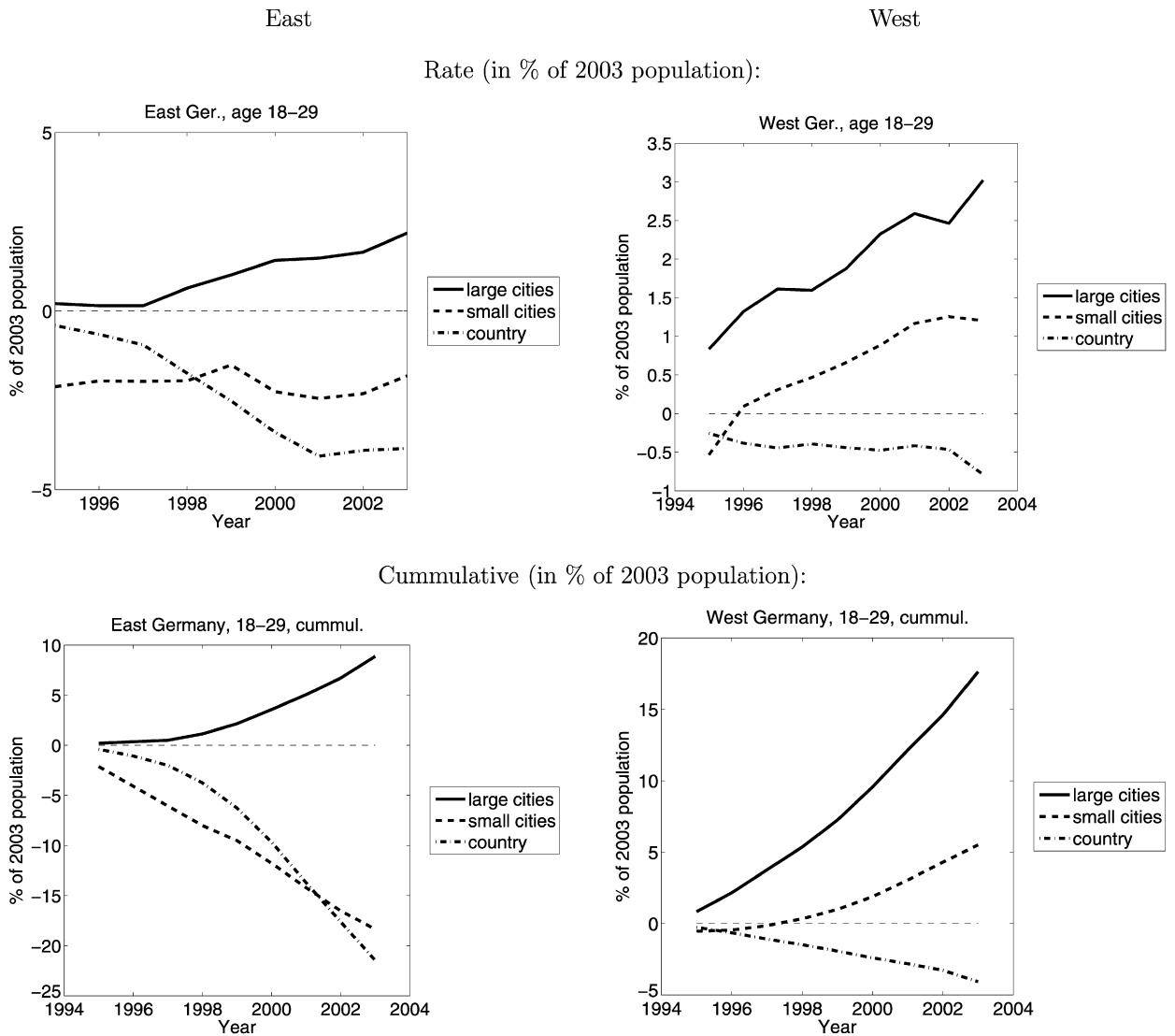


Fig. 12. Migration patterns of 18–29 year old, inner-German migration only.

Germany have been big, see Merkl and Snower (2006) and adjustment costs are large, see Burda (2006). But should we be confident that East Germany would recover quickly, if all these policy distortions were to be removed? The model in Uhlig (2006, 2008) provides a simple framework to show that this may not be so. It shows that one region (East Germany) can have higher unemployment, lower productivity and persistent outward migration compared to another region (West Germany) and without any convergence taking place, despite the absence of policy distortions or costs to moving factors of production (while the latter is the main cause of the slowdown of convergence in Burda, 2006). Workers also do not suddenly become more skilled by moving from East to West. Rather, I argue, that agglomeration effects play a key role, see also Fujita et al. (1999), Krugman (1996) and Cooper (1999).

A standard labor search model would predict that the initially higher unemployment in the East should attract relatively more vacancy creation than in the West. Migration would provide for an additional valve. Something more is needed. The model in Uhlig (2006, 2008) therefore extends the standard labor search model to allow for migration as well as network externalities of production. The model closely follow the notation and exposition of Rogerson et al. (2005, Section 4). The model and some of its analysis will be restated here for completeness.

For the network externalities, consider a match of a worker and a firm. In isolation, production is assumed to be y_m (m for “match”). I assume that it is beneficial for this pair to join a network of enterprises and specialize on some specific task. Thus, as part of a network, the production by this pair is now assumed to be $y_n > y_m$ (n for “network”). Joining a network is probabilistic. I assume that this probability depends on the ratio of non-networked firm–worker-pairs m_t to networked firm–worker pairs n_t : this turns out to make the model fairly tractable. Thus, let $v = v(m_t/n_t)$ be the instantaneous probability for a non-networked firm–worker match to become part of some network of firms. Division of labor is beneficial

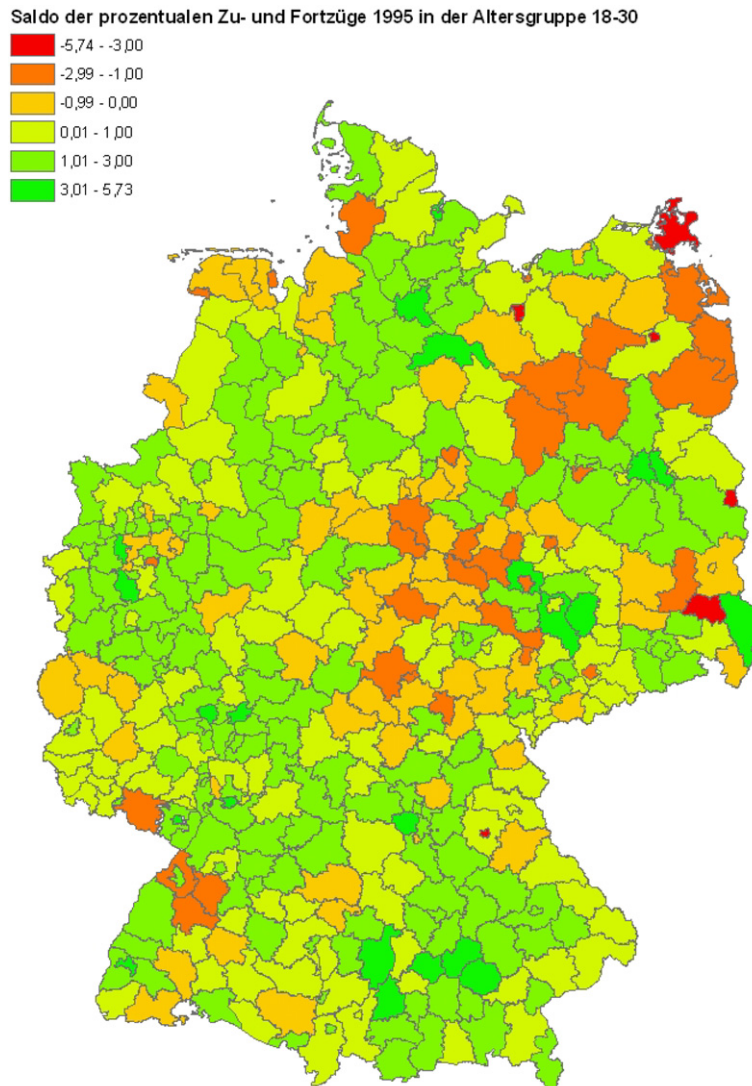


Fig. 13. Regional net migration in Germany in 1995 for the age group 18–30. Regions colored in dark red experienced an outflow of 3% or more, whereas regions that are colored dark green experienced an inflow of 3% of more, compared to the existing population. (For interpretation of the references to color in this figure legend, the reader is referred to the web version of this article.)

to all: so, the larger the networks, the better. There is no rivalry in joining a network. Furthermore, the more networks are already present, the larger shall be the chance of an unmatched firm to join one. I therefore assume that $\nu(\cdot)$ is decreasing. For simplicity, I assume that $\nu = \nu_h > 0$ for $m_t/n_t \leq \psi$ and $0 \leq \nu = \nu_l < \nu_h$ for $m_t/n_t > \psi$ and some value $\psi > 0$, satisfying

$$\nu_l \psi < \lambda < \nu_h \psi, \quad (1)$$

where λ is the exogenous job separation rate for (networked) firm–worker matches. I shall write ν , keeping in mind, that this can take one of the two values. I will calculate the equilibrium for a “guess” for ν and then determine ν with the equilibrium ratio of m_t to n_t .

For the migration part, I assume that agents have the option of moving from the region under consideration to some other outside region. Agents experience a disutility $\kappa > 0$ from moving, expressed in wage-equivalent units. I assume that with some instantaneous probability ϕ , a new disutility level κ' is drawn iid from some distribution $F(\kappa)$. Let U be the value to an unemployed worker in the region under consideration (“East Germany”) and let \bar{U} be the value to an unemployed worker in the destination region (“West Germany”). Upon receiving a new draw of the disutility κ , the worker will move, iff $U \leq \bar{U} - \kappa$. Let κ^* be value, for which equality is achieved. This modeling assumption can be seen as a rather stylized way of capturing the fact that young people in practice find it easier to move for a variety of reasons—family considerations, social networks, habits, etc.—than older people. With this interpretation, the probability ϕ is the probability of “rebirth,” with an age (parameterized as moving disutility) randomly drawn from the population distribution. The alternative would

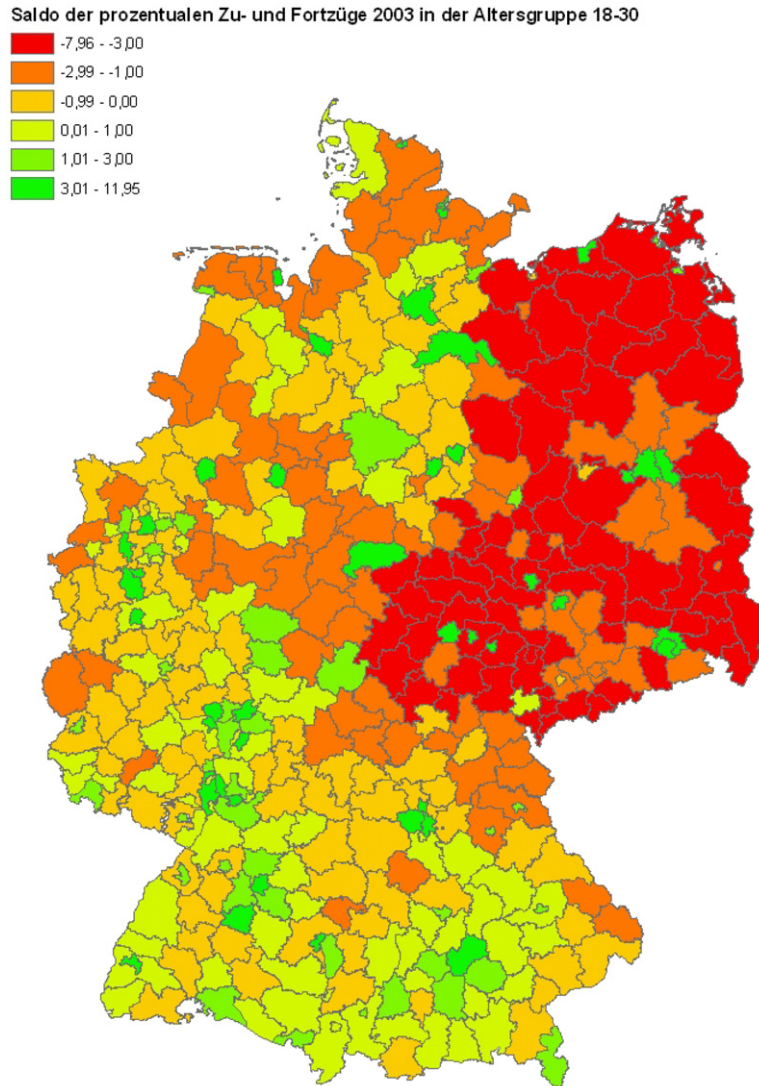


Fig. 14. Regional net migration in Germany in 2003 for the age group 18–30. Regions colored in dark red experienced an outflow of 3% or more, whereas region that are colored dark green experienced an inflow of 3% or more, compared to the existing population. Note that East Germany is now considerably more in dark red than in the previous figure. (For interpretation of the references to color in this figure legend, the reader is referred to the web version of this article.)

be to model a labor search market with life-cycle considerations which gets elaborate fairly quickly. I let ι be the rate of immigration into the region. For the West, ι should be thought of as positive. Since migration is from East to West Germany, and since West Germany is about four times as large as East Germany, I shall ignore the immigration term, and use the approximation $\iota = 0$ for simplicity.

The other features are standard and are taken from Rogerson et al. (2005, Section 4), modified to allow for non-networked as well as networked matches. I assume that workers can be unemployed, or produce in a match. While unemployed, workers receive benefits b . Firms can post vacancies at a flow cost rk per unit of time of posting the vacancy. There is free entry to posting vacancies. Let u be the mass of unemployed workers and v the mass of vacancies. Matching between vacant positions and workers happens according to a constant-returns-to-scale matching function. I write $\alpha_w = \alpha_w(v/u)$ for the rate at which unemployed workers find a job, and $\alpha_e = \alpha_e(v/u) = \alpha_w(v/u)/(v/u)$ be the rate, at which vacancies are filled, with $\alpha_w(\cdot)$ increasing and $\alpha_e(\cdot)$ decreasing in their argument.

In a match, continuous bargaining assures that the worker receives a share $0 < \theta < 1$ of the joint remaining surplus from production, which I denote with S_m for matched, but not yet networked firm–worker pairs, and S_n for networked firm–worker pairs. I assume that there is an exogenous separation rate λ , regardless of whether the match is networked or not. I assume that workers and firms discount the future at rate r .

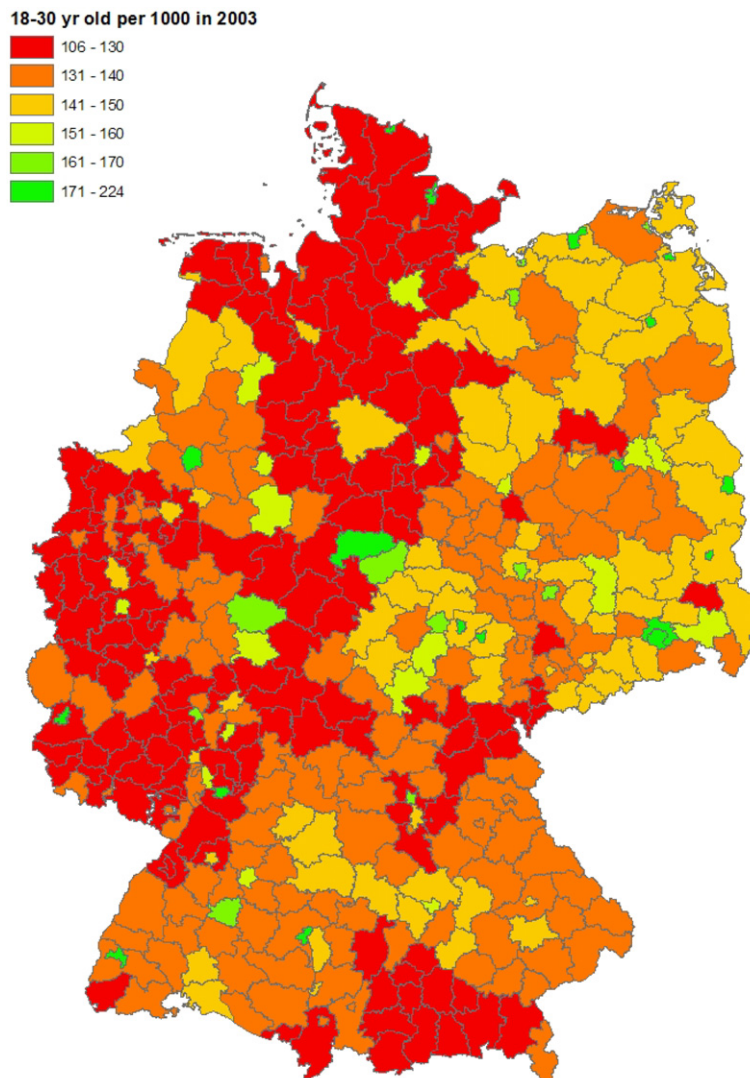


Fig. 15. Fraction of the 18–30 year old in the total population in 2003, with dark red indicating low numbers. Note that East Germany exhibits fairly average numbers, due to high pre-unification birth rates. (For interpretation of the references to color in this figure legend, the reader is referred to the web version of this article.)

3.2. Analysis and results

A more detailed analysis of the model is provided in Uhlig (2008), but some key steps shall be provided here for the sake of completeness. The value of being unemployed is given by

$$rU = b + \phi \chi(\kappa^*) + \alpha_w \theta S_m, \quad (2)$$

where

$$\chi(\kappa^*) = F(\kappa^*)(\bar{U} - U - E[\kappa | \kappa \leq \kappa^*]) = \int_0^{\kappa^*} F(\kappa) d\kappa$$

is the “option value” of moving to the outside region. It depends on U via the cutoff-level $\kappa^* = \bar{U} - U$. Eq. (2) shows that the possibility of moving to another region is tantamount to increasing the benefit level b to

$$\tilde{b} = b + \phi \chi(\kappa^*)$$

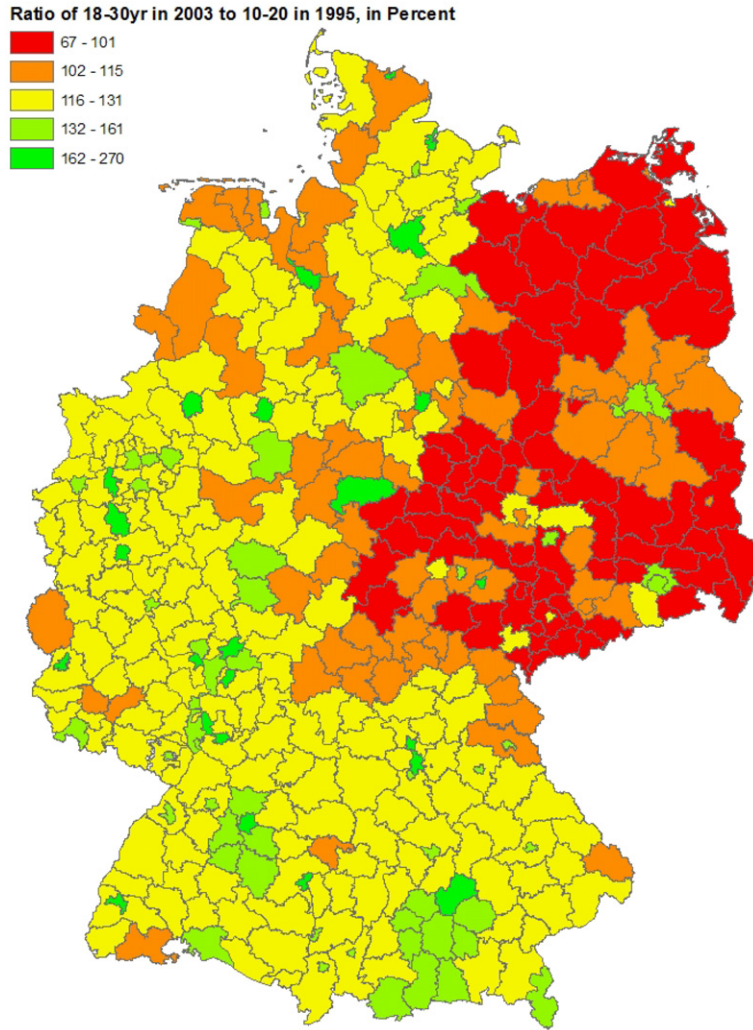


Fig. 16. Ratio of the 18–30 year old in 2003 relative to the 10–20 year old in 1995, with dark red numbers indicating numbers between 67 and 101 percent, while dark green numbers indicate numbers between 162 and 270 percent. This figure documents a dramatic exodus of the young population from East Germany. (For interpretation of the references to color in this figure legend, the reader is referred to the web version of this article.)

since the option value of moving increases the value of being unemployed.³ Therefore, Eq. (2) can be rewritten as

$$rU = \tilde{b} + \alpha_w \theta S_m. \tag{3}$$

The two equations for the surplus S_m and S_n are given by

$$(r + \lambda + \nu)S_m = y_m - rU + \nu S_n,$$

$$(r + \lambda)S_n = y_n - rU;$$

i.e., the flow value of the surplus in the networked state is given by current production minus the flow value of being unemployed (noting that the value of a firm is zero, due to free entry). The flow value of the surplus in the non-networked state also reflects the possibility of transiting into the networked state.

³ Eq. (2) can be seen from the heuristic equation

$$U \approx b + \exp^{-r\Delta t} \left((1 - (\phi + \alpha_w)\Delta t)U + \phi \Delta t \int_{\kappa} \max\{U, \bar{U} - \kappa\} dF(\kappa) + (\alpha_w \Delta t)\theta S_m \right)$$

as $\Delta t \rightarrow 0$.

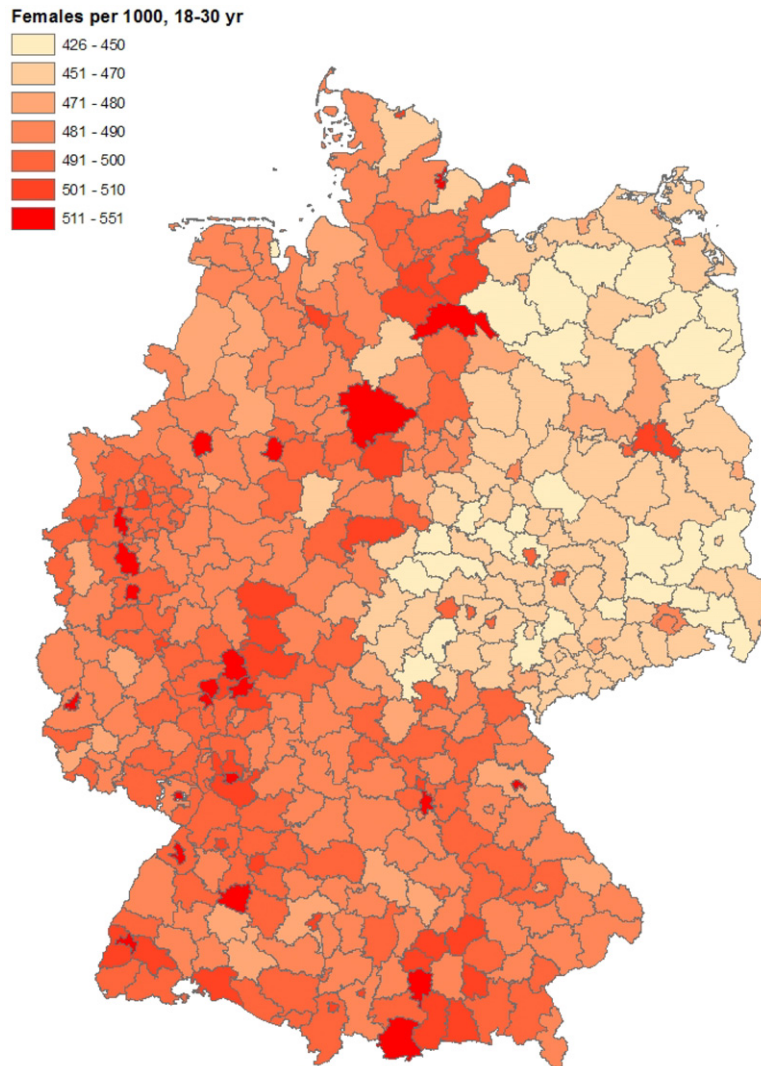


Fig. 17. Regional ratios of females to all 18–30 year old in 2003. The numbers for East Germany are low compared to West Germany, ranging typically between 42% and 47%. (For interpretation of the references to color in this figure legend, the reader is referred to the web version of this article.)

These two equations can be combined to yield

$$(r + \lambda)S_m = \tilde{y} - rU, \quad (4)$$

where

$$\tilde{y} = \tilde{y}(v) = y_m + \frac{v}{r + \lambda + v}(y_n - y_m) \quad (5)$$

is an average of the labor productivities.⁴ A higher rate of joining a network increases ceteris paribus the surplus in the same way that a higher productivity would.

Substituting rU on the right-hand side of (4) with (3) and collecting terms in S_m yields

$$(r + \lambda + \alpha_w \theta)S_m = \tilde{y} - \tilde{b}. \quad (6)$$

The vacancy posting condition is given per

$$k = \alpha_e(1 - \theta)S_m. \quad (7)$$

⁴ This averaged labor productivity \tilde{y} is generally slightly different from the population average labor productivity, which is given by

$$y^a = y_m + \frac{v}{\lambda - \phi F(\kappa^*) + v}(y_n - y_m).$$

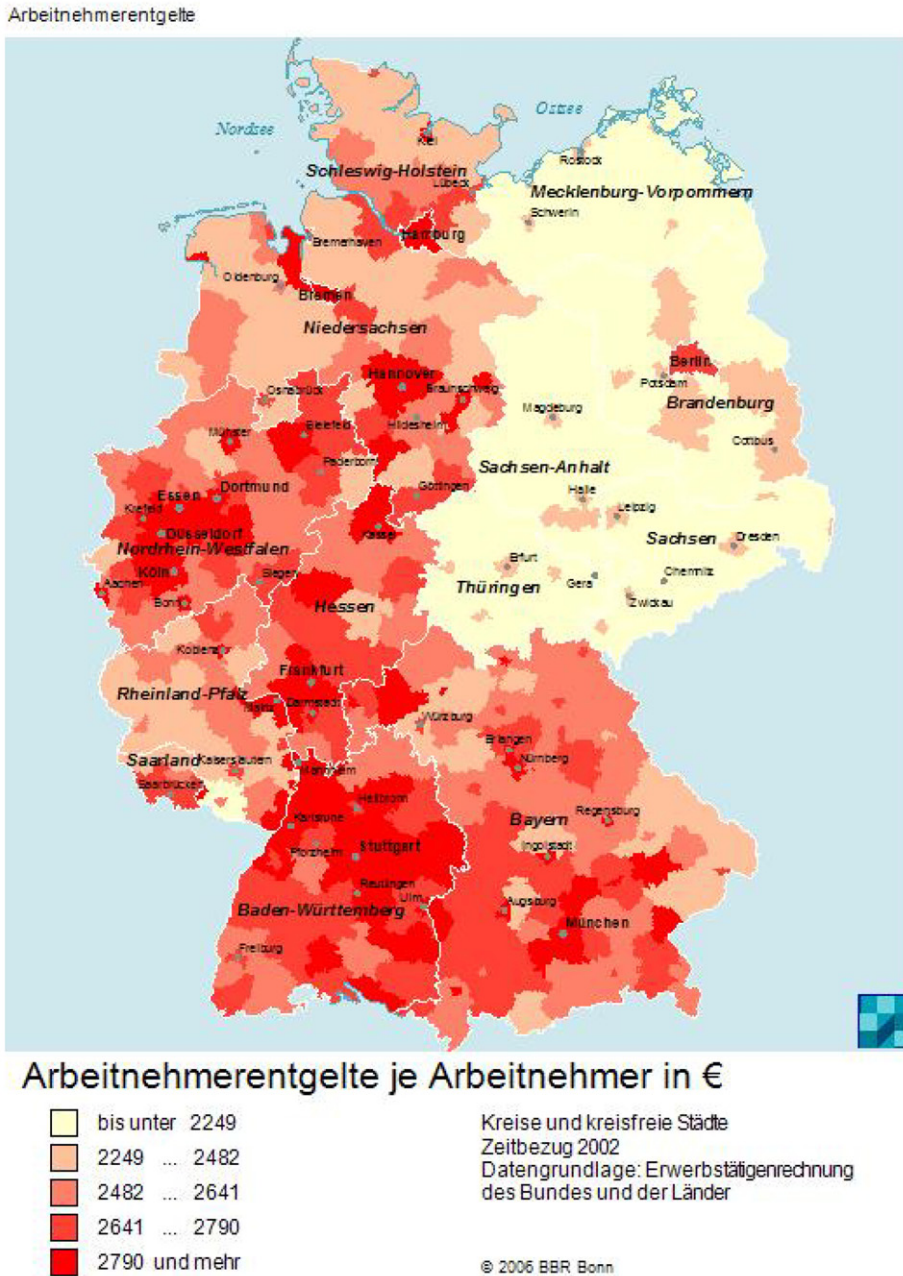


Fig. 18. Monthly salaries are low in East Germany in 2002, typically below 2249 Euros, compared to West German levels of 2641 Euros or more in the somewhat darker red regions. Data and graph computed with the INKAR CD ROM 2006. (For interpretation of the references to color in this figure legend, the reader is referred to the web version of this article.)

Use this equation to replace S_m in Eq. (6). Therefore and as in Eq. (43) of Rogerson et al. (2005), it follows that the matching rates α_e and α_w satisfy

$$\frac{r + \lambda + \alpha_w \theta}{(1 - \theta) \alpha_e} = \frac{\bar{y} - \bar{b}}{k}. \tag{8}$$

This equation amounts to a fixed point problem in κ^* . In Uhlig (2008), I provide a perturbation argument to show that there is a unique fixed point as a continuous function of ϕ for ϕ near zero.

Eq. (8) provides a number of key insights into this model. The averaged labor productivity \bar{y} and the “modified” unemployment benefit $\bar{b} = b - \phi \chi(\kappa^*)$ play the same role as in the standard model, and provide the channel for the networking and migration effects here. A lower networking rate ν and a larger migration rate $\phi \chi(\kappa^*)$ both have the effect of discour-



Fig. 19. Unemployment is high in East Germany 2004, typically above 11%, compared to typical West German levels of 7% to 11% in the north and below 7% in many regions in the south. Data and graph computed with the INKAR CD ROM 2006.

aging job creation, decreasing the job matching rate α_w for workers, increasing the vacancy filling rate α_e for firms and thus increasing the surplus of a non-networked match S_m according to Eq. (7). A lower job matching rate α_w decreases the value of being unemployed U and consequently increases the migration threshold κ^* , i.e. makes emigration more likely.

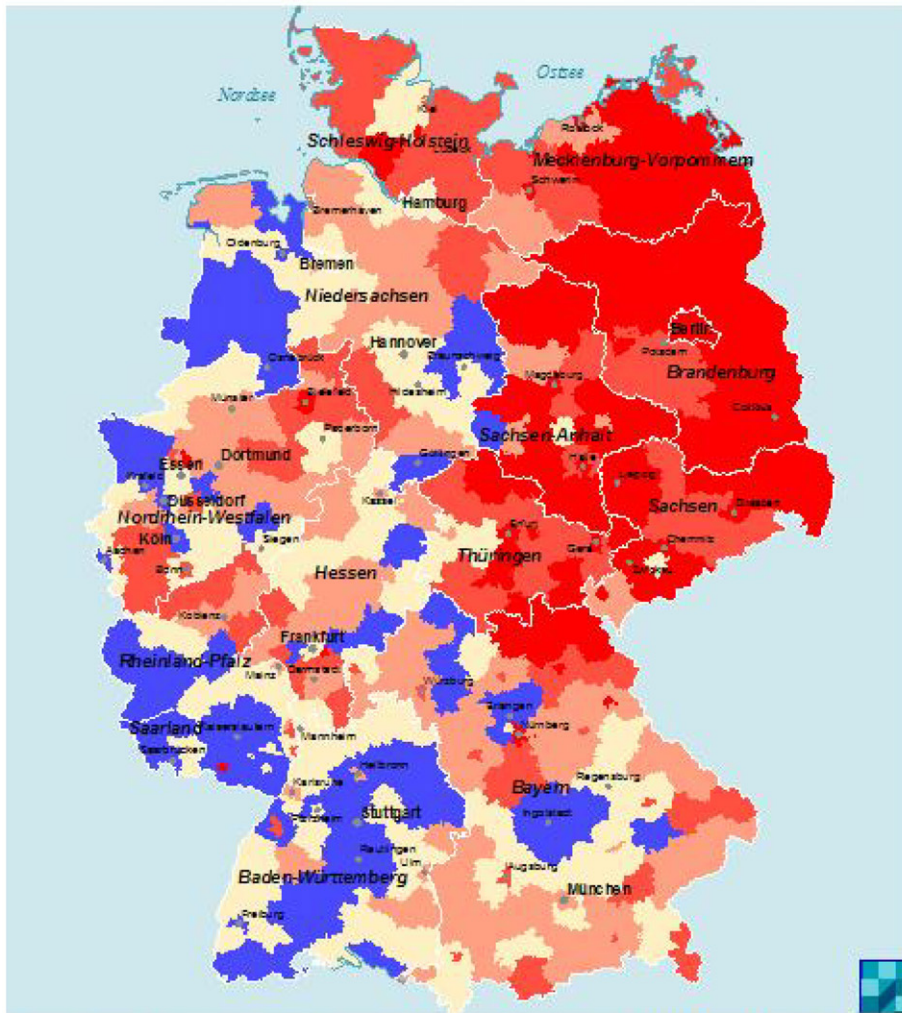
The dynamics of the model is examined in closer detail in Uhlig (2008): here, a sketch shall suffice. Let u_t be the mass of unemployed workers, and recall that m_t is the mass of workers in a non-networked match and n_t the mass of workers in networked matches. Generally, there will be migration out of the region, and therefore, u_t , m_t and n_t will not have a constant steady state. Let

$$\pi_t = u_t + m_t + n_t$$

be the total population in the region. Define

$$\tilde{u}_t = \frac{u_t}{\pi_t}, \quad \tilde{m}_t = \frac{m_t}{\pi_t}, \quad \tilde{n}_t = \frac{n_t}{\pi_t}$$

Arbeitslosenquote



Entwicklung der Arbeitslosenquote in %-Punkten



Kreise und kreisfreie Städte
 Zeitbezug 1995/2004
 Datengrundlage: Arbeitsmarktstatistik der
 Bundesagentur für Arbeit; Eurostat Regio
 Datenbank
 © 2006 BBR Bonn

Fig. 20. Change of unemployment between 1995 and 2004, showing increases of 3% or more for most of East Germany compared to no change or slight improvement in West Germany. Data and graph computed with the INKAR CD ROM 2006.

as the shares of the total population of workers for each of the three possibilities. I shall concentrate on the case where these shares are constant. Note that the rate of population decrease is given by

$$\frac{\dot{\pi}_t}{\pi_t} = -\phi F(\kappa_t^*) \tilde{u}_t. \tag{9}$$

With a constant share of unemployed $\tilde{u}_t \equiv \tilde{u}$, the population decreases exponentially. Emigration never ceases, and unemployment as a share of the population remains high. The region is slowly declining.

In Uhlig (2008), I show that the constant share solution is given as the solution to the system of equations

$$\tilde{u} \alpha_w = (1 - \tilde{u})(\lambda - \phi F(\kappa^*) \tilde{u}), \tag{10}$$

$$v \tilde{m} = (\lambda - \phi F(\kappa^*) \tilde{u}) \tilde{n}, \tag{11}$$

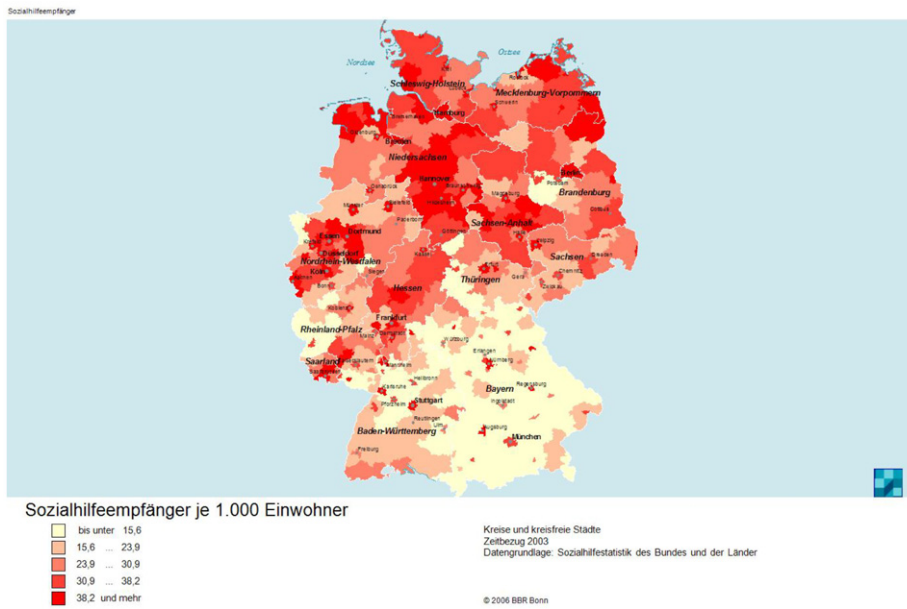


Fig. 21. The fraction of the population receiving social security is high in North and East Germany, with numbers often exceeding 30%. Data and graph computed with the INKAR CD ROM 2006.

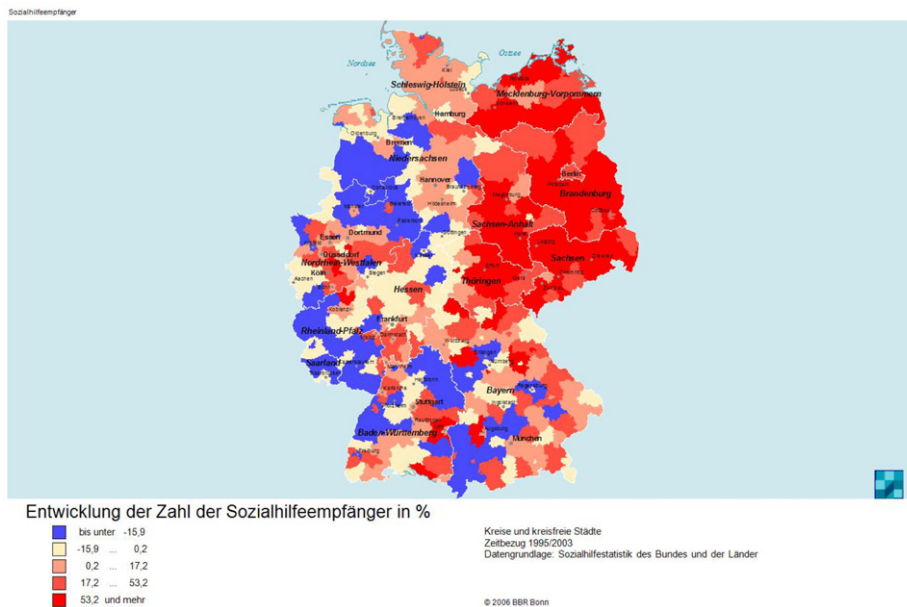


Fig. 22. The fraction of the population receiving social security has increased in East Germany from 1995 to 2003, adding more than 50% of recipients in a large number of regions. Data and graph computed with the INKAR CD ROM 2006.

$$1 = \tilde{u} + \tilde{m} + \tilde{n}. \tag{12}$$

Given the solution for κ^* and α_w , the first equation is a quadratic equation for \tilde{u} , with the relevant of the two solutions coinciding with the standard solution

$$\tilde{u} \rightarrow \frac{\lambda}{\lambda + \alpha_w} \tag{13}$$

as $\phi \rightarrow 0$. Given \tilde{u} , the remaining two linear equations can now be solved for \tilde{m} and \tilde{n} .

With Eq. (8) and for ϕ sufficiently low, a lower networking rate ν results in a lower job finding rate α_w and a higher emigration rate $\phi F(\kappa^*)$. Eq. (13) furthermore shows that the share of unemployed is also higher. Both, the higher unemployment share \tilde{u} as well as the faster emigration rate result in a faster rate of population decrease, see Eq. (9).

Anteil jüngere Arbeitslose

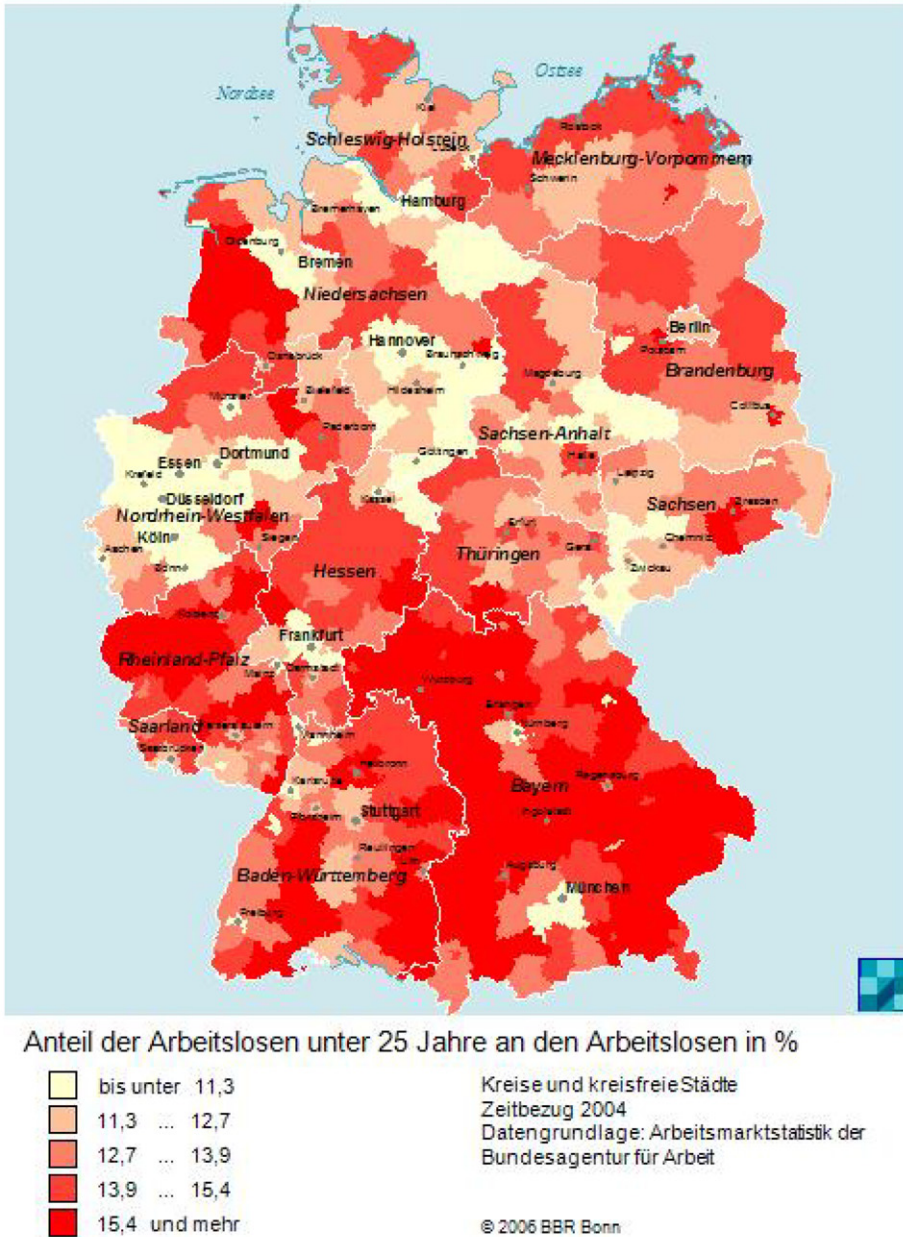


Fig. 23. Youth unemployment as a fraction of total unemployment is high in South Germany. Data and graph computed with the INKAR CD ROM 2006.

So far, I have not determined the networking rate ν . A solution to the equations above exists both for $\nu = \nu_h$ and $\nu = \nu_l$. Rewrite Eq. (11) as

$$\nu \frac{\tilde{m}}{\tilde{n}} = \lambda - \phi F(\kappa^*) \tilde{u}. \tag{14}$$

With (1), the calculated equilibrium is consistent with the step function assumed above for $\nu = \nu(m_t/n_t)$, provided ϕ or $F(\kappa^*)$ is sufficiently small.

A graphical representation of Eq. (14) is provided in Fig. 28. There are two equilibria relevant for our discussion. The “highly networked” equilibrium is the equilibrium, in which $\nu = \nu_h$, unemployment is low, and average labor productivity $\tilde{y}(\nu)$ is high. In a full general equilibrium, this equilibrium ought to characterize the destination region (“West Germany,” “vibrant city,” “industrial core”) for migrants, thus fixing \bar{U} . In that region, there is no outward migration. Ignoring inward migration, the equilibrium is given by the point W in Fig. 28. The “weakly networked equilibrium,” given by point E in

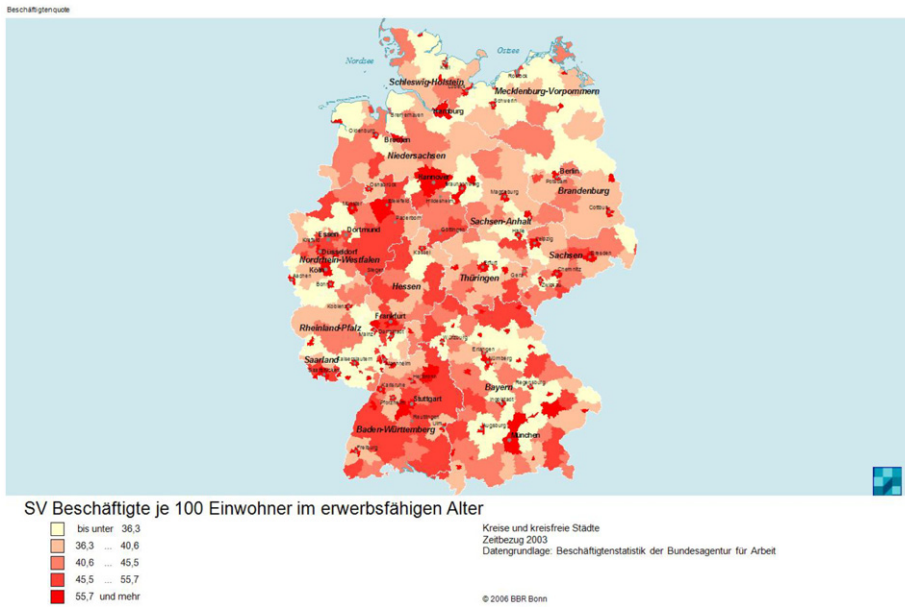


Fig. 24. The employment ratio, i.e. the fraction of the population which is employed, is low to average in East Germany. Data and graph computed with the INKAR CD ROM 2006.

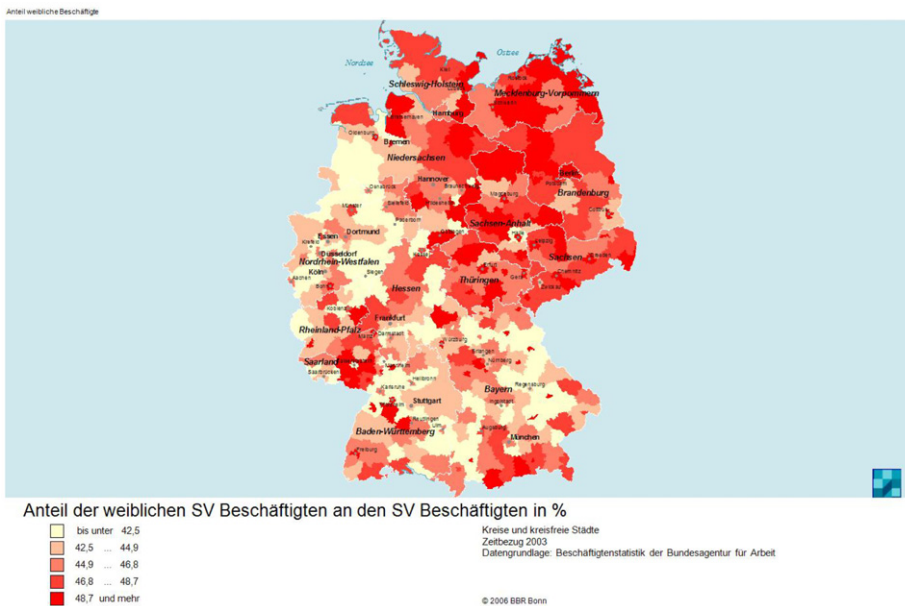


Fig. 25. The high employment ratio in East Germany is due to the relatively high female labor force participation. The fraction of employed, who are female, often exceeds 48% in East German regions. Data and graph computed with the INKAR CD ROM 2006.

Fig. 28, is the network with $v = v_l$, high unemployment and persistent emigration. One may want to think of this equilibrium as characterizing “East Germany” or, generally, a dying region. Emigration in this model never stops, eventually turning a dying region into a wasteland. The two equilibria balance two offsetting forces. The relatively higher unemployment in equilibrium E attracts more vacancy creation than in equilibrium W . However, the surplus from production is lower in the E equilibrium, due to the lower networking rate, discouraging vacancy creation.

The two other solutions to (14), shown as points A and B in Fig. 28, require additional differences between the two regions. At point A , emigration persists despite a high networking rate. At point B , no emigration takes place despite a low networking rate. While point B can be understood as the equilibrium in an economy without the possibility of emigration to a more vibrant economy (or with prohibitively high moving costs for all), point A requires that the destination region remains more attractive, even if the rate of networking in both regions is equal.

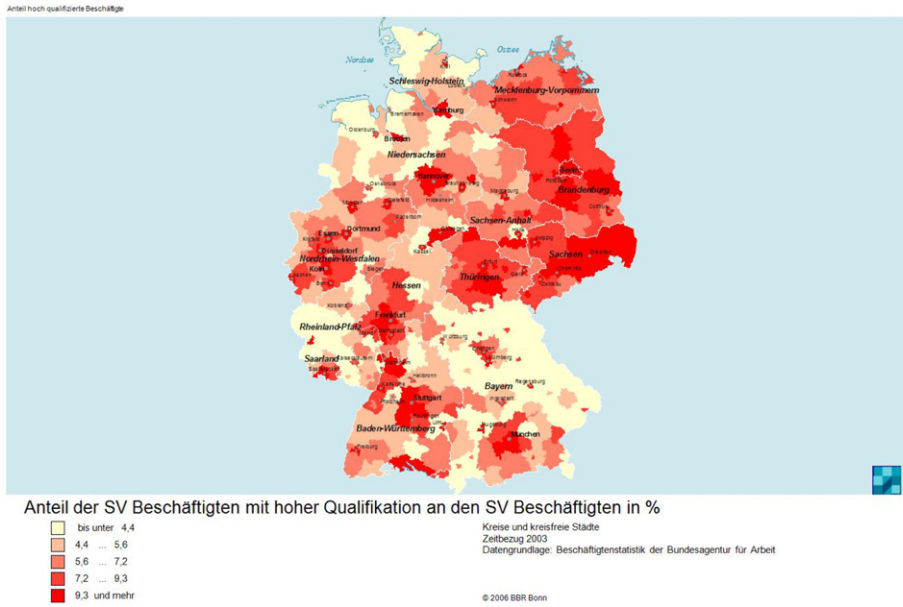


Fig. 26. The fraction of “highly qualified employees” in 2003 according to official figures tends to be high in East Germany and at above 9% for several regions there considerably higher than under 4.4% as in many southern regions. Data and graph computed with the INKAR CD ROM 2006.

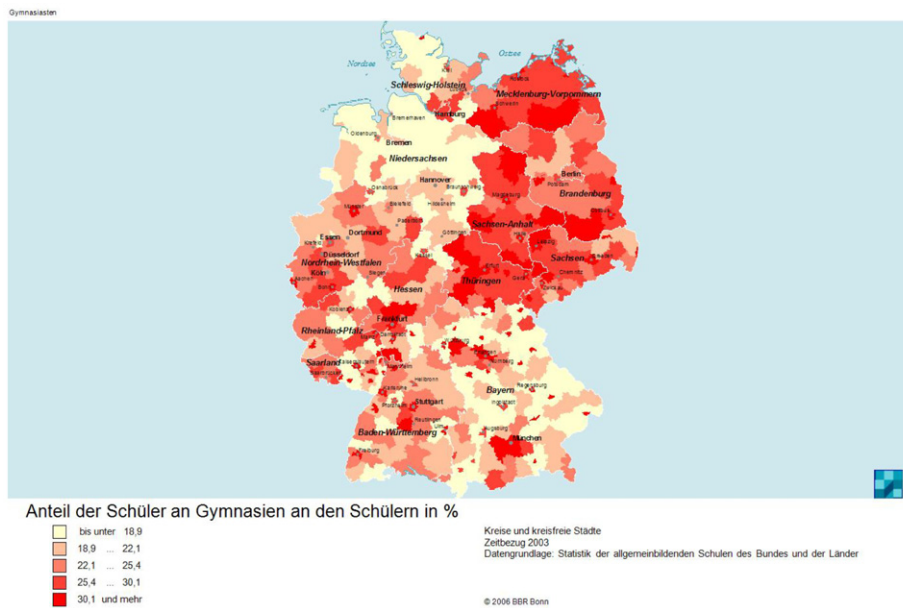


Fig. 27. The fraction of students attending the top tier (“Gymnasium”) of the three-track German school system is particularly high in East Germany, often exceeding 30% compared to numbers below 19% in a number of northern and southern regions. Data and graph computed with the INKAR CD ROM 2006.

Interestingly, for large enough values of ϕ , the equilibrium E disappears. Essentially, if emigration is fast, new matches come on line rarely, and existing matches are relatively long lived. As a result, networked matches dominate more than they would in the absence of migration. Whether this feature should be regarded as a somewhat artificial property of this model or a valid prediction requires further research.⁵ The flip-side to this argument is that the highly networked equilibrium W may also disappear with a high rate of immigration (which we have ignored in the analysis above), as this triggers the creation of many new non-networked firm-worker pairs, overloading the capacity of existing networks to integrate new

⁵ This feature may be useful for constructing a fully dynamic multi-region version of this model, as it can be utilized to eventually stop the population collapse.

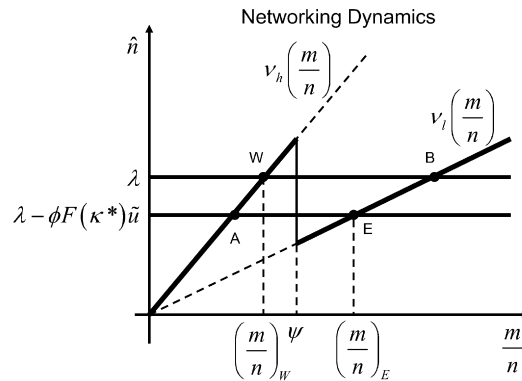


Fig. 28. A graphical representation of the dynamics for the fraction \hat{n} of networked firm–worker pairs as a function of the ratio of non-networked to networked firm–worker pairs, m/n . The equilibrium E (“East Germany”) exhibits low average productivity, high unemployment and persistent emigration, compared to the equilibrium W (“West Germany”).

members. The slump in West Germany likely has many causes, but absorbing and integrating a new workforce arriving from East Germany—as this model would then indicate—may be one of them.

The emergence and importance of clusters in East Germany has recently been studied and documented in Rosenfeld et al. (2004). In future research, their cluster data should be combined with the migration data of Section 2.1 to investigate the implications of the theory here empirically.

4. Concluding remarks

In this paper, I have documented the ongoing exodus from rural East Germany, especially among the young population. I have documented that wages there remain low and unemployment high, despite levels of education and training that are on par with Western Germany. To understand these facts, one must seek a model which allows agents to improve their situation by migration while at the same time keeping unemployment higher in the sending region. Standard labor search models would predict that firms seek out workers in East Germany directly, rather than making them migrate. I therefore elaborate on a model in Uhlig (2006, 2008), which extends the standard labor search model with network externalities between producing firms and reproduces the East–West-German facts, at least qualitatively.

The networking externality gives rise to a coordination failure in this model, see e.g. the survey by Cooper (1999). The coordination failure is slightly unusual, though, in that it is not a collective failure of firms to decide in favor of networking, but rather a problem of congestion. Given the masses of non-networked and networked firm–worker pairs m_t and n_t , there is nothing that can be done further, as the networking rate is assumed to be exogenous. If there is a coordination failure in this model, then it occurs earlier: given a certain number of networked firms n_t , a lower rate of entry (and thus higher unemployment!) would result in a higher ratio of networked to non-networked firms and would trigger the switch to a higher networking rate v_h . One solution would be to tax entry of firms in an already depressed region in order to give existing but small networks a chance to grow at a healthy pace, thereby giving the existing unmatched firms a better chance to join. This is likely stretching the implications of this model too far, though. Rather, a more detailed modeling of the networking process should be attempted before embarking on policy recommendations. Structural policies, which aim at providing fertile grounds for networks of firms, or which encourage entry of key firms, around which networks can crystallize, then seem likely candidates for yielding beneficial results.

But skepticism is in order. In his Wall Street Journal op-ed piece on German reunification, Robert Barro (1991) wrote: “No doubt, the slowness of the adjustment and the substantial movement of persons will create pressures for the German government to speed up the process. There is, however little in the history of regional growth in the U.S. and Western Europe to suggest that governments can accelerate convergence. . . . The forces of convergence are powerful in the long run, but anything approaching parity between eastern and western Germany is unimaginable anytime soon.” Nearly 15 years later and given the massive fiscal transfers from West to East Germany, these insights may—unfortunately—still be correct.

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