

Economic conditions in eastern Germany

Since unification, the east German economy has become integrated into the structures of the market economy and the international division of labour on a considerably broader and deeper scale. Nevertheless, the process of reconstruction and catching-up is at present in a difficult period of consolidation. The east German economy has shown a perceptible loss of momentum since 1995. Measured by real gross domestic product, there was no further progress in bringing west and east German economic performance into line with each other in 1997. The situation in the east German labour market is especially troubling at present. Overall, there has been little change in wage costs exceeding productivity since 1994; cases where cost pressure has been reduced and firms' productivity has been improved have often been at the expense of lay-offs. The volume of transfer payments and measures to boost the economy – which have been maintained at a very high level right up to the present – have initiated and accelerated many developments in the new Länder but the limitations of such large-scale financial assistance have now become manifest.

Considerable slowdown in growth

Since 1991, there has been an annual average rise of just under 6 % in real GDP in eastern Germany. Following a deep slump in the

*Aggregate
output*

Economic growth in eastern and western Germany

Change from previous year in %

Year	GDP at 1991 prices			Memo item East-west ratio ¹
	Germany as a whole	Eastern Germany	Western Germany	
1991 pe	+ 2.8	- 19.0	+ 5.0	7.8
1992	+ 2.2	+ 7.8	+ 1.8	9.4
1993	- 1.2	+ 9.3	- 2.0	11.4
1994	+ 2.7	+ 9.6	+ 2.1	12.4
1995 p	+ 1.8	+ 5.2	+ 1.5	13.0
1996 p	+ 1.4	+ 1.9	+ 1.3	13.2
1997 p	+ 2.2	+ 1.6	+ 2.2	13.1

¹ East German nominal GDP as % of west German GDP.

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initial period of system transformation – which reflected the long-term problems that had piled up and been left behind by the socialist economy – and a subsequent sharp surge in growth, the economy is now going through a new stage in the adjustment process. Firstly, the viability of the newly formed corporate landscape has to subject itself to the hard test of the market; secondly, the powerful stimuli imparted by start-up funding are now on the wane. In a certain respect, both of these factors may be regarded as a process of consolidation even though they involve considerable problems.

For the first time since 1991, the rise in aggregate output in 1997, at 1 ½ %, was below the corresponding rate of expansion in western Germany (just over 2 %). In 1991, how-

ever, the comparability of these trends was severely distorted by the unification-induced boom in western Germany and the slump brought about by transformation in the new Länder. Since 1991, there has been a considerable reduction of the gap in prosperity between eastern and western Germany; taking nominal per capita GDP as a rough yardstick, the east-west ratio was around 56¾ % in 1997, compared with 31 ½ % in 1991.

Sectoral trends: debit and credit sides

The precise circumstances of the waning pace of expansion in the east German economy highlight once again the major importance of construction in the catching-up process so far. In the past few years, around one-sixth of real value added and of jobs were accounted for by this sector; even excluding the indirect effects on upstream or downstream sectors of the economy, this was more than three times as high as in the west. Sooner or later, a slowdown in construction activity was almost inevitable as the east German population increasingly came to be provided with infrastructural amenities and housing approaching western standards. Given the major importance of construction in the east German economy, this was bound to be reflected in the overall picture of economic development.

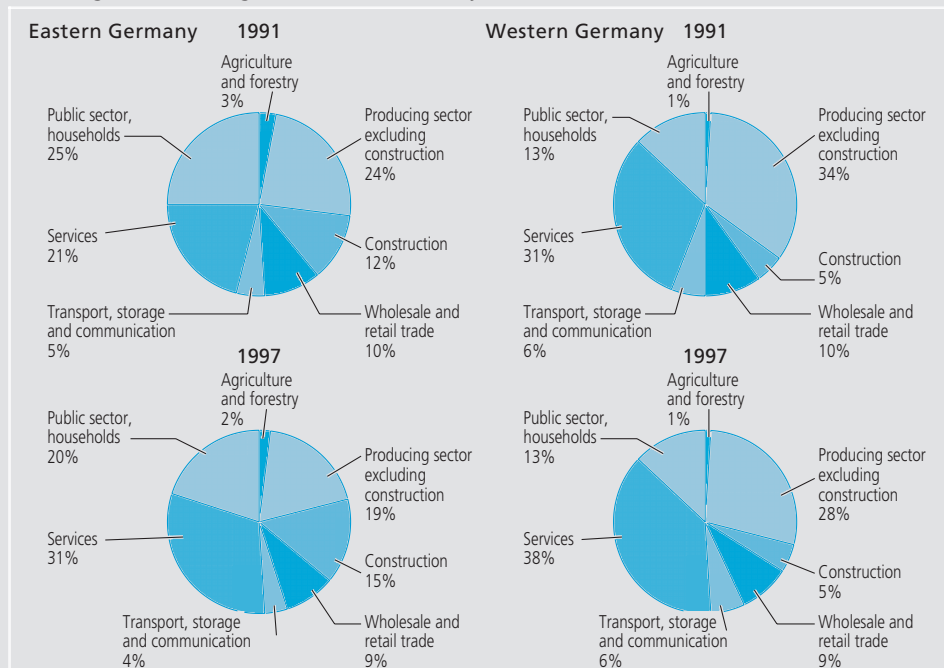
Even though real gross value added in the construction sector fell by 3 ½ % in 1997, the number of completed dwellings, at around 170,000 units, was, at the same time, more than one-quarter higher than in 1996 and reached a new peak. The provision of the

Construction

Completed residential buildings

Structure of the economy in eastern and western Germany

Percentages of nominal gross value added (unadjusted)



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east German population with housing can now be regarded as satisfactory in many places. According to the 1995 apartment and building census, 444 dwellings for every 1,000 inhabitants were already available at that time in purely statistical terms, which was higher on average than the figure according to the 1993 sample survey in western Germany. Given the continuing declining demographic trend in eastern Germany, this ratio is likely to have improved even further of late. Although no more than around three-fifths of east German dwellings were fitted to what may be regarded as a modern standard of comfort in 1995 (compared with just over four-fifths in western Germany), the large number of new or modernised dwellings has probably resulted in conditions becoming more closely aligned in terms of this major in-

dicator of prosperity, too. At all events, more than one-half of the entire housing stock is now likely to have been at least partially modernised. Bearing that in mind, it is quite appropriate at least to reduce the present generous tax incentives for residential construction. From 1999 the incentives for constructing new housing will be reduced further and the emphasis placed on modernising the stock of existing dwellings.

In 1997 the usable space created in terms of non-residential buildings was scarcely less than in 1996. The trend was quite varied, however, in terms of the individual types of buildings. Although even more office and administrative space was completed than in 1996, fewer new factory facilities and less commercial and warehousing space were

Non-residential buildings

constructed. Given the existing surplus supply of commercial properties, the decline in construction activity in this area is not surprising. The resulting painful adjustment in the level and structure of the construction industry, which is reflected not least in the large number of insolvencies, has probably not yet come to an end.

Services sector

The economic situation in eastern Germany is also aggravated by the marked slowdown in the expansion of the tertiary sector. Real gross value added in the wholesale and retail trade declined somewhat in 1997; once again there was a distinct fall in the contribution to growth made by services. One major reason for this may lie in the fact that this sector has a structure which differs markedly from that in the old Länder and which has hitherto been unsatisfactory. Non-complex service activities with a low market entry threshold and quite modest incomes are comparatively heavily represented, for example. By contrast, other services have no more than a below-average presence – especially those which are close to production. This applies to legal counselling, business consultancy, advertising agencies, private research and development institutions, and computer services, for instance. There are also identifiable shortcomings in the financial and insurance industries, however. One reason for this is that the labour-intensive head offices of these industries are in many cases located in the old Länder. Given that situation, it is especially unfortunate that even firms of architects and construction engineering businesses which up to now have been represented quite well, have

been severely affected by the crisis of adjustment in the construction industry.

In much the same way as the construction industry, the services provided by the public sector are being subjected to an inevitable process of restructuring – something which has been further intensified by the special consolidation efforts undertaken by the public sector last year. Staffing levels in the central, regional and local authorities¹ have been reduced by a total of 420,000 persons (or just over 30%) since 1991, when overstaffing in the public sector was especially evident. In 1997 around 62 persons for every 1,000 inhabitants were employed in the public sector, compared with 54 in western Germany. Taken in isolation, the decline of 4% in the number of employed persons last year signifies an acceleration of this trend, although it still understates the rationalisation efforts that have been made, since a considerable number of full-time jobs have additionally been converted into part-time jobs particularly in eastern Germany. The percentage of part-time employees is likely to have nearly doubled in this sector since 1991.

Public sector

Manufacturing, which had a particularly difficult time in the initial stage of reorientation and restructuring, has been on a steeply expansionary course since 1993. Output was stepped up by just under 9% in 1997; its pace of growth was thus around two and a half times greater than in the old Länder at the end of the period under review. Exports

Manufacturing

¹ The narrower definition has been chosen in this instance to avoid distortions due to the Federal special funds which are now legally independent.

imparted major stimuli as is indicated by the figures for turnover. Increasingly intensive use was made of production facilities in line with the rise in output. According to ifo institute surveys, utilisation went up by more than 3 percentage points within the last year. This is the highest figure since the ifo business survey was introduced in the new Länder.

Exports

The expansion of export business indicates a significant improvement in east German firms' competitiveness and their increasing integration into the international division of labour. Industrial enterprises in the new Länder hence had an above-average share last year in the boom in exports. Despite this success in exporting, the fact should not be overlooked that foreign business is still a comparatively weak pillar of their economy. Given a share of around 15 % in total turnover, its importance was scarcely half as great as in western Germany, and its contribution to the total export turnover of German industry was no higher than 3 % even at the end of the period under review.

Arduous road to greater competitiveness

Profitability

The increase in market shares does not imply a corresponding improvement in profitability. A large part of the recent success in exports is likely to have been achieved at the expense of concessions on prices. A further relaxation of the earnings-cost ratio will probably only occur once the new or regained sales markets at home and abroad are secured in the long term. Given an input ratio of around two-thirds which, according to the national ac-

counts, is, in fact, somewhat higher than in western Germany, there are a number of indications that part of the current growth in output in east German industry also has to be seen in the context of joint output with the old Länder. Moreover, there are likely to be differences in profitability between firms which function as an "extended production facility" of west German customers and those which experience a direct demand for their products. According to the Bundesbank's corporate balance sheet statistics, manufacturing firms remained in the red – at least on balance – in 1995, even though the trend in the profit-turnover ratio in this sector was significantly better than on an average of all east German enterprises.

Overall, enterprises' self-financing power is likely to have been no more than weak even given an improvement in their profitability. It therefore appears all the more noteworthy that they have acquired new plant to a total of around DM 600 billion (on a cumulative basis and at constant prices) since 1991 – not least as a result of extensive government assistance. This investment has probably been reduced by only a few disposals owing to obsolescence so far, which means that the newly accumulated capital stock during this period latterly had a share of just over 50 % in the total available stock, i.e. a ratio more than twice as high as in the western part of Germany. Plant and equipment, which is generally assumed to be closely correlated with the creation and replacement of jobs, has an even higher share, at over 80 %; this indicates that plant and machinery have largely been replaced and modernised since unification.

Capital stock

East-west comparison of pay and income in 1997

in %	
Income category	East-west ratio
Basic negotiated pay	1 89½
Monthly rate of pay 2	87
Hourly rate of pay 2	83
Actual earnings	77
Compensation per employee	74
Disposable labour income per employee	85
Total disposable income per household	e 72
Nominal per capita GDP	56¾
Memo item	
Average pension payment	e 110
Basic pension	3 85.2

1 End-of-year level. — 2 Including ancillary agreements (holiday pay and Christmas bonuses). — 3 Mid-year level.

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Even last year, however, the provision of labour with fixed capital – capital intensity – in the corporate sector was still around two-fifths lower than in western Germany, notwithstanding the fact that plant and machinery are, on average, more up-to-date.

Labour costs

Labour costs are proving to be a serious obstacle on the arduous road to greater competitiveness and profitability. In a number of major industries, basic remuneration under collective pay agreements has now reached the same level as in the old Länder. This applies to the iron and steel, metal-working and electrical engineering industries, and private banking business. On average, the level of negotiated wages and salaries at the end of 1997 corresponded to almost 90% of the comparable remuneration in western Ger-

many, compared with a pay differential of 53% at the beginning of 1991. Taking into account the fact that ancillary agreements (in particular, holiday pay and Christmas bonuses) are not as extensive and the greater number of working hours per year, the level of negotiated pay was 83% of the comparable figure in western Germany. The scope for alleviating the massive pressure of costs was generally very limited in terms of wages paid above the agreed scale. For that reason, many enterprises have relaxed strict adherence to pay settlements or forgone membership in an employers' federation as an "emergency solution". This has made it possible to curb the rise in actual earnings and at least take the sting out of the surge in costs. Given the fact that this wage indicator showed an east-west ratio of 77% in 1997, the rapid successive relative increase in the cost of labour was nevertheless very high.

The process of reconstruction in eastern Germany has been accompanied by a generally sharp growth in labour productivity. Taking all sectors together, real GDP per employed person went up by 9.3% annually between 1991 and 1997, compared with 1.9% in the old Länder. Although growth in productivity has slowed down during the past few years, it has been a major force behind the improvement in competitiveness. That is particularly true of the producing sector (excluding construction) which, at just over 12½% in 1997 as well, was much higher than the already notable gains in efficiency in western Germany. As a result, the disparity compared with firms in the old Länder was reduced fur-

Labour productivity

Pay and unit labour costs in eastern Germany

Change between 1991 and 1997 in %

Sector	Gross compensation per employee ¹	Real value added ² per employed person	Labour costs ³ per unit of real value added	Labour costs ³ per unit of nominal value added	Labour costs per unit of nominal value added in 1997 as % of the west German figure
Producing sector (excluding construction)	130.6	222.1	- 28.4	- 33.0	104.3
Construction	54.2	28.0	20.4	- 15.3	102.3
Wholesale and retail trade, and transport	95.4	72.7	13.1	- 7.9	122.7
Services ⁴	64.8	13.6	45.1	7.5	135.1
Public sector, households, etc.	92.5	10.5	74.2	- 1.4	101.2
Total economy	92.1	70.4	12.7	- 22.5	123.1

¹ Work-place concept. — ² At 1991 prices. All figures for individual sectors before deduction of imputed remuneration for bank services. — ³ Gross domestic compen-

sation per employee divided by real or nominal value added per employed person. — ⁴ Services excluding letting of dwellings.

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ther by around 6 percentage points, although it still amounts to one-third.

Industrial productivity went up sharply enough to more than compensate for the simultaneous rise in wages per employed person. Unit labour costs fell again by just over 8%. Per unit of nominal value added, they are thus at only a slightly higher level than in western Germany. Construction enterprises have now likewise succeeded in largely reducing the gap between them and their west German competitors. By contrast, the tertiary sector, to which major stimuli in creating additional jobs are ascribed given a level of unit labour costs consistent with employment, remained well behind conditions in western Germany. In the wholesale and retail trade and transport, the gap between labour costs

and productivity amounted to one-quarter and, in the case of services, to as much as one-third².

Negative labour market record

A large part of the notable gain in productivity and success in curbing costs was achieved, particularly in east German industry, at the expense of a continuing dramatic reduction in staffing levels. In 1997 employment fell – as it had in 1996 – by more than 4%. This was one of the reasons for the sharp decline in overall employment in the new Länder. Ac-

Sharp reduction in employment

² When interpreting these figures, however, it should be borne in mind that there are considerable differences between the value-added structures of the services sector in eastern and western Germany and that the figures are not necessarily representative of all sub-sectors.

Unit labour costs

According to the provisional calculations of the Federal Statistical Office, the number of employed persons fell on an annual average by more than 200,000 to 6.05 million in 1997; at 3.3 %, the decline was roughly three times larger than in the old Länder, where there have been signs of the situation stabilising since the middle of 1997. In east Germany, by contrast, around 35,000 more jobs were lost in the last three months of 1997, too, in seasonally adjusted terms. Not only did this completely offset the slight increase in employment in 1994 and 1995, it also undershot the previous low of 1993.

The fact that the number of self-employed persons stabilised latterly at a level of 510,000, following a decline in 1996, was the sole reason why last year's bleak labour market picture was not even more unfavourable. In the case of wage and salary earners, on the other hand, the decrease was 3 ½ %. With the exception of agriculture and a small number of services industries, the number of employed persons – according to present statistical data which are still incomplete – is likely to have declined on a broad front. Employees in the construction industry were particularly affected, as was the public sector (including households and non-profit institutions) where a disproportionately large number of jobs were lost.

The shedding of jobs was accentuated by the reduction in labour market policy measures. At the end of 1997, the number of persons employed in job creation schemes (including those with what are known as productive labour cost subsidies) came to 210,000, corres-

ponding to a decline of 50,000 compared with 12 months earlier. The number of participants in training schemes (150,000) in December 1997 was also 95,000 lower than a year before. Over the year as a whole, the "secondary" labour market thus lost a good deal of importance, resulting in some cases in a shift from unregistered to registered unemployment.

The cutback in labour market policy measures was one factor in the dramatic rise in officially recorded unemployment in the new Länder. Seasonally adjusted, 1.49 million persons were registered at the labour exchanges as unemployed at the end of December 1997, which was 270,000 more than a year earlier. On an average of 1997, this corresponds to a rise of around 16 ½ % over 1996, which was twice as high as in the old Länder. The unemployment rate went up from 15.7 % in 1996 to 18.1 % last year. At the end of 1997, allowing for seasonal fluctuations, the figure was 19.7 %, compared with 9.9 % for western Germany.

As before, the much higher percentage of women is a particular feature of unemployment in eastern Germany when compared with the old Länder. Although the figure fell somewhat in 1997, at 56 % it was still well above the figure for western Germany (42 %). A concomitant of this is that the unemployment rate for female members of the workforce, at around 22 ½ %, is more than twice as high as in western Germany. This also has a significant impact on the overall structure of unemployment. Since – as mentioned above – major parts of the services

Unemployment

*Active labour
market policy*

The labour market in eastern Germany

in thousands, in %

Item	1991	1992	1993	1994	1995	1996	1997
Employed persons	7,321	6,387	6,219	6,330	6,396	6,259	6,053
Change in %	–	– 12.8	– 2.6	1.8	1.0	– 2.1	– 3.3
in thousands	–	– 934	– 168	111	66	– 137	– 206
Short-time workers	1,616	370	181	97	71	71	50
Change in thousands	–	– 1,246	– 189	– 85	– 26	0	– 21
Employees in job-creation schemes	183	388	260	280	312	278	235
Change in thousands	–	205	– 128	20	32	– 35	– 43
Participants in training schemes	265	489	380	257	254	238	184
Change in thousands	–	224	– 109	– 123	– 3	– 16	– 54
Unemployed persons	913	1,170	1,149	1,142	1,047	1,169	1,363
Change in %	–	28.2	– 1.8	– 0.6	– 8.3	11.6	16.6
in thousands	–	257	– 21	– 7	– 95	122	194
Unemployment rate ¹	11.1	14.4	15.1	15.2	14.0	15.7	18.1
Beneficiary rate ²	76.7	82.2	83.5	84.8	85.1	89.5	94.2
Participation rate ³	51.7	48.0	47.1	48.0	48.1	48.1	48.1

¹ Unemployment as % of the domestic labour force. —
² Recipients of wage substitutes as % of unemployed. —

³ Domestic labour force as % of the total resident population.

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sector in eastern Germany are under-represented, those occupations in which women have a particular presence (sales staff, employees in services, administrative staff or office workers) are an important factor.

Income and financial position

*Disposable
income*

Households' disposable incomes provide important information on the standard of living that has been achieved in eastern Germany and the convergence of material living conditions. In 1997 the pace of the rise in disposable incomes is likely to have been less than half as fast as the average of the three preceding years (+ 5%). Nevertheless, this means that household budgets still grew

more quickly than in the old Länder, which resulted in a further slight rise overall in the east-west ratio for disposable incomes to around 72%. This signifies a gain of more than 20 percentage points since 1991 – mainly on account of the considerable improvements in the first few years after unification.

Once again, wages and salaries – which are the most important source of income – showed the high price extracted by exaggerated pay increases in terms of the accompanying employment-induced losses of income. For the first time, total labour earnings even showed a negative trend in 1997. After deducting taxes and social security contributions, in which the sharp increase in the contribution rates to statutory pension and

*Sources
of income*

health insurance schemes was a very significant item, the net wages and salaries of east German employees were just over 3 % lower than in 1996. The deterioration in private incomes resulting from the situation on the labour market was offset to a lesser extent than before by higher public transfer payments or income from other sources such as entrepreneurial and property income. Firstly, in 1997 the share of self-employed persons in the working population (8½ %) was still significantly lower than in western Germany (11 %). This indicates that private withdrawals from entrepreneurial income were considerably less important. Secondly, east German households are likely to derive less income from financial assets since these reserves, at an average of around DM 50,000, amounted to no more than one-third of the west German figure last year.

*Asset
acquisition*

Given a ratio of one-fifth at the time of unification, however, this figure conceals a substantial process of financial asset accumulation in which financial savings per household have more than doubled. Furthermore, this analysis includes only part of east German households' financial efforts in acquiring residential property. In parallel with building up their financial assets, considerable private funds have also been used to renovate and modernise existing dwellings and to construct or acquire new living accommodation. The share of owner-occupied dwellings in the total housing stock has now risen quite distinctly to an estimated 30 %, although this is still a long way from approaching conditions in western Germany.

In connection with the trend in income and assets, it should be borne in mind that money still has greater purchasing power in eastern Germany than in the old Länder, even though the difference has clearly levelled out over the past few years. The main reason for the more favourable living costs is that housing rents are still at a comparatively low level despite a whole number of rent adjustments since unification, a last step being the Rent Transference Act in January 1997. No further administrative interventions are envisaged following the changeover in January 1997 to the system of comparative rents that was introduced some time ago in western Germany.

*Purchasing
power of
money*

Housing rents are now generally geared to market conditions. Given the qualitative differences that continue to exist in many cases despite extensive efforts at modernisation, this means, firstly, that rents are likely to remain at a level which is (put by surveys at around one-fifth) lower than in western Germany for a considerable time. Secondly, rises in rents will probably remain within narrow limits in view of the growing number of vacant properties, a high or increasing level of unemployment and a declining population. Moreover, the fact that prices for residential construction work have fallen quite sharply and more than in the old Länder has had a restraining impact. This is one reason why rents for well appointed new apartments and renovated old buildings may often be lower than for comparable dwellings in western Germany.

There is still a price differential which favours eastern Germany in the case of services, too.

Even though prices – much the same as in the case of rents – have been raised sharply in many branches of the services industry since unification, they are frequently still lower than those in the old Länder. Examples of this are restaurant services or services for personal hygiene and housekeeping. Price differentials of this kind are made possible by the fact that many services can only be traded locally, and by wage costs being lower in absolute terms than in western Germany.

Continuing high levels of public transfers and economic assistance

*West-east
transfer
payments*

Given the described trends in economic performance and incomes, the new Länder continued to be reliant on a high level of public transfer payments to bridge the existing gap between domestic demand and output. Contrary to earlier expectations, there has been barely any decline in the need for transfer payments since 1995, when public payments had again increased considerably as a result of the east German Länder being included in the revised revenue and burden sharing arrangement between the Länder. According to the calculations of the Federal Ministry of Finance, public transfer payments in 1997, when netted out of the tax and administrative revenues received in eastern Germany by the Federal Government, amounted to DM 136 billion; this was only DM 4 billion lower than in the two previous years. These net payments latterly took up 4 ¼ % of west German GDP; the ratio was thus slightly below its 1995 peak but was still somewhat higher

than in the initial phase of the unification process.

In terms of east German value added, too, public transfer payments have declined only slightly in importance over the past few years; in 1997 the ratio was still just under one-third. There is likely to be barely any change in this situation in the current year either; budget plans for 1998 envisage payments to eastern Germany which are, in fact, on an even somewhat larger scale in absolute terms than in 1997.

The fact that public financial transfers to eastern Germany remained largely at the high level of previous years was mainly attributable to an interruption in eastern Germany's process of catching up with the west German economy. Above all, the marked rise in unemployment in eastern Germany compared with 1995 led to additional transfer payments. This factor was the main reason for the Federal Government, in particular, still having to make increasing payments up to 1996. Last year, however, the higher amounts needed for unemployment payments were almost entirely offset by major cutbacks in "active labour market policy". The fact that it has still not been possible to reduce the provision of funds for consumption purposes during the past few years is likewise attributable to labour-market-induced transfers – which also comprise other payments (such as, first and foremost, the unemployment assistance funded directly from the Federal budget). Much the same as in 1991, social security benefits alone accounted for almost two-thirds of all attributable gross public transfers

Social transfers

to eastern Germany. Subsidies made up just over one-tenth of these transfers, whereas a largely constant share of around one-quarter was for investment purposes.

*Economic
assistance*

Only some of the measures to promote the economy in the new Länder are reflected in such an analysis of the transfers, however. Promotional credits and tax concessions, in particular, for strengthening the investment activity of the east German economy are recorded in it only to a slight extent or not at all. The overall scale of these assistance measures cannot be quantified reliably; firstly, it is very difficult to determine the amount of subsidies contained in the many different loan programmes; secondly, there exist no up-to-date and comprehensive statistical data on the shortcomings in revenue due to tax relief measures.

*Realignment
of the
promotional
strategy*

The Annual Tax Act for 1996 meant that tax incentives for investment were significantly tightened overall and concentrated more than before on manufacturing. Since 1997 special depreciation facilities for investment outside the manufacturing sector and for rented housing construction have been cut back considerably.³ In addition, the investment allowance – which will be continued up to the end of 1998 at the previous level (5%, or 10% for medium-sized firms) – was restricted to the manufacturing sector.

Above and beyond that, in summer 1997 a strategy was adopted in which incentives for investment in the new Länder are to be continued after 1998 but, at the same time, restructured in essential points. Follow-up in-

centives are envisaged up to 2004, which are to focus more strongly on broadening the comparatively narrow industrial base. Furthermore, construction of new rented accommodation is to be promoted in future only in inner-city areas. In addition, the present quite diffuse range of instruments providing incentives is to be simplified by the provision, from 1999 onwards, of tax incentives for investment in the new Länder only in the form of investment allowances which will be significantly higher than under present legislation⁴; these will thus also replace the present special depreciation facilities.

The reorganisation of the promotional strategy is to be assessed positively in a number of respects; in addition to greater transparency, it has the advantage over the present mixed system of special depreciation facilities that it will also fully benefit enterprises with an unfavourable income position. Nevertheless, in terms of the priority of growth, the envisaged follow-up incentives do not go all the way to their logical conclusion since investment in

³ The previous uniform 50% rate of depreciation for new rented accommodation was halved to 25% and reduced to 20% for commercial buildings outside the manufacturing sector. On the other hand, at a rate of 40%, there are still comparatively strong incentives for investment in machinery and equipment, in-plant construction investment within manufacturing and redevelopment measures for existing blocks of rented apartments.

⁴ For in-plant investment – including the commercial buildings in the promotional allowance programme – the allowance rate from 1999 will, as a rule, be 10% of the purchase price or production cost; firms with up to 250 employees will, in fact, receive an allowance of 20%, which is to benefit not only manufacturing but also production-related services. Construction of new inner-city rented accommodation will be promoted up to the end of 2001 with an allowance rate of 10%, whereas a rate of 15% will be granted for the redevelopment of existing residential buildings up to the end of 2004, provided that it qualifies for this incentive with an expenditure of up to DM 1,200 per square metre.

Public transfers to eastern Germany

DM billion

Item	1991	1992	1993	1994	1995	1996	1997	1998 ¹
I. Gross transfers to eastern Germany								
1. Federal Government	75	88	114	114	135	138	131	139
2. West German Länder and local authorities	5	5	10	14	10	11	11	11
3. "German Unity" Fund	31	24	15	5	–	–	–	–
4. EU budget	4	5	5	6	7	7	7	7
5. Federal Labour Office	24	24	14	18	16	12	16	14
6. Statutory pension insurance scheme	–	5	9	12	17	19	18	18
Total	139	151	167	169	185	187	183	189
of which ^{pe}								
Social security benefits	56	68	77	74	79	84	81	84
Subsidies	8	10	11	17	18	15	14	16
Investment	22	23	26	26	34	33	32	33
Cash transfers, not classifiable	53	50	53	52	54	55	56	56
II. Federal Government revenues in eastern Germany (–)								
Tax revenue	– 31	– 35	– 37	– 41	– 43	– 45	– 45	– 46
Administrative revenue	– 2	– 2	– 2	– 2	– 2	– 2	– 2	– 2
Total	– 33	– 37	– 39	– 43	– 45	– 47	– 47	– 48
III. Net transfers, total	106	114	128	126	140	140	136	141
Memo item								
Deficit of the Treuhand agency ²	9	14	24	24	–	–	–	–

¹ Based on the Federal Government budget for 1998. —
² Deficit adjusted for payments and reimbursements of

interest by the Treuhand agency. — Source: Federal Ministry of Finance.

the housing sector will continue to be tax-subsidised in some cases. A clearly degressive system of incentives would also have been an advantage. It should be borne in mind in this context that a special promotion of investment over a long period is not without prob-

lems. The large-scale promotion of residential construction in eastern Germany shows that such measures harbour the risk of appreciable misallocations and do not contribute to a steadying of the workings of the economy.