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# "Sell or Slaughter": The Economic and Social Policies of German Reunification

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**CLAREMONT McKENNA COLLEGE**

**“SELL OR SLAUGHTER”**

**THE ECONOMIC AND SOCIAL POLICIES OF GERMAN REUNIFICATION**

**SUBMITTED TO**

**PROFESSOR HILARY APPEL**

**AND**

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**BY**

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## **Abstract**

This paper looks at the struggles faced by German policymakers in the years following reunification. East Germany struggled with an immediate transformation from a planned economy to a social market economy, while West Germany sent billions of Deutsche Marks to its eastern states. Because of the unequal nature of these two countries, policymakers had to decide on what they would place more emphasis: social benefits for the East or economic protection for the West. The West German state-level, Federal Government and the East German governments struggled in finding multilaterally beneficial policies. This paper looks at the four key issues of reunification: currency conversion, transfer payments, re-privatization, and unemployment. In following the German Basic Law, the policies pursued in terms of these issues tended to place emphasis on eastern social benefits.

# TABLE OF CONTENTS

1. Introduction: The Unification of a Divided Germany .....	1
2. Unification: Competing Economic and Social Policies.....	8
Section 2.1 Conversion Rate of Currency Turnover .....	8
Section 2.2 Increasing Demand for Transfer Payments .....	11
Section 2.3 Re-Privatizing Expropriated Property .....	14
Subsection 2.2.a Property.....	14
Subsection 2.2.b Industry .....	16
Subsection 2.2.c The Treuhandanstalt.....	18
Section 2.3 Combatting Rising Unemployment .....	21
3. Conclusion: Social Policies Drove Reunification.....	25
Appendix .....	29
Bibliography.....	30

## **1. Introduction: The Unification of a Divided Germany**

In 1949, Germany officially split into two countries – the German Democratic Republic (GDR) and the Federal Republic of Germany (FRG). One was communist, the other a federal parliamentary republic. One was a state-controlled economy, and the other a social market economy. These starkly different styles of government resulted in very different economies and standards of living. During this time of separation, the Western world did not acknowledge the GDR due to continually mounting tensions with the USSR. After decades of a sputtering economy and political oppression, the East Germans spoke out in Leipzig in 1989. Widespread protests across Eastern Europe sparked revolutionary change, including the resignation of East German Chairman of the Council State, Erich Honecker. The Soviet Union soon began to approach its demise and the two Germanys found themselves wishing to reunite.

Reunification would prove to be difficult, due to the deep schism between the FRG and GDR economies. Following World War II, the FRG adopted a free-market economy with only limited elements of planning and management, also known as a social market economy, to help recover from the war. The GDR, on the other hand, chose to pursue a fully planned economy. In 1948, at the time of the formal division, Fritz Selbmann, an official in the Socialist Unity Party (SED) provided insight into the East German economic policy and practice:

We will plan down to the last machine, down to the last production unit of state-owned industry, and then we will see who is stronger – the planned state-owned

industry or the non-planned free economy. For the struggle between free economy and planned state-owned economy will take place in practice... Naturally the planned economy is stronger; naturally things will go better where man uses his reason.<sup>1</sup>

Initially, Selbmann would turn out to be correct. The fully planned economy helped save the East German economy following the war, especially because of the shortage of resources and reparations East Germany had to pay the Soviets for the war-related devastation. However, the GDR could only compete with the FRG for a short period of time and by 1971 Erich Honecker ended economic reform attempts and thereby gave up competing with West German productivity and consumption.<sup>2</sup> Although many countries, including the U.S. and West Germany, suffered great economic blows during the 1970s, East Germany operated in a way that made recovery impossible. By the time of collapse, GDR productivity was less than 30 percent of its western counterpart.

The centralized planned economy hurt East Germany in many ways. The lack of competition left businesses with no incentive to reduce costs, increase productivity, or innovate. The high government subsidies wasted huge amounts of economic resources. Some heavily subsidized goods and services included food, public transportation, energy, and rent, among many others. In 1989, subsidies consisted of almost one-quarter of planned public expenditure. Furthermore, corporations gave overly generous employee benefits, referred to as “general provision”, which paid for things such as kindergarten, outpatient services, and vacations. General provision created an environment where

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<sup>1</sup> Jörg Roesler, “The Rise and Fall of the Planned Economy in the German Democratic Republic, 1945-89,” *The German History Society* 9, no. 1 (1991): 48, <http://gh.oxfordjournals.org/content/9/1/46.full.pdf+html> (accessed October 27, 2012).

<sup>2</sup> Roesler, “The Rise and Fall of the Planned Economy,” 55.

employees rarely changed jobs, which, combined with the right to work policy, led to artificially high levels of employment.<sup>3</sup> Employing too many workers decreases efficiency and drives costs up for corporations. This causes prices to subsequently increase, demand to decrease and, eventually, the economy to suffer.

GDR production equipment provides a perfect example of the Soviet Bloc's failed economic policy. With an already deteriorating economy, the SED officials chose to invest in modernizing microelectronic production equipment, rather than machines for more relevant goods such as food, tools, or building production. By 1989, only approximately one-third of machine-tool production and foodstuffs equipment were less than five years old, compared to the microelectronic production equipment of which more than 50 percent was less than five years old.<sup>4</sup> Despite electronics being a lucrative business, a certain microchip which cost 8 marks to produce on the world market cost East German producers more than 530 marks.<sup>5</sup> This 6,625 percent increase in production costs emphasizes the gross inefficiency of the centrally-planned economy as well as just how far behind East Germany was from the Western World.

Even in the face of possible reunification, eastern cooperation with West Germany was limited. Despite General Secretary Mikhail Gorbachev's small steps towards reform with *perestroika* and *glasnost*, his response to West German Chancellor Helmut Kohl's 1989 Ten-Point plan for unification proved that the Eastern Bloc would not embrace change too readily. On the day following Kohl's proposal to the West German Federal Parliament, Soviet Foreign Minister Eduard Shevardnadze, condemned

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<sup>3</sup> Gerhard A. Ritter, *The Price of German Unity* (New York: Oxford University Press, 2011), 74-76.

<sup>4</sup> Roesler, "The Rise and Fall of the Planned Economy," 56.

<sup>5</sup> Ritter, *The Price of German Unity*, 75.

the Ten Points plan and publicly opposed any border changes.<sup>6</sup> Furthermore, although the Soviet powers were open to economic ties with West Germany, neither state was willing to make the concessions demanded by the other.

Creating a mutually beneficial reunification agreement for East and West Germany presented a daunting task for both governments. The complex relationships, however, did not end with just the East versus the West. As Allan Riding noted in a *New York Times* article on February 15, 1990, surrounding states, particularly Poland and France, worried about the repercussions of a united Germany given its tumultuous and aggressive history. Key questions arose regarding the German-Polish borders as well as how a united Germany would change the balance of powers in the European Community. A fragmented Germany seemed safe, but at the same time, Western powers feared the Soviet Union and hoped for its downfall.<sup>7</sup>

East-West cooperation and the support of neighboring states were not the only hurdles of reunification. The four hurdles outlined in this paper became relevant during the reunification process. These hurdles were:

1. Consolidating the Ost-Mark and the Deutsch Mark
2. Deciding the amount of transfer payments the West would pay the East
3. Re-privatizing formerly expropriated properties
4. Avoiding high unemployment rates.

The policies designed to solve these problems could focus primarily on either economically or socially beneficial results. Therefore, policymakers had to decide which outcome was more important.

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<sup>6</sup> Pekka Kalevi Hämäläinen, *Uniting Germany: Actions and Reactions* (Boulder: Westview Press, 1994), 76.



Three levels of politicians and the Central Bank participated in the reunification and placed value on various factors. The West German federal government sought a speedy reunification and wanted to appease both the East and the West. East German politicians feared an unequal reunification in which the westerners dominated the easterners. The West German politicians at the *Länder*, or state, level placed their citizens' interest first and wanted to control the extent to which they would pay for the reunification. The West German Central Bank had existed until reunification with full autonomy.<sup>8</sup> Due to its freedom from any political authorities or pressures, it preferred austere policies that most benefitted the western economy. Although politicians did not come to a unanimous decision, the policies that they pursued tended to place more importance on social than economic problems. By doing so, post-1990 Germany turned into a psychologically unified country with deep and long-lasting economic issues, such as high government debt, tax rates, and unemployment.

This thesis will explore the four major issues and how politicians decided to solve them. The rest of this chapter will present the concerns felt by citizens and politicians alike at the start of the reunification process. The second chapter will delve into each factor and look at how the chosen policies tended to favor social rather than economic benefits. Finally, the conclusion will look at the implications of these policies.

### **Consolidating Currencies**

A major hurdle was how to reconcile the different currencies. While West Germany prospered with the Deutschmark, East Germany struggled with its weaker

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<sup>8</sup> Andreas Beyer et al., "Opting Out of the Great Inflation: German Monetary Policy After the Break Down of Bretton Woods," *NBER Working Paper Series*, no.14596 (2008): 9, <http://www.nber.org/papers/w14596> (accessed October 1, 2012).

Ostmark. Politicians and the *Bundesbank*, the West German central bank, had to work together to placate citizens from both Germanys while protecting the West German economy and enabling both economies to converge. But the question remained how to broker such a deal with two such different currencies. The *Bundesbank* suggested an austere program that would minimize damage to the West German economy, while Chancellor Helmut Kohl recommended, and eventually implemented a more generous program that expedited the unification and placed social issues across Germany above economic issues in the West. The politicians and bankers saw before them a zero-sum game where both sides desperately wanted to win.

### **Transfer Payment Levels**

As mentioned above, citizens of the West as well as their representatives worried that the reunification would result in increased taxes and debt. The stronger economy had the responsibility of supporting the weaker economy's transformation to capitalism. After all, the East German economy was becoming a part of the West German economy. The *Länder*, West German federal, and East German politicians would have to come up with a solution to finance the reunification without placing too much burden on West German taxpayers.

### **Returning Expropriated Properties**

A defining characteristic of Communism was expropriating property. For West German businesses, for civilians who had fled or moved to the FRG, and for East Germans who had simply lost their homes to the Soviet authorities, the fall of the Soviet regime raised the possibility of reclaiming formerly confiscated property. This spread fear throughout East Germany and curiosity throughout West Germany. Eastern

businesses had already begun accepting investments from western businesses and feared having to pay retribution once unification was complete. Eastern civilians feared former homeowners would return to stake their claims and/or significantly raise the rent.<sup>9</sup> Politicians had to decide which would create a more unified country: encouraging private investment in East Germany or returning private property to the rightful owners.

### **Avoiding High Unemployment**

Fears of a mass exodus to West Germany posed great concern for future employment levels across Germany. An additional concern was that competition with West German corporations would result in East German enterprises failing.<sup>10</sup> Fewer factories meant fewer jobs, and with an open border, Easterners could flood the West, creating more job competition in a country that already accepted increasingly high numbers of migrant workers. Clearly, neither East nor West Germany would benefit from increasing unemployment, and therefore policy makers would have to approach this problem very carefully and deliberately so as to not upset the balance. Furthermore, the socialist system had provided many benefits and fostered artificially high levels of employment. East Germans would lose both of these comforts with the introduction of a social market. To ease this loss, East Germany adopted West German employment benefits, but altered them in an even more socially advantageous way, which would be very expensive for the West and create an inefficient workforce in the East.

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<sup>9</sup> Hämäläinen, *Uniting Germany: Actions and Reactions*, 130.

<sup>10</sup> W.R Smyser., *The Economy of United Germany: Colossus at the Crossroads* (New York: St. Martin's Press, 1992), 32.

## 2. Unification: Competing Economic and Social Policies

### 2.1 Conversion Rate of Currency Turnover

The four previously mentioned hurdles – currency turnover, transfer payments, re-privatization and unemployment – created an extremely delicate situation for politicians and economists alike. The issue alone of currency turnover caused disagreement between the *Bundesbank* and politicians, the *Bundesbank* trying to protect the famously stable Deutschmark and Chancellor Kohl wanting to send “a clear, unmistakable signal of hope and encouragement... to the people of the GDR.”<sup>11</sup>

The disagreement did not end with just the *Bundesbank* and *Bundesregierung*. Rather every organization and interest group had an opinion on the matter, as this single decision could save or destroy not only the unification efforts, but also the economies of both Germanys. GDR politicians had recently run for *Volkskammer* election, calling for a 1:1 turnover rate for monetary holdings and wages. Other organizations of the same opinion included the Federal Union of German Employers' Association, the western SPD, parts of the CDU/CSU, and the Federal Minister of Labor. On the other side of the issue were the *Bundesbank*, Federal Finance Minister, and Federal Economics Ministry, all of which insisted on a 2:1 conversion rate for debts, savings accounts, wages, pensions, and cash holdings over DM 2,000. This proposal sparked massive demonstrations in the East. The *Bundesbank's* proposal would lead to fewer economic

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<sup>11</sup> Helmut Kohl. “Kohl’s Currency Union Proposal, 13 February 1990,” in *Uniting Germany: Documents and Debates, 1944-1993*, eds. Konrad H. Jarausch and Volker Gransow (Providence: Berghahn Books, 1994), 111.

losses in the West, but would place the Easterners at an even greater disadvantage. Federal Labor Minister Norbert Blüm declared that a conversion rate other than 1:1 would “open up profound social fault lines and have destabilizing political consequences.” Furthermore, he added, East Germans would suffer “glaring losses relative to their previous, already lower, living standards... particularly pensioners, families, and the unemployed.”<sup>12</sup> It quickly became clear that a 2:1 rate was ideal for the FRG Deutschmark and economy, but would ruin any chances for a socially and economically unified Germany.

Although it was unfeasible for politicians to accept the *Bundesbank*'s proposal for the German Economic, Social, and Monetary Union (GEMSU), the 1:1 conversion rate was not free of consequences. The eventual decision, passed in May 1990, created a rather complex system of monetary holdings conversion to go into effect on 1 June. In essence, holdings and claims faced a 2:1 conversion rate; however, cash and savings accounts between DM 2,000 and 6,000 were eligible for a 1:1 rate, depending on the holder's age. Firm's debts and housing loans were both converted at a 2:1 conversion rate and, alone, totaled over 360 billion Ostmarks.<sup>13</sup> Unfortunately, as Pöhl showed Chancellor Kohl, a 1:1 rate would result in the bankruptcy of many GDR businesses. The *Bundesbank* President noted that with a 1:1 ratio, the GDR's debt burden, which foreign creditors would receive in DMs, combined with their debts owed to the GDR national bank would translate to annual interest rates in excess of DM 20,000 million.<sup>14</sup>

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<sup>12</sup> Ritter, *The Price of German Unity*, 152-153

<sup>13</sup> Gerlinde Sinn and Hans-Werner Sinn, *Jumpstart: The Economic Unification of Germany* (Cambridge: MIT Press, 1992), 51.

<sup>14</sup> Charles S. Maier, *Dissolution: The Crisis of Communism and the End of East Germany* (Princeton: Princeton University Press, 2001), 237.

Because there was no single economic and socially ideal solution to the currency conversion, many problems arose in East Germany. One such problem faced by eastern German producers was a phenomenon called the “price-cost squeeze”. This resulted from former GDR businesses switching to Deutschmarks while having to set prices and cover costs, which included the ever-increasing wages.<sup>15</sup> Furthermore, new exposure to West German and international open market competition naturally caused output prices to fall. Low prices translated to decreasing revenues across East Germany. By the end of the first year of unification, the combination of currency appreciation and unprecedented levels of competition led to a two-thirds fall in East German output and one-third fall in total national output.<sup>16</sup>

The Council of Experts had worried and warned that introducing the Deutsche Mark too quickly would give East Germans the false illusion of closing the West-East gap in living standards.<sup>17</sup> Although the politicians did not wish to give false hope, they wanted to create both psychological and economic unification – an impossible feat without a single currency. In reality, by placing more importance on social than economic unification, the GEMSU led to immediate economic turmoil that continued for several years.

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<sup>15</sup> Thomas Lange and Geoffrey Pugh, *The Economics of German Unification* (Cheltenham: Edward Elgar Publishing Limited, 1998), 58.

<sup>16</sup> Lange and Pugh, *The Economics of German Unification*, 59.

<sup>17</sup> Michael Kreile, “The Political Economy of the New Germany,” in *The New Germany and the New Europe*, ed. Paul B. Stares (Washington, D.C.: The Brookings Institution, 1992): 69, [http://books.google.com/books?id=Q1d3OKCpEFIC&lpg=PA1&ots=j\\_TzZtBuQD&dq=the%20new%20germany%20and%20the%20new%20europe&lr&pg=PA69#v=onepage&q=the%20new%20germany%20and%20the%20new%20europe&f=false](http://books.google.com/books?id=Q1d3OKCpEFIC&lpg=PA1&ots=j_TzZtBuQD&dq=the%20new%20germany%20and%20the%20new%20europe&lr&pg=PA69#v=onepage&q=the%20new%20germany%20and%20the%20new%20europe&f=false) (accessed October 30, 2012).

## 2.2 Increasing Demand for Transfer Payments

The West German Basic Law protected all the *Länder* by guaranteeing equal living conditions throughout the country. Although the law was ratified in 1949 and amended twenty years before reunification even seemed viable, it declared that any *Länder* that acceded would also follow the Basic Law.<sup>18</sup> Because achieving immediate social and economic equality was impossible, politicians had to decide on which factor they would place more emphasis. West Germans inevitably had to economically support the unification, but contested exactly how much they would sacrifice. As previously mentioned, the West German federal government was much more willing to financially support their eastern neighbors, but state-level governments were more concerned with protecting their constituents from the potential economic consequences of unification.

While German politicians worked to economically and socially unite their countries, they also needed to create a way to finance GEMSU. Also in May 1990, West Germany created the “German Unity Fund”, which allocated DM 115 billion to East Germany over the first four years of reunification. The eleven West German *Länder* and the federal government agreed to split the burden evenly between themselves and the GDR to assist in financing the East German budget deficit (which was predicted to reach DM 50 billion) and social programs such as unemployment and welfare.<sup>19</sup> These politicians adopted many policies to address social problems in East Germany, but the

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<sup>18</sup> *Basic Law for the Federal Republic of Germany* (Bonn, Germany, May 23, 1949): Article 72, [http://www.gesetze-im-internet.de/englisch\\_gg/englisch\\_gg.html#p0320](http://www.gesetze-im-internet.de/englisch_gg/englisch_gg.html#p0320) (accessed October 17, 2012).

<sup>19</sup> Ferdinand Protzman, “Germans in Accord on a ‘Unity Fund’,” *New York Times* (May 17, 1990), <http://search.proquest.com/hnpnewyorktimes/docview/108436868/13AB998BEF61DD73068/1?aaccountid=10141>.

German Unity Fund also acted as an effort to assuage the economic concerns of West German citizens. The fund functioned more to control the redistribution of the heavy financial burden between the federal government and the West German *Länder* than to finance the East German states, which had not yet officially become a part of the Federal Republic.<sup>20</sup>

In a very bold political move, reminiscent of George H.W. Bush's "read my lips" gaffe, Chancellor Kohl promised to avoid raising income taxes by implementing the Unity Fund. To avoid raising western taxes, Bonn, the FRG capital, planned to take DM 20 billion from government savings and borrow the rest of its share from capital markets. The federal states planned to borrow as well.<sup>21</sup> Germany would soon learn that public borrowing alone could not sustain East Germany's financial needs. Despite efforts to protect the West German taxpayers, politicians did not anticipate the increased East German need for assistance and the westerners would have to feel some economic strain. By 1992, the German Unity Fund had grown to DM 160.7 billion and the actual total of financial transfers reached DM 770 billion by 1994.<sup>22</sup> To put this number into perspective, for the first six years of reunification each West German essentially paid DM 3,000 and each East German received DM 12,600 annually.<sup>23</sup>

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<sup>20</sup> Wolfgang Rensch, "Financing German Unity: Fiscal Conflict Resolution in a Complex Federation," *Publius* 28, no. 4 (Autumn 1998): 132, <http://www.jstor.org/stable/333145> (accessed November 17, 2012).

<sup>21</sup> Manfred Görtemaker, *Unifying Germany, 1989-1990*, (New York: St. Martin's Press, 1994), 152.

<sup>22</sup> Jens Hölscher and Johannes Stephan, "The 'German Model' in Decline," in *East Germany's Economic Development since Unification: Domestic and Global Aspects*, eds. Jens Hölscher and Anja Hochberg (New York: St. Martin's Press, 1998), 31.

<sup>23</sup> Michael Kaser, "The Eastern Länder as a Transition Economy" in *East Germany's Economic Development since Unification: Domestic and Global Aspects*, eds. Jens Hölscher and Anja Hochberg (New York: St. Martni's Press, 1998), 68.



When examining the German Unity Fund and Unification Treaty, it becomes increasingly clear that West German politicians decided when they would obey the Basic Law and when they would circumvent it. This inconsistency occurred in the name of equality and expediting the reunification process, but also in protecting West German citizens from economic repercussions. Wolfgang Rensch, a political scientist from the *Universität Magdeburg*, cited the Basic Law as the reason for the abrupt reunification and the efforts to converge both economies as quickly as possible. The Basic Law, however, also divides sales-tax revenue between *Länder* on a per capita basis. This led to extensive discourse and arguments between the West German states and the Federal government. Rensch explained in his 1998 journal article that should East Germany receive equal amounts of tax revenue, the old *Länder* would lose an additional DM 4 to 5 billion. In their opinions, West Germany had more sales tax receipts than the East, but would receive the same revenue in return. The German Unity Fund had already established the West German financial burden and the western, state-level politicians were, therefore, unwilling to accept any further economic losses.<sup>24</sup> For this reason, the old *Länder* proposed a staggered system in which the new *Länder* would receive 55 percent of the sales tax allocation in 1991, 70 percent in 1994, and then eventually the constitutionally mandated per capita allocation. This proposal passed initially, but in 1991 the newly confident leaders of the eastern *Länder* negotiated until their respective states earned what was their proportionate share according to Basic Law.<sup>25</sup> This process of sales tax allocation acts as yet another example of eastern and western politicians failing to find policies which would benefit both East and West Germans. The solution to this

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<sup>24</sup> Rensch, "Financing German Unity," 135.

<sup>25</sup> Rensch, "Financing German Unity," 134.

predicament resulted in a further economic burden on the West so as to allow the East to converge as quickly as possible.

### **2.3 Re-Privatizing Expropriated Property**

The tumultuous history of Germany created the complex issue of contested property ownership. Between the 1930s and 1980s, three separate initiatives confiscated private property. The first, led by the Nazis, targeted the Jewish population's homes, industrial properties and land. The Soviet authorities led the second initiative, immediately following 1945, and targeted *Junkers*, or members of Prussian and eastern German nobility. The *Bodenreform* program seized millions of acres of agricultural land, as well as industrial property and real estate as reparation for the damage done to the Soviet Union during World War II. The final expropriation effort occurred after 1949 in the recently established GDR. The state seized properties to establish large agricultural cooperatives, private firms for nationalization, and the homes, lands, and accounts abandoned by refugees who had fled to freedom.<sup>26</sup> As a result, West Germany had to decide how to distribute all of the soon-to-be-privatized property and industry. On June 15, 1990 both governments passed the "Joint Government Declaration on Open Property Questions," which was later incorporated into the Unification Treaty.

#### **2.3.a Property**

The governments created the Joint Declaration in hopes of developing a socially responsible solution which could satisfy the citizens of both countries. Of the three aforementioned expropriation efforts, attempting to return property seized by the Soviet

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<sup>26</sup> Smyser, *Economy of United Germany*, 161.

Union before the establishment of the GDR was not an option. However, the government would attempt restitution of some property seized by the Nazis, but mostly property seized by GDR authorities. This was an enormous undertaking, as almost five million Germans fled from East to West between 1950 and 1990 alone, leaving their properties and assets for the government's seizure.<sup>27</sup> Fortunately for those victims of "Aryanization", GDR refugees, and their heirs, the joint governments chose a policy that would benefit their citizens rather than expedite economic unification. The Joint Declaration on the Settlement of Open Property Questions reflected this decision:

II. Trusteeship administration and similar measures limiting the use of real estate, businesses, and other property must be rescinded. With this, citizens whose property was taken into state administration as a result of flight [from the GDR] or for other reasons will regain control of their property.<sup>28</sup>

The document continued, providing the option to accept compensation instead of the property, compensation in cases where the property could not be returned, and protecting renters from eviction or steep increases in rent.<sup>29</sup>

By mid-1991, Germans filed over 1.5 million claims for restitution, subjecting approximately one fourth of East German properties to claim. This created an overloaded and sluggish system for two reasons. First, it was unclear how to approach cases of ownership of buildings on land potentially owned by another claimant. Second, an extended period of poor record keeping in the GDR presented many cases of multiple claimants on the same property. As of 1993, the Officials at the Office for the Regulation

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<sup>27</sup> Heinz Fassman and Rainer Munz, "International Migration Review." *International Migration Review* 28, no. 3 (Autumn, 1994) <http://www.jstor.org/stable/2546819>, 529.

<sup>28</sup> *Joint Declaration of the Governments of the Federal Republic of Germany and the German Democratic Republic on the Settlement of Open Property Questions*, (Bonn, Germany, 15 June 1990), [http://germanhistorydocs.ghi-dc.org/sub\\_document.cfm?document\\_id=3099](http://germanhistorydocs.ghi-dc.org/sub_document.cfm?document_id=3099) (accessed October 17, 2012).

<sup>29</sup> *Joint Declaration of the Governments*.

of Property Questions forecast another ten years to close all of the files.<sup>30</sup> The issues of property ownership promoted the rights of displaced citizens, but essentially halted the East German economy and stymied a smooth reunification process.

### **2.3.b Industry**

The widespread expropriations confiscated not only homes, but also land and businesses in an effort to create an economy planned from its production down to its distribution. This presented the West Germans with an enormous task: privatizing an economy in which 98 percent of the GDP was publicly produced and consisted of almost two hundred cartels controlled by government ministries. These cartels, or *Kombinate*, controlled almost all production, exports, and East German resources, creating a system antithetical to a market economy. For this reason, West Germany had to reallocate and restructure East German production.<sup>31</sup> As well as addressing the issue of homes and real estate, the Joint Government Declaration addressed the question of expropriated businesses and firms:

VII. For businesses and shareholdings that were incorporated into national property through confiscation of 1949 and 1972, the former owner will be given – taking into account how valuable the business has become – the business as a whole or shares or stocks in the company, provided that he does not wish to take advantage of compensation.<sup>32</sup>

However, the issues mentioned above affected privatizing industry as well, creating an inefficient and slow process. By the ratification of the Unification Treaty, disagreements

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<sup>30</sup> Lange and Pugh, *The Economics of German Unification*, 66.

<sup>31</sup> Smyser, *The Economy of United Germany*, 151.

<sup>32</sup> *Joint Declaration of the Governments*.

within the government would alter the Joint Declaration so as to stimulate the East German economy.

The prolonging of privatization combined with prioritizing the return of property over compensation only contributed to the economic complications of unification. Economists and politicians both agreed that private investment could save the East German economy, but the problems with property ownership and consequent poor infrastructure effectively dissuaded private investors.<sup>33</sup> Before ratifying the Unification Treaty, the West German Social Democratic Party (SPD) urged reconsideration of placing property return above compensation, citing the need for legally secure investments. This resulted in a caveat in the Unification Treaty:

...there shall be no return of property rights to real estate or buildings if the real estate or building concerned is required for urgent investment purposes to be specified in detail, particularly if it is to be used for the establishment of an industrial enterprise and the implementation of this investment decision deserves support from a general economic viewpoint, above all if it creates or safeguards jobs.<sup>34</sup>

As with all other aspects of unification, two different questions emerged for West German leaders: should the government place more importance on social or economic issues? Those who agreed with the SPD were concerned that the imminent possibility of a property returning to its former owner would deter private investors and further slow the efforts of privatization. Other groups supported placing restitution above compensation because of the social principles, encouraging the return of property to its original owners. These groups stressed the importance of allowing formerly

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<sup>33</sup> Ritter, *The Price of German Unity*, 80.

<sup>34</sup> *Treaty between the FRG and the GDR on the Establishment of the Unity of Germany*, (Berlin, Germany, August 31, 1990), [http://germanhistorydocs.ghi-dc.org/sub\\_document.cfm?document\\_id=78](http://germanhistorydocs.ghi-dc.org/sub_document.cfm?document_id=78) (accessed October 17, 2012).

disenfranchised Germans to assist in the rebuilding of their economy. Furthermore, in their opinion, how could a true market economy exist without placing the utmost importance on private ownership of the means of production?<sup>35</sup> In reality, as German historian Gerhard A. Ritter explains, more factors than simply privatization deterred private investors from East Germany, including the poor GDR infrastructure, the inefficiency in most East German enterprises, and the fact that transfer payments went more towards consumption than investment. German economists had already stressed that a lack of private investment in the East German economy would result in a painfully slow recovery and an exceedingly difficult rebuilding process.

### **2.3.c The *Treuhandanstalt***

The issue of privatization was a significant hurdle in the reunification of Germany. To assist with this process, the East German government founded the *Treuhandanstalt*, or Trust Agency. This institution had the purpose of protecting centrally-owned properties from the collapsing state. However, the *Treuhand* Act and the Unification Treaty morphed the agency into one which officially privatized and reorganized the properties it originally protected. The *Treuhand* took charge of three types of properties: state-owned businesses, land, and assets such as mining properties, pharmacies, and the Ministry of State Security. The sheer number of properties was overwhelming. By mid-1990, the *Treuhand* owned over eight thousand businesses and *Kombinate*, over forty thousand factories, almost 37 billion square meters of farmland and forestry, and almost two thousand other assets. At the time, approximately 46 percent

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<sup>35</sup> Ritter, *The Price of German Unity*, 83.

of East Germans were employed by businesses and assets under control of the *Treuhand*.<sup>36</sup> Although the amount of land and other assets could not increase, the former Communist control of businesses resulted in reorganization and consolidation of properties. The restitution and selling efforts meant that these properties needed to be broken up, increasing the number of enterprises for which the *Treuhand* was responsible.<sup>37</sup>

Like many other aspects of the unification process, the business turnover rate initially moved very slowly, delaying a quick economic recovery. The *Treuhand* functioned in a way which favored West German buyers. The East German entrepreneurs and businessmen only had money from the currency conversion, were therefore asset poor and required loans. To acquire a loan, however, they needed equity capital, which they did not have.<sup>38</sup> Equity capital is an investment in businesses, such as stock. Because these businesses were owned by the state, East Germans did not have any stakes in the enterprises, and therefore no equity capital with which to receive loans. The West Germans however, despite having equity capital, did not have excess capital with which to invest in the East. Although the West German economy fared the much better during reunification than that of East Germany, between 1990 and 1992 the reunification deficit increased by more than DM 100 billion. This increased real interest rates, turned Germany into a capital-importing country, and did not leave excess capital for private

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<sup>36</sup> Herbert Brucker, *Privatization in East Germany: A Neo-Institutional Analysis* (London: Frank Cass Publishers, 1997), 151.

<sup>37</sup> Hans-Werner Sinn, "Privatization in East Germany," *NBER Working Papers Series*, no. 3998 (February 1992): 7, <http://www.nber.org/papers/w3998.pdf> (accessed September 24, 2012).

<sup>38</sup> Sinn, "Privatization in East Germany," 14.

investment in the East.<sup>39</sup> Artificially high wages in East Germany further contributed to the slow rate of business sales. The high wages resulted from West Germans negotiating East German wages so as to prevent low-wage competitors. They hoped to prevent migration to the West with enticingly high East German wages, but in reality this increased unemployment and decreased the value the appeal, of *Treuhand* enterprises.<sup>40</sup>

In an effort to appease the numerous critics of rapid privatization of large enterprises, the *Treuhandanstalt* created a branch in late 1991 called *Management-Kommanditgesellschaft* (MKG). This translates to Management-Limited Commercial Partnership and it focused on restructuring enterprises that had future promise, but no active buyers in the short run.<sup>41</sup> The East German Land of Saxony also led the ATLAS initiative which, when translated, means: Selected *Treuhandanstalt* Firms Registered by the Land for Restructuring. ATLAS petitioned to the *Treuhand* for Land control of restructuring rather than liquidation of “regionally significant” companies. This effort helped save industrially important companies such as Jenoptik GmbH, an optical equipment, precision instrument, and electronics manufacturer.<sup>42</sup> By 1993, the *Treuhandanstalt* had privatized over 80 percent of its holdings and prepared to shut its doors. Four years after its founding, the *Treuhand* closed and four organizations took its place, the most important being: *Bundesanstalt für vereinigungsbedingte Sonderaufgaben* (BvS), which monitored newly privatized firms’ contracts, and *Beteiligungs-*

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<sup>39</sup> Sinn, “Privatization in East Germany,” 12.

<sup>40</sup> Sinn, “Privatization in East Germany,” 17.

<sup>41</sup> Jeffrey Anderson, *German Unification and the Union of Europe* (Cambridge: Cambridge University Press, 1999), 122.

<sup>42</sup> Anderson, *German Unification and the Union of Europe*, 124.



*Management-Gesellschaft Berlin* (BMGB), which was responsible for the management, restructuring, and privatization of the *Treuhand*'s remaining eighty firms.<sup>43</sup>

Although the *Treuhandanstalt* itself was liquidated, the German economy had not come close to recovery. By 1993 the entire country was solidly in recession. The *Treuhand* itself had incurred approximately DM 230,000 million in debt, the German Unity Fund, which had DM 115,000 million over five years, was not nearly enough,<sup>44</sup> and the average net monetary wealth of an East German private household was only one-third of a western household.<sup>45</sup> The government would have to find new taxes and reforms to rescue the newly united economy.

## 2.4 Combatting Rising Unemployment

One of the benefits of Communist Germany was low unemployment and high job security. In 1989, just before unification, the East German workforce consisted of almost 9 million citizens – well over half of the population.<sup>46</sup> Because of the requirement to work and the deliberate efforts of planning committees to utilize the full labor capacity of the workforce, East Germany was entirely unequipped to handle the inevitable rise in unemployment.<sup>47</sup> However, no capitalist society functions with full employment and between the *Treuhandanstalt* and natural job loss due to exposure to competition, unemployment would rise at staggering rates.

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<sup>43</sup> Anderson, *German Unification and the Union of Europe*, 126.

<sup>44</sup> Ritter, *Price of German Unity*, 97.

<sup>45</sup> Ritter, *Price of German Unity*, 281.

<sup>46</sup> Lange and Pugh, *The Economics of German Unification*, 18.

<sup>47</sup> Ritter, *Price of German Unity*, 134.

To combat the social ramifications of a tumultuous economic transformation, East Germany passed the Employment Promotion Law, in June 1990. The Employment Promotion Law sought to adopt western labor market policies and attempted to offset the stress caused by the impending increase in eastern unemployment. However, the EPL differed from western policies in several ways. One aspect was the short-time working benefit. Like western labor laws, the short-time benefit provided workers who cancelled working time for social reasons almost their full wage. For example, a worker taking time off for reasons relating to their child could receive up to 68 percent of their net wages. The GDR version of the EPL, however, also made this benefit available to those workers whose job was not expected to survive the unification. Workers participating in retraining programs also qualified, and could even receive a percentage of their wage even higher than that of short-time.<sup>48</sup> Within the first year following the monetary union in July 1990, between 6.8 and 8 million workers received short-time pay. This translates to between 75 and 90 percent of the East German workforce received short-time benefits, or compensation for not working. Many West Germans, including the Federal Labor Ministry, found the East German version of the EPL inefficient and troublesome. The FLM fundamentally opposed minimum protection for the unemployed, fearing that it would diminish the incentive to find new jobs, as well as present opportunities for benefit abuse. Despite these fears, Labor Minister Blüm wrote to Dieter-Julius Cronenberg, an FDP politician, explaining why he supported such generous policies. “The shift from a planned economy to a Social Market economy with virtually no transition period [was] a unique economic and socio-political event.” Blüm continued, saying it was policy-

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<sup>48</sup> Ritter, *Price of German Unity*, 172.

makers' responsibility to, "minimize the risks wherever possible, in the interests of those people affected in the GDR".<sup>49</sup> These sentences summarize the entire reunification process. Federal-level politicians, more often than not, felt it was their duty to promote social benefits in the East over supporting the western economy.

The extent to which unemployment would increase across the entire reunified Germany did not become clear for several years. While the *Treuhandanstalt* liquidated firms in the East, unemployment naturally increased. The opposite effect, however, initially occurred in the West. The newly opened society caused an overwhelming increase in demand for Western goods, causing employment in the old *Länder* to increase from 28 to 28.7 million in 1991. Although the numbers show western employment as increasing, these jobs did not exclusively go to West Germans. The data shows 700,000 new jobs, but in that time the number of West Germans registered as unemployed only decreased by 300,000. This means that East German migrants took over half of these new jobs. The initial boost to the West German economy, which included a growing GNP and stable prices, however, did not last.<sup>50</sup> As shown in the Graph of German Unemployment (**Figure 1**), West German unemployment began to rise in 1992 and did not begin to decrease until 1997 – after five years of record high unemployment rates across the entire country. In contrast, East German unemployment increased dramatically for more than a decade following GEMSU. Notably, between 1999 and 2003 East German unemployment more than doubled that in the West.

After several years of steadily increasing unemployment rates, it became clear that efforts, such as the EPL, were failing to bring unemployment down to an

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<sup>49</sup> Ritter, *Price of German Unity*, 174.

<sup>50</sup> Smyser, *The Economy of United Germany*, 32.

economically acceptable level, especially since the officially recorded statistics did not include “hidden unemployment.” For example, **Figure 1** shows average unemployment in 1996 as approximately 12 percent. Including the 1.5 million Germans in early retirement or short-time working would bring the unemployment number closer to 15 percent.<sup>51</sup> Further political efforts in 1996 included the Action Program for Investment and Jobs and Program for more Growth and Employment). The Investment and Jobs Program sought several reforms, including deregulation of businesses, changes in corporate taxation, and creating incentives for start-up businesses. The Growth and Employment Program focused more on cutting labor costs and public spending. The program reduced benefits such as sick-pay and paid vacation, prevented any increases in monthly child-benefit allowances, and implemented a two year pay-freeze for public sector employees.<sup>52</sup> These efforts to reduce the state role in the economy, to create more competitive businesses, and to reduce unemployment reflect one of the few areas of reunification in which policies placed more importance on economic rather than social issues. East Germany had transformed from a Communist society with a workforce consisting of well over half the population to an open market economy where one-in-seven workers were jobless.<sup>53</sup> With such disparity between the job levels in East and West Germany, the Basic Law, calling for equal living conditions throughout the entire country, could not be followed without sacrificing some social benefits, which discouraged people in the East from seeking employment.

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<sup>51</sup> Jens Bastian, “The Institutional Architecture of an Alliance for Jobs,” in *East Germany’s Economic Development since Unification: Domestic and Global Aspects*, eds. Jens Hölscher and Anja Hochberg (New York: St. Martin’s Press, 1998), 127.

<sup>52</sup> Bastian, “The Institutional Architecture of an Alliance for Jobs,” 128.

<sup>53</sup> Lange and Pugh, *The Economic of German Unification*, 18.

### **3. Conclusion: Social Policies Drove Reunification**

The long and messy reunification process began in 1989 when policymakers hoped to quickly create a unified Germany. West Germany had prospered since World War II with a stable currency, an impressive GDP, and relatively low inflation. At the same time, East Germany had faltered. The planned economy and its massive *Kombinate* resulted in little competition between businesses. It also resulted in inefficient allocation of resources, lower rates of production, and a much weaker currency than the Deutsche Mark. When the Wall fell, easterners rushed west to embrace capitalism and drink Coca-Cola. Neither country's citizens, however, fully anticipated the consequences they would face, nor the sacrifices they would have to make.

Policymakers in both governments faced a power struggle. The West German Central Bank, the Federal Government, the *Länder*, and the East German politicians had to come to agreements on four major issues. The decisions surrounding currency conversion, transfer payments, privatization and unemployment would influence both the psychology and the economy of the unified country. The dilemma faced by these politicians was as follows: should they pursue policies that place more importance on social or economic issues? Ultimately, social factors trumped economics.

The unique power struggle between the *Bundesbank* and the Federal Government stemmed from the Central Bank's autonomy. Founded before West German officially became a country, the *Bundesbank* operated free from political authorities and pressures.

Its main responsibility was to oversee the stability of the Deutsche Mark and control inflation.<sup>54</sup> In terms of reunification, the *Bundesbank* advocated for austere measures that would protect the Deutsche Mark. The proposal of a 2:1 currency conversion rate would decrease losses in the West, but would cripple East German savings and businesses. It became clear that for the sake of a truly reunified Germany, the *Bundesbank* would have to forgo its autonomy and allow the politicians to pursue socially conscientious decisions.

The Central Bank played a smaller role in the other key issues, where disagreements were more prevalent between the different levels of politicians. In the case of transfer payments, politicians created the German Unity Fund. This allocated DM 115 million for West Germany to assist with the inevitable increase in the East German budget deficit. It became clear in the first year of reunification that the German Unity Fund grossly underestimated how much money the East would need. This sparked a negative response from the *Länder* politicians, who were most concerned with their constituents' well-being. In accordance with the German Basic Law, which declares equal living conditions throughout Germany, the state-level politicians had to yield to the Federal Government and the East German need for more economic support. The ever-increasing amounts of transfer payments caused an economic setback in the West in the name of equalizing living conditions in the entire country.

The social benefits in the East were most strongly supported by the privatization efforts. Policymakers had to decide if they should return expropriated property to disenfranchised Germans, or to encourage private investment by selling the properties to the highest bidders. Because Nazis and Communists had confiscated the property and

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<sup>54</sup> Beyer, "Opting Out of the Great Inflation," 9.

because the government wanted East Germans to feel involved in the reunification, the Joint Declaration on Open Property Settlements declared that former property-owners or their heirs could reclaim what had once been theirs. The overwhelming number of claimants combined with the poor record keeping of the GDR made this process excruciatingly slow. Private investors from the West had nothing in which to invest, slowing the East German economy's convergence, but the citizens had the hope of reclaiming their properties.

Policymakers put social issues aside for one key element of reunification: unemployment. They had predicted a swift and relatively easy reunification and believed this was occurring when West German unemployment initially decreased. East German unemployment, however, increased tremendously and that in the West soon followed. The eastern unemployment policies provided extremely generous unemployment benefits. Shortly before reunification, East Germany adopted the Employment Promotion Law. The EPL fundamentally mirrored West German employment benefits, but modified them in more generous ways. From paying workers to stay home to allowing West German unions to wage bargain in the East, huge amounts of money were spent on an unproductive workforce, further crippling the East German economy. Part of the problem stemmed from unemployed workers who received substantial pay and were therefore not incentivized to find new work. Unemployment increased at staggering rates, and policymakers realized that they would have to make social sacrifices to save the economy. With a more austere plan, they pursued deregulation of business, decreasing labor costs, and giving incentives to start-ups. These policies sought a decrease in unemployment as well as more efficient costs of production. Although the unemployed

received fewer benefits, the government hoped to encourage new business and galvanize the East German economy.

The West and East reunited quickly, but not without ramifications. Citizens on either side of the Berlin Wall paid significant prices in the name of unity. The West poured money into the East, while East Germans suffered from not only unemployment and low productivity, but also from the inferiority complex that ran deep in the East. West German politicians, in order to create a united Germany, did not pursue the most economically beneficial policies for their own country. The entire country's economy stumbled in the 1990s but began to recover in the 2000s. The short-term pursuit of policies that emphasized social over economic advantages did not prevent Germany from returning to its traditional role as the economic leader of Europe by the turn of the century. In conclusion, politicians fought and disagreed on which policies were most important to adopt, but in obeying the German Basic Law, they created a more powerful and peaceful union.



## Appendix

Figure 1: Graph of German Unemployment 1990-2003<sup>55</sup>

{Image Redacted}

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<sup>55</sup> Dr. Detlef Pollack, "Support for Democracy in Eastern and Western Germany: an Attempt to Explain the Differences," [http://georgetown.edu/sfs/cges/working\\_papers.html](http://georgetown.edu/sfs/cges/working_papers.html) (accessed October 27, 2012).

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*Treaty Between the FRG and the GDR on the Establishment of the Unity of Germany*. Berlin, Germany, August 31, 1990, [http://germanhistorydocs.ghi-dc.org/sub\\_document.cfm?document\\_id=78](http://germanhistorydocs.ghi-dc.org/sub_document.cfm?document_id=78) (accessed October 17, 2012).