East Germany's introduction to capitalism has resulted in burgeoning inequality and social misery. Right? Wrong. Bruce Headey reports on the surprising results of the first in-depth analysis of social conditions there. The results suggest that old-style social democratic redistribution may have life left in it yet.

In retrospect it seems clear that most East Germans supported unification with the Federal Republic for two main reasons: they wanted Western-style democracy and a much improved standard of living. They have got the first. But what about the second?

Examination of changes in incomes, income inequality and satisfaction with living standards in 1990-91 reveals some surprising results. A recent survey tested some 'commonsense' hypotheses about the transition to a market economy, based on data collected both before and after the fall of the communist regime. These were:

- During the first stage of transition most East Germans suffered a decline in living standards.
- The income distribution became more unequal.
- People who were previously relatively advantaged became better-off, while disadvantaged people became worse-off. That is, in the transition to capitalism, the 'rich' became richer and the 'poor' became poorer.
- East Germans became increasingly dissatisfied with their incomes, standard of living and life-as-a-whole.
- Those whose standard of living actually improved became more satisfied, while those whose standard of living declined were dissatisfied.
- In the last year East Germans became more pessimistic about the future.

The results show that most of these 'commonsense' hypotheses are false. Why does 'reality' appear to defy commonsense? One major factor has been the impact of the federal government's taxes and benefits, which have redistributed incomes in ways that may not have been...
intended, with quite dramatic effects in maintaining a high degree of equality in East Germany.

With events changing so rapidly, it is crucial to note exactly when the data was collected. The first wave of the panel was conducted in June 1990 just before the Deutschmark was introduced into East Germany and at a time when incomes and income distribution remained more or less as they had been in the last years of communism. The second wave of interviews took place 9-10 months later, in March-April 1991. This was after unification, after the first all-German elections in December 1990, and after some enterprises in the East had already been taken over by Western businesses. But it was before the abolition of many job subsidies in July 1991, which led to increased unemployment, and before the large rent increases in October. So the results help us to understand only the first phase of transition from a command economy to the West German social market economy.

The hypotheses that most people in East Germany have become worse off since the revolution appears to be unambiguously false. The real per capita income of 60.3% of households increased between May 1990 and March 1991. On average, real household incomes increased at an annual rate of 10%, a high growth rate by normal international standards. Even if households in which one or more members commutes to the West to work (which account for 5% of the labour force), the growth rate was still 6.6%. Real incomes also appear to have increased between 1989 and 1990 (that is, under the old regime), by 14.2% in nominal terms and perhaps 15.3% in real terms.

The second hypothesis, that income inequality would increase in the transition to a market economy, also appears more false than true. Income inequality, measured by net household per capita income, appears virtually unchanged. The bottom 20% had a share of total net household per capita income which had fallen by 1.3%, while the top 20% had gained 1.7%. However, even this slight change is accounted for by people earning money in West Germany. If they are excluded, it appears that inequality is unchanged.

These results astonished us and led us to search for an explanation. After much trial and error, it became clear that the main explanation was that the influence of the market, which increases inequality, is only coming slowly to East Germany, whereas the impact of the federal republic’s welfare state has been immediate and dramatic.

In trying to assess the relative impact of the market and the welfare state, we first examined shares of labour market earnings, excluding individuals with no earnings. This indicated a moderate increase in inequality. If the entire sample is considered, the share of the bottom 20% declined by 0.5% and the top was 2.8% better off. The equivalent figures excluding the commuters are 0.3% and 1.1%.

So the market has not yet greatly increased inequality for individuals who have remained in work. However, many people have lost their jobs, others have gone into early retirement, and still others are in short-time work.

Taking these people into account, it can be seen that, whether or not commuters are included, inequality of household earnings per capita (excluding government benefits) increased quite sharply between 1990 and 1991. The share of the bottom 20% declined by about 3%, and the top 20% gained 3.4%. The reason for the difference is that, although the market has not yet made individual earnings more unequal, it has had a substantial effect in reducing employment. The households earning the least are mainly those in which one or more people have lost their job, whereas households in the higher ranges are mainly those in which everyone has kept a job.

So earned income did become more unequal, but total income (including government benefits) did not. It follows that government taxes and social benefits must have exerted a more progressive, redistributive impact in 1991 than in 1990. In other words, the federal government must be acting more ‘progressively’ than the former GDR government, whose taxes and social benefits still operated in May 1990. Whether accidentally or deliberately, the federal government must be playing Robin Hood.

Under the former GDR’s tax-benefit system in 1990, 8.9% of income was transferred from the top 60% to the bottom 40% of households. Under the federal republic in 1991, 12.7% of total income was transferred to the bottom 40%. Presumably this result will surprise most readers, as it surprised us. In retrospect, however, it can be understood. The GDR government maintained a low degree of income inequality primarily by enforcing a fairly egalitarian gross income distribution. Its tax-benefit system was not exceptionally progressive. In particular, one should note that income tax was levied on most incomes at around 8%. In other words, it was close to being a flat rate tax. By contrast, the German federal government, in principle, leaves gross factor incomes to be determined by the market and then intervenes in favour of lower income groups.

In trying the understand the workings of the market in comparison with the welfare state, we have excluded pensioner households (head aged 65 or over). The federal government has been even more ‘generous’ to these households than to households on lower incomes. In January 1991, all pensions were increased by 45%, a policy action which at a stroke greatly improved the standard of living of nearly 20% of the population.

It is clear that so far in East Germany politics have been more important than economics. The federal government has been keen to improve the living standards of East Germans, and so have trade unions. Welfare state benefits have flowed generously since the unification of the two economies on July 1 1990, and this has mitigated the already patchy impact of the market on income inequality. Labour incomes have not yet become more unequal, but the effect of market forces has been to increase unemployment and so increase inequality of household earnings.
It is a common assumption that the demise of a command economy would enable those who were already relatively well off in East Germany to become better off, and would cause those who were worse off to decline further. This, too, appears to be unambiguously false.

Far from becoming better off, those who had been relatively advantaged in 1990 suffered a decline in real incomes, whereas those who were disadvantaged recorded an increase in income. Lest these results appear too surprising, it should be noted that somewhat similar figures for consecutive years are normal for Western countries, mainly due to changes in household size and to entries and exits from the labour force by members of the household. The main point here, however, is that we can reject the idea that people who had been 'rich' in East Germany in 1990 became richer by 1991, and the people who had been poor became poorer.

The figures also show an exceptional degree of volatility in the East German income distribution in 1990-91, compared to West Germany. Who have been the initial winners and who the initial losers after the revolution? The winners are virtually all households in which everyone kept a job. The losers are those households in which one or more members left the labour force (whether voluntarily or involuntarily). It should be remembered that, in many sectors of the economy, trade unions and professional associations were pressing for wage parity with the West. Virtually all people who have kept their jobs (except some who have gone on short-time work) have recorded remarkable increases. But of course many people have not kept their jobs.

In most households, labour force participation remained unchanged and earnings increased. However, more households lost than gained workers (by a ratio of nearly three to one) and in these households earnings substantially declined. In the small minority of households where labour force participation increased, earnings were well up.

We could suggest some more specific groups of winners. East Germans who commute to the West to work had average incomes in March 1991 which placed them in the top 20%, whereas in the previous year, these same people had incomes virtually the same as the East German average. A second group who were doing well in 1991 were the self-employed (the new entrepreneurs?), many of who had previously been wage or salary earners. A third group who benefited particularly, as we have already mentioned, were old-age pensioners.

Despite the fact that most real household incomes increased between May 1990 and March 1991, most respondents become less, not more satisfied with their incomes and standard of living. Satisfaction with household income declined from an average of 5.6 (on the 0-10 scale) to 4.8, and satisfaction with living standards dropped from 6.3 to 5.9. The former decline must be one of the largest ever observed in any life domain in any country in a single year.

Presumably a major reason for these results is that the standard of comparison used by East Germans in arriving at their judgements has changed. More directly than before, they compare themselves with counterparts in the West. People in most occupations can see that their counterparts in the West are better paid, and everyone is aware that living standards are much higher in the West. The revolution of 1989 raised expectations, so that even some people whose real incomes have risen, as well as those who have lost money, have disappointed expectations and feel dissatisfied. Dissatisfaction probably also resulted from heightened anxiety due to much greater insecurity of jobs and living standards and uncertainty about the effects of the imminent abolition of job and rental subsidies scheduled for later in 1991.

People in East Germany only reported increased satisfaction with their incomes and standard of living if their real incomes increased by more than a quarter. In other words, only a very large (unsustainably large?) increase in real income was sufficient to meet rising post-revolutionary expectations and the new standards of comparison used in assessing one's living standards.

Everything one reads about East Germany in the media suggests that people feel pessimistic. However, the data indicates that optimism remains high, and is virtually unchanged from 1990. The levels of optimism are much the same as in West Germany.

So the overall picture is that incomes have risen significantly in real terms, while satisfaction with income and living standards has fallen. Nevertheless, optimism about the future remains high. But although the picture is complicated, it is not incomprehensible. Comparisons with the West are probably the key. East Germans are dissatisfied because their material standards are still well below those of West Germans, but they expect, eventually, to attain those standards and so feel optimistic about the future. It is worth repeating that all these conclusions relate to the period between May 1990 and March 1991. These dates mark the first stage in the transition from communism and a command economy to Western-style democracy and a market (or social market economy). However, based on these results, it would seem very unwise to make any 'commonsense' predictions about what is likely to have happened in the former GDR since that time, or about what will happen in the future.

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Note:
1. The East German Socio-Economic Panel Study