

# Neoclassical versus Keynesian approaches to Eastern German unemployment: a rejoinder to Merkl and Snower

**Abstract:** *This rejoinder contrasts a Keynesian approach for explaining unemployment in Germany's eastern region with a neoclassical, market-failure approach advanced by Christian Merkl and Dennis Snower. A skewed distribution of headquarters favoring the western region, combined with insufficient levels of effective demand for output—and subsequently for labor—are argued to be the key causes of persistent unemployment. Seven tables offer a comparative approach to output, investment, and labor demand in Germany's eastern and western regions, noting the emergence and persistence of “involuntary” unemployment appearing as a jobs' gap in the eastern region, especially for services.*

**Key words:** *economic method, explanatory failure, involuntary unemployment, jobs' gap, Keynesian theory, neoclassical theory, Treuhand privatization.*

Working together as coauthors, Christian Merkl and Dennis Snower wrote the paper “East German Unemployment: The Myth of the Irrelevant Labor Market” (this issue, pp. 151–165). Their paper was coauthored as a direct response and challenge to ideas expressed in our paper “Explaining Persistent Unemployment in Eastern Germany,” appearing in the summer 2007 issue of the *Journal of Post Keynesian Economics*. Our paper developed out of a critique of two of their earlier papers that appeared in the summer of 2006.

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In 2006, Snower and Merkl had advance ideas seeking to explain root causes and persistence of eastern German unemployment. The title “The Caring Hand That Cripples: The East German Labor Market after Reunification” appeared both as a “working paper” from the Kiel Institute for World Economy and as a shortened version in the *American Economic Review*. As the title suggests, these two papers credited the state’s “caring hand” for contributing toward eastern Germany’s high rates of regional unemployment.

This rejoinder is written as a direct response to their challenges advanced in their “Myth” paper, also appearing in this issue of the *JPKE*. However, because this most recent paper continues to rely upon an identical approach to economic method found in their two previous papers that appeared in 2006 (Snower and Merkl 2006a; 2006b), this rejoinder could also be viewed as a sweeping critique of their use of method found in all three of their coauthored papers: an approach to method that fails to explain the actual sources of the relatively high rates of persistent unemployment plaguing Germany’s eastern region.

### **Method, attendant assumptions, and explanatory failure**

Contributions of Merkl and Snower emphasize that with the start of Germany’s reunification in 1990, West German labor union leaders with employers played a proxy role in bargaining generous wage agreements, raising eastern German wages out of line with labor productivity. This violation of free-market principles is suggested to have played the key role in generating mass unemployment in the first instance. Then, the state—with its “caring hand”—should be blamed for perpetuating high rates of unemployment: as its policies offered generous unemployment benefits and associated welfare entitlements that caused East German workers to fall into and to remain in various labor market “traps” (this issue, p. 152). In reading their contributions, one could note that the causes of the high rates of persistent unemployment in Germany’s eastern region are based largely on a “high wage assumption” coupled with a “generous welfare state assumption.” It remains our contention that these two assumptions fail to substantially account for unemployment plaguing Germany’s eastern region.

Their approach appears deeply rooted in and limited to the neoclassical tradition in economic science. Neoclassical analysis characteristically heralds the explanatory power found in Euclidian space and, above all, the first quadrant of a two-dimensional graph—with price on the “y”

axis and quantity on the “x” axis. Unemployment is then depicted schematically in the following manner. As wages fail to fall during a period of slack labor demand and excess labor supply, this failure of wages to adjust downward creates unemployment. Even though the coauthors fail to explicitly show this simple and familiar figure described here, their presentation nevertheless remains fully reducible to an iconic reliance on a Marshallian scissors approach to modeling unemployment with the attendant “sticky wages” assumption generating unemployment as a market failure: related to the problem that the labor market fails to clear because the wage remains above a competitive equilibrium. The coauthors rely on this neoclassical method with its attendant assumptions for explaining the initiation of relatively high rates of eastern Germany’s unemployment that have tended to run at about double the rates of the western region over the last one and a half decades (see Table 1).

Marginal analysis stands as a pillar of neoclassical theory, and a marginal approach is relied upon throughout their exposition to explain how eastern workers fell into labor market traps. As but one example, Merkl and Snower pose that an East German agent faces but two possible choices, and within this choice set, must also make a rational decision based on the assumption that “the marginal benefits from skill acquisition are equal to the associated marginal cost” (this issue, p. 156). Reducing a choice set for a hypothetical agent to a maximum of two possibilities—which can assumedly be measured and decided upon at the margin—simplifies economic decision making to a function that can be expressed with symbols and then manipulated with the use of lower mathematics. However, their use of the marginalist method in the tradition established by Menger (1981, p. 127) in his *Principles of Economics* raises a question that begs posing. Would an East German agent actually assess in such a scientific manner the acquiring of skills relative to their costs, and at the margins—costs that are, by and large, state subsidized?

In addition to their reliance on neoclassical method and marginalism for considering initial and persistent causes of regional unemployment, their contributions conform so neatly with a contemporary understanding of neoliberal thinking that a lengthy quote seems deserving. In their edited book, *Neo-Liberal Economic Policies: Critical Essays* (2004), Arestis and Sawyer suggest neoliberalism advocates that the public sector should retreat from active intervention in markets, one of the public sector’s historic roles under Keynesian policy. In short, neoliberalism advocates leaving economic outcomes—including labor market outcomes—to

**Table 1**  
**Unemployment rates for Germany and its two main regions (unemployed as percent of labor forces for selected years)**

Year	National averages	Western region	Eastern region
1989		7.9	n.a.
1990*		7.2	n.a.
1991	7.3	6.2	10.2
1992	8.5	6.4	14.4
1993	9.8	8.0	15.4
1994	10.6	9.0	15.7
1995	10.4	9.1	14.8
1996	11.5	9.9	16.6
1997	12.7	10.8	19.1
1998	12.3	10.3	19.2
1999	11.7	9.6	18.7
2000	10.7	8.4	18.5
2001	10.3	8.0	18.8
2002	10.8	8.5	19.2
2003	11.6	9.3	20.1
2004	11.7	9.4	20.1
2005	13.0	11.0	20.6
2006	12.0	10.2	19.2

*Source:* Bundesagentur für Arbeit, *Arbeitsmarkt in Zahlen* [Labor Market Statistics], Nuremberg, January 2007.

*Notes:* Rate of unemployment defined as share of registered unemployed relative to total number in civilian labor force.

\*In October 1990, what was the German Democratic Republic from 1949 through 1989 was integrated into the Federal Republic of Germany.

unfettered market forces. Arestis and Sawyer teach us that neoliberalism has led to a shift in economic policy over the last two decades that also holds on to

the notion that the causes of unemployment lie in the operation of the labor market, and that “inflexibility” in the labour market is a major cause of unemployment. . . . [U]nemployment should be tackled by labour market “reforms” rather than through macroeconomic demand management policies and through regional and industrial policies designed to tackle structural unemployment. The perceived “rigidities” in the labour market have been associated with trade union power, long-term employment contracts, minimum wages and so on, with the consequent “flexible” labor market policies designed to remove the source of those “rigidities.” (ibid., p. 1)

Examining economic method with attendant assumptions that Merkl and Snower rely upon to approach unemployment in eastern Germany

appears reducible to the following. Their analysis is based on an iconic application of Marshallian neoclassical economics, a reliance on Mengerian marginalism, and faith in a neoliberal supposition.

Lawson (1994, pp. 506–512; 1997, pp. 89–91) cites the importance of method in economic analysis, noting that when trying to explain or clarify reality, that an inappropriate choice of method could lead to “explanatory failure.” In considering Merkl and Snower’s choice and use of method for explaining the initial and long-term causes of unemployment in Germany’s eastern region, we think that their approach results in explanatory failure, and consequently their analysis is misleading.

With this rejoinder, we introduce use of economic method as a way to frame what we hope shall emerge as a fruitful debate over the initial causes and the ongoing tendencies for relatively high rates of persistent unemployment in Germany’s eastern region. In contrast to Merkl and Snower’s neoclassical approach, an analysis rooted in Keynes’s *General Theory* (1960) offers a vastly higher level of explanatory power for clarifying the eastern German unemployment reality. A careful rereading of Keynes leads one to judge alleged distortions in the eastern region’s labor market—such as effects of wages outstripping productivity and social welfare policies—as “secondary at best.” Even though Merkl and Snower’s understanding of unemployment is inherently supply side, we stick by our guns: arguing that eastern Germany’s relatively high rates of persistent unemployment are rooted in insufficient levels of demand for East German labor. And this phenomenon is best traced back to insufficient levels of effective aggregate demand for eastern Germany’s regional output.

### **Recognizing the importance of demand**

The eastern region’s unemployment woes are better understood when considering a broader range of variables than just wages that initially outstripped productivity followed by the “caring hand” of the state policies. Admittedly, wages were bargained above productivity. However, research by Ludwig (2006, p. 197, table 8) shows that the majority of eastern firms failed to abide by the wage treaty. By year 2005, 15 years after the start of reunification, only about 20 percent of eastern manufacturing firms offered wages at parity with the western region’s level. In addition, once wages were raised and paid to eastern workers in the deutsch mark that was introduced with German Monetary Union (GMU) in July 1990, unit labor costs moved rapidly over that decade to converge with the western region’s (see Table 2).

**Table 2**  
**Unit labor costs by selected sectors for Germany's eastern region relative to western region for 1995 through 2006**  
**(West German level = 100)**

Year	Overall private sector	Manufacturing	Construction	Trade, transport	Finance, real estate, insurance
1995	112.5	132.3	104.1	97.9	119.0
1996	108.6	123.9	96.8	96.9	117.8
1997	107.4	116.0	97.6	100.0	113.2
1998	112.6	101.7	100.9	109.5	106.4
1999	105.1	106.1	97.5	106.9	103.1
2000	101.5	99.4	109.8	99.1	102.1
2001	97.8	97.5	110.1	96.8	95.7
2002	93.1	94.4	103.1	89.7	92.2
2003	91.4	90.9	101.1	89.3	90.3
2004	90.3	88.3	102.7	89.1	89.8
2005	91.1	87.4	108.0	88.7	90.5
2006	90.7	83.0	108.2	90.2	91.5

Sources: Arbeitskreis VGR der Länder [National Accounts of States], as of March 2007, and authors' calculations.

What is important to consider is that the East German economy had relied on high levels of demand from the massive Soviet market for the Cold War decades, which generated high levels of demand for its goods and services. With labor productivity high by East bloc comparisons, but low by a West German comparison, the East German economy operated at and above full capacity and full employment—and with periods of time characterized by labor shortage. Such describes the East German economy during the decades it was integrated into the Eastern bloc.

Shifting Germany's eastern region to a hard and a strong currency with GMU in 1990 further accentuated differences in labor productivity. On top of crashing Soviet demand, there was a sharp change in consumer preferences that precipitated additional decline in demand for East German output that had traditionally supplied the internal market. Important to note is that precipitous declines in shipments to the collapsed Soviet Union and Council for Mutual Economic Assistance (CMEA) markets served as a factor helping to generate initial, precipitous declines in output, and should be recognized as key for engendering the initial surge of rising unemployment in eastern Germany as well as other countries starting their transitions to market economy at the beginning of the 1990s. Typically, the more integrated into the Soviet economy was a transition country's economy, the more precipitous the output declines during the early, recessionary phase of transition—as was evidenced in the Ukraine and the Baltic States.

For eastern Germany, after this initial and sharp decline in output, the Treuhand privatization program typically placed firms in "limbo" (Hall and Ludwig, 1995, p. 500) until their privatization fates were decided. Effects on labor demand from the bargaining up of wages—combined with the shift to the deutsch mark—became accentuated when these forces occurred in conjunction with precipitous declines in output levels associated with crashing Soviet, CMEA, and internal demand. In this environment of collapsing output levels, bargained wages were rendered fully out of line with unit labor costs.

After the initial contraction in demand at the start of the 1990s, the West German state relied on massive transfers (caring hand of the state) to effectively subsidize East German consumption relative to production of output. This skewing of transfers to social welfare payments supporting consumption served to increase demand for western German output, leading to a short-lived reunification expansion: largely benefiting West German firms shipping to the newly acquired markets in the eastern region in the first half of the 1990s.

## Unraveling the Gordian knot of East German unemployment

In chapter two of his *General Theory*, Keynes explores the (neo)classical's understanding of unemployment. He notes that in their view, unemployment caused by market failure is best categorized as "frictional and "voluntary." The frictional portion of unemployment is suggested by Keynes (1960, p. 6) to occur through "various inexactnesses of adjustment" by participants in the labor market. Voluntary unemployment, on the other hand, is suggested by Keynes to also occur if the labor market-determined wage were set at a level such that a portion of the workforce would fail "to accept a reward corresponding to the value of the product attributable to its marginal productivity" (*ibid.*, p. 6).

During 2000, unit wage costs in manufacturing reached parity with the western region. In 2001, unit wage costs—with the exception of construction activity—fell to a level below those of the western regions and have remained well below parity ever since. With the start of the current decade, and for more than seven years now, there exists no evidence suggesting that wages are too high relative to output. In recent years, unit wage costs have been running at about 10 percent lower than in the western region (see Table 2). Why is the labor market not responding to these strong and consistent market signals? That is, if unit labor costs were so relatively low, we should expect employment to rise and unemployment rates to fall. Merkl and Snower (this issue, p. 154) allege that labor market traps supported by "caring hand" policies are responsible. Evidence strongly suggests otherwise: that the eastern German labor market functions as noted, "secondary at best" to levels of output demand. Output demand could indeed pull up labor demand largely independent of wages. The reverse appears not to be true. Namely, the current low unit labor costs cannot push up (create) demand—either for output or for labor.

If market failure indeed generated the relatively high rates of voluntary unemployment in Germany's eastern region, one should expect unemployment rates to have started to fall and tend toward convergence with the western region after 2001—when the labor market had corrected itself. However, such is not the case.

In addition to the upward wage pressure allegedly causing market failure at the start of reunification, Merkl and Snower tout the effects of the West German social welfare system: that its policies were exported intact to protect the eastern population from pressures of the labor market, thereby reducing labor supply through its "generous job security provisions and costly hiring regulations" (*ibid.*, pp. 151). This assumption likewise begs questioning, as the eastern Germans were on the receiving end of a diminu-

tive and a denigrated version of the West German social welfare program. In short, the alleged “generous unemployment benefits and associated welfare entitlements” (*ibid.*, p. 151) do not and have never existed.

Unemployment compensation is far from “generous” as its levels remain substantially lower in the eastern region. Because net wages are used to calculate benefits, and because the reunification wage agreement was not enforced, unemployment compensation for an unemployed worker in Germany’s eastern region runs between 65 and 75 percent of the western region’s level. Dramatic increases in rates of child poverty have emerged in Germany in recent years (Kaefert, 2007, p. 5). And, those children in Germany growing up in poverty are characteristically located in the eastern region, and are also typically members of those households with parents depending on the “generous” unemployment benefits that Merkl and Snower naively allege.

In sum, key assumptions supporting and suggesting that variables contributing toward labor market failure served as the initial as well as the ongoing causes of relatively high rates of persistent unemployment remain unconvincing. Merkl and Snower’s reliance on neoclassical theory, marginalism, and a suspicion of social welfare supports for labor market victims in a region with shrinking output demand leads to explanatory failure when seeking to shed light on the reality of relatively high rates of persistent unemployment in Germany’s eastern region.

In the next two sections of this rejoinder, we will seek to establish that the lion’s share of unemployment in Germany’s eastern region should more correctly be characterized as “involuntary” and—in the tradition of Keynes—has more to do with insufficient levels of effective demand than alleged failures in the labor market and caring hand policies.

### **Voluntary versus involuntary unemployment**

In chapter three, “The Principle of Effective Demand,” Keynes (1960, pp. 23–34) teaches us that the portion of unemployment that is categorized as neither frictional nor voluntary should be classified more accurately as “involuntary.” Moreover, that portion of involuntary unemployment is suggested to arise when the level of effective aggregate demand proves and remains insufficient. This is what the data suggest. In other words, a sizable portion of persistent and relatively high rates of unemployment in eastern Germany is largely involuntary, as these rates emerge as outcomes of insufficient levels of effective demand.

When taking into consideration regional output as composed of private consumption, public spending, and private and public investment into

new equipment as well as new buildings, the economy of Germany's eastern region exhibits a secular tendency for these output components to decline in real terms over time. In the 1990s, public-sector transfers flowed eastward at levels high enough to offset declines in components of endogenous regional output. However, as transfer levels fell, the eastern third of Germany could be better characterized as a shrinking regional economy, with declining components of regional demand. What appears to be carrying Germany's eastern region is a growing demand for *Vorleistungsgüter*—intermediates, that is—produced and exported out of the eastern region to offset declining components in endogenous regional purchasing power. These intermediates are, by and large, produced in branch plant facilities owned by large enterprises: with their headquarters typically located in the western region. Important to note: expanding output of intermediates fails to lead the eastern region's unemployment rates toward a convergence with those of the western regions. Thus, something else appears askew (see Table 3).

Akerlof emphasizes the importance and explanatory power found in contributions of early Keynesians, and we would like to add a qualification. Not just the early Keynesians, but Keynes himself, “got a great deal of the working[s] of the economic system right” (Akerlof, 2007, p. 30). Keynes's contribution to economic theory provides a great degree of explanatory power, shedding light on economic and social reality for the region of eastern Germany, a region that could also be described as far-flung from Keynes's original musings.

That Germany's eastern region suffers declining levels in components of demand and, hence, insufficient levels of effective demand is not a popularly held thesis—at least not in Germany. The demand-oriented views of Keynesians are also not popularly held. This means that Keynesians are seldom employed in state-funded economic research institutes, or on prominent university faculties throughout Germany. Solow (2008) notes some of the negative effects derived from the narrowing of Germany's economic debate in recent decades. What puzzles Solow (*ibid.*, pp. 20–28) is that the Federal Republic relied successfully on the Keynesian tradition during the years of its noted *Wirtschaftswunder* in the 1950s and 1960s. However, as the economic debate was narrowed to neoclassical and Friedmanist monetary thinking, one associated outcome is that Germany exhibits some of the slowest rates of gross domestic product (GDP) growth in the European Union in recent decades.

One measurable outcome derived from a systematic purging of Keynesians is that essentially one perspective, a neoclassical and neoliberal perspective—fully in line with Merkl and Snower's—dominates eastern

**Table 3**  
**Total output for Germany's eastern region (excluding West Berlin) (in current euros) by components of demand, as percent of total, and for selected years**

Years	1991	1995	2000	2001	2002	2003	2004	2005	2006
Total regional output	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Of which									
Private consumption	90.3	68.9	72.6	72.5	70.6	69.8	68.2	67.8	66.6
Public spending	38.6	31.0	28.4	28.0	27.7	27.3	26.1	25.3	24.4
Fixed private and public investment	43.1	47.5	33.5	27.1	22.9	22.3	21.8	20.4	21.2
Of which									
New equipment	18.7	3.4	13.3	10.8	8.7	8.2	8.8	8.5	8.9
New buildings	25.2	34.9	20.9	16.9	14.9	14.7	13.7	12.6	12.9
Total regional demand	172.0	147.4	134.5	127.6	121.2	119.5	116.1	113.5	112.2

*Sources:* *Arbeitskreis VGR der Länder* [National Accounts of States], as of March 2007; estimation of aggregate demand for 2005 and 2006 by the Institute for Economic Research, Halle, and authors' calculations.

Germany's unemployment debate. That we are attempting with this rejoinder to characterize a portion of the 18–20 percent rates of regional unemployment as “involuntary”—and that these relatively high and persistent rates are a direct outcome of neither high and sticky wages nor social welfare policies—tends to be both unappreciated and unwelcome as a contribution in today's Germany. Today's Federal Republic could be characterized as a country where economic thinking remains largely skewed to neoclassical and neoliberal perspectives.

### **Germany's regional jobs gap**

One outcome of Germany's privatization program that was carried out under the Treuhand is that distribution of enterprise headquarters became skewed between the two German regions. By the mid-1990s the eastern region of Germany registered as almost completely void of corporate headquarters for enterprises of substantial annual revenues: engaged in manufacturing, services, wholesale and retail trade, as well as banking and insurance (see, for example, *Die hundert GroÙten Unternehmen*, 2005; Hall and Ludwig, 2007, pp. 609–611). Because the eastern region remains largely void of enterprise headquarters, there registers a reduced regional demand for services, including business services, emerging as a jobs gap.

With headquarters and main production centers located in the western region subsequent to Treuhand privatization, production in the eastern region can be readily expanded and contracted in the interests of maintaining profitability for the western headquarters. Headquarters exhibit a proclivity for gaining the largest share of value added from interregional production. In addition, demand for services and related service-sector jobs tend to remain in, or be created in, the western region geographically proximate to corporate headquarters. Comparing the eastern and western regions of Germany from the perspective of population, and relying on the measure of per 1,000 inhabitants, offers a view into the sources of insufficient levels of effective demand and the related jobs gap, what should be understood as that portion of unemployment best considered as involuntary.

After the reunification program got under way and subsidized investments flowed, Germany's eastern region exhibited a substantially higher per capita investment ratio during most of the 1990s, when compared to the western region. That is, total investment registers as relatively high in the mid- and late 1990s when expressed in current euros per 1,000 members of the eastern region's population. This tendency shifted when

**Table 4**  
**Comparative total fixed investment in Germany's eastern and western regions, in current euros per 1,000 inhabitants**

Year	Eastern region	Western region	East/West per capita ratio
1991	3,158	4,752	66.5
1992	4,524	4,875	92.8
1993	5,570	4,508	123.5
1994	6,831	4,532	150.7
1995	6,994	4,530	154.4
1996	6,679	4,507	148.2
1997	6,375	4,598	138.6
1998	6,132	4,830	127.0
1999	5,942	5,071	117.2
2000	5,654	5,328	106.1
2001	4,717	5,220	90.4
2002	4,142	4,888	84.7
2003	4,117	4,769	86.3
2004	4,156	4,757	87.4

*Sources: Arbeitskreis VGR der Länder [National Accounts of States], as of March 2007, and authors' calculations.*

expectations changed and new policies sought no longer to promote a full catching-up in industrial development and a convergence in levels of per capita output between the two German regions. Effects of changing expectations could be observed with the start of the current decade, as the "East/West per capita ratio" of investment fell to and have remained at levels substantially lower than those of the western regions (see Table 4).

Considering "total employment" with respect to 1,000 persons employed in the eastern and western regions of Germany does indeed suggest a jobs gap. That is, in 2006, the eastern region exhibits but 423 jobs per 1,000 inhabitants, and the western region shows 485 jobs per 1,000 inhabitants. This jobs gap, observable in 2006, appears as sizable and continuous over a time series stretching from 1992 through 2006 (see Table 5).

When considering the interregional jobs gap by sectors, we can also note a familiar tendency to shed labor as an integral part of raising labor productivity in the secondary sector. Both the eastern and western regions of Germany exhibit a secular tendency to shed labor in this sector over the last 15 years considered. Likewise, tertiary (service) employment exhibits a secular tendency for increasing labor demand per 1,000 inhabitants in both regions.

**Table 5**  
**Comparative employment by sectors relative to population for eastern and western regions of Germany employed persons per 1,000 inhabitants 1991 through 2006**

Year	Primary		Secondary		Tertiary		Total employment	
	East Germany	West Germany	East Germany	West Germany	East Germany	West Germany	East Germany	West Germany
1991	33	16	184	175	248	296	464	487
1992	21	15	145	171	246	300	412	485
1993	17	14	139	161	247	300	403	475
1994	17	14	143	154	256	302	416	470
1995	16	13	146	151	264	304	427	468
1996	15	11	140	146	269	308	425	465
1997	15	11	135	143	278	317	423	470
1998	15	11	130	143	278	317	426	477
1999	15	11	125	141	286	325	425	487
2000	15	11	125	141	289	335	421	489
2001	14	11	115	139	292	339	421	489
2002	14	10	110	135	295	340	418	485
2003	13	10	107	131	296	339	417	480
2004	13	10	106	128	301	343	420	481
2005	12	10	104	125	302	346	418	481
2006	12	10	104	124	307	351	423	485

Sources: *Arbeitskreis VGR der Länder* [National Accounts of States], as of March 2007, and authors' calculations.

In 1995, the secondary sector jobs gap exhibited between the eastern and western regions of Germany was mostly closed, with 146 jobs per 1,000 inhabitants in the East, and 151 per 1,000 inhabitants in the West, when the East/West ratio for investments in secondary sector activities favored the eastern region. This jobs gap, mainly in manufacturing, tended to widen in subsequent years as investments favored the western region (see Table 4). Also observable is a secular tendency for the eastern region to exhibit a relatively faster declining demand for secondary sector labor relative to the western region (see Table 5). In addition, by 2006, 44 fewer service-sector jobs were found in Germany's eastern region per 1,000 inhabitants.

If one thinks in Kaldor's (1972; 1985) terms of manufacturing as the "flywheel of growth," then the eastern region's manufacturing flywheel exhibits signs of shrinking far faster than the western region's, implying a weakening in dynamic economies. If one also takes into consideration Cohen and Zysman's (1987, pp. 16–27) notion of demand for services deriving from linkages to manufacturing that could also be judged as "direct" and "indirect," as well as "tight," "medium," or "weak," we could further suggest that demand for services and service-sector jobs is weak—relative to the western region.

When taking a comparative regional approach and when disaggregating employment in services and considering major components of trade and transport, finance, insurance, and real estate (F.I.R.E.), as well as public administration, important developments can be observed. Namely, a relatively weak manufacturing sector in a region virtually void of business headquarters of firms with substantial annual revenues is found along with a growing private-sector jobs gap between the eastern and western regions, with jobs gaps in trade and transport and F.I.R.E. running seemingly parallel (see Table 6). In sum, the eastern third of Germany suffers a jobs gap, and it is this jobs gap that we define in the tradition and spirit of Keynes as the "involuntary" component of regional unemployment rooted in insufficient levels of effective demand stemming from relatively insufficient levels of regional investment, but in an economic environment with favorable unit labor costs.

## **Conclusion and discussion**

In summary, a skewed distribution of economic activity between the two German regions—related to a skewed distribution of business headquarters—results in a comparatively weak demand for labor in the eastern region. The percentage of involuntary unemployed accounts for just over

**Table 6**  
**Comparative employment in services for regions of eastern and western Germany by activity and total employed persons per 1,000 inhabitants for 1991 through 2006**

Year	Trade and transport		F.I.R.E.		Public administration/rest		Total	
	East Germany	West Germany	East Germany	West Germany	East Germany	West Germany	East Germany	West Germany
	1991	95	121	28	15	125	124	248
1992	90	122	31	53	125	125	246	300
1993	90	120	34	54	124	126	247	300
1994	92	119	37	56	127	127	256	302
1995	94	118	39	58	131	129	264	304
1996	95	117	41	59	132	131	269	308
1997	96	117	43	62	131	131	270	310
1998	98	119	47	65	134	133	278	317
1999	99	121	50	70	137	135	286	325
2000	101	123	52	74	137	137	289	335
2001	100	124	53	77	139	138	292	339
2002	99	123	55	77	140	139	295	340
2003	99	121	56	78	141	140	296	339
2004	101	121	58	80	142	141	301	343
2005	100	122	59	81	143	143	302	346
2006	100	122	62	84	145	144	307	351

Sources: *Arbeitskreis VGR der Länder* [National Accounts of States], as of March 2007, and authors' calculations.

Notes: Trade and transport also includes tourism and media; F.I.R.E. also includes consulting, in addition to finance, insurance, and real estate; health services is included under rest.

50 percent of the total unemployed over the long term for the eastern region (see Table 7). This calculation is fully congruent with unemployment rates for the eastern region depicted as close to double the western region's over the long term.

In the eastern region, a more sizable percentage of involuntary unemployment is found in services, suggesting a disproportionately weak demand for service labor (see Table 7). The jobs gap—categorized as that portion of involuntary unemployment—appears to be rooted in declining proportions of investments in manufacturing, along with a skewed distribution of corporate headquarters—two factors disfavoring increases in related service-sector employment.

Because involuntary unemployment arises because of insufficient levels of effective demand, it should be easy to grasp why West to East transfers designed to prop up household incomes have yielded extremely limited results in promoting labor demand in the eastern region. With this in mind, Merkl and Snower's understanding of Keynesian theory appears lacking. And, where knowledge emerges, it appears reminiscent of and derivative of an introductory textbook approach traceable back to the mid-1970s. Merkl and Snower (this issue, p. 152) have it all wrong: Keynesian "pump priming" was neither mentioned nor even inferred in our paper (Hall and Ludwig, 2007, pp. 601–619). In addition, pump priming was created neither as a term nor as a principle with application to shore up unemployment in a declining region such as eastern Germany.

What the eastern region of Germany needs is a more effective regional policy than currently exists. Admittedly, privatization is a done deal. However, the curious manner in which Treuhand privatization rendered the eastern region largely void of headquarters should be kept in mind as more able policies are constructed. To wit, those struggling to derive their household incomes through finding employment in the eastern region should not be subjected to additional economic abuses and burdens associated with faulty analyses based on spurious assumptions that place the onus of unemployment on the unemployed.

Turning this debate toward policy solutions might prove rewarding. Thinking along policy lines, certainly a relocating of major financial markets back to their original base in Berlin, where these developed in the decades leading up to the Red Army's invasion in 1945, would start to increase employment in business services there. Moreover, a growing demand for labor in financial services would clearly start to reduce Berlin's unemployment rates, moving these in line with rates in other capitols among EU members. A host of other policy measures—outside of and beyond Merkl and Snower's misreading of Keynesian theory—could

**Table 7**  
**Involuntary unemployment in eastern Germany caused by insufficient labor demand total and for service sector for selected years**

Year	Total unemployed	Involuntary unemployed (total)	As percent	Involuntary unemployed (for services)	As percent
1991	1,005,745	331,056	32.9	704,274	212.7
1992	1,279,297	1,067,926	83.5	775,250	72.6
1993	1,269,676	1,034,079	81.4	763,949	73.9
1994	1,271,781	770,327	60.6	654,557	85.0
1995	1,184,838	583,125	49.2	569,351	97.6
1996	1,318,622	569,572	43.2	548,608	96.3
1997	1,514,435	616,669	40.7	566,748	91.9
1998	1,529,095	661,342	43.3	546,937	82.7
1999	1,495,779	706,112	47.2	550,817	78.0
2000	1,508,707	857,801	56.9	635,028	74.0
2001	1,532,064	929,500	60.7	641,958	69.1
2002	1,562,953	913,630	58.5	617,134	67.5
2003	1,623,614	853,151	52.5	582,429	68.3
2004	1,598,522	821,844	51.4	569,508	69.3
2005	1,614,153	840,225	52.1	585,450	69.7
2006	1,480,028	814,592	55.0	581,195	71.3

Sources: Bundesagentur für Arbeit, *Arbeitsmarkt in Zahlen* [Labor Market Statistics], Nuremberg, January 2007; and authors' calculations.

help to promote a convergence in growth rates of regional output, as well as employment and unemployment rates between Germany's two discernable regions.

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