

Labor Reallocation and Convergence: Evidence from East Germany

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Abstract

In 1992, East Germans' nominal wages were about half of West Germans'. By 1996, the gap reduced to a third, and today is about a quarter. We use matched employer-employee data for the universe of (male) Germans with social security records to study the determinants of this steep convergence. Our main result is that about half of the total convergence is driven by an improvement in the allocation of East German labor across firms. The bulk of this is driven by improvements in within-region reallocation in earlier years, while migration of East Germans to Western firms steadily grows to explain more in recent years. Before 1991, both East German firms and workers were exposed to a distorted labor market under the planned economy of the German Democratic Republic. After reunification, both firms and workers were exposed to the same labor market policies as in West Germany, while workers were also allowed to freely move across the (former) border. The evidence suggests that the competitive labor market succeeded in quickly unraveling most of the misallocation generated by the planned economy. Consistent with this hypothesis, older birth-cohorts, who were exposed to distorted labor markets for a longer period, were the ones to gain the most immediately following reunification.