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How Flexible are East German Wages?

Following the unification of the two German states trade unions and employer organizations agreed on quick adjustment of East German wages to the West German level. This shock to real wages is generally held responsible for the poor performance of the eastern economy. On the other hand, it seems that economically nonviable collective wage agreements weakened the social partners. Many observers of the transition process assert that wage setting in East German has become more flexible as it shifted to the firm level in order to stabilize employment. But so far there are no accurate aggregrate data to substantiate this claim.

This paper aims at documenting wage setting patterns in East Germany post unification. It estimates a structural switching regime model in which the observed distribution of nominal wage changes, computed from register data for 1991-2001, is generated by simultaneous processes of real, nominal or no downward wage rigidity, and measurement error.

The (preliminary) estimates suggest that flexible wage setting has become significantly more important in the course of the transition process. Although the total share of wage changes affected by downward rigidity is close to that in the western part of the country, nominal downward wage rigidity is much more frequent in the east than in the west. This pattern provides at least indirect evidence of a more important role for wage setting at the firm level in East Germany.

Furthermore, the estimates point at the existence of substantial variation in wage setting patterns across sectors (and regions). Part of the research agenda will be to exploit these variations to establish empirical links between economic performance and wage setting regimes.