

## Gunnar Myrdal and the Persistence of Germany's Regional Inequality

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**Abstract:** This paper seeks to establish that contributions to regional theory advanced by Gunnar Myrdal exhibit high levels of explanatory power when clarifying challenges facing Germany's eastern region since the fall of the Berlin Wall. Myrdal's evolutionary institutionalist contribution is contrasted with the "convergence" hypothesis advanced by R. Barro and X. Sala-i-Martin. Challenged is their prediction that Germany's eastern region would experience relatively higher annual rates of per capita output growth, and that levels of per capita output would converge between the eastern and western regions over time. Myrdal's approach is argued superior as it allows for considering backwash and spread effects within a framework of circular and cumulative causation, emerging between Germany's western and eastern regions.

**Keywords:** backwash effects, circular and cumulative causation, convergence hypothesis, Germany, Gunnar Myrdal

**JEL Classification Codes:** B15, B41, R11, R12

Even though more than twenty years have passed since his death in 1987, Gunnar Myrdal continues to hold the position of the most eminent economist whose contributions have focused on inequality. Myrdal would have it that the root causes of inequality in its myriad of manifestations must first be clarified with theory, accounting for the cumulative processes at work, and then remedied through creative policy solutions.

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Myrdal examined inequality as it emerged related to skin color. This he developed early-on in his doctoral dissertation (later published as a book), focusing on complex interrelationships between racial prejudices and discrimination on the part of whites, and related poverty experienced by black Americans (1944). In addition, Myrdal explored inequality between and among nations in the developed and underdeveloped worlds. This type of inequality served as the focus of *Asian Drama* (1968), what could be considered his *Magnus Opus*. Myrdal also took an interest in inequality between regions that could fall within a nation: a subject examined in his *Rich Lands and Poor* (1957). This is the form of inequality this inquiry explores.

In short, this inquiry seeks to establish the superior explanatory power of Myrdal's evolutionary-institutionalist approach over a neoclassical approach known widely as the "convergence hypothesis." It shall be argued and supported that Myrdal's approach exhibits vastly higher levels of explanatory power when seeking to clarify the sources of Germany's regional inequality: what has been reinforced related to the eastern region's integrating into the larger Federal Republic since the fall of the Berlin Wall in 1989.

### ***The Neoclassical Regional Development Mythos***

Myrdal contributed creatively toward a comprehensive understanding of the variables, forces, and processes at play that could lead toward regional development and underdevelopment. His assumptions and evolutionary reasoning are influenced by and fully congruent with the tradition established by Thorstein Veblen (Dopfer 1988, 229-230), and the American School of Institutional Thought carried on by Veblen's best disciples. Juxtaposing Myrdal's institutionalist approach toward regional development and under-development against mainstream theory offers sharp contrasts deserving of consideration.

A neoclassical understanding of regional development would hold: if markets were allowed to function in an unfettered fashion, then a region exhibiting a lower per capita output would grow at faster rates and inevitably catch up, closing the gap with a higher per capita output region within a predictable time-frame. This perspective is advanced in the writings of Robert Barro and Xavier Sala-i-Martin as their convergence hypothesis. The Barro and Sala-i-Martin (B-S) convergence hypothesis is based upon the assumption that capital's movement across states and regions serves as the key instrument driving economic convergence.<sup>1</sup> Such occurs as capital in a higher per capita output region is subject to (B-S 1991, 109) ". . . diminishing returns." Capital thus moves outward (B-S 1991; Barro 1996; 2002) seeking opportunities in a relatively poorer region: where new investments could be expected to benefit from relative increases in rates of output per unit of capital input, as each addition to capital stock generates ". . . enormous additions to output when the capital stock is small" (Sala-i-Martin 1996, 1343). Capital's movement is suggested to lead, over time, to a closing of the interregional per capita output gap exhibited through a *Beta* ( $\beta$ ) convergence. In addition, a *Sigma* ( $\sigma$ ) convergence is suggested to occur as the gap closes in the cross sectional dispersion of per capita output across regions as well as states and countries.<sup>2</sup>

So confident is Sala-i-Martin (1996) in the validity of his theorizing that he stresses the neoclassical model provides the likeliest explanation of the convergence phenomenon, with or without perfect capital mobility and technological diffusion. Joining in the neoclassical church chorus, Larry Summers has been noted (Barro 1996, 14) to add a qualification: namely, that a  $\beta$  coefficient with a value of two, denoting a closing of an interregional gap at two percent per annum, is so certain to be achieved by a lower per capita output region, that the term "iron law of convergence" is deemed descriptive, what Sala-i-Martin (1996, 1326) additionally and confidently describes as a "mnemonic rule" for defining the rate at which regions are to converge.<sup>3</sup>

### ***On Method and Economic Inquiry***

Contributions of Tony Lawson (1994; 1997; 2003) stress the importance of method in economic analysis. Lawson (1994, 506; 1997, 89-91) suggests that when attempting to clarify or explain "reality," that an inappropriate choice of method could lead to "explanatory failure." Does an application of the neoclassical method explain the reality of Germany's regional inequalities? That is, would capital's subjugation and then response to diminishing returns in the higher wage, western region of Germany serve as the key variable, automatically forcing capital to flow to the eastern region, and in such quantities and in such a composition that, over time, the eastern region's levels of per capita output would increase at a relatively faster rate, closing the gap and ultimately converging with the western region's?

In the period after the fall of the Berlin Wall, capital did flow from the western to the eastern region – as private and public investment. Yet, no researcher has ever established whether capital's interregional movement was causally related to the law of diminishing returns, or to public and corporate policies that sought to promote Germany's reunification.

Though uncertain of cause and effect, by 1996, the level of per capita output in the eastern region, nevertheless, achieved 63 percent of the western level, closing a portion of the per capita output gap at annual rates vastly outpacing Barro and Sala-i-Martin's (1991, 154) predictions. While exhibiting a rapid closing of the interregional per capita output gap in the first years of reunification, this gap has tended to close at much slower rates over the last ten years. The per capita output gap between the eastern and western regions tends to remain wide, with the eastern region seemingly stuck below 70 percent of the western region's level. If the B-S hypothesis bears explanatory power, then we should expect that automatic forces seeking lower unit labor costs would cause additional units of capital to flow to the poorer eastern region, leading toward a full closing of the per capita output gap. However, related to the eastern region's stagnation in per capita output growth, unemployment rates in the eastern region have run above 18 percent of the civilian labor force for the last ten years. So, would it not be more likely for labor to leave Germany's eastern region, drawn by job prospects in the western region? Myrdal's thinking would lead us to reason in this manner.

Upon closer inspection the convergence hypothesis appears to be rooted in a tautology and based upon what could be interpreted as an ideology or a creed that Barro has ostensibly promoted in his other writings (1996; 2002). Namely, achieving per capita output convergence between or across regions necessarily suggests an attendant caveat. In short, a catching up and closing of the per capita output gap of a poorer region needs to be accompanied by so-called “free market” policies.

According to the B-S approach, markets are judged as the solution to a region’s problem of lagging behind, completely excluding the possibility that perhaps market forces, themselves, could be responsible for driving per capita output divergences between and across regions, states, and countries. In this sense, the B-S grasp of economic reality should be taken in contradistinction to the evolutionary-institutionalist approach. Myrdal (1957, 26) notes explicitly:

The main idea I want to convey is that the play of forces in the market tends to increase, rather than decrease, the [regional] inequalities.

### ***Myrdal’s Evolutionary-Institutionalist Approach***

Rather than narrowing down to one variable – like capital – and to one law thought universal – like the “Law of Diminishing Returns,” and then applying said law to predict the behavior of that one variable, said capital, Myrdal offers a method that considers greater levels of complexity. In Myrdal’s world, capital in a higher income region like western Germany is not necessarily subject to the “Law of Diminishing Returns” in a deterministic manner with predictable outcomes. For Myrdal (1957, 18), the relevant variables for explaining interregional interaction are noted to be in a “circular and causal interrelation.” Forces at work could be judged as short term and subject to sharp disturbances. Other forces could register as more constant determinants. In the philosophical traditions of Charles Peirce and his student, Thorstein Veblen (Hall and Whybrow 2008), Myrdal does not separate between the physical and metaphysical, as he notes the importance of such non economic variables as “attitudes” that human beings might hold, and how these attitudes might be held by numerous members of society. In Myrdal’s world, attitudes could as readily be shaped by both economic as well as non economic forces. In addition, attitudes could generate effects on a circular and causal interrelation between and among variables, effects that could bear upon levels of economic performance, and, hence, economic outcomes.

Noting it difficult to separate the economic factors from other factors both human and societal, Myrdal (1957, 20) could be quoted: “. . . everything is cause to everything else in an interlocking circular manner.” Yet, cause and effect are not limiting in Myrdal’s world, as he notes a “principle of *cumulation*,” suggesting “. . . that the final effects of variables in relation interacting could promise benefits of a vastly greater magnitude than the costs of the policies that generated these benefits” (1957, 21).

In addition, Myrdal (1957, 27-29) suggests that a higher income region could generate "backwash effects" for a lower income region. These could occur as an economic expansion in the higher income region generates outward effects spurring, for example, outmigration from a lower wage region, or capital flight, or unequal exchange in trade. Myrdal also considers a gamut of attendant social relations pertaining to backwash effects.

Against the backwash effects there are, however, certain "spread effects" to identify and consider. Myrdal (1957, 31-33) notes that spread effects emerge as centrifugal forces emanating from the centers of economic expansion located in the lower income region. In essence, spread effects are understood as centrifugal effects spawned in the less developed region, that when strong enough, could generate an expansionary momentum countervailing against the backwash effects emanating from the higher income region.

### ***Myrdal's Method and Its Explanatory Power***

Myrdal's understanding of backwash and spread effects could be readily applied to the two German regions. With respect to surface area, the western region is about thirty-three percent larger than the eastern region, and the western region contains over eighty percent of Germany's population. The western region is wealthier in capital stock, in human capital, and according to numerous other measures. It also wields more power, placing the western region in the position of generating powerful backwash effects with which the poorer region has to contend.

The first of Myrdal's backwash effects is readily observable. A chronic level of higher per capita output and higher wages exhibited by the western region emerges through the uneven development between the two German regions, affecting interregional population movements. The overwhelming tendency is for population outmigration from the eastern region to head for greener labor market pastures in the western region. This backwash effects is so powerful that population decline in Germany's eastern region, from 1998 through 2007, has accounted for about fifty percent of the increase in the rise in per capita output, creating a "convergence illusion," a "poor man's convergence," flying in the face of Barro and Sala-i-Martin's predictions for Germany's interregional convergence (1991, 154) based upon output increases relative to population. What is more, population outmigration from Germany's eastern region is hardly homogeneous with respect to age. Members of the younger generation, typically in the range from 18 to 30 years of age (Mai 2004, Table 29, 145), often just completing educational and training programs, register as those most prone to leave for the western region (Steiner 2004). Both men and women in this age group are noted to depart for the western region in about the same numbers. What registers as significant is that a percentage of the young men return home to the eastern region, while a sizeable portion of young women are wont to integrate into the western region and bear their children there, as the research of Kröhnert and Klingholz (2007, 56-62) and Kubis and Schneider (2007) stress. Related to this loss of women in their child bearing years, the eastern region is

plagued with an excess of deaths over live births, and an overall decline in population (Deutsche Bank Research 2004). With the median age of the eastern population registering as older than the western region's, and with the eastern region facing a long term deficit in labor market entrants (Ludwig 2007, 210-218); the population problem could be noted as a non economic, demographic variable, but that is also forecasted to generate economic effects, and over a longer run, that Myrdal would have us consider as backwash effects emanating from the western region.

As part of the backwash effects, Myrdal introduces the notion that the less developed region might suffer capital flight to the more developed region. In Germany, capital flight appears to have taken its own unique form: through an outer-regional acquiring of ownership over capital stock. The higher income western region benefits from a host of backwash effects, reinforced by formal rules found in Germany's Reunification Treaty of 1990. If not by ostensible design, the Treuhand privatization agency facilitated the transfer of a significant portion of the capital stock of the old East Germany, including factories, tracts of forests and farms, as well as residential and commercial structures: and largely to the ownership of individuals and corporations based and headquartered in the western region.

One outcome to consider is that by 2004, it could be noted that among Germany's 100 largest industrial firms measured by annual revenues, only one firm, Jenoptik, was headquartered in the eastern region. Of the top 100 service sector firms, not one was headquartered in the eastern region. The same is true for the top 100 retail companies. When considering the top 25 private sector banks and insurance companies, not one had their headquarters in Germany's eastern region (see *Frankfurter Allgemeine* 2005).

By the start of this century, the eastern region of Germany could be characterized as suffering from what Veblen (1923) has referred to as "absentee ownership." With a portion of the outcomes involving transfer in title to productive stock, the eastern region's industry has been reduced to an extension of the western region. While many individuals and corporations in the western region enriched themselves with the spoils of the Cold War, within a few short years eastern Germans transitioned from living in an independent nation that had registered among the top ten industrial producers in the 1980s, to a region transformed into a province that began to specialize in the production of intermediate goods [*Vorleistungsgüter*], and largely for the inter-regional circuits of production, with the higher value-added accruing to the western based headquarters. The relatively lower wages are then earned by eastern factory laborers (Hall and Ludwig 2008, 178). This imbalance could then, register as a third backwash effect, having to do with terms of interregional trade that serve to benefit the more prosperous western region.

Spread effects could also be observed. For example, Jena, located in the State of Thuringia, and Dresden, in the State of Saxony, register as poles of regional growth, attracting labor through intraregional migration, and generating observable increases in regional output. However, there exists no evidence suggesting that the centrifugal effects of economic activity could carry an expansionary momentum, strong enough to offset the backwash effects, and the numerous advantages the western region gained relative to the eastern region with the Cold War's end.

### **Conclusion and Discussion**

This paper has sought to establish the thesis that Gunnar Myrdal's contribution to regional theory offers a vastly higher level of explanatory power when applied to challenges facing Germany's eastern region. The convergence hypothesis advanced by Robert Barro and Xavier Sala-i-Martin, in contrast, appears to limit itself to Hollywood-styled happy endings: that is, of a lower per capita output region inevitably catching-up and at a rate governed by an "iron law." In contrast, Myrdal's understanding of backwash and spread affects, as well as his accounting for forces contributing to circular and cumulative causation, are readily applicable for describing the eastern region's developmental predicament relative to the richer and more powerful western region.

Myrdal (1957, 13) would characterize the persistence of Germany's regional inequalities as inherently unstable, as the seemingly static positions of per capita output and other inequalities could be shaken up by endogenous or exogenous changes. Admittedly, future outcomes remain open. For example, changes in technologies and institutions could work in favor of the poorer, eastern region, supporting its centrifugal and thus spread effects. However, Myrdal would also have us consider that changes in technologies and institutions could serve to further generate cumulative benefits gained by the western region, with yet more challenging backwash effects spilling over to the eastern region, further aggravating and further reinforcing the persistence of Germany's regional inequalities.

### **Notes**

1. Convergence in per capita output between regions, states, and countries is approached in essentially the same way, regardless of size differences, geographic advantages and disadvantages, and also regardless of whether the BS hypothesis is applied to consider regions, states, or nations within a common currency zone, or in different currency regimes mediated by exchange rates.
2. Contributions of Barro and Sala-i-Martin use the terms per capita "output" and "income" as if these were fully synonymous and fully interchangeable. In the interests of clarity of argument, in this paper we attempt to rely on the term and concept of "output" rather than "income."
3. For a more thorough summary of the underlying assumptions of the convergence hypothesis, please see Hall and Ludwig (2006, 943-946).

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