

“Made in [East] Germany”: An analysis of East German manufacturing immediately following reunification and today

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“Made in [East] Germany”: An Analysis of East German Manufacturing Immediately Following Reunification and Today

Scott Davidson
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ABSTRACT

This paper briefly examines the factors that led to the failure of many firms in the post-communist, freshly unified East Germany, which led to mass unemployment and business closures. Afterwards, the majority of the discussion will focus on how the rough transition from communism to capitalism has resulted in a unique and advantageous environment for manufacturers in modern day East Germany due to five main factors of production: land, affordable skilled labour, infrastructure, economic security, and government subsidies. In order to provide thorough and relevant information, both secondary and primary sources will be employed, including a survey of future employment plans of students at the HHL Graduate School of Management in Leipzig. Finally, an analysis of the two successful firms of Porsche and AMD will be included to illustrate East Germany’s opportunity for unparalleled manufacturing advantages put into practice.

INTRODUCTION

With the end of the Cold War came a wave of uprisings from the Eastern Bloc countries, breaking the hegemony of the Soviet Union over the region and bringing an end to the ailing communist system that it imposed. Nowhere was this more memorable than in East Germany, where the symbolic demolition of the Berlin Wall in 1989 provided the image that defined the period in history. For those living in the German Democratic Republic (East), this event was met with elation and new hope for the region that had suffered at the hands of communism for four decades, while still within earshot of the bustling capital markets of central Berlin. After a long wait, it seemed as though it was finally time for the east to start experiencing the economic growth and wealth that had been experienced everywhere west of the Iron Curtain. However, the reunification of East and West Germany posed an intimidating challenge for policy makers and government officials faced with the daunting task of reinventing the formerly communist east economy and bringing it up to par with the west.

Although once again united as a single nation, the vast economic growth disparities between the thriving capitalistic west, and struggling east left a marked division of income and living conditions in the two areas. This meant a massive investment was needed to rebuild infrastructure and technology, with the bill being paid for by West German taxpayers. Meanwhile, the formerly nationally-owned businesses in the east now required private ownership, as well as an entire overhaul in order to adapt to the newly introduced and unfamiliar capitalism system. As a result, it soon became apparent that the rehabilitation of the anaemic eastern region would come at a great cost to residents of the west, and the positive effects of reunification may take a considerable period of time before being realized. This paper will briefly describe the initial difficulties faced by firms in East Germany during the transition to a

capital economy before investigating the current market conditions that now make East Germany an advantageous market for managers in search of a new production location.

EARLY YEARS

Although the fall of communism and the reunification of the nation was a joyous occasion for nearly all residents in East Germany, the few years to come were no doubt going to be difficult, and the benefits of capitalism were unlikely to be felt without a period of turbulence. The previous communist economy in Eastern Germany had been one of very low-competition and high government involvement, where suppliers were limited and prices fixed. Therefore, this economy was characterized by low product variety and a high degree of product scarcity, leading to rationing and the emergence of bartering and black market activity. Additionally, entrepreneurship was not popular, profitable, or viewed positively by the society, so the incentives were negligible. However, there is one exception of course being those entrepreneurs that took advantage of scarcity via black market sales (Fritsch, 2004).

Firm Conditions

Due to these previous conditions, the immediate implementation of the western economic and political systems came as a shock to the system, and put pre-existing East German firms in a challenging position. For many of these firms, formerly intended to produce a standard good with limited inputs, being thrown into a competitive market was disastrous. Firstly, the pillaging of German production equipment by the Russians, as well as the effects of the Iron Curtain largely cutting off the flow of knowledge (Fritsch, 2004), left the technology in the east far behind its western counterpart. This meant that the manufacturing industry was severely depleted and heavy investment was needed to bring factory equipment and methods up to a competitive level. Meanwhile, their internal processes lacked the efficiency of western firms and had to be entirely revamped to remove the rigid bureaucratic hierarchy that controlled all aspects of production. This was necessary to improve production efficiency, but created a great deal of confusion with employees who now needed to collaborate across departments and perform a wider variety of tasks than was previously demanded of them. Also, entirely new products and variety needed to be introduced and advertised, rather than simply manufacturing a limited number of standard, identical products. Finally, due to the low productivity resulting from these production factors, the introduction of new higher wages for eastern employees sent labour costs soaring to a level that the productivity of these firms could not sustain. As a result, many firms could not survive the transition to the capital market. By 1993, there was a sixty-five percent decline in the number of workplaces in the manufacturing sector, sending unemployment skyrocketing to over twenty percent (Fritsch, 2004).

Employment Conditions

As Segarra (1991) describes, after four decades of communism East German citizens found themselves talking for the first time about money and prices, as well as the need to organize insurance, bills, and investments for retirement. The radical reforms had forced the heart of the workforce age 25-50 to reinvent their entire lives, while also dealing with the discontent of West Germans who believed that the high government investment in the east was damaging the economic growth they had worked so hard to achieve. These radical changes and patronization from the west equated to a great deal of stress outside of the workplace, as well as confusion and overall dissatisfaction. As has been shown by many studies, stress outside of the workplace can be equally as damaging as work-related stress, and can lead to a sharp decline in productivity (Heylighen & Vidal, 2007). This is a problem currently facing the human resource departments of modern firms and has led to the creation of many new employee-friendly policies. Furthermore, the modern productivity issues of having a handful of employees with

non-work related stress could only be assumed to have been devastating to an early nineties East German firm when facing every employee at once.

With the investment into entirely new equipment and processes came the necessity for equal investment into employee training. The slow pace of the rigid communist bureaucracy and its high division of labour gave way to a system requiring more responsibility and open collaboration between departments. Therefore, not only did workers need to be retrained on the use of equipment, but also on the new environment in which work was carried out. Furthermore, even more crucial than production-level workers was the need for competent upper management to direct the company. Due to the transition to a capital market and extreme adjustments to production, the knowledge stock of previous management quickly became obsolete; therefore replacement or complete retraining of management was necessary (Fritsch, 2004). This was made even more difficult due to the emigration of skilled labour to the west. Similar to the “Brain Drain” that had depleted the East German labour stock prior to the USSR closing the border in 1952, many of the best and brightest of East Germany’s labour market were able to secure higher paying jobs in the west, leaving eastern firms without proper strategic management. All told, some one million East Germans migrated west, creating a six percent decrease in population between the years of 1989 and 1991 (Burda & Hunt, 2001). As a result, in the first few years after reunification the productivity in the east was less than forty-five percent compared to that of the west, meaning that the forced rise in wages could not be supported by the level of production, and massive layoffs as high as eighty to ninety percent in some firms were necessary (Burda & Hunt, 2001).

Implications for Business

Despite East Germany opening up as an entirely new capital market, seemingly providing opportunities for businesses, this was clearly not the case. Even with the 1.5 trillion DM government investment into the east in the decade after reunification (Burda & Hunt, 2001), the area was still very unsupportive for foreign investment. Even for firms that had the money to bring in the necessary capital, the extremely low labour productivity in the region made manufacturing in the east near impossible for a firm intending to turn a profit. For this reason, the market was not attractive to new entrants and many pre-existing firms were forced out of business. In addition, many of the firms that did maintain production in the region did so at a loss, with government funds subsidizing their efforts (Burda & Hunt, 2001).

COMING OF AGE

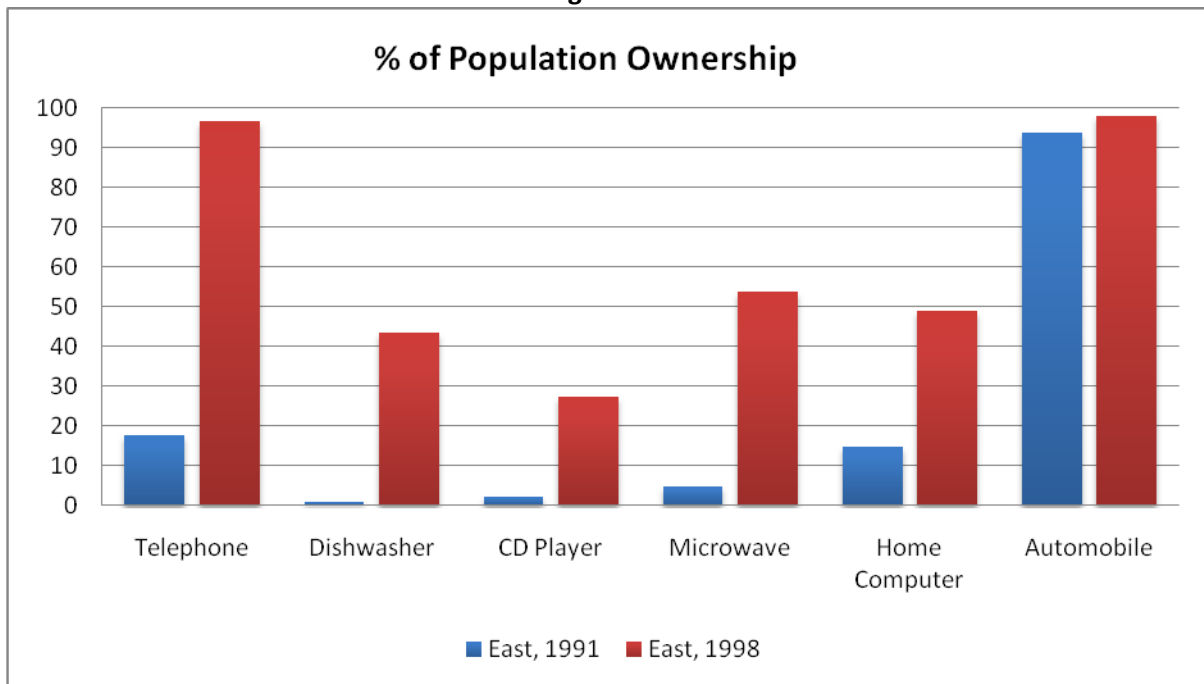
Despite the initial inabilities for East German firms to adapt to the changes of a market economy, by the year 2000 conditions had greatly improved in many important areas. In addition to the monetary investment provided by the west totalling 1.5 trillion DM from 1990-2000, sharing a common language and government with the powerful western economy had facilitated the flow of knowledge to the region (Burda & Hunt, 2001). This had helped eastern firms recover from the devastating initial phase and make clear movements along the learning curve. A decade after reunification, East Germany had a solid handle on the basics of capitalism, and saw great strides in operational efficiency for firms and quality of life for citizens.

Capitalism as Intended

A decade after reunification, the benefits of government investment had begun to be seen in some of the fundamental areas necessary for success in a market economy such as labour productivity, wages, and consumption. Labour productivity grew from less than forty-five percent of the western level in 1991, to seventy-three percent by the beginning of the new millennium, and in many sectors, East

German labour productivity actually exceeded that in the west (Burda & Hunt, 2001). As a result of this productivity increase, businesses that operated in the area could produce at a much higher efficiency, justifying the high wages that had previously drove labour cost to dangerously high levels for firms trying to be profitable. This was also beneficial for employees as real wages saw a rise from about a third of western levels at the time of reunification, to three-quarters by 1996 (Burda & Hunt, 2001). With this tremendous raise in wages, the eastern population had significantly more disposable income to spend on goods that would previously have been considered luxury items, therefore providing new opportunities for businesses to offer increasingly diverse product lines. Since employees are also consumers, an increase in wages led to an equal increase in consumption, from forty-three percent of western levels in 1991, up to seventy-three percent by 1998. Figure 1.1 illustrates the rise in consumption described by Burda & Hunt (2001) with the use of familiar products.

Figure 1.1



At long last, the capital market in the east had begun to achieve some degree of rhythm with the perpetual cycle of increased production leading to higher wages, and increased income leading to higher consumption, requiring greater production. This was immensely promising for both firms and their employees, leading to an increase in entry to the market and the growth of specific industries in the east, especially the technology sector that is so prevalent today in cities like Jena and Dresden (Herbst, 2009). Eventually, the growth described above led to the creation of one of Europe’s most unique and beneficial regions for production.

BENEFITS OF THE EAST

After the initial struggles for East German firms and their employees to adjust to the radical changes that came with an immediate shift from the collective to the capital market, the region has developed into one of many advantages for manufacturers. Although GDP and real income may still lag behind the west, the government investments into the east have generated some incentives unique from the rest of the continent. The next section of this paper will be dedicated to taking an in-depth look at some of these factors that should make East Germany attractive to foreign investment.

Land

East Germany is characterized by a handful of bustling metropolitan areas and an abundance of rural areas with few inhabitants and high unemployment for those who do reside in the country. This has allowed East Germany to become a hotbed for renewable energy production in wind and solar. As these methods require a great deal of open space to operate, the Eastern countryside has long satisfied this requirement, and at a discount rate of purchase. More recently, manufacturing firms have started to take notice and the number of companies looking at production in the East has been increasing as previous land supplies are being depleted, sending prices soaring. This is due to the fact that there are open lots right on the outskirts of dense cities, rather than two hours out of town as is the case in some other more heavily populated regions. In fact, there are even large plots of land available in the downtown area where dilapidated buildings stand amongst renovated apartments and busy shops. One such location in Leipzig is a former Druckerei (printing) factory that sits on a sizable plot of land within eyesight of the city's main square Augustusplatz. Photographs of the property and proximity to town are provided in Figure 1.2. A site this large in such a highly visible area could provide businesses in a wide array of industries with a profitable location for operations. Also, it should be noted that this is not a rare case either, as abandoned buildings like this one can be seen all throughout the city of Leipzig and Eastern Germany as a whole. However, some have already taken note of the potential and there are an ever-increasing number of developments already underway to transform these cheap central locations into lucrative businesses.

Figures 1.2



Affordable Skilled Labour

A major aid to the growth of Eastern Germany has been the increase in university student attendance from both the local population, and students around the world. Here in Leipzig, major construction to transform an old cathedral into the new Universität Leipzig has recently been completed to accommodate the rise in attendance. This is also the case in the university town of Jena, where the Friedrich-Schiller-Universität Jena provides the heartbeat of the community (Herbst, 2009). Meanwhile, the Financial Times (2011) recently rated the modest-sized HHL Graduate School of Management in Leipzig to be the number one entrepreneurial school in all of Europe. Due to my participation in this school, it is here where I conducted my survey to gauge future employment in the East German area.

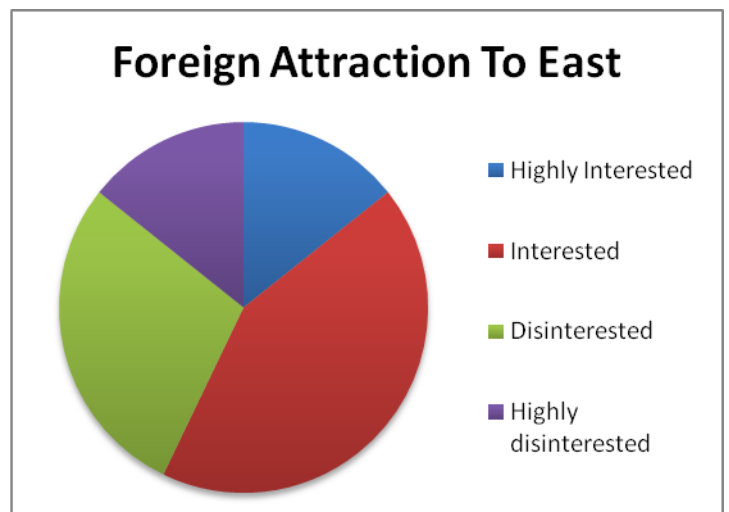
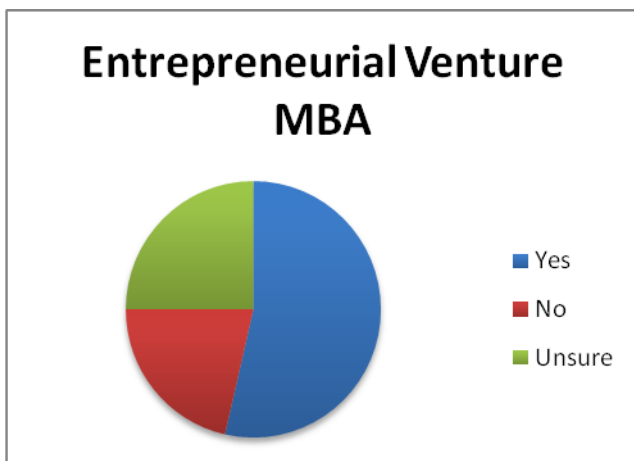
With migration of the brightest minds to the west being a major contribution to past businesses achieving sub-par performance, I decided to ask a few simple questions to determine whether or not the

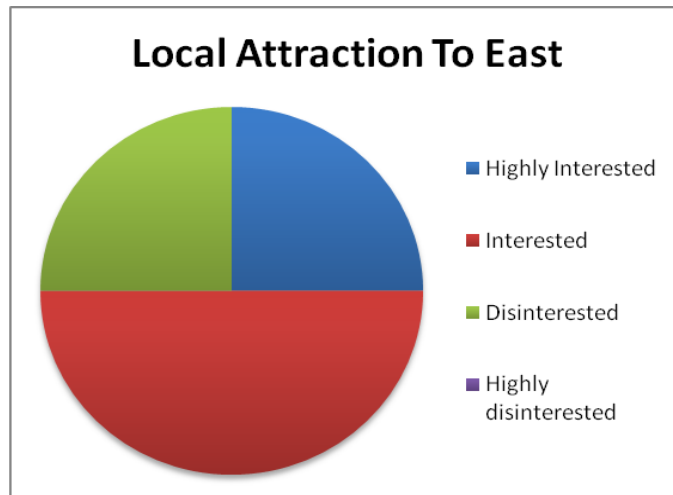
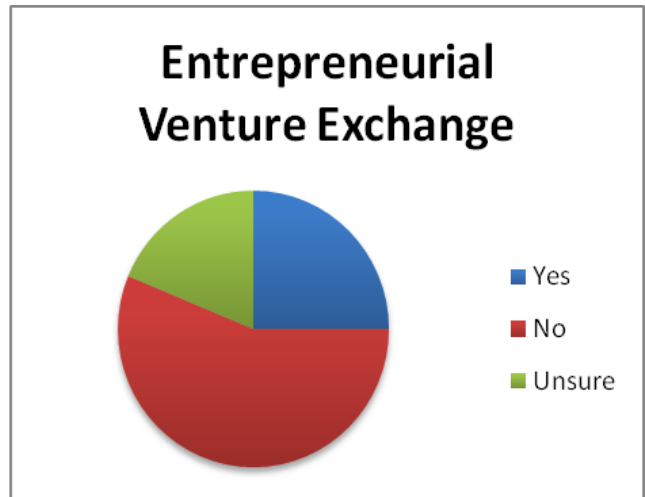
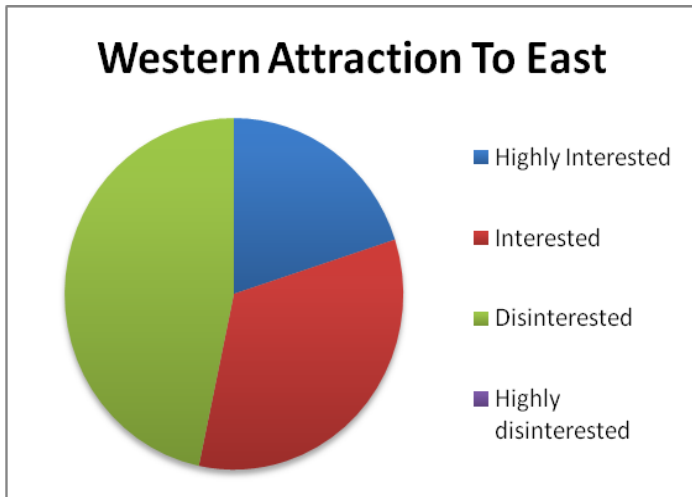
“Brain Drain” was still hindering East Germany’s expansion. The exact survey questions are written below:

- 1) Where did you live before coming to HHL?
 - An Eastern German Province _____
 - A Western German Province _____
 - Outside of Germany _____
- 2) Given your experience, how interested are you in working in Saxony, or any other Eastern German Province after graduation?
 - Highly Interested _____
 - Interested _____
 - Disinterested _____
 - Highly Disinterested _____
- 3) Do you intend on starting an entrepreneurial venture after graduation?
 - Yes _____
 - No _____
 - Unsure _____

I administered the questionnaire twice; once in an MBA course with regular HHL students, and once in my German language class attended only by foreign exchange students. Due to small classes, the sample size was relatively limited, with n=28 respondents in the MBA, and n=16 in the exchange class. However, I still believe that data provides useful insight, and the reputation of the school ensures that those students being surveyed are of the utmost calibre and likely extremely valuable to the firms that could employ them in the future. The results of the survey are illustrated on the next page in Figures 1.3.

Figures 1.3





From this data we are able to make several inferences that have both positive and negative implications for East Germany. One major positive is the high interest for East German citizens to continue to live and work in the region post-graduation. This would imply that the drain of skilled labour to the west has diminished significantly, which bodes well for the future development of the east given that the area had struggled in the past to hold onto its most valuable portion of the labour stock. Neither the East nor West Germans were strongly opposed to working in the region, with zero respondents replying “highly disinterested”. However, it does seem that there is still a level of prejudice towards the east by some Western Germans, with forty-seven percent responding with “disinterested”. Similarly, exchange students showed a general interest in East Germany after attending HHL, but still had a portion of respondents that expressed a strong disinterest. However, the disinterest by many West Germans and exchange students could be described not as prejudice towards the east, but rather the simple desire to work in their home country/region alongside their family and friends. This information likely could have been clarified by further investigation, but unfortunately I am unable to inquire prior to the due date of this paper as a result of travel plans. Furthermore, it comes as no surprise that many of the MBA students at HHL intend to start their own entrepreneurial venture due to the school specializing in that area and attracting extremely motivated students. It would be interesting to see how these students

take advantage of the unique aspects of East Germany and its potential for new business due to the lower market saturation in the area (Suder, 2008).

These results seem to vaguely mirror some of the results observed by Risen (2009) in his Atlantic article, stating that “while many of the best workers have migrated west looking for better jobs, the growth of relatively high-wage sectors in the east is drawing some of them back: according to First Solar’s Wortmann, ten percent of its Frankfurt (Oder) employees are former [Easterners] returning from the West” (p. 1)”. This is promising news for those that have tried so hard to bring the east up to par with the west. However the disposable income of East Germans still remains at around seventy-nine percent of their western countrymen (Herbst, 2009). Although this is not especially joyous news for the employees, it provides a significant incentive for firms to produce in Eastern Germany where skilled labour can be acquired at a premium rate.

Infrastructure

East Germany’s introduction to capitalism created a lot of instability, forcing many pre-existing firms out of business. This was mainly the result of outdated equipment and a lack of infrastructure that stifled productivity and drove up costs with the introduction of new higher wages, therefore leaving many people out of work. This was the unfortunate result of trying to make the move to the capital markets too rapidly, and before systems could be put in place to allow these firms to become competitive. Fortunately, the necessary infrastructure was being developed the entire time, just not quickly enough for the organizations in this era to reap the benefits. However, modern firms have clearly realized the rewards of the 140 billion DM infrastructure investment between 1992 and 1998 (Burda & Hunt, 2001). Currently, East Germany boasts a rail system equally robust as that found in the west, while the autobahn that had been expertly developed during the fascist period and left to rot during communism has been fully restored to its glory days. This strong transportation infrastructure provides a major benefit to manufacturers in the region by allowing them to ship to anywhere in Europe in a timely manner. Logistics chains can be greatly simplified by having a railway track located on-site for immediate transfer from the production floor straight onto the train and off across the continent in less than a day. Not only does this simplify operations for the organization and promote a “pull” production process, but it also bolsters the company’s reputation as a supplier that always makes shipments on time, therefore promoting future business. In addition, transcontinental transportation is strong in the region due to the government funds invested into airports and northern harbour terminals, creating the ability for transportation to the lucrative US market. Finally, telecommunications and utilities have been greatly improved over the past two decades creating lower input costs and greater connectivity for firms in the eastern region (Burda & Hunt, 2001).

Economic Security

Another attractive quality of the eastern market is how minimally the economic crisis of the Eurozone has affected the region. As a whole, Germany has been the most secure economic region in the EU, with unemployment actually decreasing from 10.6% in 2005 down to 6.8% in 2010, while continuing to experience GDP growth, albeit at the lesser rate of 2.6% (Holland et al., 2011). What is even more astounding is that the east seems to be fairing even better than the west during this period. While Germany saw a shrinking in growth by 6% nationally, the eastern states only experienced a decrease of 4.5% (Risen, 2009). According to Risen (2009) this surprising fact comes as a result of the relatively small export market in the east, as most goods produced in the region are consumed domestically. Therefore, during the uncertain times of the current economic crisis, Eastern Germany actually appears to be the safest bet in the entirety of the Eurozone.

Government Subsidies

The final and most impressive incentive for firms to operate in Eastern Germany is the provision of government subsidies to organizations located in the region under the “Guidelines on National Regional Aid for 2007-2013”. Section 1 of this treaty reads as follows:

“On the basis of Article 87(3)(a) and (c) of the Treaty, State aid granted to promote the economic development of certain disadvantaged areas within the European Union may be considered to be compatible with the common market by the Commission. This kind of State aid is known as national regional aid. National regional aid consists of aid for investment granted to large companies, or in certain limited circumstances, operating aid, which in both cases are targeted on specific regions in order to redress regional disparities. Increased levels of investment aid granted to small and medium-sized enterprises located within the disadvantaged regions over and above what is allowed in other areas are also considered as regional aid (Regional Aid, 2006, pp. 1).”

This agreement requires the German government to provide subsidies to firms operating in the “disadvantaged region” of Eastern Germany, in order to attract newcomers to the area. These subsidies are given in annual allotments based on the size and scope of a firm, its economic contributions to GDP, and number of jobs created. Furthermore, any further investment into the region by a pre-existing firm will be subject to an increase in government aid provided. In total, this agreement and its predecessor have accounted for an incredible €1.5 trillion in subsidies since reunification, providing an incredible opportunity that cannot be ignored for firms looking for a new location for their production facility (Herbst, 2009). However, as will be shown in the following examples, these subsidies are not necessary for the east to be a profitable manufacturing market, but they are often an incentive that cannot be rejected.

SUCCESSFUL PRODUCTION EXAMPLES

In order to illustrate the tremendous production benefits provided by the East German environment, the two cases of Porsche and AMD can be examined. These two facilities are unique from each other due to their size and industry, but similar in their success and utilization of the unique East German market.

Porsche

Recently, I had the opportunity to visit the modern Porsche production factory located in Leipzig. This medium-sized factory that employs 800 was built in 2002 for production of the Cayenne and Panamera models and is still considered state-of-the-art to this day. It features a private test track for vehicles and a direct connection to the rail system, allowing for quick and easy transportation of completed vehicles. Porsche selected Leipzig in East Germany for its production site against seventeen other locations for many of the reasons outlined above. The ability to acquire an affordable plot of land of necessary size right on the outskirts of the metropolitan area was a unique benefit of the East German area. Additionally, the direct connection to the railway for minimal set-up costs allowed for the elimination of vehicular transportation of finished products to a hub, while also increasing the speed and ease of delivery to anywhere in Europe. Meanwhile, the abundance of affordable skilled labour in the area filled the factory with employees within a very short period, allowing it to start operation immediately, while producing at a lower cost than it would have been able to in most other European locations. However, what sets Porsche apart from other production facilities in East Germany is the fact that government subsidies played no part in its decision to set up shop in Leipzig. Porsche is very proud of this fact and

promotes their noble philosophy that luxury goods and government subsidies do not mix. This is an excellent example of how profitable and supportive the East German environment can be for manufacturers, even without the collection of government charity (Porsche-Leipzig, 2011).

AMD

AMD is a US microprocessor giant that supplies Microsoft, Adobe, and many more familiar names in the computing industry. AMD made the move to Dresden in 1996 for the manufacturing of its products with the expectation of investing about 1.9 billion USD and of employing some 3,500 in the area. However, the success of AMD's operations in Dresden has led to an actual investment of just under 5 billion, while employment more than doubled to a total of 7,500, with plans for expansion still forthcoming (AMD, *Europa*, 2007). Once again, the abundance of discount skilled labour and available land ensured affordable set-up and production costs, while government subsidies provided an opportunity unlike anywhere in Europe. Unlike Porsche, AMD had no problems with accepting government aid, nor did the government object to issuing the funds to the massive factory that contributes so much to the economy in the east. In fact, in 2007 when AMD announced its plan to expand its facility with a 2.2 billion dollar investment, employing an additional 565 jobs to the province of Saxony, the German government was quick to cut a cheque for 262 million Euros in aid (*Europa*, 18 July 2007). Thus, the tremendous success of AMD is made that much sweeter for the firm, while the previously communist state of Saxony is finally witnessing the much-awaited benefits of capitalism.

CONCLUSION

Immediately following the collapse of the Soviet Union's control over East Germany and the elimination of the communist ideology that had seen quality of life fall far behind that of the west, expectations were set high in the region. However, these expectations may have, in hindsight, led to an overambitious attempt by government to restore capitalism to a region wherein the majority of the population had never known anything but the Soviet-style collective economy. Radical changes were implemented quickly, opening eastern businesses to a highly competitive environment in which survival was all but impossible. Similar to releasing a domesticated animal into the wild, the security and assistance that had kept them alive was now gone, and instead replaced by much more athletic and experienced firms that quickly cannibalized these weak competitors. In total, the lack of knowledge, equipment, and productive labour led to the elimination of sixty-five percent of manufacturing firms in East Germany by 1993, with many others on life-support, operating at a loss with government subsidies to keep them producing (Fritsch, 2004). As a result of these firms closing down, twenty percent of East Germans were left without employment and likely, second thoughts.

Fortunately, the twenty-first century began to show some indications of economic improvements, and the government aid in excess of 1.5 trillion DM that had been invested the previous decade started to payoff (Burda & Hunt, 2001). Wages, productivity, and local consumption all rose to previously unseen levels, which allowed firms in the area more success in both the manufacturing and sales of its products. Meanwhile, the wage increase meant that employees now had an incentive to remain in the east, rather than move to better paying employment in West Germany. This slowed the migration of skilled labour that had been so damaging to East Germany since the Iron Curtain lifted, allowing it to further develop to the state it is in today.

Currently, East Germany provides an opportunity well suited for manufacturers that is unique to the rest of Europe. As previously described, the main advantages of the east are an abundance of land, affordable skilled labour, modern infrastructure, economic stability, and government subsidies. As

shown in the two cases of Porsche and AMD, these factors can provide a manufacturing company of any size with a competitive advantage in production due to cost, location, and transportation of goods.

Unfortunately, success stories like these are far too rare, as this advantageous market has gone mostly untapped. However, as can be seen by the growing amount of construction around Leipzig, businesses are starting to take notice of the east over other parts of Europe, and even West Germany. Simply put, it is a region that offers affordable production in the heart of Europe, while allowing products to carry the trusted stamp "Made in Germany".

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