The Scope for Attracting Foreign Investors to Eastern Germany

As eastern Germany seeks to catch up economically with the West of the country, the region must expand its economic base and overcome its structural deficiencies. Among those investing in eastern Germany have been foreign-owned companies seeking access to new markets and taking advantage of favourable investment conditions. Yet the scope for attracting foreign investors has not yet been fully exploited. The DIW, commissioned by the federal economics and technology ministry, has conducted a survey of foreign investors in east Germany, their motives and the role they have played in establishing competitive economic structures.[1] On this basis economic policy recommendations have been derived for ways in which such investment can be promoted. The study focuses on the industrial sector.

Volume and structure of foreign investment

In 1997, between 120 000 and 150 000 workers were employed (subject to social insurance contributions) by foreign-owned companies.[2] This represented just over 2% of total socially insured employment of 5.2 million. The number of establishments run by foreign-owned firms is estimated at between 3 300 and 4 000.[3] Around one-third of such workers are employed in very small enterprises, to a large extent outside the goods-producing sector. The number of large companies – those with a balance sheet total of at least DM 1 million – under foreign ownership in eastern Germany (including East Berlin) is put at around 750 as of the end of 1997.[4] Such firms employed around 70 000 workers, more than 60% of them in manufacturing industry. Construction, trade and services each accounted for around 1 in 10 of such workers (cf. table 1).

[1] The full report is available in German from the DIW under the title *Der Beitrag ausländischer Investoren zum Aufbau wettbewerbsfähiger Wirtschaftsstrukturen in den neuen Bundesländern.*

[2] Firms whose capital is owned mainly by foreign nationals or companies.

[3] Estimated on the basis of a special evaluation of the panel of firms analysed by the Institut für Arbeitsmarkt- und Berufsforschung.

[4] Estimated on the basis of a special evaluation of Bundesbank statistics on German capital relations with the rest of the world. It is possible using these figures to classify subsidiary companies to the various federal states, but not to distinguish between West and East Berlin.

Most of the parent companies and shareholders are based in other EU countries or the USA; so far the non-European industrialised countries are under-represented compared with the situation in western Germany (cf. table 2). Given that it is overseas investors, in particular, that can be expected to have a particular interest in extending their market presence in the EU in future, it can be assumed that such countries offer a potential for future investment in east Germany.

Foreign-owned firms located in eastern Germany are concentrated in manufacturing industry, and within that sector in capital-intensive industries. This is also the case in western Germany. However, foreign-owned firms in eastern Germany are less active in research-intensive branches than is the case in west Germany. There are also differences with respect to the other economic sectors. Foreign investors in eastern Germany, for instance, focus to a relatively high degree on those industries whose activity is based on natural resources (agriculture and forestry, mining and quarrying, energy and water supply) and which are oriented towards local markets; the same is true of industries whose goods and services are not, or not mainly, tradeables (construction, public and personal services). By contrast, there are relatively few foreign firms in transport and communications, trade and producer services.

Within manufacturing industry in the region, the workforce in foreign-owned firms accounted for between 7% and 10% of the total, and for between 11% and 16% of total turnover in 1997 (cf. table 3). This was substantially less than in west Germany, where the corresponding figures – which have remained stable for many years – are around 15% for employment and 25% for turnover. Foreign investors were responsible for around 15% of the total investment performed by industrial firms in eastern Germany over the period 1991 to 1998. Investment activity by foreign-owned industrial firms in the region peaked in 1996, and thus later than that by other companies; since then their investment spending, too, has fallen (cf. figure 1).

The large foreign-owned companies in manufacturing industry are concentrated – in terms of their number, their workforce and their turnover – in Saxony and Thuringia, where east Germany's traditional industrial centres are located. In 1997, however, the pole position in terms of balance sheet total was taken by Saxony-Anhalt. This primarily reflects the investment projects undertaken by foreign-owned companies in oil-refining and chemicals, which had not been completed at that time and will only make their weight felt in the turnover statistics in successive years (cf. table 4).

Table 1

Key Data on Firms[1] Investing Directly and Indirectly in Eastern Germany by Economic Sector

at the end of 1997

Economic sector	Firms	Employees	Turnover	Share of workforce	Share of turnover
	number	thousands	DM billion	%	%
All sectors	616	58	24.2	100.0	100.0
Agriculture, forestry and fisheries	17	1	0.3	1.7	1.2
Mining and quarrying	6	3	0.8	5.2	3.3
Manufacturing industry	282	36	14.3	62.1	59.1
Energy and water supply	14	1	0.9	1.7	3.7
Construction	44	6	1.8	10.3	7.4
Trade, automobile maintenance and repair etc.	107	5	4.7	8.6	19.4
Hotel and catering	.	.	.	.	.
Transport and communications	17	1	0.4	1.7	1.6
Banking and insurance	.	.	.	.	.
Producer services	114	3	0.6	5.2	2.5
Personal services	.	.	.	.	.
Other public and personal services	9	2	0.4	3.4	1.6

1 Firms with a balance sheet total of more than DM 1 million in which foreigners own more than 20% of the capital or voting rights. — 2 Excluding East Berlin.
Sources: German Bundesbank; calculations by the DIW.

Until the mid-1990s the privatisation of GDR enterprises by the state privatisation agency (*Treuhandanstalt*) constituted the main means by which foreign investors gained access to manufacturing firms in eastern Germany. In 1998 around three-quarters of the employees in foreign-owned firms worked in privatised and reprivatised firms. In the coming years the role played by foreign-owned firms in the overall economic performance of the region will continue to grow, albeit only moderately. A number of investment projects that are already under way will be completed, and these firms will commence production. Additional new companies, take-overs and acquisitions of shares by foreign investors are to be expected, although little is known about the likely extent. The acquisition of shares in existing companies has now become, as in all industrialised countries, the most important means by which foreign investors embark on or expand activities in eastern Germany. Thus, the relatively limited stock of companies in the region acts as a constraint on their investment activity.

Impact on the creation of competitive economic structures

On average, foreign-owned companies have more employees and a higher turnover per employee than other companies. They are also growing faster than average corporate growth in the region.

Foreign-owned companies are geared considerably more than is the case with firms owned by west German investors towards sales in western Europe and overseas (cf. figure 2). They also make greater use of the region as a bridgehead with which to open up export markets in eastern Europe. Moreover, they are more closely integrated within the international division of labour in terms of their purchases of inputs and intermediate goods. To some extent this is due to the absence of local suppliers. In the interviews with representatives of foreign-owned companies, it became clear that they are making particularly strong efforts to expand and improve the local supply in eastern Germany. This can be achieved both by upgrading existing firms and by encouraging input suppliers to locate in the area.

Table 2

Key Data on Firms[1] Investing Directly and Indirectly in Eastern Germany,[2] by Country of Origin[3]

at the end of 1997

Country of origin	Firms	Employees	Turnover	Share of total workforce	Share of total turnover
	number	thousands	DM billion	%	%
All countries	616	58	24.2	100.0	100.0
Industrialised countries	586	53	23.2	91.4	95.9
EU countries	426	39	16.6	67.2	68.6
Belgium	26	4	2.9	6.9	12.0
Denmark	34	3	1.8	5.2	7.4
Finland	3	0	0.3	0.0	1.2
France	44	5	1.6	8.6	6.6
Ireland	3	0	0.0	0.0	0.0
Italy	20	1	0.6	1.7	2.5
Luxembourg	16	2	0.6	3.4	2.5
Netherlands	134	13	6.1	22.4	25.2
Austria	90	7	2.1	12.1	8.7
Sweden	29	1	0.7	1.7	2.9
Spain	4	0	0.1	0.0	0.4
United Kingdom	30	2	1.4	3.4	5.8
Non-EU countries	170	15	6.7	25.9	27.7
Japan	.	.	.	.	.
Canada	3	0	0.0	0.0	0.0
Liechtenstein	3	0	0.0	0.0	0.0
Malta	.	.	.	.	.
Norway	4	1	0.3	1.7	1.2
Switzerland	102	5	1.5	8.6	6.2
Turkey	.	.	.	.	.
USA	53	8	4.5	13.8	18.6
Transition countries	12	2	0.3	3.4	1.2
Russia	3	0	0.1	0.0	0.4
Developing countries	24	3	0.8	5.2	3.3
In Asia and Oceania	13	2	0.4	3.4	1.7
Hong Kong	.	.	.	.	.
South Korea	4	1	0.3	1.7	1.2

1 Firms with a balance sheet total of more than DM 1 million in which foreigners own more than 20% of the capital or voting rights. — 2 Excluding East Berlin. — 3 Some double counting results from the fact that companies with multiple foreign owners are classified under each country of origin.
Sources: German Bundesbank; calculations by the DIW.

Among the foreign-owned firms in the region, it is particularly those that had not previously been located in western Germany, or those in which the fields of operation in eastern Germany differ from those in the West of the country, that have established higher-level corporate functions in the region. This distinguishes them from the majority of the larger east German firms whose headquarters are based in western Germany. On average, a higher proportion of the workforce is involved in research and development in foreign-owned companies than in independent east-German- or west-German-owned companies. In this way, foreign investors make a significant contribution to maintaining and developing the potential for research and development in the east German economy.

In addition, foreign-owned companies – albeit with enormous government financial support and guarantees – have taken over a number of large concerns and have sought to make them viable once more; often such com-

Table 3

Proportions (%) of Overall Employment and Turnover in Eastern Germany[1] Accounted for by Foreign-owned Firms, 1997

	Employ-ment	Turnover
Manufacturing industry, total[2]	6.9	10.7
Food industry	1.4	3.8
Tobacco processing	.	.
Textile industry	12.5	16.1
Clothing industry	.	.
Leather industry	.	.
Wood industry	7.7	10.3
Paper industry	20.0	23.2
Publishing and printing	.	.
Oil-refining, coking plants	.	.
Chemical industry	9.4	15.8
Rubber and plastics	4.0	5.3
Glass, ceramics, quarrying	.	.
Metal production and processing	13.7	19.7
Metalworking	8.6	16.3
Engineering	7.6	9.4
EDP appliances, office machinery	.	.
Electrical engineering	5.7	4.4
Media technology	7.8	6.9
Measurement and metering technology	6.7	6.5
Automobile industry	8.8	24.2
Other vehicles	5.8	9.4
Furniture, toys	.	.

1 Excluding East Berlin. — 2 Excluding recycling and publishing.
Sources: German Bundesbank; Federal Statistical Office; DIW calculations.

panies are the most important industrial employers in a region and the most important source of contracts for local supply industries. Examples include:

– the shipyards in Mecklenburg-Pomerania,
– oil-refining and steel companies in Brandenburg;
– a large rolling-stock company with production locations in Brandenburg, Saxony-Anhalt and Berlin, and
– the large petroleum and chemical companies in the Leuna-Böhlen-Schkopau triangle (Saxony and Saxony-Anhalt).

Critics have repeatedly claimed that this has involved the conservation of out-dated industrial structures, with the help of considerable government subsidies. However, in these cases restructuring and substantial additional investment have in fact created industrial structures that are genuinely competitive. It must be conceded, however, that the maintenance of shipbuilding and the steel industry in the face of over-capacity in Europe and against the will of competitors was underwritten by government primarily in order to stabilise the economic base of the regions in question. Yet it is scarcely conceivable that measures to develop new industries would have produced the successful outcomes achieved in these locations with less resource commitment.

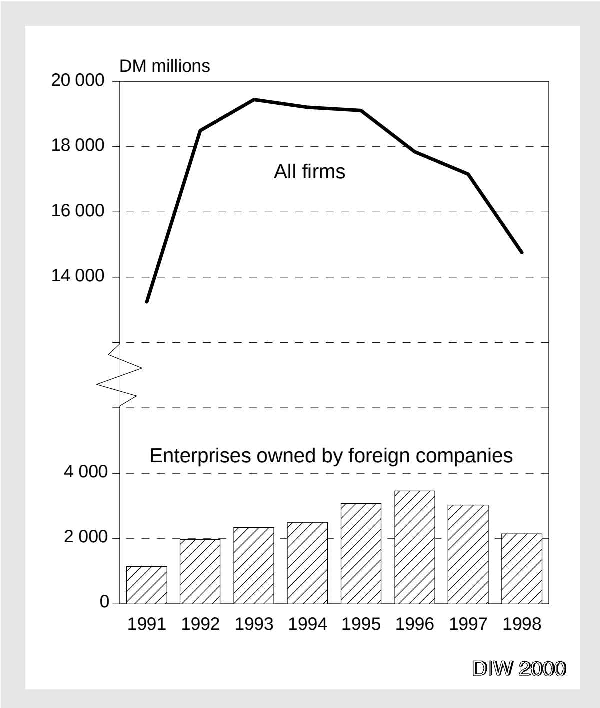
Investment motives and perceptions of the region as a production location

The most important motive for foreign firms investing in the region is the expectation of gaining market shares in existing and, above all, nascent markets. Firms are looking for distribution and production locations in market regions undergoing dynamic expansion. Thus economic growth and the creation of new markets for goods and services in Germany and Europe are the most important preconditions for foreign investors continuing to have an interest in setting up plants and acquiring companies and equity shares in eastern Germany.

Since 1990 there have been fundamental changes in the views taken of economic developments in eastern Germany, of the time it will take for the region to catch up with the West, and of market opportunities in eastern Europe. The larger east German companies are inter-

Figure 1

Investment in East German Industry



Sources: Federal Statistical Office; DIW calculations.

Table 4

Distribution of Foreign-owned Firms[1] in Manufacturing Industry over the East German States

at end of 1997

	Total	over: Brandenburg	Mecklenburg-Western Pomerania	Saxony	Saxony-Anhalt	Thuringia
Number of firms	282	49	22	105	42	64
Employees (thousands)	36	6	3	10	7	10
Turnover (DM billion)	22.9	1.8	1.4	4.3	2.6	4.3
Balance sheet total (DM billion)	27.6	1.8	1.9	3.7	8.8	4.2

1 Firms with a balance sheet total of more than DM 1 million in which foreigners own more than 20% of the capital or voting rights.
Source: German Bundesbank.

ested in selling their products not only in the region itself and in eastern Europe, but also in western Germany and western Europe. Investment locations in the region are frequently in competition with structurally weak and highly subsidised regions in the western and southern Member States of the EU. East Germany's attraction for foreign investors is currently explained largely by the following three factors:

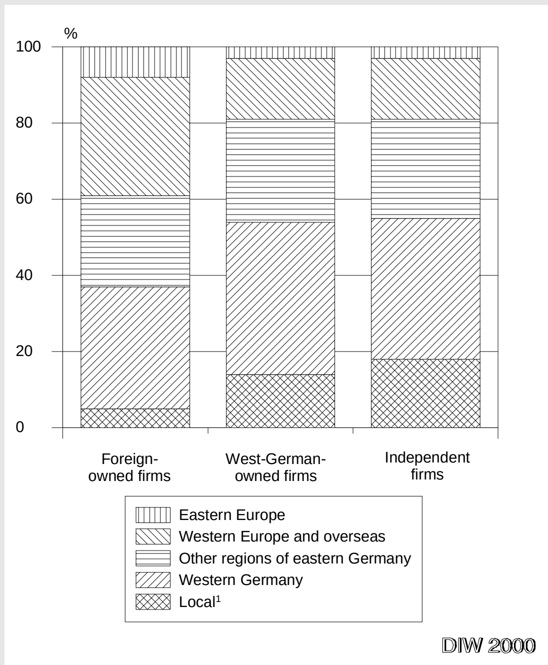
– direct access to the German and western European market;
– the low cost of capital, thanks largely to government support for investment and
– the supply of highly qualified and motivated workers at relatively low labour costs.

The most important government support measure – in terms of volume – has been the availability of investment grants under the joint central-state government programme to improve regional economic structure *(Gemeinschaftsaufgabe zur Verbesserung der regionalen Wirtschaftsstruktur – GA)*. On average, foreign companies receive the same level of support as German firms. Around 15% of GA funding for the goods-producing sector went to foreign-owned firms. The generous support for investment is one of the reasons why foreign-owned firms have focused on capital-intensive branches of manufacturing industry. Most of the numerous other support measures were targeted primarily at small and medium-sized enterprises; their large size and the fact that they belong to foreign concerns meant that foreign companies were often unable to take advantage of such measures.

Looking at the results of a survey of more than 3 300 companies in eastern Germany at the beginning of 1998, it is interesting to note that, on average, foreign-owned companies take a more positive view of eastern Germany as a production location than west-German-owned firms. This is particularly true with respect to the availability of skilled labour, government support and real estate prices. They were also satisfied with the performance of the economic development agencies, chambers of trade and commerce, and local banks. It must be

Figure 2

Spatial Distribution of the Sales of East German Industrial Firms in 1997



1 Sales within a radius of 30 km; including adjacent areas of western Germany.

expected, though, that such institutions pay greater attention to foreign firms, most of which are relatively large, than to the other, usually smaller firms. Both the foreign-owned and the other companies were united in mentioning, in particular, the high cost of energy, local government levies (e.g. water, sewage) and the operations of the local public administration as locational disadvantages. The criticism of east Germany as a production location expressed by firms' representatives in interviews[5] relates in some cases to conditions applying in Germany as a whole, such as the allegedly high nominal business tax rates, high indirect labour costs, detailed government regulation, and, in some cases, poor service by the public administration. Difficulties were also encountered in obtaining work and permanent residence permits for non-EU foreigners. Significant progress has been made during the 1990s in reducing the time taken to approve planning and other applications, a problem to which investors had previously drawn attention for many years. An additional blight on the image of east German production locations was the frequently still inadequate command of foreign languages on the part of employees and civil servants.

Conclusions and economic policy implications

So far, foreign-owned companies have invested in areas of the east German economy that have often not been attractive to west German firms, as the latter already had an established position in the markets in question, and had adequate productive capacity and modern plant at their disposal. In most cases these areas are capital intensive and are not amongst the most dynamic in terms of expansion. In some cases investment by foreign companies has led to cut-throat competition.

A further increase in foreign investment in industry is desirable in order to broaden out the economic base of the region. Steps should be taken to tap this source of investment. Yet the region will only be able to attract additional foreign investment if it is more attractive as a production location than other areas of the EU.

Currently, eastern Germany's main advantages over the West of the country are its lower labour costs and the substantial government support available for investment throughout the region. These advantages will not remain in place indefinitely, however, and must be successively replaced by other features. In order, in particular, to attract investors producing goods and services for which demand is expected to grow in the future, investment support under the GA scheme should be focused more heavily on such areas and on research and development. At the same time, there must be no let-up in the pace at which the infrastructure of the region is being extended and modernised. Support for investment must be given priority over that for consumption to a greater extent than is currently the case.

Increasingly, emphasis should also be placed on improving the so-called soft locational factors, in order to make eastern Germany attractive to highly skilled workers, from both Germany and abroad. Improvements must be made in terms of housing, culture, leisure, schools (particularly international schools), and, not least, tolerance of foreigners. Some foreign investors and the economic development agencies also take the view that the marketing activities for Germany, and particularly for eastern Germany, as a production location could also be improved.

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[5] In order to determine the motives of foreign-owned companies behind their investment in eastern Germany and their evaluation of production conditions there, 25 interviews were conducted with directors or executive managers of large foreign companies operating in the region.