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Project: *The Dynamics of Local Labor Markets: Evidence from German Unification*

FEDC Data to be Used: IAB Employee Sample, 1975-2001

Project Description:

Previous studies have documented large and surprisingly persistent differentials in wages and unemployment rates between regional labor markets. A separate literature shows that changes in labor supply, for example following a large inflow of immigrants, have little effect on wages and employment in local labor markets.

This project analyzes whether and how wages and employment in regions respond to large shocks to labor demand and supply following German unification. It exploits the fact that local labor markets in the vicinity of East Germany were more affected by the supply of East German labor and the demand for localized products (especially services) than other West German regions.

For the empirical analysis, I plan to combine data from the IAB Employee Sample with regional statistics on migration flows, unemployment rates and other available measures of labor demand conditions. In a first step, the descriptive analysis will address the following questions: First, are there significant differences in relative wages and employment patterns between regional labor markets in West Germany prior to unification? Second, how did relative employment and wages change with unification? In particular, do we see an integration of the border regions in West Germany into the overall labor market? Third, are there in turn increasing wage and employment differentials between East German regions after unification?

In a second step, the project will develop a spatial equilibrium model to analyze three (for now) possible explanations for the observed patterns both theoretically and empirically: migration from East to West Germany, increase in the size of product markets, production externalities (agglomeration effects).

The proposed project will contribute to the literature in at least two ways: first, it is the first paper to use a large exogenous change in local labor market conditions to analyze the adjustment of wages, employment (jobs) and labor supply (migration). Second, the paper

studies the dynamics of local labor markets in the context of a fairly rigid labor market, which is likely to affect how much and especially, how fast supply and demand will adjust to the new environment.

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