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# Requirements for successful privatization: Lessons from the Treuhandanstalt's approach

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# Kiel Working Papers

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**REQUIREMENTS FOR  
SUCCESSFUL PRIVATIZATION — LESSONS FROM  
THE TREUHANDANSTALT'S APPROACH**

by  
Klaus-Dieter Schmidt  
July 1995



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## **Abstract**

The paper analyses the Treuhandanstalt's privatization approach by putting it in a public choice perspective. It comes to the conclusion that the Treuhandanstalt had been very successful in reaching its economic **and** social targets. Economists might worry that the Treuhandanstalt's operation had accumulated too much waste caused by social considerations. And politicians might lament that its strategy implied that millions of people were „outplaced“ or „downsized“ in the name of privatization. But in terms of the interaction of economics and politics the Treuhandanstalt's performance had not been so far from the optimum.

*„When you have an economy, you have goods and services. When you have politics, you have laws and statesmen. However, when you put the two together, you ain't got nothing.“*

*Steve Magee*

## **I Introduction: Privatization as an Instrumental Choice<sup>1</sup>**

Some years ago, privatization was the creed of politicians in all transition countries. At that time everybody was convinced that selling state-owned companies would be the best way to transform them for better. Meanwhile, privatization has lost its fade. It has become an awkward albatross unable of a speedy take-off and a soft landing. Only in the Czech Republic transferring ownership proceeded smoothly. In other countries, however, it is behind schedule. In Hungary, sales have been completely blocked since last year's elections. In Poland it is hoped that the so-called mass privatization program (MPP) could breathe new life into the privatization process. But the complexity of the MPP holds many dangers. There are still enough possibilities for politicians of delaying it.

On the other hand, politicians cannot delay decisions to a never-never day. Privatization or non-privatization is also an instrumental choice in public finance. It is not possible for governments to keep unprofitable companies in the public sector, whatever the costs for the taxpayers. Sooner or later this strategy will become too costly, and thus also suboptimal in terms of political economy.

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<sup>1</sup> The paper was presented at the conference „Privatization in Poland and East Germany: A Comparison“, held in Tutzing from 17–20 May 1995. Very helpful comments to the draft were provided by my colleagues Birgit Sander and Uwe Siegmund and by the participants of the conference.

The crucial question is: what has made privatization so unpopular with politicians and voters? The answer is simple: while economists tend to debate on privatization in an abstract way, politicians and ordinary people face an existential problem. As Jan Winiecki (1992, p. 71) pointed out, „privatization as part of the transition to the market is a major political, not an economic change“. Even in western countries conservatives do win elections not because but in spite of privatization.

There is obviously a trade-off between economic and political efficiency: economic agents make all efforts to maximize their economic welfare, while politicians take all actions to maximize their electorate welfare (Magee, Brock, Young, 1989). The focus of economic agents is allocation, that of political party leaders is distribution. However, maximizing both economic **and** political efficiency is impossible. The consequence is that governments frequently choose a policy of second best (or second worst), which is economically **and** politically equally inefficient.

This paper examines the Treuhandanstalt's (THA) privatization approach by putting it in a public choice perspective. It argues that the THA was permanently on a tightrope walk between economic and political privatization. The „Treuhandgesetz“ (Law on Privatization) listed the transformation of ownership as only one of the explicit targets. The THA was also required „to create in as many companies as possible the ability to compete“. This legal provision became a wide-open gateway for political intervention. Although the THA's team was strongly committed to privatization and did its best to resist political pressure, its decisions could not be free of ambiguity. Many of its decisions reflected a delicate political equilibrium that balanced conflicting interests of the groups involved. As a consequence, the THA's strategy undoubtedly has some shortcomings in terms of economic efficiency. Nonetheless, governments in transition countries might learn from it. They will also find many pluses. Rational policy means making a good choice. The lessons from the THA's approach may be moderately helpful in advising on the best choice possible.

## II Some Critical Issues: Political versus Economic Privatization

### 1 *Targets of Privatization*

Perhaps the clearest lesson from the German experiences is that it is necessary to consistently define the targets of privatization. The crucial point of any political equilibrium model is that allocative and distributive targets often overlap. For politicians in transition countries the „fair“ distribution of people's property is an essential requirement. At a first glance, the distribution of vouchers seems to be just the thing. But in fact, a long debate over this instrument has raised some doubts. It has rather delayed than accelerated the privatization process in most countries — last but not least in Poland. Obviously, the voucher privatization is far from being politically efficient.

It goes without saying that voucher privatization is not the best choice in terms of economic efficiency. From the Coase theorem we can learn that allocative efficiency does not depend on the distribution of property rights. The initial distribution may affect the allocation of capital but not the efficiency of capital allocation. What matters is that the property rights are effectively enforced (Vaubel, 1992).

It was an invaluable advantage that the THA could neglect distributional considerations. It was not obliged to realize suitable proceeds from the sale of companies and other assets. On the contrary, it had a soft budget constraint which allowed even huge losses.<sup>2</sup> In retrospect, it was fortunate that the privatization process was not overlapped by a debate on the distribution of „people's property“. Given the enormous costs of privatization and restructuring of THA companies, vouchers would have become a source of severe disappointment and political discontent.

The Achilles heel of the THA was not a conflict between efficiency and equity but between privatization and restructuring. The law stated clearly that the state-owned com-

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<sup>2</sup> According to the THA Law possible proceeds should be used for compensating for the „losses“ of East German savers caused by applying a conversion rate of 1:2 (rather than 1:1) for parts of savings deposits.



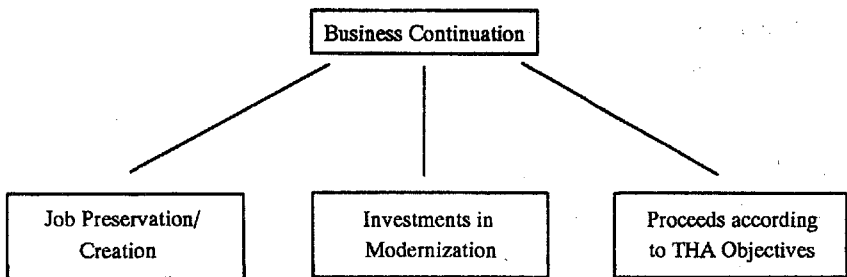
panies should be „privatized as quickly as possible“, but also „put into conditions to be fit to compete“. However, the law did not fix any hierarchical relationship between the two targets. Consequently, it was never clear which target should be considered to be more important. The THA was permanently criticized to emphasize privatizing rather than restructuring. It was argued that both should be considered as complementary targets and not as alternative ones. Actually, the protagonists of a pre-restructuring strategy were often interested in stopping or delaying the speed of the privatization and not in increasing it. The great majority of companies owned by the THA was heavily overmanned and could not be brought to the market without a huge decline in staff. Often a local anti-privatization coalition of workers, unions, churches, state governments and municipal administration came in being ready to block any privatization if their interests were not adequately taken into consideration.

Under these conditions the THA was pursuing a privatization strategy which focused not only on the target but also on the route to the target. Its basic line for privatization was to preserve a company as far as possible. The THA therefore required potential investors to offer a business concept in which they could convincingly demonstrate that they were able to continue the operation of the company with a good hope of success. The term „continuation“ was interpreted very narrowly, to mean retaining the main emphasis on the business and its location. This greatly restricted the range of possibilities for privatization. Generally speaking, a potential investor was considered unsuccessful if he intended to turn the company to some other use or re-sell it. The THA thus assumed (not always on any firm basis) that the investor intended to carry out his project somewhere else if he was turned down. It is without any doubt difficult to justify this fixation with the preservation of companies and production locations on any economic grounds. As the THA itself has conceded, it could be that an investor offering a better strategy was turned down. In the words of its lady President, the strategy was not selling companies but purchasing investors: „We are purchasing: ... we give preference to a buyer if he is contributing sales channels, if he can close the innovation and technology gap ... as quickly as possible and thus enable the company to survive“ (Breuel, 1992). The THA was thus attempting to prevent privatization leading to asset-stripping, which could result in serious regional employment problems, and

was therefore prepared to make concessions against its final targets if it could thereby more readily attain its intermediate targets. The consequence of this was that it was not pursuing privatization in accordance with any rigid set of rules, but was keeping its options open.

While a private seller of a company is normally interested in maximizing his proceeds and in putting himself out of business and responsibility, the THA had been forced to ensure that its targets were reached. In contrast to normal acquisition contracts the crucial matter was generally not the selling price. As an institution with „deep pockets“ it was able to sell companies even at a negative price. However, in this case it can expect that the investor will hold what he has promised. The THA, therefore, had made great efforts to clarify the essentials of the contracts before they were signed. Although the THA's acquisition contracts are considered as lean by international standards they comprise all those issues which really matter: clauses regarding the continuation of the company, employment and investment guaranties, revaluation of assets — and finally the purchase price. Most of these clauses are not customary in normal acquisition contracts (Schmidt, 1994).

Figure 1 – Cornerstones of THA Contracts



The typical THA contract had been based on a few cornerstones reflecting the THA's economic and social targets.

- The main target was business continuation. The THA had an outstanding interest to enforce an investor's commitment with regard to keeping the company running. The trauma to be avoided was the destruction of a company that wants to tear out the surplus value lying within. However, in certain cases the THA faced a dilemma: it was not just selling the „jam“, but mainly selling „bread and butter“ companies, many of them stale and mouldy enough to be suitable for bankruptcy. Often the company was more worth dead than alive. Then the THA had no choice. It had to put its hands in „deep pockets“. This is one of the reasons why the THA's privatization strategy caused huge losses: many companies were sold at a negative price.
- Moreover, the THA did not only stipulate a company's future business program but also important strategic variables such as employment and investment. Principally, the THA was interested in contracting high employment and investment obligations, and it often paid a high price for it. There was a trade-off between the number of jobs and the amount of investments to be obtained and the purchase price agreed.
- Compared to the other goals the purchase price, which is normally the essential in acquisition contracts, played only a minor role. It was frequently determined by the investor's promises rather than by the value of the company's assets.

It goes without saying that the THA was interested that the investor held what he had promised. The THA pumped a lot of money into the companies. As a consequence, it was obliged to do its best to safeguard what it had reached in lengthy negotiations with the investor. The typical acquisition contract is fully crammed with warranties. Now, after closing its privatization shop at the end of 1994, it was forced to open another one, for contract management and controlling in order to ensure that contracts are kept. By that the THA must accompany „its“ companies for a long time.

Although the privatization of a state-owned company is presumably the most effective form of restructuring, it does not guarantee its survival. Like any other company, it can fail if its new owner is not up to the job. The THA had a clear preference for taking its line from the investor's corporate strategy when reaching privatization decisions: the business concept was the A and O in negotiations, not the purchase price. However, a business concept is not an objective basis for taking decisions. It leaves a huge scope for subjective judgement to the side of carrying out privatizing. It rests on the assumption that the THA would be omniscient. In this respect, its privatization strategy mirrored the old socialist system of central planning (Schatz, 1992). If a number of bidders submit totally different strategies, the choice often becomes difficult. The purchase price, in contrast, is an objective measure. An investor who offers a price higher than that offered by any other bidder has usually the best corporate strategy, as he will risk good money if he can actually expect an appropriate return on it.

From the point of view of a company continuing business as well as preserving or creating jobs and undertaking investments are not reasonably economic objectives. First of all, a company should make profits. Therefore, privatization must keep a company free from such tasks which interfere with its true task. It is no surprise that more and more privatized firms, as it turns out that their business cannot flourish as fast as it was expected, consider the employment and investment obligations as a fetter.

Undoubtedly, in this respect the THA became an instrument of industrial and employment policy. This is — under the aspect of economic efficiency — the weak point of its privatization strategy. On the other hand, it was perhaps the price to be paid for political feasibility. The political economy cannot be in an equilibrium without a positive message. „Privatization“ is obviously not a positive message, but „privatization creates jobs“ is one.

As Anthony Downs (1957) pointed out, the rational voter is the ignorant voter who is only imperfectly informed. He or she can be easily manipulated by obfuscation (Magee, Brock, Young, 1989). Politicians can successfully propagate a bad policy as long as the deficiencies are not detectable by voters. In some respect the THA strategy

was fully in line with the principle of optimal obfuscation: the THA could serve up a palatable lunch without presenting the bill. This will come later.

In this respect the tactics rather than the targets in the privatization process raise many doubts. The THA has always endeavoured to find widespread political support for a quick privatization. In this way many companies have been kept alive with no other purpose than to keep workers employed. Whatever may be said in favour of these tactics, they have nothing to do with the primary target of the THA to create viable firms by privatization. Such an allocation to less efficient investors will be corrected, sooner or later, by the market — or, if politicians resist, continued subsidies will be necessary.

The lessons from all this are that a multiple system of targets which tend to contradict one another may be politically very efficient in terms of optimal obfuscation. Provided there are sufficient resources, politicians can sponsor a policy which particularizes benefits but generalizes costs. However, there is no doubt that the results are deeply unsatisfactory under the aspect of economic efficiency.

## 2 *Responsibility for Privatization*

Although the THA had not been established as a holding by law, it became the only owner of companies. This status proved an invaluable advantage in the privatization process. Neither the government nor the companies themselves were directly involved. Responsibility rested solely with the THA.

It is not possible to protect privatization against the demagoguery of the political debate. It is also not possible to shield an independent privatization agency from political pressure. However, an independent institution is better qualified to cope with the issue. Experience in Poland and Hungary has shown that tactical games of political parties, self-management boards and trade unions might easily block even the most convincing privatization strategies. Privatization needs a „lightning conductor“, and the THA had been that institution which was ideal for venting anger on it.

Legally, the THA was a curiosity. It was neither an official authority nor a holding company. It was, so to speak, sailing in a no-man's land between politics and economy. In some respects it was comparable with the Deutsche Bundesbank; for the former chancellor Helmut Schmidt it was simply the „side-government east“ (Czada, 1993). But in fact, the THA had only limited autonomy at its disposal. It was financed by the federal ministry of finance, co-administered by the „Verwaltungsrat“ („management trust“), whose members represented different political groups, „guided“ by numerous advisory committees and, last but not least, controlled by the parliament. The THA's independence stemmed to a great extent from the reputation which it gained under the sound but forceful leadership of its long-standing lady president Birgit Breuel.

From the perspective of the public choice approach a privatization agency established in the no-man's land between politics and economy comes perhaps close to an endogenous equilibrium. In such an equilibrium none of the players can reach a maximum. Every player has to calculate the decisions of the other players in response to his own decision (Magee, Brock, Young, 1989). It is true that the THA had to calculate the constraints imposed by the lobby, but the lobby itself had also rationally allocated its resources in response to the decision of the THA. Just because the legal construction of the THA was permanently criticized by pressure groups, it was obviously the right one.

### 3 *Forms of Privatization*

In principle, two basic models can be used for privatization: the auction model and the bargaining model (Schmidt, 1993).

- Using the auction model, a company is sold to the highest bidder. The criteria for selection can be combined in any required manner: the highest offer price, the most convincing corporate strategy, the highest number of jobs promised, or a combination of all of them. The auction model is favoured by most theoretical economists (Smith, 1991).

- Using the bargaining model, bilateral negotiations decide which bidder is to be successful. The procedure is always recommended by economists when no perfect market exists, e.g., when only a small number of bidders appear or are allowed to appear.

However, each of the two models has, admittedly, some further advantages and disadvantages. For instance, the question has to be asked as to which model will lead to the best possible valuation of the company and thus a good selling price. In this respect the auction model is superior to the negotiation model, on condition that competition between the bidders exists.

The THA was basically free in its choice of privatization instruments, but in fact the choice was determined by the targets it was striving to attain, as its interests were not to find „any“ buyer, but the „right“ buyer, one who was willing and able to restructure a run-down company and continue its operations. In most cases it decided in favour of a flexible approach which was officially labelled as „industry-oriented marketing“. Actually, the THA was very innovative in developing adequate privatization procedures which, however, cannot be adequately evaluated within the small scope of this paper. Apart from the mass privatization in the retail and catering trade where fixed procedures were employed, it nearly always regarded the sale of a company as a unique event. In some cases it also tied up a „package“ and endeavoured to privatize more than one company at a time in each tender. This was the case especially in problem industries (steel, chemicals, ship-building and micro-electronics), where the crucial point was the preservation of existing industrial networks.

For the privatization procedure the THA generally applied minimum standards, containing the following major points among others: calculation of value, sales negotiation, sales decision, and contract formulation. Apart from this, however, the privatization teams were given plenty of free scope in their handling. This has been seen by many as an important shortcoming since this took a major proportion of the decision-taking process out of the range of public supervision. But the THA attributed at least part of its success in privatization to this regulation. Actually, the lack of transparency — the THA reached most of its decisions behind closed doors, and it is hard to

check up on them — was optimal in terms of obfuscation. By that, the THA was virtually outside of public control.<sup>3</sup>

Public choice theory suggests that it is harder for voters to detect the deficiencies of an indirect rather than of a direct policy. The THA sold a huge number of companies at an extremely low or even negative price. But in this respect it was seldom penalized by public opinion. As the THA did mostly focus on non-price considerations such as employment-level maintenance and further capital investment agreements, the distributive elements of its approach remained largely undetectable.

#### *4 Costs of Privatization*

Since mid 1990 the THA has pumped a lot of money into the eastern German economy. The privatization of the „people's property“ is expected to make a profit of roughly 70 billion DM, but this figure has to be set against the expenditures incurred during the course of privatization which will total about 340 billion DM. As a consequence, a net loss of 270 billion DM has to be transferred to the state budget.

Blame for the fact that the privatization of companies would deeply end up in the red is not only to be laid at the THA's door, not even the major part of it. The deficit is principally attributable to the mismanagement of the old socialist system, which drained companies of their financial lifeblood. However, the question needs to be asked as to whether the deficit shown in the profit-and-loss account might not have been smaller if the THA had devoted its efforts exclusively to its privatization task rather than having to fulfil obligations under structural and social policy as well. In fact, the size of these deficits results from the THA placing far greater weight on other targets in its negotiations, particularly the preservation of jobs, rather than on the maximization of proceeds.

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<sup>3</sup> An investigating committee of the Federal Parliament, initiated by the opposition parties, has come to nothing. The THA has been very successful in withholding information from the committee.



The THA was meant to realize a positive amount as the proceeds of its privatization sales, but was also allowed to sell at a loss if the privatization was thus achieved more quickly and successfully. Actually, it enjoyed a soft budget constraint. There were numerous early warnings against doing it (Maurer, Sander, Schmidt, 1991; Hax, 1992). By that, so it was argued, the THA was able to prolong the survival of bankrupt companies which had better been liquidated in the first place. A limited budget, on the other hand, would have forced the THA to concentrate on companies with a good chance to become viable.

However, it is unlikely that the THA would have been able to liquidate the majority of „hopeless cases“ and after that close its shop. Presumably, it would still be alive as a holding for some hundred companies continuously depending on subsidies. In this respect the THA faced only a trade-off between high costs of privatization and high costs of long-term subsidization. There are good reasons to believe that a once-and-for-ever subsidy in the form of a low or negative selling price had come much cheaper than a permanent subsidy. According to this the THA approach has not only been politically but also economically efficient as it has minimized the costs of subsidization.

### 5 *Results of Privatization*

The THA was able to close its shop at the end of 1994. Within 4 ½ years it had privatized or liquidated more than 13,000 companies (a rate of 10 per day) which is undoubtedly an impressive success story. Nevertheless, the THA has invested a lot of money in getting its targets realized. Time must tell whether the results make all these efforts worthwhile.

Meanwhile the THA has opened another shop, the „Bundesanstalt für vereinigungsbedingte Sonderaufgaben“ (BVS) which has to take care that contracts are kept. At present, the BVS data base includes approximately 50,000 contracts which have to be controlled and managed for a long time. Initially, the THA regarded the examination of contracts as its foremost task. But soon it realized that it would be necessary to focus on the field of contract management because a large number of contracts were potential candidates for re-negotiations or, if worst came to worst, for bringing defaulting

investors to court. Consequently, the BVS must consider its task in a broader sense: as a permanent management of risks involved in the contracts.

It is still too early for a final judgement. The period of validity of contracts often covers several years, and most investors are free with respect to timing their obligations. Only a minority of companies has already set up in the market. A large number is still facing difficulties and will fail sooner or later. According to information obtained from the BVS, in February 1995 a total of 3,000 re-negotiations (4,000 objects) were registered of which 2,500 contracts (3,400 objects) could be concluded. Only 20 percent of re-negotiations were scheduled in the contracts, 80 percent were initiated by the investor or the THA and its successor, the BVS. Obviously, more and more investors ask for re-negotiations because of financial difficulties.

The crucial point is: the BVS cannot force an investor to keep the contract whatever the costs may be. It must be, in principle, ready to re-negotiate. The BVS's main concern must be the healthy future of the company. This is not promoted if the investor is condemned to pay a fine — and, as a consequence, goes bankrupt. One of the spectacular cases is that of the Märkische Faser AG which got into serious trouble immediately after privatization. ( A description of its unsuccessful privatization is given in the Annex).

Penalties can only work by the same principle as traffic regulations do: they should take care that the necessary steps are taken. By threat of punishment it is hoped to hold the number of offenders low.

Nevertheless, the BVS feels rather unhappy with applying this instrument: until now it has only taken about 100 investors to court, but it is estimated by BVS's officials that another 700 or 800 may follow. „On the practical side it has become apparent that fixing the level of such penalties is rather like walking a tightrope: a balancing act between the economic benefits to be gained thereby and the danger of frightening off potential investors“ (Baumgarten, 1992, p. 286). In fact, the typical THA contract with its specific safeguard clauses shifts an incalculable risk onto the investor. An employment

and investment guaranty may easily become a time bomb. The BVS cannot be interested in letting it go off.

Therefore, the BVS hesitates to take a sledgehammer to crack a nut. It prefers other measures instead of imposing a fine. An adequate measure is to raise the purchase price subsequently. From the legal point of view raising the purchase price is easier to handle than enforcing a penalty (Wächter, 1994).

Although the THA focused its sales strategy on finding investors able to give the company a secure future, inevitably a great part of them must fail. In many cases the business concept proved to be unable to carry the load. The new owners often miscalculated their possibilities to run their company successfully. They overestimated the cash flows and, accordingly, the net asset value of the company. Frequently, these difficulties have a strong connection with the collapse of exports to the former CMEA countries. Initially, many West German and foreign investors expected to get rapid access to the eastern markets by purchasing a THA company but this strategy did not work out. Investors who failed their targets will hardly be able to pay a penalty.

There is an ongoing discussion between the BVS on the one hand and investors and their attorneys on the other as to whether a vital change in circumstances assumed by the parties at the time the contract was concluded could be an argument for re-negotiating the contract. In principle, the BVS is willing to talk about a reduction of the purchase price or the penalty, but not about a repurchase of the company. However, some jurists consider many of the contract clauses (such as business continuation, employment and investment clauses) to be not litigable according to the German law.

The THA has been very proud that — on average — the employment and investment targets were surpassed: in 1993, e.g., about 9,200 contracts with employment guarantees were examined. 596,000 jobs were maintained or created instead of 520,000 guaranteed. However, 1,650 investors did not reach their employment targets: they provided only two thirds of the jobs they promised. Similar results were reached in respect to investment guaranties: in 1993, nearly 2,500 contracts were controlled of which

2,000 surpassed and 470 failed the targets. On average, 19 billion DM were invested instead of 15 billion DM guaranteed (Tables 1-3).

Table 1 – Employment and Investment Guarantees in THA Contracts 1990-1994  
(Cumulated Total)

	1990	1991	1992	1993	1994
	Employment commitments (number)				
Guaranteed by contract	25,565	411,989	778,468	919,236	974,389
Safeguarded by penalties	8,203	258,700	580,368	708,560	760,862
	Investment commitments (mill. DM)				
Guaranteed by contract	11,725	41,450	88,043	106,399	142,463
Safeguarded by penalties	175	13,494	54,828	71,433	107,117

Source: THA/BVS.

Table 2 – THA Contracts under Examination 1990-1993  
– Employment Guaranties –

	1990	1991	1992	1993
	Number of examined contracts			
Total	38	2,786	7,311	9,205
	Number of guaranteed jobs			
Total				
Target	5,217	202,625	438,816	520,215
Realization	5,360	237,018	515,110	596,022
Difference	+114	+34,393	+76,294	+75,807
Of which companies				
Target realized				
Target	3,613	161,356	356,965	384,856
Realization	3,975	207,886	460,425	507,692
Difference	+362	+46,530	+103,460	+122,836
Target failed				
Target	1,604	41,269	81,851	135,359
Realization	1,385	29,132	54,685	88,330
Difference	-219	-12,137	-27,166	-47,029

Source: THA/BVS.

Table 3 – THA Contracts under Examination 1990–1993  
– Investment Guaranties –

	1990	1991	1992	1993
Total	Number of examined contracts			
	3	131	770	2,489
Total	Number of guaranteed investments			
	6	256	2,496	15,318
Realization	13	400	3,433	19,154
Difference	+7	+144	+937	+3,836
Of which companies				
Target realized				
Target	6	191	2,204	13,838
Realization	13	354	3,292	18,476
Difference	+7	+163	+1,088	+4,638
Target failed				
Target	–	65	292	1,480
Realization	–	46	141	678
Difference	–	-19	-151	-802

Source: THA/BVS.

Table 4 – THA Contracts under Examination 1993  
– Companies which failed Employment and Investment Guaranties –

Deviation	Number of examined contracts	Commitments		Difference
		guaranteed	realized	
Employment commitments (number)				
Minus 10 %	303	41,235	39,316	-1,919
Minus 11–50 %	541	55,850	42,795	-13,055
Minus 51 and more %	581	31,754	2,946	-28,808
Total	1,425	128,839	85,057	-43,782
Investment commitments (mill. DM)				
Minus 10 %	55	97	93	-4
Minus 11–50 %	120	523	354	-169
Minus 51 and more %	205	763	105	-658
Total	380	1,383	552	-813

Source: BVS.

Nevertheless, for many investors the employment and investment obligations are a high hurdle. It is interesting enough that of those 20 percent of companies which failed employment and investment targets a significant share failed considerably: in 1993, e.g., 40 percent of failing companies fell short of their employment commitments by

more than 50 percent, and in respect to investment commitments the share was even 55 percent (Table 4).

Because of the lack of convincing criteria it is difficult to judge the performance of the THA. Peter Friedrich (1994) rightly pointed out that the overall performance of the THA must be seen as a compound of past **and** future performance. Consequently, much will depend on the ongoing contract management of its successor organization, the BVS. In cases, in which the THA has failed to reach its targets, Friedrich advocates intensive re-negotiation and even taking back of companies and plants by the BVS.

From an economic point of view there might be good reasons for doing so. However, there are no signs at all that the political parties as well as the populace in Germany could be interested in opening up a new battlefield in the form of a second round of privatization. As we can learn from public choice theory: if in political markets the opponents are convinced that they have reached their equilibrium, then the distance between them will become small. Consequently, they will lose all their interest in deploying further resources. One possible consequence of this decline in policy distance is that also the controller might find it advisable to pursue a strategy of „benign neglect“.

From this we have to conclude that the failures of privatization can only be corrected by the markets. From an economist's point of view this is certainly a good solution. One might hope that the political groups will accept the results and do not reject them.

### **III Conclusions: Lessons from Privatization**

Compared to the troublesome experience in most transformation countries the THA has written a success story. It has reached by and large its economic **and** social targets. Economists might worry that the THA's strategy has accumulated too much economic waste caused by social considerations. And politicians might lament that this strategy implied that millions of people were „outplaced“, „downsized“ or „delayed“ in the name of privatization. Both might be right, but the THA was not an institution operating in an economic and political vacuum. It had to carefully balance polarized inter-

ests. In terms of the interaction of economics and politics its performance has not been so far from the optimum. Its unpopularity has largely been a problem of success, not of failure.

Among the lessons which have been learnt from the THA approach those are perhaps the most important ones:

**First:** It is important to fix clear targets for privatization. The targets must be compatible. Allocation and distribution do not necessarily contradict each other, but allocation should be given priority. Distribution must be the result of allocation, not vice versa. In this respect, the THA was in a rather comfortable position. It was able to operate without any distributive considerations.

In other respects the THA had much more trouble: it had a preference to push companies into the private sector as quickly as possible, convinced that private owners could restructure them more effectively than itself. But it suffered from strong political pressure to restructure first and privatize later. Fortunately, the THA found acceptable ways and means to avoid severe conflicts.

The theory of economic policy suggests that a multiple target system also requires a system of multiple means. For each target pursued a special means should be available. The means for pursuing economic targets was privatization, the means for pursuing social targets was a soft budget constraint. The THA did not suffer from the task to distribute some thousands of companies to millions of mini-shareholders neither able to invest additional money nor to give management guidance to „their“ company. In this respect its task was much easier than the task of governments in transition countries.

**Second:** It must be clear which institution should be responsible for privatization. This institution must be independent and free from political governance. The THA had always been not only the locomotive that pulled the privatization train but also the driver. Too many persons on the tender provoke long-standing disputes. This must delay or even stop the train. In addition, the driver must

be a strong personality able to stay on course and to keep the timetable. In this respect the THA was benefiting from the courage, cleverness and reputation of its lady president.

Third: Public auctions are, in principle, the best means of privatization. They provide the best allocation of assets and, in this way, the best price. Normally, they are less controversial than direct sales because the procedure guarantees transparency and fairness. The THA did not have a great liking for auctions. It preferred negotiations behind closed doors. From an economist's point of view this seems to be hard to justify. However, given the deplorable state of the majority of companies, it cannot be denied that public auctions would have involved incalculable risks for the THA.

An interesting lesson from this is that wrong means do not necessarily produce a wrong outcome in terms of economic and political efficiency. In order to operate successfully in a different political environment the THA's shield was disinformation rather than information. Obviously, the THA's „closed-door privatization“ has satisfied optimal obfuscation better than any other means of privatization.

Fourth: It is self-evident that a privatization agency which tends to purchase investors must have a filled pocket. However, it should not operate without a budget constraint. An unlimited budget encourages public spending by emphasizing the benefits rather than the costs. Instead of talking about the future financial burden of privatization, the THA preferred to speak of contracted employment or investment guarantees.

Fifth: Privatization must be kept off political battlefields. In this respect the THA has been much more successful than governments in transition countries including Poland (Lewandowski, 1994). Certainly, the THA had been able to „sugar the bill“, and spending money is always a reliable social mollifier. However, the masterpiece of the THA was its timing: it had completed most



of its privatization program before political parties, in 1994, could start into the super-election-year campaign.

Governments facing difficulties prefer a policy which might help temporarily at least: they do nothing. By that, in borrowing a phrase from Richard Rose and Guy Peters (1978), they hope to buy time. But buying time is costly and involves risks. The risk that speedy privatization might lead to an inferior outcome is perhaps smaller than the risk of doing nothing. Speed prevents politicians from reversal. The transformation process must be a one-way route — without turnarounds.

**Annex:**

**The Märkische Faser AG – A Case Study**

*Privatization*

The Märkische Faser AG, Premnitz (MF), formerly named VEB Chemiefaserwerk „Friedrich Engels“, Premnitz, was one out of ten parts of the former VEB Chemiefaserkombinat Schwarza „Wilhelm Pieck“, Rudolstadt. As a company which employed more than 6,000 people it belonged to the biggest producers of synthetic fibres in the former GDR. In June 1990 it was transformed into an independent stock corporation.

In October 1990 the Treuhand steering committee<sup>4</sup> recommended either a quick privatization or a liquidation of the company. In November 1990 the MF presented a concept for restructuring in which financial requirements in the range of 300 mill. DM were estimated to be necessary in the period from 1991 to 1993. Nearly half of this volume was assumed to be outside financing provided by the Treuhandanstalt. Employment should be reduced by 30 p.c. until the end of 1990 and by further 30 p.c. until the end of 1991. Production should be focused on the core business, the product range, however, should be renewed completely.

The THA attempted to acquire a big investor and approached leading West German producers — Bayer and Akzo among them. Investment consultants were charged with identifying other potential investors and a public invitation of tender was organized. In addition, the MF managing board itself tried to establish contacts with potential investors, e.g. in Japan. All efforts, though, did not yield any final agreement, neither for the company as a whole nor for any part of it.

In the process of reorganizing the MF's business activities two of its production units were separated and sold individually: in February 1991, the Novoktan GmbH, a lim-

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<sup>4</sup> Leitungsausschuß, i.e. a group of external experts in charge of evaluating the enterprises and advising the management board whether to continue or liquidate them.

ited liability company with 2 mill. DM nominal capital and 220 employees, was sold to the Alcor Chemie AG, a Swiss chemical producer, at a price of less than 1 mill. DM. In December 1991 the Aktivkohle und Umweltschutz GmbH (Activated Carbon and Environmental Protection Ltd.) with 1 mill. DM nominal capital and 54 employees was sold to WBL Absorptionstechnik Holding AG at a price of 1 mill. DM.

In August 1991, the Treuhand steering committee insisted once again on its recommendation: the MF should be sold quickly or liquidated. However, there was only one seriously interested buyer, the Alcor Chemie AG, which bought the company in October 1991. The THA considered this deal to be problematic because Alcor's business strategy for the MF was entirely based on exports into the CIS. However, this risk had to be assessed against the outstanding regional importance of the MF for employment. Finally, the contract with Alcor was concluded on the following terms: although the assets in the opening balance had a volume of 400 mill. DM, the sales price was only 5 mill. DM and old debts of 175 mill. DM were released. Alcor promised to keep 1,990 jobs and to invest 100 mill. DM, thereof 60 mill. DM until the end of 1993 and 40 mill. DM until the end of 1995. Non-fulfilment of both the total investment guarantee and 85 p.c. of the employment guarantee (1,700 jobs) was penalized. If real estate was to be sold, Alcor would have to pay the THA 50 p.c. of the additional revenues. In December 1991 the terms of contract, namely those concerning future investments, were changed: until the end of 1993 at least 30 mill. DM had to be invested. Otherwise the THA would have been entitled to cancel the entire contract without any obligation to repay the expenditures. At that time, based on a Russian declaration to fulfil the purchase contract with the MF, the THA assumed the privatization to be feasible.

### *Re-negotiation*

Already in January 1992, the creditworthiness of the CIS business partners worsened perceptibly and subsequently, the MF found itself in a liquidity bottleneck. In April 1992 Alcor approached the THA demanding additional funds of 100 mill. DM. This was justified, they argued, by a vital change in the circumstances which were assumed

as the contract was concluded. In August 1992 Alcor increased its demand for additional funds up to 110–120 mill. DM. They should be assigned to clear up ecological damages and to pay back liquidity credits. As the THA rejected, the MF managing board decided in September 1992 to close the shop. In response, the employees occupied the enterprise. By this, public attention was drawn to the case and the federal government felt strong pressure to intervene.

At that point, the state of affairs was as follows: the THA had granted support of more than 330 mill. DM, out of which 175 mill. DM were used to redeem old debts, the rest mainly served to overcome liquidity bottlenecks. However, Alcor abstained from supplying any liquidity to the MF and called for further support on part of the THA. Finally, the THA and the Landesentwicklungsgesellschaft Brandenburg repurchased at equal shares MF real estate of the value of 25 mill. DM. In December 1992, the THA, the state government of Brandenburg, Alcor and the MF jointly decided on a „minutes of results“ (Ergebnisprotokoll) to raise further funds by reselling non-essential parts of MF's real estate to the THA. All in all, further 20 mill. DM were raised by this initiative. In addition, the THA promised to grant consulting assistance. It commissioned a commercial consultant to prepare an expertise. The outcome was that MF's survival was crucially dependent on fundamental structural changes. This would have required 260 mill. DM only to continue the business and further 220 mill. DM to finance future investments. Based on this expertise Alcor made subsequent claims of almost 300 mill. DM. In April 1993 the THA rejected these demands and called attention to the volume of payments and concessions it had already made. In May 1993 Alcor intended to withdraw further liquidity from the MF. The THA intervened and pointed out that this would violate the contract. In June 1993 Alcor announced a further reduction of employment of the MF. The THA insisted that the employment guarantees had to be kept. Otherwise it would enforce the payment of penalties.

For a longer time the fate of the MF is still undecided. Alcor, the owner of the MF, wanted to get rid of it, but the THA was refusing to take the company back. There was a new possible investor, Rostextil (Russia), who was interested in buying MF. But no contract has been signed yet. According to reliable sources Rostextil was not willing to

fulfil the employment guarantees contracted by Alcor. In September 1994 MF was bought by the West NBL Beteiligungsholding GmbH, which belongs to the Westdeutsche Landesbank. However, the West NBL will manage the MF only temporarily and is in search of an investor willing and able to restructure the company.

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