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Working Paper

## Ownership structure and enterprise performance in the transition process: Evidence from Eastern Germany

Kiel Working Papers, No. 530

**Provided in cooperation with:**

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Suggested citation: Schmidt, Klaus-Dieter (1992) : Ownership structure and enterprise performance in the transition process: Evidence from Eastern Germany, Kiel Working Papers, No. 530, <http://hdl.handle.net/10419/47149>

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Kiel Working Paper No. 530

**OWNERSHIP STRUCTURE AND ENTERPRISE  
PERFORMANCE IN THE TRANSITION PROCESS:  
EVIDENCE FROM EASTERN GERMANY**

by  
Klaus-Dieter Schmidt

October 1992

Institut für Weltwirtschaft an der Universität Kiel  
The Kiel Institute of World Economics

ISSN 0342-0787

Institute of World Economics  
Düsternbrooker Weg 120  
2300 Kiel  
Federal Republic of Germany

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Ag 3994 / 92  
Wirtschaft  
Kiel

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## Introduction<sup>1</sup>

The transformation of a former socialist economy requires a complete reorganization of enterprises and restructuring of institutional frameworks. This type of economy has been characterized inter alia by

- dominance of large, state-owned conglomerates and companies,
- absence of competition and, hence, a low rate of market-exit and -entry,
- poor market orientation (especially with respect to foreign markets),
- technological backwardness,
- deficiencies in corporate behaviour as with respect to improving efficiency, risk taking and profit orientation.

In a socialist economy loss making companies were able to survive. In a western-style market economy, however, unprofitable firms either have to adjust themselves to become profitable - or they have to die.

In a transforming economy there is a common legacy of most companies: low competitiveness as the result of obsolete capital stock and overmanning, insufficient product qualities not satisfying demand, inadequate management capacities, distorted specialization patterns and trade orientation towards the former COMECON, high and partly ill-designed vertical and horizontal integration, suboptimal size of conglomerates and companies. As it was pointed out by Hax (1992) the socialist economy did not know "enterprises" in the usual sense - which means autonomous economic units subject to a hard budget constraint and operating in a competitive environment. Rather the conglomerates and their subunits were bureaucratic organizations in a hierarchically structured and centrally commanded system of production. The task is to convert such bureaucratic units into viable, competitive enterprises.

The paper focuses on the microeconomic effects of changes in ownership structure and enterprise behaviour in the transition process. There are good reasons to argue that the recovery of a former socialist economy is unlikely to happen without reorganization and privatization of the

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<sup>1</sup> An earlier version of this paper was presented at the ACE-Workshop "Entrepreneurial Possibilities Developing in Central East European Countries and the Enactment of Their Economic Reforms" held on 10-14 September 1992 in Balatonalmádi. The author wishes to thank the participants of the workshop and, above all, his colleague Birgit Sander for helpful suggestions.

large state-owned companies. Private property is the core of a market economy. A mainly private market economy provides at best what ailing state-owned companies need: promising concepts, market-oriented management and fresh money (Steinherr, Perrée, 1992).

## **I Restructuring under State and Private Ownership: The Theoretical Background**

The overwhelming majority of economists and policy makers agree that private ownership is important for transforming a socialist economy - but there is no consensus on how important it is. The discussion on privatization in western market economies has come to the conclusion that other factors are even more important, especially the pressure exerted by competitive markets and a hard budget constraint. As shown by Vickers and Yarrow (1988), the performance of an enterprise depends not just on ownership but on the economic environment in which it operates. On the other hand, only private ownership provides the incentives necessary to make former socialist firms able to meet the requirements of the market.

A strategy of reorganizing and restructuring a former socialist economy on the micro sphere has to start with designing new economic units - and privatization is a strong lever to do this. The typical socialist company has been a conglomerate of dependent factories with a wide range of production lines often locally far distributed, and it is just impossible to give it simply into private ownership. Therefore, it has to be broken up into a number of independent units. A competitive economy is characterized by a mix of (few) large and (many) medium and small sized producers. Without splitting and regrouping former socialist conglomerates cannot be privatized efficiently.

A newly designed enterprise should be privatized as quickly as possible. From experiences in western market economies we learn that the state is a weak owner. He is often subject to political pressures - on part of central and local governments, on part of trade unions or on part of political parties - which make for suboptimal efficiency levels: there is always a minister, mayor or union leader who opposes against firing workers or closing down a production line. With state ownership the principal-agent problem can hardly be solved (Fink, Schediwy, 1992).

However, splitting up a large state-owned company is not easy. The Privatization Agency is generally meeting with strong resistance on part of both the management and the workforce. The Agency can often sell only the profitable parts and is forced to close the others. Furthermore, for a loss-making large state-owned company it is much easier to receive subsidies than for a small- or medium-sized firm.

Privatization provides the best way to reorganize a state-owned enterprise and not vice versa. Such an enterprise urgently needs a new entrepreneurial concept which promises profits. Cer-

tainly, an entrepreneurial concept cannot simply be attained by privatization. But it can be expected that a private investor is better qualified to identify and to realize profitable business opportunities than any state agency. This task requires talented and experienced managers who are usually not greedy to join a state company. Management capacities are a scarce resource in the market economy and they are even more scarce in a former socialist economy striving for marketization.

The key for reorganizing and restructuring a former socialist company is financial resources. For such a company which is often facing an uncertain future it is not easy or even impossible to obtain financing on the capital market. Consequently, its investment expenditures have to be sourced out of public funds - and the risk of failures is immense when public financing is at stake. A privatized enterprise, on the other hand, has its own capital at risk, with no chance of government bail out. Its lending activities are undertaken strictly according to tough credit-worthy criteria. Insofar, quick privatization is also the best way to separate viable and non-viable firms. A private investor risks losing his money, thus he will take his decisions very deliberately. One can conclude that a firm which cannot find a bidder has no chance to survive and should be closed down.

To summarize: the task for firms in a transforming economy is to achieve long-run economic performance or - referring to a concept of Douglass C. North (1992) - to reach adaptive efficiency. In contrast to allocative efficiency it is a dynamic concept which is concerned "with the willingness ... to acquire knowledge and learning to induce innovation, to undertake risk and creative activity of all sorts, as well as to resolve problems and bottlenecks ... through time" (p. 3). Introducing private ownership is presumably the best way to create adaptively efficient firms.

## **II Enterprise Performance and Ownership Structure: The Findings**

### **1. The Data Base**

The paper examines the effects of privatization on reorganization and restructuring of companies in Eastern Germany. Up to the end of July 1992 the Treuhandanstalt (the agency in charge of privatization) had completely or overwhelmingly privatized a total of about 5800 companies but still had another 4000 companies to privatize (Table 1). The core question is: how has economic performance developed with regard to those companies that have been privatized in contrast to those that have remained in Treuhand ownership? The hypothesis is that the situation of privatized companies has rather improved than worsened while for Treuhand companies the contrary is true.

**Table 1 - State of Privatization in Eastern Germany (State: End of August 1992)**

	October 1990	March 1991	March 1992	August 1992
Companies initially in ownership of the Treuhandanstalt	8300	9035	11555	12142
of which:				
Privatized(a)		1783	5238	5789
Completely	.	1287	4658	5209
Partly(b)	.	496	580	580
In liquidation (c)	.	216	1465	2083
To be privatized	.	6983	4615	3985
Completely	.	6685	1539	.
Partly(d)	.	298	2676	.
Others(e)	.	53	237	285

(a) Including reprivatized. - (b) More than 50 p.c. - (c) Including by merging and splitting. - (d) Less than 50 p.c. - (e) Given to municipalities and to preliminary ownership.

Source: Treuhandanstalt.

Several reasons call for focusing on the impact of ownership changes in the so-called industrial area:

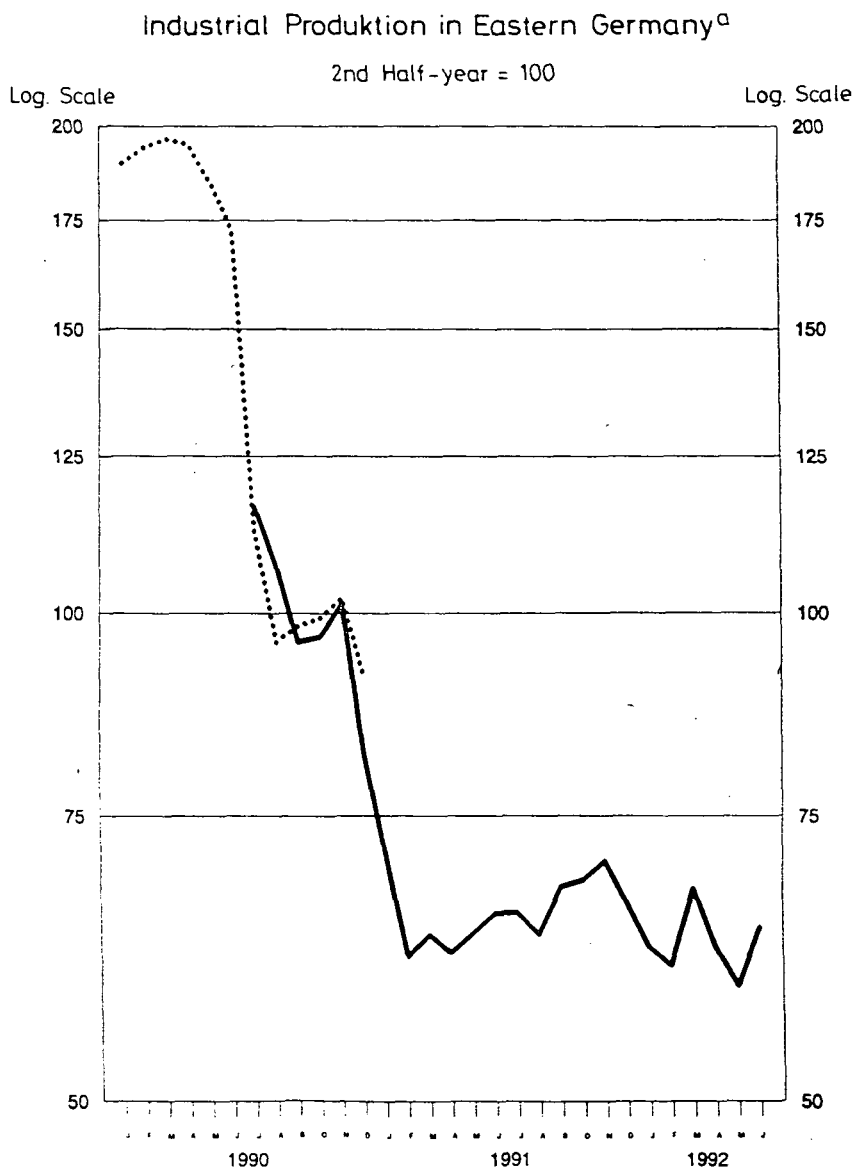
- More than others (except agriculture) this sector is under severe pressure. It has lost most of its previous markets - thus production has come down to two thirds of its previous level and is now stagnating (Graph 1). The majority of firms (still) suffers from low competitiveness: turnover per employee (as a rough performance indicator) reaches only about one third of the level in the West German industry.
- In this sector privatization is lagging behind. While in other branches like retail trade, hotels, restaurants or pharmacies most entities have been sold off quickly, a great number of industrial enterprises is still completely or partly in state ownership.
- For this sector data are somewhat better than for other sectors. The information available allows to evaluate the present performance of companies, the problems they are currently facing, the short and medium term expectations and the design of restructuring programs. It goes without saying that data do not meet the requirements for careful investigations.

Data used in this paper mainly come from polls of several German Research Institutes, especially from the Deutsches Institut für Wirtschaftsforschung Berlin (DIW) and the Institut für Wirtschaftsforschung Halle (IWH). They were collected at different times and published in different series. The underlying samples of enterprises are varying widely; hence the quality of in-



formation is difficult to evaluate. Despite these insufficiencies, these poll-data are the only ones providing separate information for enterprises under private and state ownership.

**Graph 1**



Source: Statistisches Bundesamt.

Nevertheless, further caveats are necessary. Above all, data can be biased in three ways:

- Possibly, poll samples are not fully representative. They can be biased towards large and old state-owned enterprises (both privatized and still in the ownership of the Treuhandanstalt) and biased against small- and medium-sized private firms just built-up from scratch. Newly established firms are presumably performing better than the old ones.

- Probably not all of the interviewed enterprises assess their current situation and future prospects as realistic. Especially the Treuhand-enterprises tend to overrate themselves.
- Necessarily, there is a strong selection in the privatization process. This causes a positive correlation between the (future) competitiveness of enterprises and their privatization chances. Enterprises already privatized are bearing the quality label ("Gütesiegel") of being chosen by risk-sensitive private investors. Hence, it is of no surprise that with on-going privatization the non-privatized enterprises are becoming less competitive on the average.

With a few exemptions no differentiation between types of companies in private ownership is possible. One can assume that the situation of private companies newly founded is much better than the situation of companies newly privatized. (Information on the ownership structure in Eastern German manufacturing is given in the appendix).

## 2. Current State of Affairs

In summer 1990, when the German Economic, Monetary and Social Union (GEMSU) was started, everybody became aware that the Eastern German industry was facing severe trouble. One year later, in summer 1991, the deplorable state became manifest. According to a representative poll among roughly 1 500 large firms - initially or still in the ownership of the Treuhandanstalt - only 10 p.c. considered themselves as competitive at that time (Graph 2).

The causes the companies identified for the desolate state varied, however, the majority reported the same problems. In detail they complained about

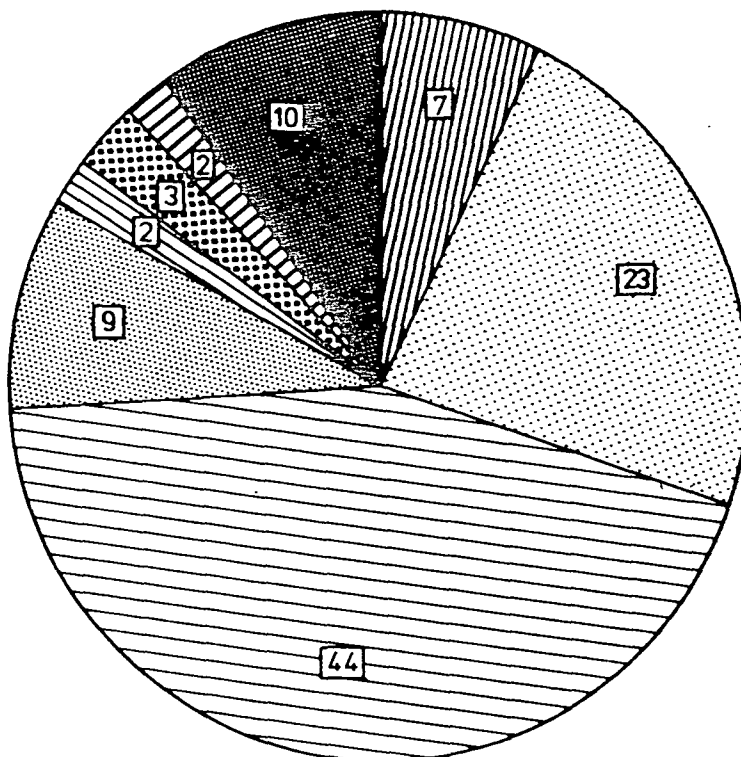
- too low sales
- too large and obsolete production capacities
- too large labour force
- too little funds for investment
- too fast wage increase.

In some cases answers were obviously inconsistent. While 70 p.c. of companies were complaining about difficulties in finding customers for their products and in getting access to trade distribution networks, only a small fraction of companies doubted the quality of their goods and services. Poor product quality, however, was one of the salient and most negative features of the socialist economies and their opening up induced massive substitution of domestically produced goods for (western) foreign goods: Eastern German producers did not only lose most of

their markets for cars, electronics, opticals, products of mechanical engineering and other sophisticated products but also for clothing, furniture and even for foodstuff.

**Graph 2**

**Self Assessment of Competitiveness by Eastern German Industrial Enterprises in Summer 1991**



**P.c. of enterprises take themselves for competitive**

within half a year	in an indefinite period
within one year	never
within two years	no assessment possible
in more than two years	at present full competitive

Source: Deutsches Institut für Wirtschaftsforschung, Berlin.

However strong or weak the companies may have been - they obviously also had a lot of illusions about their future prospects. The majority of them considered it to be sufficient to modernize plants, to improve marketing and, above all, to reduce labour force. Therefore, many companies favoured a defensive strategy of cost reduction and neglected innovative strategies

such as developing new products. According to the 1991 poll roughly 50 p.c. of enterprises were planning investment in new capacities, 40 p.c. sales activities and 30 p.c. staff cuts. Less than 10 p.c. considered the development of new products, the improvement of product quality and/or the reduction of product prices as urgent.

The overly optimistic expectations of companies were also reflected by their assessment of future competitiveness: 85 p.c. believed to become competitive within a period of two years, half of them even within one year. However, most of them were wrong: one year later, in summer 1992, more than 70 p.c. of firms initially or presently in the ownership of the Treuhandanstalt classified themselves as not competitive, in summer 1991 the figure was 90 p.c. Many companies believed that it would be possible to stabilize exports to the former COMECON-countries at a high level. They failed to turn around their exports from East to West or, as the consequence of their low competitiveness on western markets, to cut down their production. Instead of it they produced on stock - in the hope that the government would find a way to revitalize east-exports.

The data from the 1992 poll show that the expectations of private or privatized firms were somewhat more optimistic than those of Treuhand-firms (Table 2). The difference, however, was lower than possibly expected: 83 p.c. of Treuhand-companies reported to be not competitive, but also 67 p.c. of privatized companies initially in state ownership. A possible explanation for this small difference may be that the figures collected from Treuhand-companies were overly optimistic while those from the privatized companies were very realistic. The prime strategy of top managers in publicly owned enterprises is to keep their job as long as possible. Consequently, their main interest is to make the Treuhandanstalt believe that successful restructuring is possible. In this context it is instructive that according to the projections the Treuhandanstalt collected from her companies, sales in the first half of 1992 were planned to increase by 20 p.c., while in fact sales decreased by more than 20 p.c.

It is not surprising that companies yet before 1990 in private ownership or founded after 1990 demonstrated a much better performance than companies just privatized: about 60 p.c. of them considered themselves as fully competitive.

**Table 2 - Self-Assessment of Competitiveness by Eastern German Industrial Enterprises in Summer 1991 and 1992**

	1991	1992
... p.c. of enterprises considered themselves as non-competitive		
All enterprises	90 (a)	67
of which:		
Private enterprises	.	49
Privatized enterprises initially in state ownership	.	62
Private enterprises before 1990 in private ownership	.	44
Private enterprises founded after 1990	.	39
Treuhand enterprises	.	83
(a) Enterprises initially or still in Treuhand-ownership.		

Source: Deutsches Institut für Wirtschaftsforschung, Berlin.

*a) Production and Turnover*

A slight stabilization of turnover in the first half of 1992 - this was the major message of a poll taken from 250 Eastern German industrial enterprises in February 1992 (Table 3): 41 p.c. of companies expected increasing sales, 42 p.c. stagnating and only 17 p.c. decreasing sales. The overwhelming majority failed to come up to these expectations: according to official statistics sales decreased by about 17 p.c. in comparison to the second half year 1991. In face of these facts the initially optimistic forecasts that recovery in the Eastern German industry would begin to materialize in 1992 had to be revised considerably downwards.

The data grouping indicates that firms already privatized were significantly more optimistic in their sales projections than those in the Treuhand-ownership. The share of firms expecting increasing sales rose steadily among privatized firms while it dropped slightly among the Treuhand-firms from autumn 1991 to spring 1992. In fact, privatized firms were more successful in sales promotion than Treuhand-firms. While privatized firms were able to stabilize turnover in the first half year 1992, the Treuhand-firms suffered further from a significant decline. Certainly, for some part this result is due to biased selection - with an increase in the number of privatized firms the future of the non-privatized firms is becoming worse on average. For another and probably more important part, however, these figures seem to indicate that restructuring of privatized firms is running much more successfully than restructuring of Treuhand-firms.

**Table 3 - Expected (E) and Realized (R) Development in Turnover by Eastern German Industrial Enterprises (a)**

	Privatized Enterprises			Treuhand-Enterprises		
	Increasing	Stagnating	Decreasing	Increasing	Stagnating	Decreasing
1st Half Year 1991						
(E)	30	18	52	8	26	66
(R)	.	.	.	.	.	.
2nd Half Year 1991						
(E)	38	44	18	39	27	34
(R)	30	18	52	8	26	66
1st Half Year 1992						
(E)	47	35	18	34	49	17
(R)	33	37	30	29	29	42

(a) Change against previous half year; not seasonally adjusted.

Source: Institut für Wirtschaftsforschung, Halle.

*b) Market Shares*

The Achilles heel of most Eastern German industrial companies is low product quality. All companies have experienced a dramatic loss of market shares - both in export markets and in domestic markets. The situation is changing very slowly. In summer 1992 merely one half of the polled companies reported their market chances were beginning to improve (Table 4). However, while already 60 p.c. of privatized firms saw an increasing acceptance of their products only 44 p.c. of Treuhand-firms shared this view. It is not clear whether privatized firms have really been more successful in creating new or improved products. By all means, they have benefited from using the purchaser's distribution network of their partners in Western Germany.

**Table 4 - Acceptance of Eastern German Products 1992**

	Yes	Partly	No
... p.c. of enterprises with improving market chances			
Privatized enterprises	24	36	56
Treuhand enterprises	13	31	40

Source: Institut für Wirtschaftsforschung, Halle.

It is no surprise that the polled privatized companies have been more successful in entering "export markets" than the Treuhand-companies: their sales in Western Germany and foreign

countries in comparison to total sales rose from 28 p.c. in 1989 to 48 p.c. in 1991 (Table 5). The Treuhand-companies have been able to manage only a minor shift in their sales structure (from 35 p.c. to 39 p.c.).

**Table 5 - Sales of Eastern German Industrial Enterprises in Western German and Foreign Markets (in p.c. of Total Sales) 1989-1991**

	All Enterprises	Privatized Enterprises	Treuhand-Enterprises
1989	33	28	35
1990	39	37	40
1991	44	48	39
1992(a)	42	.	.

(a) 1st half year.

Source: Institut für Wirtschaftsforschung, Halle.

These findings are remarkable because many of already privatized companies are small and medium sized ones which usually have advantages in supplying local markets. They are often used as prolonged workbenches for domestic producers. Therefore, for the remaining Treuhand-companies export markets should be more important than home markets. However, these companies suffer to a great extent from the breakdown of trade with their former partners in Central and Eastern Europe. Treuhand-companies with strong performance in western export markets are still an exception.

### c) *Profits*

The dynamics of economic restructuring of Eastern German companies depend essentially on their possibilities of closing the productivity gap under the conditions of rapid wage increase. Although the companies have made some progress in cost cutting, according to the poll merely 22 p.c. of privatized firms and 10 p.c. of Treuhand-firms were making profits in spring 1992 (Table 6). Two thirds of all firms indicated that they expected to be back in the black until the end of 1993. On average, the privatized firms will reach the profit zone one year earlier than the Treuhand-firms.

Not all these hopes will come true. It is absolutely implausible that already in 1993 two thirds of the Eastern German industrial firms will reach profitability and that more than 90 p.c. of

them will reach profitability at all.<sup>2</sup> To a great extent the assessments expressed in the polls are based on the optimistic expectation that it will be possible to stabilize the exports to the states of the former Soviet Union. Such optimism is far from realistic. In recent months, trade with these states has completely collapsed and there is no reason to believe that it will recover soon. One should remember that one year ago 60 p.c. (!) of Eastern German industrial firms said in a poll that they expected to operate in the black already in 1992.

**Table 6 - Assessment of Eastern German Industrial Enterprises Reaching Profitability**

	Privatized Enterprises		Treuhand-Enterprises	
... p.c. of enterprises operate or plan to operate at profits on ... (a)				
31.03.1992	22	(22)	10	(10)
31.12.1992	20	(42)	15	(25)
31.12.1993	24	(66)	42	(67)
later	26	(92)	25	(92)

(a) In brackets: cumulated shares.

Source: Institut für Wirtschaftsforschung, Halle.

A nearly unsolvable problem for Eastern German companies is the fast wage increase. They will have to face a catch-up of tariff wages up to the Western German level by the end of 1994. This means: wages will nearly double during the coming 2 1/2 years. On the other side, the cost-cutting potential by raising productivity is - at least in the short run - limited: for the majority of firms it is impossible to compensate for yearly wage increases of more than 25 p.c. Assessments concerning the ratio of productivity to wage increase made in spring 1992 indicated that only 18 p.c. of firms were able to outstrip wage increases by equally large productivity increases (Table 7). 47 p.c. of Treuhand-firms and 29 p.c. of privatized firms failed to push productivity strong enough to compensate for wage increases. Although a significant number of firms reported that they had been able to close the gap in 1992, a hard core of firms has remained in trouble.

<sup>2</sup> Information from the Treuhandanstalt indicates that nearly none of her companies makes profits. According to Treuhandanstalt calculations average losses in 1991 accounted for 48 p.c. of companies' total turnover: 40 p.c. of companies (which have been classified as able to survive by means of their own efforts) reported losses of 15 p.c., 30 p.c. of companies (which can only survive with the support of strong partners) reported losses of 5 p.c., and 30 p.c. of companies (which have no realistic chance to survive) reported losses of 90 p.c. in terms of turnover.



**Table 7 - Assessment of Productivity and Wage Increase by Eastern German Industrial Enterprises**

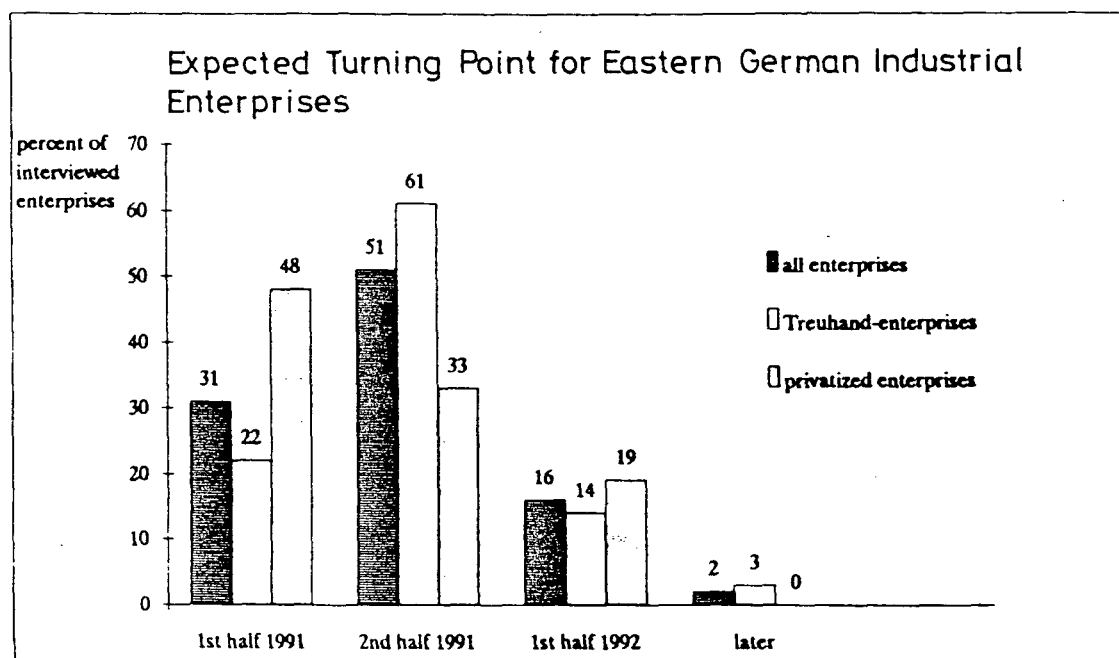
	Privatized Enterprises		Treuhand-Enterprises	
	1991	1992	1991	1992
Productivity increase faster than wage increase	24	33	16	31
Productivity increase equal to wage increase	47	28	37	31
Productivity increase lower than wage increase	29	39	47	38

Source: Institut für Wirtschaftsforschung, Halle.

### 3. Prospects

In summer 1991 31 p.c. of polled firms believed to have already passed their lowest point and 51 p.c. of firms expected to have passed it at the end of 1991 (Graph 3). This assessment has proved to be far too optimistic. Latest statistical figures indicate a new setback in orders and production - indicating that the expected recovery will not begin to materialize before spring 1993.

**Graph 3**



Source: Institut für Wirtschaftsforschung, Halle

Regardless of this general error of judgement there were significant differences between the privatized and Treuhand-firms. On average, privatized firms expected to pass their turning point four to six months earlier than Treuhand-firms. This can also be seen as a clear sign for different efforts in economic reorganization: while 76 p.c. of the privatized firms were convinced to be running successfully, only 25 p.c. of Treuhand-firms expressed this view.

Clearly it is no surprise that an already privatized firm can be more optimistic about its prospects than a firm still in Treuhandanstalt-ownership: the best firms will be transferred first from state to private hands. But also a promising state-owned enterprise is facing an uncertain future as long as it remains under the shelter of a state agency. Consequently, many companies lament over the slow decision process in the Treuhand-bureaucracy. For example, 58 p.c. of the polled firms reported troubles with the Treuhandanstalt - they doubted that she was running restructuring successfully. A big problem for the firms is to get the agreement of the Treuhandanstalt to their reorganization concepts. Without this agreement they have no access to bank credits and thus they are unable to finance any investment. The Treuhandanstalt may have good reasons to refuse its approval to the firm's restructuring concepts - many firms are hardly in circumstances in which they can be restructured without further ado, and some firms cannot be restructured at all. However, a company which is not able to invest is running unavoidably deeper into difficulties.

### **III Adjustment Behaviour in Private and State-Owned Enterprises: The Evaluation**

Evidently, privatized firms provide much better preconditions for successful restructuring than Treuhand-firms. They have - in contrast to many Treuhand-firms - a chance to become viable at all, because

- they have a convincing entrepreneurial concept;
- they have access to funds for capital investment and
- they have the possibility to establish a new promising management.

It is a speciality of the German model of privatization that the Treuhandanstalt does not sell any enterprise unless these requirements are fulfilled (Hax 1992, Schatz 1992). As far as possible the Treuhandanstalt takes into consideration not only the needs of the companies to be privatized but also the wishes of private investors. She tailors the enterprises according to the investor's concept. Thus a privatized enterprise has better prospects for future success than enterprises remaining in Treuhand-ownership.

## 1. Selected Adjustment Indicators

All Eastern German industrial companies have implemented various measures to stabilize or, if possible, to even improve their economic situation. In the short term, however, the main objective of the management has been to secure the companies mere survival. Thus, adjustment behaviour has been dominated by defensive strategies. The most urgent task has been to cut costs by reducing employment. Only gradually have companies started to implement offensive strategies in order to improve their long-run prospects. According to two polls from summer 1991 and 1992 companies mainly have

- set up or extended their activities on other regional markets,
- changed their product assortment,
- started the manufacture of new or considerably changed or improved products,
- rationalized extensively (Table 8).

Although the strategic behaviour of privatized companies and Treuhand-companies mostly exhibits strong similarities, striking differences are visible. In the latest poll

- 52 p.c. of privatized companies reported on extensive rationalizing while only 37 p.c. of Treuhand-companies did so,
- 62 p.c. of privatized companies saw the necessity to modernize their equipment while only 39 p.c. of the Treuhand-companies did so,
- 55 p.c. of the Treuhand-companies made efforts to splinter off parts of their activities while out of privatized companies - which have been carefully tailored before the privatization - only 35 p.c. did so.

The 1992 poll shows clearly that most of these measures are still of great importance for both groups of companies - but compared with the previous year they seem to be more important for Treuhand-companies than for privatized ones.

**Table 8 - Measures for Restructuring Implemented by Eastern German Enterprises in Summer 1991 and 1992**

	... p.c. of all companies have taken the following measures(a)			
	Privatized Enterprises		Treuhand-Enterprises	
	1991	1992	1991	1992
Tightening of product assortment	28	16	35	24
Enlarging of product assortment	57	.	58	.
Reducing of manufacturing penetration	15	6	21	16
Setting up or extending of companies' activities	66	79	71	89
of which				
in Eastern Germany	5	} 79	56	} 89
in Western Germany	31		40	
in western foreign countries	12	25	20	54
in eastern foreign countries	7	28	17	43
Increasing supply of pre-products by non-Eastern-German companies	30	24	38	27
Manufacturing new or considerably changed products	59	47	62	61
of which				
based on their own research and development or in cooperation with others	36	.	42	.
in licence production or off-shore production	22	.	25	.
Extensive rationalizing	52	52	37	54
Splitting up of company units	35	4	55	29
Reorganizing of internal cost calculation	50	42	54	52
Investing in new equipment	62	52	39	52
Reducing employment	.	16	.	51

(a) Multiple entry allowed. Individual items may not add up to 100 p.c.

Source: Deutsches Institut für Wirtschaftsforschung, Berlin.

### *Investment*

Capital investment is the most important vehicle in driving the process of restructuring. Nearly all Eastern German companies have invested in both plant and equipment modernization - in order to cut costs, to improve product quality and to strengthen their international competitiveness. Nevertheless, different patterns do appear: data grouping indicates that investment activities of privatized firms are much stronger than investment of Treuhand-firms (Table 9). In 1992 the level of realized and planned investment per employee is four times higher, and the share of investment in turnover is twice as high for privatized as for Treuhand-firms. This can be

interpreted as a further sign that privatized firms are focusing on long-term restructuring while Treuhand-firms are predominantly short-term oriented and mainly invest in order to secure survival. According to the latest poll privatized firms will invest 24 000 DM per employee in 1992, which is two thirds above the same ratio for firms in Western Germany (14 000 DM). In contrast, investment per employee of Treuhand-firms will remain very low - on average 5 000 DM. Obviously, in many Treuhand-companies the management has lost courage and has given up.

**Table 9 - Fixed Capital Investment by Eastern German Industrial Enterprises 1991 and 1992**

	Per Enterprise (Mill. DM)		Per Employee (DM)		Per 100 DM/ Turnover	
	1991	1992	1991	1992	1991	1992
Privatized Enterprises	4.7	9.5	11200	24100	30	40
large	9.0	28.5	8400	24900	.	.
small and medium	2.5	3.4	13000	22100	.	.
Treuhand-Enterprises	7.2	6.5	3900	5800	10	20
large	18.6	15.4	4200	5000	.	.
small and medium	0.8	1.4	3500	6500	.	.

Source: Institut für Wirtschaftsforschung, Halle.

The poor investment activities of Treuhand-companies are also emanating from financing problems. Since they are not able to obtain money from the capital markets they must operate with money of the Treuhandanstalt (e.g. in form of allocating equity capital) or with short-term bank credits (which must be backed by Treuhand-guarantees). In contrast to this privatized firms have a much better access to sources of financing - not only to bank loans but also to other funds as obtaining direct financing from western partners and from public investment support programs (Table 10).

**Table 10 - Main Sources of Financing of Capital Investments of Eastern German Industrial Enterprises in 1992 (p.c.)**

	Privatized Enterprises	Treuhand-Enterprises
Own financing	32	32 (a)
Credits	40	54
Financing by western partners	7	1
Financing by public promotion programs	18	12
Others	3	1

(a) Including direct financing by the Treuhandanstalt.

Source: Institut für Wirtschaftsforschung, Halle.

### *Employment*

An enterprise whose existence is at stake cannot avoid closing unprofitable lines of production and reducing workforce. The Eastern German industrial companies have been heavily over-staffed. Consequently, employment in the industrial sector has decreased dramatically - up to now - down to 40 p.c. of its previous level.

Normally, for a privatized enterprise it is much easier to fire workers than for a public enterprise. The results of different polls indicate that Treuhand-companies have been able to delay the process of reducing employment for some time. Now the situation has changed - a wave of dismissals is under way: the Treuhand-firms have announced to reduce their workforce in 1992 by approximately one third, mostly in order to eliminate overemployment which so far has been hidden by means of short-time work (Table 11). In this respect privatized companies are strongly different from Treuhand-companies: they have obviously less need for further staff cuts. But it should not be overlooked that privatized firms are generally in a better position since an investor can press the Treuhandanstalt to reduce the workforce before changing ownership - in the course of the privatization she runs down the number of employees by two-fifth on average. Nevertheless, not all privatized firms are out of the wood. Some of them have difficulties in stabilizing employment on the promised level.

**Table 11 - Planned Dismissals and Short-Time Work in Eastern Industrial Enterprises 1992 (in p.c. of Employed Persons)**

	Dismissals		Short-Time Workers		
	Year	of which:	January 1992	June 1992	December 1992
		2nd Half Year			
Privatized enterprises	-8	-2	10	10	6
of which:					
In ownership of Western German or foreign enterprises	-11	-2	9	9	4
Treuhand-enterprises	-31	-18	23	22	13

Source: Deutsches Institut für Wirtschaftsforschung, Berlin.

Another big problem for the Treuhand-enterprises is not only sustaining labour surplus in general but also growing shortage of specific kinds and qualifications. An enterprise in trouble is mostly left by its most mobile and qualified workers. Treuhand-companies thus are suffering more than privatized companies from negative selection. The only means to stop the exodus would be paying competitive wages. However, Treuhand-companies are seldom in a position which would allow to do this.

## 2. Self-Assessment of Restructuring Strategies

It is no surprise that privatized companies and Treuhand-companies think differently about their prospects: the first group is much more optimistic than the second one, and this is certainly justified. Privatized companies are in a better starting position than Treuhand-companies. Above all, they have a convincing entrepreneurial concept and they have the opportunities to realize it. Although the majority of the remaining companies has been classified by the Treuhandanstalt as viable the management of these companies is doubtful about the efforts undertaken so far. According to the 1992 poll only 25 p.c. of Treuhand-companies are convinced that their adjustment is running successfully, whereas 76 p.c. of privatized companies expressed this view (Table 12).

**Table 12 - Self-Assessment of Restructuring Strategies by Eastern German Industrial Companies**

	Restructuring program is considered by ... p.c. as		
	successful	partly successful	not successful
Privatized companies	76	10	14
Treuhand-companies	25	36	39

Source: Institut für Wirtschaftsforschung, Halle.

It has become evident that many companies under the charge of the Treuhandanstalt will never become viable - except with heavy subsidies. A state agency with only 3 000 employees is hardly able to restructure the presently remaining 4 000 companies. This is why the management of these companies now finally favours rapid privatization, after refusing it for a long time.

## IV Privatization and Reorganization: The Conclusions

Although the paper suffers from a number of short-comings due to a poor database it provides some evidence that a change in ownership - from public to private - is most important for creating significant improvements in the efficiencies of former socialist companies. It would be quite wrong to ignore the findings which have been described.

The benefits of privatization are obvious: the company obtains a promising entrepreneurial concept, fresh money for financing investment and a new management. It is not easy to decide what is more important. The keystone for improving the company's performance is perhaps the change in the management style (Bishop, Kay 1992). The former socialist managers have a preference to emphasize more engineering than marketing and financing; they have always maximized output instead of profit - and they have never learnt to think in terms of opportunity costs. It is unlikely that they will be able to change their style by frustrating contacts with a

sponsoring department of a state-owned agency. Consequently, the managers of many Treuhand-companies remain in a waiting position. They believe in the Treuhandanstalt's capability to find either a private investor - or to hold out the company by providing liquidity. Through this, necessary decisions concerning the company's future are delayed.

Certainly, privatization is not a panacea. The paper makes clear that under the special conditions in Eastern Germany, where enterprises were suddenly exposed to competition without any protection by trade barriers or an exchange rate, privatized firms are facing hard times as well as firms under the charge of the Treuhandanstalt. However, there is strong evidence that the privatized firms will cope with the problem much better than the Treuhand-firms.

The paper also underlines the merits of the German two-stage approach of privatization - first tailoring and selling companies on the basis of individual negotiations and according to concepts of potential investors, and second reorganization and restructuring under private ownership. It is obviously the best way to make the formerly socialist companies fit for the market economy, and in this respect superior to other forms of privatization favoured in Central and Eastern European countries such as equity privatization, employee ownership or voucher privatization.



## Appendix

### On the Ownership Structure in Eastern German Manufacturing

The ownership structure in Eastern German manufacturing is still a "black box". There is no consistent data base which would allow correct calculations. In the following available data from official statistics and from polls are mixed; missing data are estimated as far as possible.

The definition of "manufacturing" adopted here corresponds to the Statistisches Bundesamt's reporting practice.<sup>3</sup> Included are only enterprises with 20 and more employees. Excluded is - by this limitation - the majority of firms of handicrafts. Insofar, the data refer by and large only to enterprises which form the so-called "industrial sector".

The classification of ownership categories is normally done by differentiating between legal owners. In Eastern Germany, however, there is a great number of enterprises with a mixed ownership - due to the fact that the Treuhandanstalt is privatizing not only complete enterprises but often parts of them. Many of the enterprises classified to still be privatized are yet partly in private hands. Through this the share of Treuhand-ownership may be somewhat higher than indicated in the figures.

The used data apply to enterprises (Unternehmen) as legal units - not to local units (Betriebe). An unknown number of local units in Eastern Germany is in the ownership of enterprises which have their headquarters in Western Germany. By definition, they should be excluded from reporting. However, it is not clear whether this problem has been handled sufficiently in the different statistics.

Within the private sector a distinction is merely made between enterprises in the ownership of Eastern German citizens and of Western German and foreign companies. No distinction is possible between those private enterprises which were either private before 1990 or were founded after 1990 and those former state-own enterprises which have been privatized. The used poll data mostly refer to the second category, but in a few cases they included also the first one.

According to latest official statistics (July 1992) the number of enterprises (with 20 and more employees) in Eastern German manufacturing was 5400 (Table A1).<sup>4</sup> From the polls one can derive that 77 p.c. of them were in private ownership, 23 p.c. in Treuhand-ownership. However,

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<sup>3</sup> Statistik im Bergbau und im verarbeitenden Gewerbe.

<sup>4</sup> The number of local units (Betriebe) was about 6200.

these figures are partly misleading because private enterprises are on the average much smaller than Treuhand-enterprises. In terms of employment the industrial sector is still dominated by Treuhand-enterprises: their polled share was 67 p.c.

**Table A1 - Ownership Structure in Eastern German Manufacturing (a) - State: July 1992**

	Enterprises		Employees	
	No.	P.C.	No.	P.C.
Total	5400	100	900000	100
of which:				
Private Enterprises	4160	77	390000	33
in the ownership of				
Eastern German citizens	3560	66	215000	24
Western German or foreign companies	600	11	175000	19
Treuhand-Enterprises	1240	23	510000	67

(a) Enterprises with 20 and more employees.

Source: Statistisches Bundesamt; Deutsches Institut für Wirtschaftsforschung, Berlin; own calculations.

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