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REPORT

Selected Principles, Elements and Experiences of Privatisation in Germany

Karl Fasbender

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Karl Fasbender

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PREFACE

In most states with market oriented economic systems privatisation plays an important role in the political discussion, mainly due to the fundamental problem of all economic systems, which is scarcity of available resources. The responsible politicians try to improve the allocation of scarce resources and to increase the financial possibilities for needed development investments by creating an adequate macroeconomic framework and a business-friendly environment. Within the scope of these efforts the production of goods and commercial services by state-owned enterprises only plays a very limited role. The state would be best advised to leave these functions to the, in this regard, more efficient private sector. The public sector should concentrate its respective efforts only on the production of so-called Public Goods and, for political reasons, eventually on some sub-sectors, which are essential for the security of the country.

Nearly all market economies and especially states which are in the transitional process from more centrally administered to market oriented economic systems, have room for manoeuvre towards privatisation of state-owned enterprises. Privatisation facilitates the improvement of factor allocation and the reduction of budget constraints, not only by the way of sales revenues but also by creating a broader tax-base, decreasing the need to provide subsidies and, last but not least, mobilising private resources for the aimed development-process. This is also true for the Republic of India as well as for the Federal Republic of Germany.

However, privatisation causes not only advantages for the economic systems and the public budgets, but also some economic and financial costs. These costs have to be reduced as much as possible by an efficient target-oriented policy. Although the corresponding policies and experiences in one country can hardly be a blueprint for another country, a policy-dialogue at various levels about privatisation and on the underlying legal and economic frameworks is helpful for all involved parties. The exchange of experiences can also contribute to the avoidance of disappointments and setbacks that could jeopardise the privatisation policy introduced.

Relating to the above the Government of India noticed: "Thus, while one would do well to learn from the successful experience, one would have to be careful of the pitfalls as well. In the final analysis, while experience of other countries is available by the way of guidance, one would have to evolve one's own techniques, best suited to the level of

development of the country. ... The historic, cultural and institutional context influences the way in which and the pace at which privatisation is implemented” (Ministry of Disinvestment 2003, p.1). Experience sharing between experts of different countries is an appropriate way of learning from each other and avoiding the disadvantages of blue prints at the same time.

On initiative of the Ministers of Finance of the Republic of India and the Federal Republic of Germany, both governments agreed, therefore, to enhance the exchange of experiences about disinvestment/privatisation in the framework of economic co-operation. The Ministry of Disinvestment (since June 2004: Department of Disinvestment in the Ministry of Finance) and the Bundesministerium fuer wirtschaftliche Zusammenarbeit und Entwicklung, BMZ, (Federal Ministry for Economic Cooperation and Development) are the responsible authorities. The German contributions will be provided by the Deutsche Gesellschaft fuer Technische Zusammenarbeit, GTZ, (German Agency for Technical Cooperation) on behalf of BMZ.

This Report gives an overview of selected principles, elements and experiences of privatisation in Germany, with special reference to the new Federal States in East Germany and under consideration of selected aspects in neighbouring countries. The intention is not to present a complete abstract, but to provide a discussion basis for identifying starting points for a future dialogue about lessons learnt. This paper was elaborated by the Hamburg Institute of International Economics (HWWA) at the instigation of Sanjeev S. Ahluwalia, IAS, (Department of Disinvestment) and Dr. Dietrich Kebschull (GTZ). The author would like to express his sincere thanks to both of them as well as to Gunnar Geyer, Carsten Hefeker, Britta Jens and to Rasul Shams (all HWWA) for their valuable suggestions.

As this overview might be of interest also for other purposes, it was published, with some deviations, by HWWA with the friendly permission of GTZ.

Hamburg, June 2004

Karl Fasbender

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ABBREVIATIONS

ABM	Arbeitsplatzbeschaffungsmaßnahmen (work-promotion measures)
AG	Aktiengesellschaft (limited company)
ASB	Arbeitsbeschaffungsgesellschaften (employment companies)
BMF	Bundesministerium der Finanzen (Federal Ministry of Finance)
BMZ	Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung (Federal Ministry for Economic Cooperation and Development)
BvS	Bundesanstalt für vereinigungsbedingte Sonderaufgaben (Federal Agency for special tasks of German unification)
DAG	Deutsche Angestellten Gewerkschaft (German Employees Trade Union)
DGB	Deutscher Gewerkschaftsbund (German Federation of Trade Unions)
DM	Deutsche Mark (1.95583 DM = 1 Euro)
EBO	Employee-Buy-Out
EU	European Union
FAZ	Frankfurter Allgemeine Zeitung
FDI	Foreign Direct Investments
GDR	German Democratic Republic
GOI	Government of India
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit GmbH (German Agency for Technical Cooperation)
HWWA	Hamburgisches Welt-Wirtschafts-Archiv (Hamburg Institute of International Economics)
IMF	International Monetary Fund
KG	Kommanditgesellschaft (limited partnership)
LLBO	Leveraged Lease-Buy-Out
MBI	Management-Buy-In
MBO	Management-Buy-Out
NZZ	Neue Zürcher Zeitung
OECD	Organisation for Economic Co-operation and Development
POE	Privately-owned enterprises
SOE	State-owned enterprises
THA	Treuhandanstalt (public trust agency)
US\$	US Dollar
ZL	Polish Zloty

1. Background of Privatisation

Scarcity of financial, but also of human and natural resources is and always has been a major problem for consumers, producers and politicians in all societies, developed and less developed ones. The main challenge of all players in the development process is to allocate available scarce resources in an efficient way, in order to reach an optimal output. Without continued and successful efforts towards an improved allocation of resources the economies of all societies cannot reach an appropriate gross domestic product and a sufficient standard of living.

1.1 Theoretical Basis

In theory only two basic solutions for the steering process needed for an optimal allocation of resources are conceivable. In reality mixtures between these two basic solutions have been applied (cf. on this and the following Borrmann, Fasbender, et.al. 1990, pp. 15). For the following remarks it will be sufficient to concentrate on the two basic solutions:

1. **Centralised decision making** by organs of state: Experiences in all parts of the world (not only in socialist or communist countries) have shown, that **centrally administered economic regulatory systems** are not able to solve the problem of scarcity in a proper way. Above all, these systems lack adequate instruments and incentives as well as effective sanction mechanisms to induce rational economic behaviour. The economic signals in this system are too weak to adhere to the principle of minimising inputs and maximising outputs. Not seldom production firms even tend to the opposite. This is especially true for state-owned firms, which are typical for this kind of economic system. But in strict regulatory economies this is also partly true for privately owned companies. For the firms as well as for the whole economy the above mentioned framework conditions results in any case in a relatively low level of efficiency and dynamism, connected with insufficient incentives to introduce new innovations for reaching higher outputs at lower costs and/or a better quality. Poor economic results of centrally planned economies are the main reason for turning away from this system in nearly all states of the world.
2. The basic alternative is a **decentralised economic system** respectively a **market-economy system**. In this system consumers and entrepreneurs plan their own

consumption or production of goods and services on an individual basis, without central control. This means that it is up to the citizens to determine on basis of the available resources what is consumed, what is produced, how it is produced and for whom. The co-ordination of the different planes takes place by way of free price formation and competition in markets. As the decision-making process of the individual companies has to take place on the basis of their own limited resources, the entrepreneurs try continuously to find a more efficient way for the optimal utilisation of available scarce resources.

Market prices indicate the relative scarcity of goods and services. Changes in prices act as a signal that production and the use of factors of production need to be adjusted to the changed levels of scarcity. Rising prices – for instance - signal growing scarcity and act as a spur to increased production (signal function) and vice versa. Market prices also act as a punitive mechanism (sanction function) for suppliers who are insufficiently competitive. Such suppliers will be eliminated from the market if the going price is no longer sufficient to cover their production costs. However, the prices also simultaneously act as an incentive for entrepreneurs to increase productivity or to produce alternative products to draw a sufficient or greater profit from their market positions (incentive function). Therefore, price mechanism and competition determine a constant pressure to raise the efficiency of factor inputs. This includes a steady pressure towards an optimal utilisation of scarce resources. This means, the market economy has an effective system to raise the efficiency of factor inputs, based on the available (limited) resources (cf. Borrmann, Holthus 1992, p. 16).

Consequently the main players in market economy systems are private entrepreneurs and consumers, not the state in his role as a producer of goods and services. Nevertheless, the state has to play an important role as a moderator and facilitator of the economic system. His main function is the provision of the needed institutional and physical infrastructure, especially the necessary legal framework for all players in the market system. Above all an undistorted price mechanism, a functioning competition, private property rights, individual control over property and the free choice of occupation and business have to be provided. This includes correctives against market failures (for example caused by monopolies) and, in the case of social market economies (e.g. in Germany) or market economies with a human face (e.g. in India), socially oriented safety measures.

It is apparent, that in a market economy with a decentralised decision-making process state-owned firms are an alien element. These firms, even profit-making ones, are usually less efficient than private ones. Via subsidies, political motivated targets, etc., they often initiate furthermore distortions of price mechanism and competition, damage the allocation of public resources and affect the mobilisation of private resources. Last but not least in most cases it is cheaper to buy goods and services instead of producing them by public companies. Therefore **the state should not act as a producer of goods and services. Exceptions** should be the **production of so called public goods**, only (education, health, infrastructure, etc.). However an increasing part of these products is produced in many states, including Germany, more efficiently by private firms.

1.2 Selected Consequences

- In market oriented economies, in which state-owned firms still play a substantial role in the production process (because of tradition, a broad definition of public goods, etc.) **privatisation should increase the efficiency of the economic system as well as of the privatised companies**. Last but not least privatisation should **provide additional public resources** (by means of less subsidies, broader tax base and/or sales earnings) and **mobilise private resources** for the development process.
- During the transition process from a centrally planned economic system towards a market economy, in which the ownership structure is still embossed by public firms, **privatisation should result in addition in a new private and institutional structure**, replacing the existing system with its low efficiency pressure and distorted price signals.

In both cases **privatisation has to be connected with deregulation and demonopolisation**, especially with regard to a functioning competition, the driving force of a market economy. Not only public but also private monopolies distort market prices and competitiveness. In case of natural monopolies or medium-term needed monopolies (e.g. during restructuring-processes) an independent regulatory or supervisory authority may be useful (e.g. in the case of German Telecom).

As a result of deregulation “Competition may not be increased overnight, but over a longer term industrial restructuring and technological change may make markets more contestable and so create a spur towards increased efficiency. The initial criticism that

privatisation did nothing other than change ownership of property rights failed to recognise the dynamic nature of privatisation, and instead analysed it in a very short-term, static framework.“ (Bailey 1995, p. 306).

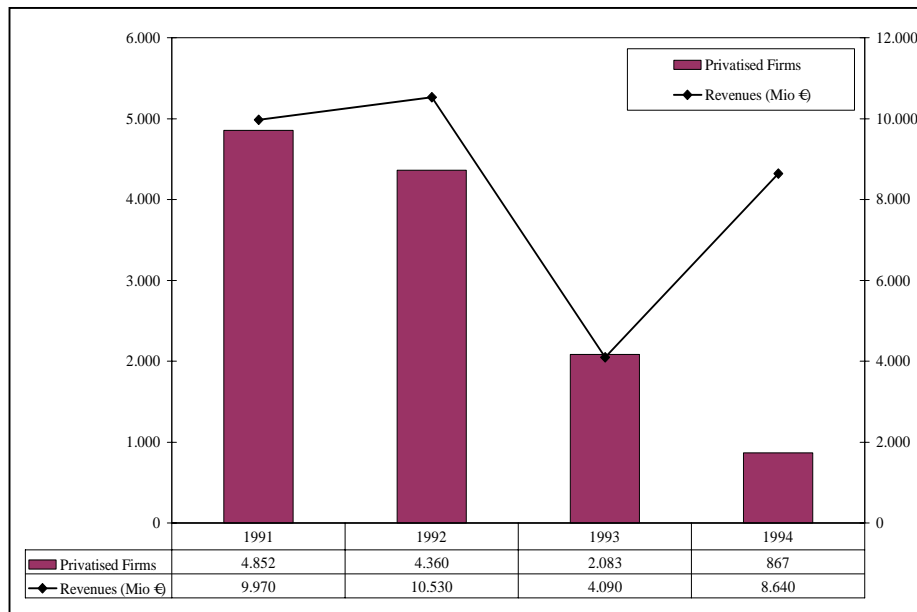
2. Main Reasons for Privatisation

In Germany both of the main reasons for privatisation, stated above, were given: Privatisation to change a centrally administered economic system into a decentralised market system (in East Germany) and privatisation to improve the existing social market economy system (in West Germany).

2.1 Challenges in East and West Germany

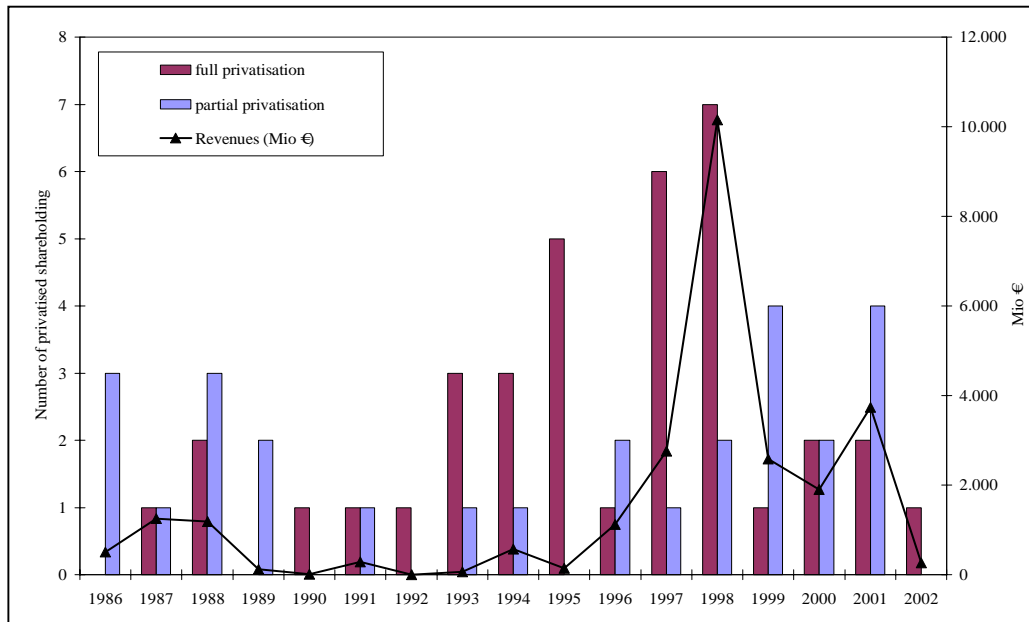
During the transition process of the centralised economic system in the former German Democratic Republic (GDR or **East Germany**) to the decentralised market system of the Federal Republic of Germany (West Germany) about 8,500 state-owned enterprises (SOE), which were separated, mainly for reasons of demonopolisation, into nearly 14,000 companies, had to be privatised within less than five years from 1990 onwards. In fact 12,162 companies have been sold for totally 33.23 billion Euro (see Chart 1),(from these firms 855 enterprises have been sold to foreign investors). 265 enterprises have been handed over to the communities. About 3,000 or nearly one quarter of firms have been liquidated partially or totally, compared with around 40% in Poland. In the framework of a so-called ‘small privatisation’ about 25,000 other small business-undertakings (hotels, shops, pubs, restaurants, etc.) have been sold to private investors. In addition, 4,300 firms have been given back to their former private owners. (cf. among others Breuel 1994, pp. 14 and Vetter 1995). **The responsible agency for privatisation** in East Germany was the **Treuhandanstalt** (usually called Treuhand or THA). This public trust-agency was established (1990) only for the purposes to hold in trust and to privatise all public undertakings in the former GDR. The Treuhand acted – relatively independent, but supervised by the Federal Ministry of Finance – on the basis of a special law and the unification treaty (Art. 25). The operations of THA ended in December 1994 and were completed by a successor-agency (BvS).

Chart 1: Privatisations and revenues of the Treuhand, 1991-1994



Source: Mohamed Alsayani, Privatisierung als Politik der Entstaatlichung und der Systemtransformation, Frankfurt 1997, p. 94

Chart 2: Privatisations and revenues of the German Government, 1986-2002 (without Treuhand 1991-1994)



For detailed data see Annex 1.

Source: BMF, Bundesbeteiligungsbericht, Berlin, several volumes.

- But also in **West Germany** the Federal Government, the Federal Countries or States (Bundesländer) and the Communities have owned and still owns a lot of public firms, in spite of ongoing privatisation since the 1960s and increasingly since the mid of the 1980s (see Chart 2). This is because of the historical development as well as the former broad definition of public goods. For example, the Federal Government still holds a part of the shares in the telecommunication company (31%), the postal services (50%) and the railway company (100%). The Federal Countries hold, for instance, shares in energy supply companies, banks, airports, universities and in a few cases they have even some shares at production firms (e.g. Volkswagen). Many of the 16,000 Communities still have the ownership at local transport undertakings, water supply companies, lodging-companies and other firms. The Communities in the former GDR, even in the framework of privatisation, got about 265 firms, as mentioned above. Totally the Communities still hold shares (sometimes only a control stock) in nearly 100,000 small and medium scale undertakings. In comparison, the Federal Government has investments in 120 companies (1982: in 958 and 1991 in 214 firms). In 37 of these 120 enterprises (2002) the government has shares of at least 25% (cf. BMF 2002).

In the Federal Government and the Federal States the Ministries of Finance are usually responsible for privatisation. Management consultant firms and/or banks do most of the practical work on their behalf. Also the Communities choose their operational consulting firms or experts on a case to case basis, according to the requirements of privatisation.

2.2 Main Motives for Privatisation

Although privatisation in West Germany already began during the early 1960s, the process is still ongoing, as the above mentioned figures underline. One of the reasons for the step-by-step approach is a ‘resistance-coalition’ between the trade unions of public employees and a part of politicians in nearly all parties. Many civil servants fear to lose some advantages from their public status and/or to lose their job. Some politicians would like to save the “family silver“ for times of need and/or to keep direct political influence. In the meantime the scarcity of public resources has forced the politicians to rethink their opinion. Privatisation on all public levels is speeded up, also in the other West European States. **Budget constraints** in the meantime **have become**

one of the main motives for privatisation. Also in these cases the Competition and Anti-Cartel Laws of Germany and the European Union have to be considered.

In all it can be stated that a lot of public enterprises have been privatised under different business environments in Germany. **Nearly all existing methods have been applied.** Also **different elements of a social safety net have been adopted.** This means, many years of experiences with privatisation are available. Although socio-economic **experiences in one country should not and cannot be a blue-print for other states,** they should consider the experiences for their own decision making. This has been done for instance by the East European States, which have supplemented the methods, used in Germany by new elements, including so-called ‘give-away schemes’, mostly ‘voucher schemes’.

In the following some general lessons learnt and different methods of privatisation in Germany, in selected cases also from neighbouring countries, are outlined. Special emphasis is given to the elements of privatisation in East Germany after reunification, because nearly all procedures were tested and/or adopted in this part of Germany. The aim of this paper is not to give a complete abstract or to review the Treuhand policy as a whole. The purpose is to provide an overview of elements employed as a basis for discussion and/or more detailed analyses of specific subjects or procedures.

3. Requirements and Procedures of Privatisation

Different methods can be used for privatisation. In principle they do not differ from the methods which private entrepreneurs use to sell their firm to another private investor. The selection of the most appropriate method depends on kind and size of the undertaking, the situation on capital markets and, last but not least, on the expected number of potential buyers. In any case, **two general requirements should be fulfilled:** A transparent privatisation process and due diligence of company.

The **due diligence or valuation of company** is the needed basis for identifying the potential sales-price. As a basic principle the value of the firm can be derived in two ways. Either by considering the current (net) value of all assets or by calculating the expected value of net inflows (discounted future cash-flow methods). A special form of

the current value assessment is the break down or liquidation value method. In this case the lowest limit for the sales-price will be calculated. In other words, if no offer will be given above this price limit, it is financially more justified to liquidate the firm. In reality auxiliary expedient methods often have to be used, because procedures of bookkeeping, etc. in public sector do not provide the required information. This due diligence can be carried out by management and internal experts of the seller or by independent management consultants or firms. The second alternative usually provides a better basis for price-negotiations. But in any case, the price is always the result of negotiations, auctions or of the demand on the stock market (cf. among others Alsayani 1997, pp. 54).

The second general requirement is a **transparent privatisation procedure**, mainly for two reasons. **Firstly**, to inform a high number of potential investors in order to achieve reasonable sales revenues. Main precondition is to provide a chance to all potential buyers to declare their interest. Therefore, at least “the details of any privatisation of state property should be made public in advance (...). Within a fixed period of time, say six weeks for large firms and three weeks for small firms, every one should be entitled to make a counter-offer, ...”. This general rule has to be adopted according the special situation, e.g. in case of selling shares, according the regulations of the stock market. **Secondly**, to minimise “the danger of abuse, corruption and insider deals and the ensuring political problems...”(Schmiedling 1991, p. 105). That means, the decision making process, including the decision criteria, should be as transparent as possible: formalised, standardised and anonymous.

3.1 Selected Methods of Privatisation

The utilisation of many different privatisation methods in Germany was mainly the result of the ‘shock therapy privatisation’ in the eastern part of the country, which required ‘creative utilisation’ of available privatisation instruments. In the following some selected privatisation methods will be outlined (cf. among others Alsayani 1997, pp. 88).

- **Sales of state-owned enterprises (SOE) on the stock market:** Business organisation, staff payment and legal aspects of SOE differ, as a rule, from those of private companies. Therefore, changes of legal status of the enterprise and the corporate culture are needed. The SOE has to be commercialised and to be prepared

for the requirements of the stock market. The offer for the sale of shares will usually be done by way of a bank or a consortium of banks. If the enterprise is a monopoly two additional steps have to be taken beforehand: separation of the enterprise into several units and measures to avoid misuse of the monopoly status of the non-competitive parts (see 'Demonopolisation' in Chapter 4.1). The whole process is not only time consuming but also causes relatively high transaction costs. Therefore **this method is only justified for large scale enterprises and concerns with positive streams of present and/or expected income (positive market price)**. Furthermore, a functional capital market is indispensable for stock market sales.

The advantage of this method is that high sales revenues can be achieved. If the capital markets do not allow the sale of all shares at appropriate prices, the **shares may be sold in several tranches**. The owner has the option to wait for selling the remaining parts of shares in a more propitious situation on the stock market. This also has the advantage that the public owner may keep for some time a strategic control stock (25.1% of shares) or even the majority of shares, if wanted. In these cases the stock market defines the price for remaining sales. This procedure has been used, for instance, in the cases of Lufthansa (where the politicians wanted to keep for some time a control stock) and of German Telecom (where the politicians intended to maximise the outcome per share). In the case of Lufthansa it is noteworthy that the Central Government reduced its proportion of shares not only through sales but also by non-participating at capital increases of the company.

But improving the market mechanism and receiving high sales revenues were not exclusive objectives of the government. The Central Government also intended to introduce **shares as a form of saving and capital accumulation to the general public**. For this purpose in the 1960s the shares of some companies (Volkswagen, VEBA, etc.) were issued with a low par value and could be bought by people with a limited income for a preferential price. These shares were called **people's shares** (Volksaktien). This procedure enabled some 4.5 million Germans to become shareholder with a total amount of roughly 500 million Euro. Later on, this complicated procedure (because of the necessity of reviewing the income situation of purchasers) was changed. A kind of loyalty bonus system was introduced: All private, non institutional buyers were allowed to buy a limited number of shares at a preferential price, under the precondition that they keep the shares for a certain period. As an example Deutsche Telekom may be highlighted. Its respective policy made shares very popular in the population. Moreover, the employees of Telecom

were entitled to buy **employees shares** (shares with a special discount – cf. also Chapter 4.2).

The **policy of distributing shares or vouchers free of charge** (except for a few bonus shares) **was not introduced in Germany**. (The same is true e.g. for China, Vietnam and Croatia). Main reason was the fact that by means of this procedure no capital was provided, neither to the companies, which needed funds for urgent restructuring measures, nor to the government, which needed the revenues for development investments. In addition, an efficient control of management is nearly impossible to achieve by inexperienced small shareholders only.

‘Give-away schemes’ were employed in several Central and East European States, mostly by using vouchers, which the citizens could buy for an administration fee or a symbolic price (see also Chapter 4.2). A widespread participation in the privatisation of ‘people’s property’ should be achieved by these voucher programmes. But the utilisation of voucher programmes differed strongly in the post-communist countries. In **Russia** about 29% of shares in participating enterprises were ‘offered for sale’ by the voucher method. In the **Czech Republic** most large-scale companies (about 55% of their value) were ‘sold’ (1991-2002) by this method (Musil 2003). Analyses of the Czech privatisation programme point out, that the above mentioned disadvantages of voucher methods still have a negative impact on the performance of the economy (cf. Katz, Owen 2002, p. 555). Apart from that, the reasons for these programmes have been economically oriented only to a limited extend.

“The reasons for bypassing the ordinary domestic currency (by vouchers) were several: the lack of adequate capital in the hands of the public, the lack of a functioning capital market, the believe that this populist programme would serve as a successful midwife to the capitalist economy by actively encouraging the population to participate in the new economic framework, and, not least the desire to disenfranchise those who had acquired a disproportionate share of the outstanding domestic currency by profiting from illegal activities under the prior regime” (Katz; Owen 2002, p. 557).

- **Direct Bids for Sale:** An alternative method for changing the corporate form of a SOE into a limited company is privatisation via direct requests for sales offers

(Bietverfahren). This method was used in East Germany (but also in states like Croatia and Hungary) for complex enterprises in the chemical, oil, iron and steel industries. In other words, the method was used for enterprises with a small number of potential strategic investors. The Treuhand offered directly, often on its own initiative, to potential strategic investors a selected enterprise for sale. The decisions about the sale and its conditions (among others concerning business plan, investments and intended employment) were made in the frame of bilateral negotiations (**bargaining model**). This procedure is faster and causes less transaction costs than the change into a limited company. Another advantage is the rather easy selection of appropriate strategic investors, needed for the restructuring of companies. The main disadvantage is the lack of transparency, although formal criteria were considered in the negotiations. But because of time pressure and the limited number of potential strategic investors in some sub-sectors, Treuhand accepted this disadvantage. It tried to minimise negative consequences, e.g. accusations of corruption, by enhanced internal and external controls. Nevertheless, not seldom this privatisation method was the basis for political conflicts.

- **A variant of this bargaining model is the freehand-sale-method:** In these cases the Treuhand discussed individually with potential buyers of small and medium scale enterprises without formalised procedures about business and restructuring plans, planned employment, sales prices, management competence, etc. “The Treuhand could choose freely whomever it considered the best investor for a particular enterprise. When doing so, the sales price was considered as only one of many criteria which were taken into account, and not necessarily the most important criterion. It is evident that this sort of privatization is predisposed to lead to low revenues and high expenses” (Boes 1997, p. 183). Therefore, the utilisation of freehand-sale methods (also called free sale methods) was justified mainly by the unique political situation of East Germany in the reunited Germany. Nevertheless, this bargaining model was also basis for controversial political discussions. But it should also be mentioned that preliminary (insufficient) results of respective negotiations have not seldom been the reason for increasing the number of potential investors, thus the bargaining power of THA, by additional calls for tenders.
- **Limited calls for tenders:** This method is based on a more formalised procedure and was used especially for medium scale enterprises. The Treuhand identified a small number of potential investors (short list) from the respective sub-sector, and

asked them directly to provide bids for purchase, according to given information, standards and other decision-making criteria. This bargaining method speeded up the privatisation process without most of the disadvantages of informal sales procedures. One exception may be highlighted: If the participating bidders collude, (which is not implausible within a small number of bidders) the outcome of bargaining will be inefficient ex post.

- **Public calls for tenders:** This method is the most formalised, standardised and open proceeding. It is especially appropriate for the privatisation of small and medium sized companies with similar conditions. The published calls for tenders include proposed take-over agreements and all information needed for decision making. As the potential buyers are allowed to provide a bid for purchase only once, they are forced to declare their maximum willingness to pay. The sales price was the most important decision criterion (**adjusted auction model**). This procedure was used by Treuhand in the framework of the so-called small or minor privatisation of about 25000 hotels, restaurants and other small firms. As this method enabled fast decision-making, the above mentioned mass-privatisation was realised in East Germany within a relatively short period (less than two years). The political rationale of this method was to address the entire interested public, but especially potential investors from the region (East Germany). Thus, a strong class of medium-sized proprietors with managerial responsibility and knowledge should be created in a region, where these management-qualities hardly existed, because of limited individual property rights in the former GDR.

Public tenders or auctions are usually seen as one of the best means of privatisation from the economist's point of view, at least for small and medium scale enterprises. "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" (Schmidt 1995, p. 155).

3.2 Management-Buy-Out (MBO) and related Stakeholder-Models

Per definition privatisation implies the change of ownership of an enterprise from the public to the private sector. In the framework of the Management-Buy-Out-Method (which has to be seen in connection with one of the above mentioned bargaining-models), the **ownership of SOE will be transferred to the existing (public)**

managers, who intend to change their legal status into private managers and owners by buying their ‘own firm’. Surprisingly the middle-management and not the top-management purchased most of the MBO-companies in the eastern part of Germany. (This method was also used in Central and Eastern Europe, e.g. in Poland and Russia).

“The conditions for sales to the East German managers did not differ from those offered to West German big business, as far as the price and securities demanded and the managerial abilities of the buyers were concerned, though the Treuhand did agree to postpone payment for parts of the sales (e.g. for the land and for certain heavy machinery) for some years, up to the time when it was expected that the enterprise would start to earn a profit” (Roesler 1994, pp. 510).

However **MBOs were also used as an alternative to liquidation**, if no external purchaser was available. In many of these cases THA subsidised the starting phase of the privatised business by providing know-how, loan guarantees and/or by cancellation of debts from the former SOE (in case of liquidation the state would have had to pay these debts anyway). The respective measures should meet the main constraints of MBOs: lack of financial resources and insufficient marketing know-how.

As large scale enterprises require huge capital-inputs, etc. (too high for the existing management), this method focuses on small and medium scale firms only. According to analysts only companies with a maximum of 200 employees should be privatised by way of MBO. As a result, their average number of employees was about 70 in East Germany (about 60% of MBO-firms had less than 50 and only 5% more than 250 employees) (cf. Dechant 1995, p. 341). A special sub-form of this method tries to meet the lack of financial possibilities by leasing cost-intensive lands and/or machines (**Leveraged Lease-Buy-Out: LLBO**). Other sub-forms, usually combined with MBO, try to integrate employees (**Employee-Buy-Out: EBO**) or external managers from West Germany (**Management-Buy-In: MBI**) into the privatisation process. Processes and conditions of sales were more or less the same in all cases.

In the framework of the MBO-method, which was nearly unknown in Europe at the beginning of the 1990s, 2,761 state-owned firms have been sold until the end of THA-operations in December 1994. About 300 units of these were sold as a combination of MBO and MBE and about another 300 ones within the sub-form MBI. Unfortunately, all the sales are summarised in the under the headline ‘Management-Buy-Out’ in the available statistics.

This method of privatisation became popular not only in Eastern but also in Western Europe. The main reason is the success of the MBO-enterprises in the eastern part of Germany. Only 2% of MBOs were liquidated until the end of 1994, although hardly any subsidies were paid and no credits granted until this date. “Unexpectedly, **MBOs/MBIs were a better privatization instrument than originally believed.** The success obviously results from the main advantage of using MBOs to take over firms: the former managers of a firm typically have better information about the firm and its prospects than any outside investor. To substantiate the success of Treuhand’s MBO/MBI policy, consider the following. In nearly a quarter of the MBO/MBI firms, profits are higher than expected and approximately every sixth firm started to increase the number of employees that they have previously cut” (Boes 1997, p. 191). Based on an empirical analysis about MBOs it was stated: “Management-Buy-Out should be regarded as an effective method of privatisation.” This would apply also for the industrial sector, where the optimal preconditions (low capital-intensive operations and limited marketing know-how needed after the take over) are normally not fulfilled. Therefore, this method is more appropriate for trade, service and to some extent, construction firms (Dechant 1995, p. 346).

Key-factors of the success-story in Germany were the facts, that the MBO-method was used **only for small and medium scale enterprises** and that Treuhand required also for this method a **business plan from the potential owners.** In the business plan the potential investors have to indicate not only their investment and employment planning but also their efforts to overcome the weaknesses of this method, namely ‘no external inputs for capital and marketing know-how’ and ‘low incentives to improve the corporate governance of the company’. In Russia and some other countries of the former Soviet Union also large scale enterprises were privatised via this method. In these states the framework conditions in the 1990s are also widely regarded as collusive. An efficient control of management was not given. As a result the positive impact of privatisation on corporate governance was very limited and mismanagement was increasing (not only in MBO-companies) (cf. among others Liebermann; Veimetra 1996). Admittedly it has to be considered, that the data base about large scale MBOs in Russia is rather thin. The same is true for small and medium scale MBOs in East Europe as well as in Germany, because the relatively small enterprises in these countries do not have to publish annual reports.

4. Selected Lessons Learnt

From the ongoing privatisation processes in Germany and other European Countries some economic and social oriented findings with regard to lessons learnt and further analyses should be highlighted:

4.1 Economic Aspects

- A **business friendly environment** is not only important for a functioning market economy but also for a sufficient demand of potential private investors for buying state owned enterprises (increased attractiveness of privatisation objects). In this connection, a **reliable legal and institutional framework** is an indispensable precondition, especially its components property rights and competition policy as well as law.

The former GDR had the advantage that important elements of the business environment, above all the legal ones, were transferred from West to East Germany from one day to another. But there were also disadvantages, above all the politically set unrealistic exchange rate between the West and East German currency (1 to 1, instead of market rate 1 to 3) and the increase of salaries, which exceeded (again for political reasons) by far the increase of labour productivity. Nevertheless the new Federal States in East Germany had the “advantage of having a ‘big brother’ to guide them and to support them while other post-communist societies had to adopt the policies of ‘learning by doing’ or ‘help yourself’ ”(Gupta 1998, p. 38). In **Central and Eastern Europe** the creation of a private business friendly environment and the initiation of privatisation were more or less parallel processes. Inevitable uncertainties for the decision making slowed down the privatisation processes. Advantages in Eastern Europe were among others, that their enterprises did not have to compete immediately on the world markets (gradual reduction of external tariffs) and that the exchange rates for their currencies formed (in contrast to East Germany) a more adequate basis to meet international competition.

This means, especially for countries in the transition process to market economies, that **privatisation cannot be seen as an isolated task**. Privatisation and creation of a business friendly environment (by deregulation, liberalisation, etc.) are two sides of the same coin. In order to achieve higher efficiency, markets should be liberalised for instance “by dissolving former statutory monopolies so as to allow freedom of

Box: Lessons of OECD Experience

Privatisation policies are complex, in that they seek to meet multiple and at times conflicting objectives. They also involve many participants, are often contentious in that they change the status quo, affect vested interests and act as a catalyst for change. Therefore, sound design of management and implementation processes are needed to ensure that privatisation succeeds. In each country, the approach to implementation has been shaped by domestic political considerations, the existing legal tradition and policy objectives of the government. Despite great variation in practice and the fact that there is no single right or wrong approach, this report has sought to provide an overview of the issues that privatisation practitioners have had to consider and found effective. The following are some of the key lessons learned based on OECD experience.

1. Ensure that privatisation has political support at the highest level
2. Identify and articulate policy objectives up front
3. Ensure transparency and integrity of the process
4. Draw upon external advice and dedicate resources
5. Address competition and regulatory issues prior to sale
6. Ensure that an effective communication of the policy is in place to explain the policy, and to address stakeholder concerns
7. Limit restrictions on foreign ownership
8. Sequencing of sales can affect the programmes' success
9. Staging of a sale should be driven by commercial considerations
10. Post-privatisation control devices should be used judiciously

Privatisation is often part of a broader programme of structural reform, and never takes place in isolation. For this reason its success is critically linked to the adequacy of complementary institutions (such as regulatory bodies, a competition authority and the court system); legislation (for example, property rights, bankruptcy and competition law); and complementary policies (these include policies such as financial market reforms, labour market reforms, and trade liberalisation) that help support the proper functioning of the privatised assets.

Source: OECD, *Privatising State-owned Enterprises*, Paris 2003, p. 18

entry for competitors. Examples include deregulation of road passenger transport, less strict licensing for operators of long distance coaches and local bus services, and allowing other companies to start operations in telecommunications, electricity generation and in supply of gas to households.“ (Bailey 1995, p. 307).

- Linked with the legal framework for business, clear **decisions have to be made about the potential involvement of private foreign direct investments (FDI)** and/or joint ventures in the privatisation-process. Foreign investors enhance the domestic competition, provide additional capital and new technologies for the aimed development, increase the domestic stock of know how, save employment, etc. In East Germany, for instance, 855 enterprises have been sold to foreign investors. These investors provided proceeds of about 6.2 bill. DM (3.17 bill. Euro), made investment commitments of totally 21,8 bill. DM (11.15 bill. Euro) and gave job guarantees to more than 152,000 employees (cf. Dempsey 1994). Side-effects of FDI (usually arranged by international investment-banks) have been in many cases higher sales revenues than offered by domestic potential buyers (cf. FAZ, 03.04.1992).

If these and other effects of FDI are wanted, the national investment laws have to give the same or at least similar rights and duties to domestic and foreign investors. Potential foreign investors can be reached, for example, by Chambers of Commerce and Investment Banks.

- **Privatisation policy and law** have to comprise **clear, credible and transparent objectives**. Because of the overall goal “improving the market system“ and the main motive “reduction of budget constraints“, the objectives have to include – as a rule – the realisation of **high sales revenues, the avoidance of monopolies and a relatively fast privatisation process**.

The profit-making objective includes the possibility to sell shares of big companies in two or three tranches if the capital markets do not allow a sufficient demand at reasonable prices. Examples are the privatisation of German Telecom or the German Postal Authority. To document the seriousness of privatisation efforts and to give the private sector already influence on management decisions, the first tranche

should comprise one third or more of the total shares, at least more shares than needed for a control stock.

The objectives, mentioned above, include in particular cases also the **liquidation of firms**. These cases are given, for instance, if no private investor intends to buy a loss-making firm – even at a symbolic price - and subsidies for restructuring do not guarantee a sustainable undertaking. This was true, for instance, for a part of the enterprises in the former GDR. Accordingly the tasks of the **Treuhand**, responsible for privatisation in East Germany, can be summarised (in the first phase) as follows: **‘Privatisation as much as possible, liquidation as much as necessary’**. During the second phase a third task was added for political reasons (saving jobs): **‘restructuring of firms with potentials on markets, if indispensable, to avoid liquidation’** (see also below: Restructuring before or after Privatisation).

In addition to the economic main objectives in East Germany, as well as in West Germany and other European countries, **social oriented tasks** were added. These tasks as well as the restructuring and demonopolisation tasks will be described in the following paragraphs. National targets for reasons of security or prestige are of minor importance in Europe (in contrary to the past). They are achieved normally by keeping a control stock on shares of selected enterprises (e.g. national air lines).

- **Privatisation authority:** In the creation of a clear and compatible privatisation policy and law all main players should be involved to achieve, as far as possible, a decision-basis by consensus. This would be helpful to keep privatisation to a large extent out of ‘political battlefields’. **But with regard to the implementation of policy and law, experiences have shown that the concentration of power and know-how** needed for privatisation in a political subdivision **in one ministry or agency is helpful** for the efficiency and speed of process.

The responsible authority should provide the needed information about policy and state-owned enterprises for privatisation. It should select and supervise also the management consultants or firms, which assess the privatisation objects as well as business plans of potential buyers and facilitate the transfer of public property into private property. “It is always better to have an independent institution responsible for privatization. It can provide the necessary force, lead, speed and credibility to the whole exercise. But every care should be taken to insulate it from political interferences to be able to achieve the best economic dividends” (Gupta 1998, p.39).

Another economist reviewed: “It must be clear which institution should be responsible for privatization. This institution must be independent and free from political governance” (Schmidt 1995, p. 155).

These remarks are based on the experiences in Germany and other European states. The most consequent concentration of privatisation power and know-how was given in the case of the Treuhandanstalt. But this extreme solution cannot be a blueprint for other countries (cf. among others Meyer-Koester 1992 and Roesler 1994, p.514). The situation in East Germany was unique. The task of THA was not only to privatise many state-owned enterprises (SOE), but also to change the property structure of an entire economy with a limited competitiveness at an extraordinary speed and integrate it into the competition-intensive German and European markets. This had to be done in a period where the traditional East German export markets in the former communist countries were collapsing.

Therefore, the special requirements of German reunification called for special solutions, also with regard to the privatisation by Treuhand. “By taking the responsibility of assessing the companies, deciding about their viability and not restructuring enterprises which it did not consider worth restructuring from the macroeconomic point of view Treuhand saved a lot of funds to restructure viable enterprises...This was only possible because the agency was a centralised, monopolistic privatisation agency which combined ownership rights and the right to dispose over the former SOEs. This enabled it to handle a huge number of complex and socially painful decisions that a pluralistic parliamentary system could not have made in a similar manner.” (Mueller 1996, p. 148).

In spite of the special situation in East Germany it may be helpful to analyse the procedures and lessons learnt of Treuhandanstalt, not only with emphasis on methods, instruments and other elements of privatisation and restructuring, but also with regard to organisational and institutional elements of this agency.

- **Demonopolisation:** As mentioned above, in the former socialist countries and centrally administered economies privatisation should not only reduce budget constraints but should also result in a new private and institutional ownership structure. Also in market economies privatisation plays an important role to solve financial bottlenecks and to improve the decentralised market system. Although the starting base is not exactly the same, **in all countries the transfer of public**

monopolies into private monopoly power does not meet the tasks of the market system. Monopolies or firms with a near monopoly-type market position do not necessarily have to be large enterprises. Medium scale enterprises may also have a regional or local monopoly position, e.g. companies for electricity or water supply.

There may even be a conflict between the simultaneous achievement of the targets maximum revenues and increasing efficiency of the economy. Barley gave an example of an insufficient conflict-solution during the first acts of privatisation of monopolies in **Britain**: "...the Treasury believed that the sale of British Telecom as a single company would raise more revenue than the sale of its individual parts. In other words it put greater privatisation revenues before greater efficiency.

The benefits of higher privatisation receipts were immediately obvious. ... The benefits of greater competition are less immediately obvious. More diffuse and of a much longer time scale. ...Although telecommunications was partly liberalised, by allowing a second company (Mercury) to start operations, the immediate impact was extremely small in terms of market penetration." (Barley 1995, p. 310)

Not only the British Treasury but also other European governments have learned from this and similar "tests". In case of natural **monopolies** or medium term monopolies (if the firms need some time for restructuring) the enterprises **have to be controlled in the framework of a Competition- and Anti-Cartel-Law** by an independent authority. Moreover, deregulation should be carried out consequently in order to give other companies (not only one) a fair chance to compete.

In the normal case the process of transferring public monopolies into private firms will comprise four steps (see also World Bank 1996, p. 57):

(1) **Separation**: Separating the competitive parts from the monopoly parts to improve competition as much as possible. In East Germany the monopolies and enterprises with an extreme vertical and/or horizontal concentration were separated into different autonomous parts. All in all 8,500 enterprises were split into approximately 14,000 ones, as mentioned in Chapter 2.1.

In West Germany the Deutsche Bundespost (postal authority) was separated into three parts: **Deutsche Post** or German postal company (letters, parcels, logistics); **Deutsche Telekom** (telecommunications); **Postbank** (bank services). The Deutsche Post was given a medium term limited monopoly for some services, which was annulled step by step. At the moment only for one service a

monopoly position is left over (standard letters until 2007). The establishment of German Telecom was combined with a far reaching liberalisation of the telecommunications market. A temporary monopoly position (until 2003) was given for local telephone calls (city calls). But Telecom has also a natural monopoly for telephone lines. These lines Telecom has to lease also to competitors by law. The case of Postbank was rather easy to handle, because the bank had to compete with other banks from the beginning.

- (2) **Regulation:** The second step is to establish laws and institutions to control and regulate the business policy of natural monopolies, to avoid abnormally high profits and to keep certain quality standards. This was for instance the case for Deutsche Telekom. Laws and a Supervisory Authority have also to take care, that Telecom is not using its market position to impede competition by renting out telephone lines at excessive prices.
- (3) **Commercialisation:** This third step involves the creation of enterprises, that (although still state firms) are similar in structure and operation to private ones. This means, among other things, that the enterprises have to be removed from the control of ministries, assets have to be re-valued, the management has to prepare the company for privatisation and is responsible to a board of directors. This was the case in all three above mentioned SOE, namely Deutsche Post, Deutsche Telekom and Postbank (cf. among others Schmidt 1996, pp. 45).
- (4) **Change of ownership:** The fourth step is the core of privatisation. The responsible public authority sells the enterprise or initially a part of it to private investors, usually via stock markets (see Chapter 3.1).

The above mentioned time-consuming step by step approach is, of course, justified for monopolies and large enterprises, only. “Small firms have proved much easier to privatise than large ones. Most small firms were engaged in trade and services, activities with simple technology and easy entry. None of the major obstacles to privatising larger entities – high capital requirements, major restructuring needs, and regulatory and government weaknesses – apply to small firms. Local authorities can take charge of transferring small units, and because they are easier to value, many parties can gain access to enough information for open auctions to succeed“ (World Bank 1996, pp. 56).

- **Restructuring before or after Privatisation:** Most economists and politicians in Germany take the view that the best way to increase the efficiency of a state-owned

firm by operational and physical measures is to carry out the restructuring after privatisation by the purchaser. The private investor should form a sustainable undertaking according to his own plans and under his own responsibility. Civil servants could meet the requirements of the potential private buyer only partly. Consequently public investments for restructuring would be partly a waste of capital.

Therefore, in the starting phase of privatisation in East Germany, the main task of Treuhandanstalt was to transfer the state-owned firms into private property as fast as possible. But, since the search for buyers took for a part of the firms several years and the number of liquidated enterprises increased drastically, “the Treuhand was forced to restructure many of its enterprises itself in order to make these companies viable. ... At the commencement of its operations the Treuhand established supervisory boards in each joint stock company and took an active part in choosing the members, mainly amongst West German managers. The initial task of these boards was to decide whether to retain or to replace existing managers. The Treuhand also took over the task of assessing its state-owned companies as to their viability and giving recommendations as to whether they should be restructured or liquidated. ... So in spite of its original policy to give preference to restructuring by private investors, the Treuhand was very active in restructuring enterprises while simultaneously searching for suitable investors.” (Mueller 1996, p. 136). The preferences were given to “investor-neutral“ investments.

The above mentioned procedure required a great number of qualified managers from the private sector. But because of the high demand for qualified managers, experienced in the restructuring and reorganising of companies, there was a great bottleneck, especially in the first half of the 1990s. Treuhand tried to solve this problem by setting up five **management holding companies** in 1992/93. Each of these so-called **Management KGs**, managed by experts from private sector, was responsible for 9 to 18 companies. Thus, the limited and expensive restructuring know-how could be made available to several enterprises at the same time.

Altogether about 90 companies with 20,000 to 30,000 employees were rehabilitated by the Management KGs. In sum, 80 companies and four units have been sold to the private sector. Commitments have been given for 7,110 jobs and for DM 695.6 million (355.7 mil. Euro) investments. According to some observers the restructuring by Management KGs has been slow and costly, but an overall impact analysis is not available yet. From the political point of view, Management KGs

have been a success-story (cf. Boes, Kayser 1997, pp. 138 and Mueller 1996, pp. 145).

In West Germany a similar procedure has been chosen only for preparing large enterprises for the stock market. In these cases experienced managers from the private sector have been appointed, to restructure individual enterprises according to the needs of a limited company. As these managers had good chances to make their future career in the privatised company, their motivation was usually very high. Examples may be the privatisation of Deutsche Lufthansa, Deutsche Post or Deutsche Bahn (German Railways). In the last case, the restructuring-process is still ongoing.

Finally it may be stated, that **restructuring by private investors** after privatisation is in the normal case the **most efficient solution**. The former Minister of Finance Theo Waigel summarised as follows: “Experience teaches that privatisation is the best form of restructuring. The private investor takes over all the risks and opportunities when he buys a company. He will try, through investment, modernisation and realisation of market opportunities to increase the earning power of business and with it the job security” for his remaining employees (quoted from Parkes 1992). **But if** the search for buyers takes a long time, the transferring of enterprises into limited companies is a rather long process and/or if **industrial kernels in rural areas** have to be saved a ‘wait and see policy’ is economically and financially not justified. **Restructuring by the public seller before privatisation may be the logic consequence**. In East Germany main preconditions were a credible scheme for the reconstruction of enterprise and its profitability in future .

In any case a **proper strategy for the management** is important for the restructuring of companies. “If the managers are afraid that they will lose their job in the near future anyhow, they have a particular strong incentive to use their remaining time to enrich themselves at the expenses of the firm, ... If managers consider it likely that they may make a future career in the private firm, they may do their best to establish their credentials” (Schmiedling 1991, p.104). In the normal case Treuhand tried to solve this conflict by choosing external managers from the private sector (sometimes in combination with selected qualified managers from existing staff), who received success-oriented incentives (mainly a percentage of value added of the company).

4.2 Social Safety Aspects

As many state-owned companies are overstaffed, privatisation often involves suspension of a part of the employees. For social reasons, but also for political ones (e.g. to achieve a relatively high acceptance of the privatisation policy in the population) socially oriented flanking measures are needed. In the following, some of the instruments used in Germany are highlighted. But first of all, two facts should be highlighted:

- (1) There is a **conflict between social targets and the target of high sales revenues**. In other words, the costs for achieving social targets have to be paid mainly by means of less revenues. In a review about privatisation in **Lithuania** it is stated for instance: “The job preservation requirements place a heavy burden on society, since these requirements result in the reduction of the entity’s price and lower privatisation revenues. It does not solve the problem of unemployment either. This problem is simply put off, since the investor is only required to preserve a fraction of the total number of jobs for a limited period of time...” (Bogdanovicus 2000). But it should also be considered that the specification of too many objectives for one instrument, in this case privatisation, has negative consequences for the achievement of all individual objectives.
- (2) The following remarks have to be seen against the background of the **social safety net in Germany**. According to this safety system, all unemployed persons will receive for a certain time (1–1.5 years) financial contributions from an obligatory unemployment insurance, to which employers and employees have to contribute during the time of employment. In addition, a so-called ‘**social plan**’ has to be negotiated between the workers council and the management, if a firm has to release a great part of its long-time employed staff for reasons of restructuring. This is also true for restructuring in combination with privatisation. Elements of this social plan may be a ‘**golden handshake**’ and/or the possibility for older staff to go into **early retirement**, without or with limited financial disadvantages only. For example in 1994, the last year of Treuhand operations, 650,000 East German employees went into ‘early retirement’ (cf. Hampe 1995, p. 568).

Decision criteria manpower planning: A preventive creation of privatisation processes may reduce the volume of cuts in manpower. This is one of the reasons why Treuhand requested already from its second year of operation

(1991) onwards a **business plan** from potential buyers, **which should inform** not only about investment intentions, etc., but **also about the manpower planning**. That way THA had the chance, to give investors, who intended to adopt rather labour intensive technologies, a special treatment. If job creation was an essential criteria for selection between various potential investors, the buyer had to give a job guarantee. In case of non-achievement of the employment-promise, the entrepreneur had to pay a penalty between 2,500 and 20,000 Euro for every missing workplace. Treuhand received job guarantees for 1.5 mil. employees (cf. Priewe 1994, pp. 26). On average, the provision of working places was about 16% higher than assured (according to an empirical THA-analysis for the years 1991-1993 – cf. Schmidt 1995, p. 152).

Saving jobs by Management-Buy-Outs (MBO): MBOs, but also Employee Buy-outs (EBO) and other mixed forms, belong to the standard instruments of privatisation, as mentioned in Chapter 3.2.. These instruments are used normally for small and medium scale enterprises (in East Germany the 2,761 MBOs had 70 employees on average) and contribute to the development of the middle-class. **But MBOs were used also as an alternative solution to liquidation, if no potential buyer was available.** In other words: **To avoid unemployment, the firms were sold at a relatively low price to the management,** if a realistic business plan had been worked out before. In some of these cases even “negative sales prices” were accepted, for instance via cancellation of “old” debts of the firm or by providing credit-collateral. With regard to job-saving MBOs can be reviewed as a success story. They contributed to the 3.2 million jobs in small and medium scale industries with about 7%. At the end of THA-operations nearly 20% of the MBOs already had more employees than at the time of taking over the public undertaking (cf. Lipinski 1992 and Priewe 1994, p. 22).

In **connection with job saving,** the strategy “**restructuring firms before privatisation**” can also be reviewed (cf. Chapter 4.1). Treuhand saved by Management KGs – for instance – between 25% and 35% of the employees of the involved 90 companies. A review of these figures has to consider that for most of these firms no purchaser was available before restructuring. In other words, **restructuring was an alternative to liquidation and the suspension of all staff.** The respective efforts contributed also to the **preservation of**

industrial kernels in rural or other relatively remote areas and thus to the creation of new jobs in other firms. **Therefore, the indirect employment impact was much higher than the mentioned direct one.**

Short-time work and job creating measures: During the restructuring phase of firms (sometimes also of companies, which were still in the “waiting phase” for privatisation) layoffs of employees were necessary. To avoid mass dismissals, Treuhand introduced short-time work for a part of the labour-force (in 1994 for 97000 East German labourers), often **combined with vocational retraining and off-the-job education** (in 1994 for 240,000 employees). These qualification measures, supported by the Central Government through subsidies for the establishment of new small firms and by THA through facilitation of so-called **work-promotion measures** (ABM: Arbeitsplatzbeschaffungsmassnahmen) by means of interest-free loans up to 10% of total costs, created a lot of new jobs, according to estimations for more than one million workers (cf. among others Breuel 1994, p. 18 and Hampe 1995, p. 568). This kind of labour market policy, legally not part of THA-responsibilities, was based on an agreement (1991) between Treuhand and German trade unions (DGB and DAG). Another instrument was the promotion of work, employment and structural development in special **employment companies** (Beschäftigungsgesellschaften, ABS). These companies were formed on a temporary basis “to employ workers mainly in social and environmental activities, with the aim of making the process of the privatisation of THA companies socially bearable” (Mueller 1996a, p. 396).

Last but not least, it should be mentioned that periods of short-time work are widening the scope for employment-reduction by natural fluctuation, including early retirements. These staff-fluctuations in East and West Germany in many cases contributed significantly to the solution of over-employment. The Deutsche Telekom had, for instance, in 1989 about 225,000 employees (50% of which were civil servants) at its disposal. Within ten years the staff was reduced by 60,000, mainly through natural fluctuation.

Preserving the rights of Civil Servants: A substantial part of long-term employed staff in state-owned companies are nearly irredeemable, according to

their special legal rights as civil servants. These employees, especially the older ones, are often not willing to lose their privileges (for instance regarding pensions) by changing to a private employer. In these cases the public owner, that means the Federal Government, a Federal Country or Community, tries to employ them otherwise and/or offers early retirement to elder employees. In several cases, the public owner “lent” the civil servants to the new private owner. This means, the new employer has to pay for salaries and the usual extras of the private sector. The former employer has to pay for the difference between private and public extras, based on an agreement with labour unions. For example, this has been done in the case of the German Railway and the German Postal companies.

Influencing distribution effects of privatisation: Privatisation does not only have an influence on the property structure between public and private sectors, but also on income distribution between employers and employees. To avoid or reduce potential conflicts, the public owners introduced in case of privatisation of stock corporations so-called **people’s shares or preference shares**. In other words private buyers and/or employees are offered a certain number of shares at a relatively low price. In return the beneficiaries may not sell the shares for a certain period (1-3 years, in the case of employee shares of German Post even 6 years). Side-effect of the respective actions was the introduction of shares as a saving-form to people. As a successful example, the privatisation of German Telecom may be highlighted (see also Chapter 3.1). Between 50% and 64% of Telecom-staff bought preference shares of each of the three tranches (in the years 1996, 1999 and 2000). In total, 35% of all shares are owned by private purchasers, 34% by institutional buyers. (The government still holds a proportion of 31% of shares).

Similar preferences were given in other countries, too. **Poland**, for example, gave from about 500 state-owned enterprises, which were transformed into limited companies in line with the Investment-Fund-Law (1993), up to 20% of shares free of charge to employees. In other cases shares were ‘sold’ to the population in exchange for an administration fee (20 ZL. for a certificate). Although 95% of all Polish adults participated in this **voucher programme**, the objective to accumulate capital in form of shares was achieved only partly. About half of the buyers already sold their certificates during the first month for

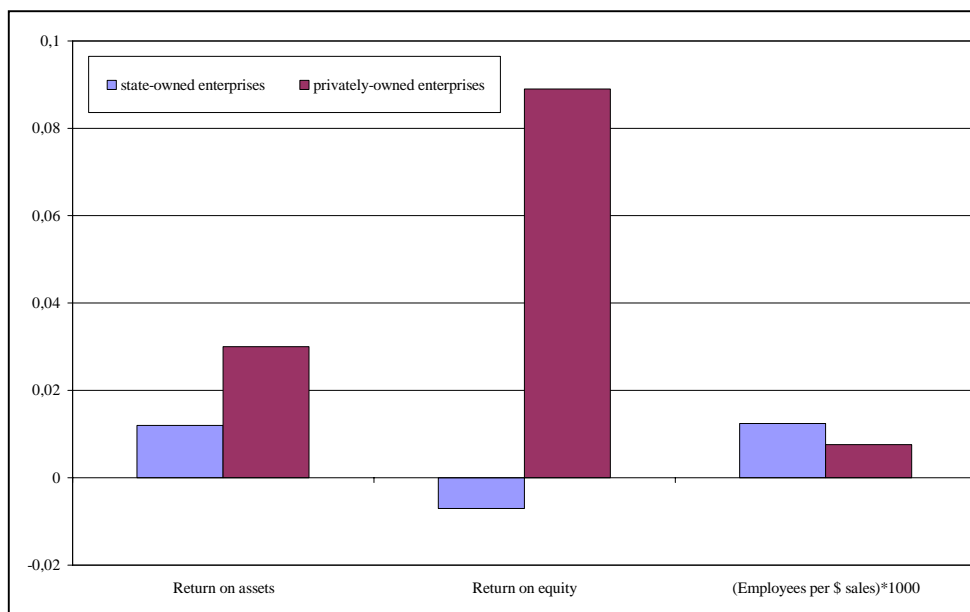
a benefit of up to 750% on the informal and formal markets. In other cases the labour forces are allowed to buy up to 20% of shares with a price reduction of 50% (as long as the value of shares did not exceed the average annual salary in public sector, multiplied with the number of employees), (cf. Seyler 1995 and NZZ, 26.11.1996). About the impact of this and related voucher methods (cf. also Chapter 3.1) on income and capital distribution only few and controversial empirical information are available.

5. Concluding Remarks

Worldwide experiences have shown that privatisation, if facilitated by an appropriate legal and institutional framework, contributes significantly to an increased efficiency and dynamism of the privatised companies. This is underlined for instance by the surveys of Dewenter and Malatesta (2001), who analysed some 500 firms all over the world. About one third of these firms were state-owned ones. According to this analysis, privately owned companies on average realise a better return on equity than SOE (8.5 versus 0.2%) and a higher return on assets (2.7 vs.1%). In addition private companies have a higher labour productivity (a lower share of employees per US\$ sold - see Chart 3). Furthermore, privatisation is beneficial to potential investors, as Chart 4 shows. Other studies analysing the impact of privatisation on the respective firms also produce positive results. According to three other different studies the profitability (net income per sales) improved in 63 to 71% and the efficiency (real sales per employee) could be raised in 79 to 86% of all enterprises. Last but not least, also the investment quota (capital expenditures per sales) increased in 55 to 67% of privatised companies (see Chart 5).

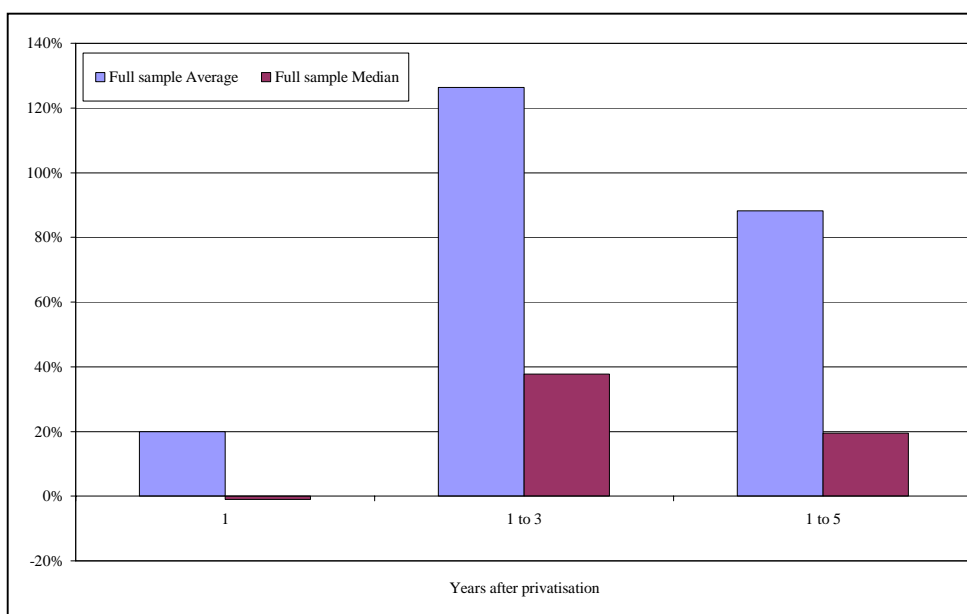
In addition experiences in Germany have shown, that **privatisation is a very important element to increase efficiency of the former SOE and dynamism of the economic system, to mobilise private resources for the development process, to improve the allocation of public resources and, last but not least, to reduce public debts and/or budget constraints.**

Chart 3: Comparison of efficiency of state-owned vs. privately-owned enterprises



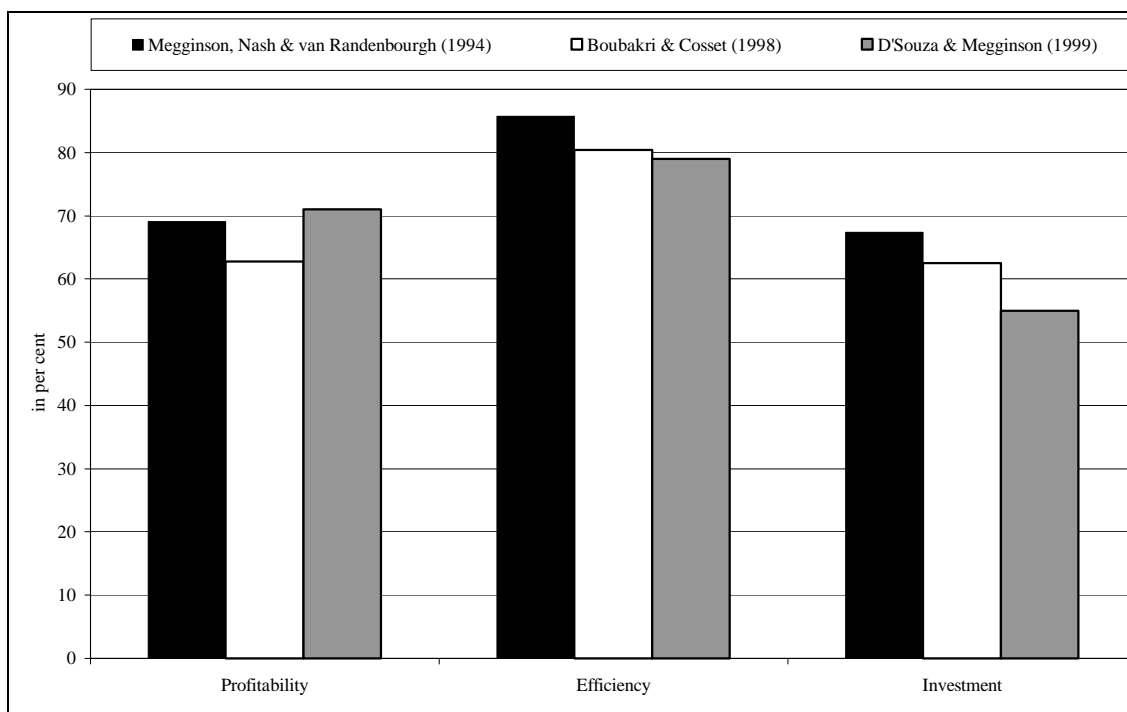
Note: Sample of 500 enterprises (world-wide) for the years 1975, 1985, and 1995.
Source: see Annex 2.

Chart 4: Long-term return after privatisation



Note: Measured for 102 (year 1), 97 (years 1 to 3), and 78 (years 1 to 5) firms.
Source: see Annex 2.

Chart 5: Share of firms with improved profitability, efficiency, and investment after privatisation



Note: Sample of 218, 170 respectively, 154 firms (world-wide).
Source: Box in Chart 5.

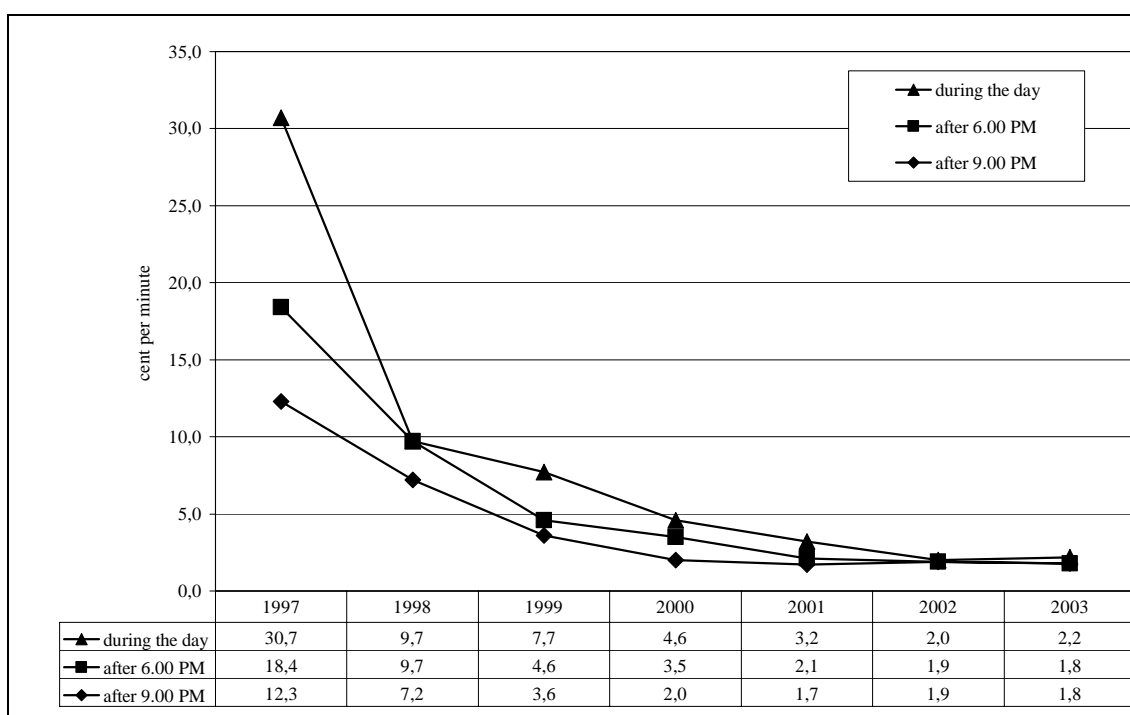
Under budget aspects privatisation may even have a positive impact if the sales revenues are near to zero. This is the case, for example, if the new investor takes over the debts of the former SOE, new subsidies are not longer needed (or only for a short starting phase), and/or higher tax-income can be expected in future.

The above mentioned and other effects will contribute to a growing gross domestic product and an increasing standard of living. The additional economic growth will also create new working places which will contribute to compensate the layoffs in the privatisation phase. But it has to be taken into account that the extend of the privatisation-impact depends not only on the economic frame-conditions but also on the pattern of expenditure of privatisation-revenues (more consumption or more growth oriented expenditures?).

In general it can be stated that the main players public organs, entrepreneurs and employees, will benefit in the medium and longer term from privatisation. In the short run especially part of the employees will suffer disadvantages. To what extent the

consumers will benefit, depends tangible on the degree of competition and demonopolisation. The impact of individual privatised companies is difficult to measure. But privatisation of public monopolies, combined with demonopolisation, often has easily observable benefits for the consumers. The privatisation of German Telecom in connection with the liberalisation of telecommunication markets in Germany led, for example, to a higher quality of services and price reductions for normal telephone calls of more than 85% (see Chart 6). Significant price reductions can be observed, among others, for the development on the markets for electricity and air transportation after privatisation.

Chart 6: Development of Standard Tariffs for normal telephone calls during working days, 1997-2003



Source: Deutsche Telekom, Bonn 2003.

The German Finance Minister Hans Eichel summarised the impact of privatisation as follows: Privatisation “strengthens the economy, provides incentives for Germany as a financial centre and helps to improve the competitive position of enterprises and to develop more efficient structures for performing government tasks. In this way privatisation policy supports the protection and creation of new jobs, and promotes

innovations and sustained growth.” (Eichel 2003, p. 6). A similar impact will be true for India.

In addition to the normal transaction costs, **privatisation may cause economic and financial costs**, too. As many state-owned companies are overstaffed, privatisation is (as mentioned above) often combined with the suspension of a part of employees. Flanking social measures, especially job-saving efforts, are usually rather expensive. In East Germany the costs of supporting social measures have been very high (compared with West Germany), because of political demands in the framework of reunification. Also restructuring investments, if required before the privatisation of companies, caused relatively high expenses. However, these measures contributed to the preservation of industrial kernels in relatively underdeveloped areas and to the maintenance of social peace.

Most of the supporting social measures are discussed and/or designed in co-operation with the trade unions (e.g. the management holding companies and job creating measures). Thus, they also contributed to the development of a professional relationship between trade unions and Treuhand.

It is the task of decision-makers to create an economically effective and efficient privatisation policy under consideration of social aspects. A lot of experiences are available in Germany, India and other states. Although lessons learnt in one state can hardly be a blue print for actions in another state, experience sharing between countries is helpful to avoid mistakes and disappointments, which could jeopardise the privatisation policy. It is hoped that this Report contributes to initiate fruitful dialogues on privatisation.

6. Annexes

Annex 1: Privatisation activities of the German Federal Government, 1986-2002

Year	full	Partial	Revenue (mio.€)
	Privatisation		
1986	0	3	509,5
1987	1	1	1247,8
1988	2	3	1190,2
1989	0	2	117,4
1990	1	0	9
1991	1	1	284,1
1992	1	0	0
1993	3	1	62,6
1994	3	1	571,5
1995	5	0	145,8
1996	1	2	1119,7
1997	6	1	2757,1
1998	7	2	10154,7
1999	1	4	2584,8
2000	2	2	1899,1
2001	2	4	3732,4
2002	1	0	262,2
Sum	37	27	26647,9

Note: Treuhand (1991-1994) and special assets of Federal Government not included.
Source: BMF, Bundesbeteiligungsbericht, Berlin, several volumes.

Annex 2: Long-term return after privatisation

Return on acquired assets		Years after privatization		
		1	1 to 3	1 to 5
Full sample	Average	0,199	1,264	0,882
	Median	-0,01	0,377	0,195

Source: Dewenter, Kathryn; Malatesta, Paul, „State-owned and privately owned firms: An empirical analysis of profitability, leverage, and labour intensity“, American Economic Review, No. 91, 2001, pp. 320-340.

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