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Centralized Decentralization

Corporate Governance in the East German Economic Transition

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Foreword

This EDI Working Paper will be published as one of 12 chapters in a forthcoming book entitled: ***Corporate Governance in Transitional Economies: Insider Control and the Role of Banks*** edited by Masahiko Aoki and Hyung-Ki Kim. The book will have three parts:

Part 1: Generic and Comparative Issues: Theory and Policy Implications (chapters 1–3)

Part 2: Country Studies in Comparative Perspectives (chapters 4–8)

Part 3: Relevance and Lessons of the Japanese and German Experience (chapters 9–12)

A list of titles is provided on the inside back cover of this paper.

The book presents the results of a research project on corporate governance issues in transitional economies from a new perspective based on comparative institutional analysis. A concern with three issues—the emergent phenomena of insider control, the possible role of banks in corporate governance, and the desirability of the comparative analytic approach—sets the common ground for the research presented in this volume.

The coexistence of the alternative models of corporate control in the developed countries suggests that the possible "lessons" for the transitional economies may not be so obvious. It makes little sense to judge the merits of each corporate governance model and its applicability to the transitional economies without taking into account a country's stage of development and the history of its institutions and conventions. In designing corporate governance structures for the transitional economies, economists are required to identify the specific conditions under which each corporate control model (or combination of models) works, the availability of these conditions in the transitional economies, and the most efficient approach to achieve these conditions. By pooling rich individual country studies and cross-examining and comparing their implications, we may be able to avoid premature generalizations or theorizing based on the observation of a single economy. By comparing the workings of diverse systems, we may also be able to uncover latent factors that are conducive to, or constrain, the workability of particular governance structures. Comparative analysis may thus serve in the social sciences as a kind of proxy for laboratory experiments.

This work was prepared as part of EDI's multiyear *Program for the Study of the Japanese Development Management Experience* which is financed by the Policy and Human Resources Development Trust Fund established at the World Bank by the Government of Japan. The Program is managed by the Studies and Training Design Division of the World Bank's Economic Development Institute.

Hyung-Ki Kim, Chief
Studies and Training Design Division
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Centralized Decentralization: Corporate Governance in the East German Economic Transition

Ernst-Ludwig von Thadden

Following its integration into the West German political and economic system, East Germany's transition to a private-ownership economy has been markedly different from the transition experiences of other economies. Therefore, most comparative studies of monetary, fiscal, or trade policy in economic transition do not include East Germany. The same is true with respect to enterprise reform and corporate governance,[1] although it is repeatedly emphasized that, as far as established corporate governance structures are concerned, "German and Japanese models may offer some clues" (Gray and Hanson 1993). Yet, although the corporate governance structures in the East German transition have been quite different from the established structures in West Germany, they offer some interesting insights into the problem of enterprise reform. This chapter describes and analyzes these transitional governance structures.

The transformation of the East German corporate sector started from conditions that differed in many respects from those in the rest of Eastern Europe. West Germany was ready to provide huge amounts of physical as well as human capital and a set of established and highly refined institutions and regulations. Furthermore, the corporate and financial structures to emerge from the transition process were to some extent predetermined by the existing West German models. Yet, the basic problems for the transition were the same as those faced throughout Eastern Europe and Russia: "enterprise reform, which requires the imposition of bottom-line discipline, definition and change of ownership, and reform of management" (Fischer and Gelb 1991). The experience in most Eastern European countries during economic liberalization, most notably in Russia and Poland, has shown that these problems are especially difficult for larger corporations,[2] where insider interest groups and the size of the firms have prevented the effective transfer of control and the implementation of a hard budget constraint (Kornai 1979).[3] For these larger firms, the problem of "controlling the insider control" (Aoki, in this volume) has become a crucial issue in the transformation process.

As analyzed in detail below, the East German transformation experience has been quite quite different in this respect. After an initial period of uncertainty and experimentation, accompanied also by attempts at asset stripping and "self-privatization" on the side of the firms, a strong, centralized public trust company was built up, which owned all formerly state-owned firms and over a period of four years restructured and sold them off. I will argue in more detail below that, taking into account the enormous amount of resources available from the West, privatization has been relatively slow in its early phase, and that after the initial investment in organizational structure, corporate control exercised by the trust company has been strong. The transformation process has produced a corporate structure in which almost all big firms have been broken up or liquidated, top managements exchanged, and large parts of the work force dismissed. Insider control has been largely dismantled, and the industrial structure has changed drastically. The privatization process has completely changed the problem of corporate control by

virtually eliminating all large, independently owned companies (see section entitled "Decentralized Ownership: Postprivatization").

On a macroeconomic level, this transition is comparable to the workings of the takeover mechanism in the theory of the "market for corporate control," as developed by Manne (1965), Jensen and Ruback (1983), and others, where the individual firm is the focus. "When a breakdown of the internal control system imposes large costs on shareholders from incompetent, lazy, or dishonest managers, takeover bids in the market for corporate control provide a vehicle for replacing the entire internal control system" (Jensen and Ruback 1983, p. 44). During this process, a "raider" concentrates the shareholding of the company in one hand by buying out small shareholders, undertakes the restructuring deemed profitable, and sells out again to diversify his risk. Although in some respects this analogy is inappropriate for the observed macroeconomic process,[4] it correctly captures the feature of successive centralization and decentralization in the transformation of corporate East Germany.

In competitive capital markets, market conditions and the endowment and management abilities of the raider determine how long the raider will keep the acquired company under his control and what restructuring will be undertaken. In the transitional context, a government-owned trust company has different incentives. In particular, profitability is not the sole criterion that determines how the trustee exercises control. Just as government regulatory agencies can be "captured" by the firms they are supposed to regulate (see Stigler 1971 and Laffont and Tirole 1993), a privatization agency is likely to be captured by the interest groups under its supervision.

The institutional development in the East German privatization process exhibits two highly complementary features, which, I will argue, can be interpreted as responses to this problem. First, the public trust company was designed to be in an institution with a fixed, finite lifetime, so that expected rents from long-term collusion between the agency and its environment were limited.[5] Second, the agency was given a high degree of independence from government and parliament, limiting the pressure from public interest groups. ("External Control of the THA," below, describes these features in some detail and provides a preliminary assessment.)

This chapter is organized as follows. The next section gives a brief survey of the evolution of the corporate sector in East Germany before 1989. The third section sketches the economic development after the fall of the Berlin Wall. The fourth section analyzes in detail corporate governance issues during the transformation process, and is followed by a description of the external control mechanisms of the privatization agency. The sixth section describes the pattern that emerges from the transition. The final section offers some interpretations and an assessment of the relevance of the East German experience for other transforming economies.

;aSome Determinants of Economic Structure before 1989

Soon after the four zones in occupied Germany had been established, large-scale nationalization of private property began in the Soviet Zone in 1945. In 1947, the land reform, which nationalized all land holdings above 100 hectares, was largely completed. From 1946 on, all companies owned by former war and Nazi criminals and almost all larger companies were transformed into "people-owned businesses" (*volkseigene Betriebe*, VEBS). As a result, a three-tier pattern of state ownership of industry emerged: 1,631 firms with 580,000 employees came under the control of the "Deutsche Wirtschaftskommision" (central government control), 3,064 firms with 220,000 employees came under Länder (state) control, and 2,064 smaller firms were under community control.

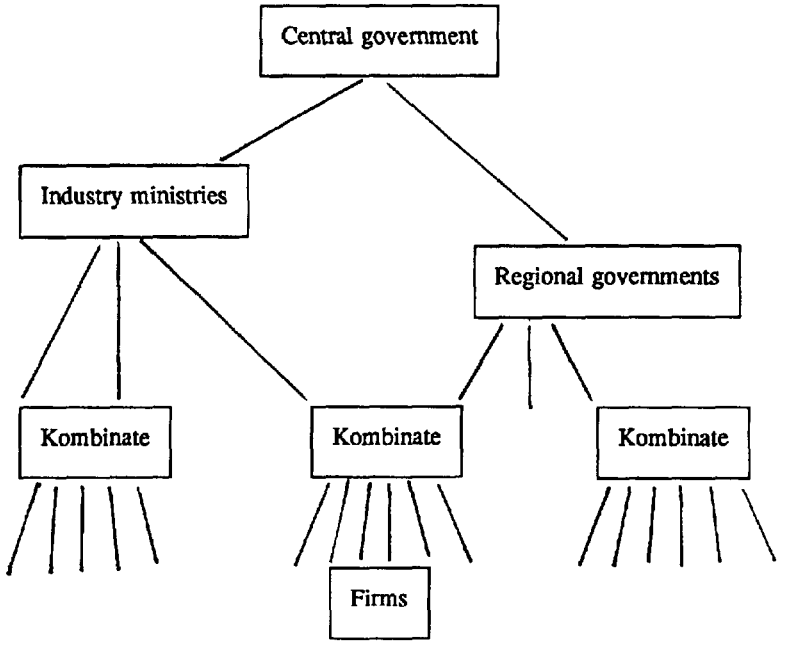
On October 7, 1949, the constitution of the GDR (*Deutsche Demokratische Republik*) came into force, in 1950 the first five-year plan was adopted, and in 1951 the ruling Socialist Party declared the

building of socialism the goal of the new state. Still, in 1955 more than 44 percent of the gross national product of the GDR was produced by small and medium-size private companies (THA 1993a).

From 1966 on, centralized planning and economic concentration were intensified through the creation of large conglomerates, the *Kombinate*. The largest *Kombinate* were directly subordinated to one of the planning ministries, and the smaller ones were usually overseen by local authorities, in particular the district governments (see figure 8-1). In 1972 the remaining private companies (approximately 11,000) were nationalized, and in 1986 the Eleventh Party Congress declared the *Kombinate* to be the backbone of the centrally planned economy.

Inside the *Kombinate*, the businesses were usually grouped around one core company that had economic and political control and whose top management was controlled by party officials. Among the *Kombinate*, by far most important were the 152 centrally controlled *Kombinate* of industry and construction. By June 30, 1990, there were approximately 2,450 VEBs employing a total of about 2.7 million people; only 17 of these *Kombinate* had less than 5,000 employees, and 48 had more than 20,000.[6] All 430 *Kombinate* taken together accounted for 90 percent of total employment in industry and 72 percent in construction.

Figure 8-1. Socialist Governance



Historically the emergence of the *Kombinate* coincided with the wave of conglomerate mergers in the Western world, in particular the United States, at the end of the 1960s (cf., for example, Scherer 1988). Yet, while many of those mergers were subsequently undone, the trend in the GDR led to ever-increasing integration. The degree of vertical integration of the Kombinate was significantly higher than in Western companies. For example, the "IFA-Kombinat Pkw Karl-Marx-Stadt," responsible for the production of automobiles, produced about 80 percent of the value of their cars within the *Kombinat*, including machine tools and metals (von Schleinitz 1993); the corresponding value for Toyota in the late 1980s was 27 percent (Womack, Jones, and Roos 1991, p. 155).

The *Kombinate* were also usually excessively horizontally integrated. This was mainly because of politically motivated merger decisions, but also because of the desire to be autarkic within the *Kombinat* ("an economy within the economy") and government regulations that prescribed the provision of certain services by the *Kombinate*. Reflecting the excessive degree of horizontal integration, most *Kombinate* were also highly dispersed geographically.[7]

While excessive integration was a common phenomenon in all Eastern European economies, the emphasis on vertical integration was particularly strong in the GDR. Similarly problematic was the industry structure that had been developed under central planning. As documented by Sinn and Sinn (1993, pp. 52–53), 9.9 percent of the labor force of the GDR were employed in agriculture, compared with 4.2 percent in the West, and 34.1 percent in manufacturing (29.7 percent in the West). Trade and services employed only 19 percent of the Eastern work force, as compared with 37.4 percent in the West.

;aPolitical and Economic Development after 1989

On November 9, 1989, the Berlin Wall fell, and on October 3, 1990, the GDR ceased to exist, joining the Federal Republic of Germany in the form of five new states and East Berlin.[8] In the less than eleven months between these dates, the GDR had two governments—a reform-socialist one, trying to preserve as much of the old order as possible by modifying it, and, after March 18, 1990, a freely elected conservative government that paved the way for reunification as efficiently as possible.

By January 1990 it had become clear to most participants in the political decision process that drastic measures were necessary to prevent the economic collapse of the GDR, and that in this process the traditional model of full state-ownership of the means of production was no longer tenable. On March 1, the government passed the "conversion decree," which stipulated that each business had to be converted into a joint stock company (*Aktiengesellschaft*) or limited liability company (*GmbH*) according to West German law. Furthermore, the foundation of a public "trust institution" (*Treuhandanstalt*) was announced, which was to take over all previously state-owned enterprises.

Although impeded by a plethora of technical and institutional problems, this decree triggered a wave of spontaneous corporate reorganizations. By the end of June, 3,605 former VEBs incorporated themselves, and more than 200 *Kombinate* were dissolved (von Gusinski 1993). The powerful need to break free of the old *Kimbinate* was occasionally supplemented by strategies to create joint structures, born out of the hope of exploiting scale economies or obtaining greater bargaining power with potential investors or the government.

Parallel to this flurry of reorganizations, the law of March 7 concerning the reprivatization of companies that had been nationalized in 1972 initiated a first wave of reprivatizations. By the end of September, almost 3,000 small and medium-size companies were transferred back to their previous owners (THA 1993c).

After the elections of March 18, the movement toward a market economy, and finally toward economic unification with the West, became irresistible. On June 17, the government passed the "Treuhand Act," which stipulated that every VEB not yet incorporated was declared to be so by July 1. More important, the *Treuhandanstalt* (henceforth, THA) was given the explicit task of privatizing the people-owned property. The main purpose of the law was "to reduce, by means of privatization, the entrepreneurial activity of the state as fast and as far as possible."[9] The THA was to be incorporated as a public institution according to West German law and designed, in a decentralized fashion, as a holding company with several independent subsidiaries.

On July 1, the Treaty on Currency, Economic, and Social Union (CESU) between the two parts of Germany came into force. Under the terms of the treaty, the GDR adopted most of the economic and social legislation of West Germany, as well as accepting the DM as its currency. Except for limited amounts of personal wealth, the exchange rate between East German mark and deutsche mark was set at 2:1. Because this rate also applied to corporate balance sheets, East German firms found themselves indebted by approximately DM 130 billion overnight.[10] From July to September alone, the THA guaranteed DM 25.4 billion of liquidity credits from Western banks to prevent the immediate bankruptcy of East German firms.

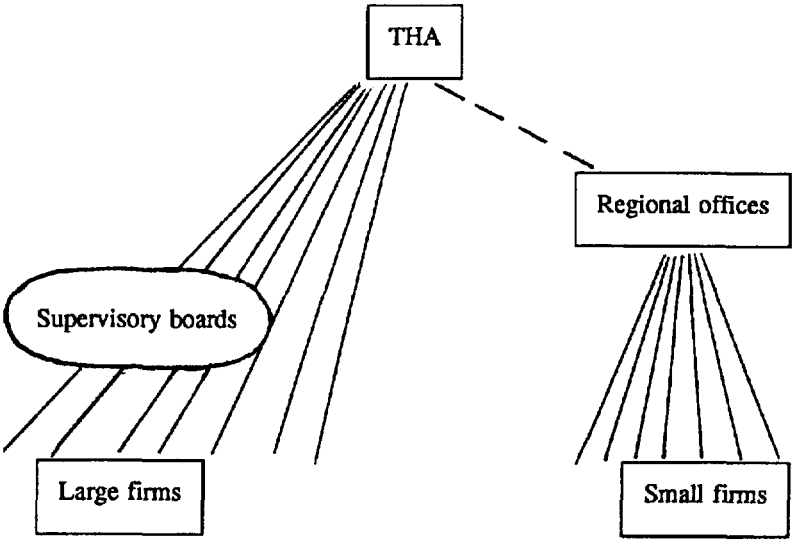
As of July 1, the THA owned approximately 8,500 firms with 4.1 million employees.[11] From September on, the new President, D. Rohwedder (formerly CEO of Hoesch AG, Dortmund), determinedly transformed the THA into a large organization with a hierarchical central structure and well-defined decentralized competencies. Under the new structure, the center in Berlin was to be directly in charge of all firms with more than 1,500 employees, and the 15 regional branches would oversee the remaining firms (see figure 8-2). On the day after German unification, on October 3, all 15 heads of the regional branches were replaced by Western managers, and in the following days the East German managers in the THA's supervisory board were dismissed.

The tightening of control allowed the THA to interfere effectively with early attempts at asset stripping and self-privatization, which plague the transition process in many other Eastern European countries (see, for example, Phelps and others 1993) and had begun to develop in 1990 in East Germany.[12]

As a basis for its future operations, the THA requested its firms to provide opening balance sheets (*Eröffnungsbilanzen*) by October 30, 1990, a deadline that soon had to be extended to June 30, 1990, and to January 31, 1992, for conglomerates. The opening balance sheets had to be accompanied by a three-year corporate strategy and were evaluated by THA managers (volumes up to DM 10 million) and a "governance committee" (*Leitungsausschuß*), a group of up to eighty top West German managers assembled by the Ministry of Finance (see THA 1993a, p. 22). This evaluation determined which firms were to be liquidated if no buyers could be found, and which could be restructured.[13] During the subsequent process of breaking up the *Kombinate*, the THA was assigned far-reaching competencies by the so-called "Splitting Act" (*Spaltungsgesetz*) of May 4, 1991, a law that facilitated the split of Treuhand companies into marketable units.

The consolidation of the THA's structure and the preparation of the opening balance sheets proved to be time-consuming. By March 31, 1991, the THA had sold or reduced its interest to a minority stake in 1,378 firms, about 15 percent of its total stock at the time. By May 1991, only 6 percent of all balance sheets had been evaluated (Sinn and Sinn 1993). Sales in this early phase were often impeded by organizational problems on the side of the THA and driven by the prospect of potential bargains for the buyers. This early stage of privatization certainly was considered to be a buyers' market.[14] The THA finalized its opening balance sheet—which valued its net corporate holdings as of July 1, 1990 at -DM 179 billion—only on September 29, 1992.[15]

Figure 8-2. Treuhand Governance

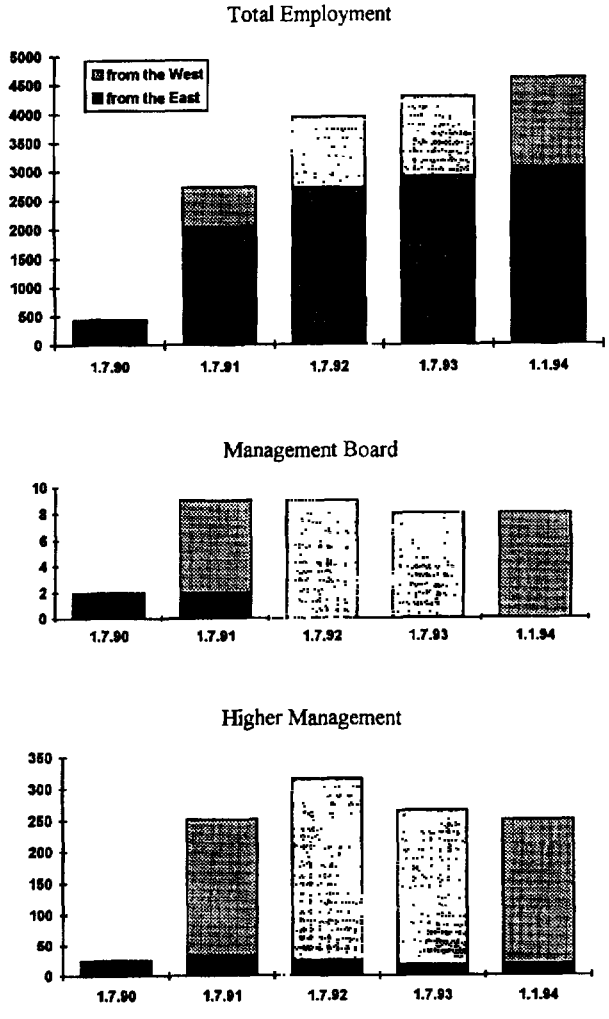


By this time, the East German economy had experienced a depression "without precedence in modern economic history" (Sinn and Sinn 1993, p. 35). Between early 1990 and the end of 1991, gross domestic product (GDP) fell by 35 percent.[16] Employment fell on a similarly dramatic scale. Between the first half of 1990 and the second half of 1993, when the transitional depression seemed to have reached its bottom, employment in East Germany dropped from around 9.3 million to 6.3 million.[17]

By early summer of 1991, the THA had largely consolidated its structure. It had increased the number of its employees by more than 500 percent between June 1990 and June 1991 (see figure 8-3)—a number that does not even count the replacements of East Germans by West Germans—it had created 455 supervisory boards for its larger firms, and it had completed large parts of the so-called "small privatization," that is, the sale of retail stores, pharmacies, and the like. The structure and activity of the THA will be analyzed in more detail in the following two sections.

By March 1993, the 232 *Kombinate* the Treuhand had owned in July 1990 were almost all split into smaller units, 44 of them were privatized and 72 were liquidated (see figure 8-4). As of March 31, 1994, the THA had sold or restituted to former owners 8,620 companies and 7,182 company parts, had liquidated or was in the process of liquidating 3,276 companies, and still owned 788 companies. By the end of 1994, the THA will cease to exist in its present form. It is estimated that approximately 100 of its firms will neither be sold nor liquidated by then. Too large to be liquidated, they will stay under

Figure 8-3. Employment Treuhandanstalt



Note: East: Five new federal states plus East Berlin. West: Old federal states and abroad.

Source: Treuhandanstalt; Müller 1993; author's calculations.

public ownership, in the form of a limited liability holding company that will be 100 percent owned by the Ministry of Finance. The bulk of the THA's present administrative functions (contract monitoring, reprivatization, and so forth) will be continued until the end of 1996 by a federal agency under the authority of the Ministry of Finance. The THA's closing balance sheet, including provisions for future financial and environmental liabilities, is expected to show a deficit of -DM 275 billion.[18]

;aCentralized Ownership: The Treuhand

When the Treuhand Act assigned the THA the task of reducing the "entrepreneurial activity of the state as fast and as far as possible," it had approximately 440 employees; an improvised, mainly regional structure; no supervisory board; and a small management board, mainly staffed by government bureaucrats. Two weeks later, the supervisory board and the management board had been newly appointed.[19]

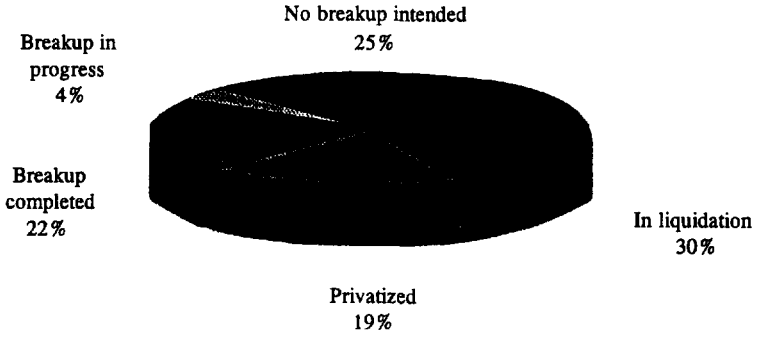
The THA's broad goals were defined by the Treuhand Act. Its two most important immediate strategic problems, however, were to redefine its organizational form and the priorities in building up its new structure. On both issues, the management seemed to be indecisive, consumed by the magnitude of the daily problems. After five weeks in office, the new president had to step down and was replaced by the chairman of the supervisory board, D. Rohwedder, who subsequently implemented a structure that partly substantiated and partly contradicted the initial framework set by legislation.

The Treuhand Act had prescribed a decentralized structure, with several subholdings integrating the old industry ministries, next to regional agencies, all under the control of a weak center. Within days after taking office, Rohwedder announced that he would drop the concept of subholdings in favor of a more concentrated organizational form. Although formally in breach of the law,[20] the dynamics of the institutional development proved that, in this early phase of the transition, there was room for discretionary strategic choices.

The second important decision in the early phase of the THA was to place emphasis on the development of its internal organization. On the one hand, this emphasis is reflected in the enormous growth of the work force in the THA center (which grew from 123 to 1,564 within one year) and by the expansion of all levels of higher management, which grew from 24 in July 1990 to 250 in July 1991 (see figure 8-3). In contrast to the policy in its firms, where the THA used local management resources as much as possible,[21] the share of Westerners among higher-level managers in the THA increased from 0 to 91 percent between July 1990 and July 1991 (see figure 8-3), about three-quarters of whom came from the West German private sector.[22] Hence, a significant part of available human resources was invested in the THA rather than its firms.

On the other hand, at least as important in the structure were the considerable amount of time and resources invested in the search for the most appropriate organizational form of the THA center. While the center had initially—after the decision to drop the plans for decentralized organization— experimented with a strictly unitary organizational structure (see Williamson 1975), after several months it adopted a more sectoral structure that was reminiscent of the branch structure of the former industry ministries.[23]

Figure 8-4. Breakup of the 232 Treuhand-Kombinate, March 1993



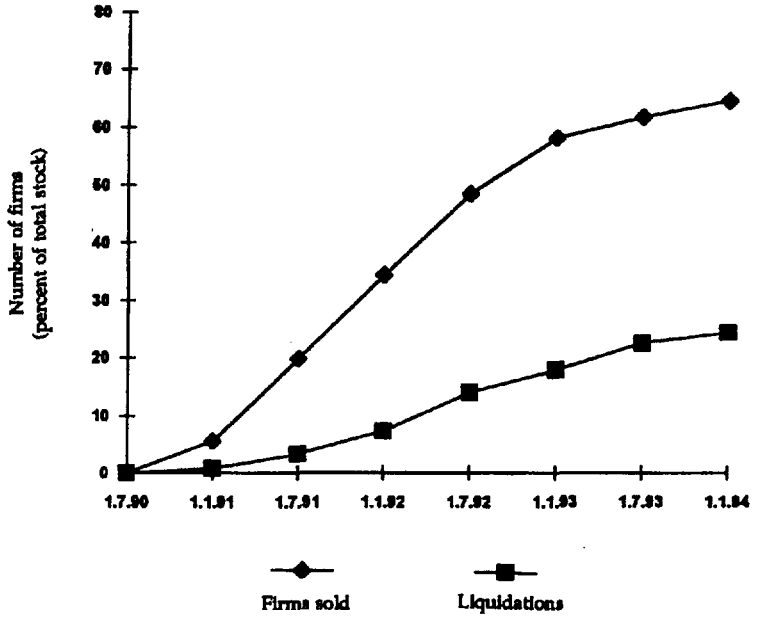
Source: Treuhandanstalt 1993b.

In principle, the decision to invest heavily in the development of the center was contestable because the Treuhand Act had explicitly stated that privatization was to be undertaken as fast as possible. Yet, since the act had stated several potentially conflicting objectives, this choice of priorities was clearly defendable (for a discussion of legal issues, see Hommelhoff 1991). The relatively slow start of the privatization process, however, created another problem. The THA came under increasing public pressure to undertake "regional structural policies" in spring 1991, when the East German economy began to collapse, and the overwhelming position of the formerly state-owned firms were still under the control of the THA. Indeed, in March 1991, in a crisis consultation among the federal government, the heads of the new East German states, and the THA, the THA acknowledged its responsibility to cooperate in such policies.[24] It is difficult to speculate about possible THA policies in the absence of this agreement. But the division of roles between government and THA was so well defined by spring 1991, and privatization was pursued so energetically from spring onward, that it is unlikely that this agreement induced more than minor changes of THA strategy.

The THA's choice of its organizational strategy is quite clearly reflected in the time series of company sales, shown in figure 8-5. Within the first year of its existence, when it put emphasis on the development of its internal structure, the THA sold less than 20 percent of its firms. During the next eighteen months, using its increasing experience in marketing, information processing, and international relations, it sold another 38 percent of its stock at a relatively steady, fast pace. During the next year, when most of the obviously interesting companies had been sold, it still sold another 6.5 percent, and in its final year sold an estimated 4 percent.[25] The resulting graph has a slight *S*-form: relatively low sales initially; relatively high, steady sales in the middle period; and declining sales during an extended final period.

To put this graph into perspective, consider a hypothetical, alternative "fast" policy choice, under which the THA would have been smaller and less active.[26] Suppose that the THA had chosen to auction off its stock of firms rather than rely on extended bilateral negotiations,[27] break the stock-flow constraint of mass privatizations along the lines proposed by Sinn and Sinn (1993) and Bolton and Roland (1992), leave the restructuring of its firms entirely to their buyers, and establish its organizational structure with lower priority and on a lesser scale during the process.[28]

Figure 8-5. Evolution of Treuhand Sales and Liquidations



Note: "Firms sold": fully or majority privatized or transferred to local authorities; "liquidations": liquidation completed or in progress.
Source: Treuhandanstalt; author's calculations.

Such an approach, by all expectations, would have led to a much more strongly front-loaded evolution of sales. The most profitable purchases and the most favorable matches between buyers and sellers would have been undertaken quickly, resulting in high initial sales rates. This effect would have been reinforced by the lack of experience and internal control in the privatization agency.[29] At the same time, the exhaustion of clearly profitable matches and uncertainty over the value of the residual portfolio would have resulted in lower sales rates in the later phases of the privatization process, possibly with a higher overall share of liquidations at the end.

Whether such a front-loaded strategy would have been superior is a question beyond the scope of this chapter.[30] The point to be noted here is that the THA's actual strategy of building up a strong center with competence and bargaining power was only one of several strategies available, and that other strategies would have led to other privatization patterns.[31] The question of whether the THA sold off its stock too slowly has not been in the forefront in the German public debate. A more frequently voiced complaint has been that the THA restructured too little and privatized too fast.[32]

By all accounts, the THA was fully operative by the early summer of 1991. The remainder of this section will discuss in more detail the governance structure of the resulting organization. The question of external control mechanisms of the THA will be taken up in the next section.

The organizational change initiated by the THA's president in August 1990 entailed a strengthening of central control, complemented by a well-defined element of regional decentralization. The resulting hierarchy was extremely flat (see figure 8-2). Treuhand firms with more than 1,500 employees (as of

January 1, 1991) reported directly to the center, and most firms with fewer than 1,500 employees were administered by the THA's regional offices.[33] The regional offices had a high degree of autarky, with full financial responsibility for all decisions up to DM 30 million. Under this two-tier structure, full control over each firm generally rested either with the center or a regional office. In addition to this structure, the center established so-called task forces of outside consultants to provide the regional offices with expertise and regulatory know-how from the top and to facilitate the information flow from the regions back to the center.[34]

For firms controlled by the center, major questions concerning the survival and reorganization of the firm were decided directly by the THA's management board, and regular issues were dealt with by the "industry directorate" (*Branchendirektorat*) responsible for the respective firm. As of August 1991, there were twenty such directorates, designed along the standard industry classification standards, and three to five directorates reported to one member of the management board. As an additional layer of control below the center, larger firms were endowed with supervisory boards, which were usually grouped around a senior, sometimes retired, Western manager. Yet, in contrast to West German practice, supervisory boards of THA-owned firms often get actively involved in the restructuring process, contributing financial know-how, management experience, and contacts. Therefore, the controlling function of supervisory boards of THA firms is superseded, and to some extent reduced, by their consulting function.

It has been pointed out repeatedly by the THA, as well as by economic and political commentators, that the THA has neither the task nor the resources to restructure and run the operations of its firms.[35] It is clear, however, that because of the complexity of the firms' adjustment dynamics and the size of its holdings, efficiency considerations force any organization the size of the THA to limit the center's operational activities and to delegate authority down through the hierarchy.[36] The more interesting question is, given the THA's constraints and political task, to what extent its governance structure has been hierarchical and centralized.

In this respect, the principal yardstick to judge the THA's governance structure is the extent to which key decisions are taken by the center and how lower-level planning is controlled by the center. Here, I will use four criteria to evaluate this structure: the extent of company liquidations, the supervision of corporate planning, company breakups, and management turnover. According to these criteria, and given its socioeconomic environment, the THA's governance of larger firms[37] must be considered to be strongly centralized.

Under the THA's policy, the most important decision for each firm—liquidation or continuation—has rested with the center and has been reconsidered regularly. Figure 8-5 depicts the evolution of liquidations of THA firms through January 1, 1994. By summer 1994, one-quarter of all THA firms had been liquidated or were in liquidation. Compared with all other transitional economies, this is an extraordinarily large number.

Because the center judged less than 10 percent of its firms to be viable without much restructuring at the end of 1991,[38] the decision to continue usually implied the decision to restructure. The general stance of the THA toward restructuring firms has been described by the THA's vice president as follows: "We shall give the firms sufficient time, which we set individually. Firms that cannot be privatized for certain in the foreseeable future are looked after intensively . . . and controlled individually."[39] Accordingly, the THA's industry directorates are in regular contact with all firms under restructuring, control their quarterly reports, and evaluate their business concepts.[40] Although much of the operational part of the restructuring is delegated to external consultants, overall central planning and the threat of selective intervention impose tight restrictions on THA firms.[41]

Complementing the center's control of the operation of its companies, the 1991 Splitting Act facilitates the redesign of the corporate structure of the old state-owned firms. The act provides the THA with a relatively flexible and extensively used tool to split up companies and resize business structures according to its own or, prospective investors' concerns. As a result of this activity, the approximately 8,500 firms the THA owned on July 1, 1990, had become 23,188 units by March 1994, including reprivatized or spun-off business parts, but not counting formal dissolutions through mergers and splits. This figure actually underestimates the extent of corporate breakups under THA control, because it does not include the transfers of business parts with communal functions to local authorities. Conversely, an explicit aim of the THA's policy is to realize synergies between its firms, either by directly merging otherwise unviable units or by coordinating activities bet
ween firms (THA 1993a, p. 2).

Finally, consider the issue of management turnover. In the context of established stock market economies, corporate control has been defined as "the rights to hire, fire and set the compensation of top-level managers" (Jensen and Ruback 1983). While this is certainly too narrow a definition for transitional economies, it still constitutes an important element of corporate control. Although the German Stock Company Act provides management of joint stock companies—and hence many of the large THA firms—with a considerable degree of independence from their owners, the THA has used this control right very actively. Between September 1990 and July 1991 alone, the THA dismissed 1,400 top managers, 400 of them for political reasons (Fischer, Hax, and Schneider 1993, p. 554). Although many of the immediate problem cases were solved in this early phase, the THA maintained a policy of active managerial control. In 1992 the THA dismissed 500 top managers directly, and an additional 300 were replaced in companies with supervisory boards (THA 1993a, p. 24).

In the early period of management restructuring, a significant portion of managerial turnover was accomplished by internal succession. The longer the restructuring lasted, however, the greater became the need for Western management qualifications, particularly in strongly market-dependent areas such as finance and marketing. The THA's policy toward its management clearly reflects this need. While the share of Westerners on managing boards of THA firms—also because of the large number of firms—was still relatively low in July 1991 (8 percent), this share increased to approximately 30 percent by July 1992 (see Dyck 1992 for a comprehensive analysis).

;aExternal Control of the THA

From its creation under the socialist government of the GDR on, the THA had the legal status of a "federal agency" (*bundesunmittelbare— Anstalt des öffentlichen Rechts*). Although it was not entirely clear what this meant under the legal system of the GDR,[42] it gave the THA a high degree of formal independence in the administrative hierarchy of post-reunification Germany. It removed it from the direct control of the executive and put it in the same legal category as the Bundesbank and the Federal Employment Agency (*Bundesanstalt für Arbeit*). The THA operates largely independently of government orders, but is subject to legal supervision by the Ministry of Finance.[43] Schuppert (1992, p. 186) describes the THA as an "organization in the overlap of two legal domains" (that of public and private law). Therefore, control of the THA is effectively shared among the Ministry of Finance, the THA's supervisory board, the Federal Accounting Office (*Bundesrechnungshof*), and the Parliament, which I will briefly discuss in turn.

Until reunification, legal supervision of the THA was incumbent on the prime minister of the GDR. Since October 3, 1990, this task has resided with the Federal Ministry of Finance. As a consequence, the THA reports to the Ministry monthly and needs the Ministry's approval for its yearly budget. The

Ministry's approval is also required if the THA wants to exceed its yearly credit limit of DM 30 billion (this figure has been increased from DM 25 billion in 1990 and 1991). Within this limit, the THA has direct and virtually unrestricted access to the credit market: the "Treuhand Credit Act" of July 1992 permits the THA to issue government-backed bonds up to this amount without the disclosure requirements imposed on other issuers.[44]

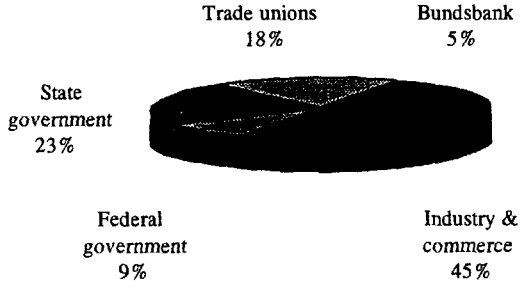
On the operational level, the Ministry must approve of all restructuring decisions involving volumes above DM 100 million.[45] In practice, the Ministry's role in controlling the THA can be considered to have been largely passive. A perceived lack of control of the THA led to the appointment of a special investigatory committee of Parliament in 1993. Here, for example, the vice president of the Federal Accounting Office accused the Ministry of "shortcomings" in its supervision of the THA.[46]

Reflecting the THA's hybrid legal status between public and private law, Ministry supervision is complemented by that of a supervisory board (*Verwaltungsrat*) modeled along the lines of corporation law.[47] The supervisory board appoints and dismisses the management board, must approve major management decisions, and advises the management. To this end, it is regularly informed by the management board and meets once a month.

In practice, the advisory function of the supervisory board has been at least as important as its control function.[48] The supervisory board is a way to institutionalize the exchange of information between the THA and different interest groups and to mediate between them. Figure 8-6 shows the composition of the supervisory board as appointed by the federal government by January 1, 1991. The regional interests (five of the twenty-two seats), expressed through the governments of the five East German states, and the trade unions (four seats) are both more strongly represented than the federal government. Dominant as a group are the employers (ten seats), with representatives from various industries (none yet from the banking sector).

On the operational level, the most effective control of the THA has probably been exterted by the Federal Accounting Office. The Federal Accounting Office examines all aspects of the THA's activity with respect to their financial correctness and economic responsibility on an ongoing basis. Its regular and special reports not only compile response information about mismanagement or fraud inside the THA, but also consider larger organizational issues. In particular, the proposed structure of the THA-successor institutions has been criticized extensively by the Federal Accounting Office on the grounds that it yielded too much to THA interests. The compromise that was agreed upon in May 1994 took these concerns fully into account.[49]

Figure 8-6. Composition of Treuhand Supervisory Board, January 1, 1991



Source: Treuhandanstalt 1992.

The role of parliament in controlling the THA generally has been restricted to setting the legislative frame of THA activity and following this activity through a parliamentary committee. Given the high degree of formal independence of the THA, the Parliament has no legal authority over the THA's regular operations. Furthermore, in practice even the ex post control of the THA's activity through a special investigatory committee has turned out to be difficult. Backed by the government, the THA has been very reluctant to provide the information the committee deemed necessary. In March 1994, members of the committee initiated a suit in the Constitutional Court to force the THA supervisory board to open its files to the committee.

The general picture that emerges from this analysis is one of almost complete operational independence and significant organizational freedom. Institutional independence has been an explicit goal of government policy toward the THA: "The THA can fulfill their tasks only if it can take the necessary decisions with great independence. . . I want to stress once more, and publicly stand up for it, that the Federal Government—and, most of all, I myself, as the chancellor of the Federal Republic of Germany—will do everything to guarantee this independence for the appropriate decisions" (Kohl 1992).

Hence, probably the most important control mechanism of the THA has been time. Although the Treuhand Act of June 1990 had not been specific about the timing of the THA's activity, a consensus soon emerged that the THA was to be an institution with a finite life. The Treuhand Credit Act of 1992 limited the THA's funding to the period of 1992–94. In May 1994, government and Parliament agreed on the institutional details that allow dissolution of the THA as planned at the end of 1994; a corresponding law was to be passed by parliament in the summer of 1994. Although some THA activities—particularly contract management and the reorganization and sale of the remaining THA firms—will have to be continued for some years after 1994, this will be done by different agencies that will be directly subordinated to the Ministry of Finance.

In a first, and still preliminary, assessment, this institutional commitment limits the long-term gains available from collusion and lobbying of interest groups, and hence the "regulatory capture" of the institution (see Laffont and Tirole 1993). The less long-lasting the relationship between the privatization agency and its counterparts in business and administration is perceived to be, the less incentive there is to invest in mutually advantageous favoritism. At the same time, the longer an institution with such important distributional competencies operates, the stronger is the external pressure, and the temptation to yield to such pressure, on the side of its members.[50]

For such a commitment to terminate to be credible, it must be complemented by measures limiting the incentives for ex post renegotiation. In the case of the THA, career concerns and reputation seem to have played an important role in this respect. As Seibel (1993) has documented, much of the THA's top management below the board level has been in their late fifties and sixties, seeking a last challenge in their careers. For this group, the incentives for lobbying and influence activities (Milgrom 1988) to extend the life of the institution much beyond the planned duration seem to be naturally diminished.

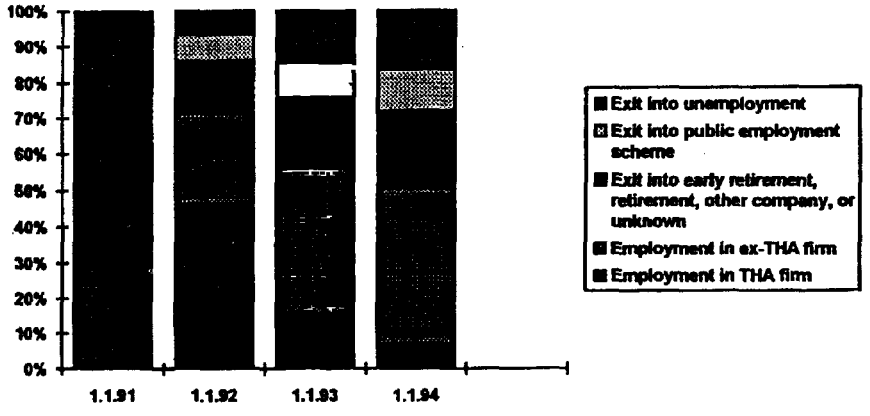
For younger top managers, in particular some members of the board from West German industry, reputation seems to provide some incentives to accomplish the THA's task in time. Since the THA's overall task—to privatize "as fast and as far as possible"—has been clearly defined from the beginning, delays in the privatization process, and even more so an extended coexistence of the THA with its firms, would have a negative effect on the reputation of the THA's top management. The reaction of the THA's president to the draft bill enacting the THA's successor institutions has been very critical, on the grounds that the bill effectively prolongs the life of an institution that was designed to be transitional.

;aDecentralized Ownership: Postprivatization

For the problem of corporate governance, a decisive structural consequence of the transition process in East Germany has been the entailed decrease in firm size. As shown earlier, most of the employment in the GDR had been in the large *Kombinate*. By June 30, 1991, after the THA had become actively involved in the restructuring of the *Kombinate*, 72 percent of the approximately 2.2 million employees of THA-owned firms were employed in firms with more than 500 employees. By the end of 1993, however, more than 75 percent of employment in THA and ex-THA firms was in firms with fewer than 500 employees.[51]

This enormous leftward shift of the distribution of company size can largely be attributed to the restructuring activity of the THA, and in particular to its two policies of massive labor shedding and company splitting prior to privatization. The latter activity has been described above. With respect to the former, figure 8-7 provides quantitative evidence.

Figure 8-7. Evolution of Work Force of THA Firms, January 1, 1991



Note: Total = 2,922 million.
Source: Treuhandanstalt.

Between January 1, 1991, and December 31, 1993, THA firms lost between 40 and 50 percent of their total work force to unemployment, early retirement, publicly funded employment schemes, or withdrawal from the labor market.[52] During the first year of the privatization process, when the early bargains were made and the THA made little use of penalties in privatization contracts, buyers often reduced the work forces of the acquired firms substantially. Later, because of the drastic cuts by the THA prior to privatization, the new owners generally reduced employment only little further and, in the longer run, more than met their contractually agreed upon employment targets.[53]

By March 31, 1994, with the breakup of the old firms largely completed (see "Political and Economic Development after 1989," above), the THA had privatized or reprivatized 18,279 businesses or business parts. Of these new entities 14.5 percent were created by management buyouts, 23.6 percent were restitutions to former owners, 4.6 percent were bought by foreign firms, and the remaining

57.3 percent were almost exclusively purchased by West German firms. Figure 8-8 presents the size distribution of acquiring and acquired firms for the 1,426 acquisitions registered with the Federal Cartel Office between 1989 and 1992.

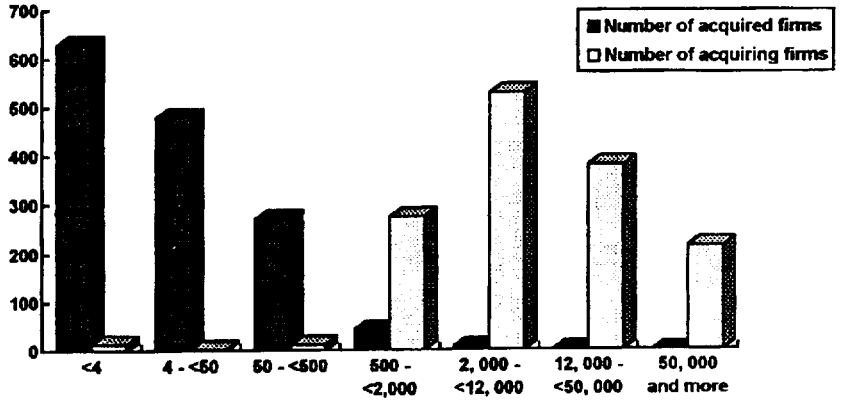
Despite the sample selection bias toward larger companies, the data clearly exhibit the extreme asymmetry between acquiring and acquired firms in this takeover wave. On the one hand, 78 percent of all acquired firms in the sample had annual turnover of less than DM 50 million. On the other hand, 79 percent of all acquiring firms had annual turnover of more than DM 2 billion. Taking into account that many of the smaller transactions not recorded in this sample were undertaken by small to medium-size West German firms, the general picture is that of a rather wide range of buying firms in the West purchasing a population of predominantly small firms in the East.

These data imply two kinds of corporate governance structures in posttransition East Germany. First, a significant fraction of privatized firms—including most management buyouts and reprivatizations—are owner-managed. In this group, corporate governance problems caused by the separation of ownership and control in larger firms are likely to be of secondary importance compared with direct agency costs of outside finance.[54] Second, most of the remaining privatized firms have become subdivisions of larger Western companies and are therefore subject to internal rather than external control problems.[55] Putting it crudely, one can characterize this second group of firms as one for which the problem of corporate governance has been shifted from the East to the West.

Of the institutions that are generally considered to be important in the privatization processes, in East Germany the stock market has played no role in the transition. Until the spring of 1994 only one East German firm attempted to go public, but this offering was ill-designed and the privatized firm ended in bankruptcy less than two years later.

The role of banks in the transformation process has been limited and has given rise to some controversy in Germany. While the big West German banks and the savings and loan institutions very quickly established an efficient branch network in the East,[56] the banks' lending activity lagged significantly behind the depository business. Only since 1992 has the volume of private bank lending in East Germany exceeded that of the deposits collected. Even then, lending was very cautious. As late as March 1992, after more than a year and a half in the East, 92 percent of all outstanding bank loans to THA firms were government-guaranteed.[57] Hence, even for THA firms, banks provided virtually no risky loans. This contrasts with the lending practice in the West, where approximately 30 percent of short- and medium-term lending is uncollateralized, let alone government-guaranteed (Drukarczyk, Duttle, and Rieger 1985).

Figure 8-8. Size Distribution of Acquiring and Acquired Firms in East Germany, 1989–92, by Turnover
(in million DM)



Source: Frisch 1992, 1993.

The reluctance to provide risky finance points to deficiencies in monitoring and screening by banks in the earlier phase of the economic transition. This is consistent with the empirical finding by Brandkamp (1993), who reports for a sample of small business start-ups that banks played a relatively minor role in advising new firms. More than a quarter of all respondents obtained no consulting at all. Of the rest, most advice came from professional consultants, followed by local chambers of commerce, friends from the West, and, finally, banks.

Furthermore, throughout the transition process, banks showed extreme restraint with respect to equity participations. Under increasing public pressure, the president of the German Banking Association finally promised the German chancellor in January 1993 that the banks would buy THA firms worth DM 1 billion. One year later, banks had bought just two firms. The banks often emphasized that they considered such engagements not to be their business.[58] In contrast, private banks contributed substantially to the restructuring of THA firms, primarily by consulting for THA branches and firms and through their representation on THA firm supervisory boards. In 1991 about 25 percent of THA firm supervisory board seats were held by bankers (Carlin and Mayer 1992). Yet, it is interesting to note that representatives of West German banks neither held seats on the THA supervisory board nor served on the THA management board.[59]

;aConclusions

By the end of 1994 the transition from centrally planned socialism to capitalism in East Germany will be largely completed. The political and macroeconomic design of the transformation process has been criticized on several grounds, most prominently with respect to the allocation of property rights (Bundeswirtschaftsministerium 1991; Sinn and Sinn 1993), the extent of regulation of business activity (Bundeswirtschaftsministerium 1991), the emphasis on privatization by sale (Sinn and Sinn 1993; Bolton

and Roland 1992), the centralized wage policy (Akerlof and others 1991; Begg and Portes 1992), and the implementation of monetary union (Pöhl 1993).

This chapter has ignored these issues and focused on privatization problems at the corporate level. Here, experiences in other Central or Eastern European countries have shown that loss of control and a resulting obstruction of corporate restructuring by insiders can create serious problems for the transition process. These dangers have been largely avoided in the German case. As discussed in the previous sections, this can be credited primarily to the form of transitional corporate governance imposed on the East German economy by the West. The main feature of this system has been that the state actually tightened control in the first phase of the transition by making significant investments into new control structures.

The major implication of this policy has been the possibility of tougher bargaining with entrenched management and of restructuring—particularly dismantling—large firms prior to privatization. Centralization thus has allowed the process to overcome the free-rider problem in the restructuring of loosely controlled firms in a manner comparable to the workings of hostile takeovers in competitive capital markets. Furthermore, and beyond the scope of this chapter, it has permitted those involved to address other, more structural, goals, such as the consideration of regional problems, industry structure, and ownership distribution.[60]

At least three elements of institution design have supported this process of centralized decentralization. First, as discussed earlier, heavy initial investment in the organizational and human capital of the privatization agency has created the structure necessary for the complex managerial tasks of control, bargaining, and restructuring during the privatization process. Second, the privatization agency has had a high degree of organizational independence, and even more operational freedom. Third, it has operated under an explicit time limit, which helped to limit collusion between the agency and its clients.

When asking what this specific transformation experience can imply for other economies in transition, it is useful to first identify what has been unique to the German case. There are three major elements. First, the large material transfers; second, the transfer of human capital; and third, the availability of an advanced and refined legal and administrative structure.

Of these three elements, the first sets the East German economy far apart from all other transitional economies in quantitative terms. However, the major part of the transfers from the West—which were between DM 150 and 200 billion a year, depending on the estimates— did not even involve the THA. Most of these transfers were either for consumption or for infrastructure investment, dictated by the constitutional and economic necessity to equalize living standards in both parts of Germany as fast as possible. The THA's total operating deficit between July 1990 and the end of 1994 was approximately DM 216 billion, an average of DM 48 billion a year. This deficit resulted almost exclusively from the obligation to honor firms' outstanding old debts; to finance the clean-up of environmental damages; to pay high wages, above productivity levels; and to finance West German type social benefits for dismissed employees in keeping with West German precedents. Hence, it is safe to say that the "pure" costs of operating a strong, independent privatization agency have been relatively small, in particular in view of the large sums available internationally for the restructuring of Eastern Europe.

Another question is to what extent the large transfers from the West have facilitated the THA's privatization policy. Clearly, such enormous transfers would ease any privatization program. But it seems rather unlikely that these transfers were essential for the THA's policy. They seem to have had slight success in generating widespread support for economic reform in the population. Surveys by the Allensbach Institute, for example, show that the proportion of East Germans who were "quite satisfied" with the market-based West German economic system dropped from almost 80 percent in early 1990 to around 35 percent in late 1993.[61]

The other two elements clearly also had an important positive impact on the operations of the THA. There have, however, also been downsides to both of them. With respect to the third element, it has been argued that the provision of a large set of highly refined institutions and regulations may hinder rather than promote the emergence of entrepreneurial activity (see Bundeswirtschaftsministerium 1991). These concerns have often been voiced with respect to environmental or labor market regulations. A piece of legislation that directly impeded the activity of the THA concerns the management of firms governed by supervisory boards. Under German company law such management is responsible only to the supervisory board, and thus the owner has no direct means of imposing his or her will on the management. There have been several cases in which the THA had to go into lengthy legal procedures to obtain information from management or simply to sack managers that opposed THA plans.[62] The Splitting Act of 1991 is an example of a piece of legislation introduced to curb the rights granted to corporate insiders under existing legislation.

The strong inflow of human capital from the West—often provided for free or for only small fees by Western companies—has also had its downside. Because it was already common in 1990 for West German firms to establish business links with East German counterparts, send consultants, or advise on supervisory boards, West German firms often gained detailed information about potential Eastern competitors or acquisitions. This often put them in a strong bargaining position in negotiations with the THA, not only with respect to the takeover price, but also in regard to the restructuring or liquidation decisions included in the sales contract. In several cases negotiations broke down after protracted bilateral bargaining, and the Eastern firm, not having been able to establish alternative business contacts in the meantime, was liquidated.

Hence, although the East German transition took place under extremely privileged material conditions, it does not appear that its privatization strategy of centralized decentralization depended on these conditions. What seems to have been more important is the commitment to an independent, finitely lived privatization agency, with the capability to tighten control prior to privatization. The experience of the Hungarian "centralization" strategy of Autumn 1991 (see Voszka 1994) shows that such policies are problematic if implemented only partially. In particular, if the privatization agency is controlled by the government, the "rights to hire, fire, and set the compensation of top-level managers" (Jensen and Ruback 1983) may easily degenerate into a source of government favoritism and party power. Similarly, if there is no clear commitment to the completion of the privatization program and "if the state proves to be a generous owner and permissive controller, this formal subordination may be more convenient for the managers than strong private ownership" (Voszka 1994). Creating an environment in which managers know that such formal subordination is only a means to implement private control is an integral part of the design of transition processes.

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Footnotes Chapter 8

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1. See, for example, Dittus 1994; Gray and Hanson 1993; Phelps, Frydman, Rapaczynski, and Shleifer 1993; or van Wijnbergen 1992. A notable exception is Carlin and Mayer 1992.

2. See, for example, Berg 1993; Litwack ,in this volume; and Boycko, Shleifer, and Vishny 1993. An interesting review of empirical evidence and some recent theories is given by Aghion and Carlin 1994.

3. According to Berg 1993, Poland loses firms "in the 'Bermuda Triangle' of management, the Workers' Council and the unions."

4. The process is described in more detail in following two sections. Yet it is certainly true that the breakdown of the economic system of East Germany before November 1989 imposed high costs on the population, that the overthrow of the system was triggered by the population (through the mass exodus in September–October 1989 and the peaceful revolution in November 1989), and that the compensation was considerable (several hundred billion dollars within a decade—the estimates vary).

5. Historically, the original law enacting the institution did not set a time limit; the consensus emerged in the subsequent legislative process. See "External Control of the THA," below.

6. The data are based on the *Statistical Register of Business of the GDR* as of June 30, 1990, provided by Die Wirtschaft 1993; 2.7 million were approximately 30 percent of the total workforce of the GDR at that time.

7. For example, the "Kombinat Haushaltsgeräte Karl-Marx-Stadt" consisted of 29 businesses with 217 production units in 118 districts (Hornich 1993).

8. An excellent account of the economic and political development from 1989 to 1992 and its problems is given by Sinn and Sinn 1993. The standard reference on most legal, economic, and institutional aspects of the workings of the Treuhandanstalt is Fischer, Hax, and Schneider 1993.

9. Gesetzblatt der DDR I, S. 300.

10. Sinn and Sinn (1993, p. 276) report total debt of GDR firms with the central bank in 1989 of 260.4 billion East German marks. The opening balance sheet of the THA (THA 1992, p. 17) as of July 1, 1990, reports total liabilities of THA firms with credit institutions of DM 104 billion.

11. Some authors put the initial number of THA firms at 8,000. The figure here is from THA (1993a). To put the employment figure into perspective, total employment in East Germany in the third quarter of 1990 was 8.8 million (Statistiches Bundesamt 1991).

12. The most famous example is the attempted self-privatization of the former state monopoly hotel group, Interhotel. This case played an important part in the resignation of the first THA president. For other instances, see the case studies compiled by Die Wirtschaft (1993).

13. In September 1991, a preliminary analysis of the available evaluations found approximately 70 percent of the THA firms to be viable (*Treuhand Informationen* 1991).

14. "Well-informed buyers, who were interested in specific parts of the Kombinate . . . could buy at favorable terms during this period" (Müller 1993). For a description of the state of East German firms and the difficulties faced by prospective investors, see also Albach 1992.

15. Carlin and Mayer (1992) rightly emphasize that most of this debt is completely unrelated to the THA's restructuring and privatization tasks—in particular, the large financial and environmental liabilities the THA had been forced to take on.

16. The measurement of GDP in the GDR is subject to well-known difficulties with data of Eastern Block countries. The figure reported here is the estimate by Sinn and Sinn (1993).

17. Officially, in the second half of 1993 unemployment in East Germany was 1.2 million. The difference is explained by the 0.6 million in publicly funded employment or qualification programs, 0.8 million in early retirement, and 0.35 million commuters to West Germany (Statistisches Bundesamt 1994).

18. This figure includes provisions for future liabilities, for example, DM 20 billion for the cleanup and repair of nuclear sites and coal mines.

19. An excellent reference for the evolution of the THA's structure is Seibel 1993.

20. The Treuhand Act stated: "The Treuhandanstalt realizes its tasks in a decentralized organisational structure through Treuhand sub-holdings" (Gesetzblatt der DDR I, S. 300). When asked about the legal implications of his concept, Rohwedder replied that "where there is no claimant there is no judge" (Handelsblatt August 27, 1990).

21. The share of Westerners on THA firm management boards rose from approximately 4 to 8 percent between July 1990 and July 1991 (Dyck 1992). See below.

22. Numbers are based on the preliminary evaluation of questionnaires reported in Czada 1993.

23. See Seibel 1993 for a more detailed account.

24. "Principles of the Cooperation of Federal Government, New Federal States, and THA for the Recovery East" (Bundesregierung 1991).

25. These percentages refer to the number of businesses sold. Although "stock value" is difficult to define for East Germany, the number of transactions probably provides a better measure for the THA's activity than the value of transactions.

26. Some observers find that the THA accomplished most of its task "in the amazingly short span of four years" (*The Economist*, April 30, 1994). This cannot be debated. The question is whether, given the amazing amount of funds available, one could have amazed these observers even more.

27. See Akerlof, Rose, Yellen, and Hessenius 1991 (section 5) for a discussion of possible employment consequences of such policies.

28. This policy would have been closer to the Czech and the attempted Polish mass privatization policies (Berg 1993; Carlin and Mayer 1993). Auctions, in particular, were used by the THA only twice and for a specific group of firms.

29. Even under the actual policy of the THA, these effects were quite visibly present in the time between July 1990 and summer 1991 (see the brief remarks in the section "Political and Economic Development after 1989," above). Some of the critical assessments of the THA's activity, such as Kampe 1993, emphasize such cases.

30. On the problem of the optimal speed of restructuring see Aghion and Carlin 1994.

31. One particular feature of the German privatization process, however, suggests that the THA's chosen strategy was superior in practice. The "Property Act" of September 23, 1990, imposed a general priority of restitution over compensation for most former owners of East German companies. In practice, this led to a significant delay in the privatization process, and this would have impeded any possible policy variant (see Bundeswirtschaftschaftsministerium 1991; Sinn and Sinn 1993).

32. In view of the disastrous employment situation in East Germany, this is a predictable public reaction. For a more systematic argument, see Nolte 1993.

33. Of the total number of 10,344 THA firms of July 1, 1991, the center controlled 36 percent, and the regional offices 64 percent.

34. In practice, these flows were less than smooth because of agency problems in the relationship between task forces and regional offices.

35. Many economic observers, free from political pressure, go even further. For example, Fischer, Hax, and Schneider (1993, p. 5) state that "the effective re-organization and rescue of thousands of companies cannot be initiated by a bureaucratic organization such as the Treuhandanstalt."

36. See Milgrom and Roberts 1992 for a detailed discussion of the principles of organization, and Aghion and Tirole 1994 for an analysis of different realizations of authority.

37. Recall the division of responsibilities between center and regional offices described above.

38. As of December 31, 1991, for 1,536 center-controlled firms the evaluation of opening balance sheets found 9 percent to be viable without much restructuring and 18.2 percent to be absolutely unviable. The remaining 72.8 percent were judged to be more or less promising after restructuring (Gless and Schwalbach 1993).

39. H. Brahms in *Treuhand Informationen* 17 (1992), p. 3.

40. For a more detailed description of the planning instruments used by the center, see THA 1993a (p. 2).

41. The following complaint by the head of the supervisory board of Takraf AG is typical for the control exercised by the THA: "We had to pre-plan the cost of material up to DM 5,000 for the next year. This makes entrepreneurial activity quite impossible" (*Wirtschaftswoche* 50, 1992, p. 198)

42. This kind of institution did not exist under East German law.

43. For details, see, for example, Kloepfer 1993.

44. In practice, the placement of THA bonds is undertaken in close cooperation with the Ministry of Finance and the Budesbank (THA 1993a, p. 28).

45. This is according to THA guidelines of August 1991. The figures have changed slightly since then (see Gless and Schwalbach 1993).

46. *Frankfurter Allgemeine Zeitung*, December 3, 1993.

47. For a brief description of the role of the supervisory board in German corporation law, including more extensive references, see Baums 1993.

48. Given the composition of the supervisory board, however, the dividing lines separating controlling, advising, and lobbying are not easy to draw.

49. See the interview with the office's president in *Frankfurter Allgemeine Zeitung*, May 17, 1994.

50. An interesting empirical study by Czada (1993) substantiates this argument. For a sample of 165 higher-level managers of the THA, 58.8 percent stated that external influences on their activity had increased from 1991 to 1992; only 9.7 percent perceived decreasing external influences.

51. THA 1993b, 1994, Monatsberichte.

52. Nolte 1993 provides additional evidence and further references.

53. A first evaluation of contract fulfillment for 1991-92 (84 percent of all contracts) shows overfulfillment by 16 percent (THA 1994).

54. See, in particular, Jensen and Meckling 1976. See also Aghion and Bolton 1992; von Thadden 1990, forthcoming; Hellwig 1994.

55. See, for example, Williamson 1975, and Milgrom and Roberts 1992.

56. By December 1990, Deutsche Bank and Dresdner Bank alone had established 263 branches in East Germany, mostly taken over from the former state bank. See Wagner 1993 for details.

57. See Bundesverband Deutscher Banken 1992.

58. For a view from Deutsche Bank, see, for example, Krupp 1993: "It is not the primary task of banks to develop entrepreneurial activity. This would go against the classical division of roles in a market economy and, in the end, would be beyond the banks' capabilities."

59. G. Rexrodt, on the management board from September 1991 to January 1993, had been with Citibank since January 1990, after eight years in public service in Berlin.

60. These issues are emphasized in Dornbusch and Wolf 1993 and Carlin and Mayer 1992. Carlin 1993, however, rightly points to the severe, and sometimes devastating, structural implications of the economic transition in East Germany.

61. See *International Herald Tribune*, April 20, 1994.

62. For relevant case studies see, for example, *Dic Wirtschaft* 1993.

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