

# Has the regulation of old debts in the successor companies proven worthwhile?

## *Projevila se regulace starých dluhů u nástupnických společností jako rentabilní?*

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**Abstract:** The old debt problem resulting from the transformation of the agricultural co-operatives of the former GDR (German Democratic Republic) is described with respect to its evolution and its economic policy treatment during the process of transformation. So far, the measures for the treatment of old debts have had business economically stabilising effects. Nevertheless, debts are still growing. The farms which are affected by such old debts are strongly interested in solving this problem. This explains the intensity of the results' discussion of a scientific expert opinion on an analysis of the mode of action of the old debt regulation in agriculture. The conclusions which can be drawn from the public discussion of these results with respect to the future treatment of these old debts show, that the affected farms favour a kind of bonus rule for debt repayment. Such a regulation also seems to be acceptable for the treasury as the final bearer of the remaining debts and as a solution to minimise the taxpayers' burden.

**Keywords:** agricultural co-operatives, old debt, transformation

**Abstrakt:** Problém starých dluhů vyplývající z transformace zemědělských družstev bývalé NDR (Německé demokratické republiky) je popsán s ohledem na vývoj ekonomické politiky během transformačního procesu. Dosud působila opatření pro nakládání se starými dluhy na obchod a ekonomiku stabilizačně. Nicméně dluhy stále rostou. Hospodářství, která mají takovéto staré dluhy, se o vyřešení tohoto problému velmi zajímají. To vysvětluje intenzitu výsledné diskuse a výměny názorů vědeckých odborníků o způsobu jednání v případě regulace starých dluhů v zemědělství. Závěry, které mohou být shrnuty z veřejné diskuse o těchto výsledcích s ohledem na tyto staré dluhy, ukazují, že postižená hospodářství jsou nakloněna určitému bonusovému pravidlu pro proplacení dluhu. Taková regulace je akceptovatelná i pro státní pokladnu jako konečného nositele zůstávajících dluhů a jako řešení k minimalizaci břemene daňových poplatníků.

**Klíčová slova:** zemědělská družstva, staré dluhy, transformace

## INTRODUCTION

With the transition of the whole economic system from a planned to a market economy and, in this context, with the privatisation of the agricultural producers' co-operatives respectively their organisational change into other legal forms (registered co-operatives, private limited company or joint stock company) as well as with the realised currency reform (exchange of the Mark of the GDR into Deutsche Mark in the relation of 2 : 1 per 1. 7. 1990) the problem of a financially new evaluation of the operational assets and debts has arisen.

This change of the economic system necessarily led to an extensive change of the economic framework of the agricultural farms. Thus, producer prices of plant and animal products fell to about 25 to 35% of the former price level, while for example credit burdens (investment credits) increased. This was due to, firstly, an increasing interest rate level from formerly 1 to 3% to now about 8 to 10% (retroactively from 1. 7. 1990 by an unilateral state-

ment of the lenders) and, secondly, rising redemption instalment to about 10% from formerly 2%.

The extremely complicated situation, which resulted from this process, might have led to the total break down of many agricultural farms if no state intervention was provided. In order to allow the farms a chance to survive, short-term liquidity assistance has been provided and a debt moratorium has been agreed upon:

- In August 1990, the still acting GDR government put 150 millions DM (Deutsche Mark) at disposal for taking over interest liabilities.
- Credit repayments were suspended until 31. 12. 1990.
- Agricultural producers' co-operatives, which were heavily burdened with debts due to state regulation, received an amount of 340.5 millions DM as a partial reduction of debt (Law Gazette of the GDR 1990, Part I, No. 17, p.135).
- For the period of 1. 1. to 28. 2. 1992 the federal government of Germany provided another 50 millions DM for interest refunds.

However, these measures were not adequate for a permanent solution of the problem. The farms remained having credit burdens, which are called **old debts**.<sup>1</sup> With regard to treatment of these old debts, a number of regulations were enacted, which are explained in the following.

## MEASURES CONCERNING THE TREATMENT OF OLD DEBTS

### Partial reduction of debt by the Treuhandanstalt<sup>2</sup>

- Legal basis was the unification contract article 25, sub-section 3, sentence 3 to 6 and the on this basis enacted administrative rule (this regulation *did not create a legal claim* for debt relief, as a directive or an order would have done). Parties concerned are the respective farms and the Treuhandanstalt.
- Co-operatives of animal and plant production, horticulture as well as freshwater fishery could be freed of debts. This did not hold for interim co-operative institutions, melioration, forest and dairy co-operatives. Here only firms which were capable of development and financial recovery received a partial reduction of debt.<sup>3</sup>

Table 1. Old debt and partial reduction of debt by the Treuhandanstalt

	Affected farms (no.)	Old credits per 31.3.1991 (in millions DM)
Old credits of agricultural farms	n.a.	7,600
Applications for reduction of debt	3,116	6,990
Farms included in partial reduction of debt	1,397	4,593
Given partial reduction of debt	1,382	1,363
Balance relief including annex-2-capital equipment	1,519 <sup>1)</sup>	3,259

1) Agreements on the alteration of priority were also made with co-operative farms which had no claim for partial debt relief (e.g. interim co-operative institutions, melioration co-operatives)

Source: Forstner and Hirschauer 2001, p. 35

<sup>1</sup> Those bank liabilities of the former agricultural producers' co-operatives and their successors in title are called old debts, which have accrued before 1. 7. 1990 (currency reform) (Tholen 1992).

<sup>2</sup> German privatisation institution for state owned property.

<sup>3</sup> The capability of development and financial recovery had to be proved by presentation of so-called *operational development plans*.

<sup>4</sup> Special type of co-operative bank.

<sup>5</sup> The *Erblastentilgungsfonds* was created in the context of the German unification process, in order to get over the inherited financial burdens of the German unification and to secure a long-term *set-up* in the new *Bundesländer* (BGB 1993, Part I, p. 944).

<sup>6</sup> The resulting extraordinary income was allocated to reserves and was **not** included in the *asset settlements* of the agricultural producers' co-operatives' successors.

<sup>7</sup> FIBOR (Frankfurt-Interbank-Offered-Rate) has been the relevant interest rate, which has been replaced with the EURIBOR (Euro-Interbank-Offered-Rate) on 1. 1. 1999 (Hirschauer et.al., 2000, pp. 117–118).

<sup>8</sup> The annex 2 of the agreement upon changing priorities lists, all assets classified as *not necessary for the operation* with their value in the DM opening balance sheet.

- Only credits for those investments, which have been *given by public order* and did *not concern assets necessary for the firms operation*, as well as *credits which got worthless* after the unification could be disencumbered (e.g. investments for municipal purpose or power adjustments to lignite heating).
- Floating capital credits were not disencumbered.
- 3 116 requests were given (Rawert 1994, p. 132).
- 1.4 thousand millions DM were provided by the Treuhandanstalt for a partial reduction of debt plus another 400 millions DM for already accumulated interests. This was not sufficient for a 100 % reduction of debt of all those credits, which were classified for disencumberment.
- By means of the partial debt relief, 78% of the old debts classified for disencumberment could be redeemed. With regard to all old debts, this quota amounted to 18% (Böhme 2000).

### Balance relief for farms

- Legal basis is the DM balance law (article 16, sub-section 3 and 4). Participating parties are the concerned farms, the German Co-operative Bank as the main creditor, 157 Raiffeisenbanken<sup>4</sup> and roughly 15 co-operative banks.
- The creditor banks agreed upon an alteration of priority (hence, liabilities for old credits have a *lower priority than other and future liabilities*, collaterals were released).
- In the case of liquidation of the concerned farm, banks can enforce an open claim. The banks got a guarantee by the state for repayment of such debts by allocating the not redeemed credit amount to the so-called *Erblastentilgungsfonds*.<sup>5</sup> Since this fund is financed by means of taxes, the taxpayers carry the final burden.
- Old debts and accumulated interests could be eliminated from the liabilities of the farms.<sup>6</sup> Anyhow, this resulted only in a deferment of payment as interest payments still accumulate (though no compound interest)<sup>7</sup>. Per annum, *0.25% of the credit amount* have to be paid as administrative apportionment of cost.
- Assets which were not necessary for the farms' operation had to be sold (flats, cultural centres, holiday camps which are so-called annex-2-capital equipment<sup>8</sup>) and the

respective revenues had to be utilised for debt redemption (until 31. 12. 1995).

- Furthermore, the farms are obliged to utilise 20% of their realised profits (prior to taxation) for debt redemption.

Despite these extraordinarily effective economic regulations, for the farms the remaining debt burden was oppressive. In addition, for the former members of the agricultural producers' co-operatives, it was hardly understandable, that on the basis of the legislation of the federal government, the old GDR credit contracts were de facto treated equally to credit contracts which came about under market economic conditions and on the basis of optional decisions. Furthermore, due to the effects of the changed economic framework, real asset losses of the former agricultural producers' co-operatives were much higher than it could be expected by the currency exchange relation from 2 : 1. Real asset losses amounted to about 3 to 4 : 1 (Hagelschuer 1995), including total worthlessness of credits for off-farm investments.

Because of this reason, an agricultural producers' co-operative (in liquidation) took legal action against this old debt regulation at the Federal Supreme Court. With its judgement of 16. 10. 1993, this court confirmed the lawfulness of the legal regulations regarding the treatment of old debts. This was finally confirmed with the judgement of the Federal Constitutional Court of 8. 4. 1997.

Anyhow, the Federal Constitutional Court determined in its judgement, that the federal government would have to examine after half of the period of the old debt regulation (total time period amounts to 20 years) whether the farms with old debts and an adequate business management are able to redeem these debts within this 20 year period (Hirschauer and Forstner 2000b, pp.79–82).

## EVALUATION OF THE PRESENT OLD DEBT REGULATION

In order to conduct this evaluation, two scientific institutions were put in charge of providing the necessary preparatory work. These are the Federal Agricultural Research Centre in Braunschweig-Völkenrode and the department of Farm Management Theory of the Faculty of Agriculture and Horticulture at the Humboldt University of Berlin. Dr. Bernhard Forstner and Dr. Norbert Hirschauer were the two researchers which were entrusted with these tasks. They presented the results of their analyses in a number of publications ahead of a final colloquium, which were there discussed quite committedly and contrarily with regard to the evaluation of the results.

As a result of an open discussion (Colloquium at the Faculty of Agriculture and Horticulture at the Humboldt University of Berlin at 14. 5. 2001) in front of many repre-

sentatives of co-operatives, associations, Länder Governments and the Federal Government, it could be emphasised that the realised way of the old debt regulation has led to:

- the relief of the farms in terms of their debt service (repayment, interest) up to realisation of profits, which has the effect that the old debt burden does not represent a danger which would endanger their existence; liquidity and creditworthiness were not and are not disturbed by the old debt;
- the renunciation of compound interest payments limited the liabilities' increase and acted as a subsidised debt service;
- the treatment of *realised* debts services (repayment and interest payments) in the balance acted as tax relieved expense items;
- the fact that extraordinary profits of the granted partial reduction of debt as well as the balance relief have not been considered of the asset settlements<sup>9</sup>, which preserved the financial strength of the farms;
- the method of balance relief, which in the sum of all granted tax, financial and economic relief resulted in an advantageous situation of the respective farms in relation to those farms without old debts. With respect to their effects, the authors regard these advantages equally to state subsidies<sup>10</sup>.

For the first time, the scientifically accurate and mathematically formulated models on a complex business economic evaluation of the old debt regulation have led to comprehensive insights regarding some interesting but so far hidden facts. In relation with a corresponding farm of reference without any old debts, a subsidy-like advantage resulted from the sum of all regulations:

1. The reduction of the equity capital for asset settlements and therefore avoidance of additional capital outflow.
2. Taxation advantages regarding the service of credits (repayment and interest payments got tax relief).
3. Interest privileges because of non-compliance of computation of compound interest.
4. A low capital service burden for those assets which have been financed with old credits.
5. The still unlimited period of lending.

However, exactly at this ascertained subsidy-like advantage of the presently prevailing regulation of old debts, the evaluation of many practical men differs from those of the researchers.

Practical comparisons on the basis of actual business economic outcomes of test farms or by co-operative examination associations did not show any provable advantages nor disadvantages for those farms with old debts as compared to farms without old debts. In terms of management and productivity ratios of plant and animal production, the differences between the groups of farms with and without old debts were not significant.

<sup>9</sup> Anyhow, this has been a disadvantage for the leaving members and led to expectations on their part with regard to judicial decisions.

<sup>10</sup> The value increases with the period of repayment. E.g. in the case of a 15 years lasting repayment period the balance relieve corresponds in its total effect a subsidy of 55% of the old debt burden.

Table 2. Year of final repayment of old debts on the basis of a FIBOR of 5%

Constant yearly payment DM/ha	End of repayment of old debts respectively their interests in the case of an old debt burden per ha					
	600	1200	1500	1800	2400	3000
20	2 077	2 445	2 973	–	–	–
40	2 021	2 077	2 125	2 195	2 445	2 973
60	2 009	2 035	2 053	2 077	2 146	2 271
80	2 005	2 021	2 031	2 044	2 077	2 125
100	2 002	2 013	2 021	2 029	2 049	2 077

Source: Wissing 1995, p.2

Although the outlined advantageous effects are not to be called into question, their influence on the real farm results seems to be compensated by other influences. Therefore, it can not be spoken of ‘competition distorting subsidies’.

What are the contributions of the named authors with their systematic and analytical, scientifically accurate work for answering the question given by the Federal Constitutional Court?

Decisive for answering and examining the problems given by the Federal Constitutional Court were the following results:

1. Despite the debt redemption of 1.4 thousand millions DM, in most farms debts amount to a bigger sum than at the beginning of the old debt regulation (hardly interest and redemption payments). This situation is non-motivating for the respective farms.
2. When payments for credit service are made, the given division between redemption and interest payments has the effect, that the farms can only service interests and hardly any repayments of old credits can be made.
3. The sale of operational not necessary assets within a given period of time led to inefficient dispositions. So far the respective sales revenues covered only 80% of the repayment amount.
4. About 43% of the farms with old debts could not make any repayments yet (Forstner and Hirschauer 2000).
5. As a result, it is to be expected, that the majority of farms will not be able to redeem their old debts within a period of 20 years (see Table 2).

De facto the following can be noticed:

- The old debt regulation has sustainably compensated for the disadvantageous effects of high credit burdens not due to negligence.
- The economic obligation for redemption is low because the period of regulation is not restricted for the respective farms.
- Still, the obligation for the farms to redeem their credits is high.
- The majority of the old debtors has economically no real possibility to repay their credits within the 20 years period, given by the Federal Constitutional Court.

– Due to the equalisation claims on the so-called Erblast-entilgungsfonds agreed upon in contracts, the banks do not bear a risk.

– It is the taxpayer, who has finally to pay for the open credit burdens.

This results in unambiguous interests:

On the one hand, there are the old debtors, who want to repay but are economically able to do so only on a limited scale. And on the other hand, the Ministry of Finance, which wants the receivable debts of these debtors to be repaid.

In this context, the discussion between the participating groups was interesting with regard to this problem. Especially the manager of the respective farms made clear that the increasing debt burden represents a heavy load for the farms. Future plans are not independent of these debts. Furthermore, it is irresponsible to transfer a farm with such a high debt burden to the following generation. In average, debts amount to about 3.5 millions DM per farm (Forstner and Hirschauer 1999).

## WHICH SOLUTIONS CAN BE OFFERED?

1. The old debts which have been worthless when the partial reduction of debt of 1993/94 was carried out and which have been classified for disencumbrment but were actually not relieved (22% of old credits classified for disencumbrment) should also be relieved under the same conditions as the 1993 relieved credits.
2. The so far unfavourable relation between the redemption of old debts and redemption of accumulated interest debts should be improved in favour of debt repayments (change of the repayment formula).
3. Based on the will of the old debtors to free themselves from the debt burden, respective agreements for repayment commitments should be arranged which take into account the farm specific situation and which should lead to a total debt redemption if the agreement is realised (bonus rule). This way, it would be feasible to reduce the taxpayers’ burden as much as possible.
4. Because of political and economic reasons, all these so far mentioned possibilities from 1 to 3 have not to have any influence on the already realised asset settlements.

5. If the proposed measures are not taken, the debt amount would permanently keep increasing, although the old debts do not represent a significant economic burden of the farms. Finally, this would result in a maximised burden for the taxpayers.

Economically, an immediate reduction of debt would be most convenient, but this does hardly seem to be feasible politically, although the subsidy-like effect of the present old debt regulation represents a supporting argument with regard to the not affected farmers. Anyhow, the decisive argument is the growing debt for the banks advantage and the taxpayers disadvantage. In this context, there exists further need for political action.

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