

# Committing to Grow: Privatizations and Firm Dynamics in East Germany

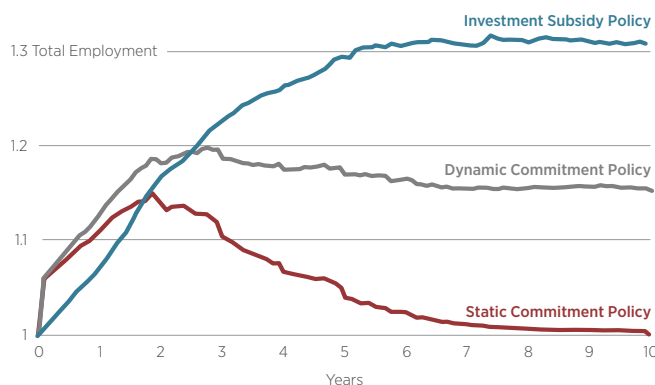
Based on BFI Working Paper 2023-114, “[Committing to Grow: Privatizations and Firm Dynamics in East Germany](#),” by Ufuk Akcigit, University of Chicago; Harun Alp, Federal Reserve Board; André Diegmann, Halle Institute for Economic Research; and Nicolas Serrano-Velarde, Bocconi University

After the fall of the Iron Curtain and the privatization of businesses, Germany required new owners of East German assets to commit to employment targets, resulting in a 22% points higher annual employment growth rate, a 14% points higher annual productivity growth, and a 3.6% points higher probability of exit for firms with binding employment targets. Without these targets, aggregate employment in these firms would have been 15% lower after 10 years.

Industrial policy is often implemented to preserve employment during economic shocks. Yet, despite such policies’ ubiquity, little is known about the effects of these interventions. In this paper, the authors study a novel policy designed to preserve employment during the privatization of East German firms following the fall of the Iron Curtain, a period expected to raise unemployment at a significant social cost. To ensure employment levels remained at a certain level, policymakers required that new owners of East German firms commit to employment targets, with penalties imposed for falling below the committed employment level. These labor commitments were applied to over 18,000 privatization contracts, covering more than 900,000 workers in East Germany.

The authors’ analysis involves three steps, the first of which employs a dynamic model that highlights three channels through which a firm is affected by a binding employment target, i.e.,

**Figure 1 • Total Employment under Alternative Economic Scenarios**



Note: This figure shows total employment implied by the model under three different cases: (1) baseline economy (gray line), (2) counterfactual economy with no dynamic effect (red line) and (3) counterfactual economy with investment subsidies (blue line). The decomposition results suggest that the dynamic effect of employment targets on productivity growth contributed to the employment dynamics significantly. The authors’ calibrated model attributes one-third of the employment growth over three years to dynamic effects. After 10 years, the static effect of the policy completely disappears (red line goes back to 1), as by that time there are no more firms with employment commitment left. That is, all the employment gains shown by the gray line are due to dynamic effect after 10 years, implying a 15% permanent employment increase relative to a no-commitment scenario.

in which the target is higher than the current employment level. The first channel stems from the firm's static labor decision, which induces an upwardly distorted employment choice; the second channel arises dynamically as binding targets induce higher productivity growth; and the third channel operates through the extensive margin choice of the firm to exit, that is, firms with binding employment targets are more likely to exit as binding targets introduce a fixed-cost-like structure in the cash flow of the firm. In the authors' second step, they apply this model to novel contract-level data provided by the German Archives, revealing that:

- Firms with binding labor targets are associated with a 22% points higher annual employment growth rate compared to those without.
- Binding labor contracts also lead to an additional yearly productivity growth of approximately 14% points.
- Furthermore, firms with binding contracts exhibit, on average, a 3.6% points higher probability of exiting by the end of the commitment period. Relative to the baseline exit rate of 5.5%, this represents an economically sizable increase in the exit margin.

These findings are consistent with the model's predictions.

For the third step in their analysis, the authors calibrate their model to the data and run counterfactual scenarios to quantitatively assess the importance of the different channels on firm behavior. They find the following:

- When the authors simulate an economy without employment targets, they find that aggregate employment would be 15% points lower permanently after 10 years.

- The authors then decompose the impact of employment targets on total employment into its "static commitment policy" and "dynamic commitment policy" components by shutting down its impact on productivity improvements to find that one-third of employment growth is attributable to dynamic effects in the short run; in the long run, the entire permanent increase in employment is driven by the dynamic effects.
- Lastly, the authors find that an alternative policy of subsidizing investment into productivity is costly and, that while such a policy results in higher permanent employment levels relative to the employment target policy, the increase is more gradual over the commitment period. In other words, the subsidy policy is less effective in the short run to preserve employment.

Among its other contributions to the literature, this work contributes to the understanding of the transition of former Eastern Block economies and the process of economic convergence with Western countries. Similar to other Eastern European countries, East Germany started out with lower levels of economic freedom, GDP per worker, nominal wages, and labor productivity. Over the years following reunification, the Eastern German economy started to converge in many dimensions, and research has explored many of them, including management, labor reallocation, immigration, capital investment, among others. This work describes how the implementation of strategic goals, in the form of labor commitments set by the government, can contribute to higher productivity growth by generating a dynamic catch-up in productivity of firms.

## READ THE WORKING PAPER

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