

# UNITED ARAB REPUBLIC

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Financing of Nationally-owned  
Industries in the GDR

by

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## I. Introduction

Nationally - owned enterprises and Associations of Nationally - owned Enterprises (branch organizations) are independent units in a socialist economy from technological economic and legal point of view. They have to be linked to the economy and the overall targets of social development by planning and management. Socialist ownership doesn't mean that all enterprises could be managed as only one super-enterprise. The conditions of socialist market and commodity production the branch structure and different location of enterprises call for establishment of relatively independent units for planning and management of socialist industry. Hence public enterprises are considered as lowest units of national planning running on the principle of economic accountability. The branch organizations represent the medium level of planning and management also running on economic accountability.

That's why finances of nationally owned industries became a separate part of the socialist financial system. The enterprises and branch organizations in public industry, trade, transport, housing, and service sector are going with their own budgets to be linked to the government budgets on local resp. central level. Management of public enterprises and branch organizations includes, consequently, an efficient and economical utilization of financial resources. Planning includes financial planning. Since a system of economic incentives is coming to the fore to be applied in planning and management, it includes financial incentives, too.

The role of finances increased since the United Socialist Party in 1963 initiated the New Economic System of Planning and Management that explicitly placed maximalization of national income and efficient utilization of resources as the main criteria of economic activities.



From theoretical point of view we must state that finances are an integrated part of commodity production. Since money exists because of the doubling of goods in goods and money, it emerges the independent money flow simultaneously with commodity circulation. From this arise two conclusions:

- 1- The reproduction process is both physical and monetary reproduction. The latter is the basis of the financial system that is to effect and control the continuous reproduction process (single and expanded reproduction);
- 2- The financial reproduction process allows for both distribution of financial means between the branches of economy by centralization of parts of enterprises' gross-income and government spending for economic development of new industries and other public needs.

To sum up :

Finances of nationally - owned industries are those monetary relations which appear with economic accountability as a system of management and planning, which effect reproduction process by forming distribution and spending of money funds, which serve as a tool for control, and which are directed resp. utilized by a socialist state in order to fulfil its tasks at all.

If we analyse the given definition of finances of nationally - owned industries we will find that the tasks to be solved in this field involve several effects. There is on first place the distribution-effect . That includes the distribution of gross income accordingly to needs of the reproduction process of enterprises; the redistribution of parts of the gross income and of enterprise funds by the branch associations; the transfer to the state budget resp. the distribution of means by the branch organizations received from the budget.



On the other hand there is the incentive-effect of finances. That includes levers and measurements directed to make best use of enterprise and branch resources like capacity material input and time factor in order to promote productivity and efficiency. The stabilization-effect of finances of nationally - owned industries is expressed by formation and spending of reserve funds and ensuring liquidity.

Last but not least there remains to mention the control - effect of finances. The whole process of management planning and supervision of enterprises and branch organizations is subjected to control. Control takes place automatically involved in the system of economic accountability as well as by supervision bodies like elected councils, auditing, state administration, and bodies of co-determination of workers in the branches.

It is impossible to deal with all these problems in this paper . Therefore some of the most important questions have been selected and will be discussed in the forthcoming chapters. Historical aspects are mainly excluded. The treatise is devoted to the financial system actually operating in nationally - owned industries of the GDR.



## II. The Financial Flow of the Industrial Reproduction Process Subjected to Planning and Management

In this chapter on first place the financial flow in public industries will be discussed. Since public ownership exists the financial reproduction process of industries is tied to the state budget and banks as well. Enterprises and branch associations are socialist commodity producers going with economic accountability. Every unit represents a more or less self-regulating and self - stabilizing system as subject for management and planning. The material and moral interest of every unit must be tied to the interests of the society as a whole.

This has to be ensured by objectives for structural development of branches (not single targets), efficiency criteria, standards for distribution of profit and amortizations, pricing, balancing of resources, sectoral and regional coordination etc.

The associations have management functions above all with respect to modern technology (distribution of investments), development and processing of high-level products with low cost, long-term co-operation of subcontractors, development of the productive power "science" (development of products and technologies), and marketing research.

The enterprises must have sufficient scope for decision-making. The criterion for efficient management is net profit.

Accordingly, in given limits we can consider enterprise finances and branch finances as a more or less self-regulating system. The limits are given by medium-term planning resp. by the approved annual plan. The financial flow is bound to the system of management and planning. Decentralized financing requires delegated responsibility in correlation with incentives adjusting the social needs with personal material interest.



### The Financial Flow on Enterprise Level

Since public enterprises are running on economic accountability a relatively independent financial flow arises in the reproduction process. The financial flow is tied to the monetary form of enterprise funds. This can easily be explained by the help of the famous Marx' formula outlining the reproduction process of enterprises. He explained the process of circulation of capital as follows:

$$M \longrightarrow C \dots\dots\dots P \dots\dots\dots C' \longrightarrow M'$$

M represents the monetary fund at the beginning of circulation;

C represents the commodity input required (i.e. assets, raw materials, fittings, and consumption goods adequate to wages);

P represents the production process

C' represents the final products including the surplus value embodied in commodities

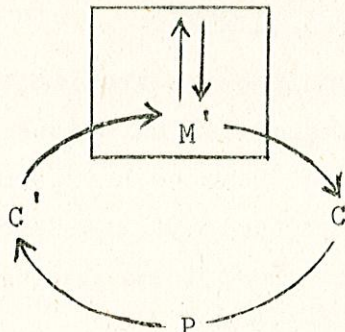
M' represents the monetary fund at the end of the circulation including the surplus value in money.

Monetary circulation is to mediate this process. Thus, the monetary funds are permanently changing - over in commodity funds and vice versa. Since monetary circulation is the basis for financial flow it reflects the physical(material) circulation like a mirror. Consequently, financial distribution allocation and spending will effect the material reproduction process.

The monetary phase of reproduction process is in correspondence with receipts ( $C' - M'$ ) and spendings ( $M - C$ ) as well as with payments to and allocations from the branch association resp. the budget and the bank.



The context will be clearer by the following scheme:



Accordingly, it can be stated that the monetary flow that takes place in this phase of funds-circulation is permanently creating three types of financial relations:

1- Receipts and spendings

Receipts are turnover proceeds resulting from realized sale. Spending is the distribution of these means for covering the costs of production and sale, investments, increase of working capital, and bonuses.

Consequently, public enterprises must have a separate financial plan determining the expected receipts and spendings. It outlines the financial reproduction process which is affected by two important limitations:

- Required payments resp. approved allocations;
- Receipts and spendings are permanently adjusted by financial incentives.

As to incentives there are examples as follows: The receipts may be affected by price deduction respectively price markup according to quality classification of the products. Both receipts and spendings will increase



by penalties for contract violation or by tardiness rates to be paid by the costumers resp. to be paid to the suppliers. Spendings will also be affected by the amount and rate of interest for credits. Lowering of cost will add to profit and, consequently, will increase the bonus funds available for profit sharing of the workers. In case of investments that claim additional ground it is to pay an acreage-levy to the budget that adds to the initial expenditure.

## 2- Payments

Payments are destinated for the branch association, the budget, the bank, and the insurance organization. They include profit transfer, taxes, insurances, paying-off of credits, and some kinds of special-purposed transfers. Profit transfer takes place if a part of planned profit is to transfer to the branch association for distribution on branch level resp. for transfer to the state budget. It is usually determined by normative (standard) how many per cent of the planned profit of the branch is to transfer to the state budget. The branch association has to fix whether and to what percentage every enterprice affiliated to a given branch has to contribute to profit distribution. The percentage may be valid for a few years. It includes both profit distribution in order to meet budget obligations and profit distribution between the enterprises of a given branch as far as the development of the branch requires such a distribution.



Taxes and insurances are to pay to the budget resp. the insurance administrations (for social insurance resp. insurances for personal danger and property damage liability insurance). Taxes in public sector include on first place the so-called production - fund - levy. That is a levy applied as a percentage upon assets thus earmarking an expected minimum efficiency or interest on productive funds. The other taxes are local taxes like land tax, motor vehicle tax. In some branches an indirect taxation is tied with pricing. The fixed price includes a part of surplus value to be realized with certain products. In some cases the rate of these taxes is high (petrol, cars, alcohol). In public sectors those taxes are well-known as production levy and trade levy, but the system is undergoing some reforms now.

The paying - off of credits includes both investment credits and credits for working capital. Payments are directed to the bank that granted credit.

Special - purposed transfer depends highly on the national system of financing. In the GDR it includes payments by the enterprises to the branch organization. Examples are :

Depreciations usually remain in enterprises as source for investments. As far as a distribution is necessary enterprises have to transfer a part of realized depreciations (amortizations) to the branch. By the help of clearing rates enterprises have to contribute to the costs of branch administration and to the costs of the research and development projects of the branch (development of products and technologies). Finally, special - purposed transfer may also include the paying-off of financial liabilities of the enterprises caused by non-fulfilment of profit targets in previous periods in favour of the branch reserve fund resp. the budget.



### 3- Allocations

Allocations can be granted by the state budget by the branch associations and by banks. They include subsidies, making up for losses, insurance service, allocations for investments, credits, and special-purposed allocations.

Subsidies are usually based upon output units in cases with higher cost than fixed industrial sale price, under the precondition that production should be maintained. They are to cover by the budget (negative taxes or negative profit transfer).

Making - up for losses takes place if the enterprise didn't observe the financial targets and losses appeared. In such cases it might happen that the association makes up for the loss by granting an allocation out of its reserve funds. If the situation improves in the following year and liquidity of the enterprise is established the allocation is to pay back as far as the enterprise realized excess profit (more than planned). Naturally, such allocation should only be granted after mobilization of all enterprise reserves and tied to carefully prepared rationalization programmes in order to prevent further losses. Enterprises cannot claim such allocations.

Insurance service (benefit) is to pay in cases of damages in accordance with the contracts.

Allocations for investments are tied to the approved investment plan. They may also include the increase of working capital. Allocations can be granted by the state budget to be distributed by the branch organizations and, besides the central allocation, they can be granted by the branch organizations themselves.



In the latter case allocations are granted out of the pool formed in the course of profit and depreciation distribution.

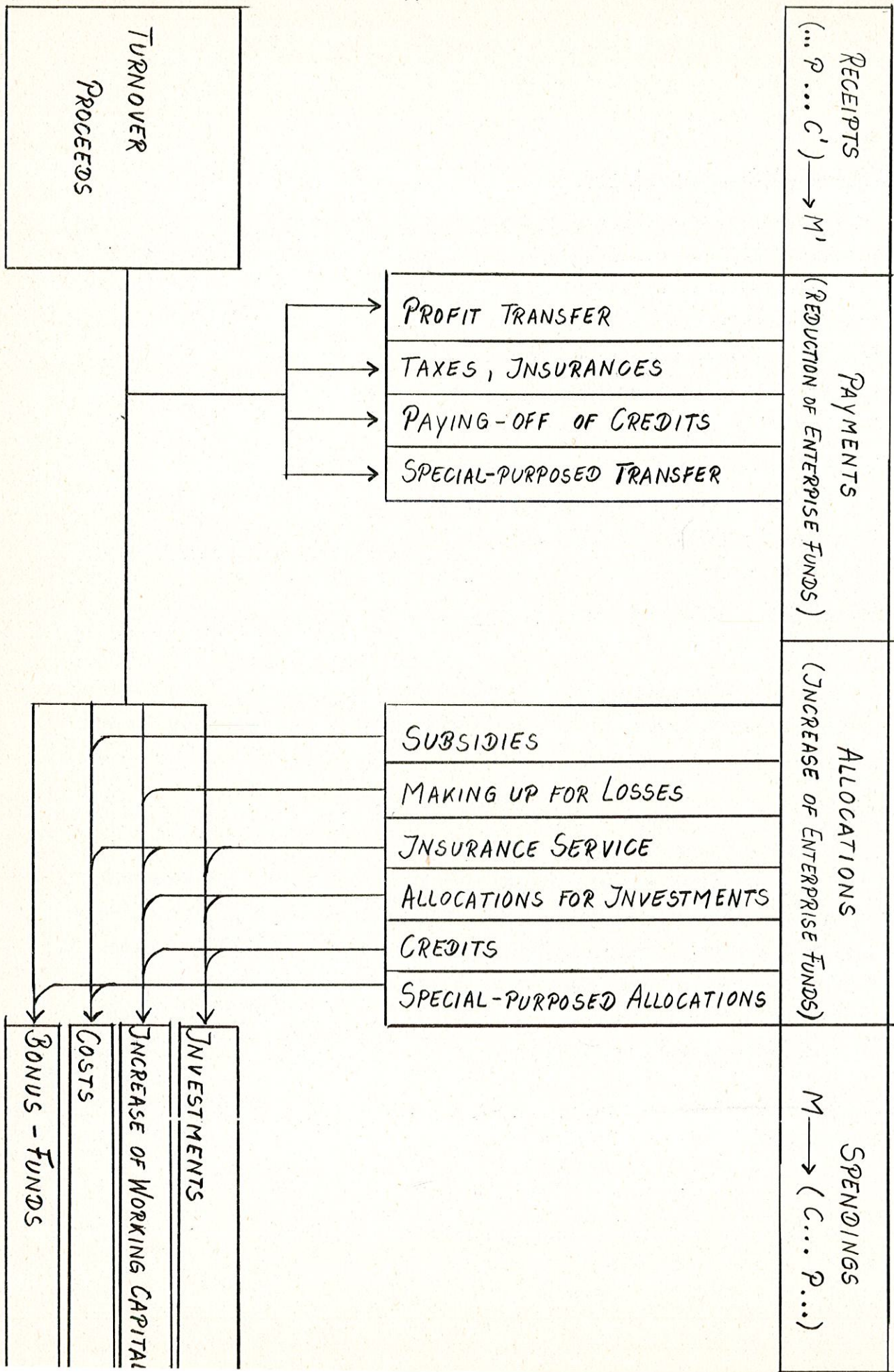
Credits can be both investment credits and credits for working capital (investments). They are preliminarily allocated means. Credits have to be granted in correspondence with targets for output and investments, and they must be based upon efficiency estimations. Clearing credits are not considered as allocations but as current affairs of money circulation.

A special type of credits are liquidity credits to substitute working capital in cases of losses. But there must be guarantee to make up the loss latest in the following year.

Special-purposed allocations are usually granted by the branch organizations. An outstanding example is financing of development of products and technologies out of branch funds.

The interrelationship between receipts and spendings on the one hand and payments and allocations on the other hand is displayed by the scheme on page 11.







### The Financial Flow on Branch Level

The branches are represented by Associations of Nationally - owned enterprises. They are the centres for management and planning of an industry. This includes financial planning and financing of enterprises as far as branch decisions are necessary. The associations are running on the principle of economic accountability. That means:

- 1) The association is directing the branch in an economic way based upon prospective plans.
- 2) The underlying idea for decision-making is efficiency in the frame work of the given branch, especially with respect to development of products and technologies as well as with regarded to investments and specialization.
- 3) Branch-profitability is the economic main criterion for activity of the branch.
- 4) A system of material (personal) incentives is applied in order to harmonize personal interests with those of the enterprise the branch and the national economy.

The utilization of productive powers the appropriate distribution of resources among the enterprises and the assignment of top-level cadres are most important for economic results of the branch as a whole. Management functions have to base upon for-sighted estimations of technological and economic development. This requires high management perfection. The associations are using some financial instruments for management to make sure that they can meet their responsibility for the branch by accountability instead by administration.

The financial tools for management are several funds to be formed by associations.



The Profit Fund is to collect profit shares from the affiliated enterprises to be distributed in the frame work of the branch resp. to be transferred to state budget. The enterprises can get allocations from the associations for investments and working capital.

The Amortization Fund is to collect parts of amortizations (depreciations) not necessary for reproduction in enterprises. The means are shifted to the Profit Fund.

The Reserve Fund is to form by portions of the Profit Fund esp. in case of over-fulfilment. It is necessary to fulfil the financial payments to the state budget even in case that some enterprises do not observe their targets. It is in this context that the association has to spend out of the Reserve Fund. Under certain circumstances payments to the enterprises are possible .

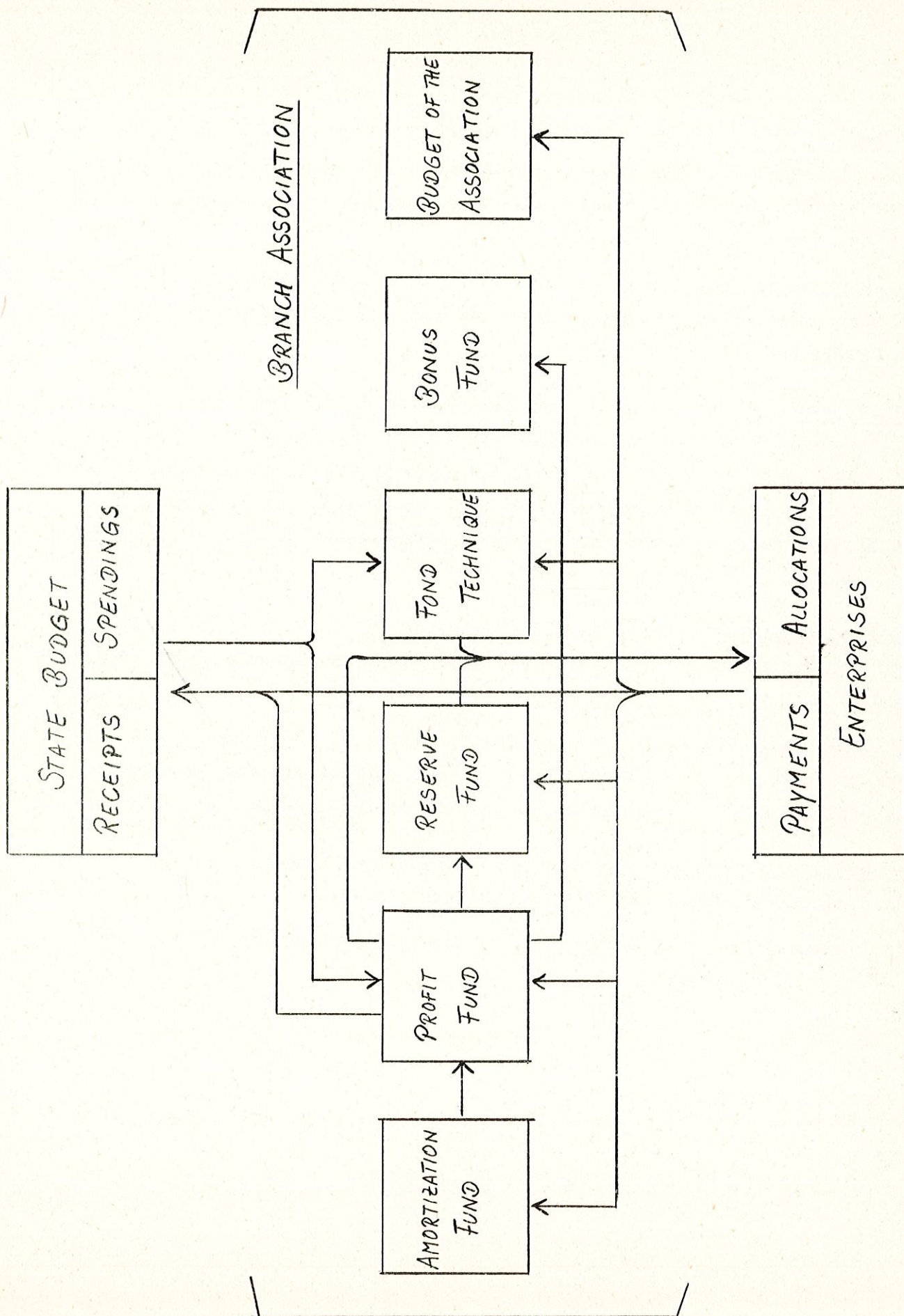
The Fund Technique depends on clearing rates of the enterprises. It is used for financing of industrial research work and technological development in the branch.

The Bonus Fund depends on the aggregated profit of the branch and is to form by portions of the Profit Fund. It is for bonusses to be paid to the employees of the association depending on achievements.

The Budget of the Association is also formed by a clearing rate. It covers the administrative expenditures of the association.

The financial flow on branch level is shown by the scheme on page (14) .







We can summarize this flow by five types of financial relations:

1. Collection of means (payments of affiliated enterprises).  
These are: Parts of profit and depreciations, taxes and special-purposed transfer.
2. Payments to the budget.
3. Allocations from the budget.
4. Distribution of collected means (as far as not payable to the budget) and means allocated by the budget in the frame work of the branch accordingly to the approved financial plans and necessities which arise.
5. Financing of the branch association itself including administration, research and development centre, investments in new projects not yet independent etc.

The branch associations usually are not subjected to credits, but they take part in credit planning with regard to the branch as a whole. The credit plan is applied by contracts between the enterprises and their bank settlement.

#### The Influence of the System of Management on Financial Flow

The applied system of management highly influences the financial flow with respect to payments and allocations. On first place the status of the medium-placed level of management will canalize financial flow in a certain way that means this management level that links enterprises with the central level (ministries). There can be applied two basic schemes of affiliation of enterprises: The production or branch principle and the regional principle.



In the first case enterprises are affiliated to a branch organization. The branch organizations are affiliated to the Ministry of Industry (or there might be several ministries). In the second case enterprises are affiliated to a regional economic council. In the GDR the production principle is applied as management scheme for the main branches of industry. There are about 100 branch organizations with 1700 enterprises which cover the major part of industrial output.

On the other hand about 2800 local enterprises are affiliated to 14 regional economic councils. Besides the public local enterprises there exist about 8000 semi-state resp. private industrial enterprises. But to a great extent the output of local enterprises contributes to the final products of enterprises under branch management by the help of co-operation contracts. Public industries cover 87 percent of the output. The local industries are linked with the branch associations by forming of so-called article groups. Market requires common market research, co-ordination of investments, exchange of technological documentations etc. That's why branch associations work together with the local enterprises (either public as well as semi-state and private enterprises). The leading enterprise for an article group can be a branch enterprise or a local enterprise (even a semi-state enterprise). This makes clear that the branch principle dominates the regional principle under the viewpoint of market, product development, investments and technology.

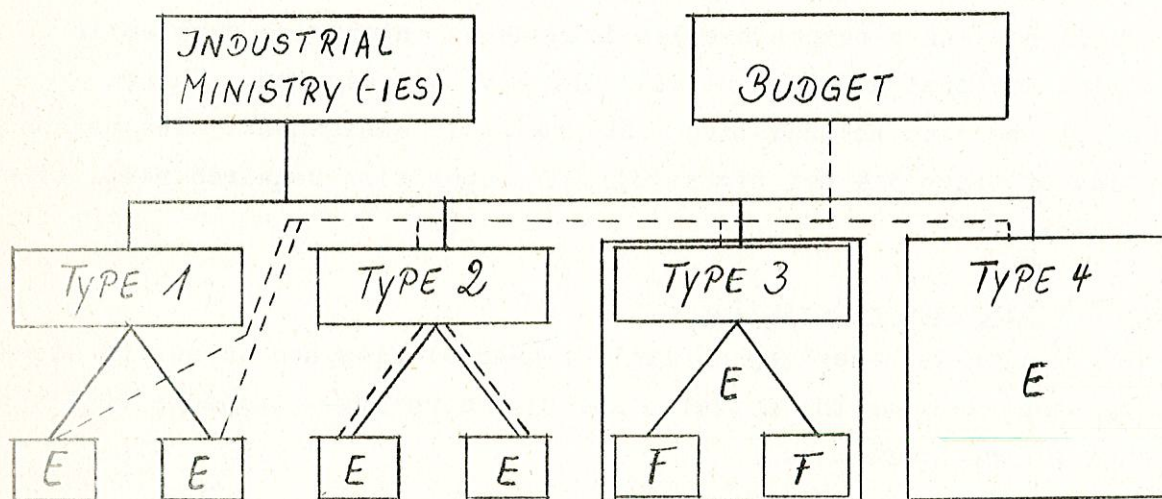
As to the production or branch principle different types or schemes of management can be applied also influencing financial flow. The branch can be represented by:

- 1- an association of administrative type and more or less independent enterprises;
- 2- an association of commercial type going with economic accountability and more or less independent enterprises;
- 3- a branch organization of commercial type going with economic accountability, however with enterprises (factories) completely dependent on the branch organization;
- 4- one huge enterprise that represents a complete industry (e.g. Carl Zeiss Jena, Leuna Chemical Works).



In the GDR now the second third and fourth approach are simultaneously applied. In the fifties the first type of management was widespread, however, by time it appeared as not efficient enough. Now the second type of branch management is applied as the main approach whereas the third and fourth model is only applied in special cases.

According to the types of branch organization the financial flow is quite different. That is shown by the following scheme:



Types 1 to 4 represent the branch organizations

E represents the enterprises

F represents dependent factories

———— represents the affiliation in management

- - - - represents the financial flow

The financial flow on branch level as explained in the previous paragraph is regarded to the model type 2. In the model type 1 the branch administration is going without special financial funds for distribution and financing. That is to do by the budget. In model type 3



the financial affairs are only managed by the association, because purchase and sale are completely centralized. There remain allocations to the factories as internal affairs inside the branch (the enterprise). Model type 4 is clear by nature.

The main reasons for abolishment of management analog type 1 are :  
First: Responsibility should be given in one hand for both material and financial processes. Second : Industrial development and planning have to be understood more as a branch problem than as an enterprise problem in order to link sectoral development with the national economy. Third: Finance should be used as incentive integrated in management. The reasons for creation of types 3+4 are technological cooperation required resp. sizes of enterprises.

#### Financial Planning and Programming

Financial planning is necessary to limit financial flow and to set up standards to be compared with the actual state by accounting. Subjects of financial planning are above all:

- gross - and net profit,
- taxes and payments to be transferred to the budget,
- profit distribution,
- financing of investments and working capital,
- paying-off of credits,
- subsidies .

Since enterprises and branch associations form a more or less self-regulating system financial planning is on first place a matter of management on enterprise - and branch level.

Planning should be as comprehensive as necessary for this purpose. Financial plans are inseparable parts of the respective enterprise or branch plan. Cornerstones of financial plans must be linked to the budget resp. to



banks (credit plan). For this purpose every branch association gets some financial objectives set up by government. These are:

The financial objective for net-profit transfer to budget resp.  
the financial objective for allocations granted by the government;

The minimum foreign trade result for both export and import.

The branch association has to set up objectives for the enterprises so that they can fulfil its obligations to the budget. That includes the distribution of profit and amortizations to cover investments, subsidies, working capital, the Reserve Fund, the Fund Technique, and the Bonus Fund of the association. Usually the enterprises get financial targets as follows:

Net profit;

Percentage of net profit to be transferred to the association.

The percentage should be fixed valid for some years.

Besides this financial planning of enterprises is based upon laws contracts and branch regulations. These are :

The percentage of amortizations to be transferred to the association;

Tariffs for taxes;

Rates for subsidies per output unit (in exceptional cases only);

Amount of credits available resp. paying-off of credits;

Interest;

Clearing rates;

Allocations approved by the association.



Financial planning of public industries can be annual planning short-run planning for periods during the year and medium - term planning. The annual plan is considered as the most important plan. Since medium-term planning with respect to output, investments, material supply, training ect. is successively getting the major part of planning, the question arises whether financial planning should also be included in medium-term planning. Thus, the annual plans will more or less be an adjustment of targets in scope of one year. Nevertheless medium-term planning includes some financial targets. These are on first place:

- 1- Financial efficiency of increasing output taking into consideration changes in quality and assortment;
- 2- Financial efficiency of technological programmes and rationalization programmes;
- 3- Financial efficiency of investments;
- 4- Financial efficiency of specialization and concentration of production in the frame-work of the branch in question.

Financial targets in this concern are initial expenditures and additional gross-resp. net-profit.

But there is no complete budget. Nowadays there is a new move to shift the budget system to a two-year cycle. It is in this context that also financial planning in industries will probably be shifted to a a two-year period. The final decision will depend on the experiences with medium-term normatives (standards) for net profit distribution applied presently.



### Financial Incentives

Enterprises and branch associations going with economic accountability need introduction of economic incentives (levers) in the system of management and planning.

The implementation of incentives has to adjust sectoral activities accordingly to the approved plan and, moreover, has to ensure a realistic sectoral planning, too.

Financial incentives are only a part of incentives out of an appropriate system as a whole. The incentive system is mainly tied to profit and wages, that means it is directed to maximize value added resp. national income. Maximizing national income requires making best utilization of resources like raw materials, capacities, assets, skill, organization, and co-operation.

To guarantee observation of targets it needs an adequate system of incentives to harmonize personal and sectoral interests with the interests of the socialist society as a whole.

The scheme on page 22 brings in a system the different incentives applied in public sector in order to ensure observance of plan-targets. The incentives involved in the system of economic accountability are mostly financial incentives. They are directed to the collective of the enterprise or branch as a whole. On the other hand the incentives involved in the system of personal material incentives are on first place tied with distribution of consumptive income. They are directed to the single worker or manager resp. to teams of workers, engineers, economists, managers etc. Since those incentives are tied with income distribution the financial aspect is only an auxiliary one (e.g. wage-tax-tariff differentiation according to performances).



# SCHEME INTRODUCING THE COMPREHENSIVE SYSTEM OF MATERIAL INCENTIVES

## INCENTIVES OF PERSONAL MATERIAL INTEREST

PAYMENTS  
BY RESULTS

GRATIFICATION FOR IDEAL  
PERFORMANCE, INNOVATIONS,  
MANAGEMENT

BONUS FUND

BONUSES

PROFIT SHARING

TAX-TARIFFS

WAGES

PROFIT

COMMODITY SUPPLY

SOCIAL AND CULTURAL  
CONDITIONS

GENERAL INCENTIVES  
OF PERSONAL  
MATERIAL INTEREST

ADDITIONAL VACANCY-  
TIME GRANTED BY RESULTS  
OR FOR LONG DURATION  
OF EMPLOYMENT

## INCENTIVES OF ECONOMIC ACCOUNTABILITY

RELATIONS BETWEEN THE PRICES OF  
DIFFERENT PRODUCTS (TURNOVER AT  
ECONOMIC BASED PRICES)

PRICE

DIFFERENT PRICES ANALOG QUALITY  
DESIGNATION

DIFFERENT PRICES FOR OUTDATED  
AND NEW PRODUCTS

PLACING TO ACCOUNT THE EXPENSES  
ADEQUATE TO THE ECONOMIC PROCESS  
(DEPRECIATIONS, REPAIR, EXPENDITURE  
FOR RESEARCH, DEVELOPMENT AND  
LUNCHING COSTS)

COSTS

ECONOMIC CORRECT DEFINITION OF  
PLANNED AND EFFECTIVE COSTS  
(INTEREST, PENALTY, LIABILITY FOR  
DAMAGES)

CREDIT

CREDIT TERMS

INTEREST RATES

PRODUCTION FUND LEVY

STANDARDS FOR NET PROFIT  
TRANSFER TO THE BUDGET

STANDARDS FOR FORMATION OF  
THE BONUS FUND



## II. Profit Profitability and Capital-Efficiency

The second chapter deals with efficiency as far as it appears in financial terms. But in no way this will be a limitation by reason that financial efficiency reflects physical and time effects like a mirror. The outstanding financial criterion of efficiency is profit of socialist enterprises and branch associations. This is valid with regard to both home and foreign market. Consequently, distribution of profit links the different requirements like financing of investments or forming of bonus funds with efficiency. The problems which emerge in case of losses and liability will also be treated in this chapter.

### Profit as the Main Efficiency Criterion an Enterprise and Branch Level

Profit is an integrated part of socialist commodity production. Under socialism profit is neither the motive power nor the aim of production, but profit is to be used to encourage socialist producers to such achievements and reactions that serve the interest of every individual as well as the society as a whole. Thus, profit has to play its role in management functions in planning and as an important link in the applied system of incentives, too.

The utilization of the profit criterion essentially contributes to economic direction of industries on the contrary to administrative direction. That's why:

- 1.- Profit comprehensively reflects economic results of enterprises and branch associations and it appears as an appropriate indicator for measure of efficiency.
- 2.- Profit is the most important source of accumulation in the economy that effects growth rate as well as distribution of national income.



- 3- Profit most adequate expresses the relationship between both accumulation and spending of means (funds) on first place with respect to investments capital efficiency and bonuses (profit sharing of workers).
- 4- Profit in its function as incentive links interest of enterprise collectives (teams) with individual interests of workers engineers and managers to the effect that the activities of every individual can be canalized towards efficiency.

There are two preconditions to be observed in order to make profit ready as the main efficiency criterion:

- 1- The overall planning system has to be qualified. Planning has to outline the targets and tendencies of development which are essential for the economy. This is to outline the field of operation of the profit criterion.
- 2- The conditions of realization (formation) and distribution of profit must definitely be fixed. Thus, last few years some measurements took place in order to ensure that realized profit can be a measure of efficiency. The outstanding measurements were as follows: New evaluation of fixed assets and establishment of rules of depreciation on this basis; the reform of industrial prices to the effect that prices reflect the real average cost for articles; the introduction of a flexible system of pricing; the differentiation of prices according to quality designation and new resp. outdated products, too; the introduction of a production fund levy (interest on assets); the facing of public enterprises with world market (the inclusion of foreign trade results into the profit of enterprises and branch associations as far as they are responsible for them); the dependence of investments



There are three groups of profit distribution analogous to the purposes of spending:

- 1- Transfer to the budget
  - a) Production levy (turnover tax)
  - b) Production fund levy
  - c) Profit transfer
  - d) Redemption of financial debts
- 2- Financing of production funds
  - a) Investments
  - b) Paying - off of investment credits
  - c) Working capital
- 3- Financing of bonus fund

The transfer to the budget depends on different regulations. In every case the production fund levy must be transferred because it represents an efficiency rate of assets. Since the percentage is fixed for long time there is no connection with effective realized profit. This levy appears like an interest rate on productive capital funds. Thus, the net profit will be higher in case of full utilization of capacities than vice versa. Now the production fund levy is introduced in nearly all industries and even in public trade as trade funds levy. The percentage of the production fund levy is different in branches since prices are fixed on cost basis.

The production levy (turnover tax) has to be transferred according to sale (turnover proceeds). It disappeared in many branches after the price reform was executed last few years. Nevertheless, there remain branches and articles subjected to production levy.



from the realized profit (self-financing of branch and enterprise investments); the dependence of bonuses and profit sharing from profit; the introduction of a differentiated system of interest rates (for credits), sanctions, penalties, tardiness rates, all affecting profit.

Under these preconditions profit indicates the contribution of enterprises and branch associations to national income. Since wages also represent national income and since basic wages are fixed by tariffs profit remains as a variable part of national income that expresses sectoral achievements. Now profit has to be distributed in order to cover state accumulation (taxes, levies, payments) as well as branch and enterprise accumulation and bonuses (profit sharing), too.

#### The Distribution of Profit

Distribution of profit is necessary since it is the main source for financial accumulation on enterprise and branch level as well as on national level. Under conditions of public ownership distribution is a matter of resource allocation among the enterprises sectors and regions. On the other hand distribution influences central or decentral spending.

Public ownership of enterprises results in public appropriation of profit. Therefore central accumulation of profit by the budget would easily be possible in order to execute centralized spending according to targets. But the system of economic accountability imposes some other functions on profit which also determine distribution. Besides its function as source for national accumulation profit has to serve as measure for achievements as economic incentive and as source for financing on enterprise and branch level, too. That needs some rules in order to meet the different requirements.



Profit transfer represents the contribution of branches and enterprises to central accumulation besides production fund levy and production levy. The rate is fixed by a percentage valid for some years and for the branch association as a whole. It is up to the branch management to differentiate this percentage among the affiliated enterprises in order to meet the different financial requirements of enterprises. As far as the branch association holds that a profit distribution between enterprises should take place profit transfer from the respective enterprises to the Profit Fund of the association has to be higher than the budget requires. On the other hand the branch association may allocate the exceeding transfer to those enterprises that are in need. In industries or enterprises which should be expanded speedily the rate of profit transfer might be zero.

Redemption of financial debts is understood as wiping-out of debts that are caused by previous plan periods. If an enterprise was not in the position to transfer the normative share of profit in time it is obliged to make up its debts because it is liable for planned profit transfer to the budget.

The financing of production funds covers both investment and working capital. As far as investments are in question profit can be used as source for new investments as well as cover for paying-off of investment credits. The available amount for these purposes is all the realized profit after deduction of both transfer to budget and allocations to the bonus fund.

The financing of bonus fund depends on the achievements of the enterprise. If the targets (profit, export) are fulfilled the maximum rate can be allocated.



But distribution of profit is not simply distribution. There also the incentive effect is coming in the picture. Profit indicates the degree of efficiency and productivity. Maximalization of profit, however, depends on the observance of certain conditions.

The conditions are:

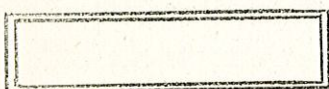
- (1) Turnover proceeds are based upon fixed prices for a period or agreed prices for an order.
- (2) The production levy (turnover tax) depends on the tariff regarded to sale.
- (3) The production fund levy depends on the fixed percentage (efficiency rate) of assets.
- (4) Profit transfer depends on the long-term normatives determining the share of transfer.
- (5) In case<sup>of</sup> exceeding net profit (over-fulfilment) on first place the normative rate of profit transfer to the budget and also the redemption of financial debts must have the priority before production funds and bonus funds are allowed to be allocated.

If these five conditions are observed maximal profit will be the indicator<sup>for</sup> maximal contribution to national income. That's why gross profit under the set of fixed prices depends on sale and low cost. The operating result under assumption of a fixed rate of turnover tax depends on the total amount of gross profit. Net profit under the precondition of a fixed percentage of production fund levy depends on an efficient utilization of assets (capacities). The allocation of production funds and bonus funds under assumption of a fixed rate of profit transfer to the budget depends on the total amount of net profit. The exceeding net profit and financial debts depend on the degree of fulfilment of targets.

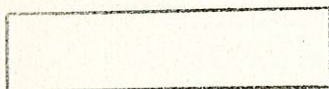


The five conditions are the constants, and enterprises as well as branch associations have to find out how to make economical use of the variables, on first place low cost and highly efficient utilization of production funds (fixed assets and working capital). The system of constants and variables is to bring in line the interests of individuals, enterprises and branch associations with those of the socialist society as a whole.

The scheme on page 31 easily explains the context.



represents constant items



represents variable items

In enterprises producing articles not subjected to production levy (turnover tax) gross profit and operating result are identical. The production fund levy usually amounts to 1 - 6 per cent of the value of assets that covers a certain percentage of the operating result depending on achievements. The profit transfer may claim between 20 and 100 per cent of the net profit. Since self-financing of investments is approved as a rule industries with rapid technological development and high rates of growth will go with a low rate of profit transfer to the budget and vice versa.

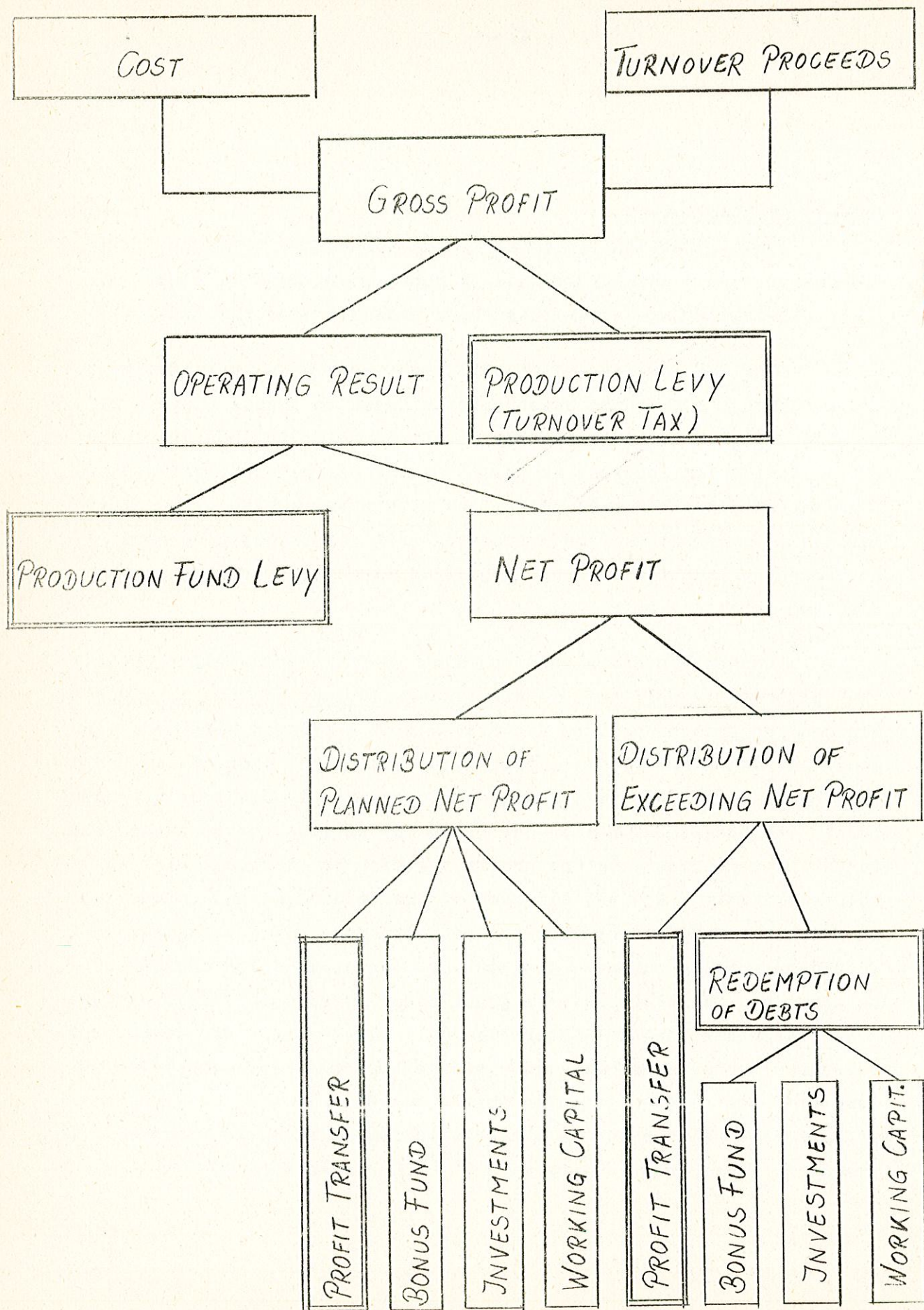
There are some additional incentives tied to plan-offers and overfulfilment. In case of overfulfilment of the profit target the enterprise has to transfer most of the additional profit to the budget resp. the branch association (e.g. 50 per cent to budget and 20 per cent to the reserve fund of the branch association). The remaining



part is determined for the production fund and the bonus fund of the enterprise. In case of plan-offers, however, the enterprise will gain a higher share of the expected additional profit. Assume that the profit target is fixed by the branch association and that the enterprise outbids this target by the annual plan-offers to be approved by the branch association. In this case only a minor part of the offered additional profit is to transfer to the budget and the branch association (e.g. 20 per cent for budget and 20 per cent for the branch). That means that an outbid of targets is higher evaluated than overfulfilment. This is an essential rule in order to ensure realistic plan-offers. Otherwise enterprises would be encouraged to hold back their real opportunities thus awaiting a high rate of overfulfilment of profit targets.

The total amount of realized net profit is highly influenced by flexible prices. Fixed prices do not mean rigid prices. First: The enterprises contribute to costing and pricing. Second: The price is higher for modern than for outdated products. Third: There is a price differentiation according to quality designation. Therefore the fixed price is not simply a limit for profit realization, but on first place an incentive that promotes efficiency. Prices of industrial goods are fixed in that sense that the same article has the same price in the branch as a whole. Enterprises have to adjust their individual article cost (order cost) to this measure. But prices are flexible because (1) under changed conditions of production, material supply, import, market etc. price will be changed; (2) the enterprises determine the price level by the standards of products (up-to-date products, quality). For instance profit will increase if quality improves so that a greater part of the output can be delivered to the price of the first quality group.







### Losses and Liability

This question is coming in the fore since we consider the economy of public enterprises and branch associations as a more or less self-regulating system based upon economic accountability.

The consequences of liability may appear as an incentive to avoid losses. But if the enterprise is faced to losses there must be some definite regulations. It is not to refer to subsidies tied to output units, because in this case the planned cost are higher than the attainable market price, and government agreed with maintenance of production by good reasons. But losses may also appear in current production although profit is expected according to the approved financial plan.

Losses are diminished realized profit (i.e. smaller profit than planned) as well as absolute losses. In case of realizing diminished profit the planned distribution of profit is affected. Assume that the remaining net profit (i.e. after deduction of the production fund levy) is high enough to cover the planned profit transfer to the budget but not or not fully allocations to the enterprise funds. Nevertheless, planned profit transfer to the budget has absolute priority. Now the director of the enterprise has to decide on whether or not investments can be postponed. If investments should be carried out according to the plan a liquidity credit must be applied. But the bank will grant such a credit only if there are some guarantees that the enterprise will make up the loss soon. Now the example should be modified. Assume that the realized profit is less than the planned transfer to the budget. In this case the enterprise remains liable to the budget with regard to the difference. The liability (debt) has to appear in the balance sheet as a financial



debt. It might happen that the branch association covers the debt by their reserve fund. But in this case the enterprise remains liable to the branch association. The financial debt must be paid off at the earliest possible date.

In case of realizing total loss instead of profit the enterprise needs liquidity credits for both maintenance of current operations and investments (to be financed by planned profit). The enterprise has to offer guarantees for making up the loss in good time. Otherwise the investments have to be postponed. On the other hand the enterprise remains liable to the budget for the planned profit transfer. The financial debts have to appear in the balance sheet, even if the branch association covers the obligation to the budget by its reserve fund. In the latter case the enterprise has to pay back its debt to the association.

To sum up: In every case enterprises have to transfer the planned profit rate to the budget. As far as the realized total profit is less than the obligation of transfer, a financial debt emerges to be paid off as soon as possible.

As far as profit is not available to cover the planned investments <sup>it</sup> ~~the~~ is to decide on a liquidity credit. If the bank refuses the credit/enterprise has to postpone its investments.

As far as total losses appear the enterprise needs another liquidity credit for financial stabilization and maintenance of current operations. But the bank will grant the credit only under the precondition of a rationalization programme being submitted by the director of the relevant enterprise.



It might happen that later on enterprises are not in the position to pay off liquidity credits respectively financial debts. At this point<sup>it</sup> starts the so-called stabilization procedure.

It includes dependent from the degree of its liquidity the following scale of measurements:

- 1- The director of the enterprise in question has to submit proposals aimed to re-establish profitability of the enterprise to the director of the branch association (rationalization programmes).
- 2- The director of the association can order to cover the losses once more by the branch reserve fund. If the branch association as a whole observed the profit target including the profit transfer to the budget it can surrender on the contribution of the illiquid enterprise.
- 3- The bank can make its approval for further granting of liquidity credits dependent on guarantees of the director of the association.
- 4- If there is no hope to settle the problem in commercial and financial field the profile of production or the type of organization have to be changed. It might also happen that the enterprise will lose its independence. After getting a new profile it might remain as an dependent department of another enterprise (processing some items in the framework of a comprehensive co-operation, but on a profitable scheme of division of labour).
- 5- If personal incapability and disqualification of the directors appear as the main reason they have to be dismissed and substituted by a more capable team.
- 6- If losses are caused by disappearance of demand and if there is no chance to change the profile of the enterprise it will be closed and the workers will be shifted to another job.



Enterprises are responsible for losses if they were their faults. On the other hand they can claim that the central planning body and the branch association set up realistic and balanced overall targets. It happens that these bodies order operative changes of targets caused by important national requirements. In such cases enterprises must get an appropriate compensation thus maintaining profit as the main efficiency criterion for their own work.

#### Sharing of Foreign Trade Results

An important share of GDR output is realized on foreign market. On the other hand import of raw materials and equipments require foreign currency as financial cover. The financial result of foreign trade operations highly influences efficiency of the economy. Last twenty years the foreign trade monopoly of the socialist state was executed only by action of the public foreign trade companies which are operating as wholesale traders. Now after establishment of a sound public industry it is necessary to face enterprises going with remarkable export and import activities to the world market. Nowadays industrial enterprises and branch associations closely co-operate with the foreign trade company that is in charge of the branch. Besides some measurements in the field of organization the introduction of profit sharing between foreign trade companies and industrial associations and enterprises is being tackled now. This is a quite different state of affairs. The remarkable change should be explained with respect to both export and import.

As to export, it appears the following picture:

Hitherto: Enterprises and branch associations (in short industry) were responsible for realization of the difference between cost and industrial sales price.



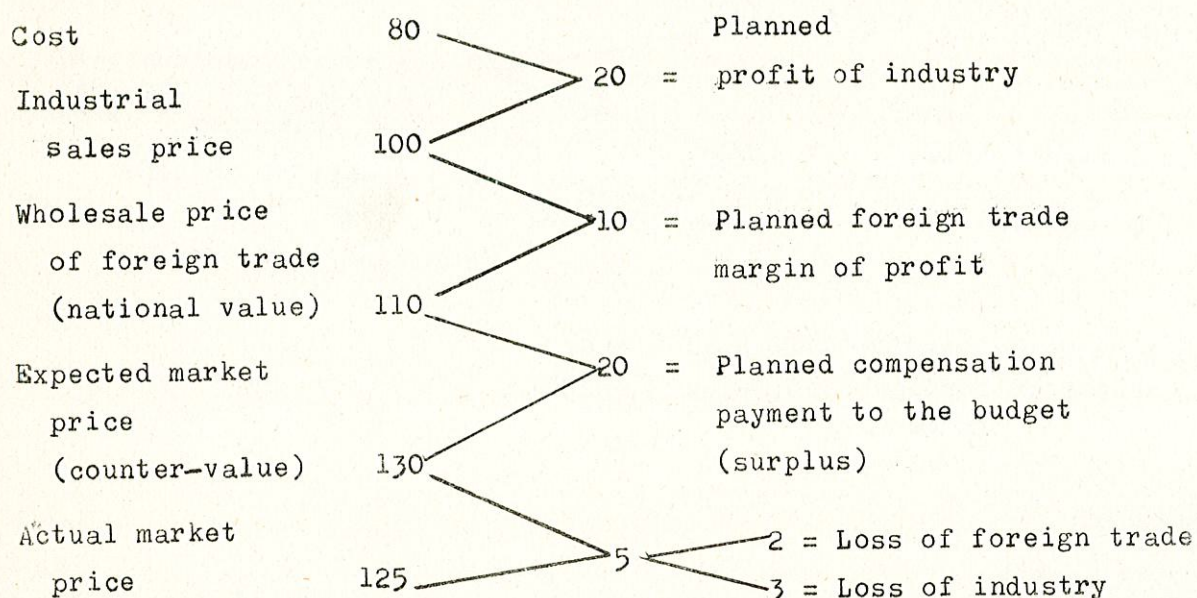
Foreign trade was responsible for realization of the difference between industrial sales price and (export) market price.

Now : Industry is responsible for realization of the difference between cost and industrial sales price.  
Industry and foreign trade are commonly responsible for realization of the difference between industrial sales price and market price.

This is applied by common fixing of the commodity structure of export market share, by common efforts in getting high market prices, by fixing of an advantageous structure of markets (countries), by common market research, advertisement, storage etc. But the incentive of co-operation is profit sharing. Industry will get a part of exceeding foreign trade profit respectively has to share losses. This part of foreign trade result, consequently, will appear in the balance sheet of the respective industry.



1. Example

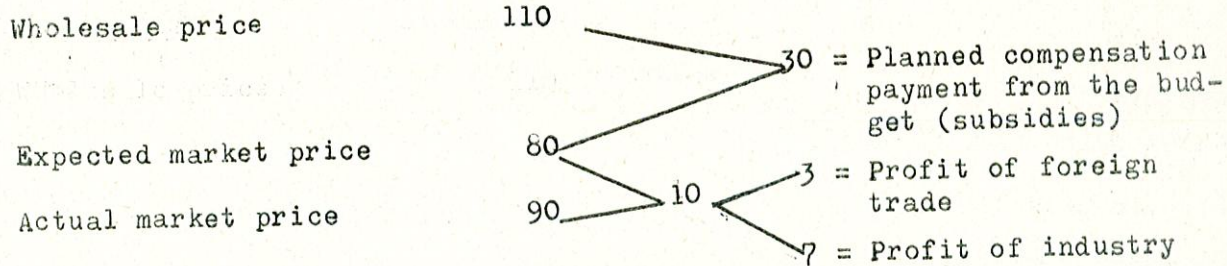


Total profit of industry = 20 minus 3 = 17

Total profit of foreign trade = 10 minus 2 = 8



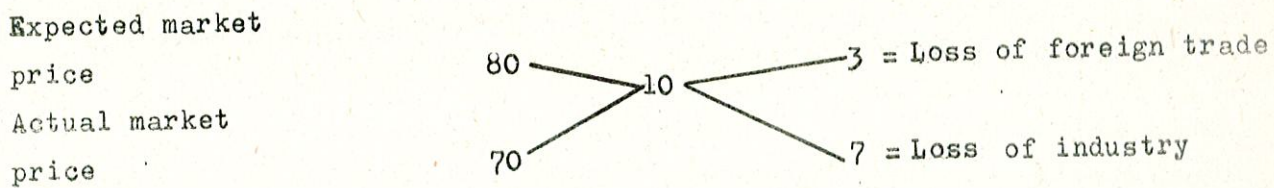
2. Example



Total profit of industry = 20 plus 7 = 27

Total profit of foreign trade = 10 plus 3 = 13

3. Example



Total profit of industry = 20 minus 7 = 13

Total profit of foreign trade = 10 minus 3 = 7



As to import, it is a similar system.

Hitherto : Foreign trade was responsible for import and realized the difference between market price (counter-value of currency prise) and home market wholesale price.

Industry consumed the imported materials and had not any responsibility for import.

Now : Foreign trade and industry are commonly responsible for the realization of market price and home market wholesale price.

This is applied by common fixing of the structure of commodities to be imported dependent on requirements and minimal demand of currencies, by well-priced dates (seasons) of imports according to storage feasibilities in industry, by fixing of an advantageous structure of suppliers (countries), and by fixing of home market wholesale prices for the imported goods and for national products in a well - founded relationship. The main incentive for co-operation is profit sharing similar to export operations.

The economic result of foreign trade affects the profit and loss account of the branch associations and those enterprises which essentially depend on import and export business. The additional profit shares resulting from foreign trade co-determine the enterprise bonus fund as part of the total profit. But these portions of profit are special purposed for measurements aimed to further improvement of foreign trade. The following measurements for instance can be financed out of this fund: Rationalization of production and marketing to ensure expanding output of products on world standard level, cover of risks in foreign trade, compensation for credits in foreign currency, establishment of stores (depots) for finished goods to be exported in good time as well as for spare parts etc. The above mentioned incentives are tied to deviations of the actual market price from the expected market price by reasons of both good or bad results of produc-



tion and marketing. There are some other incentives, however, not tied to market prices and additional profit. The industry can get currency titles on foreign currency made available by the Foreign Trade Bank if export plan is overfulfilled or import materials are saved (except equipments). In this case branch associations or enterprises can buy equipments and licences additional to normal (planned) agreements. Thus, the enterprises can settle some tasks earlier than planned, that will also affect the interests of workers engineers and managers. Enterprises can also get currency credits for equipments and licences granted by the Foreign Trade Bank for increase of production of profitable export goods resp. of substitution products thus saving imports.



#### IV. Conclusions

The aims of financial planning of public industries are both maximal increase of national income and financing of current production as well as economic development. The financial flow has to be established and followed up with regard to these aims. The most important management criterion is net profit. Net profit increases by

more output and sale,  
cutting-down of costs,  
higher efficiency of production funds  
(fixed assets and working capital),  
price improvements with regard to both  
material supply and sale.

Net profit appears as efficiency criterion under the precondition that the national economic development plan ensures balanced growth. Thus, planning and economic incentives tied to management criteria must be considered as a unity.

The paper is concentrated on the main issues of financing of nationally-owned enterprises in the GDR. Naturally, a lot of items would need further explanation. Such fields as the procedure of investment financing, the limitation and financing of working capital, the financing of industrial research work and development of products and technologies, credit planning in public industries etc. would need much more space for discussion. But this can not be done in one run. It goes without saying that the statement can only be understood as an introduction of the main features and problems under discussion.



