

Privatization in Germany: The Case of Lufthansa

by

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## ABSTRACT

Privatization has been adopted by both advanced and developing states for a range of reasons. Principle theories of privatization focus on the role of economic theory, budgetary needs, ideology, party political motives to divide social democratic movements, and internationalization as the driving force behind privatization. The case of the privatization of Lufthansa is examined to test these various theories to determine which forces are most important in Germany. The case study, based on primary and secondary sources, as well as extensive interviews with corporate and union officials, indicates that a combination of budgetary crisis (due to the costs of unification) and increasing competition in the global airline industry led to the privatization of Lufthansa. Massive budgetary shortfalls created a "crisis space" within which German leaders could more forcefully pursue privatization as a policy option. At the same time, developments at Lufthansa and in the airline industry generally made the carrier an attractive candidate for divestment.

Prior to privatization, Lufthansa embarked on an ambitious and extensive rationalization and restructuring campaign, designed to increase competitiveness and, by extension, international investor interest. These efforts represent a shift in the balance of power at Lufthansa in favor of management, but it is too early to tell whether the traditional "German model," as it exists at Lufthansa, is in transition. While the substance of the management-labor bargain is changing, the structures within which this bargain is negotiated are not. Increasing international pressure, however, continues to threaten the structures themselves, particularly with respect to "out-staffing" of flight crews on international flights operated in conjunction with Lufthansa's new strategic alliance partners, and within the context of a new, decentralized corporate structure which threatens to localize wage bargaining and offer more room for managerial experimentation.

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## Chapter 1: Introduction - Theories of Privatization

Beginning, symbolically, with the victory of the Conservative Party in Britain under Margaret Thatcher in 1979, the size of the public sector in almost all countries contracted or remained the same.<sup>1</sup> This development was unique in the history of the global public sector, as it has, with minor exceptions, expanded in virtually every previous era. The apparent victory of monetarism, illustrated by the reversal of French monetary and fiscal policy in 1983,<sup>2</sup> not only brought about apparent convergence in monetary policy on tight control over inflation, but also facilitated a major re-evaluation on the proper boundary between state and society. Just twenty years after the perceived triumph of the mixed economy and technocratic macro-economic management in the 1960s,<sup>3</sup> both advanced and developing states appeared to embrace privatization as a means of reducing the state's role in the economy, increasing the efficiency of formerly public enterprises, and achieving various other economic and political policy goals. Revenue figures alone represent an incomplete measure of this shift, but are nonetheless illustrative. Between 1985 and 1993, approximately \$328 billion had been raised by 100 governments through sales of public enterprises to private actors, while proposed sales will raise \$150 billion by 1998.<sup>4</sup> By the beginning of the 1990s, privatization was truly a global phenomenon, adopted by advanced, developing and post-communist states in a sweeping affirmation of the market as the most efficient and distributionally acceptable mechanism through which to provide even traditionally "public" goods and services.<sup>5</sup>

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<sup>1</sup>Leroy P. Jones, Pankaj Tandon and Ingo Vogelsang, *Selling Public Enterprises: A Cost-Benefit Methodology* (Cambridge, MA: MIT Press, 1990).

<sup>2</sup>Jeffrey Sachs and Charles Wyplosz, "The Economic Consequences of President Mitterrand," in *Economic Policy*, 2 (April 1986): 261-322.

<sup>3</sup>Two prominent works describing this view are Andrew Shonfield, *Modern Capitalism* (New York: Oxford, UP, 1965), and John Kenneth Galbraith, *The New Industrial State* (Boston: Houghton Mifflin, 1967).

<sup>4</sup>Vincent Wright, "Industrial Privatization in Western Europe: Pressures, Problems and Paradoxes," in Vincent Wright, ed., *Privatization in Western Europe: Pressures, Problems and Paradoxes* (London: Pinter Publishers, 1994).

<sup>5</sup>For a survey of privatization in advanced OECD states, see Barrie Stevens, "Prospects for Privatisation in OECD Countries," *National Westminster Bank Quarterly Review* (August 1992): 2-22; for a treatment of privatization in developing states, particularly Latin America, see William P. Glade, ed., *State Shrinking: A Comparative Inquiry into Privatization* (Austin, TX: Institute of Latin American Studies, 1986); for a discussion of privatization efforts in

The pace and scope of privatization, however, varied significantly among states and regions. For example, while Great Britain, France and New Zealand implemented extensive privatization programs, states in Latin America and Africa adopted more cautious ones, some actually rejecting privatization as an acceptable or viable policy.<sup>6</sup> A broad range of countries fall between these poles, including Germany, which was committed to privatization in principal, while posting comparatively modest results.<sup>7</sup> These differences between states can be traced to either different starting points, in terms of the initial size of the public sector; institutional differences, such as the lack of mature equity markets; or to differences in policy goals. This study focuses on the case of the privatization of Lufthansa to test various theories of privatization, and to illuminate the distinctive institutional features and implications of privatization in Germany.

### 1.A Introduction: What is Privatization?

Before launching into a discussion of privatization in Germany, it is essential to precisely define the concept of "privatization." The term is deceptively simple, and has been used to describe a broad range of government policies designed to reduce the scope of government in the economy. The *MIT Dictionary of Modern Economics* (1994) defines privatization as:

"[t]he policy of converting public ownership of an asset to private ownership or of permitting the performance of a certain activity, hitherto carried out by the department of a public organization, by a private sector business."(345)

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Eastern Europe, see Ferdinando Targetti, ed., *Privatization in Europe: West and East Experiences* (Brookfield, VT: Dartmouth Publishing Co., 1992).

<sup>6</sup>Stevens, "Prospects for Privatisation in OECD Countries," 2-22. See Table 2.4 for a comparison of revenues among selected OECD countries from privatization.

<sup>7</sup>Josef Esser labeled Germany's privatization campaign "symbolic privatization," due to this discrepancy between the stated intentions and actual results of privatization. See Josef Esser, "'Symbolic Privatisation': The Politics of Privatisation in West Germany," *West European Politics* 11:4 (October 1988): 61-73; updated in "Germany: Symbolic Privatizations in a Social Market Economy," in Vincent Wright, ed., *Privatization in Western Europe: Pressures, Problems and Paradoxes* (London: Pinter, 1994): 105-121.

While this definition encompasses two main variants of privatization -- sale and contracting out -- many other policies have also been subsumed under the label "privatization," such as joint ventures, recapitalizations, and the sale of minority stakes or subsidiaries of public enterprises.<sup>8</sup> Each of these forms of privatization necessitate different analyses. For example, the contracting out of services, such as waste disposal, implicates theories of incomplete contracting and information asymmetries. Conversely, an initial public offering of shares in a public enterprise implicates debates surrounding the efficiency of capital markets as an adequate disciplinarian for managerial behavior. This study will focus on the more traditional form of privatization, the total or partial<sup>9</sup> sale of government enterprises to private actors, or what Vickers and Wright (1988) term "industrial privatization."

The choice to focus on industrial privatization reflects two primary considerations. First, industrial privatization represents the most visible and enduring example of redrawing the state-society boundary. Floatations of huge public enterprises, such as Lufthansa or British Telecom, attract both domestic and international attention due to their implications for potential investors, current employees, and incumbent management. They are enduring because the costs associated with renationalization, both political and economic, are quite substantial. It is unclear whether asset sales are irreversible, or whether the privatization boom is simply another phase of Hirschman's "involvement cycle," whereby popular support for the public sector ebbs and flows in historical patterns.<sup>10</sup> There is no doubt, however, that privatization has facilitated the growth of entirely new sets of interests which are likely to strenuously oppose any plans to discontinue or reverse

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<sup>8</sup>John Vickers and Vincent Wright, "The Politics of Industrial Privatisation in Western Europe: An Overview," *West European Politics* 11:4 (October 1988): 1-30. There are numerous methods of privatization, ranging from initial public offerings of company stock, share giveaways to workers or low-income citizens, joint venture contracts, and service contracts, to name a few. For a comprehensive discussion of the various techniques of privatization and the problems involved in their implementation, see Charles Vuylsteke, *Techniques of Privatization of State-Owned Enterprises: Volume I - Methods and Implementation* (Washington, D.C.: World Bank, 1988); Madsen Pirie, *Privatization* (Hants, UK: Wildwood House Ltd., 1988); Jones, et. al., *Selling Public Enterprises: A Cost-Benefit Methodology*; and William T. Gormley, Jr., ed., *Privatization and Its Alternatives* (Madison, WI: U. of Wisconsin Press, 1991).

<sup>9</sup>"Partial" is used here to mean a sale of greater than 50% of a public enterprise to private actors.

<sup>10</sup>Albert O. Hirschman, *Shifting Involvements: Private Interest and Public Action* (Princeton, NJ: Princeton U. Press, 1982).

privatization -- not least the legion of accountants, investment bankers and lawyers who have constructed an entirely new niche in corporate finance.

Second, due to this visibility and import, sales of public enterprises are easier to examine and present discrete cases for analysis. As stated above, I will examine the German government's sale of Lufthansa to test five distinct theories of privatization, and to explore the implications of privatization for the traditional "German model." The case of Lufthansa was chosen for a host of reasons, the most important being: its size and importance for the German economy; its position in an increasingly competitive international service industry; its history as a tightly controlled state enterprise with industrial policy importance in terms of employment and competitiveness; and its role as a model for the future privatization of Deutsche Telekom in 1996. Furthermore, the Lufthansa restructuring program, implemented to facilitate privatization, was hailed as the exemplar of a "new German model" of industrial relations.

Accordingly, this study will consist of three parts. The rest of this chapter will briefly outline five alternative theories of privatization -- each answering the question, "why do states privatize public enterprises?" The second chapter will explore the privatization of Lufthansa in detail, describing two distinct phases of privatization: first, the failed attempt by Finance Minister Gerhard Stoltenberg in 1984-85; and then the successful partial privatization in autumn 1994. Finally, the concluding chapter will apply the Lufthansa case to the theories outlined in chapter 1 to determine which factors were most important in the German privatization campaign of the early 1990s. A final section in chapter 3 will discuss the implications of the Lufthansa privatization for the traditional "German model" of industrial relations, and will explore future directions and challenges for each of the social partners in Germany's political economy.

### 1.B Alternative Theories of Privatization

The motives behind privatization are as many and varied as the individual privatizations themselves.<sup>11</sup> Examining the literature, however,

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<sup>11</sup>Due to their complexity, privatization initiatives are very difficult to model theoretically. As a result, much of the political economy literature on privatization is descriptive and confined to case-by-case analysis. This presents a problem for the social scientist which, I

five main categories of explanation can be identified. These five theories of privatization are: 1) economic; 2) budgetary; 3) ideological; 4) domestic political; and 5) international. Each of the theories outlined below is, to some degree, an ideal type. I do not maintain that lines arbitrarily drawn between various theories are impermeable. In fact, the privatization of Lufthansa was the result of a mix of many factors. The goal of this study, however, is to discover which factors were most important in the decision to privatize Lufthansa, and to examine the wider ramifications of the Lufthansa privatization process for the company itself, and for the German model. With this important introduction, I will now outline these theories of privatization which will be tested by the case of Lufthansa.

### 1.B.i The Economic Theory of Privatization

The economic argument for privatization rests on the idea that public enterprises lack the same incentive structures as private firms.<sup>12</sup> As a result, they are more inefficient than private firms in terms of internal production efficiency, prices, and profitability. Specifically, a public enterprise eludes the following market disciplines on management behavior: 1) there is no fiduciary duty to maximize profits for shareholders; 2) a public enterprise is insulated from threats of takeover; and 3) the public enterprise is also

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submit, is common in the field of political economy. On the one hand, does one focus on trying to construct and test theories of privatization which, although refutable in individual cases, nonetheless offer a degree of generalizability and provide a benchmark for empirical research? Conversely, does one pick a case or set of cases based upon their intrinsic interest to the examiner, and then proceed to explain why that particular event happened, drawing specific conclusions which may point to general trends? Each approach is logically sound, and I do not presume to assert the worth of one over the other. This section, however, will build several theories from observations contained in the literature, and then attempt to test these theories by examining the case of Lufthansa.

<sup>12</sup>A great volume of economic literature exists on privatization, some works focus on policy prescription and analysis, while other studies focus on formal economic modeling. Just to note some of the major economic works on privatization, see John Vickers and George Yarrow, *Privatization: An Economic Analysis* (Cambridge, MA: MIT Press, 1988); Dieter Bös, *Privatization: A Theoretical Treatment* (Oxford, UK: Clarendon Press, 1991); Dennis J. Gayle and Jonathan N. Goodrich, eds., *Privatization and Deregulation in Global Perspective* (New York: Quorum Books, 1990); Glade, *State Shrinking: A Comparative Inquiry into Privatization*; Jones, et. al., *Selling Public Enterprises: A Cost-Benefit Methodology*; and E.N. Suleiman and J. Waterbury, eds., *The Political Economy of Public Sector Reform and Privatization* (Boulder, CO: Westview Press, 1990).



shielded from bankruptcy and reorganization.<sup>13</sup> As the state holds all residual rights associated with property ownership (use, extraction of benefits, and transfer), it can choose to pursue welfare goals, such as employment positions or low pricing for lower income citizens, as opposed to profit-maximization. In addition, the following negative aspects of public enterprises have been highlighted by economists:<sup>14</sup>

- production inefficiency and lack of innovation;
- artificially high wages and over-protection of workers and management, fueling high production costs;
- a high public sector borrowing requirement (PSBR) to fund a substantial public sector may crowd out private investment;
- many public enterprises are active in sectors where they are the only producer, thus they restrict consumer choice; and
- the political objective functions of bureaucrats running public enterprises differs from the original public interest rationale for nationalization.

Assuming, along with most economists, that governments can meet welfare objectives either through general macro-economic policy or through direct transfer payments, as opposed to the operation of public enterprises, privatization allows governments to solve these efficiency problems through the transfer of ownership from public to private actors. From a supply-side perspective, internal efficiency would improve in these enterprises due to the introduction of market incentives. On the demand-side, increasing internal

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<sup>13</sup>Wladimir Andreff, "French Privatization Techniques and Experience," in Ferdinando Targetti, ed., *Privatization in Europe: West and East Experiences* (Brookfield, VT: Dartmouth Publishing Co., 1992). Furthermore, public enterprises often have access to capital investment on generous terms either from the state treasury itself, or from special arrangements with commercial banks.

<sup>14</sup>See generally, Ferdinando Targetti, "The Privatization of Industry with Particular Regard to Economies in Transition," in Ferdinando Targetti, ed., *Privatization in Europe: West and East Experiences* (Brookfield, VT: Dartmouth Publishing Co., 1992); David Steel and David Heald, "Privatizing Public Enterprise: The Record of the UK Conservative Government 1979 - 1983," in William P. Glade, ed., *State Shrinking: A Comparative Inquiry into Privatization* (Austin, TX: Institute of Latin American Studies, 1986); Vickers and Yarrow, *Privatization: An Economic Analysis*; and Bös, *Privatization: A Theoretical Treatment*.

efficiency could lead to decreasing prices for consumers, enhancing distributional welfare in tandem with allocative efficiency.<sup>15</sup>

The economic debate on the advantages of a change in ownership *per se* is complex and highly contested. Empirical work comparing public, private and mixed enterprises reveals no clear case for a particular form of ownership in terms of greater efficiency.<sup>16</sup> In general, private enterprises were found to be slightly more efficient than public or mixed enterprises. More important in determining relative efficiency gains, however, is the competitive environment in the relevant industry. In competitive markets, where price elasticity was high, there could be both efficiency and welfare gains -- as both prices and production costs fall. Yet in monopolistic sectors, such as utilities, privatization could result in minimal efficiency gains and monopoly rents.<sup>17</sup> The case of oligopoly is more complex. Although Baumol's theory of contestable markets maintains that the threat of potential competition is enough to condition private managers to avoid rent-seeking and to maximize efficiency,<sup>18</sup> subsequent research reveals that incumbents in even contestable

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<sup>15</sup>An important preliminary question, however, is whether the state can sell an enterprise to begin with. As Jones, et. al. (1990) state the theoretical paradox: "if a public enterprise is making money, the government won't sell it; if it's losing money, the private sector won't buy it." In reality, the public and private sectors value a public enterprise differently due to the private sectors' belief that sufficient efficiency gains can be made under new business and management conditions to outweigh the initial costs of purchasing the public enterprise. This differential in valuation, rather than the price of the enterprise itself, is what drives privatization. Jones, et. al., *Selling Public Enterprises: A Cost-Benefit Methodology*. The same illusion holds for the offering price for a public enterprise when it is privatized. In theory, the offer price should be equal to the net present value of the expected revenues of the enterprise, thus creating no incentive for the government to part with any enterprise (as long as it was not losing money, in which case the private sector theoretically would not be interested anyway). Yet the belief in efficiency gains causes the offer price to be above this expected value, assuming the government does not sell the enterprise at an artificially low price, as in the case of so-called "employee shares," to be discussed below. See Stevens, "Prospects for Privatisation in OECD Countries," 2-22. This begs the question of how such perceptions are formed. Specifically, what is the case for efficiency gains on the basis of the character of ownership alone? The following section outlines this debate.

<sup>16</sup>For a review of the major empirical studies in this regard, see Dieter Bös, "Privatization in Europe: A Comparison of Approaches," *Oxford Review of Economic Policy*, 9:1 (September 1993): 95-111; Bös, *Privatization: A Theoretical Treatment*, 50-59.

<sup>17</sup>The seminal article on the importance of market competition, as opposed to the character of ownership *per se*, in evaluating the gains to privatization is John A. Kay and David Thompson, "Privatisation: A Policy in Search of a Rationale," *The Economic Journal* 96 (March 1986): 18-32. See also Vickers and Yarrow, *Privatization: An Economic Analysis*; and Bös, "Privatization in Europe: A Comparison of Approaches," 95-111.

<sup>18</sup>W.J. Baumol, J.C. Panzar and R.D. Willig, *Contestable Markets and the Theory of Industry Structure* (New York: Harcourt Brace Jovanovich, 1982). Contestable markets theory was often used within the context of airlines due to the natural limitations of airport infrastructure and

markets have enormous advantages (reputation, fixed investment, incentives to oppose new entry and to adopt predatory pricing in the absence of regulation) which effectively preclude serious threats of entry.<sup>19</sup>

Although the validity of the assertion that market competition is as important as the character of ownership in improving the efficiency of public enterprises through privatization is highly debated, even assuming its truth leads to a secondary debate among economists as to the proper policy response. Just a few of the alternatives to privatization include:

- changing the legal form to a private-law corporation whose shares are 100% owned by the state;
- replacement of the management;
- reduction of union power (for example, by restructuring the enterprise into smaller units under a holding-company structure); and
- creation of competition by facilitating market entry<sup>20</sup>

Each of these alternatives seeks to retain state-ownership while introducing competition to foster the growth of market incentives. Opponents of these alternatives, however, emphasize the importance of owning the residual rights to an enterprise as central to shaping the incentive structure facing managers. For example, the literature in public choice theory places great weight on the numerous layers existing between the ultimate owners of public enterprises (the taxpayers) and their counterparts in private firms (shareholders). As Hanke and Walters (1990) argue:

“[P]ublic enterprises are not owned by individuals who have a residual claim on the assets of these organizations. The nominal

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the substantial “fixed” (as opposed to “sunk”) costs associated with operating a global air carrier.

<sup>19</sup>See David J. Thompson, “Privatisation in the U.K.: De-regulation and the Advantage of Incumbency,” *European Economic Review* 31 (1987): 368-374; Jones, et. al., *Selling Public Enterprises: A Cost-Benefit Methodology*; Bös, *Privatization: A Theoretical Treatment*. An exception to this general rule is the case where firms enter the market only for a brief time to exploit an unmet demand, only to leave after sufficient profits had been made and incumbents had responded by expanding production to meet this demand (cream-skimming)

<sup>20</sup>Described in Bös, “Privatization in Europe: A Comparison of Approaches,” 95-111.

owners of public enterprises, the taxpayer-owners, cannot buy and sell public enterprise assets. Consequently, taxpayer-owners do not have strong incentives to monitor the behavior of public managers and employees.

Taxpayer-owners could capture some benefits from increased efficiency of public enterprises through tax reductions. However, if realized, incremental benefits from improved efficiency would be spread over many taxpayers, so that individual benefits would be rather small. In addition, the individual's cost of obtaining these benefits -- acquiring information, monitoring bureaucrats, and organizing an effective political force to modify the behavior of public managers and employees -- would be very high. Add to this the lack of threats from potential corporate takeover specialists and the near impossibility of bankruptcy for public enterprises, and we have significant differences between public and private enterprises."<sup>21</sup>

Bös also emphasizes the importance of sending a signal to domestic and foreign capital markets in order to attract investment and reduce the demand on government funds.<sup>22</sup> He argues further that only a change in ownership will necessitate both the internal restructuring and additional policy developments to foster increased efficiency and welfare gains from former public enterprises. Ultimately, however, the arguments of public choice theorists, and of Bös, hinge on the preference for one set of principal-agent relationships (shareholders-private managers) over another (voters-government bureaucrats-public managers). The contours of the principal-agent problem are therefore essential to the economic theory of privatization.

In a nutshell, principal-agent theory explains inefficiency as a result of two complications in the principal-agent relationship: 1) the principal and agent do not share the same goals; and 2) the agent possesses an information advantage over the principal. Thus, structures must be found which create incentives for the agent to act in the principals' interest, and the principal must have some tools which allow him to gain access to information

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<sup>21</sup>Steve H. Hanke and Stephen J.K. Walters, "Privatization and Public Choice: Lessons for the LDCs," in Dennis J. Gayle and Jonathan N. Goodrich, eds., *Privatization and Deregulation in Global Perspective* (New York: Quorum Books, 1990), p. 98. For a reply to public choice theory on privatization, see Paul Starr, "The Limits of Privatization," in Dennis J. Gayle and Jonathan N. Goodrich, eds., *Privatization and Deregulation in Global Perspective* (New York: Quorum Books, 1990): 109-125.

<sup>22</sup>Bös, "Privatization in Europe: A Comparison of Approaches," 95-111.

concerning the operation of the enterprise. The more layers between the ultimate principal and the acting agent, the more information problems hinder efficiency and the ability to monitor and control the agent's (in this case, the manager's) behavior.<sup>23</sup> As Figure 1.1 illustrates, public enterprises tend to have more layers between principals (taxpayers) and agents (public sector managers), than private corporations.

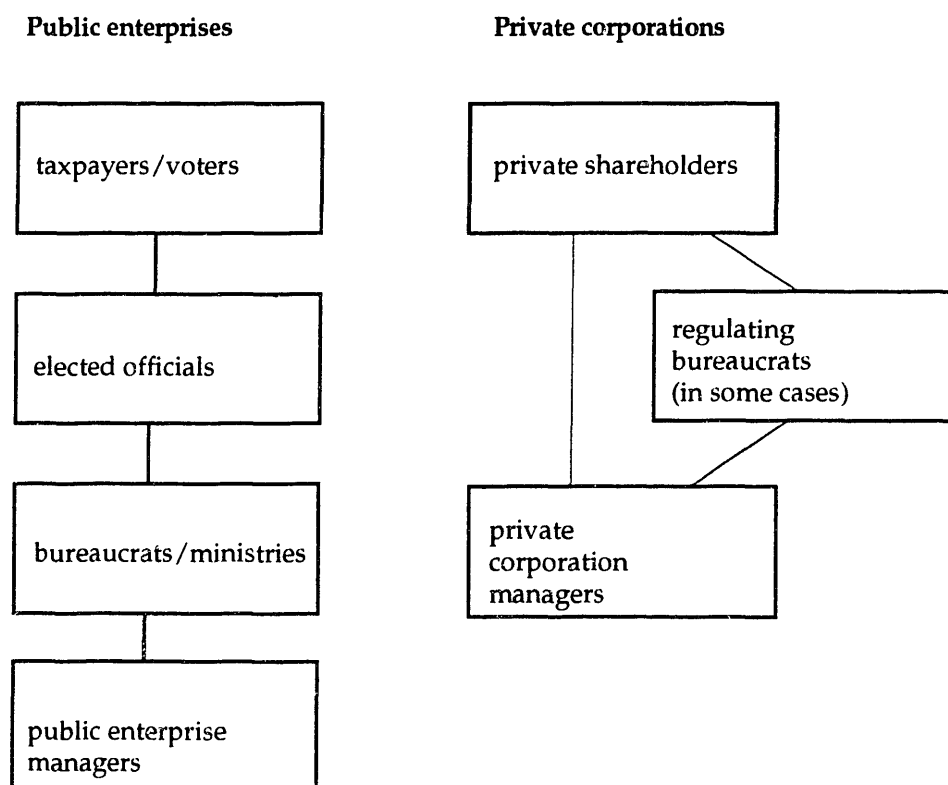


Figure 1.1: Alternative Principal-Agent Tracks  
(Adapted from Bös, 1993)

Simply shifting the principal-agent relationship from the model on the left to the one on the right will not solve monitoring and information problems. In fact, a disperse group of shareholders is a functional equivalent to the mass of taxpayers in the public enterprise model. In both cases,

<sup>23</sup>See Vickers and Yarrow, *Privatization: An Economic Analysis*; Bös, "Privatization in Europe: A Comparison of Approaches," 95-111; Saul Estrin and Virginia Pérotin, "The Regulation of British and French Nationalised Industries," *European Economic Review* 31 (1987): 361-65.

managers are relatively free from close scrutiny and enjoy significant information advantages over principals. The main difference, then, is the introduction of other, market-based incentive structures, such as the concept of fiduciary duty, the threat of takeover, and the possibility of bankruptcy. Yet each of these systems is also dependent on important institutional factors, such as the strength and tenacity of the shareholder-plaintiffs' bar, the maturity of domestic securities exchanges, and the willingness of the government to allow an important industries to go into liquidation. Moreover, the original discussion on the competitiveness of the industry in question is also decisive. If a monopoly is transferred to the private sector, then private managers, insulated from their principals and customers, have the capacity to avoid maximizing efficiency and reducing price.

Accordingly, the question of regulation (or deregulation) is closely connected with debates on privatization. Clearly, a complete discussion of this complicated and fascinating field in economics is beyond the scope of this study. With respect to privatization, however, regulation is a key element in programs to privatize traditional "natural" monopolies such as telecommunications, utilities, and some areas of transport, such as railroads.<sup>24</sup> In each case, the government must decide the extent of regulation, which may threaten both the revenues raised by privatization (by reducing the sale price) and the efficiency gains to transferring ownership to private hands.<sup>25</sup> The government, in its role as the "framer" of privatization

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<sup>24</sup>Since Great Britain has the broadest experience with privatizing and regulating such enterprises, much of the literature in this field focuses on the British experience. See, for example, John Kay and John Vickers, "Regulatory Reform in Britain," *Economic Policy* 7 (October 1988): 288-351; Mark Armstrong, Simon Cowan and John Vickers, *Regulatory Reform: Economic Analysis and British Experience* (Cambridge, MA: MIT Press, 1994); David Heald, "The United Kingdom: Privatisation and its Political Context," *West European Politics*, 11:4 (October 1988): 31-48; Alastair McAuley, "Market Failure Versus State Failure," in Ferdinando Targetti, ed., *Privatization in Europe: West and East Experiences* (Brookfield, VT: Dartmouth Publishing Co., 1992); John A. Kay, "Introduction: Public Ownership, Public Regulation or Public Subsidy?" *European Economic Review* 31 (1987): 343-345; and Cento Veljanovski, *Selling the State: Privatisation in Britain* (London: Weidenfeld and Nicolson, 1987).

<sup>25</sup>A technique which has a similar effect is the retention of a so-called "golden share," whereby the state retains 25% of the shares of the newly privatized company in order to veto changes in ownership and control of the enterprise, and to influence important firm decisions. Such an action seriously impairs the takeover discipline of private-sector managers, and again brings into question the efficiency and/or control gains to privatization. See Cento Veljanovski, "Privatization: Progress, Issues, and Problems," in Dennis J. Gayle and Jonathan N. Goodrich, eds., *Privatization and Deregulation in Global Perspective* (New York: Quorum Books, 1990): 63-79. The German government originally planned to retain a strategic 25.1% share in Lufthansa following privatization in 1994, see Bundesminister der Finanzen, *Bericht des*

(to borrow Bös' (1993) term), must ultimately weigh its interests in welfare goals against the efficiency gains of switching to the profit-motive through privatization. Obviously, this decision is not solely based upon the economic debates outlined here. Rather, they are the result of a highly political process motivated by specific political goals, in addition to concerns of economic efficiency. Therefore, we must now turn to alternative, political theories of privatization.

### 1.B.ii The Budgetary Theory

A more banal economic motive behind privatization is the reduction of state debt, preferably without tax increases. Governments are most likely to privatize state enterprises to meet domestic budgetary goals if two principal conditions exist. First, the government faces a debt burden which is (or at least is perceived to be) unacceptably high. Second, the public sector itself is of sufficient size, such that privatization could actually impact debt levels.

The sale of public enterprises, particularly loss-making or inefficient ones, is beneficial to fiscally constrained governments in a number of ways. First, revenues from sales represent an instant, albeit "one-shot," infusion of capital which can be directed toward debt reduction or other government programs. Second, the state is spared both operating expenses and future potential bail-out costs for these enterprises in times of economic downturn or industry crisis. Third, selling off key assets may consolidate the state's portfolio, thereby reducing the number of public enterprises and narrowing administrative activities to a more manageable level.<sup>26</sup> At the same time, however, although (in theory) the sales price of a public enterprise is supposed to equal the net present value of future income from the enterprise in question,<sup>27</sup> it is often the case that sales prices are either politically

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*Bundesministers der Finanzen zur "Verringerung von Beteiligungen und Liegenschaften des Bundes"* (Bonn: Bundesministerium der Finanzen, 13 July, 1992).

<sup>26</sup>The advantage of this consolidation is that the state can concentrate on unprofitable, "truly" public activities, such as postal delivery, tax collection, etc. The government also avoids popular disapproval for poor service or product provision by shifting responsibility to the private sector. The down-side of consolidation is that internal cross-subsidization is no longer easy to achieve. That is, loss makers can no longer be subsidized by profitable state enterprises. This could lead to tax increases or other forms of revenue increasing, as well as new or increased regulation, the costs of which may outweigh the original fiscal advantages of privatization.

<sup>27</sup>Stevens, "Prospects for Privatisation in OECD Countries," 2-22.

determined, or are affected by the fact that the enterprise for sale is a natural monopoly (or is the main actor in an oligopolistic market).

As discussed above, there is significant debate in the economic literature about the advantages of private as opposed to public ownership for enterprises in non-competitive industries, and empirical work suggests that private ownership does not automatically translate into efficiency gains, particularly in monopolistic or oligopolistic markets. This raises interesting issues for governments with respect to their *ex ante* calculations of the net costs and benefits of privatization. It may be the case that a highly regulated private monopoly will be both inefficient and more costly to the government, in terms of the costs of monitoring predatory behavior, than were the costs of direct government ownership and control. One limitation to the budgetary theory, however, is the fact that high debt levels have been a common phenomenon in most states throughout history. Thus, it remains unclear why debt reduction should facilitate such a massive embrace of privatization in the 1980s and 1990s in contrast to previous eras of budgetary crisis.<sup>28</sup> An alternative theory argues that privatization may be the product of ideological motives, rather than a sterile cost-benefit analysis.

### 1.B.iii The Ideology Theory

Another theory of privatization emphasizes the role of ideology as its primary motive. Specifically, a resurgence of "anti-statism" across both developed and developing states leads to a critical re-evaluation of the role of the state in the economy, and a resolution to redraw these boundaries in favor of the private market. Anti-statism consists of two distinct elements. The first builds upon the economic discussion above with respect to public choice or neo-classical theories of public enterprises. According to these approaches, state control over industry distorts incentive structures within public enterprises by politicizing them and removing them from the market. Public managers illustrate both the moral hazard problem of being insulated from the economic effects of poor performance -- e.g. there is no possibility for the state phone system or the postal service to be taken over or to go bankrupt -- and the related principal-agent problem of being unaccountable directly to

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<sup>28</sup>High debt levels may, in fact, have contributed to nationalization movements in advanced states following World War II, and, more recently, among developing states.



their customers (citizens) and possibly to the government itself (through bureaucratic autonomy). An unsophisticated version of the incentives prong of the anti-state position is that public enterprises are *a priori* inefficient, and that private monopolies are preferable to public ones.<sup>29</sup>

The second prong of anti-statism is a general appeal to individual freedom. Transferring ownership and control over public enterprises to private actors provides individuals not only with greater choice as consumers as a result of increased competition and market responsiveness, but also the freedom to become owners themselves. Thus, selling the government's stake in public enterprises also promotes increased and more wide-spread ownership of property. Empirically, however, it is unclear whether this "democratization" of ownership has actually occurred because of privatization.<sup>30</sup> In sum, anti-statism revolves around belief that the state is an inefficient economic actor, that private owners and managers can produce more efficient and distributionally acceptable economic outcomes, that private ownership increases the transparency and accountability of formerly public enterprises, and that privatization enhances individual freedom.

The ideological theory is appealing due to the recognition that the emergence of monetarism in various guises (Thatcherism, Reaganomics) appears to be the mirror image of the Keynesian revolution following World War II. It seems intuitively true to claim that neo-classical economic theory is an ideological force behind the rush by many states to privatize public holdings, particularly in industrial sectors. We would expect, therefore, that states with conservative (classical liberal) governments would be more likely to have substantial privatization programs relative to social democratic states. We would also expect that governments motivated primarily by ideology would be less concerned with maximizing sale price, or with the resolution of particular welfare issues prior to privatization. Instead, governments motivated by ideological concerns will be interested mainly in transferring public enterprises as quickly as possible into private hands. Finally, the ideological theory is appealing due to its potential to fill a hole in the political

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<sup>29</sup>See Baumol, et. al., *Contestable Markets and the Theory of Industry Structure* ; Milton Friedman, *Capitalism and Freedom* (Chicago: Univ. of Chicago P. 1962).

<sup>30</sup>See Vickers and Wright, "The Politics of Industrial Privatisation in Western Europe: An Overview," 1-30.

economy literature which avoids rigorous discussion of the role of ideas as shaping policy choice.

There are numerous problems with the ideological theory, however, which can be broken down into empirical and methodological limitations. With respect to empirical doubts, it seems clear that the character of the ruling government is not a controlling factor with respect to the zeal of privatizers. For example, France adopted a more vigorous privatization program under a socialist government than Germany under a free-market/conservative coalition in the mid-1980s. Although the visible example of Great Britain under Thatcher best illustrates the ideology theory, numerous countries with moderate privatization programs need a more sophisticated model to explain variation between states. This leads to methodological issues surrounding the ability to test the ideological theory. Governments are rarely consistent in justifying policy initiatives, and, as Vickers and Wright (1988) point out, some privatization campaigns are justified *ex post* rather than *ex ante*. As the institutionalist literature emphasizes, policy-making structures, which vary among states, may go further in explaining how ideas become distorted or transformed during the policy-making process.<sup>31</sup>

Some scholars have attempted to operationalize an ideas-based approach to policy-making by grafting institutionalist analysis onto an ideological perspective.<sup>32</sup> Perhaps the most compelling work in this regard is Peter Hall's edited volume *The Political Power of Economic Ideas* (1989), which documents the acceptance or rejection of Keynesianism in various states. Starting with the assumption that ideas matter, Hall defines particular institutional features of a political economy which affect openness to new ideas during a particular era. Structures such as the relative autonomy of the executive branch and the civil service, the existence of a strong central bank, and collective experiences with policy successes and failures all impact the capacity of an idea, such as privatization, to transform official government

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<sup>31</sup>See e.g., Sven Steinmo, Kathleen Thelen and Frank Longstreth, *Structuring Politics: Historical Institutionalism in Comparative Analysis* (New York: Cambridge, UP, 1992).

<sup>32</sup>See Peter A. Hall, ed., *The Political Power of Economic Ideas: Keynesianism Across Nations* (Princeton, NJ: Princeton UP, 1989); Sheri E. Berman, *Ideas and Politics: Social Democratic Parties in Interwar Europe* (PhD. dissertation, Harvard University, Government, 1994).

policy. Thus, variation between states can be traced to differences in these key institutions.<sup>33</sup>

Due to features such as the division of power between federal and Land governments, the existence of broad-based centrist parties, and the political consensus surrounding the acceptance of the *Sozialmarktwirtschaft*, we would expect privatization in Germany to have a profoundly non-ideological tone. Nonetheless, it is important to bear in mind the importance of the ideas behind privatization in examining the case of Lufthansa, with a view toward analyzing how institutional factors within Germany actually shape these ideas and transform them in the policy-making process. It is more likely, therefore, that one of the other privatization theories (or some combination of them) would go further in explaining the motives behind privatization in Germany. A fourth theory of privatization, for example, stresses domestic political goals as the primary motive behind privatization.

#### 1.B.iv The Political Consolidation Theory

Beyond economic and ideological motives, there may be additional political motives for privatization which are more strategic than the political goals of seeking popular approval through debt reduction and the elimination of inefficiencies. Literature on popular capitalism reveals that one domestic political motive of governments with respect to privatization is the entrenchment of denationalization through the creation of a new, broad property owning class.<sup>34</sup> Some states, for example Germany during the late 1950s and 1960s, will offer shares to lower income citizens and workers at a

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<sup>33</sup>Important works comparing the institutions of various states with respect to the pace and scope of privatization include: Vincent Wright, ed., *Privatization in Western Europe: Pressures, Problems and Paradoxes* (London: Pinter, 1994); Estrin and Pérotin, "The Regulation of British and French Nationalised Industries," 361-65 (comparing British and French executive and bureaucratic structures); Gayle and Goodrich, *Privatization and Deregulation in Global Perspective*; Glade, *State Shrinking: A Comparative Inquiry into Privatization*; Gordon Smith, "The Nature of the Unified State," in Gordon Smith, William E. Paterson, Peter H. Merkl and Stephen Padgett, eds., *Developments in German Politics* (Durham: Duke UP, 1992) (comparing the structure of the executive in Germany to other European states). For reviews of the distinctive institutional features in Germany, see Klaus König, "Developments in Privatization in the Federal Republic of Germany: Problems, Status, Outlook," *International Review of Administrative Sciences*, 54 (1988): 517-551; Ingo Vogelsang, "Deregulation and Privatization in Germany," *Journal of Public Policy* 8:2 (April - June 1988): 195 - 212.

<sup>34</sup>See Vickers and Wright, "The Politics of Industrial Privatisation in Western Europe: An Overview," 1-30.

substantially reduced price per share to induce their investment in newly privatized enterprises.<sup>35</sup> This serves several purposes. First, it facilitates an “equity-holding ethos” which may attract international capital flows to domestic securities exchanges. Second, it insures against future renationalization by making it more expensive, both fiscally and politically, for opposition (usually social-democratic) parties who may gain power. Third, it cultivates electoral support among sectors of the population who may not otherwise support center-right governments.

“Popular capitalism,” as such initiatives are labeled, serves not only to entrench denationalization and cultivate support for the ruling (conservative) government. Many scholars argue that privatization is a tool to weaken social-democratic parties and particularly labor unions.<sup>36</sup> Not only are vested property rights created within these movements which may preclude a unified opposition to renationalization, but shifting ownership to the private sphere replaces social objectives with profit maximization. This undermines both the objectives of social democratic movements and the legitimacy of their leaders, who are now in a less favorable position to protect welfare interests.

After the failure of *Volkskapitalismus* in the 1960s in Germany, the desire to divide the union movement seems to have faded as a motive for German privatization. The results of the British program in the 1980s are also mixed, as most shareholders sold their interests shortly following privatization.<sup>37</sup> Despite the absence of “people’s shares,” the German government in the 1980s did offer special shares to employees of privatized companies. Moreover, the goals of dividing unions and social democratic opposition parties can be served through means other than people’s shares in conjunction with privatization, as the restructuring program at Lufthansa prior to privatization illustrates. The appeal of the political consolidation theory, therefore, is its inclusion of party politics in considering what motivates privatization, particularly for conservative governments. A final

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<sup>35</sup>Richard A. Hawkins, “Privatisation in Western Germany, 1957 to 1990,” *National Westminster Bank Quarterly Review* (November 1991): 14-22.

<sup>36</sup>See Vickers and Wright, “The Politics of Industrial Privatisation in Western Europe: An Overview,” 1-30; Bös, *Privatization: A Theoretical Treatment*.

<sup>37</sup>Peter Curwen and David Holmes, “Returns to Small Shareholders from Privatisation,” *National Westminster Bank Quarterly Review* (February 1992): 41-58.

privatization theory, however, focuses on how international forces transform domestic institutions instead of being exclusively shaped by them.

### 1.B.v The Internationalization Theory

Finally, there is an internationalization theory which maintains that growing product and financial market globalization is causing governments to privatize state industries in competitive sectors in order to facilitate their survival and success.<sup>38</sup> Within the European context, internationalization influences privatization in three ways. First, the globalization of international finance not only appears to constrain macro-economic policy,<sup>39</sup> but, more positively, it provides an additional source of investment capital for domestic industry, particularly for enterprises to be privatized.<sup>40</sup> Moreover, attracting these flows through privatization initiatives may serve to mature domestic stock exchanges which could attract flows for other domestic industries. These aspects are critical for Germany, where traditional bank-industry links are weakening due to the liquidity squeeze of unification.

Second, international trade flows pressure exposed industries to rationalize production, to adjust to new global market demands, and to adopt new technologies. These pressures manifest themselves in three distinct forms. First, states recognize that structural adjustment is best managed by private actors acting on market signals. This relates to the ideological motive, and represents a recognition by the state that private actors are better positioned to gain access to global market information. Private managers, freed from political pressures commonly used by public enterprises to shield themselves from increasing competition, can implement necessary cost cutting measures, reorganization plans, and investment strategies. Second, growing international competition and technological developments have combined to erode traditional natural monopoly justifications for public enterprise. This is most evident in international telecommunications

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<sup>38</sup>Stevens, "Prospects for Privatisation in OECD Countries," 2-22. Stevens argues that, while domestic economic factors were the engine of privatization in the 1980s, international pressures will be the dominant force for privatization in the 1990s.

<sup>39</sup>Jeffrey A. Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45:4 (1991): 425-451.

<sup>40</sup>At the same time, one could question whether this is a new development, as Marcello De Cecco points that governments have always manipulated global financial markets to their advantage. Unpublished presentation to CES - Harvard University, October, 1994.

liberalization,<sup>41</sup> but is also the case for airlines. Ironically, through application of free-market policies of private ownership and liberalization, “national champions” could emerge which, while being domestic monopolies, nevertheless face international competition which pressures such firms to reduce production costs and prices to consumers. A third way in which trade flows affect change is through the mobilization of domestic political actors. For example, cheaper telecommunications products and services in America influenced business leaders and consumers in Europe to lobby for greater liberalization to facilitate lower costs to both producers and consumers.<sup>42</sup>

A third international pressure particular to the European states is the role of the European Union in promoting liberalization. Brussels currently lacks the authority to influence the pace of privatization, and it is not clear it would adopt this role if given the opportunity.<sup>43</sup> Yet the process of constructing the common market reinforces the pressures of trade flows in competitive industries. Moreover, first movers, such as Britain, lobby for greater liberalization, increasing the desire of competitors to transfer management and ownership to private hands in order to initiate the rationalization necessary to compete with other, “leaner” European firms. For example, the fact that British Airways was in private hands and

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<sup>41</sup>See Philip Genschel and Raymund Werle, “From National Hierarchies to International Standardization: Model Changes in the Governance of Telecommunications,” *Journal of Public Policy* 13:3 (July-September 1993): 203-226; Wayne Sandholtz, “Institutions and Collective Action: The New Telecommunications in Western Europe,” *World Politics* 45: 2, (January 1993): 242-270.

<sup>42</sup>See Genschel and Werle, “From National Hierarchies to International Standardization: Model Changes in the Governance of Telecommunications,” 203-226; Sandholtz, “Institutions and Collective Action: The New Telecommunications in Western Europe,” 242-270. The erosion of natural monopoly justifications for public enterprises is complemented by a new consumerism which mobilizes domestic coalitions in support of liberalization and privatization. For a general treatment of the relationship between international trade flows and domestic political coalitions, see Ronald Rogowski, *Commerce and Coalitions* (Princeton, NJ: Princeton UP, 1989).

<sup>43</sup> Bös, “Privatization in Europe: A Comparison of Approaches,” 95-111. Bös explains that Article 222 of the Treaty of Rome is neutral with respect to the character of property ownership (a reflection of the substantial public sectors in key states, such as France, at that time). At the same time, however, Bös envisions convergence upon European-wide privatization based on one of two alternative pressures: 1) competition in the European market from efficient private firms will pressure public enterprises to rationalize, which is best done in conjunction with privatization; or 2) the EU Commission will begin to apply competition law (pursuant to Article 90) more rigorously in order to break up state monopolies in such sectors as telecommunications and air transport.

flourishing was an additional influence pushing the German government to privatize Lufthansa.

The internationalization theory has several advantages. First, it captures the importance of the position of a political economy in the world economy. Thus, as a state which depends heavily on exports as the main source of economic growth, Germany would appear to be a good candidate for careful analysis. Yet another advantage of the internationalization theory is its simultaneous emphasis on competitive industries in addition to whole economies. Such an approach could explain differences in the speed and scope of privatization on a sectoral basis. Airlines and telecommunications, for example, would be expected to be good candidates for privatization in any state, while utilities may be a more controversial choice, given the local nature of utility provision. Once again, however, one disadvantage to the internationalization theory (like other theories of policy convergence) is its equal unreliability for predicting and matching empirical results. Air France remains a state-owned industry, as do many other public companies acting in internationally competitive markets. Therefore, although the internationalization theory goes farthest in escaping the constraints of domestic institutions by describing the strong international pressures to alter those institutions, these international forces must nonetheless work their way through complicated domestic policy filters before emerging as new policy.

### 1.C Why privatize now? Domestic Institutions as Policy Filters

Each of the theories outlined above can be viewed as exogenous inputs into a policy process whose mechanics are embodied in domestic institutions which translate preferences into policy outcomes. Such a model is similar to the one Gourevitch uses in *Politics in Hard Times*, and is schematically depicted in Figure 1.2. Thus, in discussing privatization in Western Europe, it is necessary to identify those key domestic institutions which affect the pace and scope of privatization initiatives. In the interests of parsimony, three principal institutions can be identified for comparative study: the structure of executive policy-making power; the strength of the domestic securities exchanges; and the health of the firms to be privatized.

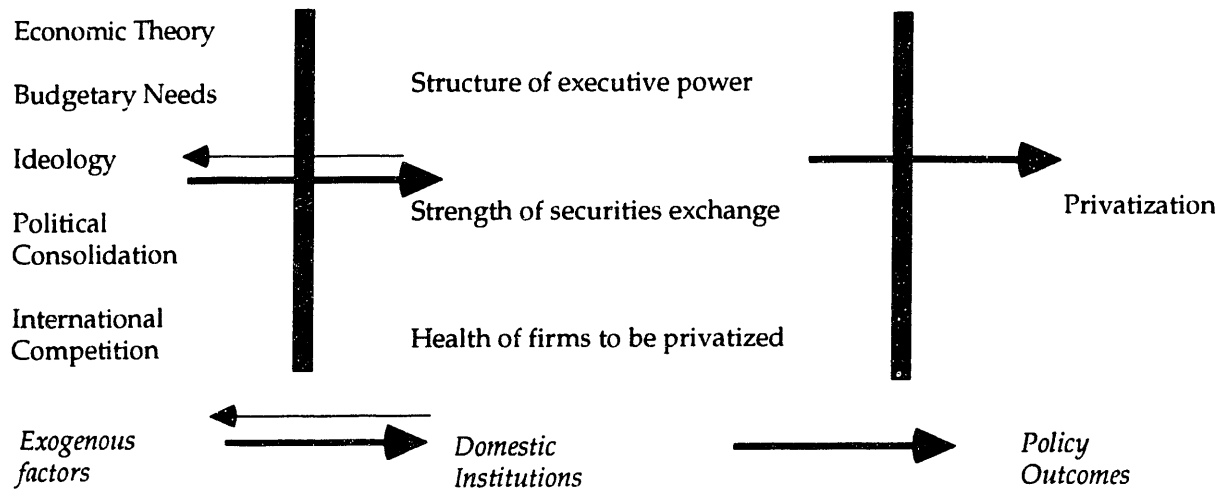


Figure 1.2: The Privatization Process

The first important domestic institutional variable is the degree to which the executive is free to implement privatization initiatives. This implicates Katzenstein's strong state - weak state continuum.<sup>44</sup> If the executive is dependent upon the agreement of a ruling coalition, for example, the process of privatization may be difficult to implement. Moreover, if so-called "distributional coalitions" enjoy access to the policy-making process at many points, privatization would presumably be slowed and altered to reflect these distributional concerns. Comparing Britain and Germany, for example, one would expect the relatively strong British executive to be able to more effectively pursue privatization free from both delay and distributional warping, whereas the reality of coalition government and cooperative federalism in Germany give distributional groups greater access to affect the pace and scope of privatization. Indeed, the evolution of the European Union appears to have enhanced the power of the *Länder* to block federal initiatives, or to amend them to address distributional concerns.<sup>45</sup>

<sup>44</sup>Peter Katzenstein, "Introduction" and "Conclusion," in Peter Katzenstein, ed., *Between Power and Plenty* (Madison: University of Wisconsin Press, 1978); Peter Evans, Dietrich Rueschemeyer and Theda Skocpol, eds., *Bringing The State Back In* (New York: Cambridge University Press, 1985).

<sup>45</sup>Razeeen Sally and Douglas Webber, "The Solidarity Pact: A Case Study in the Politics of Unified Germany," *German Politics*, 3:1 (April 1994): 18-46.



A second major institutional variable is the structure of the capital markets within states. This draws upon the late-developer thesis of Gershenkron, as well as Zysman's typology of financial markets.<sup>46</sup> Assuming the government wants to raise the maximum amount of revenue possible from its sale of state enterprises, and assuming it wants to achieve some degree of broad private ownership to facilitate democratic and transparency aims, a mature and effective securities market is vital to success. As Veljanovski points out, the success of the market-mechanism in conditioning economic decision-making depends not only on private ownership *per se*, but on the transferability of that ownership.<sup>47</sup> Although the viability of the "market for corporate control" as a disciplinary force facilitating efficient economic outcomes in the case of natural monopolies is uncertain, an effective securities market is critical for the ability to effectively privatize public enterprises.

In gauging the effectiveness or "maturity" of a securities exchange, one must go beyond quantitative factors concerning the volumetric capacity of domestic securities exchanges, to explore qualitatively how they are organized and regulated. Vickers and Wright (1988) point out that exchanges had surprisingly little trouble (volumetrically) in administering share issues for public enterprises due to the overwhelming domestic and international demand for shares in these concerns.<sup>48</sup> Yet this ignores the various procedural safeguards which are critical to the functioning of an exchange for purposes of the market for corporate control, which is essential for the market mechanism to ensure efficient performance of these enterprises. For example, a key factor dissuading American investors from actively investing in the Frankfurt exchange was its lack of an effective insider trading regime, which privileged institutional (normally bank) investors in Germany.<sup>49</sup>

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<sup>46</sup>Alexander Gershenkron, *Economic Backwardness in Historical Perspective* (Cambridge, MA: Harvard University Press, 1962); John Zysman, *Governments, Markets, and Growth* (Ithaca, NY: Cornell University Press, 1983).

<sup>47</sup>Veljanovski, *Selling the State: Privatisation in Britain*, see especially chapter 4.

<sup>48</sup>Vickers and Wright, "The Politics of Industrial Privatisation in Western Europe: An Overview," 1-30. This includes states where domestic securities exchanges were believed to be virtually non-existent, as in Jamaica. See John Redwood, "Privatization: A Consultant's Perspective," in Dennis J. Gayle and Jonathan N. Goodrich, eds., *Privatization and Deregulation in Global Perspective* (New York: Quorum Books, 1990): 48-62.

<sup>49</sup>See Daniel J. Standen, "Insider Trading Reforms Sweep Across Germany: Bracing for the Cold Winds of Change," *Harvard International Law Journal*, 36:1 (Winter 1995): 177-206.

Such qualitative factors shape the methods and scope of privatization among European states.

A final domestic factor which straddles the border of institutional and more managerial inputs to the privatization process is the economic health of the specific firms targeted for privatization. Despite exogenous forces pushing for privatization in particular industries, and despite facilitating institutional conditions, if targeted firms are poorly situated to be subjected to private market competition: 1) the government is unlikely to find investors; 2) the price per share issued will be low; and 3) the resulting private company may quickly go under in the face of intensified competition without access to state subsidies. Ironically, however, the ability for state-appointed managers to rationalize Lufthansa raises important questions concerning the supposed impossibility of efficient management under state ownership. Although rationalization was implemented "under the shadow of impending privatization," reforms were nonetheless initiated under state "control."

In sum, the case of Lufthansa will test five distinct theories of privatization to add more empirical evidence with which to evaluate the question of why states privatize public enterprises. Beyond this goal, however, this study will attempt to place privatization within the broader context of changes in the traditional "German model" of industrial relations. Original motives are translated into policy through distinctive domestic institutions -- in this case, those of the traditional German model. Yet as Figure 1.2 indicates, there is room for feedback effects from the process itself, as well as from its final outcome. These feedback effects are the core of the changing German model, and will be explored in the conclusion in chapter 3. First, however, the case of the privatization of Lufthansa needs to be carefully documented in order to approach both goals of this study.

## Chapter 2: The Privatization of Lufthansa

The privatization of Lufthansa took over ten years to complete after it was initially proposed in 1984, and illustrates the many institutional hurdles to privatization in Germany. The many legal and social obstacles to the sale of the government's remaining 36% share provide a further example of the conflict between traditional industrial policy goals and the new shift toward deregulation and privatization in western Europe. In this chapter I will examine the case of Lufthansa in four parts. The first part, discusses the history of the public sector in post-World War II Germany and the corporate history of Lufthansa. Second, I will examine the first attempt by Finance Minister Gerhard Stoltenberg to partially privatize Lufthansa in 1984-85. Third, the successful initiative of Finance Minister Theo Waigel in 1990-94 will be explored. Finally, I will conclude with a brief discussion of the current and future challenges facing Lufthansa and its social partners as they attempt to complete the privatization project and to improve Lufthansa's competitive position in the international air travel industry.

### 2.A A Brief History of Public Enterprises in Germany From 1945 to 1983

To place the privatization of Lufthansa in wider historical context, it is useful to survey the origins and character of the public sector in Germany since 1945. An important preliminary distinction must be made between public enterprises at the federal level and those at the *Land* or municipal level. Consistent with Germany's federal structure and the division of administrative power between federal and *Länder* governments, a sizable portion of public activities are under the control or ownership of *Land* or local authorities. *Land* assets typically include banks, utilities and other industrial firms, while local enterprises include schools, baths, cleaning services and waste disposal.<sup>50</sup> While the federal government has frequently

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<sup>50</sup>Josef Esser, "'Symbolic Privatisation': The Politics of Privatisation in West Germany," *West European Politics* 11:4 (October 1988): 61-73; updated in, "Germany: Symbolic Privatizations in a Social Market Economy," in Vincent Wright, ed., *Privatization in Western Europe: Pressures, Problems and Paradoxes* (London: Pinter, 1994): 105-121; Klaus König, "Developments in Privatization in West Germany: Problems, Status, Outlook," *International Review of*

explored privatization possibilities, *Länder* and local authorities are extremely reluctant to privatize assets or contract out public services to private providers due to the importance of these enterprises and services to regional economies. This is particularly the case for regional banks, which provide a vital source of investment capital for local industries, and hence are jealously guarded by public authorities.<sup>51</sup> This key difference between federal and regional approaches to privatization within Germany explains why the pace of privatization in Germany has lagged in comparison to other European states, such as Britain or France, which lack such a division of authority. Accordingly, in focusing on federal privatization, a significant portion of the public sector in Germany is excluded from consideration.<sup>52</sup>

Limiting the discussion to federal holdings, three aspects are important to consider: the size, origin, and character of public enterprises. Relative to other western European states, the size of Germany's public sector was quite small throughout the post-World War II era. For example, data from 1978 revealed that the share of total company turnover of public enterprises in Germany was 3.9%, compared with 82% in Austria, 51.8% in Italy, 24.9% in France and 12.5% in Britain.<sup>53</sup> Unlike other western European states with strong labor movements, Germany resisted the push to nationalize many key industries after World War II. This was due not only to the weakness of the groups supporting nationalization, but also because nationalization and a strong central government was linked to the abuses of the Nazi regime. This legacy was also responsible for the federal structure of the Bundesrepublik after 1949.

As a result, much of the public sector in post-War Germany represented an inheritance from the Nazi regime (industrial concerns such as Salzgitter and Volkswagen), the Weimar Republic (banks and related industry holdings nationalized during the Depression-era), as well as the Prussian

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*Administrative Sciences*, 54 (1988): 517-551; Ingo Vogelsang, "Deregulation and Privatization in Germany," *Journal of Public Policy* 8:2 (April - June 1988): 195 - 212.

<sup>51</sup>For an interesting work on the importance of regional bank-industry links, see Richard Deeg, *Banks and the State in Germany* (Ph.D. Dissertation, M.I.T. Political Science Department, 1992).

<sup>52</sup>Clearly, then, the future of privatization in Germany is heavily dependent upon attitudes at the *Land* and local levels. This point will be discussed in the conclusion in chapter 3.

<sup>53</sup>Esser, "Germany: Symbolic Privatizations in a Social Market Economy," 109.

Empire (telecommunications and railroads).<sup>54</sup> Following World War II, many banks were returned to private ownership, but their corresponding industrial holdings were not.<sup>55</sup> While the size of the public sector did not experience the expansion of other states, the existing public sector was both socially accepted and, in the cases of the railroads, telecommunications and post, and in Land navigable waterways, public ownership was protected by the *Grundgesetz*, necessitating a two-thirds vote in both houses of parliament to privatize them.<sup>56</sup> In German company and budgetary law, public enterprises are allowed to exist, but only if they serve a public interest and their functions can not be provided more efficiently by the private sector.<sup>57</sup> In sum, German law is neutral with respect to the character of property ownership, with the burden of proof on the government to define and defend its conception of the public interest and the public sector's capacity to serve it.

During the immediate post-War era, both conservative and liberal governments in Germany used the inherited public sector as a tool of industrial policy. The Adenauer administration involved the public sector in its efforts to reconstruct the German economy, and SPD governments in the late 1960s and 1970s used the public sector as part of their overall Keynesian demand-management initiatives.<sup>58</sup> An important exception to this consensus regarding the extent of the public sector was the first main privatization initiative, the sale of *Volksaktien* ("people's shares") designed by Ludwig Erhard in 1957.

Under the banner of *Volkskapitalismus* ("people's capitalism"), the government proposed to sell its shares in certain public enterprises (Volkswagen was the first firm tabbed for the program) at discounted prices to workers of those firms and to lower-income individuals. Due to political

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<sup>54</sup>Esser, "Germany: Symbolic Privatizations in a Social Market Economy," 108-9; Richard A. Hawkins, "Privatisation in Western Germany, 1957 to 1990," *National Westminster Bank Quarterly Review* (November 1991): 14-22.

<sup>55</sup>Hawkins, "Privatisation in Western Germany, 1957 to 1990," 14-22.

<sup>56</sup>Esser, "Germany: Symbolic Privatizations in a Social Market Economy," 108-9. The relevant article is Article 87. Articles 134 and 135 stipulated that the holdings of Prussia and the Third Reich in private companies would transfer over to the new government. Fritz Knauss, *Privatisierungs- und Beteiligungspolitik in der Bundesrepublik Deutschland* (Baden-Baden: Nomos Verlag, 1993), p. 128.

<sup>57</sup>König, "Developments in Privatization in West Germany: Problems, Status, Outlook." König explains that the language of the relevant laws refers strictly to new businesses, although the same criteria can be applied to existing public enterprises.

<sup>58</sup>Esser, "Germany: Symbolic Privatizations in a Social Market Economy," 108-9.

opposition, however, the government postponed its sale of Volkswagen shares and elected to sell a portion of its interest in the former Prussian mining firm Preussag in 1959 as a trial run for the program.<sup>59</sup> This initial success was followed by the partial privatization of Volkswagen in 1961 (the federal government retained a 20% share) and of VEBA in 1965 (a 54.5% retained share).<sup>60</sup> Each share issue was substantially oversubscribed.

Despite this apparent success, several problems emerged with the sale of *Volksaktien* which resulted in the cancellation of the program in 1965 following the VEBA sale. First, individuals who bought the shares at a substantial discount would sell their shares the next day, when the price of the shares on the market was in many cases several times the original purchase price. Thus, the program had the unintended consequence of being a simple transfer payment from the state to workers and lower income individuals, rather than serving the original goal of creating a nation of small equity-holders.<sup>61</sup> Second, a downturn in the world market caused the VEBA shares to actually lose value, resulting in government intervention to prop the share price and further damaging public interest in investing in equity shares.<sup>62</sup> Finally, the ruling CDU-CSU/FDP coalition was forced in 1965-66 to share power with the SPD, which opposed the *Volksaktien* program. Accordingly, the *Volksaktien* program failed to create an equity culture in Germany among individual shareholders, a trait that endures today in the German political economy. In 1990, only 11% of the population owned equity shares, the rest preferring secure holdings in the form of savings accounts, housing accounts or government bonds.<sup>63</sup>

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<sup>59</sup>Hawkins, "Privatisation in Western Germany, 1957 to 1990," 14-22. A Ministry of Federal Property was established in 1957 to administer the privatization program.

<sup>60</sup>Hawkins, "Privatisation in Western Germany, 1957 to 1990," 14-22. It is interesting to note that the Land of Lower Saxony strongly opposed the privatization of Volkswagen on industrial policy grounds, so much so that it purchased 20% of the federal government's holding which was sold.

<sup>61</sup>Esser, "'Symbolic Privatisation': The Politics of Privatisation in West Germany," 61-73. Similar problems appeared in Britain, where popular capitalism was also implemented. Ironically, a study showed that small investors in Britain would have gained higher returns had they held on to their shares in privatized industries as opposed to quickly selling them, placing the money in a building-society account, or investing in a random sample of stocks. See Peter Curwen and David Holmes, "Returns to Small Shareholders from Privatisation," *National Westminster Bank Quarterly Review* (February 1992): 41-57.

<sup>62</sup>Hawkins, "Privatisation in Western Germany, 1957 to 1990," 14-22.

<sup>63</sup>Esser, "Germany: Symbolic Privatizations in a Social Market Economy," 111.

**Table 2.1: Size of Public Sector in (West) Germany 1970-89**

Year	Total Holdings	
	Direct Holdings	(greater than 25% stake)
1970	97	697
1971	95	760
1972	93	776
1973	87	850
1974	88	865
1975	87	885
1976	90	915
1977	91	941
1978	90	938
1979	88	985
1980	86	899
1981	85	928
1982	84	958
1983	83	487
1984	81	474
1985	79	454
1986	80	463
1987	80	459
1988	77	412
1989	77	337

Source: Knauss, 1993

Under SPD/FDP governments in the late 1960s and 1970s, the public sector in Germany expanded significantly, mostly through acquisitions by existing public enterprises of competitors or downstream concerns. Esser argues this was due mainly to growing international competition in the industries where most public enterprises were active -- including coal, steel and shipbuilding.<sup>64</sup> As a result of 1970s acquisitions, "the number of companies in which the federal State held at least 25% of the shares increased from 697 in 1970 to 958 in 1982. The federal capital involved rose from 3.7 to 7 billion DM during the same period."<sup>65</sup> This expansion is detailed in Table 2.1.

<sup>64</sup>Esser, "Germany: Symbolic Privatizations in a Social Market Economy," 109.

<sup>65</sup>Esser, "Symbolic Privatisation: The Politics of Privatisation in West Germany," 68.

Public ownership was concentrated mostly in banks, utilities, auto production, the crisis industries of coal, steel and shipbuilding, as well as in research and development labs. It is important to note that this expansion of the public sector was not part of an overall nationalization plan of the SPD. Instead, it was a product of the strategic calculations of the individual public enterprises themselves with respect to their acquisitions policies. Nevertheless, the perceived bloating of the public sector, combined with the rise to power of the conservative CDU-CSU/FDP government in 1982, provided the impetus for another major privatization initiative

A second major program of privatization was drafted by Finance Minister Gerhard Stoltenberg in 1984 shortly after the election of the CDU-CSU/FDP Kohl government. The guiding principle of the government was essentially a restatement of Article 65 of the *Bundeshaushaltsordnung*, which states that the federal government can only have a stake in a private company if a federal interest exists and the most efficient way to serve it is through state ownership. A 1983 government report asserts:

“State activities are to be concentrated on true public tasks; those public services which the private sector can perform more efficiently are preferably to be handed over to private firms; and those parts of State assets are to be privatized where it can be done without infringement of the public interest.”<sup>66</sup>

Stoltenberg’s plan included the partial sale of the government’s stake in Lufthansa, which at that time amounted to approximately 80%. Table 2.2 outlines the other firms considered in Stoltenberg’s plan. This proposal initiated a ten year process which illustrates the many political hurdles to privatization in Germany. An important parallel history to the evolution of the public sector in Germany, however, was the evolution of Lufthansa itself. Symptomatic of developments in the public sector through history, Lufthansa was originally under tight state control as an important strategic industry, and was gradually privatized until the final share sale in 1994. Its history is an important part of the privatization story, as it illustrates the original strategic and industrial policy grounds for nationalization, and then how changes in

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<sup>66</sup>*Jahreswirtschaftsbericht der Bundesregierung*, Bundestags-Drucksache 9/2400, 27 January, 1983 (Bonn, 1983), p. 11.



the global market eroded these traditional justifications for substantial state involvement.

## 2.B A Brief History of Deutsche Lufthansa AG

The first German airline, Deutschen Luftreederei (DLR), was founded in 1919, and was just the first of many small carriers which emerged in the 1920s, all heavily supported by the *Reichsverkehrsministerium*.<sup>67</sup> The original idea of consolidating the many smaller carriers into a national airline was first conceived by the director of the Luftfahrt Abteilung at the *Reichsverkehrsministerium*, Ernst Brandenburg, and supported by Deutsche Bank's Dr. Kurt Weigelt. Both believed that the global airline competition was an important arena for national interests. Accordingly, Deutsche Luft Hansa AG was founded on January 6, 1926 with original capital of DM 50,000, the product of a merger between two principal carriers, Aero Lloyd (from whence the crane symbol was borrowed) and Junkers Luftverkehr AG (from whence the colors were borrowed). Its original mission statement reflects the industrial policy goals of the German government at that time:

- 1) to link Germany with the important European markets;
- 2) to link the important cities of Germany to the European flight network;  
and
- 3) to bring Germany into contact with important trading partners outside of Europe.

Two years later a freight subsidiary, Condor, was founded, and within ten years Lufthansa (as it was renamed in 1933) was a major global passenger, freight and post airline with links to all continents. With the rise of the Nazi regime, however, Lufthansa was slowly overtaken by military interests, and

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<sup>67</sup>For a colorful and detailed history of Lufthansa and the German air industry generally, see Rudolf Braunburg, *Kranich in der Sonne: Die Geschichte der Lufthansa* (Munich: Kindler Verlag GmbH, 1978). For general background on the evolution of the European and international air traffic industry, see Vicki K. Golich, "Liberalizing International Air Transport Services," in Dennis J. Gayle and Jonathan N. Goodrich, eds., *Privatization and Deregulation in Global Perspective* (New York: Quorum Books, 1990): 156-176; Betsy Gidwitz, *The Politics of International Air Transport* (Lexington, MA: Lexington Books, 1980).

**Table 2.2: Stoltenberg's 1984 Privatization Plan**

Company	Activity	Nominal Capital	Turnover (83)	Government Holding (%)	Possible New Holding
VIAG	energy, aluminium, chemicals	DM580m	DM5.9bn	87.4 direct 12.56 KfW	75
Volkswagen	vehicle manufacture	DM1.2bn	DM40bn	20 direct 20 Lower Saxony	14
Prakla-Seismos	oil, gas exploration	DM26m	DM319m	95 direct 5 IVG	50+
IVG	industrial management, ship repair, property, transport	DM54m	DM575m	100 direct	75
Deutsche Pfandbriefanstalt	mortgage bank	DM243.9m	DM51.8bn*	67.88 direct 32.12 public inst's.	50+
Deutsche Siedlungs und Landesrentenbank	infrastructure lending-rural	DM256m	DM30.5bn*	99 direct 1 by 4 länder	50+
Deutsche Lufthansa	airline	DM900m	DM8.9bn	74.3 direct 7.9 public inst's.	55
DIAG	plant, machine tools, printing	DM160m	DM593m	100 ERP	50+
GfN	finances, builds and leases motorway service points	DM190m	DM190m	100 direct	N/A
Schenker & Co.	worldwide road haulage	DM60m	DM5.9m	100 Bundesbahn	N/A
Deutsche Verkehrsbank	bank and house bank to Bundesbahn	DM65m	DM5bn*	100 Bundesbahn	N/A
Amliches bayerisches Reisebüro GmbH	travel agency	DM13m	N/A	55 Bundesbahn	N/A
Deutsches Reisebüro (DER)	travel agency	DM18m	N/A	50.1 Bundesbahn	N/A

^ Taken from Peter Bruce, "Bonn Takes a Step Towards Privatisation," Financial Times, November 15, 1984, i:2; Esser, 1988.

\* Balance sheet total (end 83)

became a virtual appendage of the *Luftwaffe* once World War II began.<sup>68</sup> It flew its last route in early 1945, and then shut down operations and went into liquidation.

During the immediate post-War period, the prospect of an autonomous German airline was out of the question. In 1953, however, a company called LUFTAG was created to explore the possibilities of, and necessity for, a German domestic airline.<sup>69</sup> The starting capital of DM 6 million (for LUFTAG) came from the federal government, the Bundesbahn and the *Land* Nordrhein-Westfalen. Accordingly, at that time the entire board of directors was comprised of government ministers, as well as the head of the Bundesbahn, who made sure that Lufthansa did not seriously compete with rail travel to and from frequently-traveled routes.

Once the feasibility for such a firm was determined, and permission granted from the occupying powers, LUFTAG set about purchasing planes and hiring cockpit and ground personnel. On August 6, 1954, it was renamed Deutsche Lufthansa AG, and its first flight from Hamburg to Düsseldorf took place in spring 1955 only by special exception to the allied command's ban on autonomous German air traffic. Only in May, 1955 did Germany receive its full air sovereignty back from the allied command. The starting capital for Deutsche Lufthansa AG was DM 50 million, with the federal government holding a 85.44% share.

It was critical that Lufthansa was organized as a private stock corporation. As such, the company has a fiduciary duty to its stockholders, as in the United States, to maximize the value of their assets. As the dominant shareholder, the government could focus on other goals besides profit-maximization, yet this legal form allowed Lufthansa to avoid substantial transformation costs when privatization was ultimately considered in the 1980s and 1990s. This was not the case for the Bundesbahn, Deutsche Telekom, or other public-law companies, which first had to restructure the legal relationships between employees, management, and owners, before proceeding with privatization. Figure 2.1 illustrates the standard privatization process for public-law companies. Fortunately, Lufthansa

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<sup>68</sup>Lufthansa was used as a vehicle to escape the constraints for the Versailles Treaty with respect to a German air force. For example, pilots would be trained at Lufthansa education centers, and research and development on fighter planes was undertaken within Lufthansa. See Braunburg, *Kranich in der Sonne: Die Geschichte der Lufthansa* .

<sup>69</sup>Braunburg, *Kranich in der Sonne: Die Geschichte der Lufthansa* .

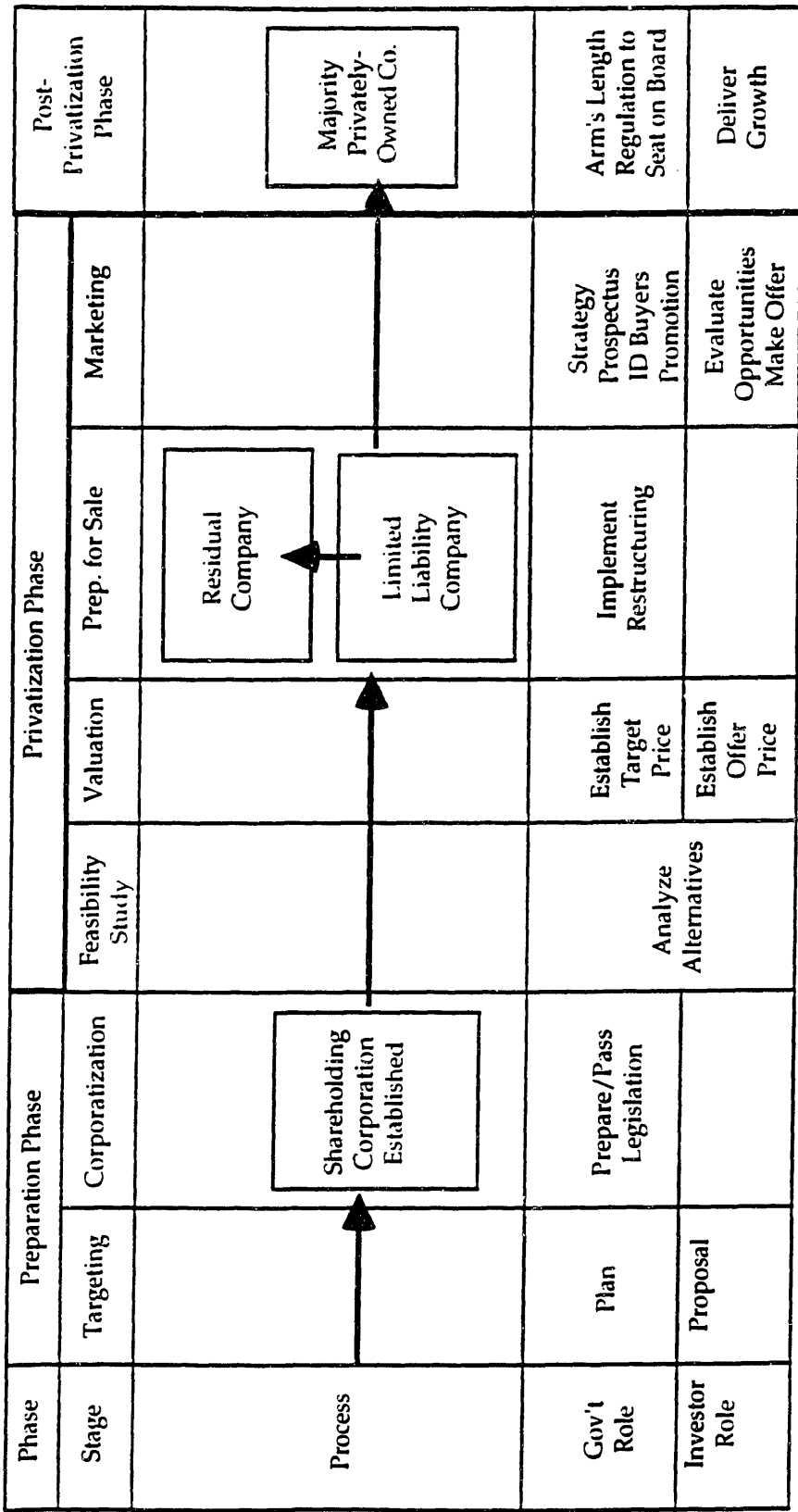


Figure 2.1 The Privatization Process  
 Taken from Ernst & Young, Privatization: Investing in State-Owned Enterprises Around the World  
 (New York, NY: John Wiley & Sons, 1994): 5.

avoided the corporatization phase which is normally required for many privatization.

Despite the fortuity that Lufthansa was organized as a private-law company, from the beginning, Lufthansa employees were insured by the *Versorgungsanstalt des Bundes und der Länder* (VBL). This institution insures employees in public enterprises as if they were official Beamte (civil servants), meaning a relatively more comprehensive and costly pension and insurance plan was offered to all employees of Lufthansa. To remain insured by the VBL, Lufthansa had to satisfy the following three covenants of the VBL:

- 1) the government's share of the enterprise must not fall below 50%;
- 2) the firm remains active in a sector which serves the public interest; and
- 3) the firm had to conclude collective wage agreements with its employees.<sup>70</sup>

The VBL issue was to become the key hurdle to privatization in 1994, and will be discussed at length below. It is nevertheless important to highlight at the outset the particular legal structures which were created when Lufthansa was founded, as they shaped subsequent developments.

In the years following the re-emergence of Lufthansa, the government's stake in the carrier stayed significantly above 50%, guaranteeing the state substantial influence over major strategic planning. Table 2.3 documents the evolution of Lufthansa's subscribed capital. Consistent with privatization in Germany generally, the government's stake was always reduced step-by step, and occasionally increased to a higher percentage. At the time of the rise of the Kohl administration in 1982, the federal government held a 74.31% stake in Lufthansa, and when added to the stakes held by various *Länder*, the Bundesbahn, and other federally-held enterprises, Lufthansa was, in effect, 80% publicly owned. It is within this context that the first attempt to significantly reduce the government's holding was made by Finance Minister Gerhard Stoltenberg in 1984-85.

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<sup>70</sup>Discussed in "Lufthansa Hintergrund: Lufthansa und die VBL," Deutsche Lufthansa AG, 6 July, 1994.

**Table 2.3: Development of Lufthansa's Subscribed Capital**

Approval of General Shareholder's Meeting	Capital Increase (DM Million)	Subscribed Capital (DM Million)	Share of Fed. Government (DM Million)	Share of Fed. Government (per cent)
6-Jan-53		6	4.5	75%
16-Nov-53	19	25	21.125	84.50%
8-Aug-54	25	50	42.721	85.44%
4-Oct-55	30	80	57.853	72.32%
4-Dec-56	40	120	89.962	74.97%
27-Oct-59	60	180	146.306	81.28%
12-Dec-60	70	250	213.128	85.25%
20-Jul-65	150	400	297.257	74.31%
8-Aug-73	200	600	445.886	74.31%
29-Jun-78	300	900	668.829	74.31%
8-Jul-87	300	1200	784.612	65.38%
14-Jul-88	6.5	1206.5	784.612	65.03%
5-Jul-89	313.5	1520	784.612	51.62%
4-Jul-90	6	1526	784.612	51.42%
6-Jul-94	382	1908	680.765	35.68%

Source: Deutsche Lufthansa AG, 1995

### 2.C The First Privatization Attempt: 1984-1989

When the Kohl administration won its first election since coming to power in *Die Wende* of 1982, monetarism appeared to have emerged as the dominant policy approach in Europe. Beginning with the election of Thatcher in 1979 and of Kohl in 1983, and confirmed by the conversion of the socialist government in France to monetarism in late 1983, the free-market foundations for European-wide privatization campaigns seemed to be secure.<sup>71</sup> Yet figures from the end of the 1980s indicate that privatization initiatives varied in their pace and scope (see Table 2.4). While Great Britain had raised £44.5 billion from a plethora of privatizations, Germany had

<sup>71</sup>For a detailed account of the French retreat from Keynesianism, see Jeffrey Sachs and Charles Wyplosz, "The Economic Consequences of President Mitterrand," *Economic Policy*, 2 (April 1986): 261-322.

received just £3.34 billion. Even traditionally *etatist* France had raised £8.24 billion during the same period.<sup>72</sup> Tracing the evolution of the privatization of Lufthansa illustrates several institutional obstacles to vigorous privatization in Germany during the 1980s, thereby explaining these differences.

In the first two years of the Kohl administration, a coalition of the center-right CDU/CSU and the free market FDP, progress on reducing the government's interests in over 900 enterprises was extremely limited.<sup>73</sup> A notable exception was the sale of 13% of the government's interest in VEBA, a producer of aluminum, chemicals and other energy products, which raised DM 800 million for the treasury and left the federal government with a 30% interest in the firm. In 1984, the Kohl government had not expressed tremendous interest in privatization as a policy priority, nor was privatization an ideological touchstone for the new government's economic policy, as it was for the Thatcher administration.<sup>74</sup> Nevertheless, Finance Minister Gerhard Stoltenberg presented a privatization plan to the cabinet in October, 1984 which included a proposal to reduce the government's stake in Lufthansa from 79% to 55% (see Table 2.2).

The details of Stoltenberg's plan reveal less an ideological commitment to transferring managerial control and ownership to private hands, and more a desire to raise revenues for the government treasury. As Table 2.2 illustrates, seven out of the eleven candidates for "privatization" were to remain under the control of the government, as the state would retain a 50% share or greater. Moreover, the federal government's stake in Volkswagen was to be reduced from an already-minority 20% share to a 14% share, while the strategic 20% stake of the *Land* of Lower Saxony would remain untouched. Finally, three other candidates were relatively small enterprises, two of them subsidiaries of the Bundesbahn, and the government's future interest in them was unclear. Yet while the state retained control in many cases, it nevertheless stood to gain a fiscal boost from its limited sale of shares

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<sup>72</sup>It is important to remember, however, that these differences reflect, in part, the different starting points of these states. The size of the public sector was significantly smaller in Germany as compared with Britain or France, see discussion in section 2.A.

<sup>73</sup>See Robert Fraser, ed., *Privatization: The UK Experience and International Trends* (Essex, UK: Longman, 1988); Esser, "'Symbolic Privatisation': The Politics of Privatisation in West Germany."

<sup>74</sup>Peter Bruce, "Bonn Takes a Step Toward Privatisation," *Financial Times*, November 15, 1984, I:2.

-- the program was estimated to raise DM 2 billion.<sup>75</sup> In the sense that the program could be labeled "privatization" at all stemmed from the intention of the government to regard this first sale as the beginning of a continuous process of state divestment. It was this implicit intention which mobilized virtually immediate political opposition to Stoltenberg's plan.

Intuitively, one might expect conservative parties in Germany, such as

**Table 2.4: Privatization in Selected OECD Countries 1980-1991**

Country	Privatization period	Accumulated privatization proceeds absolute (£ equivalent)	as % of average annual GDP over the privatization period
Austria	1987-90	Sch12.7 billion (£0.6 b)	0.90
Canada	1984-90	C\$3.1 billion (£1.6 b)	0.60
France	1983-91	FF82.4 billion (£8.24 b)	1.50
Germany*	1984-90	DM9.7 billion (£3.34 b)	0.50
Italy	1983-91	L13,500 billion (£6.25 b)	1.40
Japan	1986-88	¥11,000 billion (£47.8 b)	3.10
Netherlands	1987-91	FL4.9 billion (£1.5 b)	1.00
New Zealand	1987-91	NZ\$9.0 billion (£3.0 b)	14.10
Portugal	1989-91	Esc364 billion (£1.5 b)	4.30
Spain	1986-90	Ptas207 billion (£1.2 b)	0.50
Sweden	1987-90	SKr14 billion (£1.3 b)	1.20
Turkey	1988-91	TL3,500 billion (£0.3 b)	1.60
UK	1979-91	£44.5 billion	11.90

\* Area of Federal Republic of Germany before unification

Source: Stevens, 1992

the Bavarian CSU, to embrace privatization as a way of subjecting inefficient state-owned enterprises to the discipline of the market. The reality, however, is that regional industrial policy interests played a large role in knocking Lufthansa off Stoltenberg's privatization list in 1984-85.<sup>76</sup> Opposition to the

<sup>75</sup>Bruce, "Bonn Takes a Step Toward Privatisation."

<sup>76</sup>Bruce, "Bonn Takes a Step Toward Privatisation;" Esser, "'Symbolic Privatisation': The Politics of Privatisation in West Germany."



partial privatization of Lufthansa in 1984 was led by Franz Josef Strauss, Minister President of Bavaria and head of the CSU. Strauss was a member of the boards of both Lufthansa and the European Airbus Industrie consortium. Moreover, a key partner in the Airbus consortium, Messerschmidt Bölkow-Blohm, was located in Bavaria. Strauss' own personal interests by virtue of his business positions is mere speculation, yet his public statements reveal his opposition to the partial privatization of Lufthansa was driven by his fear that private ownership would result in changes in procurement policies which would reduce orders for new planes from Airbus.<sup>77</sup>

Strauss' ability to engineer the removal of Lufthansa from Stoltenberg's list of privatization candidates in 1985 illustrates the institutional hurdles to effective privatization programs in Germany. Two critical institutional constraints are the need for compromise among the members of the ruling coalition, and the division of policy-making power between the federal government and the *Länder* according to Germany's particular brand of federalism. Beyond his adamant opposition within the cabinet itself (Strauss managed to delay consideration of Stoltenberg's proposal for quite some time), Strauss threatened Bavarian-led resistance in the Bundesrat, should the plan reach that stage in the approval process.<sup>78</sup> As the 1993 Solidarity Pact illustrates, the consensual features of cooperative federalism have, in fact, been enhanced by unification, preserving the power of the Bundesrat veto (and, by extension, the threat of exercising that veto).<sup>79</sup> Despite later assurances by Stoltenberg that the state would retain managerial control with a 55% stake in Lufthansa, with 15% of the state's previous holding to be sold to the public and 10% to a newly created holding company controlled by industry leaders, Strauss' opposition defeated the first attempt by the Kohl administration to reduce its stake in Lufthansa.<sup>80</sup>

Strauss forcefully documented his adamant opposition to the idea of privatizing Lufthansa in August, 1985, in a letter which was leaked to the

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<sup>77</sup>Strauss was also angered by the apparent policy reversal of Kohl himself, who had apparently earlier pledged not to disturb the federal government's stake in Lufthansa. See Bruce, "Bonn Takes a Step Toward Privatisation."

<sup>78</sup>Bruce, "Bonn Takes a Step Toward Privatisation."

<sup>79</sup>Razee Sally and Douglas Webber, "The Solidarity Pact: A Case Study in the Politics of Unified Germany," *German Politics*, 3:1 (April 1994): 18-46.

<sup>80</sup>Peter Bruce, "Lufthansa Escapes Plan for Part Privatisation," *Financial Times*, March 22, 1985, 1:3; Rupert Cornwell, "Strauss Scuttles Plans to Sell Off Part of Lufthansa," *Financial Times*, September 21, 1985, 1:2.

press.<sup>81</sup> His chief objection was, as he made clear during the debate on Stoltenberg's plan, the potential for private management to direct purchases away from Airbus. Significantly, he mentioned that purchasing policy should remain the responsibility of the government, and not the market, due to the fact that aircraft sales "had virtually nothing any longer to do with fair competition."<sup>82</sup> Strauss' comment reflects the view that market competition, at least in the airline industry, may not guarantee allocatively efficient and/or distributionally acceptable economic outcomes. This illustrates a core debate surrounding the original justification for state ownership and its continuing validity. As discussed in section 2.A, the public sector was always accepted by both major parties as an essential part of the economy. Public enterprises were active in two main spheres. The first was in sectors of the economy, such as telecommunications, which have traditionally been considered either natural monopolies or industries tending toward oligopoly. Government involvement was therefore justified to protect consumer interests. The second sphere was in sectors which were considered important to national industrial policy: crisis industries such as coal, steel or shipbuilding; energy; and transportation. The airline industry, due to its strategic military heritage, is a sector with traditionally high levels of state involvement. In 1985, most major European airlines, including British Airways, were owned and controlled by the state. Add to this the fact that the EU was still in its dormancy, and that international competition in air travel was muted by strict control over domestic markets and bilateral agreements regulating travel between individual states, and Strauss' fears become more plausible.

While Strauss' opposition was both necessary and sufficient to scuttle the original plan to reduce the government's stake in Lufthansa, his was not the only dissenting voice with respect to the government's privatization plan. On the one hand, *Länder* governments stubbornly refused to part with their own stakes in such enterprises, and opposed attempts to privatize regional development banks due to concerns over possible changes in favorable lending policies to regional enterprises and farms.<sup>83</sup> This was particularly the case with the proposed privatization of DSL. The *Land* government of Berlin also opposed the plans to privatize DIAG due to the potential employment

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<sup>81</sup>Cornwell, "Strauss Scuttles Plans to Sell Off Part of Lufthansa."

<sup>82</sup>Quoted in Cornwell, "Strauss Scuttles Plans to Sell Off Part of Lufthansa," I:2.

<sup>83</sup>Bruce, "Bonn Takes a Step Toward Privatisation."

effects of a planned rationalization program under private ownership and control.

On the other hand, unions for the most part also opposed privatization. The proposal to reduce the federal government's 20% stake in Volkswagen would have shifted the balance on the Aufsichtsrat in favor of management interests, and thus provoked fierce union resistance. Moreover, officials at the two main unions at Lufthansa -- the Gewerkschaft Öffentliche Dienste, Transport und Verkehr (ÖTV, representing 15,000 blue-collar workers), and the Deutsche Angestellten-Gewerkschaft (DAG, representing 5,000 cockpit, cabin and technical crew-members) -- were always opposed to privatizing Lufthansa due to their own interests in high wages and benefits, job security, and their conviction that air traffic, as a critical element of infrastructure, was a fundamentally public sphere.<sup>84</sup> Officials at ÖTV stated that they were concerned, upon studying the effects of liberalization and deregulation in the United States, about the possible reduction in service to rural areas, as well as possible broader negative effects for regional economies. In sum, the opposition of regional interests, channeled through institutions conducive to blocking major privatization initiatives, led to the cancellation of the government's plans to partially privatize Lufthansa in 1985.

Although Strauss was able to defeat plans to sell the government's own shares in Lufthansa, it proved more difficult to oppose the government's decision not to participate in a planned capital increase at Lufthansa in 1987. According to German securities law, any capital increase must be offered to all present owners of stock, who then have the option to either subscribe for additional shares or not to participate in the new issue.<sup>85</sup> In 1987, Lufthansa approved a capital increase and the government decided only partially to participate.<sup>86</sup> By not participating in the issue, the federal government's share

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<sup>84</sup>Interviews with officials at ÖTV and DAG, February and March, 1995.

<sup>85</sup>See sections 186 and 187 of the German Aktiengesetz (AktG). Each shareholder receives a Bezugsrecht, a form of option, allowing her to purchase enough shares in the capital increase to maintain her present share. Bezugsrechte can also be sold on a secondary market. The transferability of Bezugsrechte is thus important for the government, as their sale can raise money while simultaneously reducing the government's share in the public enterprise, all the while retaining the present number of government shares, to be sold later when the share prices may be higher.

<sup>86</sup>Haig Simonian, "State Share in Lufthansa to Fall," *Financial Times*, May 20, 1987, I:34; Andrew Fisher, "Lufthansa Share Sale Attacked," *Financial Times*, July 4, 1987, I:10; Haig Simonian, "Privatisation 5: Impediments to Rapid Progress," *Financial Times*, September 16, 1987, Survey, p. V.

was to fall from 75% to 65%.<sup>87</sup> In an intriguing move, however, the unsubscribed portion of the federal government's share was purchased by two Bavarian banks -- Bayerische Landesbank Girozentrale, partly owned by the *Land's* savings banks association; and the Bayerische Landesanstalt für Aufbaufinanzierung, a *Land*-owned credit institution. This transfer of state control from the federal to the *Land* level brought intense criticism from the free-market FDP, who argued that the transaction not only failed to forward the privatization of Lufthansa, but actually created further obstacles to later privatization by granting the Bavarian government a strategic 5% share in the enterprise.<sup>88</sup> Two years later, however, the federal government's stake was significantly reduced in a second capital increase in which the government refused to participate. The DM 300 million issue, appropriately conducted one year after Strauss' death, diluted the federal government's share from 65% to 51% (55% including shares held by the Bundesbahn and other federal agencies).<sup>89</sup>

By the end of the 1980s, some progress had been made to reduce the overall holdings of the federal government. Although these efforts were neither as large nor as wide spread as those in Britain, the number of public enterprises declined from 958 in 1982 to 337 in 1989.<sup>90</sup> As in the case of Lufthansa, however, much of the divestment was not total. Rather, the government retained a strategic stake in many public enterprises. Accordingly, scholars such as Esser have labeled the German privatization program of the 1980s as "symbolic privatization."<sup>91</sup> While the government could point to significant successes, such as the sale of VEBA, IVG and VIAG, and while some failures such as the sale of the government's stake in Volkswagen were due to international factors beyond the control of the government (in that case the stock market crash of 1987 and the revelation of foreign exchange fraud at Volkswagen), observers were generally

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<sup>87</sup>Such a technique has been called "hidden privatization," just as the purchase of shares in such an increase is called "hidden subsidization," the most recent example being Air France in 1993.

<sup>88</sup>Fisher, "Lufthansa Share Sale Attacked," I:10.

<sup>89</sup>David Goodhart, "Bonn May Consider Sale of its Holding in Lufthansa," *Financial Times*, November 29, 1990, I:30. The federal government received DM 98.4 million from the sale of its Bezugsrechte during this issue. Knauss, *Privatisierungs- und Beteiligungspolitik in der Bundesrepublik Deutschland*, p. 156.

<sup>90</sup>Knauss, *Privatisierungs- und Beteiligungspolitik in der Bundesrepublik Deutschland*, 147.

<sup>91</sup>Esser, "Germany: Symbolic Privatizations in a Social Market Economy;" "Symbolic Privatisation: The Politics of Privatisation in West Germany."

disappointed with the decided lack of zeal with which the government pursued privatization.<sup>92</sup> In the government's defense, however, the size of the public sector in Germany was not great to start with. Moreover, there was no apparent need for the government to undertake a massive privatization initiative. Firms such as Lufthansa were largely successful and relatively independent of governmental micro-management. Absent significant budgetary crisis or public outcry against the public sector, there was simply no compelling political or economic reason to push an aggressive privatization program through a series of formidable institutional obstacles and against significant opposition.<sup>93</sup> This environment changed radically in 1990 with unification, and this ushered in a new chapter in the history of Lufthansa privatization.

#### 2.D Unification and the Second Attempt at Privatization: 1990-1994<sup>94</sup>

In late 1990, Finance Minister Theo Waigel (a leader of the Bavarian CSU) announced that a new privatization campaign would harbor "no taboos" with respect to which public enterprises would be considered for possible privatization.<sup>95</sup> In reference to the federal government's stake in Lufthansa, Waigel replied that the sale of the state's share was only a matter of "practicalities such as timing and share price."<sup>96</sup> To explain the reasons for the successful privatization of Lufthansa in 1994, I will first explore why the government was able to overcome traditional obstacles to privatizing Lufthansa. Second, I will examine the internal restructuring at Lufthansa which was essential to the "timing and share price" Waigel referenced in 1990. The privatization issue was successful due to the convergence of government initiative and the perceived corporate health of Lufthansa. Without either of these elements, divestment would not have occurred.

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<sup>92</sup>See e.g., Gerhard Fels, "No Time to Back Away from Revitalization: The West German Economy," *Financial Times*, December 16, 1987, I:17.

<sup>93</sup>Thanks to Professor Josef Esser, who discussed this point in an interview in Frankfurt (March, 1995).

<sup>94</sup>The discussion of the 1990-94 privatization initiative is largely based on several interviews conducted in Germany in February and March, 1995. A list of the officials interviewed is included as Appendix A.

<sup>95</sup>Goodhart, "Bonn May Consider Sale of its Holding in Lufthansa." Significantly, Waigel refused at that time to consider the possible privatization of Deutsche Telekom.

<sup>96</sup>Goodhart, "Bonn May Consider Sale of its Holding in Lufthansa."

### 2.D.i Changes in the Domestic and International Environment: Eroding Traditional Political Opposition

As discussed above, the primary reasons for the failure to privatize Lufthansa in 1985 were: 1) divisions within the ruling coalition; 2) the opposition of regional interests based upon the protectionist nature of the air transport industry at that time; and 3) the simultaneous existence of relatively low public sector debt levels and the robust financial health of Lufthansa. In the early 1990s, each of these sources of opposition were eroded by important domestic and international developments. With respect to the federal government, two important shifts were central to the renewed interest in privatizing Lufthansa. The first major shift was the new pressure placed on the budget due to unification, while the second was the fundamental change in the international air transport industry due to globalization.

#### 2.D.i.a Unification and the Liquidity Crisis

An extensive discussion of the economic and political complexities of German unification is well beyond the scope of this study.<sup>97</sup> The aspect of unification which was central to the Lufthansa privatization story was the rising level of the government deficit caused by massive transfer payments to eastern Germany. While few expected the transition from a command economy to a market economy to be an easy and quick process, the problems encountered during the unification process were more extensive and intractable than many first anticipated. These problems were exacerbated as western Germany slid into recession in 1992-93. The resulting drain of public sector funds rendered the federal government on one hand in need of funds

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<sup>97</sup>A few of the many works on this subject include: Hans-Werner Sinn and Gerlinde Sinn, *Jumpstart: The Economic Unification of Germany* (Cambridge, MA: MIT Press, 1992); Ulrich Heilemann & Reimut Jochimsen, *Christmas in July? The Political Economy of German Unification Reconsidered* (Washington, D.C.: Brookings Institute Occasional Papers, 1993); Michael G. Huelshoff, Andrei S. Markovits and Simon Reich, eds., *From Bundesrepublik to Deutschland: German Politics After Unification* (Ann Arbor, MI: U. Michigan Press, 1993); Peter H. Merkl, *German Unification in the European Context* (University Park, PA: U. Pennsylvania Press, 1993); Christopher Anderson, Karl Kaltenthaler and Wolfgang Luthardt, *The Domestic Politics of German Unification* (Boulder, CO: Lynne Rienner Publishers, 1993).

in order to counteract the growing deficit, and on the other hand incapable of granting substantial funds to existing public enterprises such as Lufthansa.

As the *OECD Survey of Germany* reported in 1994, unification caused a tremendous shift in Germany's public finances.<sup>98</sup> Through a commitment to tight monetary policy and restrained fiscal policy, Germany managed to balance its budget by the end of the 1980s. Massive transfers to eastern Germany in the wake of unification, averaging 4 to 5% of west Germany's GDP annually, quickly erased these fiscal gains. The general government balance (federal, state and municipal) shifted from a modest surplus in 1989 to a deficit which equaled 3.3% of GDP in 1993.<sup>99</sup> (See Table 2.5) Although this figure still lagged behind many other OECD states, if such a deficit level lingered over time, the debt/GDP ratio would not meet Maastricht criteria. Beyond such potential dangers, however, was the simple fact that such deficit levels were grossly abnormal by German standards.

The financial burden on the federal government increased further as a result of the 1993 Solidarity Pact.<sup>100</sup> Before 1993, transfer payments from west to east Germany were funded in part through the floatation of bonds by the German Unity Fund. The Solidarity Pact was designed to end this program by integrating the new *Länder* into the normal revenue-sharing scheme already in place among western *Länder*. The burden of funding this transition, however, was placed primarily on the federal government, as the share of the VAT given to the *Länder* was increased from 37% to 44%, effective in 1995. This funding increase was in addition to continued direct transfer payments from the federal government to the new *Länder*, detailed in Table 2.6.

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<sup>98</sup>*OECD Economic Surveys: Germany* (Paris: OECD, 1994), see especially section III.

<sup>99</sup>The OECD report argues, however, that the increase in the deficit in 1993 was mainly due to cyclical factors. While the structural deficit (cyclically-adjusted) deficit has been reduced, this is mainly due to sharp restrictions on the growth of public spending. In its conclusion, the OECD argues for more vigorous privatization and deregulation initiatives. See *OECD Economic Surveys: Germany*, 119-123.

<sup>100</sup>Razeen Sally and Douglas Webber, "The Solidarity Pact: A Case Study in the Politics of Unified Germany;" *OECD Economic Surveys: Germany*, 60-61.

Facing rising deficits due to increasing obligations in eastern Germany, and recognizing that the transition there would require much more time and funding than originally anticipated, the federal government was obviously under great pressure to raise revenues and reduce expenditures in the early 1990s. Given Kohl's election pledges to reduce the corporate tax burden in order to attract investment flows into Germany, privatization offered a

**Table 2.5: German Federal Budgets (DM billion)**

	1989	1990	1991	1992	1993	1994
<b>Expenditure</b>	<b>289.80</b>	<b>380.20</b>	<b>401.80</b>	<b>427.20</b>	<b>457.50</b>	<b>480.00</b>
(As a % of GDP)	13.00	15.70	14.30	14.10	14.70	14.90
of which:						
Consumption	82.20	85.60	91.80	95.50	94.50	93.50
Interest Payments	32.10	34.20	39.60	43.80	45.80	52.80
Investment	8.00	8.50	11.00	13.80	12.50	13.20
Transfers and lending	167.50	252.00	259.40	274.10	304.70	320.50
of which:						
To other administrations	37.60	40.50	64.90	78.00	81.90	101.90
Others	129.90	211.50	194.50	196.00	222.80	218.60
<b>Revenues</b>	<b>269.70</b>	<b>332.10</b>	<b>348.60</b>	<b>387.80</b>	<b>390.50</b>	<b>410.30</b>
(As a % of GDP)	12.10	13.70	12.40	12.80	12.60	12.70
of which:						
Taxes	247.10	276.00	317.90	352.90	356.00	375.20
Others	22.60	56.00	30.70	34.90	34.50	35.10
<b>Financial Balance</b>	<b>-20.10</b>	<b>-48.00</b>	<b>-53.20</b>	<b>-39.30</b>	<b>-66.90</b>	<b>-69.70</b>
(As a % of GDP)	-0.90	-2.00	-1.90	-1.30	-2.20	-2.10
<b>General government balance*</b>		<b>-49.70</b>	<b>-90.90</b>	<b>-78.50</b>	<b>-101.80</b>	<b>-95.50</b>
(As a % of GDP)		-2.00	-3.20	-2.60	-3.30	-2.90

\* = including Länder and municipal governments

Source: OECD, 1994

vehicle through which the government could raise money through divestment without tax increases. The government would also save money by avoiding the subsidy or rescue of ailing public enterprises.<sup>101</sup> Unification

<sup>101</sup>Another important advantage of major privatization initiatives is their ability to attract international capital to domestic exchanges. This was particularly important for Germany for three major reasons: 1) the shortage of liquidity from both the government and the major banks due to the demands of unification; 2) the attempt by the government to construct "Finanzplatz



had thus re-opened the debate surrounding the continued justification for certain public assets, particularly holdings in private-law enterprises such as Lufthansa. In late 1990, the Bundesbank stressed the need to reduce the deficit, highlighting privatization as a particularly attractive policy-option.<sup>102</sup> While pressures on the federal budget were driving the Kohl administration toward a more aggressive privatization policy, other international developments were simultaneously eroding the regional industrial policy interests which previously blocked the 1984-85 initiative.

**Table 2.6: Public Sector Transfers to eastern Germany (DM billion)**

	1991	1992	1993	1994
<b>1. Gross transfers</b>	<b>140.00</b>	<b>152.00</b>	<b>169.00</b>	<b>178.00</b>
Federal government transfers to the eastern länder and communities	75.00	89.00	116.00	127.00
Western länder and communities	5.00	5.00	10.00	14.00
German Unity Fund borrowing	31.00	24.00	15.00	5.00
Transfers from EC	4.00	5.00	5.00	6.00
Other	25.00	29.00	23.00	26.00
<b>2. Receipts</b>	<b>33.00</b>	<b>37.00</b>	<b>39.00</b>	<b>42.00</b>
of which:				
Federal tax receipts from the east	31.00	35.00	37.00	40.00
Federal administrative receipts from the east	2.00	2.00	2.00	2.00
<b>3. Net transfers (1 - 2)</b>	<b>107.00</b>	<b>115.00</b>	<b>130.00</b>	<b>136.00</b>
As a percentage of:				
All-German GDP	3.80	3.80	4.20	4.20
Western German GDP	4.10	4.10	4.60	4.70
Eastern German GDP	58.00	49.00	47.00	44.00

Source: OECD, 1994

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Frankfurt" as a major European financial center in the EU; and 3) the shaken confidence in the traditional German corporate governance structures in the aftermath of the *Schneider* and *Metalgesellschaft* scandals. See discussion in section 2.D.v.

<sup>102</sup>Andrew Fisher, "Unity Sparks Debate Over State Assets," *Financial Times*, January 8, 1991, Survey, p. XIV. The federal government also conducted an internal audit of its holdings to identify potential privatization candidates. See Bundesminister der Finanzen, *Bericht des Bundesministers der Finanzen zur "Verringerung von Beteiligungen und Liegenschaften des Bundes* (Bonn: Ministry of Finance, 13 July, 1992).

### 2.D.i.b Global Pressures in the Air Transport Industry

The airline industry has traditionally been under the tight control of nation-states due to its importance for security and industrial policy.<sup>103</sup> Since its beginnings, passenger and cargo traffic has been regulated by bilateral agreements between states.<sup>104</sup> Beginning in the 1960s, the demand for air travel increased dramatically, averaging 14.4% annual growth through 1980.<sup>105</sup> Despite this growth in demand, profit margins for carriers were increasingly squeezed because of overcapacity and the distortions of regulated traffic, which undermined potential gains from economies of scale and scope on international routes. These regulatory distortions are usefully categorized into four main areas:<sup>106</sup>

- Bilateral restrictions on entry, capacity, traffic, fares and routes;
- Domestic regulatory policies such as safety regulations, taxation and limits on entry and domestic traffic;
- Ancillary market restrictions on computerized reservations systems (CRS), or monopolistic provision of airport facilities or services; and
- State-ownership and subsidization

Lufthansa, like other carriers during this period, benefited from a protected domestic market, state subsidies, and a contractually guaranteed

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<sup>103</sup>A complete discussion of the evolution of international air transport is clearly beyond the scope of this study. For interesting and informative examinations of this history, see OECD, *International Air Transport: The Challenges Ahead* (Paris: OECD, 1993); Vicki K. Golich, "Liberalizing International Air Transport Services, 156-176; Francis McGowan and Paul Seabright, "Deregulating European Airlines," *Economic Policy* (October, 1989): 283-344; Daniel M. Kasper, *Deregulation and Globalization: Liberalizing International Trade in Air Services* (Cambridge, MA: Ballinger Publishing Co., 1988); Gidwitz, *The Politics of International Air Transport* .

<sup>104</sup>Although the United States attempted to construct a liberalized global traffic system in 1944 at the Chicago Convention, traditional national interests in protecting domestic markets prevented such an order from being established. As a result, the international airline industry was based on the sovereignty principle, whereby all traffic was regulated by bilateral agreements, such as the Bermuda Agreements between the United States and Great Britain. Airlines became important symbols of national pride and technological preeminence, and were frequently used as tools of industrial policy. Even the comparatively liberal United States heavily subsidized the creation and expansion of Pan American Airlines in the 1960s. These psychological and economic factors are more important than fading national security concerns with respect to lingering protectionism in the airline industry.

<sup>105</sup>OECD, *International Air Transport: The Challenges Ahead* .

<sup>106</sup>Golich, "Liberalizing International Air Transport Services," 156-176; Kasper, *Deregulation and Globalization: Liberalizing International Trade in Air Services* , 2-5.

percentage of traffic on important international routes, particularly to North America. Although these percentages, and the fares its was allowed to charge passengers and cargo clients, were fixed either by the federal government or by bilateral agreements, they were sufficient to insulate the carrier from competitive pressures to increase efficiency. These conditions changed dramatically as a result of airline deregulation in the United States, which intensified international competition just as the global airline industry began to liberalize.

Deregulation in the United States (beginning in 1978) transformed the nature of competition in international travel.<sup>107</sup> These developments had two main implications for the airline industry in Europe, and for Lufthansa in particular. First, as the domestic market became saturated in the United States, thereby squeezing profit margins, intense competition shifted to lucrative international routes, thereby "exporting" competition to international markets.<sup>108</sup> Second, the American experience provided European policy-makers with an example of how deregulation could affect the European market, even acknowledging numerous differences between the European and American markets, such as alternative means of travel between cities (for example, high-speed trains and the Channel Tunnel).

Thus, while the demand for passenger travel continued to grow 6 to 7% annually in the 1980s, profit margins continued to shrink due to increasing competition for international traffic. While Lufthansa and other

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<sup>107</sup>Briefly summarized, deregulation in the American airline industry resulted in four main changes in the market: 1) ticket prices fell; 2) the number of routes increased; 3) after a brief increase in the number of carriers, there was a massive consolidation of carriers into a few major players; and 4) discriminatory pricing and development of the hub-spoke system limited service to rural destinations and established high barriers to entry for new firms. Golich, "Liberalizing International Air Transport Services," 156-176; Francis McGowan and Paul Seabright, "Deregulating European Airlines," 283-344. Concentration and the exercise of market power comes about due to several market and technological factors. Advanced computerized booking systems allow for efficient routing of passengers and for the automatic fare distribution of passengers on flights which guarantee the maximum possible profit from each flight. The start-up costs for such systems are enormous, and further gains are possible through international coordination. Moreover, due to infrastructure limitations, docking space at most airports (owned by individual airlines) is limited. These market realities pose formidable barriers to entry for new firms, and benefit the large firms able to take advantage of economies of scale and sunk costs with respect to computer systems and the purchase of landing space. See generally, Paul Betts, "Survey of Business Locations in Europe," *Financial Times*, September 27, 1994, Survey p. III; Emma Tucker, "Flying the Flag Crowds the Air: The Problem at the Heart of Airline Competition," *Financial Times*, July 29, 1994, 1:2.

<sup>108</sup>Kasper, *Deregulation and Globalization: Liberalizing International Trade in Air Services* .

state-owned carriers were mostly protected from such competition, experts believed that global liberalization in air transport would lead to a market where a few "global players" would accommodate virtually all international traffic, while inefficient carriers would be priced out of the market. Accordingly, Lufthansa was pressured by "first-movers," like British Airways (privatized in 1987), who diverted a substantial amount of international traffic to their home markets. Even as fare setting and route selection was liberalized, protected domestic markets meant that carriers could exploit barriers to entry, such as restricted access to landing spaces, the high costs of developing computerized reservation systems (privileging carriers displayed on initial option screens), and sunk infrastructural investments in new planes and equipment. Moreover, British Airways and American carriers benefited from lower personnel costs relative to Lufthansa. These pressures pushed Lufthansa and other carriers to build international alliances, which benefited participants by spreading investment costs and opening access to previously restricted markets.

Parallel to these developments was the re-emergence of the EC in 1985 and the subsequent activities of the Commission to liberalize air transport within Europe.<sup>109</sup> A three stage program was designed to loosen restrictions on fares, routes, and market access within Europe -- with an open market for air travel planned for 1997. Significantly, the European Court of Justice struck down the EC competition policy exemption for European carriers with respect to fares in the *Nouvelles Frontieres* case in 1986. The ability for European carriers to set up branch offices in any Member State threatened even traditionally protected domestic markets, and made international traffic even more important for Lufthansa. Due, in part, to the government's privatization plans, Lufthansa joined the German government in its effort to promote greater liberalization.<sup>110</sup> Lufthansa also pushed the government to

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<sup>109</sup>See generally, Francis McGowan and Paul Seabright, "Deregulating European Airlines," 283-344; Heinz Ruhnau, "Reformkonzepts für den Luftverkehr," in Otto Vogel, ed., *Deregulierung und Privatisierung* (Bonn: Deutscher Instituts-Verlag, 1988): 126-135; Betts, "Survey of Business Locations in Europe;" Tucker, "Flying the Flag Crowds the Air: The Problem at the Heart of Airline Competition," 1:2.

<sup>110</sup>As these efforts developed, European states became divided into two camps. The first (consisting of Britain, the Netherlands and, later, Germany) sought complete liberalization and bitterly opposed state subsidies to ailing airlines which, in their view, were doomed to failure given the failure to link these subsidies to restructuring, which these states held to be essential to compete in the international market. The other camp (France, Belgium, Greece and Portugal) argued that, in the absence of multilateral agreements on air traffic, liberalization

negotiate favorable renewals to existing bilateral agreements, especially with the United States.

Increased international competition, primarily from U.S. carriers, necessitated both investment in more fuel-efficient aircraft and a radical restructuring of traditional (mainly state-owned and controlled) corporate governance structures in order to reduce costs and maximize revenues. These developments undermined traditional industrial policy justifications for state-support and protectionism, as investment needs eroded existing relationships between airlines and aircraft manufacturers by shifting orders toward more fuel-efficient airplanes. In this way, regional interests, such as those previously represented by Strauss in the mid-1980s, gradually lost their empirical bases, and thus their persuasiveness. First-movers who rushed to embrace streamlined corporate structures and negotiate global alliances clearly had advantages in the global market. In sum, increasing global competition from low cost carriers pressured Lufthansa to reduce costs, to reorganize corporate decision making to enhance flexibility, and to seek global partners to expand route networks and share operating costs. Vanishing protection for its domestic market, via EU liberalization, intensified these pressures. Global recession in the early 1990s triggered the first downturn in the international air traffic market, further exacerbating competitive pressures (see Table 2.7). Thus, Lufthansa's restructuring campaign in response to these pressures was an essential precondition to privatization.

#### 2.D.ii The Reluctant Candidate: The Poor Financial Health of Lufthansa in the Early 1990s

Ironically, just as the government embraced the privatization of Lufthansa with renewed vigor and greater determination, the poor financial health of Lufthansa precluded a quick and profitable sale of the federal

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only benefited those states which had concluded lucrative bilateral arrangements with the United States, such as Britain and Germany. In the alternative, these states conceded that globalization necessitated both the rationalization and eventual privatization of state carriers, as old industrial and military justifications for state-ownership had faded away, but maintained that "one-time, last-time" subsidies were necessary to rehabilitate their troubled airlines in order to prepare them for privatization. In 1994, Britain filed suit in French courts opposing the subsidization of Air France as a violation of EU competition law. See "London klagt gegen die Air France. Wegen Wettbewerbsverzerrung durch Milliarden-Subventionen," *Süddeutsche Zeitung*, October 5, 1994 (Wirtschaft section).

government's shares. Three principal factors were responsible for the financial crisis at Lufthansa: 1) the decline of the world air traffic market; 2) over-investment in the late 1980s in anticipation of the common market; and 3) relatively high administrative and personnel costs, combined with a large inherited structure for corporate functions.<sup>111</sup>

**Table 2.7: Operating Results for Global Carriers and Lufthansa**

	Net Results for IATA Carriers (\$ million)	Net Results for Lufthansa (\$ million)
1988	1600	61.9
1989	300	77.5
1990	-2700	5.6
1991	-4000	-277.5
1992	-4800	-233.1
1993	-4100	-69.4

Source: Deutsche Lufthansa AG, 1994; Author's calculations

The first source of difficulty for Lufthansa was the decline in the global air traffic market. Lufthansa's operating results were consistent with the substantial losses recorded by world airlines from 1990-1993 (see Table 2.7). As was the case with virtually all other airlines, Lufthansa suffered from over-capacity problems, combined with declining revenues due to intense price competition for economy-class passengers -- which comprised the lion's share of the increase in passenger traffic during this time. Competition was particularly intense on trans-Atlantic routes, where Lufthansa was forced to reduce its fares up to 36% in 1992 to compete with lower-cost American competitors.<sup>112</sup> The weakness of the dollar during this time also damaged Lufthansa's performance, costing the carrier an estimated DM 100 million

<sup>111</sup>See Lufthansa AG, *1993 Annual Report* (Köln: Lufthansa AG, 1994); Lufthansa AG, *International Offering Circular* (Köln: Lufthansa AG, 1994); Christopher Parkes, "Lufthansa in Cost-Cutting Plan as Privatisation Looms," *Financial Times*, August 14, 1992, I:16; Fisher, "Unity Sparks Debate Over State Assets;" Christopher Parkes, "Ready for Take-off: The Share Issue by Germany's Lufthansa," *Financial Times*, September 20, 1994, 20.

<sup>112</sup>Parkes, "Lufthansa in Cost-Cutting Plan as Privatisation Looms." Combined IATA losses on international traffic between 1990 and 1993 amounted to almost \$16 billion. Experts identified the 1991 Gulf War and the international recession as the primary causes for the downturn. Lufthansa AG, *International Offering Circular*.

annually.<sup>113</sup> Finally, the downturn in the Germany economy after unification also reduced demand for both business travel and cargo delivery.

A second major factor in the financial crisis facing Lufthansa in the early 1990s was over-investment in the latter half of the 1980s, particularly in new aircraft and route expansion in eastern Europe and Asia. Increases in administrative personnel and investment in over 120 new aircraft caused Lufthansa's net debt to skyrocket to DM 6 billion. While payroll costs rose 37% between 1989 and 1992, productivity increased by just 7%.<sup>114</sup> Financial journalists reported that misplaced optimism over the completion of the common market had "tempted the board into an unprecedented spending spree."<sup>115</sup> Although the chairmen during this period (Heinz Ruhnau and Herbert Culmann) have been criticized for managerial incompetence and poor judgment,<sup>116</sup> their earlier misjudgments returned to benefit Lufthansa, as current chair Jürgen Weber inherited one of the most modern fleets of any international carrier, as well as an extensive network in eastern Europe and in Asia (particularly Beijing).<sup>117</sup> Nevertheless, the investment program of the late 1980s had reduced the carrier's capital quota from 35.8% in 1989 to 17.9% in 1992 -- that is, Lufthansa was 82.1% in debt.<sup>118</sup> Yet a simple capital increase was difficult for several reasons. First, the poor performance of the airline precluded wide-spread interest and a high share price for Lufthansa stock. Second, the government was not in a position to purchase additional shares or otherwise aid the ailing airline due to the fiscal pressures of unification. Without government participation, a capital increase would reduce the federal government's stake below 50%, causing Lufthansa to be dropped by the VBL, resulting in the loss of employee pensions with no spare capital to create a new, in-house pension fund.

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<sup>113</sup>Parkes, "Lufthansa in Cost-Cutting Plan as Privatisation Looms," I:16. The weakness of the dollar was also a benefit to Lufthansa, as fuel purchases are commonly made in dollars (Lufthansa's fuel costs decreased 11.3% in 1994 alone).

<sup>114</sup>Parkes, "Lufthansa in Cost-Cutting Plan as Privatisation Looms," I:16.

<sup>115</sup>Parkes, "Ready for Take-off: The Share Issue by Germany's Lufthansa," 20.

<sup>116</sup>See Karl Heinz Lange, "Kohle für den Kranich," *Die Woche*, May 11, 1994.

<sup>117</sup>Interview with Ingo Marowsky, ÖTV, March, 1995.

<sup>118</sup>Lange, Karl Heinz, "Kohle für den Kranich." The important implication of this high debt ratio was the difficulty in obtaining bank credit, the traditional form of industrial finance in Germany (as opposed to equity issues). Banks were not only reluctant to extend extraordinary credit due to the capital squeeze of unification, but also due to such scandals as the *Schneider* affair. Accordingly, Lufthansa was forced to look to the equity markets for capital, necessitating a painful rationalization process which may have had a longer time-horizon had it taken place under the aegis of bank credit as opposed to an international share issue.

A third, structural problem at Lufthansa was the high cost of its operations. As noted above, administrative staff had increased 47% between 1986 and 1990. Moreover, partially because of high social insurance costs, personnel costs at Lufthansa were a full 30% higher than those at its chief European competitor, British Airways.<sup>119</sup> Costs per-seat/per-mile were over 17¢ in 1991, compared with an average of 9.5¢ for American carriers, and of all European carriers, Lufthansa had the largest gap between revenue and cost per available ton kilometer.<sup>120</sup> While Lufthansa employees were not officially Beamte, because of the company's private-law status, they nevertheless received benefits and wages which were more in line with public sector employees than those offered by other private airlines competing in the global market. Infrastructure costs, such as airport tolls, were also higher in Germany than in other European states. Finally, structural inefficiencies at Lufthansa also contributed to higher costs. For example, it used a hub-spoke system which was not appropriate for the relatively small German domestic market. Lufthansa was also plagued by "a gridlock bureaucracy which stretched from the boardroom to the check-in desk."<sup>121</sup>

Thus, in 1992 Lufthansa found itself in a paradoxical situation. It needed a capital increase in order to reduce overall company debt, and to restructure the corporation in order to reduce costs. At the same time, however, its ability to raise capital was dependent upon rationalization efforts prior to share issue, and the issue itself was in doubt due to the legal problems accompanying a reduction in the state's share to under 50%. In many ways, Lufthansa's financial situation resembled that of the Bundesrepublik: a combination of high costs and a downturn in the global economy led to a capital shortage which could not be filled by traditional channels. Such was the situation facing Jürgen Weber when he was named Lufthansa's new Chairman of the Board of Management in late 1991.

### 2.D.iii Weber's Project 93

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<sup>119</sup>Parkes, "Lufthansa in Cost-Cutting Plan as Privatisation Looms," I:16.

<sup>120</sup>"Lufthansa Managers Buoyed By Second-Quarter Results," *Aviation Week and Space Technology*, 134:2, July 12, 1993, 30; Anthony L. Velocci, Jr., "Getting Competitive at Lufthansa," *Aviation Week and Space Technology*, 138:10, March 8, 1993, pp. 36-39.

<sup>121</sup>Parkes, "Lufthansa in Cost-Cutting Plan as Privatisation Looms," I:16.



In August, 1992, Weber introduced his new plan to restructure the ailing Lufthansa, labeled "Program 93."<sup>122</sup> The plan was to have three distinct phases: rationalization; privatization; and re-organization. Each phase was dependent on its predecessor: privatization was dependent on a high share price which meant that the airline had to regain its competitiveness to attract investors; while re-organizing the company into independent units could only proceed when management had the necessary capital and freedom (both from the government and the VBL) which privatization would provide. The first, and most important phase (rationalization) had four distinct components: workforce reductions and wage restructuring; cost reductions and route consolidation; revenue increases; and international alliances and international route strengthening.

#### 2.D.iii.a Lowering Personnel Costs: The German Model In Action

The cornerstone of the cost-reduction package was the 1992 wage agreement between Lufthansa and its two major unions, the Gewerkschaft Öffentliche Dienste, Transport und Verkehr (ÖTV, representing 15,000 blue-collar workers), and the Deutsche Angestellten-Gewerkschaft (DAG, representing 5,000 cockpit, cabin and technical crew-members).<sup>123</sup> The agreement froze wage increases for all employees, and created two lower starting salary levels for entering employees. Moreover, overtime pay was linked to monthly salary, replacing the previous practice of a common overtime pay for all employees. Working hours for pilots were increased 7%, while management worked to curb wasteful practices such as the traditional right of pilots to have separate meals provided for them on flights.<sup>124</sup> A

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<sup>122</sup>See Lufthansa AG, *International Offering Circular*; Velocci, "Getting Competitive at Lufthansa," 36-39; "Lufthansa Chief Plots Turnaround Strategy," *Aviation Week and Space Technology*, 138:10 (March 8, 1993), pp. 40-43; Christopher Parkes, "Survey of Germany," *Financial Times*, November 21, 1994, Survey, p. VIII; Volker Wörl, "SZ-Gespräch mit Lufthansa-Chef Jürgen Weber: Die Altersversorgung wird als Schicksalsfrage," *Süddeutsche Zeitung*, December 18, 1993; Parkes, "Lufthansa in Cost-Cutting Plan as Privatisation Looms," I:16.

<sup>123</sup>"Lufthansa, Unions Agree to Layoffs, Wage Freeze," *Aviation Week and Space Technology* 137:10, (September 7, 1992), p. 51. The following discussion is also based on extensive interviews with officials at ÖTV and DAG, as well as with the head of Investor Relations at Lufthansa.

<sup>124</sup>A vivid example was set when Lufthansa fired a pilot who delayed a flight 45 minutes in order for his meal to be prepared and loaded onto the plane after it had been forgotten. See Parkes, "Survey of Germany," VIII.

supplemental agreement in October, 1993 provided a one-time payment to employees which equaled an annualized wage increase of 2.3%, while pay rates increased by a modest 2.7% in 1994.<sup>125</sup>

Beyond freezing wage increases and trimming employee benefits, the 1992 agreement also provided for reductions in the workforce. The number of employees at Lufthansa fell by 2.6% in 1992, and by over 8% in 1993 and 1994 -- the total number of workers decreased from around 49,000 in 1991 to approximately 39,000 at the beginning of 1995.<sup>126</sup> Consistent with the "social contract" model of German industrial relations, however, workforce reductions were accompanied by various compensation packages. There were four main categories of compensation, mostly connected with the age of the employee in question: 1) early retirement (for those 58 and older); 2) extended unpaid vacation leave (for those 53 and older); 3) voluntary dismissal with compensation payments; and 4) an increase in part time work (from 5% of workforce in 1990 to 10% in 1994).<sup>127</sup> Accordingly, Lufthansa could boast in 1994 that none of its 8,000 former employees were involuntarily dismissed. At ÖTV, redundancies were structured so that younger employees and/or those with families were protected. As one ÖTV leader expressed it, "the rule was not last in, first out; rather first in, first out."<sup>128</sup>

A final major issue in the 1992 wage agreement was the creation of a low-cost airline to take over Lufthansa's domestic German routes due to the high operating fees and costs in (see section 2.D.iii.b for discussion on route restructuring). Lufthansa planned to establish its new Lufthansa Express as an independent limited liability company (GmbH), to service domestic routes. This was consistent with its future plans for restructuring the company into independent units (or "profit centers") within the framework of a larger, holding-company-type corporate structure (see discussion on restructuring in section 2.E). The unions, however, were deeply opposed to the creation of a

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<sup>125</sup>Deutsche Lufthansa AG, *Annual Report 1993*, p. 24. Cockpit crews separately agreed to a 12.5% decrease in maximum salary entitlements, with those already benefiting allowed to retain their salaries while accepting only 50% of future wage increases. Lufthansa AG, *International Offering Circular*.

<sup>126</sup>Deutsche Lufthansa AG, *Weltluftverkehr: Lufthansa und Konkurrenz*, (Köln: Deutsche Lufthansa AG, 1994; David Waller, "State-owned Airline Prepares to leave the Nest: How the Reorganization of Germany's Lufthansa is Cutting Costs," *Financial Times*, May 10, 1994, I:19. Administrative positions were cut twice as much as other positions within the airline.

<sup>127</sup>Deutsche Lufthansa AG, *Annual Report, 1993*; interviews with ÖTV and DAG officials, February and March, 1995.

<sup>128</sup>Interviews at ÖTV, February, 1995.

two-tier wage structure, and feared the loss of political power at the firm level which would accompany the creation of an independent company. The unions were also concerned that Lufthansa Express would set a dangerous precedent for future management-employee relations, whereby union power would be diminished and new employees would be forced to accept lower wages and benefits in comparison to older employees or workers at other subsidiaries within the Lufthansa group. The compromise reached within the 1992 wage agreement provided for the creation of Lufthansa Express, but as a division within Lufthansa as opposed to an independent GmbH. Accordingly, it is included in the same collective wage agreements which govern employment conditions throughout Lufthansa. In exchange, the unions agreed to a new, low-cost format, and pilots separately agreed to longer working hours consistent with the new structure.

Although the 1992 Lufthansa wage agreement was hailed as a new model for industrial relations in Germany, this declaration reflects the substance of the agreement rather than its form. The agreement was new in the sense that labor agreed to substantial concessions and appeared to accept the adoption of a new, "lean and mean" corporate governance structure. The format of the negotiations, however, shows that the German model of strong labor-management cooperation, coordinated decision-making, and extensive information sharing was, in fact, validated by the new agreement. As all parties to the negotiations pointed out in interviews, labor concessions did not result from a shift in the balance of power at Lufthansa in favor of management. Rather, compromise reflected a mutual recognition of the crisis facing the airline, which stood at the brink of bankruptcy. The most important challenges for the traditional German model lie in the future of the company, as it faces increasing international competition and re-organizes accordingly, as will be discussed below and in the conclusion.

The cutting of personnel costs was a critical element in the rationalization program at Lufthansa, saving the company approximately DM 500 million between 1992 and 1994. During that same time period, unit costs decreased 25% while productivity rose 37%.<sup>129</sup> Beyond these financial gains, however, were the rewards associated with the changing perceptions of financial experts, who approved of Lufthansa's efforts to increase

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<sup>129</sup>Lufthansa AG, *International Offering Circular* ; Parkes, "Ready for Take-off: The Share Issue by Germany's Lufthansa," I:20; Parkes, "Survey of Germany," VIII.

competitiveness. These perceptions were critical to the success of the proposed share issue, both for maximizing share prices and for widely distributing the shares among European investors. Personnel costs were just one part of Lufthansa's Program 93, however, as both operating cost cuts and revenue increases each contributed an additional DM 500 million to the financial recovery of the carrier.

#### 2.D.iii.b Operating Cost Savings and Route Consolidation

In addition to cost savings through personnel reductions, Lufthansa also cut total capital spending by 10% in 1993 alone, and sought ways to control operating costs.<sup>130</sup> By the beginning of 1993, 26 aircraft were either sold or decommissioned, and the entire fleet was to be reduced to 212 planes by 1995.<sup>131</sup> Lufthansa sold its entire Airbus A310/200 fleet (13 planes) to Federal Express, and the complete Boeing 737 fleet was also slated to be sold. As mentioned above, the remaining fleet averaged just 5.4 years old, further facilitating efficiency gains through reductions in fuel usage. Chairman Jürgen Weber highlighted this fact in an interview in December, 1993, noting that Lufthansa had completed the difficult and expensive task of modernizing its fleet, while other carriers still faced these massive costs.<sup>132</sup> Lufthansa also reduced its stakes in the Kempinski and Penta hotel chains, and reduced its massive inventory of spare parts.<sup>133</sup> Company-owned facilities were sold or leased-back, including the firm's Köln headquarters.

Other efforts at reducing inefficiencies and controlling costs involved investigating and adopting new technologies. For example, satellite communication and navigation technology was saving United Airlines \$100,000 annually.<sup>134</sup> As mentioned above, more fuel-efficient aircraft were expected to decrease overall costs. The German government also used

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<sup>130</sup>Lufthansa AG, *International Offering Circular* ; Velocci, "Getting Competitive at Lufthansa," 36-39.

<sup>131</sup>Velocci, "Getting Competitive at Lufthansa," 36-39; Wörl, "SZ-Gespräch mit Lufthansa-Chef Jürgen Weber: Die Altersversorgung wird als Schicksalsfrage."

<sup>132</sup>Wörl, "SZ-Gespräch mit Lufthansa-Chef Jürgen Weber: Die Altersversorgung wird als Schicksalsfrage."

<sup>133</sup>Parkes, "Survey of Germany," VIII.

<sup>134</sup>"New Technology Key to Airline Cost Cuts," *Aviation Week and Space Technology* 137:21 (November 23, 1992) pp. 42-43. One problem facing a global satellite system is that it requires a global accord which is not forthcoming for political reasons.

computer modeling to simulate the flow of traffic through airports at various times in order to explore more efficient uses for airport and airline employees.<sup>135</sup>

Lufthansa also targeted route consolidation and restructuring as another area for cost savings. Consolidating routes, particularly to North America (for example, dropping direct service to unprofitable routes such as Charlotte and Philadelphia), saved \$37 million between November 1992 and January 1993 alone.<sup>136</sup> First class service on European routes was transformed into a larger business class. As discussed above, Lufthansa Express was established in October, 1992 to offer low cost service for domestic German routes, including more flexible fares and enhanced customer services like express check-in. Instead of using the traditional hub-spoke system, developed in the United States to increase revenues per flight by increasing load factors, Lufthansa Express adopted a "ping pong" system between selected major cities.<sup>137</sup> This reduces costs once spent on housing flight crews at hub cities, while maintenance is able to be routinely and cheaply provided at home cities. Despite rising airport fees, domestic service -- which accounted for 19% of revenues in 1994 -- achieved break-even results in 1993 and 1994 due to these improvements. Lufthansa's international network was substantially strengthened by its global alliances, notably with United Airlines and with Thai Airlines (see discussion below in section 2.D.iii.d). While these efforts reduced costs at Lufthansa, efforts were simultaneously directed toward raising revenues.

### 2.D.iii.c Increasing Revenues

In addition to restructuring its European network to increase load-factors, Lufthansa introduced a new frequent flyer program ("Miles and More") and engaged in more competitive fare pricing in order to boost ticket sales. Though an ardent opponent of "suicidal" price wars, Lufthansa

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<sup>135</sup>"New Technology Key to Airline Cost Cuts," 42-43.

<sup>136</sup>Velocci, "Getting Competitive at Lufthansa," 36-39.

<sup>137</sup>The hub-spoke system was found to entail higher costs in due to rising airport fees (especially in Germany) and the inefficient use of employees -- as banks of flights come in simultaneously, there is substantial idle time for airline employees. See "New Technology Key to Airline Cost Cuts," 42-43.

adopted competitive pricing strategies designed to match rivals' prices.<sup>138</sup> When the third phase of EU airline liberalization began in 1993 -- whereby airlines could set up businesses or subsidiaries in any Member State, in addition to introducing third-state cabotage rights (the right to pick up and transport passengers within a third state on flights originating in another state) -- Lufthansa initiated its "Welcome Europe" low-price campaign to win new passengers, and also increased last-minute ticket sales. Global recession and decreasing fares caused revenues to fall in 1993, although recovery contributed to a 7.8% increase in revenues in the first six months of 1994.<sup>139</sup>

Lufthansa also adopted a new marketing campaign designed to take advantage of being "made in Germany," highlighting quality service, punctuality and higher efficiency. It also established rail links to localities within Germany to offer wider service in its domestic market. On the topic of the new marketing approach at Lufthansa, Frederick W. Reid (Vice-President for the Americas) stated, "We have fundamentally changed our thinking from 'defending Germany' to competing in appropriate markets."<sup>140</sup> Even in the recession year 1993, Lufthansa's efforts were successful, as passenger load factors on North American routes increased from 68.9% to 71.2%, on European flights from 54.2% to 58%, and on Asian flights from 64% to 69.7%.<sup>141</sup> Lufthansa's share of overall world passenger traffic increased 6.9% in 1993. These results are independent of Lufthansa's highly successful cargo operations, where it is the world's leading freight carrier. A central factor in increasing revenues and passenger demand, however, was the construction of Lufthansa's global alliance system, the last element in the rationalization phase of Weber's Program 93.

#### 2.D.iii.d International Alliances

An important response to growing international competition in air transport has been the formation of strategic alliances between airlines of various states (see discussion above in section 2.D.i.b). These alliances provide many mutual benefits, the most important being: access to protected

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<sup>138</sup>Velocci, "Getting Competitive at Lufthansa," 36-39.

<sup>139</sup>Lufthansa AG, *International Offering Circular* .

<sup>140</sup>Velocci, "Getting Competitive at Lufthansa," 36-39.

<sup>141</sup>Deutsche Lufthansa AG, *Annual Report, 1993* .

domestic markets; increased revenues, as airlines are able to offer more destinations at more flexible times and fares; risk sharing; and pooling of resources for costly investments such as computerized reservations systems.<sup>142</sup> Thus, an integral part of Program 93 was the construction of an international network which would provide Lufthansa passengers with greater flexibility, particularly on North American routes. A few of Lufthansa's important international alliances and joint ventures are the following (a complete list of Lufthansa equity holdings and strategic partnerships is found in Appendix B):

- strategic alliance with United Airlines
- strategic alliance with Thai Airlines
- strategic alliance with Brazil's Varig
- 25% stake in DHL for cargo business
- joint venture in Chinese aircraft maintenance venture, Amerco
- equity holdings in Austria's Lauda Air and Luxembourg's Luxair
- partner, with Luxair, in Cargolux Airlines
- 25% share in Skychef air catering company
- collaboration in freight hub in Sharjah in the Gulf, with plans to expand into Indonesia
- cooperative agreements with Japan Airlines; Air France; Finnair<sup>143</sup>

The construction of the global alliance of United-Lufthansa-Thai was a key development in the recovery of Lufthansa due to the perceived need for global carriers to build such alliances in anticipation of global liberalization in air transport. Although cross-equity holdings were ruled out pending privatization, the links between the carriers are expected to deepen in the future to include such holdings.<sup>144</sup>

Lufthansa's agreement with United depended heavily on completion of the US-German air traffic accord in March, 1994, which foundered over the

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<sup>142</sup>For example, Lufthansa is working with VARIG to develop the AMADEUS reservation system in Brazil. Lufthansa AG, *International Offering Circular* .

<sup>143</sup>List compiled from Lufthansa AG, *International Offering Circular* ;Velocci, "Getting Competitive at Lufthansa," 36-39; Parkes, "Ready for Take-off: The Share Issue by Germany's Lufthansa," I:20; Parkes, "Survey of Germany," VIII.

<sup>144</sup>Curiously, the absence of such links, combined with the intensity of trans-Atlantic air travel competition caused some skepticism among investment experts regarding the Lufthansa privatization until the pension issue was resolved. See Parkes, "Ready for Take-off: The Share Issue by Germany's Lufthansa," I:20.

degree of access to the American market to be allowed German carriers.<sup>145</sup> Previously, under a 1955 agreement, 76% of all transatlantic travel between the US and Germany was allocated to US carriers. Under the new agreement, the number of flights from Germany to the US would be frozen for two years, and then gradually increase during the next two. Significantly, and illustrative of increasing competition in the industry, there was significant pressure from other US carriers to destroy the Lufthansa-United deal by not approving the new agreement, yet this opposition was overcome. The agreement enabled a code-sharing agreement<sup>146</sup> to be implemented between Lufthansa and United Airlines, granting Lufthansa greater access to the lucrative North American market and further facilitating its economic comeback. Lufthansa now offers its passengers over forty new destinations in the United States and reservations for connecting flights on United are made with the same flight and fare codes as normal Lufthansa flights.

By reducing operating and personnel costs, raising revenues, and building international alliances, Program 93 dramatically rescued Lufthansa from the brink of bankruptcy. Weber announced in 1994 that Lufthansa would record its first profit since 1990, and offer its first dividend payment to shareholders since 1989.<sup>147</sup> Not only was the financial health of the airline more robust, but it was also perceived to be well positioned to successfully compete internationally, especially given its massive capacity advantage in eastern Europe. The next stage was clearly a capital increase to address the capital quota problem outlined above. While this dovetailed the government's interest in privatizing Lufthansa, it brought the pension issue to the forefront as the key stumbling-block to the sale of the state's shares.

#### 2.D.iv The Pension Hurdle

<sup>145</sup>Jeffrey M. Lenorovitz, "Lufthansa To Choose U.S. Strategic Partner," *Aviation Week and Space Technology*, 139:11, September 13, 1993, pp. 30-31. United was chosen over American Airlines due to its more extensive Asian presence. See Reuter Text line, "Lufthansa -United Airlines Alliance Wird Die Rentabilität Beider Unternehmen Steigern," Oct. 6, 1993. See the discussion in section 2.D.i.b on the international air transport industry generally.

<sup>146</sup>Such an agreement allows two airlines to market each other's flights under the same ticketing code. For a discussion of the German negotiating strategy, see "SZ-Interview mit Bundesverkehrsminister Wissmann: Lufthansa soll ein Global Player werden," *Süddeutsche Zeitung*, October 8, 1993.

<sup>147</sup>Paul Betts, "Lufthansa Likely to Break Even This Year," *Financial Times*, April 5, 1994, I:19. Lufthansa AG, *International Offering Circular* .



Since its beginning in 1953, pensions for Lufthansa employees were provided by the *Versorgungsanstalt des Bundes und der Länder (VBL)*.<sup>148</sup> Lufthansa had to satisfy the following three covenants to remain insured by the VBL:

- 1) the government's share of the enterprise must not fall below 50%;
- 2) the firm must remain active in a sector which serves the public interest; and
- 3) the firm has to apply public sector wage scales or wage scales which are substantially similar to public sector wage scales.<sup>149</sup>

Clearly, privatization implicated the first of these conditions. While the VBL problem was recognized very early in the privatization process, it was ignored because the financial health of Lufthansa precluded a successful share sale. Once Program 93 began to show results toward the end of 1993, the VBL problem shifted to the forefront of negotiations between the government, Lufthansa, the VBL, and the unions and employees.

The security of employee pensions was a non-negotiable issue for Lufthansa's unions, and management joined with labor to form a united front in negotiations with the government and the VBL. In reference to the pension issue, Weber stated that "the social implications [of privatization without pension guarantees] would be unacceptable."<sup>150</sup> Officials at Lufthansa report that the government was, in fact, curiously indifferent to the

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<sup>148</sup>The VBL is a public institution which provided pensions to its members who do not have civil servant status, but nonetheless work in enterprises which serve the public interest. Most of its members are federal, regional and local authorities, although a few private stock corporations, such as Lufthansa, are also members. The pension plans offered by the VBL are designed to give members benefits on par with civil servants. Payments to the VBL are made by employers, and for most of its history, Lufthansa has paid more into the VBL than it has taken out in pension payments. As a result, the VBL itself had an interest in retaining Lufthansa in order to subsidize its other obligations to other members (such as local authorities). See Lufthansa AG, *International Offering Circular*.

<sup>149</sup>Discussed in "Lufthansa Hintergrund: Lufthansa und die VBL," Deutsche Lufthansa AG, 6 July, 1994; Lufthansa AG, *International Offering Circular*.

<sup>150</sup>"Waigel Sieht Hohe LH-Verkaufserlöse" Reuter News Service, May 4, 1995. Weber later stated that the pension issue was the "question of destiny" for Lufthansa. Wörl, "SZ-Gespräch mit Lufthansa-Chef Jürgen Weber: Die Altersversorgung wird als Schicksalsfrage."

VBL problem. Thus, the first task during the negotiations was to convince the government that the VBL problem was one it should be interested in solving, and then that it should contribute financially to the solution.<sup>151</sup> Once the federal government joined the negotiations in earnest, the two main issues were: 1) the assignment of risk in the event Lufthansa was dismissed from the VBL due to privatization; and 2) the construction of a post-privatization pension scheme.

There were several options open to the parties to solve the VBL problem.<sup>152</sup> Two radical solutions were immediately dismissed: 1) a government take-over of Lufthansa pension obligations; and 2) a Lufthansa-funded transferal from the VBL to another, private insurance system. Both options were too expensive for the parties implicated. An acceptable solution, therefore, had to be one which was jointly funded by the government, Lufthansa, and the VBL. One major debate which delayed consideration of various options, however, was the simple question of who bore the risk in the event Lufthansa broke the first VBL requirement in the absence of an agreement between the parties.

If Lufthansa had been privatized without addressing the VBL problem, several scenarios were plausible. The most likely result, which the unions feared most, was that Lufthansa would simply be dropped by the VBL. As the Lufthansa offering circular stated:

“unilateral termination by VBL would have resulted in Lufthansa being obliged to pay to VBL an amount equal to the present value of the pension entitlements of Lufthansa’s pensioners, and to accrue pension provisions in respect of all pension entitlements of all relevant employees.”<sup>153</sup>

Had this occurred, Lufthansa’s balance sheet would have been overloaded by pension claims and it would have become insolvent. Such fears were

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<sup>151</sup>Interviews with Lufthansa officials, February, 1995.

<sup>152</sup>Interviews with Lufthansa and union officials, February and March, 1995; see also Wörl, “SZ-Gespräch mit Lufthansa-Chef Jürgen Weber: Die Altersversorgung wird als Schicksalsfrage.”

<sup>153</sup>Lufthansa AG, *International Offering Circular*, 58. The only alternative open to Lufthansa at that point would have been to file a civil suit against VBL and the government (the government could also file suit against VBL) to force payment of claims. Yet VBL could easily deny all coverage due to the violation of its explicit rules, while the government (as a simple majority shareholder) could also reject any demands for it to pay for the pension schemes.

grounded in the recognition by all parties that the government was unable and unwilling to fund Lufthansa pensions after privatization, as this would not only place great pressure on the treasury, but would also contradict its stand against subsidies for European airlines. Negotiations, therefore, were arduous and lengthy due to the delicate issue of how much each of the parties would have to pay to avoid the greater costs of Lufthansa bankruptcy.

After rejecting the assignment of risk completely to the government or to Lufthansa, two competing models emerged for a compromise plan.<sup>154</sup> The first, labeled the Zäsur-Model, proposed that current Lufthansa retirees remain insured by the VBL, while current and future employees receive an equivalent pension from a new company pension scheme. A competing model would have Lufthansa remain insured by the VBL, under a negotiated exception to the VBL conditions strictly for Lufthansa, pending the creation of a new in-house plan. Since the current, high level of pension benefits was most secure under continued VBL insurance, the unions preferred the second model, while the VBL was obviously opposed. The complicating factor throughout the negotiations was the lack of a precedent for a company being forced out of the VBL due to privatization, thus the VBL was concerned about the ramifications of the Lufthansa settlement for future cases.

After months of negotiations, an agreement between the government, Lufthansa and the VBL was announced on May 4, 1994.<sup>155</sup> Under the terms of the agreement, pension claims for Lufthansa retirees remain with the VBL and are funded through payments by the federal government totaling DM 1.1 billion, spread over 15 years (DM 80 million per year). Lufthansa is responsible for designing and funding an in-house pension scheme identical to that previously provided by the VBL. The new Lufthansa pension fund

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<sup>154</sup>Interviews with Lufthansa and union officials, February and March, 1995; see also Wörl, "SZ-Gespräch mit Lufthansa-Chef Jürgen Weber: Die Altersversorgung wird als Schicksalsfrage."

<sup>155</sup>See Lufthansa AG, *International Offering Circular*; "Lufthansa Hintergrund: Lufthansa und die VBL," Deutsche Lufthansa AG, 6 July, 1994; "Lufthansa reif zur Privatisierung. Waigel hat der Lösung des Pensionsproblems zugestimmt." *Süddeutsche Zeitung*, May 4, 1994; "Die Lufthansa entflieht dem Käfig: 'Türe auf' für Kapitalerhöhung und Privatisierung," *Neue Züricher Zeitung*, May 5, 1994; "Weg Für Weitere Lufthansa-Privatisierung Frei," Reuter German News Service, May 4, 1994; "Waigel Sieht Hohe LH-Verkaufserlöse" Reuter News Service, May 4, 1995; David Waller, "Lufthansa Privatisation Clears Last Hurdle," *Financial Times*, May 5, 1994, I:2; Hans Ehnert, "Lufthansa-Privatisierung Wird Nicht Billig," Reuter News Service, May 4, 1994. This section is also based heavily upon interviews with Lufthansa and union officials, February and March, 1995.

will cost DM 1.6 billion, with DM 1.1 billion provided by Lufthansa, and the remaining DM 500 million provided by the federal government (classified as "interest payments"). In addition, the government established a DM 1.1 billion guaranty fund for current Lufthansa employees in the event of insolvency.<sup>156</sup> The resulting DM 1.6 billion will be paid over ten years, increasing the federal government's annual payment for the Lufthansa privatization to DM 154 million for the next ten years, and DM 80 million for an additional five years.

Such a large settlement could not go uncriticized, and some analysts questioned whether the costs of privatizing Lufthansa outweighed the budgetary benefits.<sup>157</sup> Given the federal government's DM 500 million payment to Lufthansa, the government also appeared to undermine its own position against subsidies for European airlines. Lufthansa and the government quickly responded to such arguments. With respect to the costs of privatization, Finance Minister Theo Waigel stressed the fact that the sale of the government's *Bezugsrechte* alone for the first share issue (estimated to raise DM 154 million) would cover its first year of obligations to Lufthansa and the VBL.<sup>158</sup> In addition, the sale of the government's stake was expected to raise DM 3.1 billion for the treasury which, if applied to deficit reduction, would result in interest payment savings of over DM 200 million annually -- again, more than required to meet state obligations. It was also understood that the DM 1.1 billion guarantee fund would only be implicated should Lufthansa go bankrupt and current employees benefits need to be secured. Given the low probability of insolvency, most experts did not include the DM 1.1 billion in their calculations of the final settlement. On the issue of the DM 500 million "subsidy," Lufthansa officials stressed that the VBL settlement saved money for all parties concerned, thus the government's one-time payment represented a settlement to avoid over DM 4 billion in potential liabilities if the VBL problem had not been solved and privatization had

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<sup>156</sup>Lufthansa agreed to join the Pensionssicherungsverein (PSV), a private pension insurance fund. The government's guaranty was provided to augment coverage from the PSV.

<sup>157</sup>Ehnert, "Lufthansa-Privatisierung Wird Nicht Billig." The costs of funding the new company pension fund were expected to be over DM 89 million per year for Lufthansa, complicating efforts to control cost increases. Lufthansa AG, *International Offering Circular*.

<sup>158</sup>"Weg Für Weitere Lufthansa-Privatisierung Frei," Reuter German News Service, May 4, 1994; "Waigel Sieht Hohe LH-Verkaufserlöse" Reuter News Service, May 4, 1995.

reduced the state's share under 50%, necessitating the dismissal of Lufthansa from the VBL.<sup>159</sup>

Once agreement had been reached between Lufthansa, VBL and the government, the deal had to be presented to Lufthansa's unions for approval.<sup>160</sup> A supplemental agreement was negotiated between the unions and Lufthansa regarding the VBL solution and Lufthansa's plans to reorganize the company into separate subsidiaries under a holding-company-type superstructure (see discussion in 2.E.ii below). As pension rights had been secured by the deal, the main disagreement arose over how to guarantee workers rights in the new concern-structure. In a critical victory for the unions, the independent companies within the holding-structure would each be subject to the same collective wage agreement. Accordingly, Lufthansa and the unions announced their agreement regarding the VBL solution and the corporate reorganization plan. After the cabinet, advisory board, and the general shareholders meetings had approved a capital increase, the way was finally clear for a share issue without government participation, resulting in the formal (partial) privatization of Lufthansa nearly ten years after Stoltenberg originally tabbed it as a privatization candidate.<sup>161</sup>

#### 2.D.v The 1994 Share Issue

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<sup>159</sup>Interview with Lufthansa officials, March, 1995. Lufthansa's legal experts maintained that the federal government's payments with respect to privatization did not constitute "state aid" within the meaning of Article 92 of the Treaty of Rome, yet neither they, nor the government's counsel could guarantee that the EU Commission would not investigate the transaction for possible violations. The VBL agreement was submitted to the Commission for its review, and no problems were foreseen by the parties prior to the share issue in autumn, 1994. See Lufthansa AG, *International Offering Circular*.

<sup>160</sup>"ÖTV - Noch Harte Verhandlungen Zu Lufthansa-Paket," Reuter German News Service, May 5, 1994; interviews with union officials, February and March, 1995.

<sup>161</sup>Quentin Peel, "Lufthansa sell-off Plan Approved," *Financial Times*, May 20, 1994, I:2. Shareholders approved the plan at their annual meeting in July. Waller, "Lufthansa Returns to the Black at Midway," I:23. At the same time, Lufthansa announced it would pay its first dividend in five years. In 1989, Lufthansa paid dividends of DM 4 per share, then in 1990 DM 2.5 per share (for preferred shares only). In planning its dividend payment scheme, Lufthansa made it clear that it would first pay preferred shareholders the guaranteed dividend through 1995 (DM 2.5 per share) in additional to any dividend received in the 1994 fiscal year. Lufthansa further reported in August, 1994 that its pre tax profits increased in the second quarter from DM 23 million to DM 163 million from 1993 to 1994. "Lufthansa Sieht Sich Wieder Dividendenfähig," Reuter German News Service, August 19, 1994.

The plan to reduce the government's share to below 50% involved a three-stage process.<sup>162</sup> First, the state would refuse to participate in another stock issue, dropping its share to 40%. Second, an initial tranche of government shares would be sold to private investors. Finally, the remaining government shares would be sold by the end of 1995, provided the market for the shares was favorable. The significance of the issue was larger than the comparatively small size of the capital increase itself. For Lufthansa, according to Weber, the main benefit of privatization was "the psychological effect on employees and customers."<sup>163</sup> Investment bankers, less sensitive to the political issues surrounding workforce reductions, claimed that privatization allowed Lufthansa greater freedom to implement further rationalization and cost-cutting measures.

Although by international standards, the size of the Lufthansa issue was quite small, there was extensive international interest due to the perception that it would prove to be a "trial run" for the privatization of Deutsche Telekom in 1996.<sup>164</sup> According to the *Financial Times*, the Lufthansa share issue would influence "future privatisation issues, German companies' attitudes to new methods of promoting investor interest and the way in which big German banks are being forced to relax some of the cosy practices of which foreign banks have often complained."<sup>165</sup> More broadly, the Lufthansa privatization issue was part of a larger effort to establish "Finanzplatz Frankfurt" as a main financial center in Europe by overcoming traditional views in the international investment community that the German capital markets were relatively weak and offered few prospects for attractive returns.

The Lufthansa share issue implicates and forces a re-evaluation of the literature on the links between industry and the universal banks.<sup>166</sup>

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<sup>162</sup>Waller, "Lufthansa Privatisation Clears Last Hurdle," I:2.

<sup>163</sup>David Waller, David, "State-owned Airline Prepares to Leave the Nest: How the Reorganization of Germany's Lufthansa is Cutting Costs," *Financial Times*, May 10, 1994, I:19.

<sup>164</sup>Andrew Fisher and Antonia Sharpe, "A Test-Flight Towards Prize on the Horizon: Method of Lufthansa Issue Clears Way for Deutsche Telekom," *Financial Times*, September 12, 1994, I:17.

<sup>165</sup>Fisher and Sharpe, "A Test-Flight Towards Prize on the Horizon: Method of Lufthansa Issue Clears Way for Deutsche Telekom," I:17.

<sup>166</sup>See e.g., Alexander Gershenkron, *Economic Backwardness in Historical Perspective* (Cambridge, MA: Harvard University Press, 1962); Peter Katzenstein, *Between Power and Plenty* (Ithaca, NY: Cornell University Press, 1978); John Zysman, *Governments, Markets, and Growth* (Ithaca, NY: Cornell University Press, 1983).

Although the view of the universal banks as the main engine of economic growth in Germany has been criticized by scholars emphasizing regional bank-industry links,<sup>167</sup> it is undisputed that the equity markets were never a primary source of liquidity for German firms. Even when major German companies issued stock on domestic exchanges, the majority of shares were purchased by their bank partners, forming strong cross-equity links which discouraged outsiders to invest in such firms. These links simultaneously explain and are explained by the specific design of the German securities exchanges and the investment habits of German citizens. While more than 20% of citizens in the United States and Great Britain own equity shares in listed companies, only 6% of Germans do. At the end of 1993, market capitalization of German shares comprised 30% of GNP, as compared to more than 60% in the United States and Japan.<sup>168</sup> Institutional features, such as the lack of insider trading regulations, further undermine the popular confidence necessary to facilitate widespread public ownership of equity securities by perpetuating the notion of a select group of insiders with exclusive access to valuable corporate information.

The push to privatize Lufthansa coincided with a more general effort by the Kohl administration to deepen the German capital markets (to use the government's terminology, to construct "Finanzplatz Frankfurt"). These efforts reflected the many international and domestic factors which pressured both the federal government and the various securities exchanges to restructure existing financial institutions. First, the enormous costs of unification went far beyond even the substantial resources of the universal banks. The government therefore had to appeal to both domestic and international investors to attract investment capital for domestic enterprises in eastern and western Germany. Second, the integrity of the traditional corporate governance structure was shaken by the *Schneider* and *Metallgesellschaft* scandals, in which poor bank oversight led to gross fiscal mismanagement which led these concerns to the brink of bankruptcy. As a result, experts called for greater transparency in company affairs by strengthening capital markets -- thereby broadening ownership and

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<sup>167</sup>See Richard Deeg, *Banks and the State in Germany* (Ph.D. Dissertation, M.I.T. Political Science Department, 1992).

<sup>168</sup>David Waller, "Survey of German Banking and Finance," *Financial Times*, May 31, 1994, Sec. I.

increasing monitoring of management through market forces (the market for corporate control, for example). Third, greater international competition in financial services, combined with the rise of massive and rapid global capital flows, was channeling investment to more secure and predictable markets in London and New York, thereby diverting a vast source of urgently-needed capital away from Germany.<sup>169</sup> Finally, developments toward monetary union in the EU influenced the German government's desire to base the new European Monetary Institute in Frankfurt as a symbol of Germany's strong influence over European monetary policy. Accordingly, in order to strengthen the appeal of German securities exchanges, the government (in cooperation with the Bundesbank) approved the establishment of an electronic futures market, the DTB; allowed for the existence of money market funds; and relaxed minimum reserves requirements for banks. Significantly, the federal government passed the Second Financial Markets Act in July 1994, which mandated criminal penalties for insider trading abuses for the first time.<sup>170</sup>

The Lufthansa share issue was thus an integral part of the government's effort to showcase its securities markets and to spread ownership as widely as possible, including among international investors. An important aspect of the Lufthansa share issue which forwarded these goals was the decision to make the offering international in scope. Dresdner Bank lead a consortium of 20 banks, including Morgan Stanley & Co International, S.G. Warburg and Paribas.<sup>171</sup> Although bankers hoped for a truly international offering, the issue was bounded to ensure that ownership remained primarily in German hands due to EU and German regulations surrounding airline ownership.<sup>172</sup> Accordingly, the large US market was

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<sup>169</sup>Jeffrey A. Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45:4 (1991): 425-451.

<sup>170</sup>For a detailed description of the legal and political dimensions of the Second Financial Markets Act, see Daniel J. Standen, "Insider Trading Reforms Sweep Across Germany: Bracing for the Cold Winds of Change," *Harvard International Law Journal*, 36:1 (Winter 1995): 177-206.

<sup>171</sup>Lufthansa AG, *International Offering Circular*; "Lufthansa-Privatisierung Begonnen." Reuter German News Service, September 22, 1994. Curiously, Dresdner Bank was selected due to the influence of Aufsichtsrat chairman Dr. Wolfgang Röller, who was also the chairman of the executive board at Dresdner Bank. Interview with Lufthansa officials, March, 1995.

<sup>172</sup>"Lufthansa-Privatisierung Begonnen." As discussed below, these regulations are currently blocking the complete privatization of Lufthansa. See section 2.E below.



excluded from the offering, although US investors will be eligible for the second tranche of Lufthansa shares scheduled to be sold in 1995.<sup>173</sup>

Another issuing technique used for the first time in Germany to ensure investor interest and a high share price was the bookbuilding method. This system, which is standard practice in the United States and Britain, involves undertaking a "roadshow," where corporate executives inform potential investors about the prospects for the company, while investment bankers gauge investor interest in order to set the optimum price for the eventual offering. This method also enables the company to target long-term investors before the share sale takes place.<sup>174</sup> This method contrasts sharply with the traditional German practice of fixing a price before the issue, thus subjecting the offering to the risks of the market. Owing to the success of this process in the Lufthansa offering, experts such as Werner Michael Waldeck, former Chairman of the Frankfurt Stock Exchange, were convinced that the traditional method would be left behind.<sup>175</sup> Regional German banks, however, were somewhat critical of being confined to their home base in selling shares allocated to them under the book-building method (which takes advantage of local contacts).

The Lufthansa share sale finally took place in October, 1994, and was highly successful due, in part, to the use of these new investment banking techniques.<sup>176</sup> The issue was oversubscribed, allowing the government to sell

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<sup>173</sup>Officials at Lufthansa argue, however, that the decision to exclude the US from the offering was based primarily on two factors: 1) the lack of a strong interest in Lufthansa's shares in the US; and 2) the fact that registering the shares pursuant to a Rule 144a offering would be too time consuming and costly for Lufthansa, considering the differences in accounting procedures which make it difficult for German firms to comply with United States securities laws. Interview with Lufthansa officials, February, 1995.

<sup>174</sup>In this way, the bookbuilding method allows banks to avoid the volatility of the market in order to privilege institutional investors. "Lufthansa Mit Neuem Plazierungsverfahren." Reuter News Service, September 7, 1994.

<sup>175</sup>Interview with Werner Michael Waldeck, February, 1995. See also "Lufthansa Mit Neuem Plazierungsverfahren." An important inquiry beyond the scope of this examination is the influence of Anglo-American investment banking techniques on the traditional German model. Specifically, it remains to be seen whether the "lean and mean" corporate governance structure favored by such investment bankers will become the measuring stick for German companies, perhaps threatening the traditional German model of management-labor cooperation (which implicates higher costs than in the US or the UK). See discussion in chapter 3 on the future of the German model.

<sup>176</sup>Parkes, "Ready for Take-off: The Share Issue by Germany's Lufthansa," I:20; "Lufthansa Erfolgreich Privatisiert." Reuter German News Service, September 30, 1994; "Lufthansa-Privatisierung Begonnen." Reuter German News Service, September 22, 1994; Fisher and

the first tranche of its shares under its so-called "green-shoe option," reducing its stake in Lufthansa to 35% (see Table 2.8).<sup>177</sup> The rights issue raised over DM 1.2 billion for Lufthansa, and approximately DM 382.2 million for the federal treasury through the sale of the state's Bezugsrechte and its first block of shares. Reflecting the advantages of the bookbuilding method, the final share price was DM 182, just two Marks shy of the market value of DM 184. Despite traditional skepticism surrounding continental privatization issues and their traditionally poor post-sale performance, international investors were apparently convinced by the rationalization program at Lufthansa.<sup>178</sup> After overcoming substantial obstacles, Lufthansa could finally discard the label "state-owned carrier."

## 2.E 1995 and Beyond: The Future of Lufthansa Through the Eyes of the Social Partners

The partial privatization of Lufthansa in October, 1994 was not an end in itself. Rather, for each of the parties involved in negotiating the final form of privatization, it was a means to a larger end. To conclude this case study of the Lufthansa privatization, therefore, it is important to identify the challenges facing each party in 1995 and beyond.

### 2.E.i The Federal Government

The revenues gained from the Lufthansa privatization were part of an overall government campaign to reduce the overall federal debt burden. By late 1994, it appeared as though these efforts were paying off, with the government expecting a DM 10 billion debt savings in 1995.<sup>179</sup> Privatization, however, was only part of a larger government consolidation plan which also

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Sharpe, "A Test-Flight Towards Prize on the Horizon: Method of Lufthansa Issue Clears Way for Deutsche Telekom," I:17.

<sup>177</sup> Andrew Fisher, "Lufthansa Issue Increased to Meet Demand," *Financial Times*, October 25, 1994, I:30. In contrast to earlier privatizations, there were no employee shares created pursuant to the offering. For the sale of the second tranche of government shares, the unions are currently negotiating for the creation of such special shares for workers at Lufthansa. Interviews with ÖTV officials, February and March, 1995.

<sup>178</sup> Antonia Sharpe, "Survey of International Equity Offerings," *Financial Times*, September 21, 1994, Survey, p. II.

<sup>179</sup> "Kreditaufnahme 1995 Zehn Milliarden DM Weniger." Reuter German News Service, November 23, 1994.

featured a modest tax increase, a freeze on spending, and a reliance upon 3% projected growth in the economy in 1995. The government planned to sell its remaining Lufthansa shares by the end of 1995 as part of larger project of divesting state transportation interests, expanding and internationalizing transportation systems (like railroads) in accordance with EU regulations, and soliciting private capital for new projects, such as roads and rail links to the former DDR.<sup>180</sup> The federal government embarked upon a more aggressive phase of privatization, expecting its proceeds to be over DM 7 billion by the end of 1995.<sup>181</sup> The SPD, however, criticized the new privatization zeal, accusing the government of “selling the family silver” in an attempt to cover-up fundamental budgetary mismanagement in the wake of unification.<sup>182</sup> With respect to Lufthansa, however, there was universal agreement that the government could count its divestment as a major success.

Two key problems faced the government at the beginning of 1995. First, the government needed to design a method for selling its remaining 36% share. Although the share issue in 1994 was vastly oversubscribed, allowing the government to sell the first of two tranches of its own shares, the government stopped short of divesting its entire stake. There were two main reasons for this. The first was strictly financial -- as Lufthansa expected to earn an estimated DM 700 million in profits over the next three years, the government could not only receive dividend income, but could wait until the share price was sufficiently high to sell its remaining shares at a premium, further aiding in deficit reduction. Second, regulatory restrictions currently block total divestment. In order to maintain its flag-carrier status pursuant to Germany’s bilateral air traffic agreements, Lufthansa must remain 50% owned by German nationals. A similar EU regulation requires Europeans airlines to be at least 50% owned by EU citizens.<sup>183</sup> Absent an amendment or repeal of these laws, any further sale of the government’s shares must involve placing restrictions on their trade, thus reducing share price. For example, as opposed to bearer shares, the government could

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<sup>180</sup>“Lufthansa soll 1995 voll privatisiert werden. Minister Wissmann erläutert die Verkehrspolitik der neuen Legislaturperiode.” *Süddeutsche Zeitung*, December 16, 1994.

<sup>181</sup>“Milliardenerlöse Für Bund Durch Privatisierung.” Reuter German News Service, July 14, 1994.

<sup>182</sup>“Soziales Und Zinsen Belasten Haushalt 1995.” Reuter German News Service, July 14, 1994.

<sup>183</sup>Regulation (EEC) 2407/92 governs the new European licensing procedures within the context of the new third package of air liberalization measures. See Lufthansa AG, *International Offering Circular*, 53-54.

register its Lufthansa shares and require that these shares could only be traded among German citizens. Yet this would largely defeat the main goal of privatization for the federal government: to maximize revenues in order to reduce the federal deficit. This paradox is the biggest obstacle to selling the government's remaining shares by the end of 1995. Until it is solved, the government will continue to hold a so-called "golden share" which it does not want. A related problem is the unwillingness of regional authorities in Bavaria and North Rhine Westphalia to part with their strategic stakes in Lufthansa.<sup>184</sup>

**Table 2.8: Change in Government Ownership (1993-1994)**

	Subscribed Capital	Subscribed Capital
	(before 1994 capital increase)	(after 1994 capital increase)
	%	%
Bundesrepublik Deutschland	51.42	35.68
Kreditanstalt für Wiederaufbau	1.77	1.77
Bundespost	1.03	1.03
Bundesbahn/ Deutsche Bahn AG	0.50	0.40
State of North Rhine Westphalia	2.21	1.77
Other Land Authorities*	2.23	10.05
Others	43.07	49.30
<b>Total</b>	<b>100.00</b>	<b>100.00</b>

\* = includes Hessische Landesbank and the Münchener Gesellschaft für Luftverkehrswerte  
Source: Deutsche Lufthansa AG, 1995

A second issue facing the federal government are the obstacles to liberalizing air transport both within Europe and globally. Within the EU, there appears to be two camps with respect to further liberalization: a protectionist camp (France, Belgium, Greece, and Portugal) are strong supporters of continued subsidies and protected markets, while another camp (Britain, the Netherlands, and Germany) are lobbying for increased

<sup>184</sup>Franz Jägerle, "Privatisierung; Vater Staat macht auf privat." *Top Business*, December 1, 1994.

liberalization and an end to state subsidies. Although the Commission is pressing forward with an integrated air traffic system and increased access to protected markets, this disparity between states will be hard to overcome, especially in view of the fact that the "early privatizers" (British Airways, Lufthansa) have a distinct competitive advantage over other firms which are still state-owned, thus increasing the costs of rationalization for those carriers. In the larger global context, the federal government will continue to be periodically pressured by the need to renegotiate bilateral traffic agreements, like the acrimonious process with the United States in 1993-94. In sum, beyond its goals to completely divest, the federal government holds the role of environment-setter -- attempting to widen the available market within which Lufthansa is well positioned to successfully compete against other national carriers.

### 2.E.ii Lufthansa

The partial privatization of Lufthansa was the second element in the overall plan of Lufthansa management to position the firm to successfully compete in the global market. By January, 1995, the company had been restored to profitability through the rationalization program, and had been officially transferred out of state hands.<sup>185</sup> The final stage was a planned restructuring, whereby the firm's individual operations would become independent, wholly-owned subsidiaries of Deutsche Lufthansa AG, which would then resemble a holding company.<sup>186</sup> These new subsidiaries were: Lufthansa Cargo AG (4300 employees; operating in freight delivery); Lufthansa Technik AG (10,000; maintenance); and Lufthansa Systems GmbH (1100; information services). At the parent company (24,000), the board of directors was reduced from six to five members, representing three primary departments (chair of the board; finance; personnel) and two operational spheres (passenger service; and operations -- a merger between flight business

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<sup>185</sup>Lufthansa announced in late 1994 that profits by 1997 would be in the range of DM 500-700 million. "Lufthansa-Sanierung Ist Voll Gelungen." Reuter German News Service, January 20, 1995.

<sup>186</sup>Interviews with Lufthansa officials, February, 1995. See also "Lufthansa-Sanierung Ist Voll Gelungen;" "Eine neue Konzernstruktur für die Lufthansa. Fracht, Technik und Bodendienste sollen selbständig werden." *Süddeutsche Zeitung*, January 10, 1994; "Lufthansa zuendet zweite Stufe der Sanierung." *Süddeutsche Zeitung*, September 16, 1994. The consulting firm of Roland Berger & Partner (Munich) was retained to design the plan.

and maintenance).<sup>187</sup> Figure 2.2 shows a schematic chart of the new concern-structure. An advisory board, consisting of the five board members and the business directors of the nine independent businesses, will meet monthly to coordinate decision-making and to develop overall firm strategy. Members of the board of directors of the parent company will be chairmen of the advisory boards of each subsidiary.

According to Weber, there were four primary reasons for the reorganization plan:<sup>188</sup>

- autonomous units are closer to customer and can respond quickly to customer needs
- less red tape
- greater team spirit
- faster and more efficient reaction to changing customer needs

One additional reason for the reorganization was to give more flexibility and international visibility to successful divisions, such as the important cargo division (22% of revenues in 1993).<sup>189</sup> An independent cargo company, in turn, will be divided into regional share-holding companies to increase flexibility. In this way, decisions are made quicker and closer to the problem area, and finances become more transparent. The new division of competencies between the parent company and the subsidiaries was succinctly captured by the *Financial Times*:

“The result will be a wholesale restructuring of the classic German ‘pyramid’ management structure - where virtually every decision is made at the apex - which will leave the main board in charge of group strategy and the passenger airline, while fostering entrepreneurialism in the other companies. They will be expected to seek out new business and newcomers apart from Lufthansa in the world market and. . . counter cost

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<sup>187</sup>“Eine neue Konzernstruktur für die Lufthansa. Fracht, Technik und Bodendienste sollen selbständig werden.”

<sup>188</sup>Deutsche Lufthansa AG, *Annual Report, 1993* .

<sup>189</sup>Michael Mecham, “Lufthansa Cargo Pursues New Identity, Partners,” *Aviation Week and Space Technology*, August 9, 1993, pp. 37-41.

pressures with 'greater flexibility' that is available to them under the existing group structure."<sup>190</sup>

Although the efficiency gains from the new structure are yet to be quantified by Lufthansa management, officials are convinced that the restructuring was essential to the future global competitiveness of the company. This restructuring plan is a visible example the adoption of decentralized, "lean and mean" corporate governance structures at Lufthansa in response to the apparent success of other, similarly-organized global competitors, such as British Airways.

### 2.E.ii The Unions: Caught in the Middle<sup>191</sup>

German legal provisions have institutionalized the role of unions in negotiating wage agreements and participating in firm decision-making down to the plant level.<sup>192</sup> Such cooperation was critical to the success of Lufthansa's Program 93, as the 1992 wage agreement slashed personnel costs while the 1994 supplemental agreement allowed for Lufthansa's transfer out of the VBL and the adoption of a new corporate structure.<sup>193</sup> Significantly, the unions negotiated a settlement to the restructuring plan whereby employees at the various subsidiaries would all be compensated according to one central wage agreement. There are indications, however, that this may have been a temporary victory. Ultimately, Lufthansa officials intend to shift to subsidiary-level wage bargaining, and larger international competitive forces continue to pressure Lufthansa to cut costs and improve operational efficiency. These pressures were universally identified by labor officials as the biggest challenge for the future.

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<sup>190</sup>Parkes, "Survey of Germany," VIII.

<sup>191</sup>The discussion in this section is based upon interviews with union officials in February and March, 1995.

<sup>192</sup>See Joan M. Feldman, "In Europe, Works Councils," *Air Transport World* (February 1993): 72-73.

<sup>193</sup>Curiously, when asked whether the 1992 wage deal was a *quid pro quo* for a favorable resolution to the VBL problem and the Lufthansa restructuring plan, union officials responded "yes," while Lufthansa officials firmly denied any such deal.

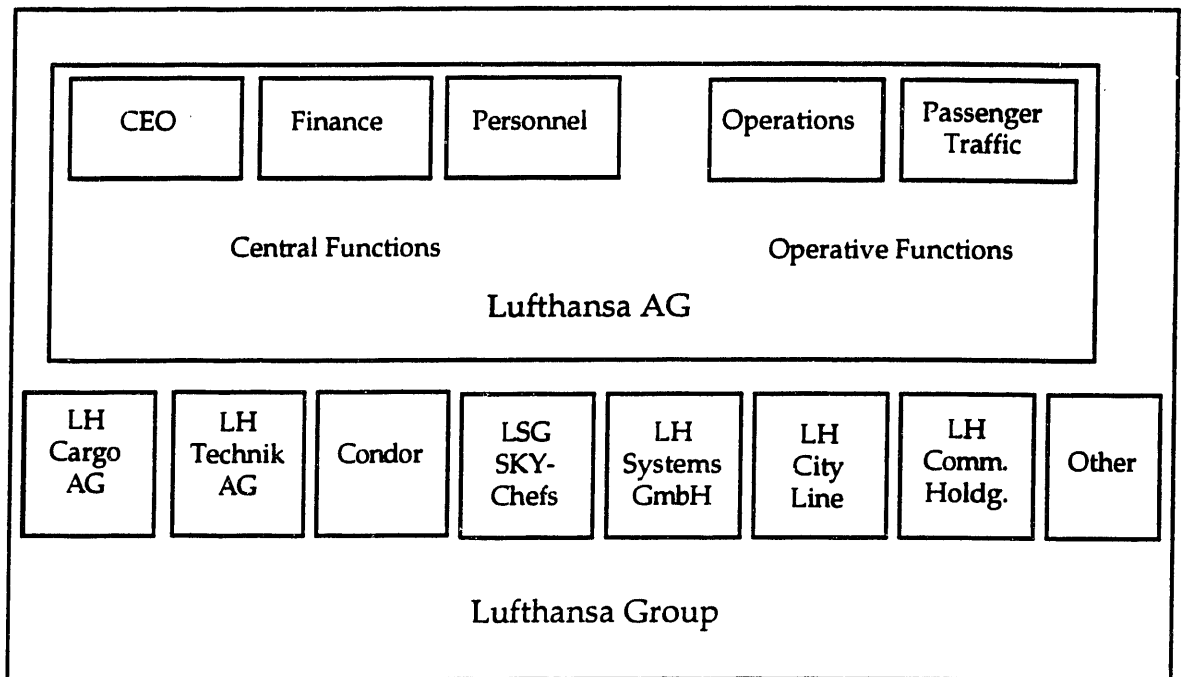


Figure 2.2 New Structure of Lufthansa Group  
 Taken from Lufthansa AG, Charts & Figures, February 1995

Beginning with the conclusion of the 1992 wage agreement, however, the most important task for the unions was to maintain membership in the face of massive job cuts. This was particularly the case for ÖTV, who bore the brunt of workforce reductions, as the majority were in administrative personnel and ground crew staff. In this regard, ÖTV has been relatively successful, having recruited 2,000 new members since 1992 (3,000 were lost through workforce reductions in the same period). Overall union strategy is to maintain high membership and organizational cohesion to act as a counterweight to management interests. Two primary challenges exist in this regard: maintaining relations between ÖTV and DAG; and maintaining cohesion within the unions themselves within the new holding company structure at Lufthansa.

The relationship between the DAG and the ÖTV has been hostile throughout the post-war period. This stems from fundamental organizational differences between DGB unions (with which ÖTV is affiliated), which organize on the *Industrieprinzip* of "one industry-one union," and DAG unions, which organize on the *Berufsprinzip* of representing a particular occupation (white collar workers at Lufthansa, for example). This fundamental difference is reflected in differing policies with



respect to a wide range of issues. Three principal examples of these differences are:

- **Wages:** the DAG supports one broad income increase for all employees, while ÖTV lobbies for scaled increases with lower income workers receiving a higher increase than higher income employees (the “Sozialkomponent”);
- **Vacation Pay:** DAG supports a uniform grant of 10% of monthly income as vacation pay, while ÖTV supports a flat payment of DM x thousand for all employees, again with the purpose of leveling out differences between wage levels; and
- **Working Hours:** ÖTV supported the 35 hour work week, while the DAG was indifferent to working hours, choosing instead to focus on compensation issues.

During the 1970s, relations between the two unions were openly hostile, causing intense competition between them in recruiting new members. One unfortunate result for both unions was that some new employees would join neither union, eroding overall union strength. When local labor organizations (for example, firefighters unions) threatened to band with DAG to displace the ÖTV, the heads of both main unions met and agreed to form a common front in negotiations with management. This *Konkrierendes Miteinander* (“competitive co-existence”) was established in late 1994, after negotiations with Lufthansa had to be undertaken literally in two separate rooms. This new cooperation is one vehicle through which labor hopes to form a stronger balance to management interests.

The second main challenge to union cohesion is the new holding company structure at Lufthansa. The first task for the unions was to elect works councils for each of the new companies, and then to train them in order to insure a united bargaining front at the individual company level. According to ÖTV, negotiations will take place primarily at the company level, but within a company-level “peak bargaining” arrangement, whereby the head of ÖTV will have regular contact with Lufthansa chairman Jürgen Weber. Despite these institutional measures, unions are very anxious that the new holding-company structure is simply the first step in an effort to decentralize all labor relations. In the opinion of the unions, this would seriously undermine union cohesion and thus reduce overall union

strength.<sup>194</sup> One DAG official suggested that the new structure at Lufthansa was the first step in privatizing the concern piece-by-piece in order to avoid the time consuming and expensive process of organizing a share sale for the parent company itself. Regardless of the presumed motive behind the reorganization, union officials uniformly believed that decentralization, though good for competitiveness, nonetheless had the negative side of undermining union strength in order to proceed with further cost-cutting measures which may not be possible at the corporation-level.

The intense pressure to reduce costs, moreover, stems from the second major danger to union interests: those forces subsumed under the label of "internationalization" or "globalization." Three distinct challenges face unions in this regard: pressures to cut costs and to adopt "lean and mean" corporate governance structures; the necessity to form global alliances with other carriers; and changes originating from Brussels through new EU regulation. The first set of pressures were discussed above in terms of wage negotiations and the new concern-structure at Lufthansa. In this regard, union officials hope to stress the productivity gains associated with a contented and motivated workforce, as opposed to "negative" gains made through continued cost-cutting at the expense of worker benefits.

The new trend toward global alliances presents an interesting organizational problem for German unions. On the one hand, it is clear that such alliances are essential for the future health of globally competitive airlines. Latecomers face the possibility of being locked-out of such alliances, which expand the network of routes available to participating airlines and provide access to protected markets. On the other hand, workers at carriers participating in such alliances must find some way to coordinate strategy in term of their relationship with management. Again, the issue appears to be one of balancing the power of management, which necessarily expands due to such alliances. Owing to its membership in the International Transport-workers Federation (ITF), ÖTV was able to form a working group with an affiliated union at United Airlines almost immediately following the creation of their strategic alliance. The same was not true with Thai Airlines, which is

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<sup>194</sup>One ÖTV official pointed to the example of ABB, which reorganized itself into 90 independent companies, resulting in an erosion of union strength. When the concern was reconsolidated, the balance of power was clearly in management's favor. This is precisely the scenario the unions at Lufthansa seek to avoid.

non-union. Yet the same issues exist with respect to both alliances: How will cooperative flights be staffed? Which wage and benefit systems will be used for which flights? Should the Lufthansa-United-Thai alliance evolve to include cross-equity holdings, it will be imperative for the unions to establish some kind of representation at Thai. Yet it is unclear what form such organization will have, given political institutional constraints within Thailand, as well as ordinary organizational difficulties within the unions themselves.

Gaining institutional access to decision-making and establishing a counterweight to management are issues which also face Lufthansa's unions at the EU level. The problem of access stems from the perceived "democratic deficit" within the EU, whereby workers' interests are only indirectly represented in Brussels through national governments. Unions thus faced two problems: first, they were lacking in complete information about what was transpiring at the EU level; and second, their interests were not completely articulated by the federal government. In order to solve both problems, the unions have established offices in Brussels and act as independent lobbyists for their concerns. ÖTV sent Monika Wulf-Mathies, previously head of wage negotiations at Lufthansa and member of the Aufsichtsrat, to Brussels as their representative. A second major problem was similar to the other organizational puzzle with respect to global alliances. Specifically, given the split in European airlines between state-owned subsidized carriers and privatized ones, there are numerous barriers to a united labor policy on air transport developments. While fora such as the ITF and the Committee of Transport workers in the European Union (CTEU) are useful in this regard, this internal division within the EU was universally cited as a major problem for Lufthansa's unions and European airline employee interests generally. Accordingly, the unions have joined Lufthansa and the government in lobbying for greater liberalization within the EU and the elimination of state subsidies.

Pressures from low-cost, non-union international carriers is perhaps the chief problem facing Lufthansa's unions, who look to the federal government and the EU to shield them from the possible social ramifications of cost-cutting and lean-management. Developments such as the shift to a decentralized holding-company structure at Lufthansa threaten to divide employees between old and young workers. The unions are convinced that

these new corporate structures are the first step in a broader plan to negotiate cheaper agreements with new employees, while maintaining existing agreements with older workers until they leave the company or retire. How the unions should respond to this development is unclear even within the unions themselves. Some officials at ÖTV, for example, stress the need to "sell" the union to new members as the only way to maintain a united front against management interests. Yet the series of compromises reached in the 1992 wage agreement and later seem to confirm the fact that cuts need to be made, and the easiest way to do this for those social costs within the control of German companies is to reduce entry level salaries and benefits. Thus, young workers could either not join unions who easily sacrifice their interests, or could gradually gain control of the unions and renegotiate agreements to the detriment of older workers. This potential division between older and younger workers due to international cost pressures is clearly a main challenge to unions in the wake of Lufthansa's privatization.

To briefly summarize, privatization was not an end in itself for management or labor at Lufthansa. Rather, it was a stage in an ongoing process to adapt to international competitive pressures within the confines of the traditional German model. At the same time, however, the compromises necessary to save the airline may have set in motion a process which threatens to undermine the German model itself, to the detriment of worker interests. Caught between representing the interests of their membership and facing international pressures beyond their control, unions are trapped in the middle of the transformation taking place in the global airline industry, an industry where only a few global players will survive. Clearly, Lufthansa is well-positioned to be one of these players by virtue of its spectacular rationalization and restructuring process. The success of this process is even more remarkable because it developed within the existing "social contract" between management and labor; whereby corporate decision-making at the firm level is undertaken within the framework of consensual negotiation between management and labor (in works councils), while industry-level wages and benefits are negotiated by peak-associations. Yet increasing international pressures are threatening to shrink the ambit of the social contract, and it remains to be seen how far unions are willing to compromise

in the name of "competitiveness," when the traditional strengths of the German model are being eroded by a new commitment to "profit über alles."

## Chapter 3: Conclusions - Privatization and the German Model

Privatization is the most visible example of the current process of change within the public sector in advanced industrial states. The transfer of public enterprises from state to private ownership and control is a dramatic, and potentially enduring, redefinition of the state-society boundary after decades of expansion following World War II. Given the profound effects of privatization on traditional relationships between governments, workers and managers of public enterprises, understanding the motives behind privatization is central to examining and comparing changes within the political economies of advanced industrial societies. The motives and techniques of privatization are as many and varied as individual privatization initiatives themselves, however, making it difficult to specify particular motives for privatization in a given historical moment.

This study has tried to mix theory and practice by constructing several ideal-typical theories of privatization and then testing them by exploring the privatization of Lufthansa. Two goals directed the research for this work: first, to add to the empirical data in order to describe what forces are driving privatization in Germany, and advanced states generally; and second, to examine how privatization influences larger changes in the German political economy. This concluding chapter takes each of these goals in turn, discussing first how the Lufthansa case adds to our understanding of why states (especially Germany) privatize public enterprises, and second the implications of privatization for the changing "German model."

### 3.A Lufthansa and Theories of Privatization

Examining the theories of privatization outlined in chapter 1 in light of the Lufthansa story, a distinction must be made between the first attempt at privatization in the mid-1980s, and the successful attempt in the 1990s. Entrenched regional industrial policy interests were able to defeat Stoltenberg's first attempt at privatization because there were neither compelling budgetary nor competitiveness reasons to sell the government's shares. More precisely, budgetary and competitiveness motives were not strong enough to overcome opposing interests and institutional hurdles to

privatization at the federal level in Germany. This begs the question, what exactly changed between 1984 and 1994?

One conclusion from the Lufthansa story is that ideology is not a primary motive behind privatization in Germany. In contrast to Great Britain, where an explicit disdain for the public sector was a hallmark of the Thatcher years, the Kohl administration never embarked upon a crusade to roll back the frontiers of the state. There are two main reasons for this key difference in approach: the first is party-political; and the second is institutional. Since the creation of the Federal Republic in 1949, the political landscape has been dominated by the two, broadly centrist parties (CDU and SPD). Despite general differences in party programs and constituencies (the CDU being conservative and catering to business interests, the SPD embracing social democratic views and worker interests), both parties accept the social market economy and narrowing victory margins in recent elections translates into a general timidity to embrace radical views. Moreover, radical positions are served by fringe parties, such as the *Republikaner* and the Greens. The one party which embraces a radical privatization policy, the FDP, has suffered heavy losses in recent elections, fueling the perception that their ability to remain over the 5% threshold to remain in parliament is solely by virtue of "loaned" votes from the CDU.<sup>195</sup> It remains to be seen, however, how the impact of new social movements and the growing dissatisfaction with the established parties in Germany will affect the willingness of the CDU and the SPD to adopt more radical stances in order to win support, or at least define themselves in contrast to their competitors. Indeed, the current intensification of federal privatization efforts may be a product of a new effort by the CDU to embrace more defining policies. As discussed below, however, even this new initiative is justified not on ideological grounds. Rather, it is based on budgetary and competitiveness concerns.

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<sup>195</sup>This perception lies at the core of the current tension between the FDP and the CDU in recent months. For example, in the wake of the elections in Hesse, FDP chair Klaus Kinkel fiercely rejected the claim that their position in the Landtag was a gift from CDU voters, and emphasized the FDP's continuing re-evaluation of both its own program and the relationship with the CDU/CSU. Regarding party politics in Germany generally, see Peter J. Katzenstein, ed., *Industry and Politics in West Germany: Toward the Third Republic* (Ithaca, NY: Cornell University Press, 1989); Gordon Smith, William E. Paterson, Peter H. Merkl and Stephen Padgett, *Developments in German Politics* (Durham, NC: Duke University Press, 1992); Herbert Kitschelt, *The Logics of Party Formation: Ecological Politics in Belgium and West Germany* (Ithaca, NY: Cornell University Press, 1989).

Institutional structures in Germany amplify this emphasis on moderation and compromise. Two features have special relevance to the pace and scope of privatization: the necessities of coalition government; and the particular system of German federalism. Coalition politics requires compromise among the ruling parties to navigate necessary legislation through parliament. Such was the case with the Lufthansa project in 1984: although the FDP and CDU were solidly behind partial divestment, regional interests resulted in insurmountable CSU opposition. The ability for coalition rifts to frustrate policy initiatives is enhanced by the hurdles of German federalism. Specifically, the capacity for *Länder* interests to block legislation in the *Bundesrat* is a key obstacle for radical policy programs. Strauss' ability to undermine the first attempt to sell the federal government's shares in Lufthansa was linked to his credible threat of *Bundesrat* veto. As federalism in Germany responds to increasing EU regulation, the interests of the *Länder* have assumed even greater strength in watering-down executive policy projects.<sup>196</sup> Given the decreasing number of federal assets, the future of privatization in Germany depends on attitudes at the *Länder* and municipal levels. As Waldeck documents, while federal industrial assets were valued at DM 7.4 billion at the end of 1992, *Länder* and municipal assets totaled DM 13 billion.<sup>197</sup>

Another institutional barrier to ideologically motivated privatization in Germany is the relative weakness of the capital markets. Due to the heavy dependence of share issues on the perceptions of experts in the investment banking community, even substantial reforms enacted recently by the Kohl administration will take time to bear fruit in attracting large flows of foreign investment capital.<sup>198</sup> Again, Britain provides a useful contrast, where the size and maturity of the City of London was a major facilitating factor in the success of the ambitious British program. Despite efforts to construct

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<sup>196</sup>See Richard Deeg, "Germany's *Länder* and the Federalization of the European Union" Paper presented at the American Political Science Association, New York, September 4, 1994; Razeen Sally and Douglas Webber, "The Solidarity Pact: A Case Study in the Politics of Unified Germany," *German Politics*, 3:1 (April 1994): 18-46.

<sup>197</sup>Werner Michael Waldeck, "Privatisation: The Philosophy in Germany," Paper presented at the 18th Congress of the European Federation of Financial Analysts' Societies, 20-23 September, 1994. On new *Länder* initiatives, see Michael Lindemann, "Survey of Germany," *Financial Times*, November 21, 1994, Survey, p. viii.

<sup>198</sup>See Daniel J. Standen, "Insider Trading Reforms Sweep Across Germany: Bracing for the Cold Winds of Change," *Harvard International Law Journal*, 36:1 (Winter 1995): 177-206.



"Finanzplatz Frankfurt," it was telling when Deutsche Bank located their electronic futures practice in London instead of Frankfurt.

In sum, both party political and institutional factors preclude an ideologically driven privatization program in Germany. When privatization has occurred at the federal level, it has been done in a step-by-step, deliberate manner, in full cooperation not only with coalition and opposition parties, but also within the framework of the larger industrial relations system. Thus, ideological motives and economic principal-agent theory played a marginal role in the privatization of Lufthansa, and are not as useful in explaining privatization in Germany as compared to other states, such as Britain, where such factors are more important.

Similarly, issues of domestic consolidation were not critical to the Lufthansa story. After the failure of *Volkskapitalismus* in the 1960s, efforts to break unions have not been paramount in federal privatization. Although employee shares have been sold in many of the privatized enterprises, they comprise a relatively low number of shares and serve mostly as a token incentive to spur greater productivity. Significantly, employee shares were not created for the Lufthansa offering, although there was a proposal to include them in the next share sale in 1995. This is not to say that issues of legitimacy were not critical to the Lufthansa story. A combination of budgetary crisis and rapid change in the airline industry proved to be decisive in the privatization process. Each of these factors challenged the federal government's ability to respond to dramatic domestic and international change.

The first important force shaping privatization was the budgetary crisis of unification. The massive shift in the level of the budget deficit due to unification costs created a crisis-space which allowed the Kohl administration greater discretion within which to experiment with new, bolder policies. Given the administration's desire to avoid funding unification through significant tax increases, privatization offered an attractive way for the federal government to receive massive, one-shot infusions of funds which could meet what was expected to be a one-time era of massive expenditure. Although the Kohl administration's arguments in favor of privatization were couched in the language of free-market libertarianism, the force of the

federal government's position came from its detailed cost-benefit analysis.<sup>199</sup> Significantly, in the case of Lufthansa, groups expected to oppose privatization were mostly silent. The SPD tacitly supported the government's plans for Lufthansa, while unions were more concerned about protecting pension benefits and participation in corporate decision-making in the post-privatization era, than rejecting privatization itself.

Although the federal government's interest in deficit reduction helped overcome traditional regional opposition to privatizing Lufthansa, focusing on the government alone ignores half of the Lufthansa story. Another interesting counterfactual is the query, would Lufthansa have been privatized even in the absence of budgetary crisis? Parallel to developments at the federal government level, were important changes within Lufthansa, and in the international air transport industry generally. The convergence of these domestic and international pressures led to the privatization of Lufthansa, and helps explain the renewed zeal of privatization in Germany, and in advanced industrial states generally.

As detailed in chapter 2, the financial health of Lufthansa was a critical factor controlling the timing of privatization. While the poor financial position of Lufthansa was partially the result of bad judgment by previous managers, developments in the international market contributed greatly to the necessity for rationalization. Three distinct pressures were outside the exclusive control of both Lufthansa and the German government, yet directly influenced the performance of the firm: 1) global over-capacity; 2) infrastructure limitations among the world's airports; and 3) increased competition due to global airline liberalization, particularly from low-cost British and American carriers. Efforts within the EU toward greater liberalization in air traffic amplifies these competitive pressures. The third package of air traffic reforms, for example, removed restrictions on establishing operations in other member-states by transferring licensing authority to the European level.<sup>200</sup>

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<sup>199</sup>The compelling 1992 report of the Finance Ministry, which summarized the results of an extensive audit of federal assets with specific recommendations for partial or total sales, illustrates this point. See Bundesminister der Finanzen, *Bericht des Bundesministers der Finanzen zur "Verringerung von Beteiligungen und Liegenschaften des Bundes* (Bonn: Ministry of Finance, 13 July, 1992).

<sup>200</sup>See Regulation (EEC) 2407/92 for the details of the third package of air traffic reforms.

The cumulative effect of these pressures, combined with the high debt levels at Lufthansa due to over-investment, threatened the existence of Lufthansa itself. In contrast to other European carriers who benefited from substantial state subsidies (such as Air France, Sabena or Olympic Air), Lufthansa could not approach the federal government for aid, particularly given the strains on the treasury due to unification and the Kohl administration's position against subsidies. Combined with the severe downturn in world demand for air travel due to the Gulf War and global recession, the financial situation for Lufthansa in 1993 was critical. In response, Weber's Program 93 restored profitability through a drastic cost-cutting and rationalization campaign designed to convince the international investment community that Lufthansa was a good investment. Again, international forces played a critical role in the Lufthansa story, as attracting international capital investment required Lufthansa to adopt measures which were relatively new for German firms at that time. The company was pushed by international forces in both the financial and airline markets to adopt a more "lean and mean" corporate governance structure. Privatization was a key element in the reorganization program, owing to its effects on investor perceptions of management independence and flexibility -- features critical to responding to rapid changes in customer needs.<sup>201</sup>

As globalization and technological advance bring about changes in what constitutes a failed market,<sup>202</sup> governments are forced to re-evaluate their traditional roles as either providers of these goods and services, or heavy regulators of their provision. In a sense, internationalization turns the concept of "national champions" on its head. Instead of heavy state involvement in critical sectors of the economy, either through infant industry protection or by creating industrial conglomerates, internationalization pushes states to deregulate as quickly as possible in order

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<sup>201</sup>The strong influence of international forces is not unique to the air transport sector. Similar developments have been observed in other traditionally protected sectors, such as telecommunications. See Philip Genschel and Raymund Werle, "From National Hierarchies to International Standardization: Model Changes in the Governance of Telecommunications," *Journal of Public Policy* 13:3 (July-September 1993): 203-226; Wayne Sandholtz, "Institutions and Collective Action: The New Telecommunications in Western Europe," *World Politics* 45: 2, (January 1993): 242-270.

<sup>202</sup>"Failed markets" as used here mean either natural monopolies, as in the case of telecommunications, or markets which implicate special national interests, such as airlines, jails or utilities.

to position national firms to take advantage of expanding world markets. The success of first movers, such as British Airways, influenced policy-makers in Bonn and corporate decision-makers in Köln, as they worked together to structure privatization. As a result of these changes, the federal government's role has been transformed to environment setter, as opposed to service or goods provider. In the airline sector, Bonn still has a critical role in gaining access to protected markets through maintaining and expanding bilateral traffic accords, and in promoting greater liberalization both within the EU and globally, in addition to its traditional role as safety and employment regulator.

In sum, the budgetary stress of unification created an opportunity for the executive to implement bolder privatization initiatives, while the choice of privatizing Lufthansa was shaped by its financial health, as well as by international developments in the airline industry. This synergy between the government's interest in deficit reduction and Lufthansa's successful response to changing international conditions enabled privatization to succeed. Critically, however, these pressures were filtered by existing political and economic institutions. The key institutions identified in chapter 1 all shaped the privatization process in the Lufthansa case. The initial attempt by Stoltenberg in 1984 failed because of divisions within the ruling coalition and the existence of numerous veto points within the federalized structure of policy-making in Germany. In contrast, the successful effort in 1994 depended upon the transformation of traditional opponents through international competitive pressures and the fiscal crisis of unification.

These institutional processes, however, were themselves unchanged by these new pressures. Specifically, the contours of privatization were shaped by negotiations between the government, management and labor. These discussions were critical to the ultimate success of the Lufthansa share issue, as unsolved social questions would have deterred investment and almost certainly triggered a damaging confrontation between labor and management at Lufthansa. These negotiations were nevertheless shaped by the new financial and competitive reality facing Lufthansa in the 1990s. This leads to the second main query of this study, could these new forces of globalization alter existing institutions themselves? If so, what are the ramifications for Germany's traditional social partners?

### 3.B Internationalization, Privatization and the "German Model"

The distinctive political economic institutions which are collectively labeled the "German model" have been alternatively praised and eulogized. This concluding section discusses four principal questions with respect to the German model: What is it? What is threatening its endurance in the 1990s? What are some strategies to sustain or modify it? And how does the Lufthansa case fit into these changes? I argue that the same international forces which influence privatization in Germany are also threatening changes in the German model itself. The Lufthansa case is an example of how international forces pressure domestic institutional filters in Germany.

#### 3.B.i The "German Model" Briefly Defined

The merits of the so-called "German model" have been praised by many scholars as a preferable alternative to traditional "Fordist" economic arrangements.<sup>203</sup> Although the precise details of what constitutes the "German model" are contested, most recognize that the particular institutional arrangements which govern industrial production in Germany are distinct from other capitalist societies. These institutional differences, moreover, help explain the strong performance of the German economy, as well as the egalitarian distribution of wealth in German society.<sup>204</sup> Of the many features of the German model, the following elements are most important for our discussion:

- The structure of the market in Germany is grounded in the principle of the *Sozialmarktwirtschaft*: a competitive market combined with some

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<sup>203</sup>Prominent works on the German model and the current challenges to it include: Katzenstein *Industry and Politics in West Germany: Toward the Third Republic*; Michel Albert, *Capitalism vs. Capitalism* (New York: Four Walls, Eight Windows, 1993); Wolfgang Streeck, "German Capitalism: Does It Exist? Can It Survive?" in Colin Crouch and Wolfgang Streeck, eds., *Modern Capitalism or Modern Capitalism?* (London: Pinter, 1995); Gary Herrigel and Charles F. Sabel, "Craft Production in Crisis: Industrial Restructuring in Germany During the 1990s" unpublished draft paper presented to CES, Harvard University (August 1, 1994); Herbert Giersch, Karl-Heinz Paque and Holger Schmieding, *The Fading Miracle: Four Decades of Market Economy in Germany* (New York: Cambridge University Press, 1992).

<sup>204</sup>See e.g., David Soskice, "The Institutional Infrastructure for International Competitiveness: A Comparative Analysis of the UK and Germany" in Anthony B. Atkinson and Renato Brunetta, eds., *The Economics of the New Europe* (London: MacMillan, 1993): 45-70; Streeck, "German Capitalism: Does It Exist? Can It Survive?"; Herrigel and Sabel, "Craft Production in Crisis: Industrial Restructuring in Germany During the 1990s."

minimum “floor” of social equity. The prominent institutional features created to guarantee these values are the powerful *Bundeskartellsamt*, to regulate competition policy, and the extensive social welfare system, which insures a basic income for all citizens. In addition, extensive social regulations governing employment issues also remove some aspects of economic activity from market forces.

- As a result of a careful delineation of its powers and responsibilities, executive power in Germany is divided, in Streeck’s (1995) terms, both vertically and horizontally. Vertically, the executive must share power with the *Länder* in two fundamental ways: national legislation must meet with the approval of the *Bundesrat*; and certain policy areas are exclusively delegated to *Länder* authorities pursuant to the subsidiarity principle (for example, education, environmental policy, and implementation of so-called “framework legislation”).<sup>205</sup> Horizontally, the executive shares regulatory power with several powerful, independent entities, notably the *Bundeskartellsamt* and the *Bundesbank*. Lacking strong tools of industrial policy, the federal government plays the more passive role of “environment setter” -- setting the rules of the economic game, as opposed to shaping industrial outcomes.

- A final important macro-institutional feature is the para-public institutions which have been granted substantial regulatory authority by the state. The most notable of these for our discussion are the employer associations, which cannot collude with respect to pricing (due to the commitment to market competition), but can coordinate quality standards, wage bargaining, vocational training standards, and research and development goals. Another important self-regulatory institution (until the recent era of reform in the 1990s) was the securities exchanges, which lacked

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<sup>205</sup>Although developments at the EU threaten a usurpation of these policy competencies, the *Länder* have been largely successful in retaining an important gatekeeping role in the implementation and ratification of EU policy initiatives. See Richard Deeg, “Germany’s *Länder* and the Federalization of the European Union;” Fritz W. Scharpf, “The Joint-Decision Trap: Lessons from German Federalism and European Integration,” *Public Administration*, 66 (Autumn 1988): 239-278; Jeffrey Anderson, “Skeptical Reflections on a Europe of Regions: Britain, Germany, and the ERDF,” *Journal of Public Policy*, 10:4 (October-December 1990): 417-447.

formal insider-trading laws, but functioned according to a code established by the securities officials and traders themselves.<sup>206</sup>

- Beyond the macro-level institutional features listed above, three prominent micro- or firm-level institutions are also important elements of the German model. The first is the intimate links between the “universal banks” and industry.<sup>207</sup> The universal banks were the primary source of capital for German manufacturing during industrialization, and again during reconstruction following World War II. Links between banks and firms are enhanced by equity holdings by the major banks, allowing them input in corporate planning and thus supporting “patient” or “sticky” capital, which is vital to long-term investment in innovation.<sup>208</sup> Although scholars have criticized the over-emphasis on national banks, highlighting local and regional bank-industry links,<sup>209</sup> the dynamic in both cases is the same. Accordingly, equity financing and the “market for corporate control,” which is so prominent in the United States and Great Britain, is largely absent in the German model -- presumably contributing to long-term planning and an emphasis on quality, as opposed to price and short-term profit maximization.

- A second micro-level institutional feature is the distinctive cooperation between management and labor. This cooperation exists at two levels: first, industry wide collective bargaining; and second, firm-level co-determination through works councils. Workforce participation in corporate decision-making ensures general process of negotiated change and coordinated reaction to shifts in demand. This cooperation enhances the overall flexibility of German firms, and facilitates both worker productivity and overall product quality. This is particularly important because most German firms compete in high value-added niche markets, as opposed to highly competitive, price-oriented markets. It is also the critical element of the social partnership which is a hallmark of the *Sozialmarktwirtschaft*.

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<sup>206</sup>See Standen, “Insider Trading Reforms Sweep Across Germany: Bracing for the Cold Winds of Change,” 177-206.

<sup>207</sup>See Alexander Gershenkron, *Economic Backwardness in Historical Perspective* (Cambridge, MA: Harvard University Press: 1962); John Zysman, *Governments, Markets, and Growth* (Ithaca, NY: Cornell University Press, 1983).

<sup>208</sup>Bank liquidity was supported by exceptionally high savings rates among German citizens. Important cultural values such as saving could constitute an additional feature of the German model, but are excluded here in the interests of simplicity and parsimony. See, however, Streeck, *German Capitalism: Does It Exist? Can It Survive?*

<sup>209</sup>See Richard Deeg, *Banks and the State in Germany* (Ph.D. Dissertation, M.I.T. Political Science Department, 1992).

- Finally, the system of vocational training underpins the high-skill base of German manufacturing. The dual system of general education and apprenticeships guarantees a steady flow of skilled labor to German firms. Again, this institution is essential, given the importance of skilled labor in the production of complex, and frequently customized products.

These institutional features reflect societal values emphasizing a strong commitment to both the open market and social egalitarianism. They also support the general competitive advantage of German firms in high value-added, high cost goods, such as luxury automobiles, and specialty manufactured goods, such as optics and precision machine tools. Not only does the German model provide a steady pool of high skilled labor, low inflation and a stable currency, and state-sponsored infrastructure and research and development, but the distinctive industrial relations system provides the basis of trust and risk-pooling which enables employers to delegate to their workers responsibility for adjusting to changes in demand. This flexibility stands in sharp contrast to the low-skill, highly-standardized, and market-controlling features of Fordism, and was largely responsible for the success of the export-led growth in the German economy during the 1980s.

Yet the success of the German model, Streeck (1995) argues, depends upon three main factors: 1) stable or growing world product markets; 2) steady product innovation in advance of demand shifts; and 3) a steady, but limited supply of skilled labor to avoid shifts to low-cost markets where German firms would be at a natural disadvantage due to the high costs of maintaining its unique institutions. Toward the end of the 1980s, the ability of the German model to maintain these conditions was questioned by many scholars, while others argued that the German model may no longer be suited for the new international economy.

### 3.B.ii What's Wrong With the German Model in the 1990s?

The magic balance between economic growth and social egalitarianism appeared to melt away in the 1990s, as profits fell, market shares ebbed, and unemployment rose. The shock of unification magnified this sense of crisis, but unemployment in the west was already higher than previous levels in the 1980s. Worse still, Germany entered its deepest recession in post-War



history in 1993. Most troubling, however, was the observation that Germany's previously secure niche markets were being penetrated by lower-cost Japanese and American firms offering products of similar quality at lower cost than those produced within the high-cost German model. While one could argue that the crisis was merely cyclical, with the effects of downturn simply exacerbated by the costs of unification, most scholars viewed Germany's troubles as structural in nature. These structural explanations can be grouped into three main theories: 1) "secular exhaustion;" 2) unification shock; and 3) globalization.<sup>210</sup>

The secular exhaustion theory asserts that the very institutional structures that were responsible for the success of the German model were also the seeds of its own demise. The high costs of production eventually crossed an economic threshold, whereby they began to hinder innovation and productivity. Institutional rigidities in the labor market and in vocational training, moreover, undermined the adequate growth of skills to maintain the level of innovation necessary to support steady economic growth. Finally, the institutions of worker-management cooperation precluded the introduction of "lean" management systems, further inhibiting the productivity gains and innovation which the high-quality German model depended upon for sustained growth. In many ways, the secular exhaustion thesis is the economic version of the ideological theory of privatization. That is, the possibility of reforming existing institutions is rejected due to a belief that the system itself is inherently inefficient. In sum, the current crisis is viewed by this theory as the logical result of a fundamental weakness in the system itself, which the successes of the 1980s masked.

A second theory highlights the impact of unification on either exacerbating existing structural defects in the German model, or independently pushing costs above a level sufficient to remain internationally competitive. The burden on the federal government due to transfer payments and related costs of institutional transfer in eastern Germany hinders its ability to maintain and upgrade existing institutions in the west. As a result, innovation is inhibited from keeping pace with global change. Beyond the macro-effects of unification on the federal government's ability to maintain the critical infrastructure necessary for steady growth in

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<sup>210</sup>Adapted from Streeck, *German Capitalism: Does It Exist? Can It Survive?*

the west is another, micro-level argument which is the industrial analog to the "crisis-space" argument discussed above in reference to domestic motives for privatization. Several scholars focus on the process of institutional transfer in eastern Germany as creating opportunities for firms to experiment with new forms of industrial relations which may have feedback effects for existing western structures.<sup>211</sup> Alternative structures, based upon lower wages and benefits and reduced worker participation, threaten to undermine existing, high-cost systems in the west, eroding the traditional strengths of the German model.<sup>212</sup>

A final, globalization theory, resembles the internationalization theory of privatization. Again, there are macro- and micro-economic aspects to the growing influence of global economic developments on the German political economy. Regarding macro-economic changes, Streeck (1995) points out that the German model was based upon the relative immobility of production factors. An adequate, but limited skilled labor pool and a secure flow of funds from the universal banks to industry were bedrocks of the German system. As transnational capital and labor flows increased, it became difficult for national governments to regulate developments in either sector without damaging their economies. Streeck points to the impact of immigration and unification on the increase in the unskilled labor pool, which is incompatible with "high labor standards, an extended welfare state, and a normalized pattern of high-wage and high-skill employment."<sup>213</sup> In addition, international capital flows provide German firms access to cheaper investment, undermining traditional links between the universal banks and industry. Attracting these flows, a task made even more urgent by the financial stress of unification, fuels the "deregulatory bias" of globalization,

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<sup>211</sup>See e.g., Stephen Silvia, Paper presented at MIT, October, 1994 (discussing changing patterns within employers associations); Richard M. Locke, Paper presented at MIT, December, 1994 (focusing on variations within identical industrial relations institutions in eastern and western Germany).

<sup>212</sup>The phrase "lower wages" is not meant to imply a zone of low-cost, low-skill production in eastern Germany. In fact, unions and employer associations in the west structured unification in a way which intentionally raised wage levels in eastern Germany disproportionately to productivity levels, thereby trading high unemployment in eastern Germany for security against capital flight from western to eastern Germany. Rather, worker benefits are relatively lower than traditional arrangements in the west due to decreasing worker participation and reduced bargaining power owing to the economic crisis of the post-unification era. See Silvia (1994); Streeck, "German Capitalism: Does It Exist? Can It Survive?"

<sup>213</sup>Streeck, "German Capitalism: Does It Exist? Can It Survive?" 22.

which threatens the extensive system of social protections and entitlements that are characteristic of the German model.

At the level of the firm, globalization has revealed that the German model, while more flexible than Fordist forms of production organization, is nevertheless not flexible enough to keep up with other, more flexible forms of industrial production, notably in Japan and the United States.<sup>214</sup> According to Herrigel and Sabel (1994), distinctive institutional features in Germany, particularly the vocational training system and the system of craft certification, which supported the success of the German model through the 1980s, also creates barriers to further flexibility -- the type now being demanded in the niche markets within which German firms traditionally compete.

Specifically, the craft system of skill certification causes jurisdictional conflicts to arise each time a firm encounters a radical market change which demands a response from the firm in terms of organizational redesign. These jurisdictional conflicts between crafts slows innovation necessary to respond to rapid changes in global demand for given products -- a primary feature of the new world economy in the 1990s. Moreover, bureaucratic structures of decision-making within German firms further undermine a more intense union of conception and execution. Hierarchies designed to coordinate production among different craft groups (or *Berufe*) create so-called "dyadic relations" within specific pieces of the production process, as opposed to more open and flexible groups or teams containing many different kinds of workers, which collaborate to structure and restructure production according to ever-changing market signals.

A number of forces, therefore, are promoting change within the German model. This change will not come easily, however. Institutional rigidities reflect the importance of societal norms and values. The craft system of skill certification, for example, is not only a system which reinforces trust among employers, but is also a critical source of identity for industrial workers. The pride associated with the *Berufe*, as Herrigel and Sabel emphasize, makes it unlikely that a deconstruction of the craft system will occur without substantial resistance. Scholars such as Suzanne Berger stress the resilience of such micro-level institutions despite the pressures of

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<sup>214</sup>Herrigel and Sabel, "Craft Production in Crisis: Industrial Restructuring in Germany During the 1990s."

globalization which promote a degree of convergence with respect to macro-level economic policy.<sup>215</sup> The question thus becomes, are German firms changing their operating structures due to international pressures? If so, how do these changes represent fundamental institutional change? The final two sections of this chapter discuss the range of responses observed in the German political economy generally, and then the specific response of Lufthansa.

### 3.B.iii What Can German Firms Do?

Following the approach of Herrigel and Sabel (1994), minimalist and maximalist responses to global change can be identified among German firms. Minimalist strategies involve an effort by management, usually under financial duress, to cut costs and adopt minor structural changes in production. With respect to structural reforms, two distinct dynamics have emerged from minimalist efforts at various German firms, each leading to a similar problem. The first is that reform efforts are implemented only in isolated areas. The second is that reform efforts are undertaken firm wide, with the exception of "islands of tradition" within the firm. In both cases, the reluctance to undertake total restructuring in the face of institutional rigidities and entrenched opposing interests leads to a hybrid structure which lacks the integration of conception and execution necessary to achieve real efficiency gains. The reasons for the partial failure of such efforts are clear. Deconstructing the German model involves altering workplace identities which have evolved over many years. Displacing craft jurisdictions without undermining the environment of trust they support is a difficult task, one which has been approached only in piecemeal fashion at many German firms.

Maximalist strategies, while few in number, nonetheless provide examples of radical change in production organization. In their article, Herrigel and Sabel document the wide-ranging efforts at BMW to restructure their production into flexible teams, eliminating traditional craft jurisdictions, and reducing overheads and intensifying cooperation with key

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<sup>215</sup>Presentation at MIT, April 19, 1994. For an interesting collection of essays on the topic of global convergence or divergence in industrial policy and organization, see Suzanne Berger and Ronald Dore, eds., *Convergence or Diversity? National Models of Production and Distribution in a Global Economy*, (Ithaca, NY: Cornell UP, 1995).

suppliers.<sup>216</sup> Management compensation is rewarded not on status lines, but based upon the attainment of performance goals, while production is organized into teams, which are given general responsibilities without rigid rules governing the method to fulfill their responsibilities.

Significant debate lingers, however, over the necessity for reform and the precise impact of globalization on operations structures. The many doubts regarding the impact of internationalization on the German model can be grouped into three main arguments. First, many scholars doubt that the magnitude and rapidity of financial and trade flows between states is any greater than the period just prior to World War I.<sup>217</sup> This leaves open the possibility that national reactions to the negative effects of globalization might lead to a retreat to extensive national regulation and closed borders. Second, scholars argue that even if the magnitude or quality of transnational activity is somehow more profound in the present age, micro-institutional differences will remain despite general macro-economic convergence. Thus, functional necessities in the new world economy could be met by a wide array of possible institutional arrangements. Third, despite intense pressures in some market sectors, other sectors may be more resilient to change. For example, while Herrigel and Sabel focus on machine tools and automobile production, developments in the chemical industry or, more importantly, in the steadily growing service sector may be quite different. A fertile ground for further research, therefore, exists with respect to quantifying the effects of globalization on various states and on various industries within states. What can the case of Lufthansa add to this research agenda?

### 3.B.iv What Can We Learn From Lufthansa?

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<sup>216</sup>Herrigel and Sabel, "Craft Production in Crisis: Industrial Restructuring in Germany During the 1990s," 22-29. BMW's reform efforts appear to have spilled over to their suppliers as well, and the study also describes efforts at a small machine tool manufacturer in Baden-Württemberg.

<sup>217</sup>See, e.g., Robert Zevin, "Are World Financial Markets More Open?" in Tariq Banuri and Juliet B. Schor, eds., *Financial Openness and National Autonomy* (Oxford, UK: Clarendon Press, 1992); Marcello DeCecco, "Short-term Capital Movements Under the Pre-1914 International Monetary System," in Barry Eichengreen and G. Braga de Macedo, eds., *The Gold Standard in Portugal and in the World* (forthcoming); Suzanne Berger, "Introduction," in Berger and Dore, *Convergence or Diversity? National Models of Production and Distribution in a Global Economy*.

The case of Lufthansa is interesting because it lies outside the traditional manufacturing focus of the literature on the German model. The airline industry represents a sector which was expressly nationally controlled until the recent global explosion in air travel increased competition among international carriers. As traditional military and industrial policy justifications for strong state-control over air traffic faded away, replaced by intense competition among world commercial carriers, forces of globalization motivated simultaneous changes in state policy and corporate governance. The Lufthansa case illustrates both of these pressures: first, the state's push to privatize the carrier in the 1990s; second, the efforts by Lufthansa management to restructure its operations structures. The first part of this chapter examined the effects of internationalization on the government's decision to privatize Lufthansa. This final section explores how Program 93 adds to the evidence supporting either the transformation or the resilience of the German model.

As detailed in chapter 2, Lufthansa's rationalization program proceeded in two distinct phases. The first phase involved the massive cost-cutting plan which featured substantial personnel reductions, wage freezes, asset sales and efforts to increase revenues. A parallel project was the construction of Lufthansa's international strategic alliance network, notably with United Airlines, Varig and Thai. These rationalization and consolidation efforts were central to the restoration of profitability at Lufthansa, and were the key precondition to any capital increase/privatization of government shares. The second phase, conceived before privatization, but implemented afterward, involved the restructuring of the company into individual subsidiaries under a holding-company type superstructure. These efforts were designed to increase flexibility by decentralizing decision-making authority, to increase transparency of corporate finances, and to encourage entrepreneurship among company management. The driving force of these measures was to effectively respond to increasing global competition by cutting costs and enhancing service to attract a bigger share of the growing international air traffic demand. The puzzle is what to make of these efforts in terms of the debate on the changing German model.

Globalization clearly was the main pressure on Lufthansa to rationalize and restructure. Profits were squeezed by falling ticket prices and increased international competition from other, low cost carriers. Moreover, the

organizational structures of successful carriers, such as British Airways, were examined by Lufthansa management during the drafting of the reorganization plan. Decentralization through the adoption of a holding-company structure appears to be the first step in a process which could transform existing patterns of corporate governance and co-determination at Lufthansa. Pushing wage and benefit negotiations to the subsidiary level threatens to undermine overall union cohesion and strength. The increase in part-time work among Lufthansa employees also presents problems for the traditional high-cost German model, as it circumvents existing social legislation regarding wages and benefits. Another force for change stems from the construction of Lufthansa's global alliance. Not only are additional options of "out-staffing" available, whereby crews from non-union carriers would be used to staff Lufthansa international flights, but the diffusion of Anglo-American models of "lean" management may also change the style and structure of management-employee relations at Lufthansa, further undermining the traditional features of the cooperational German model. Finally, the necessity to raise investment capital through share issues, as opposed to bank lending, points to a shift in the source of financing at Lufthansa, indicating a potential weakening of traditional bank-industry links. Parallel to this process, of course, is the retreat of state participation in corporate decision-making at Lufthansa because of privatization. Each of these changes enhances the autonomy and strength of management, as institutions of trust and cooperation with ownership (banks) and labor are weakened in the name of increasing competitiveness in response to global competition.

Despite the potential for fundamental change in the structures of corporate governance at Lufthansa, the fact remains that change was negotiated at every stage with full union input. For example, workforce reductions were accompanied by lucrative compensation packages, a practice unheard of in the Anglo-American model. Regardless of the new concern-structure at Lufthansa, collective bargaining will still take place at the corporate (not subsidiary) level under the terms of the 1994 supplementary agreement. With respect to the retreat of the state and the banks, outside a major change in legislation at the German and European levels, Lufthansa will continue to be partially state-owned (although a minority stake). The major banks continue to have substantial equity stakes in Lufthansa, while

international investors tend to be institutional ones, meaning that Lufthansa can rely upon relatively stable and patient capital. Although international forces are necessitating change, these forces continue to be filtered by the principle institutions of the German model: co-determination at the firm level; tripartite bargaining between state, firm and labor with respect to fundamental industrial change; bank-firm cooperation. While macro-level globalization necessitates cost-cutting and a more flexible corporate structure, the relationships between management and labor remain governed by important and resilient micro-level institutions unique to the German model. Despite the appearance of increasing management autonomy, firms must operate within the legal structures of codetermination, barring legislative change.

While attacking high operating costs and adopting organizational changes designed to increase flexibility, Lufthansa has, thus far, avoided major institutional change which would cause us to doubt the endurance of the German model. Yet the question for the future is, will changes in the substance of the management-labor bargain ultimately affect changes in the procedure of bargaining? That is, could the "minimalist" change at Lufthansa lead to larger, structural changes which could blur the features of the traditional German model? Several indicators suggest this may be possible: decentralized labor negotiations; wage and benefits gaps between younger and older workers; potential out-staffing; and management learning-by-doing through global strategic alliances. Each of these possibilities would affect the structures governing management-labor cooperation, and thus could undermine traditional institutions of trust-building which sustained the German model throughout the post-War era. Further, macro-level institutional change could also affect firm-level structures. The growing securitization of corporate finance, for example, threatens to erode traditional bank-industry links, as the cost of international capital becomes radically cheaper in comparison to traditional domestic sources. These shifts parallel a larger trend in society itself, reflected in the growing use of consumer credit in Germany, which may lead to decreasing savings rates. Thus, as Lufthansa and Germany look to the future, the viability and appeal of the German model appears to be at least threatened by international pressures. As the Lufthansa case demonstrates, however, micro-level institutions are surprisingly resilient and flexible in the face of change. Perhaps the Lufthansa



story offers an example of facing globalization within the German model, potentially retaining the appealing features of management-labor cooperation, while shedding the inefficient high-costs which threaten to hinder growth.

### 3.C Conclusions

The privatization of Lufthansa illustrates the motives and mechanics of privatization in Germany. Both domestic and international changes undermined support for traditional opponents of privatization, while the need to privatize Lufthansa was amplified by these same pressures. Specifically, the massive increase in the federal debt level due to unification costs created a "crisis-space" which gave the executive branch greater freedom to implement a more aggressive privatization strategy. At the same time, the globalization of the air transport industry placed great pressures on Lufthansa to rationalize its organization structure and to reduce firm debt. This implicated a capital increase which was beyond the means of both the federal government and the main banks. Privatization, therefore, was a result of the convergence of firm-level pressures and macro-level pressures on the federal government.

Restructuring in the wake of privatization illustrates the current stress upon the traditional "German model" of corporate governance, particularly with respect to management-labor relations at the firm level. The potential evolution of this model implicates debates surrounding convergence or divergence in the organization of firms and economies. The Lufthansa case illustrates the intense international pressures on firms in competitive industries to adopt aspects of "best practice." While Lufthansa shed some of its traditional high costs and adopted a more decentralized corporate structure, these changes have been negotiated within the institutional framework of the German model, and have not, thus far, altered these institutions themselves. Although the form of industrial relations has not changed, the substance of the management-labor bargain has shifted decidedly against labor interests at Lufthansa, and it remains to be seen whether these changes in substance will ultimately lead to institutional changes which reflect the weaker position of labor at Lufthansa.

Further research with respect to Lufthansa can proceed on several interesting and important levels. The continued process of structural change needs to be monitored closely. Further research also should be directed at tracing the effects of enhanced management autonomy on the functioning of the new concern structure at Lufthansa, and on management-labor relations generally. With respect to management styles, the extent to which Lufthansa adopts the practices of its strategic partners will be an important indicator of a further erosion of the German model. More analysis also needs to be done on the effects of the new concern structure at Lufthansa in terms of the carrier's competitiveness. On a more macro-level, further research on the impact of the growing trend of "securitization" is needed to map changes in German attitudes toward equity holdings, and a potential shift to Anglo-American forms of corporate ownership and management control. Finally, the changing regulatory environment facing Lufthansa needs to be analyzed in order to document how these environmental changes affect corporate governance. With respect to privatization, more work needs to be done on *Länder*-level efforts at either privatizing or contracting out public goods and services.

In a rapidly changing global industry, Lufthansa has, thus far, successfully met the challenges of change. More important, its efforts have been undertaken within the confines of "the German model" of industrial relations. While labor is not materially better off than it was in the 1980s, it remains an important player in corporate decision-making, and the secure position of Lufthansa in the world market translates into greater security for Lufthansa employees. Yet change in international air transport is not a temporary phenomenon, it is a fundamental part of the market itself. As Lufthansa continues to compete, only time will tell if the current cooperation between traditional economic and social partners will continue, or will be displaced by a more adversarial system much like that in the United States and Great Britain. Despite remarkable international change, the German model remains surprisingly resilient.

## Appendix A: List of Interviews Conducted in Germany - February/March, 1995

Dr. Roland Czada  
Professor, Max Planck Institut  
Köln

Dr. Josef Esser  
Professor, Johann Wolfgang Goethe-Universität  
Frankfurt

Dr. Rolf-Dieter Graß  
Investor Relations, Lufthansa AG  
Frankfurt

Bernd Harth  
Director, Federal Employees Section  
DAG  
Frankfurt

Dr. Roger Kiem  
Attorney  
Feddersen, Laule, Scherzberg &  
Ohle Hansen Ewerwahn  
Frankfurt

Dr. Susanne Lütz  
Professor, Max Planck Institut  
Köln

Manfred Maertzke  
Director of Wage Negotiations, Civil Aviation  
Member, Lufthansa Aufsichtsrat  
ÖTV  
Stuttgart

Ingo Marowsky  
Senior Member of Representation of Flight Attendants  
Lufthansa AG  
Delegate for International Affairs, ÖTV/Civil Aviation  
Frankfurt (Interviewed in Boston)

Dr. Richard H. Sterzinger  
Attorney  
Boesebeck, Barz & Partner  
Frankfurt

Dr. Antje-Kathrin Uhl  
Labor-law Attorney  
Sigle, Loose, Schmidt-Diemitz & Partner  
Stuttgart (Degerloch)

Werner-Michael Waldeck  
Attorney, Former Chairman  
Frankfurt Stock Exchange  
Boesebeck, Barz & Partner  
Frankfurt

## Appendix B: List of Lufthansa Subsidiaries

<u>Group Companies</u>	<u>% interest owned</u>
Air Transport Training International, Inc., Tucson, USA	100
Airline Training Center Arizona (ATCA), Inc., Goodyear, USA	100
Airport Services Friedrichshafen GmbH, Friedrichshafen, BRD	100
Albatros Versicherungsdienste GmbH, Köln, BRD	100
BBL Gemeinnützige Berliner Qualifizierungsges. f. Berufe im Luftverkehr mbH, Berlin, BRD	100
Capital Gain International (1986) Ltd., Hong Kong	100
CICONIA Grundstücks-Vermietungsges. mbH & Co. oHG Norderstedt, BRD	.05*
Condor Berlin Gesellschaft für Flugdienstleistungen mbH, Berlin, BRD	100
Condor Flugdienst GmbH (CFG), Frankfurt, BRD	100
Condor/Cargo Technik GmbH, Frankfurt, BRD	100
Consolidated Catering Services (China) Ltd., Hong Kong	100
Delvag Luftfahrtversicherungs-AG, Köln, BRD	100
Delvag Rückversicherungs-AG, Köln, BRD	90
Deutsche Akademie für Flugmedizin gemeinnützige GmbH, Frankfurt, BRD	90
Deutsche Lufthansa Berlin-Stiftung, Berlin, BRD	100
Deutsche Lufthansa Unterstützungswerk GmbH (LUW) Köln, BRD	100
DLT Extra Executive Travel Reiseflug GmbH, Frankfurt, BRD	100
DLT of USA, Inc., Dover, USA	100
EFM - Gesellschaft für Enteisen und Fluszeugschleppen am Flughafen München mbH, Freising, BRD	51
Euro Lloyd DFB Reisebüro GmbH, Frankfurt, BRD	51
Euro Lloyd GHH Reisebüro GmbH, Oberhausen-Sterkade, BRD	51
Euro Lloyd Reisebüro GmbH, Köln, BRD	85
Euro Lloyd Reisebüro, Moscow, Russia	100
Euro Lloyd Travel, Inc., New York, USA	100
European Air Transport S.A./N.V., Brussels, Belgium	60
European Air Transport (Holdings) S.A., Brussels, Belgium	57.5
FGH Frankfurter Gesellschaft für Hotelwerte mbH, Frankfurt, BRD	100
German Travel Services GmbH, Frankfurt, BRD	100
German Wings Luftfahrt-Service GmbH, Köln, BRD	100
Hellenic Cargo Centers S.A. (HCC), Athens, Greece	51
LSG Airport Gastronomiegesellschaft mbH, Frankfurt, BRD	100
LSG Catering China Ltd., Hong Kong	100
LSG Catering Guam, Inc., Guam, USA	100

LSG Catering Hong Kong, Ltd., Hong Kong	100
LSG Catering Netherlands B.V., Amsterdam, Netherlands	100
LSG Catering Saipan, Inc., Saipan, Micronesia	100
LSG Catering Thailand, Ltd., Bangkok, Thailand	100
LSG Holding Asia, Ltd., Hong Kong	100
LSG Lufthansa Service Asia Ltd., Hong Kong	100
LSG Lufthansa Service Enterprises Ltd., Hong Kong	100
LSG Lufthansa Service GmbH, Frankfurt, BRD	100
LSG Lufthansa Service Guam, Inc., Guam, USA	100
LSG Lufthansa Service Hong Kong Ltd, Hong Kong	60
LSG Lufthansa Service Nordost GmbH, Berlin, BRD	100
LSG Lufthansa Service Saipan, Inc., Saipan, Micronesia	100
LSG Lufthansa Service USA Corp., Wilmington, USA	100
Lufthansa A.E.R.O. GmbH, Alzey, BRD	100
Lufthansa AirPlus Servicekarten GmbH, Neu-Isenburg, BRD	100
Lufthansa Airport- and Ground-Services GmbH, Frankfurt, BRD	100
Lufthansa Airport Services Brussels S.A., N.V., Brussels, Belgium	99
Lufthansa Airport Services Dresden GmbH, Dresden, BRD	100
Lufthansa Airport Services Italy S.r.l., Milan, Italy	99
Lufthansa Airport Services Leipzig GmbH, Leipzig, BRD	100
Lufthansa Berlin Gesellschaft für Deinstleistungen mbH, Berlin, BRD	100
Lufthansa Cargo Airlines GmbH, Kelsterbach, BRD	100
Lufthansa Cargo GmbH, Frankfurt, BRD	100
Lufthansa CityLine GmbH, Kriftel, BRD	100
Lufthansa Commercial Holding GmbH (LCH), Köln, BRD	100
Lufthansa Consulting GmbH, Köln, BRD	100
Lufthansa Design Center GmbH, Köln, BRD	100
Lufthansa Hotel-Gesellschaft mbH, Kriftel, BRD	100
Lufthansa Inmoboliaria S.A. de C.V., Mexico	100
Lufthansa International Finance (Netherlands) N.V., Amsterdam, Netherlands	100
Lufthansa International Finance N.V. (i.L.), Curaçao Lesser Antilles	100
Lufthansa Services (Thailand) Ltd., Bangkok, Thailand	49
Lufthansa Simluatorzentrum Berlin GmbH, Berlin-Schönefeld, BRD	100
Lufthansa Traditionsflug GmbH, Frankfurt, BRD	100
Orderich Company Ltd., Hong Kong	100
Penta Hotels München GmbH & CO. Hetelverwaltungs KG, München, BRD	62
Penta Hotels München, München, BRD	100
Reisebüro A.L.R. Atlantik-Luft-Reederei GmbH, Bonn, BRD	90
Reservation Data Maintenance India Private Ltd.,	

New Delhi, India	51
Südflug Gesellschaft für Flugdienstleistungen mbH, Köln, BRD	100
Terra-Studienreisen GmbH, Augsburg, BRD	100
The AirPlus Company Jersey Ltd., Jersey (Channel Islands), UK	73.1

\* = Majority of voting rights

<u>Associated Companies</u>	<u>% interest owned</u>
AFS-Aviation Fuel Services GmbH, Hamburg, BRD	50
Aircraft Maintenance and Engineering Corp. (AMECO), Beijing, China	40
Airest Restaurant- und Hotelbetriebsgesellschaft mbH, Vienna, Austria	30
Airport Club für International Executives GmbH, Frankfurt, BRD	25
AMADEUS Austria Marketinggesellschaft mbH, Salzburg, Austria	25
Amadeus Data Processing GmbH & Co., Beteiligungs-KG, Erding, BRD	50
Amadeus Global Travel Distribution S.A., Madrid, Spain	25
Askerwall & LSG Restaurant AB., Märsta, Sweden	40
BAVARIA-LLOYD Reisebüro GmbH, München, BRD	49
BEIJING Lufthansa German Center GmbH & Co. KG, Köln, BRD	27
Berliner Lufthansa Airport Services GmbH, Berlin, BRD	49
c + d Luftfracht-System GmbH, Köln, BRD	40
Cargolux Airlines International S.A., Luxembourg	24.5
Caterair International - LSG Lufthansa Service, Milbrae, USA	50
CGN Jumbo-Flug Ges. für Flugzeugvercharterung mbH, München, BRD	50
China Air Catering Ltd., Hong Kong	50
CityLine Simulator und Training GmbH, Berlin, BRD	50
De Montis Catering Roma S.r.l., Rome, Italy	40
DHL International Ltd., Bermuda, USA	25
Egyptian Aviation Servies Company Ltd., Cairo, Egypt	40
EuroBerlin S.A., Paris, France	49
Eurocargo S.A., Flughafen Luxembourg, Luxembourg	50
FIRST Reisebüro GmbH & Co. KG, Düsseldorf, BRD	20.2
GFD Gesellschaft für Flugzeildarstellung mbH, Hohn, BRD	50
Global Logistics System Europe Company for Cargo Information Services GmbH, Frankfurt, BRD	46.85
Global Logistics System Worldwide Company for Development of Freight Information Network, GmbH, Frankfurt, BRD	25
Günes Ekspres Havacilik A.S. (Sun Express), Antalya, Turkey	40

Hansa Luftbild GmbH, Münster, BRD	25.33
Hongkong Beijing Air Catering Ltd., Hong Kong	45
Hongkong Shanghai Air Catering Ltd., Hong Kong	45
IBYKUS THG Grundbuchtreuhandgesellschaft mbH & Co., KG, Heidelberg, BRD	25
ITAS Reiseveranstaltungs-GmbH, Vienna, Austria	26
Jamestown Investments Ltd., Hong Kong	37.5
Kempinski AG, Berlin, BRD	20.18
Lauda Air Luftfahrt AG., Vienna, Austria	26.47
LSG Lufthansa Service España S.A., Santa Cruz de Tenerife, Spain	40
LSG Servair B.V., Amsterdam, Netherlands	50
Lufthansa German Center GmbH, Köln, BRD	25
Lufthansa Informationstechnik und Software GmbH LIS, Berlin, BRD	46
Lufthansa Leasing GmbH & Co., Alfa-Golf KG, Grünwald, BRD	95
Lufthansa Leasing GmbH & Co., Alfa-Mike KG, Grünwald, BRD	95
Lufthansa Leasing GmbH & Co., Alfa-November KG, Grünwald, BRD	95
Lufthansa Leasing GmbH & Co., Alfa-Tango KG, Grünwald, BRD	95
Lufthansa Leasing GmbH & Co., Bravo-Juliett KG, Grünwald, BRD	95
Lufthansa Leasing GmbH & Co., Bravo-Mike KG, Gruunwald, BRD	49
Lufthansa Leasing GmbH & Co., Bravo-November KG, Grünwald, BRD	49
Lufthansa Leasing GmbH, Grünwald, BRD	49
Lufthansa Rent a Phone GmbH, Frankfurt, BRD	30
LZ-Catering GmbH, Hamburg, BRD	24.9
Mercator Reisebüro GmbH, München, BRD	49
MIRA Insurance Broker and Consulting GmbH, Köln, BRD	25
MVP Versuchs- und Planungsges. für Magnetbahnsysteme mbH, München, BRD	50
Onex Food Services, Inc., Delaware, USA	23.05
RegioKom Berlin Ges. für Bündelfunkdienste mbH, Berlin, BRD	24.9
Shannon Aerospace Ltd., Shannon, Ireland	35
Shenzen Nuclear Power Expatriate Multi-Services Co., Ltd., Shenzen, China	25
Siam Flight Services Ltd., Bangkok, Thailand	49
START Holding GmbH, Frankfurt, BRD	33.33
The AirPlus Col, Ltd., London, UK	20.29
THG Grundbuchtreuhandgesellschaft mbH, Berlin, BRD	25
Venture Capital Enterprise - VCE S.p.A., Rome, Italy	50



Xi'an Aircraft Catering Co., Ltd., Xi'an, Shaanxi , China	40
ZFB Zentrum für Flugsimulation Berlin GmbH, Berlin, BRD	50

Taken from, *Lufthansa Offering Circular*

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