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Jack Eaton*

Flying the Flag For Subsidies – Prospects for Airline Deregulation in Europe

Whereas the Airline Deregulation Act of 1978 put an end to airline subsidization in the USA, things look quite different in the European Union: after more than a decade of discussions about liberalization and the advent of the single market, most European routes are still monopolies or duopolies with state aid to airlines featuring prominently. Why has air transport liberalization made so little progress? What are the prospects for the future?

The recent decision of European Union Transport Commissioner Neil Kinnock to allow Spain to pump 87 billion pesetas (£ 460 million) into Iberia has thrown the European airline industry into uproar. The British secretary of state for transport, Sir George Young, denounced the decision as a depressing one that "threatens to undermine all our efforts to establish fair competition in the community aviation market".¹ He emphasised that UK airlines competed in Europe without subsidy and called upon the EU to insist that other airlines were also operated on purely commercial lines. He professed surprise at the Commission's argument that the payments to Iberia would not constitute state aid: "It really does stretch credibility to claim that a commercial investor would be willing to put any money at all into Iberia. It has been losing money for years."²

The Objective of Eliminating Subsidies

One objective of the Treaty of Rome is to eliminate subsidies. Article 92 formally prohibits assistance that distorts trade and confers the control of state subsidy upon an independent agency, the European Commission. As the Treaty of Rome emphasised undistorted competition as a central principle of the European Common Market, there can be no deviation from this in the Single European Market. Subsidies distort competition in this internal market and hence are prohibited. Furthermore, merely offsetting their effect would not eliminate their negative impact on the process of European integration. The control, and maximum possible prevention of state aids is an indispensable element in achieving the completion of the internal market.

It is no longer possible to describe subsidies in the words of Professor Carl Shoup of Columbia University in 1972 as "the great fiscal unknown". Rather, with the deregulation and privatization of nationalized industries during the last decade, public policy has been focused on subsidies to a considerable degree. Nevertheless, economic theory and policy regarding subsidies remains largely undeveloped. Indeed, a great deal of damage has been done by the notion that subsidies are the opposite of taxes. This seems to be derived from welfare economics, such that when an externality is encountered, the imaginary benevolent government is called into action to tax or subsidise in such quantities as to nullify the externality. Pareto optimality is thereby restored. Of course, this approach relies on the assumption of Pareto optimal prices in all markets except the one in question and also ignores the all-pervasiveness of externalities. Prest³ suggested cogent reasons why taxes and subsidies are not opposites. First, there is a difference in nature; taxes contain an element of compulsion lacking in subsidies. Nobody is legally forced to accept a subsidy in the same way as being forced to pay a tax. Secondly, it is not very helpful to talk of a negative analogue of all taxes in aggregate. "Thus the mirror image analogy between taxes and subsidies looks rather tarnished when examined closely."⁴

However, the general ban on state aids is not primarily activated by economic welfare concerns

¹ J. Wolf and K. Harper: "Fury over Kinnock bail-out", in: The Guardian, 1 February 1996.

² Ibid.

³ A. R. Prest: How much subsidy?, Institute of Economic Affairs, London 1984, p. 16.

⁴ Ibid.

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about optimal allocation but by the political imperative to render the opening of borders – dismantling classical instruments of protection – acceptable to member states. Only if a member state can be sure that its companies do not have to compete against the (virtually unlimited) resources of other states' governments will it accept integration. The vexatious part of the process for the European Commission is evaluating the distortion of competition against the common interest that the EU as a whole might have in the achievement of the objective pursued by the subsidy. "This is particularly complicated because it normally requires convincing member states to accept the harmful effect on competition for the sake of the overall benefit to all."⁵

It can also be argued that, in any case, subsidies do no good to their recipients, killing them with kindness. "The more trade is influenced by state intervention, be it for special strategic or general protectionist reasons, the poorer is the country's economic performance and welfare. To choose the right target for support produces, on average, disastrous results if it is done by public administration. The main reason is that in this domain, state failure has more severe consequences than market failure."⁶ Subsidization changes behaviour: the audacious entrepreneur is likely to change into a rent-seeking risk-avert. A strategy of subsidies changes industrial management, adversely affecting performance.

Deregulation to Increase Competition

The Airline Deregulation Act of 1978 put an end to subsidies in the USA. The rationale was that competition should increase efficiency and benefit the consumer through lower fares, driving the inefficient out of business. Consequently, no state aid was later granted to Pan Am and Eastern Airlines when they were bankrupt. Internationally, deregulation of air transport has proved more difficult, on account of national territorial sovereignty: "In the field of international aviation policy, states are not normally concerned about the commercial aircraft of other nations flying through their airspace: their primary concern is with aircraft which want to make landings in their territory for the purpose of setting down and picking up commercial traffic. What is normally called

the Right to Fly might be better called the right to land."⁷

In 1919, Air Travel & Transport, the ancestor of BA, inaugurated a commercial service to Le Bourget airport in France. Soon the air fare had been cut by 50 per cent; the French airlines, aided by state subsidies, had begun to compete. This threat to the British airline operations led to intergovernmental negotiations about how to share the route between the flag carriers of both countries. The resulting bilateral agreement became a model for regulation of companies, fares and capacity. Consequently, there developed what the British Civil Aviation Authority later called the enshrined culture of collusion between carriers. Even today, after more than a decade of discussions about liberalization in Europe and the advent of the single market, the overwhelming majority of European routes are monopolies or duopolies.

Deregulation of airlines in the single market of the European Union would mean the abolition of bilateral agreements between countries on landing rights and the creation of a domestic market similar to that of the USA. On the inauguration of the single market, the EU's third package of air travel deregulation measures came into effect. Most importantly, European Union member airlines were permitted to fly "consecutive cabotage", so that any EU airline serving a foreign destination gained the right to pick up traffic there and to carry it to a second destination in that country. For example, BA flying from London to Frankfurt could pick up traffic in Frankfurt and carry it to Berlin. However, this was restricted to fifty per cent of overall seasonal capacity until 1997. Full cabotage, or the right of any airline to fly freely inside another EU country was also delayed until April 1997, France being the main procrastinator.

Vested Interests

In February 1994, a European Commission-sponsored report from a research group, known as the "wise men", advocated further liberalization of airlines in the European Union. The biggest barrier to air transport liberalization in Europe is the crazy idea that every member state has to have its own airline. According to Dan White, an airline analyst with NatWest Securities in 1994, "deregulation in Europe would be a pretty ferocious affair – plenty of blood would be spilt. But this (the Commission's report) does not mean open skies in Europe; nor is it likely to,

⁵ R. Walther: Comment, in: J. H. J. Bourgeois (ed): *Subsidies in International Trade: A European Lawyer's perspective*, Deventer 1991, p. 17-18.

⁶ Ibid.

⁷ S. Wheatcroft: *Air Transport Policy*, London 1964, p. 68

because the vested interests working against that are simply too strong.”⁸

Government control may be blamed as a substantial barrier to deregulation. The vast majority of EU carriers are still largely nationalized or government-controlled. Among the exceptions are Swissair, with a minority 20 per cent government stake, the partially privatized Lufthansa and KLM, and the completely privatized BA. Most of the others are financially supported by their national governments. So, although the 1994 Commission-sponsored report supported privatization and an end to government subsidy, Europe's state-owned airlines play a similar role to flags, languages and national anthems for individual countries. The main explanation for the inability of successive Transport Commissioners to stop state aid to airlines can only be national prestige and national sovereignty.

Guidelines for State Aid

Control of state aid is particularly sensitive because the application of Articles 92 and 93 apparently restricts the member states' room for manoeuvre in economic policy. This applies particularly to aid granted to public undertakings. As already stated, control is even more important in a single market. Consequently, during the 1980s, the Commission tried to develop general principles for assessing certain categories of aid, the purpose being to ensure consistency and legal certainty. “The aim is to make the control of state aid clearer, more transparent and more predictable.”⁹

However, the achievement has fallen well short of this and problems in the airline industry are a principal reason. As Depayre and Pettriccione¹⁰ have remarked, there is still no agreed definition of what is a subsidy, as opposed to general governmental measures. The main problem is how to construct an intellectually logical and practical standard. The Treaty of Rome did not include detailed criteria on state aid beyond the declaration of Article 92 (1) that any state aid that distorts competition by favouring certain undertakings insofar as it affects trade between member states, be incompatible with the common market, “save as otherwise provided”.

⁸ L. Buckingham: An Air of Absurdity, in: The Guardian, 5 February 1994.

⁹ C. D. Ehlermann: The Contribution of EC Competition Policy to the Single Market, in: Common Market Law Review, 29, p. 257.

¹⁰ G. Depayre and R. Pettriccione: Definition of Subsidy, in: J. H. J. Bourgeois (ed.), op cit.

It is generally accepted that government equity participation is not a subsidy *per se*. However, there is clearly a contradiction here for the airline industry, given that the Commission report on aviation of 1994 maintained that state control appears to be an obstacle to further liberalization. Commission guidelines indicate that one criterion is where fresh capital has been contributed by the government in circumstances that would not be acceptable to a private investor operating under normal market economy conditions, then in principle such aid is incompatible with the single market and Commission approval must be obtained before such funding may be legally effected. However, guidelines also identify cases for which there is a presumption that the contribution constitutes permissible state aid. “This is, for example, the case where the recipient of the funds belongs to an industry experiencing particular structural difficulties, especially over-capacity”.¹¹ There is over-capacity in the European airline industry but, by contrast with excess capacity in some manufacturing industries, such as steel, it is not evidently the case that state aid to airlines will assist in reduction of capacity. Furthermore, although the European Court of Justice has confirmed the validity of the “private investor's test”, some precedents in the court's rulings seem to suggest that the financial intervention of a government can benefit from a derogation from the prohibition in Article 92 (1) if it is accompanied by an appropriate restructuring plan.

Examples of State Aid to Airlines

Iberia: The case of Iberia threatens the credibility of Commission criteria because in an attempt to exert some control, the Commission had announced a “one last time” policy for decisions on approval of state aid. The Iberia case is obviously controversial because the airline had already been allowed state aid in 1992. So, even before Iberia was granted approval for a further 87 billion pesetas (£ 460 million) of state aid, it was reported that if it was allowed the second amount, the entire state aid policy would lose credibility.¹²

A considerable proportion of Iberia's previous state aid (120 billion pesetas; £ 590 million) was used to finance an ambitious expansion programme in Central and South America. In January 1996, however, the Commission decided that the latest capital injection

¹¹ A. Pappalardo: Public Undertakings – Equity Infusions, in: J. H. J. Bourgeois (ed.), op cit.

¹² J. Walters: Kinnock flies into Spanish Inquisition, in: The Observer, 8 January 1995.

should not be treated as a state subsidy but as an investment by a public shareholder that could be justified on commercial grounds. The conditions attached to Commission approval of further state aid mainly required reversal of the expansion by the sale of holdings in Aerlineas Argentinas, Ladeco of Chile and Viasa of Venezuela.

Aer Lingus: The precedent for conditions to be attached by the Commission to approval of state aid was set in the case of Aer Lingus. In common with other loss-making airlines, part of its difficulties resulted from expanding its fleet during the 1980s, just before demand for air travel and freight declined at the time of the Gulf War and recessions in the USA and European economies. In addition, however, Aer Lingus had also been used as a vehicle for regional development policy, including the obligation for all transatlantic flights to make a stopover at Shannon and by operating unprofitable domestic routes. The restructuring plan required direct scheduled flights between Dublin and the USA, 1,500 redundancies and the sale of subsidiaries, including the 14 hotels that form the Copthorne chain in Britain.

Air France: In the case of the Air France state aid approval of 1994, the principle was extended. Some 20 conditions were set for approval of the state's capital injection of FFr. 20 billion (£ 2.4 billion). The main condition was an end to all restrictions on the use of Orly airport by non-French carriers, as had been demanded by BA. Put together with its takeover

of Dan Air and its 44 per cent stake in TAT (which Air France had been required to divest by Sir Leon Brittan when he was Competition Commissioner in order to gain approval for its takeover of Air Inter), this gave BA a key strategic position on routes to southern Europe. Secondly, none of the state aid was to be used for Air Inter – although this might be difficult to enforce. Air France routes were to be frozen in their present pattern and there was to be no increase in its fleet. The company, now called Groupe Air France, had to sell its holding in the Meridien hotel chain and the Commission was to be consulted before the second and third tranches of aid.

Olympic: In its case for approval of state aid to Olympic, the Greek government persuaded the European Commission that New York and Sydney flights should be maintained under the airline's restructuring plan, even though losses incurred on long haul routes to the USA and Australia were equivalent to some two thirds of overall operating losses. These routes are mainly used by migrant Greeks and in balance of payments calculations their losses are far outweighed by migrants' remittances and shipping income that contribute two thirds of total Greek export earnings. Even though Olympic's record on punctuality and passenger service is rated the poorest among EU airlines, Greek customers show a surprising loyalty to their national carrier. In addition, Olympic fulfills an important social function, being obliged to operate domestic flights to the Greek

Helen Winter

Interdependenzen zwischen Industriepolitik und Handelspolitik der Europäischen Gemeinschaft

It is worth analyzing the various and often subtle connections between industrial policy and trade policy, because these policies are becoming more important and they are used as substitutes or as complements to one another. After defining both policies and their relationships, the study examines the industrial and trade policy of the EC as a whole.

The key targets of industrial policy are to prevent or promote structural change and to improve international competitiveness. The various instruments of European industrial policy are designed to deal with international problems, but they also influence the trade relationships between other countries.

In addition to that, the EC uses trade policy instruments as some kind of industrial policy, or to protect industrial policy. This is sometimes cheaper as subsidies. But in some cases industrial policy substitutes trade policy because the application of traditional trade policy instruments is restricted by international agreements.

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islands all the year round, although some winter flights may be half-empty. The government argues that a regular air service is important for the survival of small island communities.

Sabena: Sabena has been in financial difficulties for many years. Air France – despite, or even because of – its own difficulties, took a stake in it in 1990. Swissair bought a 49.5 per cent stake in 1995. In February 1996, Pierre Godfroid, the chief executive, resigned after months of industrial strife. He was criticised for terminating all union agreements in October, after he had failed to persuade 9,500 employees to accept a pay freeze over the next three years, together with a 5 per cent increase in working hours and more flexible work practices. Strikes followed during the Christmas period and since the start of 1996. Swissair warned the unions that their actions would lead to further cost-saving measures and job losses, saying that the worsening image of Sabena was beginning to reflect on the whole group, including Swissair.

The Role of Unions in the State-owned Airlines

Union strength appears to be a common factor that cannot be overlooked. Apart from Sabena, union opposition has hindered or defeated restructuring plans at Air France, Iberia and Aer Lingus. Even the supporter of unions may be forced to admit that the perceived large national market share may have encouraged the monopolistic aspects and rent-seeking behaviour of unions. Despite management's plea that the time had passed "when the solution to problems of Air France could be found elsewhere than at Air France",¹³ in calling a strike in November 1992, the unions appealed to the state shareholder to redress irreconcilable differences arising from planned job and pay cuts. The company was forced to take a tougher line but the unions fought back in 1994, paralysing the airports and leading to government appeasement. Consequently, Attali resigned as chief executive and a more gradual restructuring plan was accepted by ballot of the workforce after the unions failed to agree. Iberia has also faced union opposition to restructuring. New smaller airlines have been set up to undercut Iberia but if all Iberia staff strike, there are no ground staff and nobody flies in or out of Spain. In general, however, although publicly-owned national

airlines at one time enjoyed a near-monopoly of service, it has become somewhat easier for consumers to find alternative supplies during industrial disputes. Unions are slow in adjusting to more contestable markets and still capable of considerable disruption in some countries.

The Pros and Cons of Airline Subsidies

As with the decision to approve the additional Iberia state aid, the British government had affected outrage at the approval of aid to Air France and applied with BA to the European Court of Justice to annul it: "This decision cannot be allowed to stand unchallenged. Allowing such a large amount of subsidy to one of the three largest airlines in Europe will distort competition. It will also jeopardize the benefits of the single market that we have worked so hard to create."¹⁴ The chairman of BA similarly complained that Air France was again being protected from the force of competition and "Air Inter, its subsidiary, which dominates the French domestic market, is not subject to any conditions at all".¹⁵

This is not strictly true, as one of the Commission's conditions for the approval of Air France state aid was that none of it could be used for Air Inter. In addition, the Commission's approval of BA's 49 per cent stake in TAT, its takeover of Dan Air and the end to all restrictions on the use of Orly airport by the French carriers had put BA back into Orly after 20 years of exclusion. That BA's shareholding in TAT has yet to pay off can hardly be blamed on the Commission. Under really restrictive national sovereignty, BA would not have such a holding in TAT.

There are some contradictions in the argument that subsidies distort competition. Kevin Murphy, airline analyst at Morgan Stanley in New York, commenting on the Air France state aid, suggested that FFfr. 20 billion was "enough money to create a new airline from scratch" but "that kind of subsidy will only perpetuate the inefficiencies that already exist at Air France".¹⁶ Similarly, Andrew Barker, airline analyst at S. G. Warburg, reckoned that "Iberia would actually be a less effective competitor if it received a subsidy because it would then take a softer attitude towards improving efficiency".¹⁷ If these views are correct, then

¹³ M. Laroniche: La Grève Générale à Air France coutera 50 millions de francs, in: *Le Monde*, 23 November 1992.

¹⁴ R. Smithers: UK takes AF decision to Court, in: *The Guardian*, 30 July 1994.

¹⁵ J. Wolf and R. Smithers: BA fumes at AF ruling, in: *The Guardian*, 28 July 1994.

¹⁶ E. Tucker: "Flying the flag crowds airways", in: *Financial Times*, 25 July 1994.

¹⁷ J. Walters, *op cit*.

BA and British government claims are not. As Barker added, a decision by Kinnock in favour of Iberia may not be disastrous for the industry as a whole.

Aviation legal specialist Henri Wassenbergh, who retired as advisor on international relations to KLM in 1990, described liberalization of airline markets as a myth and deregulation as a mistake. The globalization of air transport is clearly hindered by the bilateral air serve agreements regime based on the nationality of airlines designated to use traffic rights. Hence, "under the prevailing bilateral system the only way to introduce an international airline is to create a new nationality out of different nationalities of the merging airlines as was done for SAS".¹⁸ The European Commission's commitment to "open skies" by this route is far from total. As Transport Commissioner, Neil Kinnock ruled out any further independent agreements by EU airlines with airlines from outside the EU, such as the one negotiated between KLM and Northwest Airlines of the USA.

Wassenbergh believed that deregulation in the USA's internal economy would have happened anyway under market pressure but in a more orderly fashion. Instability seemed to result with only short term gains on pricing. For instance, People Express cut prices but went too far on administrative savings, leading to customer dissatisfaction and the demise of the company. Southwest Airlines has been successful by cutting prices but is rather exceptional. Several recent analyses of airline ticket prices in the USA conclude that airline deregulation did not make city-pair markets perfectly contestable, while some studies conclude that potential competition at origin and destination airports does not promote much price competition.¹⁹

How much less likely then, is deregulation to substantially increase price competition in the European Union, still composed of sovereign nations, notwithstanding the single market? While it is true that global competition has intensified, Europe's system of awarding take-off and landing slots at its airports (which is a practical necessity to ensure that the skies

do not become dangerously congested) operates against new entrants and in favour of the national carriers. At present only half of the possible slots are set aside for new competition.

Experts have been predicting the demise of some of the national carriers for years but with questions of national security affecting some governments' resolve to maintain their home-based airlines, the dilemmas facing the Transport Commissioner seem set to continue at least until April 1997 – the date to which full cabotage, or the right of any EU airline to fly freely within another EU country, was delayed in the EU's third package of airline deregulation measures.

If and when the EU single market is considered as a cabotage zone, this "might necessitate a revision of the Chicago Convention" on international civil aviation.²⁰ It has been argued that the competence of EU states in conceding landing rights are concessionary powers subject to the Convention. "As far as the EU Commission is concerned, there is no conflict between the Treaty of Rome and the Chicago Convention because the Convention does not prevent states from exercising their sovereignty jointly through international agreements, should they wish to do so".²¹ However, the problem arises in "interpreting Article 7 of the Chicago Convention, banning cabotage on an exclusive basis (and) there are also difficult questions of the extraterritorial jurisdiction of EU regulations which might be detrimental to outside carriers".²²

It may be true that "undoubtedly, the Commission's policy of state aid control is nowadays a rule-based system".²³ However, officials have to consider whether an uncompromising crack-down on subsidies would lead to a backlash – with the EU being blamed for bankruptcies and job losses. Subsidies may be sanctioned as long as they are in the EU's common interest – which the Commission has the discretion to decide. It has a juridical-political judgement to make, not an exercise in the economic theory of contestable markets. If we define the field of competition more widely, the British government which has been arguing against subsidies for European airlines is placed in a contradictory position by its proposed huge direct grant of £ 1.4 billion to the Channel link rail company that is in direct competition with the airlines' services from London to Paris and Brussels. As ever, economics is inseparable from politics.

¹⁸ H. A. Wassenbergh: *The Turn of the Tide? 1978-1993*, in: *ITA Magazine*, No. 49, May-June 1988.

¹⁹ D. R. Graham, D. P. Kaplan and D. S. Sibley: *Efficiency and Competition in the Airline Industry*, in: *Bell Journal of Economics*, 14, 1983, p. 118.

²⁰ E. Sochor: *The Politics of International Aviation*, London 1991, p.190.

²¹ *Ibid.* p. 193.

²² *Ibid.* p. 195.

²³ F. Rawlinson: "The Role of Policy Frameworks, Codes and Guidelines in the control of State Aid", in: L. Harden (ed.): *State Aid: Community Law and Policy*, Cologne 1993, p. 53.