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The Airbus-Boeing Dispute: Not for the WTO to Solve

The Subsidies Conflict Opens up New Opportunities for Transatlantic Relations

Jens van Scherpenberg / Nicolas Hausséguy

The Paris Air Show of June 2005, as in previous years, served as the stage for the intense competition between Airbus und Boeing. And given the volume and importance of the market for large civil aircraft, which they share, the two duopolists' increasingly sharp rivalry gets a lot of political attention. The conflict between the United States and the European Union about subsidies for new aircraft, simmering for many years already, was submitted to the World Trade Organization again in May 2005. The WTO, however, is not well-suited to solve this case. It is a purely bilateral dispute in which there is no clear division of the plaintiff's and the defendant's roles between the two sides. Moreover, the WTO dispute-settlement body will be unable to address the main background issue of the conflict—the highly problematic transatlantic defense-industrial relations. Yet the conflict does not necessarily have to lead to a deepening of the trade and security policy rivalry between the European Union and the United States. It could also open up a window of opportunity for both sides to better integrate their mutual defense-procurement markets—thus providing the Atlantic alliance with a much-needed impetus at a critical time.

The biennial Paris Air Show, at the airport of Le Bourget, the aircraft industry's biggest international event, again attracted wide public attention with carefully orchestrated press releases about new orders with which the American Boeing Corp. and the European Airbus SAS have been trying to outdo each other. Airbus demonstrated its huge A380, currently in flight tests, which has eclipsed Boeing's last monopoly with aircraft carrying more than 400 passenger seats. Boeing, on the other hand, boasted

the large number of early orders for its all-new B787 "Dreamliner" which is to tap the market for long-distance aircraft in the 250-seat segment. Against Boeing's success with the B787, Airbus offered its new A350 to compete for the same market segment. At the end, taking in 319 orders and options at a list price of \$35.9 billion compared to Boeing's 146 orders (at \$15.2 billion), Airbus could claim victory in the tournament of Le Bourget.

Of course, declarations of intention or

buy options aren't yet calculable revenues. To Boeing's distress, during the Le Bourget Air Show, Air Canada had to take advantage of a special repeal clause in canceling a high profile order for fourteen B787s and eighteen B777s (with options for another eighteen B777s and forty-six B787s) which it had placed only weeks ago. A similar fate could always happen to Airbus, too. However, as things stand, it seems likely that Airbus will succeed in overtaking Boeing on orders in 2005 for the fifth year in a row.

Not a Market like Any Other

To the open-minded observer, the commercial rivalry between the two corporations on the market for large civil aircraft may look like the perfect example of competition at work. Both firms compete on price, on quality and technical features, on ease of use and servicing, on production technology and new materials employed, and on energy efficiency. In this competition, Airbus for many years has been the more innovative producer, which is why it took substantial market share from Boeing. In the meantime, differing air-transport concepts have emerged as a new parameter of competition. Airbus is aiming at increased demand in "hub-to-hub" traffic which its huge A380 will be able to handle more efficiently. Boeing, on the other hand, with its new B787 expects to serve a growing demand for long-distance "point-to-point" connections between airports below the level of the big hubs.

Anyway, the competition of the two duopolists has resulted in substantial improvements: in noise levels, fuel economy, and costs per passenger mile in general. These have contributed in making air-transport services much more affordable in recent years, thus greatly increasing capacities to meet growing demand.

The lively and fruitful competition between the market leaders cannot mask, however, the highly politicized nature of the market in which they operate. The very entry of Airbus in 1974 into a market that

was dominated at the time by three American companies—Boeing, McDonnell Douglas, and Lockheed—was the result of a political decision by the countries involved: first, France and Germany, to be followed by Spain and the United Kingdom. The latter's British Aerospace (today BAE System) didn't join the Airbus consortium until 1979. With development costs rising ever faster, the single European (French and British) firms simply could no longer afford the costs of staying in the market for large civil aircraft, even less so the entry costs to the market segment for wide-body aircraft, which Boeing had created by launching the B747 in 1968. Nevertheless, for strategic and industrial policy reasons, European countries were not willing to leave the market to American producers alone.

To fully establish Airbus in the market next to a competitor as superior as Boeing in production costs and marketing power required tremendous costs. These were met to a considerable degree by state subsidies from the countries whose aerospace companies were part of the consortium. As a consequence of the aggressive market entry by Airbus, however, a market consolidation took place in the United States: Lockheed quit the market for large civil aircraft in 1983, McDonnell Douglas was taken over by Boeing in 1997. The transatlantic duopoly emerged—for Americans due to competition-distorting European state subsidies; for Europeans due to the lack of innovation of the defeated American competitors.

Subsidies for a Strategic Industry

Economically, the Airbus subsidies—as with all subsidies—can only be justified by the assumption that a European production of large civil aircraft creates substantial positive externalities, creating economic value beyond their achievable sales price on the market.

No European company would have been able to carry the risk of entry into a market so strongly dominated by American producers. The subsidized market entry of Airbus

into the aircraft market has led to a much more intense competition—to the benefit of airlines and their customers. Therefore, those *start up* subsidies may be justified as a variant of Friedrich List's nineteenth-century concept of "infant industry protection."

The United States did accept this motive when, during the Tokyo Round of the GATT, it pushed for negotiations on a plurilateral Agreement on Trade in Civil Aircraft (ATCA), which was eventually concluded in 1979. In this agreement the Airbus countries agreed to eliminate tariffs on aircraft and aircraft parts as well as technical barriers to trade in these goods. The United States, however, had to concede a rather vague clause against trade-distorting subsidies that was further weakened by allowing for "special factors which apply in the aircraft sector" to be taken into account.

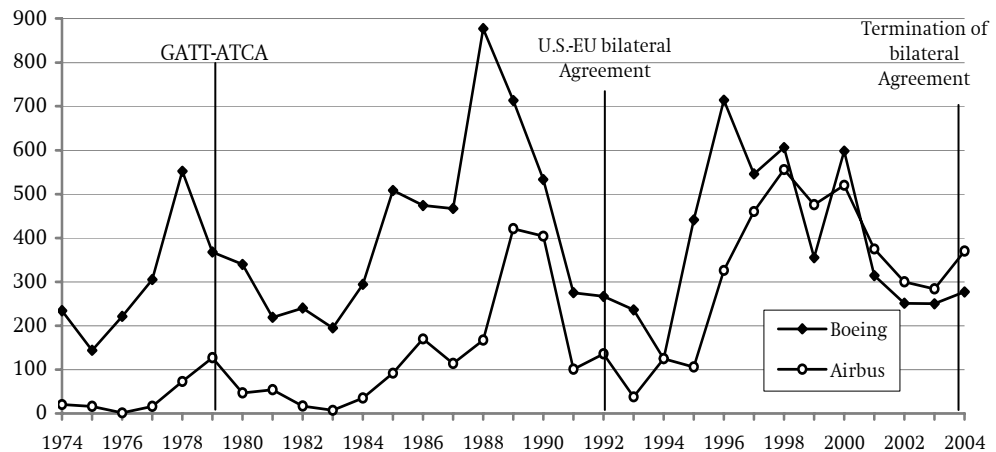
But the *continued existence* of a healthy aircraft industry, too, is of utmost political importance as a report of the US Department of Commerce of March 2005 acknowledges. "A strong aerospace industrial base supports national defense and economic security, technology development, scientific discovery, high-wage manufacturing jobs, export revenue, and national prestige"—any number of reasons, indeed, for ongoing subsidies to such a strategic industry, if its continuing economic existence were at stake. Sure enough, the argument is convincing that given their huge development costs, the fate of the whole company depends on the success of major new models such as the A380 but also the B787. This enormous risk would definitively be reflected in substantially higher costs of financing. Therefore, any subsidies, whether they are handed out as grants, tax benefits, or public loans, reduce total costs below the level that would be effective at pure, undistorted market conditions. Moreover, if one competing party is subsidized, the additional argument applies to the other party that it needs countervailing subsidies.

Thus, the successful market entry of Airbus was discussed early on as a prime example of strategic trade and industrial policy, as such becoming a contentious issue in transatlantic relations. The dispute and the various compromises achieved over the years correlate clearly with the relation of Boeing's (and McDonnell-Douglas's) yearly orders to those of Airbus (see graph on p. 4).

The year in which the GATT Agreement on Trade in Civil Aircraft (ATCA) was concluded, 1979, marked the beginning of a firm establishment of Airbus in the market; for the first time, the European manufacturer registered more than 100 orders in one year. After a deep crisis in the world aircraft market in 1980–81 in the wake of the second oil crisis, in 1989 the aircraft industry enjoyed a new upturn in which Airbus participated more than proportionally. The consortium took orders for more than 400 aircraft (not least thanks to the launching of its smaller A320 family of planes) and achieved a global market share of 30 percent—below which Airbus hasn't dropped since. Following this success, in 1992 the United States and the European Union concluded the bilateral agreement on trade in large civil aircraft. The agreement bans any state subsidies for production and marketing. It does allow, however, for launch aid by refundable loans up to a maximum level of 33 percent of development costs to develop new models. Moreover, for aircraft manufacturers, indirect subsidies through public funding of general research were to be capped at 3 percent of all revenues that are subject to the agreement.

Nevertheless, throughout the 1990s the aircraft market continued to be subject to political influence on procurement decisions of other countries. Boeing, on the one hand, could rely on the indirect trade-security linkage effective in countries with strong security policy reliance on the United States, such as Japan. Not least out of burden-sharing considerations, such countries would prefer the American

Aircraft orders for Airbus and Boeing (including MacDonnell-Douglas) 1974–2004



Source: Author's compilation based on data from Airbus SAS and Boeing Corp.

Boeing Corp. for their procurement of civil aircraft. Airbus, on the other hand, has benefited from the desire among other countries to follow a policy of dual sourcing of their civil aircraft to ensure their national economic security and political autonomy.

Since Airbus for the first time overtook Boeing on annual orders in 1999, the United States has been urging the European Union to renegotiate the 1992 bilateral agreement. Airbus has left behind the market leader Boeing on orders since 2001 and on annual deliveries since 2003. Since then, the commercial rivalry between the two companies has become considerably more heated. With the new A380, Airbus has challenged its US competitor's monopoly—and hence monopoly profit margins—that Boeing hitherto had enjoyed with the B747 in this top market segment. The intention of Airbus—to seek public development loans again for its new A350 model which has been designed to compete with the Boeing 787 “Dreamliner”—has further increased the commercial risk for Boeing. The American company has suffered a costly and time-consuming misinvestment with its “Sonic Cruiser” project—for a plane to fly at nearly the speed-of-sound—which was aborted in 2002. A large sales volume

of the B787 therefore is an essential requirement for the company.

The WTO—a Secondary Theater

In early October 2004, the US government terminated the bilateral agreement of 1992 and filed a WTO dispute-settlement case against the European Union. The United States bases its case on the GATT Agreement on Subsidies and Countervailing Measures (SCM) that was concluded in 1994 as part of the Uruguay Round agreements. The agreement provides for comprehensive definitions of prohibited and actionable subsidies that cause material damage to another contracting party. The United States is counting on the Airbus subsidies being ruled as incompatible with the SCM Agreement by the WTO dispute-settlement body.

During negotiations on the SCM Agreement, the United States had declined to renegotiate the ATCA Agreement of 1979. The US government could indeed count on the strengthened WTO dispute-settlement mechanism to deliver an enforceable ruling in its favor. Dispute-settlement rulings under the old GATT procedures had required the approval of the defending party.

Moreover, an ongoing WTO dispute-settlement procedure could be expected to

introduce an element of uncertainty into the European competitor's commercial calculations even before a final ruling on the case, which is due within eighteen months at the earliest.

However, even if, as is probable, the United States would prevail as a plaintiff in the WTO, this is unlikely to end the conflict. The European Union has filed a corresponding case against the United States because of subsidies granted to Boeing and can expect to prevail, too, with its case. Not only has Boeing been the main beneficiary among American exporters of tax benefits provided by the "Foreign Sales Corporations" legislation that has been ruled by the WTO to be in violation of GATT agreements. The company has also received a tax benefit of more than \$4 billion for the B787 project from the state of Washington, which hosts Boeing's main production sites.

Should both sides prevail in their respective WTO cases, both could be authorized to retaliate against the other—an obviously impractical result. The subsidy dispute between Canada and Brazil—the home countries of the two big manufacturers of medium-sized regional aircraft up to 100 seats, Bombardier and Embraer—is hardly a precedent to be repeated: both nations prevailed but decided to forego their right of retaliation and to continue subsidizing.

The Defense Industrial Dimension

While trade diplomats on both sides publish statements and fact sheets to win public support for their respective positions in the US-European subsidies dispute, one of the core issues behind the conflict could hold the key for a solution to the dispute that would give a strong new impetus to the transatlantic alliance.

To both the European Union and the United States, the civil aircraft industry is undoubtedly a strategic one, for once because of its macroeconomic importance: For the United States, exports of civil aircraft during the last twenty years have amounted to 3.7 percent of total exports of

goods on average. One-half to two-thirds of this figure probably are exports by Boeing. The product "civil aircraft" thus is the single most important item among American exports of manufactured goods.

Above all, every major company in the aerospace industry has a more or less significant defense component—and as such a security policy relevance. There is not only technological spillover between the defense and the civil-aircraft manufacturing divisions of a firm. Both sectors are also benefiting from each other commercially, not least because of the larger joint-revenue base and the greater economies of scale.

EADS (European Aeronautic Defence and Space Company N.V.), which is the biggest shareholder of Airbus SAS with 80 percent of shares as of 2004, still derives 64 percent of its revenue and 79 percent of its profits (EBIT) from civil-aircraft manufacturing through Airbus. At Boeing, the Commercial Aircraft division in 2004 generated only 40 percent of revenues and a quarter of earnings before interest and taxes (EBIT).

The figures for defense-related revenues of the two competitors, which the United States filed with the WTO—Boeing: \$23.7 billion; EADS and BAE Systems, the Airbus parent companies: \$23.8 billion—therefore give a rather biased picture. The lion's share of the latter amount—\$16 billion—is the defense revenues of BAE Systems, which holds only 20 percent of the Airbus capital.

Nevertheless, at Airbus and its parent companies, the defense share of revenues should increase in the future. With the order for the European military transport aircraft A400M, Airbus SAS itself will get a strong military revenue component. Moreover, EADS has developed a technically and economically highly competitive concept for a refueling aircraft, based on the Airbus A330-200. This concept has had its first marketing success already with an order from Australia. And through the "Air-Tanker" joint-venture, EADS was awarded the status of "preferred bidder" for the pending British procurement of a "Future Strategic Tanker Aircraft."

The defense share of total revenues therefore is expected to grow on the European side, too, thus strengthening also the technological and commercial base of civil-aircraft production.

An Opportunity for the Atlantic Defense Market?

With its refueling aircraft concept, EADS intends to join in the Pentagon's tender procedure for the renewal of the tanker fleet of the US Air Force that is expected to open in fall 2005. Boeing had tried to defend its current monopoly position in this market segment by exercising undue influence on the procurement process at the expense of EADS. This led to canceling and reopening the call for tenders.

As is common in the defense business, EADS is positioning itself for the new bidding to be as American as possible. First, cooperation is envisaged with Northrop Grumman, one of the large systems-integration companies in the American defense industry. Second, to equip the EADS planes—called KC-330 as tankers—with the refueling and other special equipment, a production site will be erected in Alabama. The state is home to the influential Republican senator, Jeff Sessions, member of the Senate Armed Services Committee. Sessions, as well as the committee chairman, John Warner, and Senator John McCain, ranking Republican member in the committee, explicitly support competition in the tanker procurement.

In the House Armed Services Committee whose chairman, Duncan Hunter, is one of the most radical proponents of an uncompromising "Buy American" policy in defense procurement, there are two Republican members from Alabama, Terry Everett and Mike Rogers. However, at the instigation of Duncan Hunter, the very House of Representatives on May 20, 2005, agreed on a law that prohibits any tanker procurement from such foreign-based firms that receive public subsidies for their civil-aircraft production—an undisguised "lex EADS."

It is unlikely that the Senate will agree with this clause. Nevertheless, with a view to the Airbus-Boeing subsidies conflict, the question is whether a possible EADS-Northrop Grumman joint-venture stands any chance to get at least part of the tanker order.

From the American point of view, not only is the better price to be achieved from a competitive bidding process among the arguments in favor of EADS. From the point of view of security of availability, too, "double sourcing" would be favorable. Any technical problems with one model thus would affect only part of the tanker fleet.

Moreover, the growing transatlantic interdependence and integration on the company level in the defense industry demonstrate that any thinking in terms of fortresses has ceased to fit the situation in the Atlantic defense industries. Thus, the British company BAE Systems, a shareholder and industrial partner with Airbus, has also partnered with Boeing as a (defeated) competitor of EADS in the procurement process of air-tankers for the Royal Air Force. BAE Systems is also the most important foreign partner of the American main contractor, Lockheed Martin, in the "Joint Strike Fighter" (JSF) program of the next American combat aircraft.

Thinking beyond the currently emerging constellations in the Atlantic defense industry, the optimal perspective that arises would be a concept that was conceived of in the 1990s by Jacques Gansler, the Undersecretary of Defense for Acquisition, Technology, and Logistics in the second Clinton administration. During his former function as deputy chairman of the Defense Science Board of the Pentagon where he was instrumental in setting the framework conditions for the restructuring of the US defense industry after the end of the Cold War, Gansler was acutely aware of the decreasing intensity of competition in the industry in the wake of its restructuring process. Being unusually open to transatlantic defense industrial cooperation, he

suggested a model of several (at least two) transatlantic consortia of American and European systems-integrating firms that would compete for systems leadership in major defense procurement projects.

There is no evidence that sufficient support would exist today in US government for a procurement policy that was in line with Gansler's model. Signals coming from the Pentagon leadership and from Congress in this regard are not encouraging. For the European side, however, moving in this direction would be beneficial economically as well as politically.

Intra-European Divergences

It is doubtful, though, whether there is sufficient foresight and will among the European actors involved to grasp the opportunity that arises. From EADS, signals were given, on the one hand, that the company would be willing to unilaterally renounce any launch aid for the A350 if this were a condition for being admitted to the American Tanker bidding process.

On the other hand, Airbus has made it clear that the launch-aid loans to which it is entitled would be sought as long as no satisfactory solution could be found to the subsidies dispute with Boeing. An assertive policy of increasing market share in the civil-aircraft market seems to collide at this point with a policy of more firmly establishing EADS on the American defense market. It is probably not by chance that this divergence of corporate strategies corresponds to the French-German leadership dispute at EADS and Airbus. The latter's exponents are, on the one side, Tom Enders, who has been nominated by DaimlerChrysler, the German parent company of EADS, as a co-Chief Executive Officer (CEO) at EADS and who has been responsible for the defense division of EADS, and on the other side, the French co-CEO of EADS, Noël Forgeard, hitherto CEO of Airbus. Both may well be seen as representing different positions in the subsidies dispute. The compromise reached on June 23 regarding the

leadership positions at EADS and Airbus shouldn't be expected to have solved those divergences on corporate strategy.

An equally divisive conflict on corporate strategy seems to be fought out, if less publicly, at BAE Systems by its two top managers, Chairman Dick Olver and CEO Mike Turner. CEO Turner apparently would prefer that BAE Systems relinquish its shareholding in Airbus SAS in order to achieve greater freedom to explore possibilities of a merger with a major American defense-systems company. The importance of the US defense market notwithstanding, Chairman Olver seems to see BAE Systems as a core element of the European defense industrial base. In his view, a corporate strategy reorientation toward the United States at the expense of Europe would be a mistake.

In both cases, it isn't just the respective company's position in the European or transatlantic defense industrial context that matters. At issue is also the position of the countries behind those companies—Germany and France (and Spain) with EADS, the United Kingdom with BAE Systems—toward the European project and toward the Atlantic alliance.

A Conflict Potentially Beneficial to Transatlantic Relations

The Airbus-Boeing subsidies dispute cannot be made to disappear simply by Airbus renouncing unilaterally its launch aid for the A350 and any future new models, even if promised access to the American defense market as a reward. The substantial increase in financing costs that would result from such a foregoing of public launch aid could only be compensated by a very substantial part in the American tanker procurement (which will extend over a period of ten to twenty years)—and Boeing would continue to receive subsidies.

A bilateral US-EU agreement on what constitutes prohibited subsidies and what doesn't, therefore, is still required. The alternative would be leaving the decision to the WTO dispute-settlement body. The

latter, however, cannot deliver anything but a backward-oriented decision on the volume and nature of prohibited subsidies paid out in the past.

In particular, the WTO cannot address or take into account the obvious linkage between the subsidies dispute and the defense market. This has to be left to politics—that is, to the governments of France, Germany, the United Kingdom, and Spain on the one hand, and the US government on the other.

Recently it was the *European side* that missed a chance for sending a positive signal of its interest in stronger transatlantic defense-industrial cooperation when European governments—against the wishes of the Airbus management—decided not to accept the commercially and technically superior offer of engines for the A400M military transport aircraft that was submitted by the Canadian subsidiary of US engine maker Pratt&Whitney.

This time, as to the renewal of the US Air Force tanker fleet, it is primarily for the *American side* to seize the opportunity of pointing the way toward an end to protectionism in defense procurement on both sides of the Atlantic. This should happen by negotiating a transatlantic package deal which links a gradual expiry of subsidies for large civil aircraft with better mutual access to defense markets.

Such a deal, however, should not be left solely to trade diplomats at the offices of the US Trade Representative and the EU Commissioner for Trade. The transatlantic dispute on subsidies for Airbus and Boeing doesn't belong in the same category of trade conflicts as bananas, beef from hormone-fed animals, or export tax benefits. For Europe, to be able to deal with this dispute in an adequate way on the level of foreign and security policy would be crucial at a critical juncture of the European project. As to the United States, how to deal with this dispute and its defense-industrial dimension amounts to a test of whether Europe, when push comes to shove, is being seen and treated as a strategic ally or a rival.

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