EUROPEAN AIRCRAFT SUBSIDIES

A Study of Unfair Trade Practices

Loren Thompson

RESULTS IN BRIEF

The United States historically has been the dominant supplier of commercial transports – airliners – to the global market. As recently as 20 years ago, Boeing and other U.S. companies controlled 85% of the market. But in 1970, a group of European governments established a subsidized competitor to the U.S. industry called Airbus with the goal of claiming a sizable share of global sales. The plan was successful: two of the three U.S. producers exited the market, and the sole survivor, Boeing, no longer claims a majority of new orders or deliveries. Airbus has thus become the dominant player in the global market.

The biggest single factor explaining the rise of Airbus was a type of subsidy called launch aid – low-cost or no-cost loans that enabled the European company to develop a family of airliners much faster than any purely commercial company could have, while also pricing its planes aggressively. Without government launch aid, none of the planes Airbus offers in the market today would ever have been built. The practice of providing billions of dollars in subsidies to each new Airbus model has distorted market forces, putting Boeing at a severe disadvantage in the marketplace. As a result, the United States has lost hundreds of billions of dollars in export earnings since Airbus was established, along with tens of thousands of jobs in the aerospace sector.

In 2009, the World Trade Organization decided that the launch aid provided to Airbus is largely prohibited under prevailing trade rules, and found that a range of other government subsidies the European company receives are at least "actionable" in the sense that they caused damage to Boeing and the United States. European governments have brought their own case to the WTO alleging that Boeing received unfair subsidies, but that case does not contend the U.S. company received launch aid. In fact, both companies have received other types of aid over the years, but some of that aid is permissible under trade rules and none of it has the impact of launch aid.

If the United States fails to put an end to the European practice of subsidizing Airbus planes, it will continue to lose market share in the commercial transport business, just as it has in steel, electronics and other sectors where it was once a dominant global player. With the United States currently running a trade deficit of over a billion dollars per day in manufactured goods, European aircraft subsidies have become a test case for the future of free trade and America's global competitiveness. The issue is likely to influence how the U.S. military goes about buying a future aerial refueling tanker, since one of the planes that has been offered is based upon the heavily subsidized Airbus A330.

TABLE OF CONTENTS

INTRODUCTION: EUROPEAN AIRCRAFT SUBSIDIES HAVE HARMED AMERICA

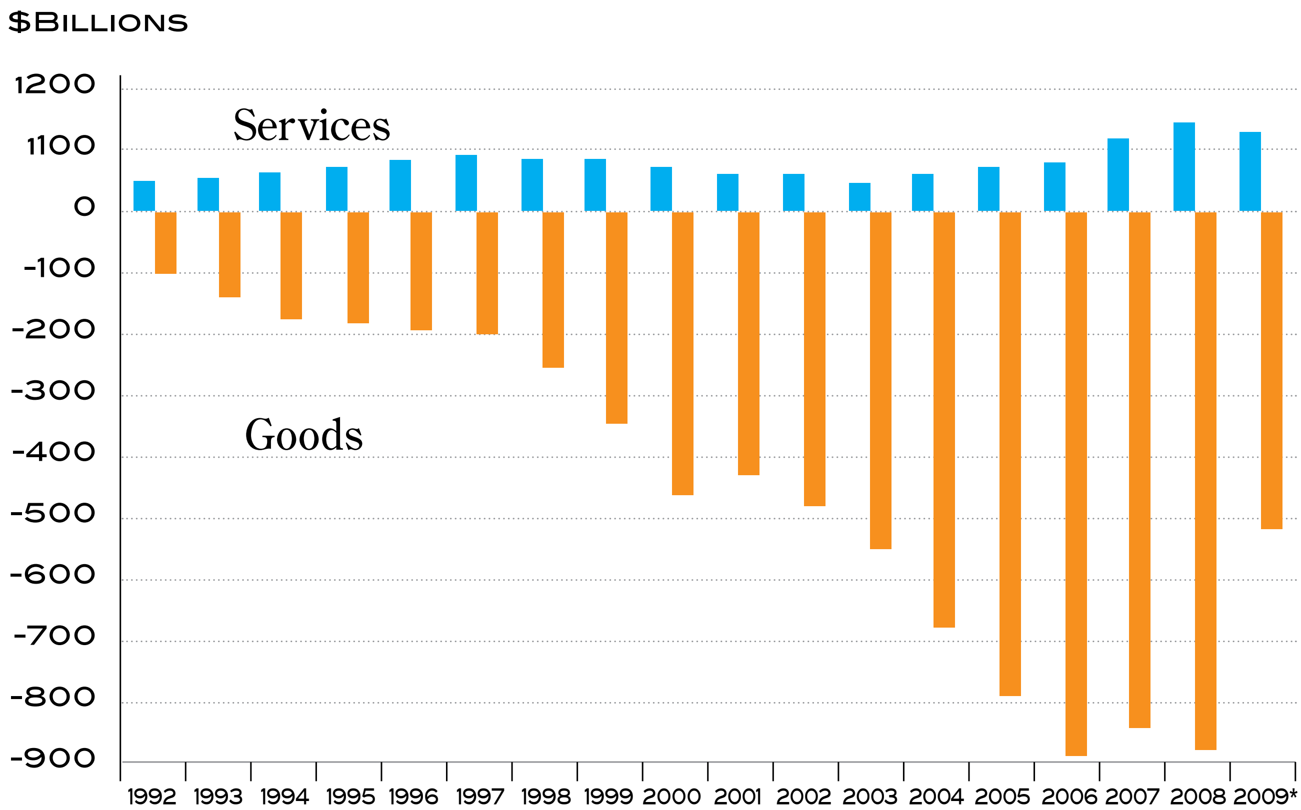
The global market for commercial transports – airliners – is expected to generate over $3 trillion in sales during the next two decades. The United States historically has been the leading supplier to that market. Its sole surviving producer of commercial transports, the Boeing Company, today remains one of the nation's biggest exporters. But Boeing's role in the commercial aviation business is being eroded by Airbus, a company that European governments established 40 years ago with the goal of winning a sizable share of the airliner market.

That goal has been achieved. Since 2000, Europe has become the dominant supplier of airliners to the global market. However, the remarkable rise of Airbus has been achieved largely through the use of subsidies from European governments – some of which the World Trade Organization has now ruled are illegal. The cumulative value of these subsidies over the 40 years that Airbus has existed approaches $200 billion in today's dollars. The subsidies have enabled Airbus to develop a fleet of transports that can compete aggressively in every market niche, without having to assume the risks that a commercial company like Boeing must carry.

This report is about how European governments implemented a multi-decade campaign to undermine America's role in the global aviation market. It begins by explaining the logic of free trade, and why commercial aircraft exports are important to America's future place in the world economy. It then describes how European governments fashioned a framework of subsidies for gradually dominating the airliner market by providing Airbus with benefits not available to its competitors – most notably through the use of low-cost (or no-cost) loans to fund the launch of new planes. The report goes on to detail complaints by the U.S. government that led the World Trade Organization to rule launch aid is unacceptable, and it dissects the largely erroneous claims of European governments that Boeing too receives unfair assistance.

The report concludes that Washington must act to end Europe's use of illegal aircraft subsidies. If it fails to do so, America will lose its ability to compete in the commercial transport sector in much the same way that it has already retreated in steel, autos, and electronics. At its inception, Airbus seemed a remote threat to America's dominance of the global airliner market, and as recently as 20 years ago it claimed only 15% of that market. But today it receives most of the orders for new planes, and as a result tens of thousands of U.S. jobs have been lost – along with hundreds of billions of dollars in export earnings. Had this occurred as a result of normal market forces, then policymakers would have to accept the verdict of the marketplace. But because it resulted from the deliberate use of improper subsidies, it is a case study in unfair trade practices that must be remedied.

U.S. Balance of Trade: 1992-2009



Source: U.S. Census Bureau, Foreign Trade Division, seasonally adjusted data.
*Data for December 2009 assumed to be average of prior 3 months.

The United States trade deficit has risen to unprecedented levels since the Cold War ended, weakening the dollar and raising doubts about its future as a global reserve currency. The imbalance is caused partly by policies of foreign governments that interfere with the functioning of market forces, such as European aircraft subsidies and China's efforts to depress the value of its currency.

FREE TRADE EMERGED AS NATIONS GRASPED THE BENEFITS OF FAIRNESS

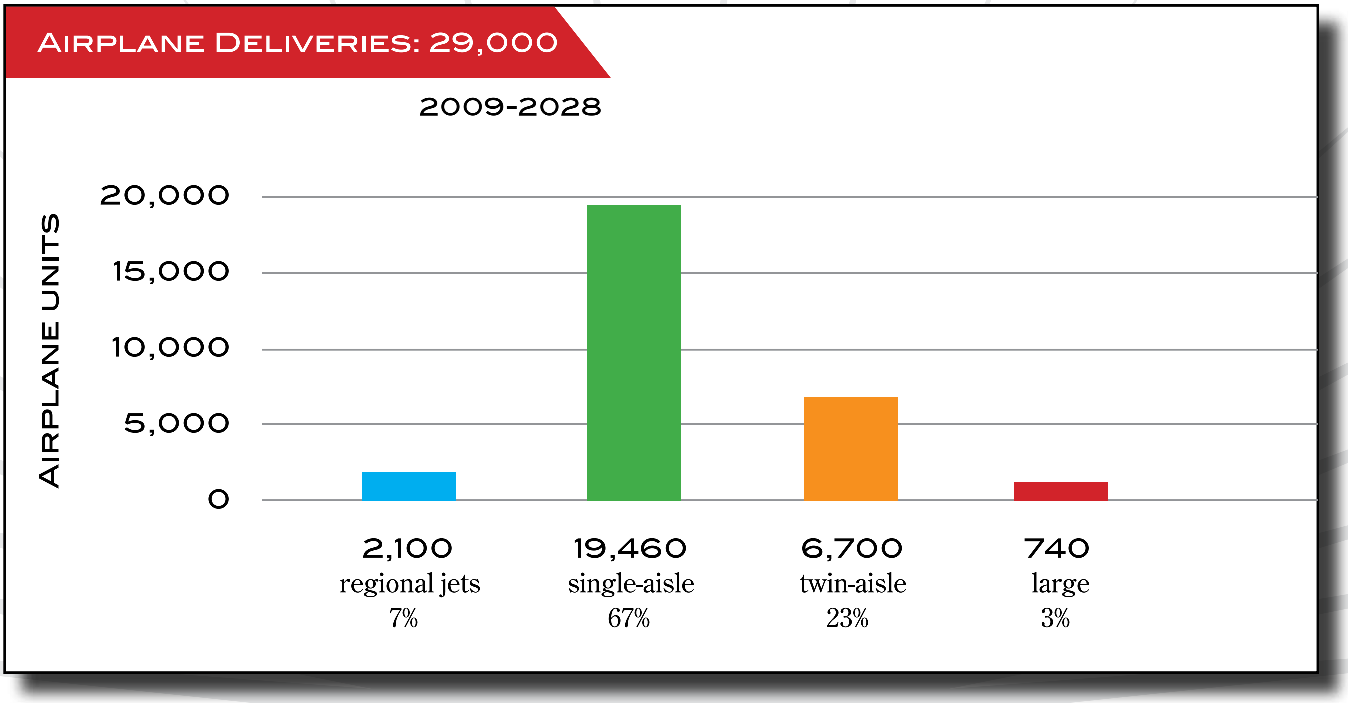
Trade is the exchange of goods and services across national borders – in other words, between nations. It is such a commonplace human activity that its advent predated the invention of money. By trading, ancient civilizations were able to obtain items not available within their own borders, and specialize in activities where they could be most productive. Thus, expansion of trade has been closely associated with improvements in the human condition, and the rise of great empires in the Mediterranean, Far East and elsewhere depended heavily on the emergence of regional trading systems. However, it was not until relatively recently that nations understood how they could organize their trade relations to produce the most stable, rewarding results.

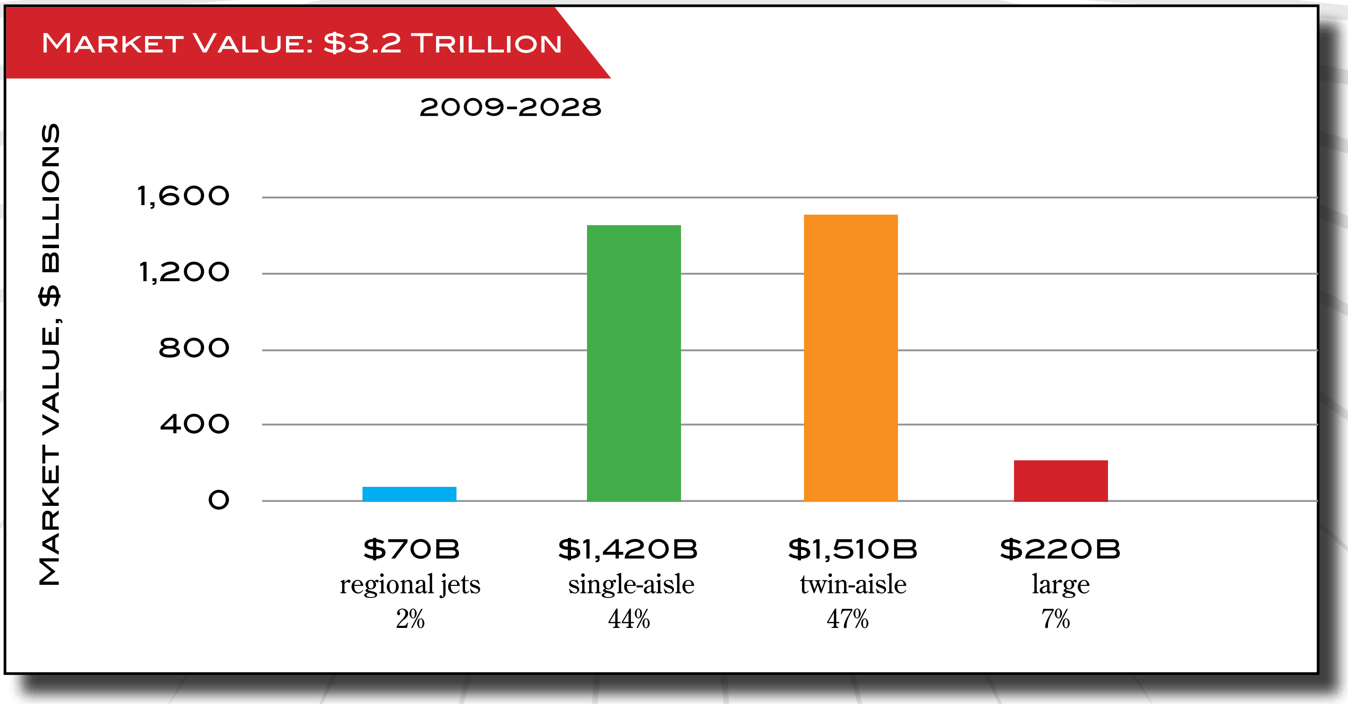
Free trade is the conduct of economic relations among nations without government interference. Interference can take many forms such as taxes, tariffs, subsidies and quotas, but what all such interventions have in common is that they impede the unfettered pursuit of commerce. In modern economic parlance, they distort market forces and diminish the potential for generating optimum results from trade relations. The analytic case for free trade was first developed during the Enlightenment by philosophers such as Adam Smith and David Ricardo. Smith argued that the "invisible hand" of self interest would spontaneously regulate markets in the absence of monopolies or government interference, while Ricardo contended that nations could achieve comparative advantage by specializing in the goods they produced most skillfully or efficiently.

These arguments gained a broad following in Europe during the 19th Century, and the resulting reduction in trade barriers made it a period of unprecedented growth. While many countries (including the United States) continued to pursue unilateral advantage by taxing imports and subsidizing exports, the cause of free trade became firmly rooted among economists. Protectionist measures taken by the U.S. and other countries during the Great Depression were widely seen as contributing to the slide toward war in the 1930s. Once the Second World War ended, the United States became a proponent of trade liberalization. In 1948, America and 22 other countries fashioned a General Agreement on Tariffs and Trade (GATT) to promote freer exchange of goods and services. After six rounds of tariff-reducing measures, the GATT system was replaced by the new World Trade Organization in 1995.

Today, the entire structure of global economic relations depends on sustaining an open trading system. The key features of that system are open access to markets; an absence of tariffs, subsidies and other trade-distorting policies; and free flow of private capital, labor and information across national borders. Although trade barriers still exist, the main thrust of economic diplomacy over the last three generations has been aimed at reducing government interference with the free interplay of market forces. Countries that seek unilateral advantage by adopting unfair trading practices or treating trade partners differently than they themselves would wish to be treated risk unraveling the political consensus that has made this the most prosperous, innovative era in human history.

A Three trillion Dollar Market





Boeing projects that airlines around the world will order 29,000 new transports over a 20-year period worth about $3.2 trillion, with the vast majority of deliveries concentrated in single-aisle aircraft. Airbus projects a similar revenue total for the same period, making commercial transports one of the biggest export items in the global trading system over the next two decades.

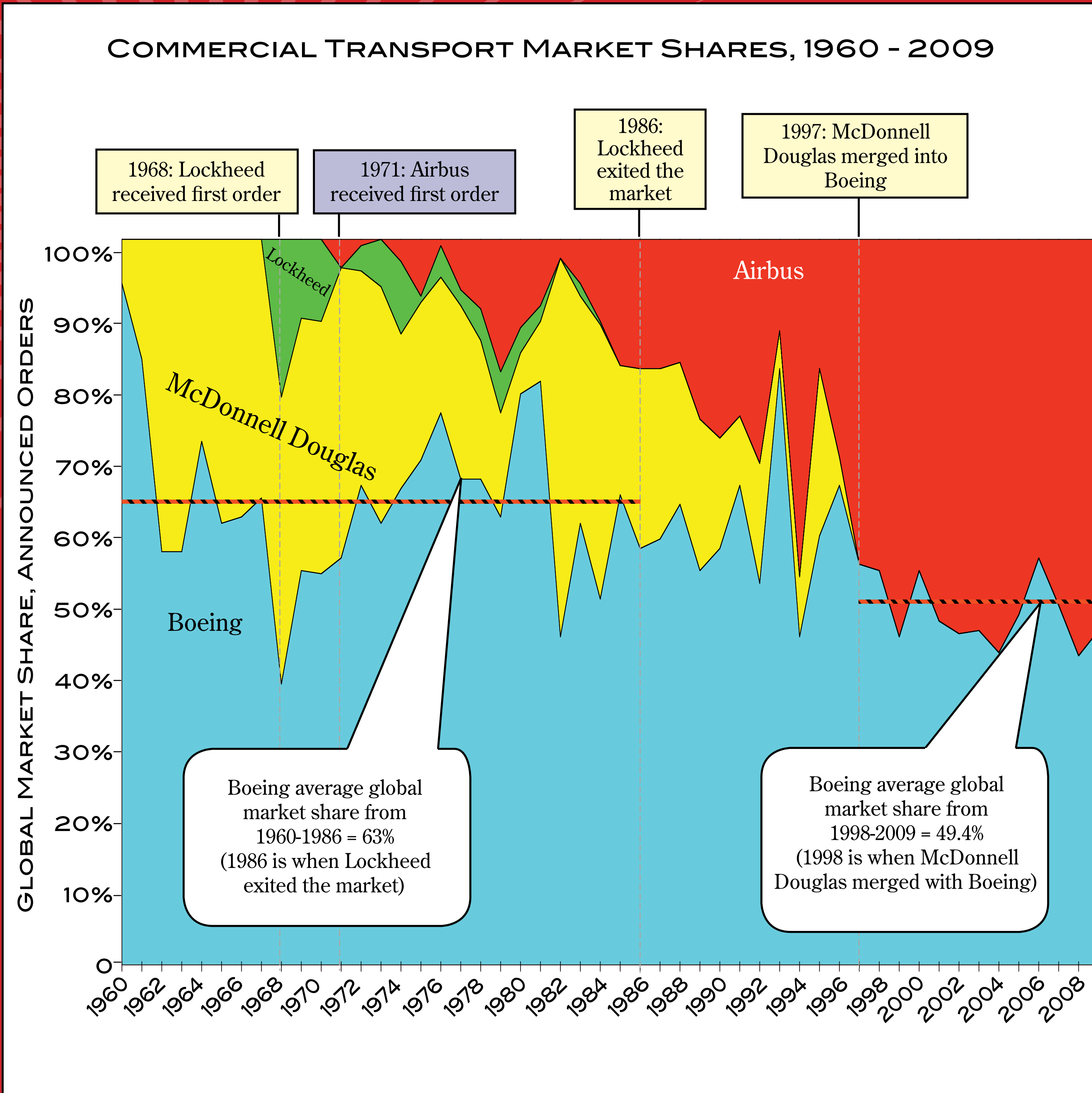
THE GLOBAL AVIATION MARKET IS CRUCIAL TO AMERICA'S TRADE BALANCE

The global market for jet-powered commercial transports first emerged in the 1950s with the appearance of planes like the Boeing 707. American companies dominated the market during its early years due to the size of the U.S. economy, the long distances Americans often must travel within their borders, and the nation's massive outlays for military technology during the Cold War – technology which often could be adapted to civil aviation uses. European companies were handicapped in competing with American companies by the economic and political fragmentation of the continent, which undercut economies of scale. In an effort to overcome these obstacles, four European governments formed a commercial transport consortium called Airbus in 1970.

Although U.S. aircraft companies benefited considerably from military contracts, they remained fundamentally private enterprises. Airbus, in contrast, was entirely a creature of the governments that had created it, and none of its early aircraft could have been launched without extensive subsidies from the member states. However, subsidies by themselves did not guarantee success: only 256 of the consortium's first plane, the A300, were sold during the 1970s. Meanwhile, Boeing offerings such as the twin-engine 737 and four-engine 747 jumbo jet dominated the global market. Additional offerings from McDonnell Douglas and Lockheed enabled the U.S. to claim over 90% of the market until Airbus introduced the highly successful A320 in the 1980s. The twin-engine, single-aisle A320 attracted considerable market interest and produced several successful variants, due to appealing performance features and aggressive pricing.

Because the structure of the global airliner industry can only sustain two suppliers in any particular niche, the growing success of Airbus made survival of secondary U.S. suppliers problematic. Lockheed exited the market in 1986 and McDonnell Douglas merged with Boeing in 1997, leaving only two companies to supply a global market that was growing at an average annual rate of about 5%. At the time of the Boeing-McDonnell merger, U.S. companies still controlled about two-thirds of the market, but this share eroded as Airbus expanded its offerings and underbid Boeing on price – often in Boeing's home market of North America, where 40% of Airbus's early planes were sold. Although the two surviving competitors sought to develop planes that addressed slightly different market niches, every Airbus sales success was a loss for Boeing. Once Airbus fielded a full family of airliners, it surpassed Boeing in sales and deliveries, claiming over half of the market every year after 2002.

Despite America's diminished role, civil aviation remains a major positive in the U.S. balance of trade. According to the Aerospace Industries Association, the U.S. had a $54 billion surplus in its aerospace trade during 2009, with much of that surplus traceable to the sale of commercial transports. Last year, 40% of all U.S. aerospace industry sales – $83 billion out of $214 billion – were civil aircraft, and most civil aircraft were exported. Boeing projects that global sales of commercial transports will exceed $3.2 trillion over the next 20 years as 29,000 new aircraft are delivered. Airbus projects sales during the same period at $3.1 trillion for 25,000 planes. Thus, airliners are a potential bright spot in the U.S. balance of trade, which currently is running a deficit of about a billion dollars per day in manufactured goods. However, the contribution of commercial transport sales to the trade balance would be much greater if Airbus had not become such a big factor in the business, and there is no guarantee Boeing will be able to preserve its present 47% market share in the years ahead.



U.S. producers dominated the global market for commercial transports until the 1990s, when Airbus began offering a diverse family of narrow-body and wide-body airliners. As subsidized European aircraft claimed a growing share of the market, two of the three U.S. producers exited the business and the sole survivor, Boeing, ceased to be the biggest recipient of new aircraft orders.

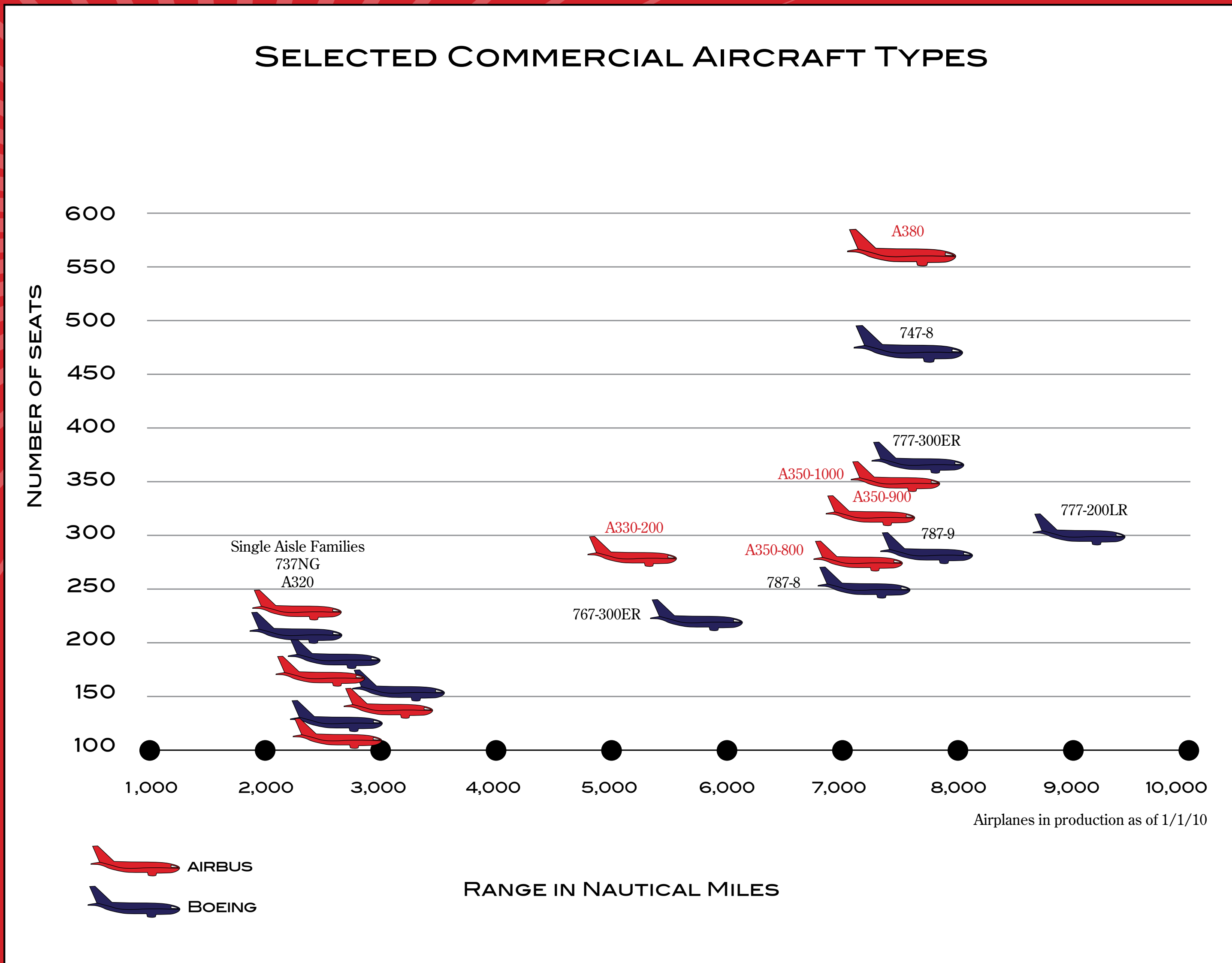
EUROPEAN SUBSIDIES WERE DESIGNED TO UNDERMINE AMERICA'S ROLE

Airbus was founded as a consortium of European aircraft companies in 1970 with the explicit goal of diminishing the dominance of American producers in the global aviation market. Recognizing the high barriers to market entry and structural disadvantages that indigenous companies faced in competing with market leader Boeing, the four founding European nations – France, Germany, Spain and the United Kingdom – embraced from the beginning the need to subsidize Airbus operations. Airbus later evolved into a joint stock company and then into a wholly-owned subsidiary of the European Aeronautic Defense & Space (EADS) Company, but the centrality of government subsidies to its commercial transport operations has never changed. None of the aircraft currently comprising the Airbus family of airliners could or would have been developed without such subsidies.

At its inception, Airbus member governments stated they were providing subsidies to support an "infant industry," subsidies that would gradually disappear as the enterprise matured. That has not happened. The initial agreement to cover costs for the development of the A300 was followed by later agreements to fund development of the A310, A320, A330, A340, A350 and A380. The latter aircraft, the biggest passenger plane in the history of civil aviation, was also the most subsidized – even though its development was begun after Airbus had become firmly established in the global market. A 1992 agreement between the United States and European countries limited the extent of subsidies but did not prevent them. Subsidies have taken several forms, but by far the most important is launch aid, the provision of low-interest or no-interest loans that need not be repaid if the aircraft model fails to achieve economic success. Such loans make it much easier for Airbus to finance the very high cost of developing new planes. While the nominal dollar value of these loans over time has only added up to about $15 billion, U.S. government experts have testified that the true market value in today's dollars is roughly $200 billion.

Airbus and Boeing both receive some commercial benefits from military contracts, local tax incentives, and other relatively modest kinds of government assistance. Much of this assistance is permissible under current trading rules, and it does not appear to have played a decisive role in shaping the rivalry between the two companies. However, Boeing gets nothing like the multi-billion-dollar infusions of launch aid that Airbus regularly receives. This aid has fundamentally altered the terms of competition between the two companies by enabling Airbus to develop new planes faster than would be feasible using private sources of funding, and to price existing planes more aggressively than would be prudent in the absence of government protectors. In effect, launch aid transfers many of the risks of being in the airliner business from Airbus to European governments, so that the company can operate more boldly in challenging Boeing's offerings to the marketplace.

European leaders have not been shy in describing what the ultimate aim of the launch aid is. French prime minister Lionel Jospin told the French National Assembly in 2000 that "we will give Airbus the means to win the battle against Boeing." Airbus executives are even more unvarnished, for example describing the heavily subsidized A380 as a Boeing 747 "killer." The existence of European aircraft subsidies was a significant factor in the decision of American producers Lockheed and McDonnell Douglas to exit the commercial aircraft business, and is the biggest single reason why Boeing no longer commands a majority share of global airliner sales. With the ranks of U.S. producers reduced to only one company by the beginning of the current decade and that one company faltering badly in its competition with Airbus, the Bush Administration decided to abandon diplomatic channels and lodge a formal trade complaint.



This chart reflects the market positioning of all Airbus and Boeing commercial transports currently in development or production. Although the two companies offer slightly different configurations in each seating/range category, the market reality is that any major order of Airbus planes is probably a loss for Boeing, and any major order of Boeing planes is probably a loss for Airbus.

THE WORLD TRADE ORGANIZATION HAS RULED SUBSIDIES ARE UNFAIR

The 1992 agreement between Europe and the United States limiting commercial transport subsidies had envisioned that government aid would gradually be phased out. But European governments made no effort to scale back concessionary loans and other subsidies for Airbus during the 1990s. After Boeing and McDonnell Douglas merged in 1997, the combined entity rapidly lost market share in the commercial transport business due to aggressive pricing by Airbus, leaving it with less than half of new aircraft orders by the early years of the new century. Convinced that Airbus was violating its obligations under the treaty that had established the World Trade Organization, the United States Trade Representative (USTR) lodged a formal complaint in 2006.

The U.S. case alleged that four European governments and various agencies of the European Union had provided an array of improper aid to Airbus, aid explicitly banned in the WTO Agreement on Subsidies and Countervailing Measures. The most serious violation cited in the U.S. case was launch aid, low-cost or no-cost loans that constituted most of the financial assistance Airbus had received (for instance, $5 billion of the $5.7 billion in assistance given to the Airbus A330 by European governments was launch aid). The United States alleged that under the terms of the WTO agreement, launch aid was both a “prohibited” subsidy of exports and an “actionable” subsidy that unfairly harmed the operations of competing suppliers of large commercial aircraft. The United States also challenged various infrastructure investments, equity infusions, debt forgiveness, research outlays and outright grants provided to Airbus as unacceptable under current trading rules. European nations lodged their own complaint against the United States in 2007 claiming that Boeing too had received improper aid, but they did not allege the existence of anything resembling launch aid.

On September 4, 2009 the World Trade Organization panel reviewing the 2006 complaint released a preliminary ruling siding with the U.S. on several key issues. It found that much of the launch aid given to Airbus was prohibited under current trade rules, and that many other measures were at least actionable in the sense that they had harmed Airbus competitors. The ruling will be finalized in 2010 with only modest changes, meaning that if European nations fail to quickly withdraw prohibited subsidies, the United States has the right to take formal steps to protect its interests. The process for addressing actionable subsidies is more complex, because it is related to the degree of damage incurred by Airbus competitors. But the fact that most launch aid was deemed unacceptable by an impartial panel of international experts was a clear victory for the United States, and will undoubtedly lead to U.S. sanctions if European governments fail to comply with the finding.

While the European counter-claim alleging improper aid to Boeing has yet to be decided, it is likely to yield a less definitive finding from the WTO because there is no claim of launch aid and Airbus or its parent company have received benefits similar to those that Boeing is alleged to have gotten. Details on the European complaint are contained in the next section. The more pressing question in the near term is how the federal government should respond to the WTO finding that the American aircraft industry has been victimized by illegal subsidies given to Airbus. The trade body has said in effect that the United States was unfairly deprived of many thousands of jobs in its aerospace sector and many billions of dollars in aerospace export earnings. The debate over what to do about that fact will focus initially on the Air Force’s next-generation aerial refueling tanker program (where a modified A330 has been offered) – and on European plans to subsidize development of an alternative to the Boeing 787 Dreamliner.

The Boeing 787 Dreamliner was conceived as a technological breakthrough that would reduce fuel consumption and exhaust emissions through extensive substitution of lightweight composite materials for heavier metal parts. Airbus is seeking several billion dollars in prohibited subsidies from European governments to fund development of an A350 competitor to the Dreamliner.

THE EUROPEAN RESPONSE TO U.S. COMPLAINTS IS WEAK AND MISLEADING

European supporters of Airbus have sought to rebut American criticism of commercial transport subsidies in their case before the World Trade Organization and elsewhere. The European response distills down to three basic themes: that Airbus subsidies are consistent with the way the commercial transport sector functions; that Boeing has not suffered substantial harm from said subsidies; and that Boeing too receives government subsidies that are similar in scale and character. The United States Trade Representative has rejected all three lines of reasoning, arguing that Airbus not only has failed to respond to the heart of the U.S. complaint, but has tacitly admitted its transgressions against normal trade practices as it sought to minimize their significance.

With regard to the contention that government aid to Airbus is consistent with prevailing practices in the aerospace sector, most of that aid has been received in the form of low-interest or no-interest loans to assist the development of new aircraft. Since the European response does not allege that Boeing received similar launch aid and Boeing is the only real competitor to Airbus, the European claim is false on its face. It may have some validity when applied to lesser forms of assistance, but those were not at the heart of the U.S. case. With regard to the contention that Boeing has not suffered substantial harm from European subsidies, that harm was extensively documented in the initial U.S. complaint and Airbus supporters fail to offer compelling counter-arguments. Because virtually every Airbus sale is a Boeing loss in the commercial transport market as currently structured, European governments effectively negate their own position on this score once they concede that subsidies exist.

With regard to the contention that Boeing has received assistance similar in character and scale to what Airbus gets, European governments have cited an array of federal, state and local benefits that they say cumulatively amount to heavy support. The main federal programs cited are Foreign Sales Corporation tax benefits, and contracts Boeing has received from the Department of Defense and NASA. However, the Foreign Sales Corporation provision was not aimed solely at the aerospace sector, it conferred a relatively modest benefit compared with European launch aid, and it was repealed in response to a case brought before the WTO. Federal contracts for military and civil aerospace hardware are not subsidies because they require the delivery of goods and services in return for payments. The regulatory framework governing such contracts usually precludes directed awards, and the activities covered by the contracts lie largely outside the scope of the WTO agreement on subsidies and countervailing measures.

The state and local subsidies that Airbus backers allege Boeing has received really do exist, but their significance is exaggerated by European governments and Airbus itself receives similar kinds of disbursements. For example, the partial sales-tax forgiveness that Boeing obtains from the state of Washington for its commercial aircraft sales is more limited in scope than the Airbus exemption from European valued-added taxes, and Boeing gets no benefit from the forgiveness unless it first spends its own money to develop and market a saleable product. Furthermore, the same benefits are available to Airbus and its parent company when they site operations in Washington and other U.S. states, as they now have. The WTO will probably declare some state and local subsidies that Boeing receives to be improper when it rules on the pending European case, but those subsidies cannot compare with the huge benefit conferred on Airbus by 40 years of launch aid.

CONCLUSION: WASHINGTON MUST ACT TO ELIMINATE UNFAIR SUBSIDIES

For forty years, European governments have conspired to undermine America's leading role in the global market for commercial aircraft. The representatives of those governments have made little effort to conceal their intentions, and they have largely succeeded. As a result, tens of thousands of U.S. aerospace jobs have disappeared, and hundreds of billions of dollars in U.S. export earnings have been lost. The World Trade Organization has now found that the subsidies Airbus leveraged to achieve its present market dominance were improper and largely prohibited by prevailing trade rules. To prevent further erosion in the U.S. aerospace industry and trade balance, Washington must take four steps in response to the WTO findings:

• The U.S. government must forcefully communicate to European governments that further use of illegal subsidies to develop new planes will not be tolerated, beginning with the proposed A350 challenger of the Boeing 787 Dreamliner. The Europeans suggest that the A350 lies outside the scope of the recently decided subsidies case, but it is clear that plans to provide that program with over $4 billion in launch aid would be condemned in any WTO review, so Washington must stop the plans from being executed before additional damage is done to U.S. interests.

• Because European governments have repeatedly demonstrated that they are unwilling to be honest or helpful in resolving the subsidies dispute, the U.S. government must determine what sanctions it can impose under existing trade rules to compensate for the unfair competitive advantages that Airbus receives. To minimize the likelihood of a spreading trade war, these sanctions – such as tariffs, quotas or other constraints – should be confined to the commercial transport sector where the subsidies dispute originated.

• The U.S. government must incorporate some redress of unfair Airbus subsidies into current plans for acquiring a new Air Force aerial refueling tanker. The modified Airbus A330 that was offered by a team competing against Boeing in the first round of competition for the tanker contract would not have been developed in the absence of over $5 billion in improper aid. To contemplate making an award without compensating for the unfair advantage the Airbus plane has received would in effect reward bad behavior and penalize Boeing for not engaging in similar impropriety.

• More broadly, the U.S. government must determine what redress of past European transgressions is necessary to balance the competitive landscape in the commercial transport business. The whole market has now been distorted by the emergence of an aircraft family and pricing structure that would not exist in the absence of illegal subsidies. It is not enough to avert further use of improper aid in the future; steps must be taken to correct the negative consequences that aid has already produced for U.S. companies and their workers.

These steps will require some time to implement, and they must take into account any further rulings the World Trade Organization makes concerning subsidies. But there is no longer any excuse for delay in acting. America's global economic standing is under siege, and it cannot tolerate the continued use of illegal measures by other nations to put its exporters at a disadvantage in global markets.

RECENT LEXINGTON INSTITUTE STUDIES ABOUT SECURITY AND THE ECONOMY:

Reversing Industrial Decline:
A Role For The Defense Budget, August 2009

Moving Forward On Smart Grid, August 2009

E-2D and Maritime Security, May 2009

Performance-Based Logistics:
A Primer For The New Administration, April 2009

Printed in the United States of America
March, 2010

Lexington Institute

Tel 703.522.5828
Fax 703.522.5837

1600 Wilson Boulevard
Suite 900 • Arlington, Virginia 22209

WWW.LEXINGTONINSTITUTE.ORG • MAIL@LEXINGTONINSTITUTE.ORG