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# The Futility of the Government Airline Bailout

BY PAUL A. CLEVELAND AND MICHAEL D. TUCKER

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In recent years many airlines have struggled, and following 9/11 Congress passed a massive aid package aimed at rescuing the industry. After years of government aid it is appropriate to ask what has been accomplished. Was the bailout truly necessary, or did it simply ignore the economic realities of the airline industry? Has the aid merely propped up weak and inefficient firms at taxpayer expense even though they will eventually fail?

The airline industry faced difficulty long before the events of September 2001. For years the union-burdened old-line hub-and-spoke carriers, such as US Airways, American, and Delta, had struggled against increasing competition from smaller, more efficient, and more cost-sensitive competitors, such as Southwest Airlines.<sup>1</sup> After 9/11 the financial hardships faced by the traditional carriers were exacerbated, and this provided a unique opportunity for these firms to petition the government for help. A little more than two weeks after the attacks, Congress passed the Air Transportation Safety and System Stabilization Act, which provided aid valued at as much as \$15 billion.<sup>2</sup>

Under the terms of the legislation, \$5 billion was paid out directly. Roughly 90 percent was given to passenger airlines, with the balance to cargo carriers. The amount paid to each company depended on its market share, which was determined by its proportion of available seat-miles offered in the market. For instance, US Airways, the company with second largest share of available seat-miles, received nearly \$800 million.<sup>3</sup> The

remaining \$10 billion was to be used by the Air Transportation Stabilization Board (ATSB) to guarantee loans. The ATSB was authorized to extend loan guarantees according to rules that made its mission statement so nebulous that it could grant almost any request.<sup>4</sup>

In her study of the package, Susanna Dokupil examined the two main arguments for the cash payments.<sup>5</sup> First, in the wake of the 9/11 attacks, proponents maintained that the government's grounding of all airlines was reason enough to provide some financial aid. To be

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sure, the forced grounding of all aircraft for several days did impose a financial cost on the carriers, and there is some justification for this argument. Second, those in favor of payments also asserted that the U.S. government had an obligation to compensate airlines for the drop in demand for air travel after 9/11. According to this argument, since the airlines could not have foreseen the attacks and the resulting drop, they should not be held financially responsible.

This second argument makes much less sense than the first. We agree with Dokupil on this point. She asserted that any compensation paid to air carriers because of a drop in demand is illogical because the potential business risk of terrorism had been known for years. Any airline executive understands that hijackings and crashes tend to promote negative perceptions about the safety of air travel. Some might argue that the size

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and scope of the attacks dwarfed any previous incident and the government had to respond because the airlines could not possibly have been prepared for such an event. Yes, but one must also ask why the government, meaning the taxpayers, should be liable. Are taxpayers to be liable for all business risks that any firm might suffer in another massive terrorist attack? We think not.

With respect to the government shutdown of operations, Dokupil noted that in reality the Federal Aviation Administration's (FAA) order came after many airlines, American and United Airlines, for example, had voluntarily halted their own operations. It is likely that the other airlines would have followed suit given the events of that day. Left to their own devices, it is not clear how long they would have chosen to ground their own planes.

However, even supposing that they would have chosen to continue to operate, the total cost to the airlines was much smaller than what the government provided. John Samples of Cato's Center for Representative Government calculated a more realistic figure for the total losses incurred by the airline industry.<sup>6</sup> In fact, Samples's source for this number was the airline executives themselves. They estimated the losses from the four-day grounding at \$300 million per day, or \$1.2 billion. This amount, though certainly significant, is far less than the \$15 billion in direct aid and loan guarantees.

By guaranteeing, or cosigning, loans, government officials claim to know how much credit should be available to struggling air carriers. To receive a loan guarantee a company was required to adopt certain reforms and to make certain management concessions.<sup>7</sup> These restrictions kept some firms away from the government's table. But the offer was good enough to entice others.<sup>8</sup> The criteria the agency adopted were designed to mimic those used by private lenders.

However, this effort was surely misguided. First, private lenders who risk their own capital are far more capable of assessing credit worthiness than government bureaucrats who risk taxpayer dollars. Moreover, it is superfluous for the government to create such an agency

as the ATSB unless, of course, its aim is to provide credit at below-market rates. But in that case, the government's intervention into the market is sure to backfire eventually and leave taxpayers on the hook for the bad loans. There is a good economic reason why some of these companies cannot obtain more credit: they are poor risks and the likelihood of default is too high. For the government to intervene in such cases is simply foolish. Finally, even if the loans are paid off, the guarantees cost firms without government backing the opportunity to borrow scarce capital. Whatever those firms would have produced might have been valued more by consumers than the services of bailed-out airlines.

### Low-Cost Challengers

An example of this faulty process is US Airways, the first airline to declare bankruptcy after 9/11. While under bankruptcy protection the company restructured its debt and received a cash infusion through an equity deal with the Retirement Systems of Alabama (RSA), a state agency. In exchange for several seats on the board and a 36.2 percent

equity stake in the airline, the RSA invested nearly \$240 million in the ailing company. The agency also invested an additional \$260 million dollars in secured and unsecured loans.<sup>9</sup>

The investment by the RSA played an important role in US Airways' initial emergence from bankruptcy protection. The company also benefited from a \$900 million federal loan guarantee and \$800 million in cash payments. To get the guarantee US Airways had to provide collateral, which it did in the form of assets ranging from airport slots and flight simulators to spare parts and airplanes and engines.<sup>10</sup> Without all this help it is likely the airline would have been liquidated. But the financial restructuring did little to change the company's underlying problem: it can't compete effectively in the industry. This is a problem for a number of the old-line carriers.

While under protection, US Airways was turned down for loans by roughly 25 banks, and the company's



Southwest Airlines

debt was downgraded to “junk” status by the major credit-rating agencies. Why, then, did the ATSB approve a loan guarantee? Did the agency have better insight into the company’s credit-worthiness? Obviously, the risk of lending to US Airways was simply too great for the banks. However, that risk becomes inconsequential with government guarantees. If necessary the American taxpayers could be forced to repay the loan.

Even before the 9/11 tragedy financial analysts had predicted a loss of \$2.5 billion for the airline industry for 2001 because of the recession the nation was experiencing.<sup>11</sup> This problem was magnified, James Gattuso of the Heritage Foundation noted, by the stiff competition old-line carriers were facing from new low-cost entrants such as JetBlue and established discounters like Southwest Airlines, which had steadily gained market share for years. In their struggle to adapt to changing market circumstances, US Airways and the others were forced to reduce costs, renegotiate with their unions, and improve efficiency, or suffer additional losses in passenger traffic. Unfortunately, US Airways has not altered its business strategy enough. Adjustment is part of the market process, but government interference interrupts the process by allowing poor performers to hang on.<sup>12</sup>

## Southwest Airlines

The history of Southwest Airlines is instructive. Southwest began operations in the early 1970s, and its presence in the industry has changed the face of passenger air travel. Unlike the old-line carriers, Southwest focused initially on the short-haul market. As James Ott and Raymond Neidl explain in their book on the company, the success of Southwest was driven by its business plan as an “aerial bus service.”<sup>13</sup> Unlike many traditional airlines, Southwest avoided hub-and-spoke networking in favor of the point-to-point operations long provided by bus lines.<sup>14</sup> Its goal was to keep costs of operations as low as possible and allow for a wider variety of destinations by providing convenient scheduling in each city it served.

When Southwest entered the industry, fares were set by a government board and the large carriers did not compete on price. Furthermore, many had little or no interest in providing short-duration flights.<sup>15</sup>

Southwest had a different view. As the firm’s founder, Herb Kelleher, put it, “[E]veryone would love to fly for

45 minutes rather than drive for six hours.”<sup>16</sup> Kelleher recognized that the demand for short-haul markets was not adequately being served and that the company could supply those markets given the right business model. Thus it looked for suitable and lucrative city-pair markets in which it could fly from one destination and back with a full complement of passengers, turning around as quickly as possible. To wring out even more costs, the airline operated only one type of aircraft and provided passengers little more than modest refreshments. As Southwest has matured, it has added new cities to its schedule and is flying longer distances. However, the underlying business model remains the same.<sup>17</sup> As a result, Southwest can provide low-price service to a wide variety of destinations with nonstop and one-stop alternatives.

The success of Southwest is fundamentally relevant to any discussion of the airline bailout because it demonstrates the larger problem for many old-line carriers with their union albatrosses: most are just plain inefficient. Therefore, one might reasonably assert the bailout is not going to change the inevitable outcome. It will only prolong the agony and do so at taxpayer expense.

As evidence, consider that last year US Airways filed for bankruptcy a second time, only 18 months after receiving its initial bailout package. When US Airways again left Chapter 11 protection this past September, its merger with America West was announced. Under the terms of the merger, America West would take control of the ailing airline and add it to its own operation. Moreover, America West would provide a \$12 million severance package to 11 US Airways executives and grant unsecured creditors 12 percent of the shares of the new company. New investors are providing \$565 million in exchange for 52 percent of the company’s shares. The remaining shares of the new firm will be held by existing America West shareholders. Old shareholders of US Airways will lose their entire stake in the airline. Thus RSA is out its \$240 million investment, which had allowed US Airways to emerge from bankruptcy the first time.<sup>18</sup> One is left to wonder what kind of financial Russian roulette is being played here.

The idea that government should protect large companies from failure is readily accepted. However, as we’ve

seen, success cannot be guaranteed. Delta, Northwest, and United, all recipients of government help, are in Chapter 11. On the whole, the evidence demonstrates that the government's bailout has failed because it does not address the real reasons that the old-line carriers are struggling. Federal aid is arguably delaying the inevitable. Allowing capital to flow freely, even if it is the result of business failure, is the best means of promoting economic progress.



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