



International Chamber of Commerce

The world business organization

Policy statement

Foreign investment in airlines: an ICC view

Commission on Air Transport, 8 November 1994

Since it was established in 1919, The International Chamber of Commerce (ICC) has argued for the freer flow of trade and capital across borders. It gave strong support to the completion of the Uruguay Round of Trade Negotiations, which was recently brought to a successful conclusion. It has worked with other international bodies to reduce barriers to foreign investment in developing countries. And in air transport, the ICC has argued that nations should progressively move to replace the existing bilateral system with new multilateral accords, which would be negotiated by groups of nations using a broader aggregated market to increase opportunities for airlines and ease the flow of passengers to a wide range of destinations.

In the current paper, the ICC addresses the issue of cross border investment in airlines, not only as a means of providing needed capital to the industry, but also as a lever which can be used to liberalise the air transport negotiating process. Recent developments on airline privatisation and the increasing number of cooperative airline ventures have made the issue an increasingly timely one. Indeed, the ICC agrees with a number of observers who see cross border investment as one of the most important aviation policy issues of the 1990s.

The airline industry's need for capital

The airline industry is a cyclical one whose success very much depends on good economic times. But the combination of the Gulf war and the recession propelled the airlines into one of their most severe downward economic cycles. In the three years from 1990-92, US carriers collectively lost more than they earned during their entire history. In Europe, during the same period, EU airlines lost more than \$3.5 billion.

Despite recent improvements in load factors, most of the world's airlines, suffering from overcapacity and increased competition, still have severe economic problems. Losses for the industry exceeded \$ 4.1 billion in 1993. In 1994, while the airlines are expected to earn their first collective profit in four years, that profit will be modest at best.

These economic difficulties have coincided with the airlines' major needs for fleet replacement. A 1992 ICAO study indicated that from 1991 to 2010, the world's airlines will have to spend more than \$800 billion on new aircraft, a figure double that of the previous 20 year period. But given world economic conditions and difficulties in attracting capital, actual purchases may fall far short of this projection.

Restrictions on foreign ownership

Despite the need for new capital, government restrictions on foreign investment in airlines continue to impede the flow of capital to the industry. In the US, which has recently liberalised its foreign investment rules, a foreign shareholder is still not allowed to hold more than 49 per cent of the equity and 25 per cent of the voting stock in a US airline, though the US Department of Transportation has proposed to Congress that the latter figure be raised to 49 per cent under certain circumstances. However, the US Government may still impose a subjective "control" test to determine whether there is a possibility that a foreign shareholder, whatever the level of his equity stake, could exercise undue influence over the airline's decision-making process. Finally, the US appears to condition its liberalised

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rules on its negotiating partners' adopting a liberal bilateral regime with the US and on other factors such as the other state ending state control over its airlines.

In the European Community, the third air transport liberalisation package sets no limit on the stake a Community national or a Community airline can hold in an airline from another EU state. But restrictions on investment by non-EU shareholders remain. Foreign investors cannot hold a majority stake in any EU airline. In addition, their investment, whatever its level, may be disallowed if the European Commission finds that such shareholders exercise "a decisive influence" on an airline, either by having the right to use all or part of its assets or through rights or contracts that give the foreign shareholder such influence on the composition of the Board or the running of the business. It should be noted, however, that EU legislation leaves open the possibility of a more liberal exchange of equity between Community airlines and non-EU investors if foreign countries liberalise their own rules on foreign investment in airlines.

Other countries' laws can be even more restrictive, either by barring foreign ownership in airlines, limiting a foreign stake to 25 per cent or less, or by maintaining substantial state ownership of an airline, effectively shutting out the possibility that private investment can be introduced. Most airlines in the Middle East and Africa are 100 per cent government-owned, and in Europe, five major EU carriers presently have government holdings ranging from 90 - 100 per cent.

Reasons for restrictions on foreign investment

The 1944 Chicago Convention organised international air transport as we know it today. The bilateral agreements which grew out of the principle of national sovereignty over airspace which forms the basis of Chicago had two consequences: one was that airlines had nationalities and that governments were given a central role in negotiating route rights; the other was a series of national laws limiting foreign ownership or control of carriers.

But the text of the Chicago Convention is neutral on the subject of foreign ownership. In fact, Article 77 of the Convention expressly permits operations involving joint or coordinated efforts among airlines to provide international service. There is, however, wording in the model forms arising from Chicago, notably in Article 6 of the Chicago standard bilateral form, that permitted either party "to withhold or revoke a certificate or permit to an airline where it is not satisfied that substantial ownership and effective control are vested in nationals of either party to this agreement ...". This or similar wording is now common in most bilateral agreements, even so-called "liberal" agreements.

Governments have offered several reasons for retaining controls over foreign investment in airlines:

National security

Governments have argued that foreign ownership of airlines could compromise national security, since civilian aircraft capacity may be widely used by the military, particularly in times of national emergency. Foreign owners, it is said, could not be counted on to supply this capacity.

Economic security

Both governments and labour union representatives have raised economic objections to foreign ownership. Some governments, particularly in countries largely dependent on tourism, argue that it would be unwise to turn over the nation's principal earner of foreign exchange into foreign hands. They are also concerned that in difficult economic times, foreign owners would be tempted to discontinue vital air links, leaving the country vulnerable to a serious disruption in the availability of air transport services.



Labour's principal concern is that job losses will follow once foreign owners take control of an airline. Union officials have also questioned whether the terms and conditions of their employment would be governed by foreign, rather than domestic labour laws.

Safety

Some interests, particularly pilots' organisations, have raised the possibility that foreign ownership could result in weakening of safety standards. These claims are frequently coupled with concerns that foreign-owned carriers which have their aircraft registered in other countries could be subject to less strict safety tests than airlines having aircraft registered in the country of designation. By extension, it is argued, there will be a move towards creating "flag of convenience" airlines in the same way that flag of convenience shipping operates in maritime transport.

Competition issues

Some government officials have expressed doubts about confidentiality and the willingness of airlines to compete vigorously with one another when they have overlapping ownership and boards of directors.

Bilateral issues

It is argued that foreign takeovers would run counter to bilateral agreements, most of which, as noted above, require "substantial ownership and control" by local nationals of the airline. If negotiating countries were unwilling to amend this clause, they could refuse to allow an airline falling into foreign hands to exercise route rights which it had previously been granted. This, it is suggested, would throw the negotiating process into stalemate.

The converse of this argument is that if the foreign-owned airline is permitted to exercise its rights, this could result in the airline gaining access to a country by the backdoor, avoiding the traditional give-and-take of bilateral negotiations. As noted in an earlier section, this has led some governments, particularly the US, to suggest that a relaxation of their investment rules should have prior conditions, namely that the foreign entity seeking to own a US carrier must come from a country that maintains a pro-competitive, private sector-run regime governed by equitable and transparent rules and regulations. This requirement for a *quid pro quo* means that liberal foreign investment rules will be established only in return for other features of a liberal bilateral agreement. It means that the openness of foreign investment rules are a matter for negotiation.

Other legal issues

A final argument made by some governments is that there must be a clearly identifiable locus of responsibility for the safety, security and economic integrity of airline companies. Their reasoning is that if a carrier is owned by nationals who are not citizens of the designating country it may be difficult to demonstrate the designating government's continuing competence in the technical aspects of airline and aircraft certification.

The case for liberalising foreign investment rules

The role of the market

The objections raised to liberalising foreign investment rules, most of them raised by governments, can be overcome. First, it should be noted that the evolution of the international aviation business should not be shaped by government officials and bureaucratic decrees. It will, or at least should be a reflection of needs felt in the commercial marketplace - including the capital markets. Experience has indicated that once market requirements put pressure on the regulatory system, governments will find ways to modify the regulations.

As indicated in an earlier section, the needs of the industry for capital are immense. With fleet costs soaring and airline deficits up as well, the capital to modernise must be found. There is no guarantee that it can be raised from local investors.

Even in countries where airlines are state-owned, budget deficits and competing claims for government financial assistance mean that some governments cannot continue to shoulder the burden of maintaining their national carriers. These developments, as well as a shift to market-led economies in countries such as those in Eastern Europe, has stimulated a wave of partial airline privatisations, many of which have involved cross-border investments. More than 25 airlines in various countries now have significant foreign holdings.

Existing multinational airlines

These economic realities as well are compelling both airlines and governments to rethink their ideas of what constitutes a "national airline". Moreover, the multinational airline is not simply a theoretical concept; such airlines already exist, as in the case of SAS, Gulf Air and Air Afrique, which are owned by contiguous countries and have a shared nationality. These airline consortia have been able to overcome the economic and regulatory obstacles which have been raised against multinational carriers. In a more recent development, Iberia of Spain purchased an 85 percent equity stake in Aerolineas Argentinas. During a subsequent negotiation between Argentina and the United States, the U.S. agreed to waive its objections to Iberia's ownership and control of the Argentine carrier.

Meeting other objections

The argument that national security concerns will be compromised if domestic carriers fall into foreign hands is not persuasive. As pointed out in the report *Free Trade in the Air* by the Think Tank on Multilateral Aviation Liberalisation:

Governments can secure their defence commitments in other ways. They can make contractual arrangements with airlines to provide aircraft in times of national emergency on lines similar to the US Civil Reserve Aircraft Fleet (CRAF) programme. Or they can take legislative powers to requisition any aircraft under their jurisdiction.

Similar points were made in comments by IATA's Aviation Regulatory Watch Group.

With regard to financial and technical responsibility, the presence of a multinationally-financed, foreign-controlled carrier would not present national governments with insurmountable difficulties, since the designating nation would remain responsible for airworthiness and airmen's certification.

Nor should concerns about economic security hinder cross-border investment. Nations quite naturally want to preserve "essential" air services, which are vital links to international commerce and tourism. But contracts with foreign owners can stipulate these requirements, and if the prospective shareholder does not provide the services, governments can maintain the residual power to step in and reassume responsibility or return the airline to local ownership.

Labour's apprehension about job losses also seems to be misplaced, since even under the present system most airlines, even those which are state-owned, have been compelled to reduce staff substantially. It would be difficult to argue that job security would be even less were foreign capital allowed to flow freely into the industry. In most cases, companies have welcomed foreign investment as a stimulant to job creation or as a means of preserving jobs that would otherwise be lost through downsizing or bankruptcy. Moreover, the history of foreign ownership in other industries does not demonstrate a general pattern of employment cutbacks once foreign owners take control.



The bilateral advantages

Among the most significant advantages to liberalised foreign investment rules would be their impact on the air transport negotiating process itself. The present bilateral system, based on national ownership and country-to-country negotiations, is increasingly seen as narrow, protectionist and out of step with the globalisation of the industry. With the passage of the North American Free Trade Agreement, the development of the ASEAN region as an economic bloc, the completion of the European single aviation market, and the emergence of similar regional affiliations within Central and South America, the potential is there for groups of nations to negotiate multilaterally, offering their airlines baskets of opportunities to a range of markets.

But changing the negotiating process is likely to be a painfully slow process. That is why some observers believe that changes in the system are more likely to come from a liberalisation of the rules on foreign investment than from major international agreements. In the words of one former US Department of Transportation official: "It has been my conviction for some time that a liberalisation of the rules governing foreign ownership would represent the most effective possible challenge to the bilateral negotiating process and thus the most important step possible toward a genuine open market for international air service." If the nationality of airline companies were effectively blurred by a more multinational corporate structure, governments might well turn their attention away from trying to protect "national" airlines and at long last to guaranteeing for their economies the most efficient air service possible.

Summary and recommendations

The time has come for a relaxation of the rules on foreign investment in airlines. Trends in the economy have long pointed to the internationalisation of markets in a number of other important fields. The internationalisation of trade and capital flows, for example, has progressed substantially in recent years. Figures from *The Economist* indicate that cross border bank lending grew from around \$324 billion in 1980 to \$7.5 trillion in 1991. In the same decade, the volume of cross-border transactions in equities alone grew from \$120 billion a year to \$1400 billion a year, more than an eleven-fold increase.

Transnational capital flows have coincided with strong growth in the number of multinational enterprises, which mix capital and management from a number of different countries. Uncounted thousands of such enterprises now exist, with no clear lines of demarcation between national responsibilities. The airline industry cannot fail to be affected by this trend and will increasingly lose its national character.

In addition to these trends, the last few years have seen progressive liberalisation of air transport in Europe and the opening up of airline competition in other regions, such as the Indian sub-continent, Australia, and New Zealand. The new EU air transport liberalisation package has already taken an important step towards broadening airline ownership provisions by requiring that EU carriers be designated as "Community airlines" rather than airlines under the substantial ownership and control of any single state.

In other developments, ICAO has devised a model designation clause, allowing developing nations forming part of an economic grouping of states to designate the airline of another developing nation to perform their air services. And Hong Kong has included a clause in its bilateral agreements allowing carriers incorporated and having their "principal place of business" in the Colony to be designated as Hong Kong carriers by the government.

Finally, the wave of airline privatisations, mentioned in an earlier section, has loosened the ties between airlines and their governments and opened the way for governments to allow substantial foreign holdings in newly privatised carriers.

Mindful of these developments, the ICC recommends:

1. That air transport development should be determined by economic and technical considerations and not by questions of national pride and national ownership;
2. That governments should progressively remove from their bilateral agreements all clauses calling for "substantial ownership and control" of airlines by nationals of a single country. To ensure accountability, phrases such as "principal place of business" or other words to similar effect should be substituted for "substantial ownership and control". Governments may choose to implement changed rules on foreign investment in several ways, for example through regional agreements using an expanded version of the ICAO model designation clause or by renegotiating their bilateral agreements to include the so-called "Hong Kong clause" mentioned in the preceding paragraphs;
3. That subjective tests of what constitutes "foreign control" of airlines should be replaced by national legislation which provides for approval of foreign investment in airlines on the basis of objective criteria alone;
4. That the liberalisation of foreign investment rules should precede, and not be conditioned on the quid pro quo of liberalising the entire negotiating regime. The ICC acknowledges that in some cases the facilitation of actual foreign control might confer unfair advantages and therefore may properly be the subject of special phasing or other arrangements. Nevertheless, the ICC sees foreign investment as an important lever to open markets, progressively eliminate cabotage as an obstructive issue and eventually to replace the bilateral system with a more liberal multilateral framework for negotiations. As such, rules to liberalise foreign investment substantially should be implemented as rapidly as possible and should not be delayed until other elements of liberalisation are in place;
5. That acceptable international competition legislation should be developed to prevent the development of anti-competitive behaviour and monopolistic practices by airlines;
6. That if it is deemed necessary, developing countries, for a specified period of time, could retain the requirement that their airlines be substantially owned and controlled by their own nationals. But these safeguards should be strictly limited as to their timeframe and/or the conditions under which they operate. Governments should be permitted, however, to allow public service air transport services to continue, operated either under subsidy or under local private ownership, based on an internationally-accepted definition of what constitutes a public service obligation.