

GAO

Report to the Honorable
Richard Gephardt, Majority Leader,
House of Representatives

December 1994

INTERNATIONAL TRADE

Long-Term Viability of U.S.-European Union Aircraft Agreement Uncertain





United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-253697

December 19, 1994

The Honorable Richard Gephardt
Majority Leader
House of Representatives

Dear Mr. Gephardt:

This report responds to your request that we review the details and implications of the 1992 U.S.-European Union bilateral aircraft agreement. Specifically, we assessed (1) the extent to which the agreement has proved viable in operation, (2) the potential impact of changes in government support on the competitiveness of the U.S. large civil aircraft industry, and (3) the efforts of the United States and the European Union to extend coverage of the agreement to other nations with aerospace industries and to related aerospace products.

As you requested, we plan no further distribution of this report until 30 days from its issue date unless you publicly announce its contents earlier. At that time we will send copies to the U.S. Trade Representative, the Secretary of Commerce, and other interested parties. Copies will also be made available to others on request.

Please contact me on (202) 512-4812 if you have any questions concerning this report. The major contributors to this report are listed in the appendix.

Sincerely yours,

A handwritten signature in black ink that reads 'Allan I. Mendelowitz'.

Allan I. Mendelowitz, Managing Director
International Trade, Finance, and Competitiveness

Executive Summary

Purpose

An objective of the 1979 Agreement on Trade in Civil Aircraft was to liberalize world trade in the civil aircraft industry through the removal of tariffs and other trade obstacles such as quotas, preferential technical standards, and export subsidies. Despite the 1979 aircraft agreement, trade tension between the United States and the European Union (EU) regarding the civil aircraft industry continued during the 1980s and early 1990s, due especially to U.S. concerns about continuing government support to EU large civil aircraft manufacturers. In July 1992 the United States and the EU entered into a bilateral agreement aimed at reducing government support to manufacturers of large civil aircraft, that is, aircraft with a capacity of 100 or more passengers.

The Majority Leader of the House of Representatives asked GAO to review the details and implications of the 1992 bilateral agreement. In this report, GAO assesses (1) the extent to which the agreement has proved viable in operation, (2) the potential impact of changes in government support on the competitiveness of the U.S. large civil aircraft industry, and (3) the efforts of the United States and the European Union to extend coverage of the agreement to other nations with aerospace industries and to related aerospace products.

Background

Three large civil aircraft manufacturers account for 90 percent of global deliveries outside the former Soviet Union. These are the Boeing Company and the McDonnell Douglas Corporation in the United States; and Airbus Industrie, G.I.E. (groupement d'intérêt économique), a consortium of four European producers (Aérospatiale of France, Deutsche Aerospace of Germany, British Aerospace of the United Kingdom, and Construcciones Aeronáuticas S.A. of Spain). The civil aircraft industry is one of the United States' leading exporters and generated a net trade surplus in civil aircraft for the United States of more than \$16 billion in 1993. However, there has been a downturn in the airline industry in the last several years, and all three manufacturers have seen significant decreases in new orders.

Despite the 1979 multilateral aircraft agreement reached during the Tokyo Round (1973-79) of multilateral trade negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT), trade tension over civil aircraft continued between the United States and the EU. A source of trade tension has been the issue of government support to their civil aircraft industries, especially direct support provided by the EU to Airbus to develop and produce new large civil aircraft. By the mid-1980s, the United States considered initiating trade action against Airbus based on

U.S. trade laws. The two parties began negotiations on the issue of government support to the civil aircraft industries in 1986, and the talks continued intermittently over the next 5 years. After the bilateral talks broke down in early 1991, the United States initiated a GATT dispute settlement procedure challenging the EU's overall subsidies to Airbus. According to U.S. government officials, the United States agreed to suspend its case on overall subsidies to Airbus in exchange for renewed efforts to conclude a bilateral agreement.¹

The United States and the EU entered into an agreement in July 1992 that limited several forms of government support to large civil aircraft manufacturers and restricted the U.S. ability to use national trade laws to pursue action against Airbus for its prior government support. The agreement's constraints on government support included (1) banning all future production support, (2) placing limits on government support for the development of new aircraft and imposing a requirement that the support be repaid at interest rates near the government cost of borrowing, (3) limiting identifiable benefits from indirect support resulting from government-funded research, and (4) requiring that any changes in repayment terms of past supports not be more favorable than past terms.

Results in Brief

Certain provisions of the bilateral agreement are the source of ongoing disagreement between the two parties, and GAO believes the parties may disagree over a number of other provisions in the future. The bilateral agreement does not contain a formal dispute settlement mechanism, but rather calls for consultations between the two parties when there is disagreement. Thus, the effectiveness of the agreement depends on the two parties acting in good faith to implement their commitments. Because of this, and given the ongoing and potential disagreements, GAO believes the long-term viability of the agreement is uncertain. However, according to the chief U.S. negotiator for aircraft, the benefits provided by the bilateral agreement—constraints on direct support provided to Airbus, in the case of the United States, and a reduction in the threat of trade action in the case of the EU—are reasonably strong incentives for them to stay in the agreement.

The bilateral agreement has been in effect for too short a period to discern any definitive changes in government support to the large civil aircraft industry. However, if European government support to Airbus were

¹It should be noted that, also in connection with subsidies to Airbus, in 1989 the United States initiated a GATT dispute settlement procedure with respect to a German exchange rate guarantee program. In January 1992, a GATT panel ruled in favor of the United States.

reduced due to the constraints on direct support, the U.S. large civil aircraft industry would benefit. Possibly offsetting this potential benefit, if the indirect support constraints were to limit future U.S. research and development expenditures on civil aerospace, then the pace of technology development and introduction in the industry might be slowed. However, U.S. negotiators have indicated that the indirect support provisions, as negotiated, should not impinge on anticipated levels of U.S. research programs.

The United States and the EU have viewed such countries as Japan, Russia, and China as potential competitors in the market for large civil aircraft. As provided for in the bilateral agreement, the United States and the EU have tried to “multilateralize” the agreement, that is, to encourage other countries with aerospace industries to agree to limits on government support similar to those in the bilateral agreement. However, a new multilateral aircraft agreement has yet to be concluded. Multilateral negotiations on aircraft are continuing under GATT. Nonetheless, based on GAO’s discussions with U.S. and EU government and industry officials, GAO believes that such an agreement is not viewed by other countries as being in their interests. For this and other reasons, GAO believes that it is not likely that a new multilateral aircraft agreement will be reached in the near future.

GAO’s Analysis

Disagreements Mark Operation of the Bilateral Agreement

Two provisions in the bilateral agreement—article 3, covering production support, and article 5, dealing with indirect government support—have been the subject of ongoing disagreement between the two parties. Moreover, GAO believes the parties may disagree over a number of other provisions in the future. These disputes have contributed to a contentious relationship between the two parties.

In the case of article 3, the two parties have openly disagreed on the definition of “production support” and have had discussions concerning this difference. The U.S. government views production support as anything other than development or research support. The EU, in contrast, has indicated that the agreement pertains only to support that is dedicated to the production of a specific aircraft program. An official from the Office of the U.S. Trade Representative said that the U.S. government has not

observed any new general production support to Airbus since the agreement was concluded but would view any such activity as a violation of the agreement.

In the case of article 5, dealing with limits on identifiable benefits from indirect government support, the two sides have strongly disagreed over the appropriate methodology for measuring such benefits. According to EU manufacturers, the inclusion of disciplines on indirect support was important to them. In March 1993, using its methodology, the EU submitted estimates that the United States might have exceeded the indirect support constraints of article 5 during 1992. In sharp contrast, the United States reported, in July 1993, that there were no identifiable benefits from indirect support during the first year of the agreement and noted that the language of the agreement clearly supported its methodology.

Article 2 of the bilateral agreement, concerning prior government commitments of support, is one of the provisions that may engender potential disagreement between the two parties. The article notes that government support to current programs, committed before July 17, 1992, is not subject to the constraints of the agreement. However, the agreement provides that the “terms and conditions on which such support is granted shall not be modified in such a manner as to render it more favorable to the recipients.” In its June 9, 1993, letter to the House Majority Leader,² GAO noted that the United States was limited in its ability to determine whether the terms and conditions of prior European government support were being modified. The United States was not provided with information about the terms and conditions of the EU’s prior government support. Although the bilateral agreement did not require that those terms and conditions be provided, the absence of this information means that the United States lacks a baseline from which to analyze potential future changes in these terms.

The bilateral agreement does not contain a formal dispute settlement mechanism, but rather calls for consultations between the two parties when there is disagreement. Thus, the effectiveness of the agreement depends on the two parties acting in good faith to implement their commitments. Because of this, and given the ongoing and potential disagreements, GAO believes the long-term viability of the agreement is uncertain. However, according to the chief U.S. negotiator for aircraft, the benefits provided by the bilateral agreement—constraints on direct support provided to Airbus, in the case of the United States, and a

²See U.S.-EC Aircraft Agreement (GAO/GGD-93-41R, June 9, 1993).

reduction in the threat of trade action in the case of the EU—are reasonably strong incentives for them to stay in the agreement.

The Agreement May Enhance the Competitiveness of U.S. Manufacturers

An important U.S. goal of the 1992 bilateral agreement was to reduce the substantial EU government support for its large civil aircraft manufacturers. Although the constraints of the bilateral agreement are potentially significant, the agreement has been in effect for too short a period to discern any definitive changes in government support to the industry. However, GAO analyzed the potential impact on the U.S. large civil aircraft industry, assuming that the agreement remains in effect.

Both production and development support have been important sources of funding to Airbus in the past. The agreement provides for the elimination of all future production support and for substantial reductions of development support from the pre-agreement level provided to Airbus. To the extent that these reductions in direct EU support are realized, the long-term prospects of U.S. manufacturers would be enhanced.

Possibly offsetting this potential benefit, if the indirect support constraints were to limit future U.S. research and development expenditures on civil aerospace, then the pace of technology development and introduction in the industry might be slowed. However, U.S. negotiators have stated that the indirect support provisions, as negotiated, should not impinge on anticipated levels of U.S. research programs.

EU manufacturers have expressed an increased interest in receiving indirect government support and, in July 1994, the German government announced a new \$800-million domestic aerospace research program, funded equally by the government and private industry. To the extent that the EU offsets reductions in direct support to European large civil aircraft manufacturers by increasing indirect support, potential gains from the agreement to the U.S. large civil aircraft industry could be reduced. However, since the annual commercial sales of the EU large civil aircraft industry are substantially lower than that of the U.S. industry, the negotiated ceiling on indirect support, which is a percentage of the civil aircraft industry turnover, would be substantially lower for the EU as well.

Efforts to Multilateralize Agreement Have Not Succeeded Thus Far

The United States and the EU have regarded Japan (a signatory of the 1979 aircraft agreement), and Russia, China, South Korea, and Taiwan (nonsignatories) as potential competitors and so agreed to try to

multilateralize the bilateral agreement. Thus far, their efforts have been unsuccessful.

Near the conclusion of the 7-year Uruguay Round negotiations, the EU attempted to link the multilateral aircraft discussions with efforts to complete the GATT agreement, by December 15, 1993. U.S. industry strongly opposed efforts to hastily agree to a text submitted November 19 by the Chairman of the GATT Subcommittee on Trade in Civil Aircraft, the forum in which the multilateral discussions were taking place. Although no multilateral aircraft agreement was reached, at the conclusion of the Uruguay Round a broader agreement on subsidies and countervailing measures was obtained that would strengthen multilateral rules on subsidies. With a few exceptions, the agreement would clearly apply to trade in aerospace products and thus meet a major objective of the U.S. aerospace industry.

Although it was agreed that multilateral negotiations on aircraft would continue, the U.S. aerospace industry has expressed satisfaction with the coverage of civil aviation provided by the new GATT rules on subsidies in conjunction with the bilateral aircraft agreement. Based on GAO's discussions with U.S. and EU government and industry officials, GAO believes that such an agreement is not viewed by other countries as being in their long-term interests. Furthermore, Canada and Japan, key participants in the negotiations, have not agreed with the support-based disciplines contained in the bilateral agreement. For these reasons, it is not likely that a revised multilateral agreement will be reached in the near future.

Recommendations

GAO is making no recommendations in this report.

Agency Comments

On November 17, 1994, GAO discussed the contents of this report with officials of the Office of the U.S. Trade Representative, including the Assistant U.S. Trade Representative for Industry, and with officials of the Department of Commerce, including the Director of Policy and Analysis, Office of Aerospace, and the Director of the Office of European Union and Regional Affairs, Trade Policy Division. The agency officials agreed that the report was generally factually accurate. They offered technical clarifications that GAO incorporated as appropriate. The agency officials did not comment on GAO's observations regarding the status of the agreement.

Contents

Executive Summary		2
Chapter 1		10
Introduction	Background	10
	Government Support Has Had an Effect on the Competitiveness of the LCA Industry	11
	1979 GATT Agreement on Civil Aircraft Did Not Address Issue of Government Support to Industry	13
	The Threat of U.S. Trade Action Helped Restart Negotiations	14
	Bilateral Agreement Was Generally Well Received by All Parties	15
	Objectives, Scope, and Methodology	16
Chapter 2		19
Disagreements Mark Operation of the Bilateral Agreement	A Number of Articles Are the Source of Actual or Potential Disagreement	19
	Consultation and Amendment Provisions Are Important to the Success of the Agreement	31
	Bilateral Agreement's Effectiveness Depends on Good Faith Efforts of Both Parties to Make It Work	32
Chapter 3		34
The Bilateral Agreement May Enhance the Competitiveness of the U.S. LCA Industry	Government Support Is Influenced by Many Factors	34
	Agreement's Impact on U.S. Industry Depends on the Extent That Support Is Constrained	37
	Potential Changes in the Structure of the Industry May Affect the Agreement	40
Chapter 4		42
Efforts to Extend the Agreement to Other Nations Have Not Succeeded to Date	Multilateral Discussions Languished for More Than a Year	43
	Conclusion of a New Aircraft Agreement Became Linked to Overall Uruguay Round Agreement	45
	U.S. Industry Was Ultimately Pleased With Outcome of the Uruguay Round	46
	Incentives for Concluding a Multilateral Agreement Have Lessened Considerably	47
Appendix	Appendix: Major Contributors to This Report	50

Abbreviations

CASA	Construcciones Aeronàuticas S.A.
CPA	critical project appraisal
CRS	Congressional Research Service
CVD	countervailing duty
DOD	Department of Defense
EU	European Union
GATT	General Agreement on Tariffs and Trade
G.I.E.	groupement d'intérêt économique
HSCT	high speed civil transport
ITC	International Trade Commission
LCA	large civil aircraft
NASA	National Aeronautics and Space Administration
SST	Supersonic Transport
USTR	Office of the U.S. Trade Representative
VLCT	very large civil transport

Introduction

Two U.S. companies (the Boeing Company and the McDonnell Douglas Corporation) and one European company (Airbus Industrie, G.I.E. (groupement d'intérêt économique))¹ dominate the world market in large civil aircraft (LCA).² During the last few years, there has been a recession in the worldwide airline industry, and the industry lost more than \$11 billion between 1990 and 1992. This loss has resulted in significant decreases in new aircraft orders and some cancellations of previously placed orders. The LCA manufacturers have been forced to reduce employment, and the competition among the three companies has been especially intense, increasing trade tension between the United States and the European Union (EU).³ Concerns were raised regarding government support to LCA manufacturers, especially direct support provided by the EU to Airbus. An attempt to resolve this trade dispute resulted in the Bilateral Agreement Concerning the Application of the General Agreement on Tariffs and Trade's (GATT) Agreement on Trade in Civil Aircraft, signed on July 17, 1992.

Background

The U.S. civilian aircraft industry is one of the country's leading exporters and ran a net trade surplus of \$16.1 billion in 1993. Boeing and McDonnell Douglas had commercial aircraft revenues in 1993 of \$20.6 billion and \$4.8 billion, respectively. Employment in the LCA divisions of Boeing and McDonnell Douglas were 75,000 and 11,000, respectively, in 1993. The 1993 commercial aircraft revenue of Airbus was \$6.6 billion, with an employment level of 27,000.

The two U.S. LCA manufacturers, along with Airbus Industrie, G.I.E., typically accounted for 90 percent of global deliveries of LCA outside the former Soviet Union. Due especially to a downturn in the airline industry, Boeing and McDonnell Douglas have seen significant decreases in new

¹Airbus Industrie, G.I.E., is a consortium of four European producers—Aérospatiale of France, Deutsche Aerospace of Germany, British Aerospace of the United Kingdom, and Construcciones Aeronáuticas S.A. of Spain. Airbus is a "groupement d'intérêt économique," a type of joint venture under French law. According to the U.S. International Trade Commission (ITC) report on Global Competitiveness of U.S. Advanced-Technology Manufacturing Industries: Large Civil Aircraft, publication 2667 (Washington, D.C.: Aug. 1993), a G.I.E. is not required to report financial results to the public. Moreover, while the partner companies are subject to taxation, the G.I.E. is not liable to pay taxes on its profits unless it so elects. U.S. manufacturers are subject to tax requirements and disclosure standards imposed by the Securities and Exchange Commission.

²Large civil aircraft (LCA) are defined in the bilateral agreement as aircraft "that are designed for passenger or cargo transportation and have 100 or more passenger seats or its equivalent in cargo configuration."

³The European Union is the successor to the European Community. The European Community changed its name to "European Union" after November 1, 1993. In this report, we use EU, even though it was the EC that had entered into the bilateral agreement with the United States.

orders during the last few years. Consequently, they have had to reduce their employment. Airbus, similarly, has seen a decrease in its orders, and the Airbus partners have also had to reduce their employment. Because of the smaller demand for new aircraft, the competition among the three major LCA manufacturers has been intense and has exacerbated existing trade tension. However, U.S. concerns about Airbus subsidies predate the recent downturn in the airline and LCA industries.

Government Support Has Had an Effect on the Competitiveness of the LCA Industry

Through the 1960s, U.S. LCA manufacturers dominated the world market. This dominance was due in part to the commercial failure of several European large aircraft programs. In an effort to establish a successful West European aircraft program, the governments of the United Kingdom and France funded and codeveloped the Supersonic Transport (SST) or “Concorde” program. The Concorde, while a technical success, was ultimately a financial disaster, and only 14 aircraft went into service. In the late 1960s, the governments of France, West Germany, and the United Kingdom initiated discussions aimed at creating a West European LCA competitor for U.S. LCA producers. In December 1970, Airbus Industrie formally began operations with Aérospatiale of France and Deutsche Aerospace as the major partners. Construcciones Aeronáuticas S.A. (CASA) of Spain joined in December 1971, and British Aerospace became a partner in January 1979. The French and German partners each own 37.9 percent of the company, the United Kingdom partner owns 20 percent, and the Spanish partner owns 4.2 percent.

Two major studies have examined the issue of government support to Airbus, and each has concluded that Airbus has received billions of dollars in support from its member governments. According to a September 1990 study prepared by Gellman Research Associates, Inc., for the U.S. Department of Commerce, Airbus would not have been commercially viable without the substantial amount of direct support it had received from its member governments since it was established.⁴ According to the study, government funding to Airbus consisted principally of loans to support the development of Airbus aircraft, but little of this aid had in fact been repaid.⁵ The Gellman study estimated that the net support committed

⁴An Economic and Financial Review of Airbus Industrie, Gellman Research Associates, Inc. (Jenkintown, PA: Sept. 4, 1990).

⁵Our March 1994 study, European Aeronautics: Strong Government Presence in Industry Structure and Research and Development Support (GAO/NSIAD-94-71, Mar. 23, 1994), reported that as of August 1993, an estimated \$3.5 billion in Airbus supports had been repaid, up from less than \$500 million when the Gellman study was published in 1990. However, as discussed in chapter 2, repayments by Deutsche Aerospace to the German government have been suspended indefinitely.

to Airbus was \$13.1 billion (i.e., \$7.7 billion in launch aid, and approximately \$5.8 billion in other support disbursed or to be disbursed minus repayments to date). The Gellman study also calculated what it called the “opportunity cost” or “true value” of these government supports, thereby increasing the value of net support committed to \$25.8 billion.

According to the August 1993 ITC report,⁶ Airbus and the EU disagreed with some of the conclusions and figures contained in the Gellman report. Airbus called the \$25.8-billion figure “a gross exaggeration,” noting that the total amount of development loans received by Airbus members was “only a fraction of that amount,” and added that the loans were being repaid. According to ITC, however, neither Airbus nor the governments of the consortium members had directly refuted the Gellman report’s conclusions on launch aid disbursed or provided an alternative figure. ITC stated that although certain slight downward adjustments of figures in the Gellman report were justified, the report appeared accurate with respect to launch aid disbursed and to be disbursed by European governments. ITC noted that information from other independent sources, including government agencies in the countries of the Airbus consortium member companies, was consistent with the conclusions of the Gellman study. Although ITC noted that it was difficult to ascertain the legitimacy of adjusting the figure for pledged and disbursed funds to reflect the true value derived from such funds, it concluded that with or without such an adjustment, government support for Airbus consortium members had been substantial.

The EU commissioned a November 1991 report prepared by Arnold & Porter that said that the U.S. commercial aircraft industry would not have achieved its dominant competitive position in world markets without huge amounts of indirect support from the U.S. government.⁷ The study also stated that “[t]he government and the industry have been operating in a close, cooperative fashion for so long that they have developed many kinds of ties that are rarely, if ever, held up to public scrutiny.” According to the study, the indirect support came through Department of Defense (DOD) and National Aeronautics and Space Administration (NASA) research and development programs and through the U.S. tax system. The indirect support was calculated to be between \$18 billion and \$22 billion in actual dollars (and between \$33.5 billion and \$41.5 billion in constant dollars) during the period from 1976 to 1990.

⁶Global Competitiveness of U.S. Advanced-Technology Manufacturing Industries.

⁷U.S. Government Support of the Commercial Aircraft Industry, Arnold & Porter (Washington, D.C.: Nov. 1991).

In March 1992, the U.S. government officially responded to the EU-commissioned study by Arnold & Porter, stating that the latter was “an attempt to deflect attention from the fundamental issue of the ongoing U.S.-EC negotiations on aircraft: the huge direct government subsidies provided by certain member states of the European community to develop and produce Airbus airplanes.” The U.S. response noted “factual and methodological errors” in the Arnold & Porter study and concluded that the report fell “far short of demonstrating significant large subsidies through military- and aerospace-related procurement and research contracts.” The U.S. response said that the Arnold & Porter study “greatly exaggerated” potential crossover benefits to the U.S. aircraft industry while “totally ignoring” the potential for similar or greater research and development crossover advantages for Airbus. It should be noted that the 1993 ITC report concluded that accurate measurement of indirect supports was impossible until mutually agreeable terms of definition were developed.

1979 GATT Agreement on Civil Aircraft Did Not Address Issue of Government Support to Industry

The economies of scale and scope in producing LCA are huge, and it has been estimated that as many as 600 units of a new aircraft must be sold before the breakeven point is reached.⁸ Consequently, exports have long been critical to both U.S. LCA manufacturers and the Airbus consortium. As Airbus began to make sales in the United States in the late 1970s, the U.S. government considered imposing a countervailing duty (CVD)⁹ to offset export subsidies provided by the Europeans. According to Tyson,¹⁰ CVD relief was blocked as a result of the argument by the U.S. air carriers that they stood to benefit from Airbus’ aggressive selling tactics.¹¹ U.S. LCA manufacturers, however, became more vocal not only about European export subsidies, but also about industrial policy support provided to the Airbus members. According to Tyson, U.S. LCA manufacturers, within the context of the Tokyo Round’s GATT discussions, called for a sectoral

⁸See Laura D’Andrea Tyson, “Industrial Policy and Trade Management in the Commercial Aircraft Industry,” *Who’s Bashing Whom? Trade Conflict in High Technology Industries*, Institute for International Economics (Washington D.C.: Nov. 1992).

⁹A CVD is an extra duty upon importation of a subsidized product equal in measure to the amount of the subsidy. The Tariff Act of 1930 (19 U.S.C. 1671), as amended, provides for the imposition of such a duty if a subsidy is provided with respect to the manufacture, production, or exportation of a class or kind of merchandise imported into the United States and if a U.S. industry is materially injured or threatened with material injury by reason of imports of that merchandise.

¹⁰*Who’s Bashing Whom?*

¹¹As noted in the following sentences, U.S. LCA manufacturers were also reluctant to pursue relief under U.S. trade laws for fear that such actions would provoke retaliation, such as through reduced sales of U.S. LCA to European airlines.

agreement to address the issues peculiar to trade in aircraft. U.S. manufacturers wanted “not only a ‘free trade’ agreement that eliminated traditional trade barriers, but also a ‘free market’ agreement that constrained European industrial policy support.”

The purpose of the 1979 GATT Agreement on Trade in Civil Aircraft was to liberalize aircraft trade; tariffs, quotas, and preferential technical standards were to be eliminated, licensing requirements prohibited, and discriminatory procurement practices banned. However, according to a Congressional Research Service (CRS) report,¹² the agreement did not include clear rules covering aircraft subsidies. The issue of government support to the LCA industry continued to be a source of trade friction between the two parties.

The Threat of U.S. Trade Action Helped Restart Negotiations

During the 1980s, Airbus continued to make inroads into the U.S. market as well as in other markets. Furthermore, the 1984 launch of the A320,¹³ which embodied new technology, represented a new competitive challenge to U.S. LCA manufacturers. After 1986, the United States and the EU held intermittent bilateral talks on trade in civilian aircraft. Although the U.S. government repeatedly considered initiating Section 301¹⁴ trade actions or CVD relief against Airbus, U.S. LCA manufacturers repeatedly opposed such actions. Europe represented a significant export market for U.S. LCA producers, and they feared retaliation from the European governments.

In late 1989, the United States initiated a GATT dispute settlement procedure against a German government program on exchange rate guarantees for its Airbus partner,¹⁵ calling it a violation of the GATT subsidies code, which bans export subsidies. Although the United States

¹²Airbus Industrie: An Economic and Trade Perspective, CRS Report for Congress, The Library of Congress (Washington, D.C.: Feb. 20, 1992).

¹³The various LCA manufacturers have striven to have a range of different aircraft, filling various market niches. The A320, launched by Airbus in March 1984, is considered a direct competitor to the Boeing 737 and the McDonnell Douglas MD-80 series. It has a range of over 2,800 nautical miles and carries 150 passengers.

¹⁴Section 301 of the Trade Act of 1974 (19 U.S.C. 2411), as amended, provides the President with the authority to enforce U.S. rights under international trade agreements and to respond to unjustifiable or discriminatory foreign government practices that burden or restrict U.S. commerce.

¹⁵In 1988, reflecting increased concern over the costs of the Airbus program, the German government decided to sell Messerschmitt-Boelkow-Blohm, the German state-owned member of the Airbus consortium, to Daimler-Benz. As part of the terms, the German government made several major concessions to Daimler-Benz, including guaranteeing against losses on export sales resulting from exchange rate changes.

and the EU appeared to have been moving toward a compromise with respect to the amount of development support that would be allowable, the bilateral talks had broken down in early 1991. In May 1991, the United States initiated a second GATT dispute settlement procedure with respect to Airbus, challenging the overall government subsidies it had previously received. The United States agreed to suspend its case on overall subsidies to Airbus in exchange for renewed efforts to conclude a bilateral agreement. A GATT panel ultimately ruled in favor of the United States in January 1992 with respect to the German exchange rate program. Although the European Commission refused to accept the GATT panel report, the German government terminated the exchange rate subsidy on January 1, 1992.

Bilateral Agreement Was Generally Well Received by All Parties

After more than 5 years of intermittent negotiations, on July 17, 1992, the United States and the European Union signed the “Agreement Concerning the Application of the GATT Agreement on Trade in Civil Aircraft.” The preamble of the bilateral agreement noted the pursuit of the two parties in “their common goal of preventing trade distortions resulting from direct or indirect government support for the development and production of large civil aircraft and of introducing greater disciplines on such support.” With the bilateral agreement, the two parties agreed that a reduction in government support to the industry would help prevent trade distortions.

The agreement established specific limits on direct development support for new large civil aircraft. The allowable support rate of 33 percent of total development costs represented a considerable reduction from prior development support levels to Airbus, which had been estimated by the Gellman study to be approximately 75 percent. The agreement’s prohibition on future production support was also a gain for the United States.

The agreement also placed constraints on the “identifiable benefits” from indirect support. EU negotiators saw the inclusion of these constraints as extremely important and noted that it was the first international recognition that there needed to be some limitations placed on indirect support. Moreover, the agreement provided the EU with some protection against U.S. government trade action due to past EU government support to Airbus.

According to Department of Commerce and U.S. Trade Representative (USTR) officials, the bilateral agreement was not a tradeoff between

constraints on EU direct support for Airbus in return for constraints on U.S. indirect support for the LCA industry. Rather, the agreement was a tradeoff between constraints on EU direct support in return for “grandfathering” of past EU support and agreement by the United States not to pursue a GATT complaint on overall subsidies to Airbus. EU officials and Airbus officials, on the other hand, have stressed the tradeoff between constraints on direct and indirect support. U.S. government officials have told us that not until the last few months before the signing of the agreement was the indirect support issue a significant part of the negotiations and that EU negotiators did not express strong interest in numeric indirect support disciplines until that time.

The U.S. civil aircraft industry generally supported the agreement, with a common industry view that it was a useful first step in eliminating EU government support for production of large civil aircraft. Airbus generally supported the agreement as well. According to Tyson, the success of Airbus was a major consideration in ultimately reaching agreement, since by 1992 Airbus’ market share had grown significantly, and its need for future government support was considerably reduced.

Objectives, Scope, and Methodology

Representative Richard Gephardt, the House Majority Leader, asked us to review the details and implications of the July 17, 1992, agreement between the United States and the EU on trade in large civil aircraft. Specifically, our objectives were to assess (1) the extent to which the agreement has proved viable in operation, (2) the potential impact of changes in government support on the competitiveness of the U.S. LCA industry, and (3) the efforts of the two parties to extend coverage of the agreement to other nations with aerospace industries and to related aerospace products.

In addressing the first objective, we interviewed U.S. government officials from the Office of the U.S. Trade Representative and the Department of Commerce who were primarily responsible for negotiating the bilateral agreement. We also interviewed officials from the Departments of State and Defense who monitored the bilateral agreement. To get the perspective of U.S. industry, we interviewed officials of the two major LCA producers in the United States (the Boeing Company and the McDonnell Douglas Corporation), one of the two major engine companies (General Electric), and the Aerospace Industries Association.¹⁶

¹⁶The Aerospace Industries Association is the nonprofit trade association representing U.S. manufacturers of commercial, military, and business aircraft; helicopters; aircraft engines; missiles; spacecraft; and related components and equipment.

To obtain information about the EU, we interviewed officials of the European Commission in Washington, D.C., and in Brussels, Belgium, including the chief negotiator for aircraft, and French government officials in Paris, France. For the EU industry perspective, we interviewed officials of Airbus Industrie, G.I.E., in Toulouse, France, and Washington, D.C., and officials of the three primary member companies of the four-member Airbus consortium (Aérospatiale in Paris, France; Deutsche Aerospace in Hamburg, Germany; and British Aerospace in Brussels, Belgium). We also interviewed European trade association officials (the European Aerospace Industry Association) in Brussels, Belgium. Information on foreign law in this report does not reflect our independent legal analysis but is based on interviews and secondary sources.

In addition, we reviewed official documents of the U.S. government and the EU, including the submissions of information by each party to the other party in conformance with the provisions of the bilateral agreement dealing with the exchange of information (transparency). We reviewed selected portions of the U.S. negotiating history leading to the signing of the bilateral agreement. We reviewed documents concerning the methodology for calculating indirect government support to the LCA industry and held extensive discussions with the key parties in this regard. We also reviewed studies prepared by CRS, ITC, and the National Commission to Ensure a Strong Competitive Airline Industry, as well as studies prepared by consultants for the U.S. government and the European Commission and by academic experts in the field.

In addressing the second objective, an analysis of the potential impact of the agreement on the U.S. civil aircraft industry, we considered the extent to which government support may be reduced due to the agreement. We reviewed several economic studies that analyzed the market conditions of the civil aircraft industry. We also reviewed reports prepared for both the U.S. government and the EU that analyzed past government support to the industry. We compared the restrictions on government support contained within the agreement with past government support to the industry.

In addressing the third objective, an assessment of efforts to multilateralize and expand the product coverage of the bilateral agreement, we interviewed the same U.S. and European government and industry officials previously mentioned. We also reviewed official GATT documents, including proposals of the United States, the EU, Canada, Japan, Norway, and Sweden concerning a new multilateral agreement on aircraft.

On November 17, 1994, we discussed the contents of this report with officials of the Office of the U.S. Trade Representative, including the Assistant U.S. Trade Representative for Industry, and with officials of the Department of Commerce, including the Director of Policy and Analysis, Office of Aerospace, and the Director of the Office of European Union and Regional Affairs, Trade Policy Division. The agency officials agreed that the report was generally factually accurate. They offered technical clarifications that we incorporated as appropriate. The agency officials did not comment on our observations regarding the status of the agreement.

We did our work between March 1993 and August 1994 in accordance with generally accepted government auditing standards.

Disagreements Mark Operation of the Bilateral Agreement

Two provisions of the bilateral agreement are the source of ongoing disagreement between the United States and the EU. Moreover, we believe the parties may disagree over several other provisions in the future. The bilateral agreement does not contain a formal dispute settlement mechanism, but rather calls for consultations between the two parties when there is disagreement. Thus, the effectiveness of the agreement depends on the two parties acting in good faith to implement their commitments. Because of this, and given the ongoing and potential disagreements, we believe the long-term viability of the agreement is uncertain. However, according to the chief U.S. negotiator for aircraft, the benefits provided by the bilateral agreement—constraints on direct support provided to Airbus, in the case of the United States, and a reduction in the threat of trade action in the case of the EU—are reasonably strong incentives for them to stay in the agreement.

A Number of Articles Are the Source of Actual or Potential Disagreement

Two provisions—article 3, covering production support, and article 5, dealing with indirect government support—have been the subject of ongoing disagreement between the United States and the EU. Four other provisions—article 2, dealing with the reporting of prior government support; article 4, covering development support; article 7 involving equity infusions; and article 8, concerning transparency—could be a source of potential disagreement. A discussion of these six articles, in the order they appear in the agreement, follows.

Determining Whether Terms of Prior Government Support Were Modified Has Been Difficult

While the bilateral agreement was primarily concerned with limiting future government support, article 2 addressed the issue of prior government support. Article 2 noted that “government support to current large civil aircraft programs, committed prior to the date of entry into force of this agreement, is not subject to the provisions of this agreement.” However, the article also noted that the “terms and conditions on which such support is granted shall not be modified in such a manner as to render it more favorable to the recipients.” Minor modifications, however, were not to be considered inconsistent with the provision.

The agreement stated that with respect to prior government commitments, a “complete list of such commitments by the Parties to this agreement already disbursed or committed shall be separately provided, including information on the type of repayment obligation and the planned period of repayment.” On July 16, 1992, the EU provided the United States with a list of such commitments.

In our June 9, 1993, letter to the House Majority Leader,¹ we noted that the United States was limited in its ability to determine whether the terms and conditions of prior European government support were being modified to render them more favorable to the recipients. This limitation was due to the fact that the July 16, 1992, list provided by the EU to the United States did not contain key terms and conditions of prior support provided by the French, German, British, and Spanish governments to the respective Airbus consortium members. We noted that, although the bilateral agreement does not require the exchange of such information, without knowing key terms and conditions of prior support the United States lacks a baseline from which to establish EU adherence to the agreement's provisions on prior support. However, a USTR official told us that it would be difficult for the member governments to modify the repayment terms and conditions of the Airbus partners without attracting public and/or parliamentary scrutiny.

An example of the problem due to the absence of key terms and conditions concerns Deutsche Aerospace. Before the signing of the bilateral agreement, with approval of the German government, Deutsche Aerospace suspended repayment of prior government support for Airbus programs. In April 1993 testimony before ITC, an Airbus official acknowledged that there had been a virtual suspension of repayments to the German government. It now appears that repayment will begin again only upon a determination by Deutsche Aerospace as to its own profitability. The U.S. government has been unable to determine whether this relaxation in repayment for Deutsche Aerospace was consistent with the terms and conditions of the loans it received. On the basis of the information provided under the agreement, it would be difficult for the United States to independently assess compliance with this provision in the future.²

Interpretation of the Production Support Provisions Has Been Subject to Disagreement

Article 3 of the bilateral agreement states that "as of entry into force of this agreement, Parties shall not grant direct government support other than what has already been firmly committed for the production of large civil aircraft. This prohibition shall apply both to existing and to future programs." The agreement defines "production" as all manufacturing,

¹See U.S.-EC Aircraft Agreement (GAO/GGD-93-41R, June 9, 1993).

²The payment suspension occurred just before the signing of the bilateral agreement and, therefore, was not covered by its provisions. However, the Deutsche Aerospace example is useful in demonstrating the difficulty the U.S. government would have in monitoring any future changes in prior government support by the EU.

marketing, and sales activities, except for export credit financing consistent with the 1985 Large Aircraft Sector Understanding³ and certain other development activities listed in the agreement.

According to the 1990 study prepared by Gellman Research Associates for the Department of Commerce, the principal form of support received by Airbus has been development support. However, the report also provided examples of production support, such as loans to Deutsche Aerospace guaranteed by the German government to ensure production. New loans of this type may now be prohibited by the bilateral agreement.

There has not been any allegation by either party of violations of the agreement with respect to the prohibition against production support. However, the two parties have openly disagreed on the definition of “production support” and have had discussions concerning this difference.

According to a Commerce Department official, the U.S. government views production support as anything other than development or research support. The EU, in contrast, has indicated that the agreement pertains only to support that is dedicated to the production of a specific aircraft program. The issue arose after the United States made an inquiry during a bilateral consultation regarding German exchange rate guarantees (see ch. 1). The EU informed the United States that the guarantees were not program specific and therefore not subject to the bilateral agreement. U.S. government officials disagreed with the EU interpretation of the agreement.

An EU official considered the discussion of this issue unnecessary since the EU has no plans to use this type of subsidy. An Airbus official noted that the EU is concerned that the United States will use its “extensive” interpretation of the production support constraints to consider loans from state-owned banks to Airbus at commercial rates to be a violation of the agreement. A USTR official said that the U.S. government has not observed any new general production support to Airbus but would view any such activity as a violation of the agreement.

Development Support Constraints Have Not Yet Been Tested

Article 4 of the bilateral agreement addresses the issue of development support. The three subsections of this article describe the terms and conditions under which either signatory can provide repayable, direct

³The Large Aircraft Sector Understanding is a 1985 Organization for Economic Cooperation and Development agreement that establishes constraints on loans that governments may offer for the purchase of large commercial aircraft.

government support for the development of a new aircraft program. The support cannot exceed 33 percent of the estimated total development costs of the new program and is to be paid back within 17 years, at a rate that is approximately the government's rate of borrowing. At the time that support is provided, the government is to establish that there is a reasonable expectation of recoupment of the direct support through a "critical project appraisal" (CPA) using conservative assumptions. Some "nonproprietary" elements of the CPA are to be provided to the other party, if requested.

According to a McDonnell Douglas official, the principal focus of the company during the negotiations on the 1992 bilateral agreement was on controlling the development support received by Airbus. He said that the agreement provides limits in areas where there previously were none. According to the Gellman study, development support had been the primary form of government support provided to the Airbus members in the past. The Gellman study estimated that the development support level for previous Airbus programs has been approximately 75 percent, which is considerably higher than the constraints allowed in the bilateral agreement.

Although the development support provisions of the agreement potentially constrain Airbus and its member companies, they are untried in practice. The launch of a totally new aircraft program is very expensive and takes a substantial amount of time.⁴ The agreement's impact on development support will not be tested until such a program is launched. However, since the agreement has taken effect, Airbus has launched a derivative program, the A319. The A319 is a smaller version of the A320, which was launched in 1984, and is expected to require substantially fewer resources than would be necessary for a completely new aircraft model. Both EU government and Airbus member company officials told us that there are currently no plans to provide government support for the A319 program.

The credibility and accuracy of the CPA is essential to the effective implementation of the development support provisions. The 33-percent limit is to be based on the CPA's forecast of the total development costs of the supported program. According to the 1993 ITC report, U.S. LCA producers have expressed concern that the agreement will permit Airbus to skew the forecasts associated with government support programs to its advantage.

⁴For example, the development of a super-jumbo aircraft (550 or more passengers) has been estimated by Boeing and Airbus to cost between \$10 billion and \$20 billion, with production of aircraft beginning around the year 2000.

The two U.S. LCA producers have expressed a desire to further reduce the allowable level of development support below the limits established in the bilateral agreement as part of any future multilateral aircraft agreement. Boeing has also stated that as part of any future multilateral agreement there should be a requirement that the CPA forecast be fully supported and reviewed by an impartial panel.

Determination of Identifiable Benefits From Indirect Support Has Been Subject to Different Interpretations

Article 5 of the bilateral agreement places constraints on the identifiable benefits from indirect government support.⁵ EU manufacturers took the position that the establishment of constraints on indirect support was an important negotiation objective for the EU. According to the 1991 study prepared by Arnold & Porter for the EU, the U.S. government had provided substantial support to the U.S. LCA industry indirectly, such as through DOD and NASA research and development contracts.

In response to the Arnold & Porter study, the Department of Commerce stated that the study fell far short of demonstrating significant large subsidies to U.S. commercial aircraft manufacturers through military- and aerospace-related procurement and research contracts. U.S. manufacturers also disagreed about the importance of government-sponsored research. In March 1994 congressional testimony, a Boeing official said that “the Boeing Company believes that government-sponsored research activities have a negligible effect on trade flows and subsequently should not be subject to trade remedies.”

Article 5.2 of the agreement limits the identifiable benefits from indirect support to 3 percent of the annual “commercial turnover”⁶ of the total civil aircraft industry of each party, or 4 percent of the annual commercial turnover of any one firm.

The analytical basis for the 3-percent and 4-percent constraints is difficult to establish clearly. An Airbus spokesman said that the two figures were arrived at through the negotiation process and not through any independent analysis. An EU official said that 3 percent of total turnover in the industry equated roughly to NASA’s 1991 budget and that this amount

⁵Indirect government support is defined in annex II of the 1992 agreement as “[F]inancial support provided by a government or by any public body within the territory of a Party for aeronautical applications, including research and development, demonstration projects and development of military aircraft, which provide an identifiable benefit to the development or production of one or more specific large civil aircraft programs.”

⁶Commercial turnover is not defined in the agreement but, according to a U.S. government official, is equivalent to the total commercial sales of a company.

provided some basis for the 3-percent figure. A U.S. LCA industry official said that after being presented with the two values, the industry considered them and believed it could live with them. He went on to say he believed that historically, the actual amounts of identifiable benefits from indirect support were not close to the two constraints, and in the future they would not be close as well.

An EU official explained that these constraints provided only a rough “economic equivalence” with the direct support constraints imposed on Airbus. He said that the commercial turnover of the U.S. aircraft industry is much greater than that of Airbus.⁷ He added that the constraints were “politically equivalent” and were the first international recognition of the need for limits on indirect support. Commerce officials told us, however, that the United States never accepted the EU view of equivalence between direct and indirect supports.

Despite the fact that the two parties reached agreement on the language of the indirect support provision, the issue has been the source of substantial strife between the two parties since the signing of the agreement. In April 1993, a Commerce Department official described the two parties as being “180 degrees” apart in their interpretations of the provisions regarding indirect support. As of June 30, 1994, the two parties had made very little progress in reaching agreement on this issue.

On March 31, 1993, the two parties had the first formal consultation regarding the agreement.⁸ At this meeting, the EU submitted a series of tables in conformance with the transparency requirements of the bilateral agreement. The United States did not provide its own estimates at that time, indicating instead that the information was being developed and would be provided in July, since the United States views the agreement year as July to June. The EU submission included an EU estimate of the dollar amount of identifiable benefits from indirect support to the European civil aircraft industry during the first year of the agreement as well as its own estimate of the U.S. government’s indirect support to the U.S. civil aircraft industry.

⁷The 1992 commercial turnovers of the United States and EU LCA industries were approximately \$23.2 billion and \$6 billion, respectively. Using the 3-percent constraint of the bilateral agreement, the limits in 1992 of identifiable benefits from indirect support would have been approximately \$700 million for the United States and \$180 million for the EU.

⁸The two sides also had met informally several times previously, as part of the multilateralization process. See chapter 4 for additional details regarding these consultations.

The EU Methodology

The EU estimated that in 1992 the European LCA industry received identifiable benefits from indirect government support of between 1.02 percent and 1.32 percent of total commercial turnover.⁹ This estimate was within the constraints of the agreement. The EU also estimated that the U.S. LCA industry received indirect government support of between 4.4 percent and 5.8 percent of commercial turnover in 1992. The EU estimate indicated that the United States was in violation of the bilateral agreement.¹⁰ The EU methodology consisted of adding up the budgetary appropriations given by the governments for aeronautics research and development for large aircraft. In the case of the United States, this amount included the 1992 budgetary authorizations for NASA Aeronautics and Transatmospheric Research, NASA Independent Research and Development, and DOD funding for the national aerospace plane.

The United States strongly disagreed with the EU methodology. A USTR official said that the EU was clearly overlooking the requirement that only “identifiable benefits” to specific large civil aircraft programs be counted against the percentage limits. Commerce officials told us that the EU was “re-interpreting” the language of the agreement and this interpretation did not conform in any way with the actual language of the agreement. According to a July 1993 State Department cable, “[w]hile the U.S. government does fund a large amount of research in the aeronautics area, only a small portion of that research provides large civil aircraft producers with spillover benefits for their civil aircraft programs. Much government-funded R&D [research and development] goes to companies that do not produce civil aircraft. In addition, most contracts are not linked to specific programs, and the results of much of this research are generally made widely available.”¹¹

The U.S. Methodology

The Department of Commerce, in conjunction with the two U.S. LCA producers, devised a methodology for determining identifiable benefits from indirect support for the bilateral agreement. The U.S. methodology

⁹The EU’s calculation of indirect support was done using two different values for annual commercial turnover (the denominator of the indirect support constraint ratio). The lower estimated level of indirect support included the engine companies and non-Airbus aeronautics companies in the calculation of annual commercial turnover. The higher estimated level of indirect support included the annual commercial turnover of Airbus partners only.

¹⁰The EU indicated that its estimate understated the magnitude of indirect benefits received by the United States since it was unable to make a full appraisal of DOD’s aeronautics research and development budget.

¹¹The agreement excludes from the indirect support constraints research and development that had been “made available on a non-discriminatory basis to large civil aircraft manufacturers of the parties.”

was to identify potential benefits from government-sponsored aeronautical research and development that may have “flowed to the development or production of one or more specific large civil aircraft programs.” Each aircraft manufacturer was asked to assess individually the identifiable reductions in the cost of its LCA programs resulting from technology obtained through government-funded research for which results have not been made publicly available. After conducting this analysis, the two U.S. manufacturers reported that there were no identifiable benefits from indirect support during the first year of the agreement. The U.S. government’s explanation for this zero value was that “the absence of identifiable benefits during the first year was expected, as the agreement calls for identifiable benefits to be calculated with respect to research performed after entry into force of the agreement and research programs typically take a number of years to yield commercial results.”

The U.S. government submitted this calculation to the EU on July 8, 1993. The head of the EU delegation said at the time that he viewed the U.S. calculation as a “decision on the part of the U.S. administration to void the indirect support discipline of all content.” He said that he would have to bring this situation to the attention of member states at the political level. A European industry official said that he believed the U.S. submission was evidence of “bad faith” in complying with the agreement.

The two parties met on October 7 and 8, 1993, for further bilateral agreement discussions. The EU presented to the United States a series of complaints regarding the U.S. methodology for measuring identifiable benefits from indirect support:

- (1) The method used was too cumbersome, especially in the way it accounted for “identifiable benefits.”
- (2) The method relied too heavily on the analysis of the industry in order to make the necessary calculations. This reliance was a potential source of bias in the methodology.
- (3) The analysis was limited to existing programs only, not considering conceptual (future) programs, such as the high speed civil transport (HSCT) or the super-jumbo aircraft.
- (4) The analysis was limited to Boeing and McDonnell Douglas and did not include government contracts with other aerospace firms.

(5) The United States did not give any value to “dead-end” research, despite the fact that the determination that a certain research path is fruitless may nevertheless provide useful and valuable information.

For these reasons, the EU considered its methodology of using the total contract value of government-supported aerospace research and development more appropriate and easier to implement. The EU argued that by including all contracts in its calculation, it was able to encompass the potential benefits of conceptual programs.¹²

In response, the United States contended that the language of the agreement clearly supported the approach that it took. U.S. negotiators argued that there is no reason to expect that government-sponsored research by companies other than Boeing and McDonnell Douglas would benefit Boeing or McDonnell Douglas, since any resultant application would be commercially available to all aircraft manufacturers, including Airbus. The United States considered the valuation of “dead-end” research to be a nebulous concept, since it is doubtful that U.S. manufacturers would independently undertake research projects for which the company did not foresee a commercial application. While refusing to renegotiate the language of the bilateral agreement, the U.S. negotiators did agree to further discussions with the EU on the measurement of conceptual programs in the context of the indirect support issue.¹³

The language of the indirect support provisions is not specific as to methodology and does not offer much guidance on the formulation of a

¹²The U.S. methodology only included benefits that have accrued to already existing or announced programs. Current research for hypothetical future programs, such as the HSCT, were not scored. The negotiators referred to these hypothetical programs as “conceptual programs.” One of the U.S. LCA manufacturers has expressed an interest in scoring conceptual programs as part of the U.S. methodology in the future. An official of this company said that his firm does not want to be placed in a position where all the benefits of a new program are scored in 1 year. A Commerce Department official noted that there is shared concern by both the United States and the EU that if conceptual programs are not counted in the current year, then there might be a “bunching” of indirect benefits in the year when the program is eventually launched. A U.S. LCA manufacturer suggested that a way to account for indirect benefits to a conceptual program is if a particular government-sponsored aeronautical research and development contract has a probability greater than X percent (X to be decided, perhaps equal to 10 percent) that a benefit would eventually result, then it should be scored. A USTR official noted that the scoring of government-funded research benefits for conceptual programs could hypothetically lead to a company being over the indirect support limit provided under the agreement, even though the conceptual program never becomes an actual program, and therefore, no actual benefits are received.

¹³The United States submitted to the EU in September 1994 the value of identifiable benefits from indirect support for the July 1993-June 1994 period. The United States concluded that there were no identifiable benefits to existing large aircraft programs. However, the United States also included a value for the potential benefits to conceptual large civil aircraft projects. This value was well within the constraints of the agreement. As of November 1994, the EU had not officially commented on the U.S. submission.

compromise. A Commerce Department official noted that one intention of the negotiators “was to be vague” with respect to indirect support. An Airbus official said that the vagueness of article 5 is partly due to ambivalence on the part of the EU at the time of the negotiations. Some members of the European aerospace industry saw a potential benefit in keeping the discussion of the issue somewhat nebulous in order to allow the industry the option of receiving more of this form of support in the future. According to a European industry official, the vagueness in language was also due to the lack of input from technically experienced “experts” during the negotiation of the agreement. An Airbus official told us that the EU is beginning to believe that the indirect support provisions of the bilateral agreement were not well drafted, since they do not appear to constrain the United States’ use of indirect support.

Discipline on Equity Infusions Generally Excluded From Agreement

Article 7 of the bilateral agreement addresses the issue of equity infusions. An equity infusion by a government to a commercial manufacturing facility usually means the purchase by the state of shares in the enterprise. As such, this form of support occurs only where there is a desire to establish some level of state ownership in an enterprise, or to increase that ownership from its existing level. The agreement states that

“[E]quity infusions are excluded from the scope of this Agreement. Equity infusions will not, however, be provided in such a manner as to undermine the disciplines foreseen in the Agreement.”

Of the three primary Airbus partners (Aérospatiale, British Aerospace, and Deutsche Aerospace), British Aerospace and Deutsche Aerospace are now private companies. However, the Government of France owns a substantial majority of Aérospatiale and uses equity infusions as a form of support to the firm.

Since the agreement was signed in July 1992, Aérospatiale has received one equity infusion. A second equity infusion is planned. In the fall of 1992, Crédit Lyonnais, a French bank, purchased a 20-percent share of Aérospatiale. The Government of France owns a majority of Crédit Lyonnais and thus was indirectly involved in the equity infusion into Aérospatiale.¹⁴ The infusion was estimated by the U.S. State Department to be worth 1.4 billion francs (approximately \$275 million). In February 1994, the Government of France announced its intention to infuse an additional

¹⁴In March 1994, the Government of France announced the intention of providing an additional 3.5 billion francs (\$608.3 million) of capital to Crédit Lyonnais.

2 billion francs (\$340 million) of equity into Aérospatiale. The EU ruled that the first infusion was consistent with its rules on state aid; but as of June 1994, it had yet to rule on the second infusion announcement.

An Airbus official informed us that if the second infusion is approved by the EU, it will be a general infusion to Aérospatiale and not explicitly designated to help its Airbus component.¹⁵ He went on to say that he did not believe the equity infusion would undermine the disciplines of the agreement. The official noted that Airbus and Aérospatiale maintain a fixed-price relationship, whereby Airbus pays Aérospatiale a previously determined amount of money for the components Aérospatiale supplies for each Airbus aircraft. He said the equity infusion will not allow Aérospatiale to lower this already negotiated price. We pointed out the possibility that the existing pricing relationship between Airbus and Aérospatiale may be unprofitable to Aérospatiale and thus may require periodic equity infusions for the company to continue operation, but the Airbus official disagreed.

One U.S. LCA manufacturer expressed both dissatisfaction with the disciplines on equity infusions and an interest in tightening them as part of a future multilateral agreement. The issue was discussed in the multilateral negotiations, and several countries expressed an interest in strengthening the discipline concerning equity infusions beyond those that are contained in the bilateral agreement. In the absence of a tightening of these rules, it remains to be seen if this issue will be a further source of strain on the agreement.

All Parties Have Expressed Concerns About the Limitations of Transparency Provisions

Article 8 of the bilateral agreement covers the issue of “transparency.” The 12 subsections of this article outline the reporting requirements of the two signatories of the agreement. These requirements include providing information on prior government commitments for LCA programs, future development support, indirect support, and equity infusions. Most of the information is required to be exchanged on an annual basis.

The U.S. LCA manufacturers considered an increased exchange of information as one of the most important goals of the agreement. A Commerce Department official explained that before the agreement, information on Airbus was buried in the annual reports of the member companies, and the origin and uses of funds for Aérospatiale were hard to

¹⁵In addition to Airbus activities, Aérospatiale manufactures military aircraft, helicopters, tactical missiles, ballistic and space systems, and other aerospace products.

decipher. Also, the G.I.E. structure of Airbus permits the company to not report financial results to the public. The U.S. government has encouraged Airbus to provide annual reports with information similar to that provided by Boeing and McDonnell Douglas to the U.S. Securities and Exchange Commission. An Airbus representative said that the company is in favor of publishing its accounts but that the decision ultimately rests with the Airbus partners.

The initial exchange of information occurred on July 16, 1992, 1 day before the agreement was signed. In accordance with article 8.2 of the agreement, the EU provided the U.S. government with information on the prior government commitments to the four members of Airbus.¹⁶ An official of the Commerce Department explained that representatives of the U.S. government were able to analyze the data only briefly before the signing of the agreement. Subsequently the U.S. government representatives gave it a more thorough examination. The official described the submission as satisfying the requirements of the agreement.

The second submission of data occurred on March 31, 1993. At that time, the U.S. negotiators provided the EU with some general information about the NASA aeronautics research and development budget and communicated their intention to provide an official submission on indirect support in July. The EU negotiators provided the United States with information for 1992 regarding a number of different transparency articles. The information in the EU submission included (1) aggregate data on government disbursements and repayments related to Airbus, (2) a formal statement that there had been no changes in the terms and conditions of prior government support since the signing of the agreement, (3) a formal statement that there had been no new commitment of government support to Airbus, (4) a report on a change in the French government's equity holdings of Aérospatiale, (5) data on indirect government support received by Airbus, and (6) an EU estimate of indirect support provided to the U.S. LCA manufacturers by the U.S. government.

The U.S. submission of July 1993 consisted of information on aeronautical research contracts between U.S. government agencies and the two U.S. LCA manufacturers. As previously mentioned, the conclusion of the analysis was that the two companies had received no identifiable benefits from indirect support provided in the first year in which the agreement was in effect.

¹⁶The requirement did not apply to the U.S. government since it had not provided direct support to the LCA industry.

The ongoing disagreement on the methodology for measuring identifiable benefits from indirect support has highlighted some dissatisfaction on the part of the EU with the transparency features of the agreement. An official of Deutsche Aerospace explained that his company saw the agreement as a means for getting increased transparency with respect to indirect support from the United States, but the official now believes the two signatories are not providing a comparable amount of information. An Airbus official said that not enough information is being provided to the EU.

The U.S. side has also expressed dissatisfaction with the transparency features of the agreement. A McDonnell Douglas official said that the agreement does not provide for enough transparency regarding the cash flow and balance sheets of the member companies of Airbus. He said that an increased focus on the transparency provisions would be most helpful to U.S. industry in achieving a level playing field with Airbus. Boeing urged USTR to enhance the transparency requirements of the bilateral agreement as part of any future multilateral agreement. Boeing requested the inclusion of detailed information on manufacturer finances and increased public scrutiny of any information provided.¹⁷ However, a USTR official told us that although the bilateral agreement does not provide for a perfect information exchange, USTR believes that the information provided through the agreement, plus information provided by other sources at its disposal, enables it to monitor the implementation of the agreement effectively.

Consultation and Amendment Provisions Are Important to the Success of the Agreement

Although they are not the subject of disagreement, two provisions bear directly on whether the agreement will remain viable. The two parties agreed to try to resolve disputes through a consultation process. The two parties can also mutually agree to amend the agreement.

The Two Parties Agreed to Consult on a Periodic Basis

In article 11 of the agreement, the two parties agreed to regular consultations, with a minimum of two a year, to ensure the correct functioning of the agreement. In the first year of the agreement, the two parties had one official consultation devoted to the bilateral agreement,

¹⁷The agreement provides that any information that is not already in the public domain may be considered proprietary at the request of the party supplying the information.

although several additional meetings occurred within the context of the multilateral negotiations.

Since the agreement has no formal dispute resolution mechanism, consultation is the only method available to the two parties to resolve their differences. In the event that one party requests a consultation, the agreement stipulates that it must be held no later than 30 days after the request is received. The parties agreed to seek resolution of any disputes within 3 months of the initial request for consultations. The dispute on indirect support has been continuing for more than a year since the first formal consultation in late March 1993.

With Mutual Consent, the Agreement Can Be Amended

Article 13 of the agreement, “Final Provisions,” contains two important features regarding the agreement’s viability, neither of which has been tested in practice. These provisions highlight the importance of consultations between the United States and the EU. With mutual consent, the two parties may amend the agreement to take into account any new situation that may arise. Also, a party can choose to withdraw from the agreement 12 months after giving written notice of its intent.

Both elements are relevant to the ongoing and potential disputes involving the bilateral agreement. If, for example, the two parties agree to strengthen the discipline on equity infusions, the agreement can be amended to reflect this circumstance. However, termination of the agreement is permissible if one or more disputes remain unresolved and one party chooses to withdraw. The ease with which withdrawal from the agreement can be accomplished reinforces the importance of having the two sides mutually agree on the interpretation of the agreement if it is to remain viable.

Bilateral Agreement’s Effectiveness Depends on Good Faith Efforts of Both Parties to Make It Work

The bilateral agreement, unlike other major trade agreements such as the GATT Uruguay Round agreement or the North American Free Trade Agreement, does not contain a formal dispute settlement mechanism. Rather, the agreement calls for consultations between the two parties in case of dispute. Thus, the effectiveness of the agreement depends on the two parties acting in good faith to implement their commitments. Because of this, and given the ongoing and potential disagreements, we believe the long-term viability of the agreement is uncertain. However, according to the chief U.S. negotiator for aircraft, the benefits provided by the bilateral agreement—constraints on direct support provided to Airbus, in the case

Chapter 2
Disagreements Mark Operation of the
Bilateral Agreement

of the United States, and a reduction in the threat of trade action in the case of the EU—are reasonably strong incentives for them to stay in the agreement.

The Bilateral Agreement May Enhance the Competitiveness of the U.S. LCA Industry

An important goal of the 1992 bilateral agreement was to reduce government support to LCA manufacturers. Although the constraints of the bilateral agreement are potentially significant, the agreement has been in effect for too short a period to discern any definitive changes in government support to the industry. However, the U.S. LCA industry would benefit if direct government support to Airbus were reduced from its previous high levels.

One possible offset of this potential benefit would occur if the indirect support constraints were to limit future U.S. research and development expenditures on civil aerospace, resulting in a slower pace of technology development and introduction in the industry. However, U.S. negotiators have said that the indirect support provisions, as negotiated, should not impinge on anticipated levels of U.S. research programs.

EU manufacturers have expressed an increased interest in receiving indirect government support. To the extent that the EU were to offset reductions in direct support to European LCA manufacturers by increasing indirect support, any potential gain to the U.S. LCA industry could be reduced. However, since the annual commercial sales of the EU large civil aircraft industry are substantially lower than those of the U.S. industry, the ceiling on indirect support, which is a percentage of the civil aircraft industry turnover, would be substantially lower for the EU as well.

Government Support Is Influenced by Many Factors

National governments have traditionally shown great interest in their domestic aerospace industry (both military and civilian). Whether they were motivated by concerns for national defense, international prestige, increased high-wage employment, or other concerns, governments have been willing to support their aerospace industries. In general, when a government chooses to provide support to a firm, a number of market effects can occur. The support may lower the cost of production, allowing the firm to underprice its competitors and increase its market share at the expense of its unsubsidized competition. The firm may choose to invest in research and development, potentially establishing a technological edge compared to its competition.¹ If the firm is inefficient or uses outdated technology, the support may permit the company to stay in business rather than cease operation. The firm may also use the support to pursue goals

¹From the perspective of the national economy, government support for research and development may be desirable even if the benefits of certain research do not justify its cost to an individual firm or industry. This situation could occur if the benefits of the research cannot be appropriated by the firm conducting the research, but accrue to the economy as a whole.

not necessarily consistent with market efficiency, such as providing increased employment or higher wages.

The nature of the support may alter the type and magnitude of the effects that might occur. A direct transfer of money from the government to the firm could allow the firm to use the resources to pursue whatever strategies are most consistent with its market success and thus present the greatest challenge to its competitors. Support can also be provided through the government's financing of projects that are not directly related to the firm's current commercial activity, such as military research and development. Such indirect support can be beneficial to a firm to the extent that the firm is able to assimilate a new technology or use research funding for other purposes. The competitive effect of indirect government support varies depending on the commercial relevance of the research and its compatibility with the plans of the firm.

From the perspective of the firm and its employees, government support is usually desirable, providing it with advantages and opportunities beyond what is available through its own resources. However, the imposition of any goals or requirements on the use of such support can lessen its attractiveness. Moreover, to the extent that government support negatively affects the long-run efficiency of a firm, its ability to successfully compete against unsupported firms may erode. For the taxpayer, the cost of such support (which is alleged to have been quite high in the case of the LCA industry, as discussed in ch. 1) must be weighed against its possible benefits, such as developing a more advanced technology or providing less expensive products.

The economics of the LCA industry provides an additional consideration relevant to the issue of government support. It has been hypothesized that without government intervention, the LCA industry would develop a monopolistic structure (i.e., one firm only).² In her book on government policy and international trade, Laura Tyson noted that “[j]udged solely on the criterion of production efficiency . . . the large jet aircraft industry tends toward a natural monopoly.”³ In an academic study on the economics of the aircraft industry, economists Richard Baldwin and Paul

²The LCA industry is characterized as one that experiences “increasing returns to scale,” where production efficiency increases with greater output. The hypothesis is that the output level that would exhaust these anticipated gains in production efficiency is higher than the total world demand for a particular aircraft model. This characteristic, along with very expensive start-up costs and a long development cycle, contributes to the monopolistic tendencies of the industry.

³Who's Bashing Whom? p. 166. Ms. Tyson's commercial aircraft chapter contains an overview of the literature on the economics of the LCA industry, along with her own analysis.

Krugman stated that “the world market in no case supports more than two firms producing aircraft that are close substitutes in demand, and perhaps only supports one without government intervention.”⁴ In an academic study of the market structure of the aircraft industry, economist Gernot Klepper stated that an important motivation of the European governments in supporting the LCA industry was to avoid a potential U.S. monopoly.⁵

The market structure of the LCA industry complicates any analysis of the impact of government support on the industry, especially from the U.S. perspective. According to Tyson, it is important for the United States to balance the possible adverse effects of foreign government support against its possible beneficial effects. The potential adverse effects include a reduced production efficiency and profit to U.S. LCA manufacturers, reduced national wage and employment opportunities, and diminished national research and development. The possible beneficial effects accrue to U.S. consumers through enhanced competition on the basis of price, product differentiation, and product innovation.

Two studies have had a central role in the debate between the United States and the EU concerning government support to the LCA industry. The 1990 study prepared by Gellman Research Associates for the U.S. Department of Commerce stated that Airbus had received billions of dollars in direct support from its member governments since it was established in 1968. The 1991 study prepared by Arnold & Porter for the EU claimed that the U.S. aerospace industry had received billions of dollars in indirect support from the U.S. government since the mid-1970s.⁶

According to Baldwin and Krugman, government support to Airbus was detrimental to aggregate U.S. welfare since the increased competition among aircraft manufacturers resulted in large forgone profits to the U.S. LCA industry, although consumers in the United States and worldwide benefited by the increased competition. Klepper’s analysis reached a similar conclusion.

Tyson said that indirect support to the U.S. LCA industry was no longer nearly as important as it has been in the past, but due to the economics of the LCA industry, the benefits of prior support are still being realized.

⁴Richard Baldwin and Paul Krugman, “Industrial Policy and International Competition in Wide-Bodied Jet Aircraft,” *Trade Policy Issues and Empirical Analysis*, ed. Robert E. Baldwin (Chicago: The University of Chicago Press, 1988), p. 71.

⁵Gernot Klepper, “Entry Into The Market For Large Transport Aircraft,” *European Economic Review* 34 (1990).

⁶See chapter 1 for a full discussion of the two studies.

Tyson believed that given the industry's economics, Airbus' only chance to compete with the U.S. LCA industry was through massive government support.

Government support to any aircraft manufacturer is perceived as detrimental by its competitors in the industry and, according to allegations by both sides to the agreement, has been very expensive. In signing the bilateral agreement, the two sides agreed to constrain future government support and reduce the trade distortions they believe result from it.

Agreement's Impact on U.S. Industry Depends on the Extent That Support Is Constrained

The implications of the agreement for the competitiveness of the U.S. LCA industry depend on the changes in government support that result from it. It is impossible to assess the competitive implications of the agreement at this point, since the agreement has not been in effect long enough to establish any definitive changes. However, given the constraints on government support within the agreement, we can analyze the types of changes in support that may occur, as well as their potential competitive impact.

To the extent that direct EU support is reduced by the agreement, the long-term prospects of the U.S. LCA industry will be enhanced. However, there are a few assumptions underpinning this conclusion that are discussed in the following analysis.

- We assume, in this section, that the agreement will remain in effect for a sufficient duration to have an impact on the U.S. and EU LCA industries. However, as discussed in chapter 2, disagreements may threaten the long-term viability of the bilateral agreement.
- We also assume that the agreement enhances the competitiveness of the U.S. LCA industry through a reduction in direct EU support to Airbus. This reduction would result in a higher price and/or lower technological advancement for future Airbus aircraft programs compared with what would be likely if no reduction in support to Airbus were to occur.
- Finally, we assume that the EU will not substitute other forms of support for the direct support constrained by the agreement. As discussed in the following section, EU manufacturers have requested an increased level of indirect support from their member governments. To the extent that increased indirect support were to offset reductions in direct support to European LCA manufacturers, then any potential gain to the U.S. LCA industry realized through the agreement could eventually be lessened.

The agreement attempts to set disciplines for three types of government support: production, development, and indirect support. The agreement prohibits all future production support, except for what has already been committed for the production of large civil aircraft. Development support is permitted in the form of loans at a rate near the government cost of borrowing, up to 33 percent of the total expected development costs of the project. These two forms of government support are considered “direct,” with government resources allocated outright to the receiving firm to support commercial activity. Both production and development support have been important sources of funding for Airbus in the past.

Despite some disagreement regarding prohibited production support, a new allocation of this form of direct support to Airbus seems unlikely in the future. The Gellman study noted that “there does not appear to be any further need for additional financial support for AI [Airbus Industrie] programs from the governments of the AI-member firms” due to a projected positive future cash flow to the company.⁷ This statement was made almost 2 years before the bilateral agreement was signed. The agreement, therefore, may have served to formalize a change in the financial condition of Airbus that had already been established.⁸

The agreement’s impact on development support will not be tested until a new aircraft program is launched. Since the agreement has been signed, Airbus has launched a derivative program, the A319. This, however, is not a true test of the agreement’s constraints since the A319 is a smaller version of the A320 and is to utilize an already established technology and design. The development of the A319 is expected to require substantially fewer resources than what would be necessary for a completely new aircraft model. A European official and two Airbus member companies told us that there are currently no plans to request government support for the project. According to an official of Deutsche Aerospace, the form of direct government support that is acceptable under the bilateral agreement is “not very interesting” to the company. He said that Deutsche Aerospace currently has a very good credit rating and would benefit very little from loans set at the government’s rate of borrowing. However, this official told us that the firm might have requested direct support from the

⁷An Economic and Financial Review of Airbus Industrie, ch. 4, p. 7.

⁸The Gellman analysis was completed before the recent downturn in demand experienced by the LCA industry. The severity and duration of the decline may require a reassessment of Airbus’ financial health and need for direct government support for existing programs. However, we have had no indications of renewed interest in production support by the Airbus members.

German government if the bilateral agreement had not been in effect. This circumstance may be considered a hopeful sign of the future importance of the bilateral agreement for U.S. LCA manufacturers. However, the current budgetary difficulties of both the French and German governments were also cited by several EU industry and government officials as an additional reason why new, direct government support has not been committed to Airbus members.⁹

The agreement states that the identifiable benefits from indirect government support are not to exceed 3 percent of the annual commercial turnover (sales) of the civil aircraft industry of each party or 4 percent of the annual turnover of any one firm. Both the historical and the current importance of indirect support have been disputed by the two parties to the agreement, but each believes the other has benefited from it.

If the indirect support constraints were to limit future U.S. research and development expenditures on civil aerospace, then the pace of technology development and introduction in the industry may be slowed. However, U.S. negotiators have said that the indirect support provisions, as negotiated, should not impinge on anticipated levels of U.S. research programs.

Since the agreement has been signed, EU manufacturers have expressed strong interest in this form of support. In December 1993, French aerospace manufacturers called for the EU to switch from direct to indirect support. In January 1994, the President of and space research from the German government. In July 1994, the German government announced a new \$800-million domestic aerospace research program, jointly funded by the government and private industry.

Any benefits received by Airbus from such research may reduce any gain to U.S. companies realized through the agreement's restrictions on direct support. However, as mentioned in chapter 2, the commercial turnover of the U.S. LCA industry is substantially higher than the EU's (more than three times greater in 1992). Since the limits on indirect support are based on a percentage of annual commercial turnover, the ceiling on identifiable benefits from indirect support would be substantially lower for the EU than for the United States.

⁹Although the United States has refrained from providing direct government support to LCA manufacturers in the past, future development support is allowed up to the amount permitted in the agreement. We have no evidence that this action is under consideration by the U.S. government, nor did U.S. manufacturers express to us any interest in being directly supported.

Equity infusions have been a traditional method of support used by the French government for Aérospatiale. As noted in chapter 2, there are indications that this behavior is continuing. If this method of support were to become a substitute for other forms of support constrained by the bilateral agreement, then any potential competitive gains to the U.S. LCA industry might be jeopardized.

Potential Changes in the Structure of the Industry May Affect the Agreement

Changes in the international structure of the civil aerospace sector may affect the significance of the bilateral agreement. Boeing and the Airbus partners are jointly exploring the economic and technical feasibility of a very large civil transport program (VLCT—an approximately 550-passenger aircraft). Given the enormous expected cost of VLCT and the relatively modest demand for such an aircraft, the expectation is that only one producer could profitably go forward with this program. The joint development of this new aircraft would enable both Boeing and the Airbus partners to realize the possible profits of the program while avoiding direct and potentially costly competition.

A number of serious problems would have to be overcome before the partnership could go forward, however. The initial issue is a determination of the feasibility of VLCT from an economic and technical standpoint. If this barrier is overcome, several complicated coordination issues would remain. Aircraft purchasers generally prefer procuring aircraft that have some degree of “commonality” with their existing fleets in order to lower operating costs.¹⁰ Any commonality between VLCT and an existing Boeing or Airbus aircraft would provide that company with an advantage over its rival. Further, the marketing of VLCT may be complicated because some of its potential business may come at the expense of existing and future Boeing and Airbus aircraft. The establishment of an international aircraft monopoly in this market niche may also raise antitrust concerns in the United States and abroad.

If, despite these and other difficulties, Boeing and the Airbus partners proceed with a joint effort to produce VLCT, the bilateral agreement may be considered an impediment to the program from the perspective of the aircraft manufacturers. A VLCT program is expected to be very expensive, and government support in excess of the limits of the bilateral agreement may be sought. As previously discussed, the EU was motivated to support Airbus in part to avoid a potential U.S. monopoly. It is far too early to

¹⁰“Commonality” refers to the degree of overlap in parts and systems between different aircraft programs. The greater the overlap, the lower the overall maintenance and training costs are to an airline compared to a set of aircraft with less commonality.

predict whether the member governments would agree to provide support to an international aircraft monopoly, even if it were limited to only one segment of the LCA market.

One purpose of the bilateral agreement was to reduce trade distortions resulting from government support to aircraft manufacturing. An international consortium of U.S. and EU manufacturers to produce VLCT would mean that the participants would not compete against each other in this market niche and therefore would not have the same “trade distortion” concerns as in the market niches where they do compete. A representative of Airbus said that the two sides could negotiate for a relaxation from the constraints of the bilateral agreement for the VLCT program if they deem it necessary.¹¹ However, the two sides may have difficulty garnering public approval for providing government support to an international aircraft monopoly.

¹¹If a multilateral aircraft agreement is successfully negotiated, the ability of the two parties to the bilateral agreement to relax its constraints on government support may be curtailed. See chapter 4 for a discussion of the multilateral negotiations.

Efforts to Extend the Agreement to Other Nations Have Not Succeeded to Date

Article 12 of the 1992 bilateral agreement called for efforts by the United States and the EU to “multilateralize” the agreement, that is, to extend it to other countries. Other signatories of the 1979 aircraft agreement such as Japan,¹ and nonsignatories such as Russia, China, South Korea, and Taiwan, were viewed as potential competitors to the United States and the EU in the LCA sector over the long term. A multilateral agreement with disciplines similar to those in the bilateral agreement was seen as being in the long-term interest of both parties. Thus far, however, a new multilateral aircraft agreement has yet to be concluded.

The multilateral negotiations began in Geneva in October 1992 within the forum of the GATT Subcommittee on Trade in Civil Aircraft. According to the chief USTR negotiator for aircraft, it became clear early in the negotiations that Canada and Japan, active participants in the talks, did not agree with the “support-based” disciplines² of the bilateral agreement. During the last 2 months of 1993, there was a flurry of activity in the multilateral negotiations. The EU attempted to link the aircraft discussions with efforts to complete, by December 15, the Uruguay Round of GATT. U.S. industry strongly opposed efforts to hastily agree to a November 19, 1993, text submitted by the Chairman of the GATT Subcommittee on Trade in Civil Aircraft, less than 1 month before the December 15 deadline.

The Uruguay Round agreement, which was concluded December 15, did not include a new agreement on civil aircraft. However, the new Agreement on Subsidies and Countervailing Measures,³ unlike the old subsidies code, would clearly apply to the aerospace industry, including civil aircraft, with a few exceptions outlined in footnotes to the new agreement. This application had been a major objective of the United States, and U.S. government and industry officials indicated they were quite pleased with the outcome of the negotiations in this regard.

¹There were 22 signatories of the 1979 aircraft agreement. These included the United States, the EU, the 12 member states of the EU (Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom), Austria, Canada, Egypt, Japan, Norway, Romania, Sweden, and Switzerland.

²The United States has explained that “support-based” constraints are appropriate for the LCA industry due to the long-term nature of new aircraft programs: “The amount of subsidization and its effects may not become evident until many years after the initial decisions by governments to grant support. Therefore, there is a need for rules to address these decisions at their inception by establishing the conditions and maximum levels for the use of such support. A support-based discipline would achieve this.”

³The old subsidies code was part of the GATT Tokyo Round agreement of 1979. The new Agreement on Subsidies and Countervailing Measures is part of the overall GATT Uruguay Round agreement.

At the conclusion of the Uruguay Round, the United States and the EU agreed that multilateral negotiations on aircraft would continue. Although U.S. LCA manufacturers would like other parties to agree to the support-based disciplines of the bilateral agreement, the U.S. aerospace industry has indicated its overall satisfaction with the status quo. It is questionable to what extent the United States will proceed with negotiations for a new multilateral aircraft agreement without the strong backing of U.S. industry. Moreover, based on our discussions with U.S. and EU government and industry officials, we believe there are no real incentives for other countries to participate in a multilateral agreement with disciplines similar to those in the bilateral agreement. Also, given the ongoing disagreement between the United States and the EU on certain provisions of the bilateral agreement, it is perhaps not surprising that other parties did not embrace the agreement. Consequently, we believe that prospects for reaching a multilateral agreement with disciplines similar to those in the bilateral agreement are not likely in the near future.

Multilateral Discussions Languished for More Than a Year

The first formal meeting of the GATT Subcommittee on Trade in Civil Aircraft took place in October 1992. According to the chief aircraft negotiator at USTR, from the outset the main players in the multilateral discussions were the United States, the EU, Canada, Japan, and to a lesser extent, Sweden and Norway. Not all 22 signatories of the 1979 aircraft agreement have participated in the negotiations, but several nonsignatories, including Russia and Brazil, have participated as observers.

The EU and the United States both submitted proposals in November 1992. A high priority for the EU was to conclude an agreement that would function as a special law for trade in aircraft, essentially excluding aircraft from coverage of other GATT laws. The EU proposal called for a provision to be inserted into the Uruguay Round's Agreement on Subsidies and Countervailing Measures (still under consideration at that time) to the effect that, for signatories of the new aircraft agreement, the new subsidies agreement would not apply to aircraft as defined in the 1979 Agreement on Trade in Civil Aircraft. The United States strongly opposed the EU position, stating that the new subsidies agreement should apply to the civil aircraft sector, just as, in its view, the old subsidies code had.

The November 1992 U.S. proposal noted that the ultimate objective should be "the progressive reduction and eventual elimination of trade-distortive government support." In accordance with article 12 of the 1992 bilateral

agreement,⁴ the November U.S. proposal also stated that product coverage should, “at the minimum, encompass all those products and services currently covered by the existing Aircraft Agreement.” According to a U.S. engine company official, although the company had supported the exclusion of civil aircraft and components from the basic research “green light” (nonactionable) category of the draft subsidies code being considered in the Uruguay Round (see the following section), the company had little interest in the indirect support language of the bilateral agreement.

Reflecting the concerns of U.S. industry, the April 1993 U.S. proposal called for a two-track approach to the negotiations: Negotiations should be concluded on large civil aircraft before proceeding on rules for other products such as engines, smaller commuter aircraft, and helicopters. The United States argued that the situation for other products was complicated by the greater range of products, the greater number of countries involved, and the relative lack of information on the nature of government support for these products.

According to U.S. government negotiators, the EU responded with little enthusiasm to the two-track approach of the United States. Similarly, according to press reports, other countries did not support this approach. The objectives of the EU were unclear with respect to the expansion of the coverage of the bilateral agreement to include engines. According to an Airbus official, only one of the three major EU engine companies actively pursued having engines covered by disciplines similar to those contained in the bilateral agreement. A U.S. engine company official noted that all engine companies have one or more international partners on their newer commercial engine programs and indicated that his company felt that the flow of indirect support to U.S. and EU engine companies was roughly comparable and not trade distorting.

The April 1993 U.S. proposal also called for a reduction in the limit on direct support for development of new LCA programs from 33 percent to 20 percent. European government officials reacted negatively to the U.S. call for a further reduction of direct support.

After a July 1993 meeting of the GATT subcommittee, the chief USTR aircraft negotiator told us that the basic problem was that there was still no agreement for a framework for the negotiations. Canada and others did

⁴Article 12 had also called for the United States and the EU to make efforts to expand the coverage of the disciplines of the bilateral agreement to all of the products covered in the 1979 GATT aircraft agreement, that is, to all civil aircraft, engines, parts, components, and other items.

not embrace the support-based approach of the bilateral agreement. Moreover, there was widening disagreement between the United States and the EU with respect to the interpretation of provisions of the bilateral agreement, especially on indirect support (see ch. 2). Not surprisingly, negotiators indicated their increasing pessimism as to whether the agreement could be multilateralized.

Conclusion of a New Aircraft Agreement Became Linked to Overall Uruguay Round Agreement

According to the chief USTR aircraft negotiator, the EU presented the ongoing deadlock in the multilateral aircraft negotiations as an impediment for concluding the entire Uruguay Round of GATT. Thus, while there had been some linkage previously between the aircraft negotiations and the overall Uruguay Round, the linkage became more pronounced. Indeed, press articles noted the importance of reaching an agreement in aircraft if there were to be a successful conclusion to the Uruguay Round.

As the Uruguay Round was drawing to its scheduled conclusion of December 15, it appeared that a new Agreement on Subsidies and Countervailing Measures would be part of the overall agreement. A high priority of the EU was to obtain exclusion of the aircraft sector from the new subsidies agreement. Conversely, a major U.S. objective was for the new subsidies agreement to cover all aerospace products, including LCA. The draft subsidies agreement then under consideration in the Uruguay Round included a footnote to a section concerning nonactionable (permitted) subsidies with respect to research and precompetitive development. The footnote said that aircraft was excluded, that is, aircraft subsidies for research and precompetitive development could be a violation of the subsidies agreement. The inclusion of this footnote in the text was important to the United States since, as noted by a USTR official, the implication was that aircraft was clearly covered by all other provisions in the subsidies agreement.

In the middle of November 1993, the Chairman of the GATT aircraft subcommittee submitted two texts for a "Revised Agreement on Trade in Civil Aircraft." The action was prompted by what he wrote was a "shared view of the participants" in the aircraft negotiations to resolve, before the scheduled completion of the Uruguay Round, some difficult issues linked to the subsidies agreement. The draft texts were transmitted by U.S. negotiators to U.S. industry officials, who expressed concern about the potential implications for the industry. According to the USTR negotiator, U.S. industry officials expressed misgivings regarding the haste of the

negotiation process, and they objected to certain elements of the text that was still under consideration.⁵

U.S. Industry Was Ultimately Pleased With Outcome of the Uruguay Round

After several weeks, the United States refused to continue to negotiate on the text under consideration. At that time, the GATT Secretariat closed discussions on the subsidies agreement, which still included the footnote that exempted aircraft from the nonactionable subsidies category for research and precompetitive development activities. In an effort to reflect some of the EU demands that civil aircraft be exempted from disciplines in the new subsidies agreement, the GATT subcommittee Chairman proposed two additional footnotes. U.S. negotiators, after suggesting some small changes, endorsed the Chairman's proposal.

The two footnotes were related to article 6.1 of the subsidies agreement, which dealt with "serious prejudice."⁶ The first footnote stated that "since it is anticipated that civil aircraft will be subject to specific multilateral rules," government subsidies to LCA manufacturers that exceed 5 percent of the cost of developing a new aircraft will not constitute a presumption of serious prejudice. According to a USTR official, the inclusion of this footnote was a concession to the EU. A U.S. industry official indicated that although U.S. industry would have preferred to retain the 5 percent serious prejudice test for civil aircraft, they agreed to the concession.

The second footnote stated that "where royalty-based financing for a civil aircraft program is not being fully repaid due to the level of actual sales falling below the level of forecast sales, this does not in itself constitute serious prejudice." The inclusion of this footnote was significant because royalty-based financing, which is the primary method used by European governments to provide support for Airbus, requires a company to pay back loans from the government based on the sales of its products.

In short, the addition of the two footnotes to the subsidies agreement represented a compromise between the United States and the EU. The United States had originally demanded that the aircraft sector be covered

⁵U.S. industry officials were concerned with the treatment of research and development under article 9 (labelled "Certain Subsidies") of the text under consideration. They were also concerned that under article 10, royalty-based financing committed before the new agreement, including such financing received by the Airbus consortium members, would have been "grandfathered" and protected from future trade actions under GATT.

⁶"Serious prejudice" refers to a situation in which a country's use of subsidies adversely affects another country's trade interests. If there is a determination of serious prejudice, the country is obligated to withdraw the subsidy or remove the adverse effects when they are identified.

by all the disciplines of the subsidies agreement, while the EU had sought a complete exemption of the sector from that agreement.

U.S. industry representatives have said that the industry was largely pleased with the ultimate outcome of the Uruguay Round negotiations with respect to aircraft. A major objective, the coverage of aircraft by the subsidies agreement, was essentially achieved, with the exceptions outlined in the footnotes. The GATT subcommittee Chairman's text for a new multilateral aircraft agreement, which was highly objectionable to U.S. industry, was rejected. Nonetheless, U.S. negotiators did commit themselves to continue negotiations and to conclude, within a year, a multilateral agreement based on the Chairman's text and "on other proposals."

Incentives for Concluding a Multilateral Agreement Have Lessened Considerably

The chief USTR negotiator for aircraft summed up the situation as follows. The U.S.-EU bilateral aircraft agreement is still in effect. The Uruguay Round subsidies agreement, to take effect July 1, 1995, has stronger disciplines than the Tokyo Round subsidies code, and it clearly applies to aircraft. This situation would be better from the U.S. point of view. The 1979 aircraft agreement is also still in effect. The U.S. aerospace industry achieved its most important objective, the inclusion of civil aircraft in the new subsidies agreement, and it has indicated that is not anxious to pursue further negotiations. A Commerce Department negotiator added that while the LCA manufacturers would probably like other countries to sign on to the disciplines of the U.S.-EU bilateral agreement, the chances are slim that the agreement will be multilateralized.

An Airbus official told us of his disappointment that a multilateral agreement had not been reached. However, provided that the U.S.-EU bilateral agreement remains in effect, and in light of the modified subsidies agreement, the European aircraft industry views the present situation as an acceptable interim solution. The Airbus official noted that, as a result of the outcome of the Uruguay Round in December 1993, nonsignatories of the bilateral agreement have more freedom to subsidize their civil aerospace industries than the United States or the EU. He said that this fact would lessen the motivation of other countries, such as Japan, Canada, or Sweden to reach a multilateral agreement.

We believe that prospects for reaching a multilateral agreement with disciplines similar to those in the bilateral agreement are very unlikely in the near future. The U.S. civil aircraft industry is generally satisfied with

the status quo, assuming the Uruguay Round is ratified. It is questionable to what extent the United States will actively pursue negotiations for a new multilateral aircraft agreement without the strong backing of U.S. industry. More significantly, Canada, Japan, and others were not interested in signing on to the support-based disciplines of the bilateral agreement, and there is less motivation for them to do so now. The chief USTR negotiator for aircraft had told us in early 1993 that other signatories of the 1979 aircraft agreement were interested in strengthening that agreement. He also noted that since both China and Taiwan wanted to become members of GATT, some leverage could perhaps be placed on them to subscribe to a multilateralized agreement. Nonetheless, based on our discussions with U.S. and EU government and industry officials, we believe there are no real incentives for other countries to be parties to a multilateralized agreement. Also, given the ongoing disagreement between the United States and the EU on certain disciplines of the bilateral agreement, it is perhaps not surprising that other parties did not embrace such disciplines. For all these reasons, it is unlikely that a revised multilateral aircraft agreement will be reached in the near future.

Major Contributors to This Report

**General Government
Division, Washington,
D.C.**

James M. McDermott, Assistant Director
Elizabeth J. Sirois, Assistant Director
Stanton J. Rothouse, Project Manager
Thomas Melito, Senior Economist
Susan S. Westin, Senior Economist
Rona H. Mendelsohn, Evaluator

**Office of the Chief
Economist,
Washington, D.C.**

Loren Yager, Assistant Director

**Office of the General
Counsel, Washington,
D.C.**

Sheila K. Ratzenberger, Assistant General Counsel
Richard R. Perruso, Attorney-Adviser

**Los Angeles Regional
Office**

Gretchen E. Bornhop, Senior Evaluator

European Office

Mary R. Offerdahl, Evaluator

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000 or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (301) 258-4097 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

**United States
General Accounting Office
Washington, D.C. 20548-0001**

**Bulk Mail
Postage & Fees Paid
GAO
Permit No. G100**

**Official Business
Penalty for Private Use \$300**

Address Correction Requested



