

Economics For Policy

Short Articles Series

Understanding Government Intervention on Flag Carriers:
The Case of Alitalia and TAP Air Portugal

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#2

2021

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Table of Contents

1. Alitalia's and TAP Air Portugal's Clipped Wings.....	3
2. Historical Background and Public Economics Rationale.....	4
3. A Political Economy Perspective.....	5
4. A Note on Private versus Public Ownership.....	6
5. Concluding Remarks.....	7
6. References.....	8

1. Alitalia's and TAP Air Portugal's Clipped Wings

In March 2020, the Italian government proposed a series of provisions in support of families, workers, and companies who were harshly hit by the Covid-19 pandemic and the related containment measures. Among other interventions within the government decree, commonly referred to as 'Cura-Italia' (lit. heal-Italy), up to €500 million were allocated to the re-nationalisation of the country's flag carrier, Alitalia (Il Sole 24 ORE, 2020b). While the whole sector of air transport risked going up due to the travel restrictions imposed to reduce the spreading of the coronavirus, the decision to bring Alitalia fully under control of the Ministry of Economy and Finances reignited a long-lived debate, given the poor performance of the airline in recent decades.

At the time of the new decree, €1.5 billion of public money had already been invested in Alitalia since May 2017, the year of its receivership, for a total of €9.2 billion in the last 45 years (Il Sole 24 Ore, 2020a). In fact, the Covid-19 crisis has only exacerbated a situation of severe financial distress in which Alitalia had been stuck for years (The Economist, 2017). The first privatisation attempts happened already in 1996 and 2006 to cut the losses that were being incurred at the time. Along similar lines, in 2008, Alitalia was placed into bankruptcy and its assets put under special administration of Intesa Sanpaolo. However, Alitalia's conditions improved only with its acquisition by Compagnia Aerea Italiana, managed by prominent Italian industrialists and partly by the advisor Intesa Sanpaolo itself. In 2014, when Alitalia was again on the verge of failing, the government assisted an agreement with Etihad Airways, which ultimately acquired a 49% quota. The joint management only lasted 3 years, however: in 2017, the Italian Ministry of Economic Development nominated three special managers and granted a €900 million bridging loan, putting the company under temporary receivership. Several managerial mistakes have been linked to this decision, predominantly concerning ownership, political influence, inefficient cost controls, and the lack of a consistent hub and alliance strategy (Beria et al., 2011). In 2020, due to the Covid-19 crisis, the situation became unsustainable once again: despite eight attempts to sell, the Italian Ministry of Finance finally acquired 100% of the shares. Alitalia was re-nationalized, the receivership ceased, and a new executive was assigned, after a workforce cut of more than 40% (La Repubblica, 2021).

The Italian case is not a one-off, however, as many other airlines are affected by similar issues (The Economist, 2021). Less than a couple of thousand kilometers away, the Portuguese flag carrier offers an analogous example of troubled management. The Portuguese flag carrier saw its first privatization attempt already in 1953, only 8 years after its establishment; then, periods of expansions alternated with changeable governance. In 2015, the center-right government allowed its acquisition by the American Atlantic Gateway Consortium, but a few months later the new left-wing government returned the majority of control to Portugal, which now owns a 72.5% stake. As the Covid-19 financial crises crushed the travel business, in the first nine months of 2020 TAP Air Portugal lost more than €700 million. In a similar fashion to what happened in Italy, the Portuguese government unveiled a €3.4 billion rescue package in December 2020, leading to more than 3500 job losses, circa one-third of the airline's workforce, payroll cuts of up to 25%, and a decrease in capacity, trimming the fleet from 108 to 88 aircrafts (Associated Press, 2020). The Portuguese Infrastructure Minister, Pedro Nuno Santos, deemed the financial support crucial to sustain the company, considering also that TAP will lose €6.7 billion through 2025, with the state planning to acquire more than a 90% stake in total (ECO News, 2020).

The turbulent recent histories of Alitalia and TAP Air Portugal prove that managing dire financial situations of socially important non-financial institutions such as flag carriers is a tough issue, which is impossible to ignore but difficult to resolve (Robe et al. 2011). While

many may be quick to conclude that poor performance should lead to the termination of the activity and that taxpayer money should not be used to artificially prolong the life of an airline that is doomed to fail, others may want to defend their flag carriers for the ideological value that they attach to it or because they have some return from its existence, either direct or indirect. As the next sections try to illustrate, the matter of flag carriers is complex and multifaceted, developing along historical, economic, and political lines. The aim of this short article is indeed to shed light on the rationale and implications of government intervention in the air transport sector through direct management or subsidisation of flag carriers, especially when these perform poorly in terms of revenues and efficiency. Resorting to the examples of Alitalia and TAP Air Portugal allows to further shed light on the interplay of economic and political motives in the air transport sector. The article will consider historical, economic and political justifications for the existence and persistence of flag carriers, touching upon the differences entailed by public and private ownership, respectively.

2. Historical Background and Public Economics Rationale

Until the liberalisation of the European airline industry in the 1990s, flag carriers in the continent enjoyed an almost total monopoly position in their respective national markets. The reasons for this setting can be traced back to both historical and economic motivations. On the one hand, the Paris Peace Conference of 1919 granted property rights over airspace to individual governments, who could limit flyovers by civil aircrafts. A cumbersome body of regulation and bilateral agreements was then subsequently introduced to hinder the entry of potential private competitors in the market and grant that air transport would be tended by state-run companies only (Arrigo, 2005). On the other hand, early investment in the air transport sector was particularly unattractive at the time because the level of technology did not allow planes to cover large distances, fly in unfavourable conditions, nor carry many passengers. Hence, governments had to step in to subsidise the provision of the service or provide it directly, which was important because air transport was used for mail and military purposes as well, rather than for the mere transportation of passengers (Heppenheimer, 2001; Vasigh et al., 2013). Thus, the economic rationale for the existence of flag carriers was originally comparable to the standard public good argument. Even more so, state-owned airlines also ensured that these services could be offered in remote areas too, namely where provision would have been deemed unprofitable by private companies.

The situation changed radically with the decision of the European Union to allow entry of private airlines in the air transport market. Even though there is consensus that liberalisation improved welfare, decreasing prices and increasing the size of the industry (Abate & Christidis, 2020; Beria & Fröhlich, 2011; Vasigh et al., 2013), many flag carriers struggled to adapt to the changing market structure. In fact, whereas private companies were guided by profit and concerned with efficiency in performance, engaging in practices of price discrimination, national airlines instead faced fierce price competition and were able to secure only slim profit margins, while keeping the same costs and managerial structures that had characterised them prior to the liberalisation (Heppenheimer, 2001). Even more so, observers have noted that the industry is now moving towards a 5-airline-group oligopoly, with more successful carriers slowly incorporating others and soon controlling 80% of the air transport market (The Economist, 2019).

The historical justification for the existence of flag carriers has naturally faded with the liberalisation of the market, as the original bilateral agreements were repealed. Similarly, the growth in the number of airlines following the market deregulation, which has been observed

both in Europe and the US, demonstrates that private agents are now willing and able to invest and survive in the air transport sector. In contrast, it may still be argued that air transport services would not be available in unprofitable conditions. In fact, flag carriers typically offer long and direct connections between intercontinental destinations and the country in which they are based, meaning that, in their absence, citizens would need to travel to other countries to board their flight.

The case is even stronger for TAP Air Portugal because it presents itself as a hub airline between Europe, South America, and Africa, connecting mainland Portugal to its former colonies. As ties between these territories are still strong today and there are substantial flows among these countries, covering direct routes to countries like Angola or Mozambique, which are not tourist destinations and might therefore be neglected by other private airlines, represents a service of public utility for those citizens who need to travel back and forth. Incidentally, Button et al. (2005) suggest that this particular route design actually reflects an effort to gain and maintain a market advantage that allows TAP Air Portugal to survive private competitors. This is because airlines offering longer routes face a generally inelastic demand and weaker competition. Importantly, however, the authors deem this advantage as 'short-lived' since routes would have to be manipulated continuously as the market changes over time. On the other hand, Italy had fewer colonies than Portugal and has maintained weaker relations to these territories. Hence, government support in the preservation of the airline is harder to justify based on the public service argument. That is, while it is true that Alitalia allows for easier travel, this might not be a compelling reason to sustain a company that has been incurring significant losses, at least within the discussion conducted thus far.

3. A Political Economy Perspective

The air transport sector, and particularly the issue of flag carriers, represents an interesting example of how market forces and political interests diverge significantly: on the one hand, state airlines that failed to adapt to the changing market structure and have incurred significant losses would be expected to exit the market; on the other hand, government intervention may preserve state airlines regardless of poor performance if motivated by political interests. In fact, there exist political arguments in support of these interventions that go beyond the economic arguments thus presented. One way to appreciate this is to recall the intuition of the Median Voter Theorem, suggesting that vote-maximising politicians will support positions that appeal to the median voter in order to entice the majority of the electorate. In the context of this article, this can explain the repeated government aid granted to flag carriers with negative balance sheets, provided that the median voter cares about the country's airline. In fact, if so, politicians will want to please the electorate by adopting a positive attitude with respect to financial rescues in favour of national carriers. In this regard, Beria et al. (2011) emblematically refer to Alitalia as a "political tool rather than operating as a competitive firm", identifying the reason for its slump in the politics-driven administration.

A first reason to argue that the median voter would want to keep the flag carrier is the existence of a sense of national pride or nostalgia for the pre-liberalisation period, namely one of privilege and success for the country since the flag carrier was the only operating airline. Note that voters may be nudged to form their opinion by the framing of the matter in media coverage. For instance, Barisone (2008) finds that the debate around the negotiations of the concession of Alitalia to French investors was the single most covered issue during the last month of political campaign before the 2008 Italian elections. While confirming the highly political nature of the topic, the article reports that news broadcasts by Canale 5, one of the main television channels in the country, portrayed the deal unilaterally negatively on several occasions, which is understandable given its right-winged ownership. Reasonably, voters

with no strong opinion or lacking information may be influenced by the media coverage and thus support the nationalisation or financial support of the Italian airline. In contrast, citizens may protest if they know that they will be paying for the airline's survival through taxes. However, Vasigh et al. (2013) claims that most citizens are rationally ignorant with respect to the air transport sector, that is, are either uninterested or not aware of the costs and benefits connected to it.

As opposed to rationally ignorant citizens, companies in the air transport market and their employees are fully informed. Intuitively, stakeholders and employees will want flag carriers to keep running in spite of the losses. In the case of Alitalia, pilots and flight attendants have typically been granted more favourable working conditions in terms of working hours, compensation, pension benefits, privileges, and allowances compared to other European flag carriers. Unions too are assumed to support the nationalisation of Alitalia since this ensures greater bargaining power as opposed to a scenario in which the company were sold to a private, possibly foreign, agent (Giuricin, 2009). Third, in addition to the direct economic impacts of air transportation, the market provides indirect and induced benefits to third parties as well: the former include gains for hotels, restaurants, and other retail activities near airports; the latter corresponds to the multiplier effects of the direct and indirect impacts. In general, there is a positive relationship between the presence of airlines and airports and regional economic performance in Italy (Donzelli, 2010). Those benefited by the airline industry, either directly or indirectly, will care that the size of the sector is maximised, and hence would rather have flag carriers operating than not.

These arguments imply that the distribution of voters may be skewed in favour of continued support of the flag carrier. The Median Voter Theorem would therefore suggest that vote-maximising politicians would be favourable of public ownership or subsidisation of flag carriers despite their losses – an attitude that has been witnessed in Italy over the past decades, epitomised by the statement of former PM Matteo Renzi, who claimed that a “President of the Council caring about Alitalia is something sacrosanct” (Procaccianti, 2020).

4. A Note on Private Versus Public Ownership

The governance of modern flag carriers comprises multi-faceted dynamics, which generate a dense discussion and major swings as in Alitalia and TAP. If, on one hand, private firms carry the risk of losses and gains, thus arranging their attitude accordingly, on the other hand public enterprises bear no direct risk, which eventually falls on taxpayers. For this reason, some behavioural phenomena may arise: in order to understand the developments of Alitalia and TAP, it may be helpful to introduce the concept of the soft budget constraint.

According to Kornai (1986), the first economist to discuss the issue, the softening of the budget constraint happens when the strict relationship between earnings and expenditures of the enterprise has been relaxed, because excess expenditure will be covered by some public institution, which is represented by a paternalistic State in the Italian and Portuguese cases, and such external financial assistance is expected with high probability. However, in order to display some level of effort to be granted the external assistance, the managers of such companies often resort to political pressures through groups, lobbies, or personal connections, thus resembling a rent-seeking behaviour as described in Krueger (1974). Because of the tight connection between economic and political players, this practice may ultimately lead to corrupt behaviour and the preservation of the flag carrier may constitute a means to pursue personal interests further. An illustrative example in this sense may be the €6 million expenses incurred by Alitalia in 2018 to provide new work uniforms to all the employees despite of the problematic financial situation, which resulted in insolvency towards

their producer; on top of this, an order of a whole new set of uniforms was put in place one year later.

The softened budget constraint (SBC) and its loose external tolerance-limits of losses come at a cost (Maskin, 1996), as they lead to two types of inefficiencies: first, there is an allocative loss due to the failure of the public enterprise to invest proactively through innovation and development, as productive efforts in SBC firms are no longer imperative; second, because the subsidy is financed by distortionary taxation, an additional deadweight loss is sustained. Such aspects suggest an underlying absence of commitment ability for a number of public companies, as in the case of Alitalia and TAP, for which once again the interplay between financial issues and some deeper socio-economic aspects appears crucial. Kornai (1986) pinpoints three interrelated behavioural consequences of SBC at firm level: first of all, the general price responsiveness of such firms declines, suggesting that a lack of competitive stance is overshadowed by the continuous access to external compensations, namely governmental subsidies; secondly, efficiency issues arise, as input-output combinations do not adjust dynamically to price signals and hence the stimulus to maximum efforts becomes weak and no longer imperative; third, due to the paternalistic stance of the government, firms with a SBC will tend to exhibit unconstrained demand for inputs (at least at a financing level). Such firms know that they can afford a deficient economic performance, because someone else will step in and bail them out. In fact, big public enterprises such as Alitalia and TAP are seldom allowed to cease their service, due to their relevance at both political and economic level nationally. They are considered 'too important to fail'. The implication is that the public opinion and public institutions trust the government to continuously subsidize its services especially in view of a potential failure.

5. Concluding Remarks

This article has outlined the historical, economic, and political justifications for the existence of flag carriers. At the same time, it has tried to explore why state-owned airlines are preserved through nationalisation efforts and repeated government financial aid despite poor economic performance and significant losses. To these ends, the cases of the national carriers of Italy and Portugal have been presented to exemplify general intuitions from theory and to provide a concrete reference to show the relevance and complexity of the issue, which is of clear interest to public policy debates given its political nature and the size of the resources it encompasses.

It will be interesting to see if the political motives will still be able to offset the strong rationale for market exit based on economic grounds in the dire financial conditions of the post-pandemic. Based on this analysis, an intensive supervision coupled with enhanced transparency and disclosure requirements may benefit the effective public management of flag carriers. A natural suggestion in this sense would be to allocate said supervisory role to a supranational body, perhaps at the European level, to better abstract from national political dynamics. However, offering more precise policy proposals would require additional scrutiny and is thus beyond the scope of this short article.

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