An Oddity in the European Regulatory Space: Peripheral Flag Carriers in the Baltic States and EU Competition Law

Viljar Veebel
University of Tartu, Tartu, Estonia
<viljar.veebel@ut.ee>

Illimar Ploom
University of Tartu, Tartu, Estonia
<illimar.ploom@ut.ee>

Abstract

This article examines the effects that EU state aid rules impose on the airline sectors of small peripheral Member States. By the same token, it looks at the Central and Eastern European airline sectors and examines the rationale behind the practice of states to keep alive their loss-making flag carriers. The article compares the vicissitudes of the Baltic flag carriers, Estonian Air and airBaltic. It is suggested that, behind the apparently irrational behavior, there could be found a rationale, namely the wish to offer connectivity above market level, and, with regard to poorer peripheral Member States, beyond market quality. This in turn is attributable to the wider external benefits to the domestic economy that air services bring but which cannot be internalized by the airlines. Therefore, in particular in the context of the asymmetrical integration model, which is on the rise in the EU, state aid rules are discovered to amplify the differences between the center and the periphery.

Keywords

state aid – airline sector – EU competition law – peripheral economies – asymmetrical integration
1 Introduction

A curious phenomenon has appeared on the European aviation landscape whereby, in spite of the existence of a single aviation market and the ban on state aid, Member States do their utmost to keep alive their often loss-making flag carriers. The situation is particularly complicated in peripheral Member States, where legacy carriers have been seriously ailing. As shareholders, states have been found propping up their airlines by way of aid injections and thus have been placed under investigation by the European Commission. Against this backdrop, the present article attempts to understand the wish to maintain inherently problematic flag carriers. What benefits do they bring to these states which would otherwise be unattainable? Would the Open Sky policy not secure it by way of fierce competition, in particular by the appearance of customer-friendly low-cost carriers?

On the basis of empirical evidence, this article argues that these losses are not solely imputable to bad management, but, notably, to the wish to offer connectivity above market level and quality. This in turn is related to the phenomenon of the wider external benefits that stable, sufficient, and business-traveler-oriented air connections bring to a country or region. These benefits, and in particular business ‘traveler-orientedness’, are of crucial importance for peripheral Member States with regard to connectivity between their capitals and major European cities. There are larger profits that accrue to the wider economy which, however, the airlines are not able to internalize. This makes state aid a logical channel to prop up connections. In contrast to what the European Commission suggests, low-cost carriers tend not to offer comparable services.

If the above logic holds, it raises doubts about the premises of EU state aid and EU competition policy. Despite a relative scarcity of explicit official statements, a recognized major, if not the primary, aim of EU competition policy.

---

1 As to explicit statements, see, e.g., paragraph 13 in the “General Guidelines”, which states that “The objective of Article 81 is to protect competition on the market as a means of enhancing consumer welfare and of ensuring an efficient allocation of resources. Competition and market integration serve these ends since the creation and preservation of an open single market promotes an efficient allocation of resources throughout the Community for the benefit of consumers”. Commission Notice: Guidelines on the application of Article 81(3) of the Treaty, OJ C 101/97, 27 April 2004, available at <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52004XC0427(07)>. See also the EU Merger Regulation, which asserts that “It is possible that the efficiencies brought about by the concentration counteract the effects on competition, and in particular the potential harm to consumers, that it might otherwise have and that, as a consequence, the concentration would not significantly impede effective competition ...”.

policy is to protect the interests of the consumer. In the case of airlines, this works against the interests of a Member State. But the latter also relates to consumers. Thus, possible distortions of competition might become ambivalent for the consumer of a specific Member State. European Commission actions can keep flight prices down yet diminish connectivity, which in turn can have an impact on a national economy. Would this not make ‘the consumer’ of the EU competition policy an abstraction? The actual consumer in a Member State may win in terms of lower prices, but simultaneously lose in connectivity, and, as will be argued, importantly in the growth potential of one’s national economy and thus in one’s future purchasing power. Predicting a possible future trajectory for the EU could come by noticing a trend in the US airline sector, where an earlier liberalization of prices has brought severe connectivity loss, not only for small but even for medium-sized cities. This becomes especially relevant in the context of the asymmetrical economic integration model, arguably prevalent in the EU since the mid-1980s. Hence, one could speak about a connectivity gap, which does not simply stand for a relatively lower number of connections available for remote, poorer and less densely populated Member States, but which concerns a systemic disadvantage that causes a deepening lag in economic growth and development as compared to Member States in the center. Could one conclude that poorer Member States will be natural losers in a competitive market? Will airlines not become a vital service with the potential to help support real convergence for peripheral states?

In order to answer these questions, two recent state aid cases concerning the Baltic flag carriers, airBaltic and Estonian Air will be examined. In terms of methodology, the two cases will be studied in parallel. These two cases have been selected as they are similar in terms of their background, yet representative of a variety of CEE flag carrier models. Based on Commission reports and


the aviation literature, the case of the Hungarian carrier, Malév and the Vilnius market in Lithuania will also receive some attention. Though airports are generally a prominent target of state aid as well, due to the limits in scope and the focus being on the practice of selected Member States, the present article restricts its focus to state aid to airlines.

2 The EU State Aid Policy: Liberalization and Deregulation

In order to discuss the Baltic cases and to understand the situation that the airline sectors in EU peripheral countries face, one needs to comprehend the relevant context. While it involves many dimensions, only the most relevant ones concerning the sector will be pursued in this section, first outlining the aims informing the creation of the EU single aviation market, and thereafter the relevant treaty articles and Commission guidelines on state aid in order to finally distill the principles underlying EU state aid policy and the changes it has bestowed on the EU airline sector.

If on a global scale largely segmented national markets, bilateral agreements and flag carriers still dominate, the EU aviation sector has witnessed a wave of deregulation and privatization since 1988.3 Whereas it is possible to witness the distinct stages of this road to reform, what is more important than the detailed story is the general direction of that story. In the EU, one can also speak about a specific policy aim, which is the establishment of a single market in the aviation sector, with private ownership of airline companies and a deregulated market as normal attributes. Indeed, even if the changes that have occurred have taken quite some time, there was a surge in the privatization of flag carriers in EU Member States in the 1990s.4 In this setting, where changes in ownership and the entry of airlines into a liberalized market have resulted in frequent demands of capital injections from previous owners (or current shareholders), questions about state aid have become practically salient. A relatively large number of state aid cases in the airline sector have been brought, especially in the 1990s when the European Commission opened investigations into more than twenty cases.5

3 Pietro Crocioni and Chris Newton, “State aid to European airlines, a critical analysis of the framework and its application”, in Advances in airline economics, the economics of airline institutions, operations and marketing (Elsevier, Amsterdam, Netherlands, 2007), 148.
It is in this context, and for the sake of protecting the freedom of the single market in aviation, that the European Commission continues to regulate the conditions that allow the granting of state aid. In terms of legal instruments, one can see a combination of EU competition law and Commission guidelines attempting to ensure the proper functioning of the market. Thus, in regulating the aviation market, 'soft law' combines with 'hard law', and fairly ordinary legislative guidelines by the Commission have become relevant, in both binding the Commission in the exercise of its discretion and guiding the European Court of Justice (ECJ) in its decisions. It has to be admitted, nonetheless, that the power that the guidelines have acquired has come indirectly from the way the latter illustrates or embodies the fundamental principles of EU law. This idiosyncratic mix of normative acts, where hard law, fundamental principles and soft law combine, has been identified as “consciously designed hybridity”, hence the guidelines, while not being “legally binding”, can be said to have “legally binding effects”.7

In the following paragraphs, the legal and procedural setting of a state aid case in the EU will be briefly described. First, with regard to the relevant hard law setting providing the dominant tone to the discourse, it is important to note that, as a principle, state aid is prohibited within the internal market. This is laid down in Article 107(1) of the Treaty on the Functioning of the European Union (TFEU): “Save as otherwise in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.”

In the above provision, the definition of state aid is provided by way of referring to its effect.8 The precise meaning of state aid draws on the interpretation

---


8 Mihalis Kekelekis, “Recent Developments in Infrastructure Funding: When Does It Not Constitute State Aid”, 10(3) estAL (2011).
of Article 107 TFEU in the rulings of the EU Courts9 and the decisions of the Commission, the latter of which follow the specific guidelines of 1994 (exclusively concerning airlines)10 and 2004 (general guidelines).11 In 2014, within its State Aid Modernisation (SAM) strategy, the Commission adopted new guidelines for airports and airlines.12 A measure is classified as state aid only in cases where the above-named conditions are all satisfied.

To now outline the ensuing logic, as it would apply to the aviation sector, the most obvious point of departure is the fact that no direct state aid is allowed for covering operating losses. If the state is among the owners of an airline, the ‘market economy investor principle’ (MEIP) – i.e. conduct comparable to a normal market situation and to a private investor’s behavior – might be applicable. This principle allows the injection of money as long as the ‘injector’ is comparable to a market economy investor. However, not all aid is automatically ruled out. Article 107(2) TFEU specifies certain exemptions. Those exemptions concern, for example, targeting individual consumers with specific problems of a social character, alleviating damages from natural disasters or leveling the disadvantages that the German unification brought to the fore. However, Article 107(3) TFEU also stipulates that there are derogations. In this


instance, abnormally low living standards or serious underemployment, promotion of a project of common European interest or remedying a serious disturbance of a Member State’s economy, or facilitation of the development of certain economic activities or areas may all make state aid acceptable should the Commission find it appropriate. Thus, a number of cases have fallen under Article 107(3) (c) which allows aid for the development of certain economic activities, provided there is no adverse effect on trading conditions which would be contrary to common interest. Still, this exemption presumes that cases are exceptional and aid must, among other stringent conditions, follow the ‘one time, last time’ principle. Any such restructuring program will be closely monitored by the Commission.

In 2006, the Commission announced a change in policy. It associated its previous approval of airline state aid cases to the policy of the liberalization of the European market, and seeing this latter process as almost completed, deemed state aid no longer necessary. Thus, the Commission has been seen as “setting the tone for its new approach to the second phase of restructuring aid decisions in the airline industry, as seen in the contentious process of privatisation of Olympic, Alitalia and Austrian Airlines”. Although in this phase the aviation sector guidelines of 1994 have continued to play an important role as far as policy content is concerned, the Commission is referring instead to the general guidelines for applying restructuring aid across sectors. In these 2004 guidelines on state aid, it is defined as “temporary and reversible assistance” and meant strictly for rescuing and restructuring firms in difficulty.

As can be seen from this brief account of EU rules and state aid policy, the main theme behind these developments is that of liberalization. The logic guiding the Commission’s management of state aid cases relies on the aim of the privatization of airline companies or that thereafter securing aid for a company does not hamper it from functioning. Thus, a liberalized market forms the main presupposition of the EU regulatory regime and the ideology of the Commission for the aviation sector. State aid is allowed only within strict limits and as an exception to the rule. The market is supposed to work well enough

13 Ibid., Section 3.6.1.
14 Balfour and Leandro, op.cit. note 4, 226–228.
15 Ibid.
16 See Application of Arts. 92 and 93 of the EC Treaty and Art. 61 of the EEA Agreement to State Aids in the Aviation Sector, op.cit. note 7.
18 Ibid., point 15 in Section 2.2.
on its own. This comes out not only from the long-standing implicit goal of the Commission to see the privatization of airlines, but also from the way it has handled such cases over time. There is a clear tendency of the Commission towards becoming stricter with state aid, and this is, among other things, reflected in the Commission’s explicit shift from relying on its specific 1994 aviation guidelines to implementing the general state aid guidelines of 2004.\footnote{Crocioni and Newton, \textit{op.cit.} note 3, 151–153.}

As a consequence of these reforms, while the customer base has dramatically expanded, the sector has also become highly volatile. Newcomers to the industry have enjoyed lower barriers, which together with the freedom to set prices, have amounted to higher competition as compared to the once tightly regulated market. Thus, as it has been argued by Balfour and Leandro, as fares have dropped, full service airlines have struggled to match rates offered by low-cost carriers \textit{(lcc)}.\footnote{Balfour and Leandro, \textit{op.cit.} note 4, 226–228.} As they see it, “this is a major constraint on profitability for established flag carriers, which tend to have a higher cost base (i.e., inherited public sector pensions etc.)”\footnote{Ibid.} The liberalization and privatization process was expected to lead to a consolidation of airlines and thus more effective services. This has happened, but it comes at a price. Like in the United States, smaller markets in regions removed from big aviation centers have suffered from connectivity loss.\footnote{Alex Mayyasi, “Can Airlines Make Money?” \textit{Priceonomics} (5 November 2015), available at <http://priceonomics.com/can-airlines-make-money>.} Comparable to the “capacity discipline” airline management strategy in the \textit{us} affecting, in particular, the country’s smaller airports,\footnote{See Michael D. Wittman and William S. Swelbar, “Trends and Market Forces Shaping Small Community Air Service in the United States”, \textit{MIT Small Community White Paper Series No. 1. ICAT Report 2013–02} (Massachusetts Institute of Technology, Cambridge, MA, 2013), available at <https://dspace.mit.edu/bitstream/handle/1721.1/79091/ICAT-2013-05.pdf>; and Michael D. Wittman, “Data Update: Trends and Market Forces Shaping Small Community Air Service in the United States”, \textit{MIT Small Community White Paper Series No. 6. ICAT Report 2014–03} (Massachusetts Institute of Technology, Cambridge, MA, 2014), available at <http://web.mit.edu/wittman/www/ICAT-2014-03.pdf>.} in the \textit{eu} the situation can be seen as particularly vulnerable in the peripheral Member States. An airline can be effective when it saves by not serving ‘thin’ peripheral routes, thereby repudiating the risk of needing to squeeze marginal profits at best from the necessarily low number of consumers. Thus, it is no wonder that while in the European aviation heartland major European flag carriers can do relatively well, the peripheral legacy carriers are almost all
in serious trouble. What does this mean for peripheral connectivity and what role do the regional flag carriers play in it? How does EU competition policy and its practical implementation fit in?

3 **The State Aid Cases of AirBaltic and Estonian Air: Fundamentally Different or Alike?**

In order to lay the ground for discussing the wider role of peripheral flag carriers in offering connectivity and the impact of state aid policy with regard to the task of this section is to understand what difference model-based variety makes to the performance of a flag carrier. With this aim in mind, two recent and rather similar cases of state aid given to flag carriers of small peripheral Member States will be juxtaposed, namely the cases of AirBaltic and Estonian Air, airlines owned respectively by Latvia and Estonia. Latvia was acquitted of its charges, whereas Estonia was found to have transgressed from the rules. The focus will be on the differences and similarities of these cases with the objective of clarifying if the different final outcomes in terms of state aid legality were mostly driven by economic circumstances, political and administrative choices, or mismanagement of legal affairs. As the wider purpose is to lay the ground for understanding the impact of EU state aid policy on peripheral flag carriers, the motive behind choosing these two cases for analysis lies in their being simultaneously comparable and yet representative of a variety of CEE flag carriers. The two were investigated almost in parallel. Also, they are comparable in terms of company size as well as geographic, demographic and other crucial background features. On an overall scale of airline business

---

24 As the 2014 Air Connectivity Gaps Report commissioned by the EU Commission claims with regard to the CEE (Central, Eastern and South-East European) region the aviation market of the region is still “relatively immature” compared to the rest of the EU; and despite significant growth over the decade after the CEE accession in 2004, connectivity still lags behind that of the EU15 countries. Additionally, between 2011 and 2013, connectivity from CEE to EU15 countries and intra-CEE started weakening, mainly as a result of the loss of a number of network/flag carriers which previously operated in the region. The impact on connectivity by the growing share of LCCs in the market has been minimal and has not been able to counter the loss of routes offered by flag carriers. PWC, “Overview of Air Transport and Current and Potential Air Connectivity Gaps in the CEE Region Paper A’ (2014), 85–86, available at <http://ec.europa.eu/transport/sites/transport/files/modes/air/studies/doc/internal_market/2014-12-overview-of-air-transport-and-current-and-potential-air-connectivity-gaps-in-the-ceed-region-paper-a.pdf>. See also Crocioni and Newton, op.cit. note 3, 157–161.
models, stretching from full service (FSC) to low-cost carriers,\textsuperscript{25} the models of these two airlines stretch from a traditional legacy carrier (Estonian Air) to the hybrid-LCC model (airBaltic).\textsuperscript{26} They thus well represent the variation in CEE flag carriers model-wise and yet are comparable in terms of background features.

Although airBaltic is several times larger than Estonian Air, both companies are veritably tiny, carrying respectively 2.9 and 0.5 million passengers in 2013, representing 0.24 percent and 0.04 percent of the European aviation market. Their share of their home markets was relatively similar, 61.4 percent for airBaltic and 43.4 percent for Estonian Air, of passengers on board in 2013.\textsuperscript{27} Perhaps most significantly, both companies have experienced problems with profitability, qualifying as “firms in difficulty” by the Rescue & Restructuring Guidelines (R&R Guidelines), in the case of airBaltic in April 2010, and Estonian Air at the beginning of 2009.\textsuperscript{28} They suffered significant losses over several years. By 2012, the negative equity of airBaltic amounted to EUR 177.12 million,\textsuperscript{29} and by October 2012, Estonian Air had losses of EUR 64 million.\textsuperscript{30} Ownership patterns

\textsuperscript{25} FSCs see much heavier overheads due to a hub and spoke modus operandi: higher operating costs on account of the extra services provided, for which a premium price is charged. They are oriented towards business passengers with a need for frequent scheduling, inter-flight flexibility and ground service linkages, as well as frequent flyer programs, free airport lounges and use of major city airports. By contrast, LCCs cut costs significantly by reducing overheads, providing a no frills service and often using secondary airports with cheaper landing charges. Inventory management is simplified by the absence of feeder routes, direct or online booking and ticketless operations. Point-to-point routes attract price-conscious passengers. See Laurie Hunter, “Low-cost Airlines: Business Model and Employment Relations”, 24(5) European Management Journal (2006), 315–321.

\textsuperscript{26} AirBaltic is an LCC (low costs and ticket prices; extra services on board and luggage only for extra charge, etc.) and a flag carrier owned by Latvia showing hybrid features (a hub and spoke system, most flights to major airports, separate business class cabins, airport lounges and a frequent flyer program). See, e.g., Raymond Kollau, “Hybrid low-cost carrier airBaltic offers organic food, Nespresso and iPads in-flight” (2011), available at <http://www.airlinetrends.com/2011/03/28/airbaltic-local-food-nespresso-ipads>.


\textsuperscript{28} Eurostat, “Annual Analyses of the EU Air Transport Market 2013: Final Report” (April 2015), 247.


of airBaltic and Estonian Air have also been similar, inasmuch as the states have gradually been taking over from private investors. Following its privatization in 1996, Estonian Air was 66 percent owned by private investors (first Maersk Air, then SAS); in 2010 the state increased its stake to 90 percent and it reached 97.34 percent in 2012.31 Likewise, private investors (again SAS, later BAS) owned 47.2 percent of airBaltic from its inception, but the Latvian state bought them out by 2012, thereby becoming the sole proprietor of airBaltic.32 Altogether, both acquisitions can be associated with the low economic performance of the airlines. While the states needed to step in in order to save the companies from bankruptcy, private investors gradually yielded their shares and ownership rights.

In addressing the facts of the two state aid cases, it is worth taking note of the fact that Latvia’s airBaltic had been experiencing financial difficulties since 2008. Therefore, in October 2011, EUR 22.7 million was granted by the state and private shareholders to the company as a loan, the interest rates of which were substantially reduced after a period of a few months. By that time, however, the Latvian state had acquired all but one of the 47.2 percent shares from private shareholder BAS, thus becoming a 99.8 percent shareholder. A second loan was granted in two parts, the first tranche of EUR 58.9 million was provided in December 2011, the second of EUR 36 million in December 2012. In December 2011, a capital increase between the state and BAS, who at that point owned merely 0.2 percent of airBaltic shares, was agreed upon in the form of a loan conversion and cash contribution from BAS (in which the latter did not participate). The Commission opened investigations regarding these measures, but also regarding: an acquisition by the shareholders of airBaltic of zero percent coupon bonds issued by the airline in 2010, several transfers and payments made to the benefit of airBaltic by a nationalized bank, and the transfer to airBaltic of a EUR 5 million claim held by Latvia in an exchange of Latvian Lats (LVL).33

Estonian Air had faced financial difficulties from 2006. As with airBaltic, it took the same three-year interval for rescue operations to begin. In 2009, EUR 7.3 million and in 2010 EUR 19.9 million were provided to the company by the state and private shareholders. With the 2010 capital injection, and the state contributing EUR 17.9 and SAS 2 million, Estonia’s share increased to 90 percent

31 Ibid.
and SAS’s decreased to 10 percent. In 2011–2012, an additional EUR 30 million was made available, this time by the state alone. Thereby Estonia increased its shareholding to 97.34 percent, while SAS’s was further diluted to 2.66 percent. It was only in December 2012, with a subsequent measure, that for the first time Estonia notified the European Commission about its intention to grant a rescue loan to Estonian Air in the amount of EUR 8.3 million. In February 2013, the government decided to provide the airline with an additional EUR 16.6 million as a loan. In June 2013, Estonia notified the Commission about the intention to grant yet another rescue loan to the company in the amount of EUR 40.7 million. In addition, the company benefited from interest rate cuts and a prolongation of the repayment period for the loan from six months to five years.

In July 2014, the Commission reached a positive decision about the compatibility of state aid in the case of airBaltic with the R&R Guidelines, and, in November 2015, a negative decision in the case of Estonian Air. AirBaltic has continued to implement its restructuring plan, whereas Estonian Air ceased operations the day following the announcement of the decision, and it has since gone bankrupt. The Estonian government did not contest the European Commission’s decision.

The following paragraphs will focus on the question of whether the differences in these cases are formal or substantive. A series of arguments regarding the differences that contribute to divergent decisions concerning, foremost, the formal management of state aid will be put forward. Namely, the Latvian state conducted its actions more prudently when compared to the actions of Estonia. A closer look reveals that the differences primarily concern the way Latvia succeeded in concentrating its aid operation into a relatively short time-span, as required by the R&R Guidelines, and put together a more convincing restructuring plan. On a substantive plane, however, the cases are rather similar.

The clearest sign of inappropriate management was the Estonian government’s 2009–2012 decisions, when the government apparently neglected the possibility that its measures would be qualified as state aid. The government gave no notification of any of these measures before December 2012. When examined in hindsight, since part of the aid granted in this earlier period was later qualified by the Commission as illegal state aid, by neglecting the need to notify the Commission of giving aid to the airline, the government undermined the possibility to organize a proper restructuring operation at once or

---

to get the later R&R case accepted. In connection with the MEIP, it was found to violate the ‘one time, last time’ principle, according to which such R&R missions can occur only once every 10 years. To this from distinguish Latvia’s case, by managing its aid in a more compact manner, the ‘one time last time’ principle was adhered to by the Latvian government. Perhaps most importantly, future prospects for Latvia’s airline, as outlined in the ReShape plan of airBaltic, were found to be reasonably reliable by the Commission. But here also the actual economic situation of the airlines comes into play. The overall strategy of airBaltic had been relatively continuous or unidirectional, thus the airline experienced only minor corrective measures. Within the years under consideration, Estonian Air saw serious overhauls, switching from a low-profile point-to-point strategy to the creation of a hub in Tallinn in 2011, and then switching back again to a low-profile strategy. Finally, on a day-to-day business scale, airBaltic had been somewhat more profitable than Estonian Air.

However, one cannot help but witness the substantial similarities between the two cases. It was only with the initial measures that BAS and SAS were contributing on equal terms; later on they remained aside. Indeed, BAS lost its position as compared to SAS, who stayed aside voluntarily. Likewise, one cannot easily conclude that Estonian Air was less attractive for private investors. Furthermore, the major culprit that brought the greatest loss to Estonian Air was the decision to try a hubbing plan similar to airBaltic’s, led by the latter’s former cco, Tero Taskila. Thus, two main things speak against Estonian Air: (a) bad management of aid; and (b) the risky adventure of 2010–2012. Indeed, apart from an expensive jet deal made by SAS, a great part of the state aid injected into Estonian Air was needed to cover losses made by the launch of a hubbing strategy that emulated airBaltic’s. If one discounts these sums (ca. EUR 30 million), the relationship of the loss in size of the companies is very similar. Indeed, the differing strategies of the flag carriers were what ended up being the greatest loss-making factor.

The similarities and differences of the cases can be summarized at three levels: (a) decent management of aid (the Estonian government failed on this); (b) the decision to try a hubbing plan similar to airBaltic’s; and (c) the differing strategies of the flag carriers. For a detailed analysis of the aid injection and its effects, the reader is referred to the respective decision of the European Commission (2013/C) (ex2013/NN) (ex 2012/N) – Estonia, Rescue aid to Estonian Air (2013), 10.


(b) the potential of a company to stay in the market with aid injections every 10 years (here *airBaltic* had a certain advantage, but when discounting the emulation of the *airBaltic* hubbing strategy by *Estonian Air* the situation is not that different); and (c) loss-making as a permanent feature (here the companies were already very similar).

Indeed, at this fundamental level as distinguished above, not only do the Baltic flag carriers fare similarly, but so do nearly all CEE legacy carriers with regard to general loss-making.\(^{38}\) During recent years, along with the Baltic flag carriers, the Czech Republic’s *csa*, Hungary’s *Malév*, Slovenia’s *Adria Airways*, and Poland’s *LOT* have all undergone state aid investigations. Except *Malév* and *Estonian Air*, the rest have passed them with flying colors. Therefore, the two main research questions acquire a regional appearance: (i) why do the CEE governments keep their ailing companies alive at that price?; and (ii) what can we make of EU competition policy? In the instance of CEE air services, does the competition policy accord with its proclaimed aim of securing consumer welfare?

Thus, there emerges a paradox. The EU institutions follow the rules, but the meaning of the competition policy becomes ambiguous. On a formal level, there are actions which comply with rules and guidelines and those which do not. In this regard, the actions and decisions of the Commission and the European Court of Justice can be deemed to be accurate. On the policy level, however, one gets confused. On the one hand, R&R aid has institutionalized large aid sums every 10 years to the ailing CEE flag carriers, which from a liberal market perspective can appear to be keeping them artificially alive.\(^{39}\) On the other hand, mistakes in aid management can incur severe losses for a nation. At this juncture, there arises a question concerning the role of flag carriers and EU competition policy. If the former only devours state subsidies, why allow such a practice to continue? Yet, if there is a real use for the flag carriers, why not admit it and initiate a policy change? As will be argued in the last section, whereas a major policy change may be required, it will not necessarily entail extensive legal innovation. The need for a policy change is underlined by the fact that, in place of its old flag carrier, the government of Estonia immediately established a new one. In other words, it did not rely on the market itself, and it did not opt for public service obligations (PSOs). Thus, in the context of state aid policy, it is crucial to understand the rationale behind these decisions to


\(^{39}\) *Ibid.*
attempt to keep ailing companies alive or to create new ones. These are the questions with which the next section deals.

Why are these questions relevant? The aim of EU competition policy is to safeguard the correct functioning of the Single Market, to ensure fair competition and to protect the consumer. But does a Member State not likewise relate to consumers in this case? If one takes the consumers of a specific Member State, the possible distortion of competition by supporting a flag carrier becomes ambivalent. Drawing on the examples of several CEE aviation markets, the following section shows that, while Commission policy keeps prices down, it simultaneously diminishes connectivity in certain regions and especially in peripheral Member States. And this has an impact on a national economy. Indeed, from the perspective of the small peripheral Member States who are concerned about the connectivity between their capitals and major European cities, ‘the consumer’ of EU competition policy is merely an abstraction. It is merely ‘a facet’ of a real consumer who may win in terms of lower prices (and more so in the center of Europe), but then lose in connectivity (especially in the EU periphery). Importantly, the growth potential of a national economy is endangered and thereby also the consumer’s future purchasing power.

4 The Rationale behind Maintaining Flag Carriers: Connectivity and Non-internalizing Benefits

In order to understand why governments of the tiny Baltic States have been desperately trying to keep alive their loss-making flag carriers, one needs to place the question in context. The most immediate context is the airline sector in Central and Eastern Europe.

However, by first assuming a still wider perspective, one can see that profitability is globally a notable issue. From 1970–2010, the airline sector as a whole saw a net post-tax profit margin of only 0.1 percent of the revenues it generated. The ability to generate profits is particularly difficult in Europe where the liberalized market has brought more intense competition between airlines and the entrance of low-cost carriers has especially pushed smaller companies into trouble. What is more, the minuscule profit margin mirrors the fact that

41 Akbar, Németh and Niemeier, op.cit. note 18, 1.
42 Németh, op.cit. note 20, 17.
overall pressure in the market is to offer the lowest price possible to the passenger. One region in which these features converge and cause serious problems is Central and Eastern Europe. Here, Member States have a less dense and generally poorer population structure but often longer distances to the European heartland, which means their airlines tend to be smaller and their economies of scale remain constrained. Thus, the literature shows CEE airlines to be “overall inefficient with low partial productivity results”, to “offer low quality” and to be unprofitable, which indicates – so this article argues – that besides their poor management practices, these conditions are attributable to a general market situation. And if there is one segment that performs the worse in these conditions, it is the flag carriers of the CEE countries.43

Because, in general, CEE flag carriers tend to be loss-making, their governments can hardly be blamed for the desire to make more profit at the expense of their competitors. While the larger states are generally favorable to state aid, there could possibly also be detected the problem of ‘strategic trade’, as the foremost aim of CEE governments – when handing out state aid – must be to keep their flag carriers alive.44 Thus what has been perceived as a fact – maintaining legacy carriers – turns out to be a goal. Of course, any gain in market size could in the medium term help the CEE governments fulfill their goals. But with such a competitive market situation, even the long-term rationality of their actions is difficult to comprehend in terms of generating larger profits. In this situation a question arises with regard to the reasons why governments want to keep their flag carriers alive. Why would they prefer state-owned companies instead of private ones?

This study suggests that to understand the behavior of CEE governments, the answer seems to lie in examining at least two important aspects: symbolic value and rational aims. On the one hand, some flag carriers boast long histories (e.g., Malév), but even if they do not they often have become objects of national pride and their brands contain emotional value. Nonetheless, this rather non-rational side cannot be made to explain everything, for example the establishment of the new flag carrier, Nordica by the Estonian government. To grasp this move and the wider tendency to keep ailing flag carriers alive, one has to turn to the rational side of the argument. And here the key appears to be that connectivity is what governments are after. In other words, this consists of a government’s attempt to secure connectivity at a higher level than that that the market would provide. In this instance, flag carriers become tools and state aid becomes the mechanism to achieve this goal. In the periphery, without

43 Akbar, Németh and Niemeier, op.cit. note 18, 1–11.
flag carriers, connectivity is sensed to sink below a certain necessary level.\footnote{Kristel Michal, “Michal: Eesti huvi on igal juhul tagada lennuühendused Euroopaga”, Postimees (30 June 2015), available at <http://majandus24.postimees.ee/3240913/michal-eesti-huvi-on-igal-juhul-tagada-lennuuhendused-euroopaga>.} Crucially, airlines cannot achieve this connectivity without state aid. However, connectivity also becomes significant when pointing to the phenomenon of positive external factors which cannot be internalized for use by airlines. For example, aviation brings profits to a region but they may not be immediately available for airlines to internalize as revenues,\footnote{Crocioni and Newton, \textit{op.cit.} note 3,152.} and this is a wider scale phenomenon than usually admitted. How does it work? An airline contributes to local employment and taxes, but it also helps the national economy in a broader sense. This phenomenon can be seen to materialize in at least three ways. An airline brings tourists who, in turn, boost exports. But it also gives access to businessmen who make direct investments in the national economy, especially with the advent of point-to-point routes. Finally, good connections contribute to wider cultural relations between peoples, making a region or country prosper in a larger sense, surpassing mere economic aspects, but in the end also securing the former.

Thus, drawing on, in particular, the Baltic region, but also on the wider CEE experience, the following thesis arises from the behavior of those governments concerned: when the level of connectivity offered by the market – i.e., (private) airlines – is not acceptable for peripheral Member States, they appear to consider it in terms of a public service that actually accounts for larger profits and benefits to a country or region than what simply becomes available to the airlines involved. Compared with the European heartland, this problem has a special bearing on smaller and peripheral Member States: longer distances and lower income levels make the periphery comparatively less reachable by means of reducing the number of possible connections. Recently, this phenomenon of the connectivity gap has been acknowledged and investigated at an EU level.\footnote{PwC, “Overview of Air Transport and Current and Potential Air Connectivity Gaps in the Cese Region Paper A’ (2014), available at <http://ec.europa.eu/transport/sites/transport/files/modes/air/studies/doc/internal_market/2014-12-overview-of-air-transport-and-current-and-potential-air-connectivity-gaps-in-the-cese-region-paper-a.pdf>; and PwC, “Overview of Air Transport and Current and Potential Air Connectivity Gaps in the Cese Region Paper B’ (2014), available at <http://ec.europa.eu/transport/sites/transport/files/modes/air/studies/doc/internal_market/2014-12-overview-of-air-transport-and-current-and-potential-air-connectivity-gaps-in-the-cese-region-paper-b.pdf>.} According to Longman and Khan, in the United States, where the deregulated aviation market has had a longer history, aside from...
other problems, such a market (eventually through mergers and downsizing) has brought about dramatic losses in connectivity, not only for remote regions (leaving some state capitals altogether without regular connections), but even for medium-sized cities, like Memphis, Cincinnati or St. Louis, which hitherto had been homes for major airports, thus making their otherwise lively business environments lose remarkably in attraction, and thereby causing many headquarters of national and international businesses to move out. As these authors argue, aviation has to be taken as a public service providing roughly equal accessibility at comparable prices to all regions and citizens, which needs cross-subsidization and which can only work well as a natural monopoly.48 The EU airline market, taking the CEE example, seems to follow the trajectory of the United States. In CEE practice, this problem can be addressed by flag carriers in two respects. They are seen as vital to secure sufficient connections with the European heartland and other international centers, but they also create networks for nearby regions beyond a country’s national borders.

A closer look reveals that such an airline (i.e., flag carrier) should be able to offer a sufficient number of vital connections in a stable manner. The first two qualities depend on a political decision, however they are also related to larger socio-economic benefits and established economic and cultural relations. The stability of connections is related to the reliability of their continued existence, which is most sensitively apparent in business relations. Indeed, without the availability of state aid, only those destinations with sufficient demand throughout the year will be served. Therefore, for business relations stability is also needed. To take an example, with its already heavily reduced network and overall 25 percent share of airport traffic, about 60 percent of all business flights departing in the early morning hours from Tallinn were still serviced by Estonian Air in its last year of existence.49 The need for a provision of stable connections and a comprehensive network is also how the situation is generally perceived in Estonia, and it figures as the main justification for maintaining a flag carrier among experts and members of national governments.50

To illustrate the role of the non-internalized benefits behind the practice of maintaining flag carriers, the examples of Budapest and Vilnius will briefly be analyzed. Although the reasons for ceasing their operations were different,

50 Ibid.
after the bankruptcy of Malév and FlyLal, there occurred a clear decrease in connectivity. Thus, in negative terms, these consequences speak about the function of flag carriers. In the paragraphs that follow, the suitability of flight connections for the business segment will be singled out. Whereas for the tourist segment any lessening of Available Seat Kilometers (ASK) may play its role, beside certain quantitative aspects (e.g., availability of routes and frequency of connections), the needs of the business segment also include a qualitative side (scheduling, stability of connections etc.).

The Hungarian national airline, Malév at one time accounted for 37 percent of passengers from Budapest. Following a decision concerning unlawful state aid, Malév stopped operations in February 2012. As the EU Commission’s Competition Directorate-General (DG Competition) shows in its policy brief, less than a week thereafter, other airlines had taken over 60 percent of Malév’s point-to-point traffic. And, at the end of 2012, low-cost carriers accounted for 51 percent of traffic at Budapest, up from 26 percent before the demise of Malév. By the end of 2012, the year-on-year fall in passenger numbers at Budapest had been cut to 4.7 percent. Direct destinations decreased from 84 cities that had been reachable in 2011 to 74 in 2012. It was estimated that, in 2014, capacity measured in Available Seat Kilometers (ASK) was 10 percent lower than it had been before Malév’s collapse. Indeed, this does not sound overly drastic. But what should be noticed is that a significant cut in destinations (nearly 12 percent) occurred, which is also reflected in the ASKS. Comparing the drop in the overall number of passengers to the drop in ASKS suggests that Malév must have previously covered those ‘thin’ routes by other companies that were considered too risky. While this is logical in market terms, this also means that Malév illustrates the pattern of flag carrier rationale outlined above with regard to providing connections above the market level. The consequences also show that the harm may be more pronounced for the business sector. Next to the 4.7 percent cut in passenger numbers conditionally showing the loss of the tourist segment (here business travelers also count as tourists spending on local services etc.), the 12 percent drop in the number of destinations can be seen to be particularly harmful to the business sector. Even a drop of 10 destinations for a year-long period can bring serious problems for businesses related to those cities. What’s more, it may not work more efficiently for cities now serviced by LCCS, as their services typically tend to be more time-consuming and less convenient for a business traveler, especially for CEE connections. Addition-

51 European Commission, op.cit. note 29, 4.
connections with bigger international centers, Malév also served as a promoter of Budapest as a regional center.  

Nonetheless, if in the case of Budapest one saw a comparatively good recovery, it can be partly attributed to the population size and density in Hungary and that of its capital, as well as its geographical position close to the European heartland. In comparison, the case of the Lithuanian national flag carrier, Lithuanian Airlines (FlyLal) that went out of business in 2009 demonstrates what can be a severe aftermath. For that airline, the number of business connections and overall number of passengers dropped drastically and remained low for several years. The number of direct flights from Vilnius were reduced from 28 to 14 destinations and the number of passengers decreased by approximately 36 percent in 2009. As DG Competition has shown, since then the number of passengers has seen a steady increase: 2012 exceeded the pre-crisis figures of 2008. In terms of destinations from Vilnius, in 2014 there were 34 direct destinations operated by more than 20 airlines. The presence of low-cost carriers in Vilnius (in particular Wiz Air and Ryanair) is very significant. Nonetheless, whereas a recovery took place, FlyLal’s quality is still disputable. For almost three years the cessation of FlyLal’s operations nearly turned Vilnius into a desert in terms of connectivity. Second, the replacement of what were mostly business connections with LCCs means there is a considerably different service on offer in terms of flight hours and destination airports. The share the LCCs currently have is nearly half of the Vilnius market. Third, within two years (2013–2015) a new flag carrier, Air Lituanica, appeared, and then disappeared. Thus, based on the two examples described above, one can see that ceasing the services of a flag carrier can cause a serious decrease in connectivity. That was the case both in Budapest and in Vilnius. In Tallinn, it was avoided only through the immediate launch of a new flag carrier.

5 Expansion of the Context: Asymmetrical Integration and Peripheral Economies

The above discussion has revealed a major rationale for justifying states to keep their flag carriers. Next to other forms of state aid to (or through) airports to airlines (including LCCs), aid to flag carriers is an effective tool for

54 European Commission, op.cit. note 29, 4.
55 This article leaves aid to LCCs out of consideration due to the limits of space and focus. The practice of the small CEE governments shows that they are primarily after securing
internalizing the wider social benefits that are not immediately available for private airlines. But this also explains why, in a liberalized market where the pressure is to keep prices down, governments need to use state aid. It is to compensate for those benefits that are out of reach to airlines. Nevertheless, this does not in itself explain why the peripheral Member States ‘strike out’ with their state aid cases. For whereas the problem of non-internalized benefits is basically similar for wealthy and densely populated regions, it is above all and foremost the smaller and poorer countries and regions who seek aviation services above the market level.

This section argues that such behavior of the poorer peripheral regions becomes truly meaningful when placed in a context of the asymmetrical integration logic dominating the EU. According to this model, a free trade regime without sufficient balancing mechanisms necessarily issues in uneven growth, of which air connectivity is both the symbol and one possible alleviation. In other words, the airline sector is a part of, and a model for, the EU asymmetric internal market. A remote, less densely populated and poorer Member State relates to the rich central Member States like a remote and poor region of a nation state to its metropolis. Therefore, just as such a region requires regional policy measures, a peripheral Member State should be justified in giving (if not receiving ‘federal’) state aid to their legacy carriers on a significantly higher level as compared to wealthier Member States. Thus, within the framework set up by the current state aid regime, the problem behind state aid and similar actions in the CEE is not about catching-up but rather about not losing out. Therefore, the discussion has to leave aviation and zoom out to the broader economic context of the EU.

According to the prevailing view, reflected, inter alia, in the single market rules and European Commission guidelines, especially in their interpretation, the market is supposed to secure not only equal conditions and even economic growth, but in the form of free trade it is supposed to bring convergence to poorer countries. On the one hand, some real convergence has been seen. CEE countries especially have witnessed high levels of economic growth and the availability of suitable quality service for business travelers for whom they consider flag carriers more suitable.

development. On the other hand, a big part of that growth preceding the crisis can be attributed to massively cheap loans fueling consumption and causing a real estate bubble. Now that cheap loans have ceased and no replacement has occurred in terms of comparable public funds and investments, CEE growth has stagnated. For quite some time, peripheral countries (especially CEE countries) in the EU have not been simply attempting to maintain the pace of growth, as Reinert and Kattel argue, they are struggling not to fall further behind. As these authors claim, these problems are systemic to the EU and its prevailing integration logic.

According to Reinert, in a free trade regime, which ties together developed and less developed countries, unless serious and protected creation or upgrading of “increasing return” industries is undertaken in the latter, there emerges the phenomenon of “uneven growth”, whereby poorer nations are unable to catch up because of systemic disadvantages. Two main barriers to entry can be outlined – scale-based and knowledge-based – and hence a less developed country is bound to specialize in low-quality activities. When a less developed country enters a free trade regime, the productivity of its industry (relatively high wages and low increasing returns) is bound to remain lower compared with its competitors. While normally this “churn process” is considered beneficial, this “normality” actually depends upon restraints. The latter are foremost marked by the policy “borders” of a nation-state, where there exist many direct and indirect stabilizers, including redistribution of income and fiscal transfers as regional policy instruments (i.e., all kinds of public services).

Though in some regards the EU is reminiscent of a nation-state, the quality as well as the quantity of its policy dimension is not comparable to one. The

60 Ibid.
63 Reinert, op.cit. note 61, 4.
stabilizing power of its budget is especially far from being alike\textsuperscript{64} (compare e.g., the size of the central EU’s and United States’ federal budgets, the United States being the closest example of a federation to the EU in terms of size, economic development and political culture).\textsuperscript{65} Thus, the EU in its present form and capacity is both unable and unwilling (the prevalent ideology of convergence by free trade) to iron out inequalities between rich and poor Member States. Here the importance of public policy becomes salient. Reinert and Kattel draw a sharp distinction between what they call ‘a Listian’ symmetrical integration logic dominating the EU up until the mid-1980s, and an asymmetrical integration taking lead in the 1990s and 2000s.\textsuperscript{66} When symmetrical integration allows joining into a common economic area of countries with a similar level of development, asymmetrical integration witnesses poorer economies joining the wealthier ones. Spain, Portugal and Greece were assisted in bringing their industry to a comparable technological level and tariffs were lifted slowly and gradually. Although the backwardness of CEE countries was much more severe, assistance comparable with that of the 1980s was not the case.\textsuperscript{67}

In this context, in the same way Baltic flag carriers previously became a symbol of peripheral aviation, peripheral aviation becomes in this section a symbol of peripheral economies trying to maintain their basic competitiveness and living standards under the conditions of the single market. State aid to national flag carriers hence signifies not only an attempt to ensure the survival of those carriers as providers of a relevant public service and to internalize wider economic benefits, but that those airlines become vital public services offering connectivity, i.e., sufficient accessibility to the European market for conducting stable business relations. Thus, and rather paradoxically, when trying to help their flag carriers, the peripheral Member States of the EU fight hard for the basic competitiveness of their economies.

\textsuperscript{64} Giandomenico Majone, \textit{Europe as the Would-be World Power: The EU at Fifty} (Cambridge University Press, New York, 2009), 115.


\textsuperscript{66} Reinert and Kattel, \textit{op.cit.} note 59, 4–17.

\textsuperscript{67} \textit{Ibid.}
6 Conclusion

Drawing on the above view of asymmetrical integration, it is possible to conclude that state aid rules, when applied to less developed Member States, amplify regional inequalities within the EU. The liberalized market in the airline sector does not support regional or cross-European equality, economic convergence and sustained growth, but rather diminishes the possibilities in peripheral countries. Hence, the single aviation market illustrates what the unequal periphery-center situation inevitably brings along to a sector. It is possible to conclude that a liberalized market is no panacea to cure inequalities, rather, it amplifies them. In the present context, there are several aspects concerning EU state aid policy which do not enable it to work for the benefit of peripheral countries. Whereas in the larger, richer and more densely populated Member States the protection of a deregulated market works to bring low prices without significantly hampering connectivity, in the smaller and poorer peripheral countries, with smaller population numbers and lower density, the lower service cost achieved is downplayed by a dearth in connectivity.

What are the possible ways to deal with this situation in aviation? If the argument of the last section holds, a paradigmatic change in thinking and policies is needed. Yet, in a curious way, current state aid rules in fact include provisions that foresee exemptions and, if their underlying logic is appropriately extended, appear as appropriate to cope with uneven economic development. The best general clue is provided by Article 107(2) (c) TFEU, which admits to the extraordinary conditions which arose after German unification. It has been obvious to the European public that a free market cannot in itself manage to secure normal development for former East Germany. Thus, Germany with its post-unification situation is a good model to that of the EU after the so-called Big Bang enlargement in 2004: old and richer Western Member States and the CEE countries form a similar combination. However, of equal value would be Article 107(3) (a) TFEU that allows exemptions for countries with abnormally low living standards. Indeed, extension of the logic of this clause to the economies of the CEE (and similar) Member States would make sense. Of course, this would primarily create a mechanism for alleviating problems in a certain sector. Yet, when targeting a sector like the airline sector, which functions as a public service, it would also help to lay the ground for convergence. So, as far as state aid regulation is concerned, even if the change would ideologically assume taking a rather long step, in practice one does not have to look at rewriting or amending treaty provisions; the current state aid rules include clauses that could serve as a basis for redesigning appropriate policies.