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POLICY BRIEF
SPECIAL EDITION

The Case against Bailing Out the Airline Industry

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March 25, 2020

In response to the COVID-19 pandemic, the federal government will again bail out the airline industry, which is in the midst of a crisis owing to dwindling passenger revenue. The president insisted on taking such actions and called emergency aid for the airline industry his "number one" priority.[1] Bailouts between $29 and $58 billion had been requested by the industry in the form of grants, loans, and tax abatements. Meanwhile, the Democrats were not opposed to a bailout, but they twice blocked procedural steps to include demands such as a $15 minimum wage, actions on climate change, and other operational "reforms."[2] There were also some bipartisan calls to limit executive compensation or end stock buybacks. Only the short-term limits on executive compensation and prohibition of dividends and stock buybacks had enough bipartisan support to make it into the final version of the bill.

Doug Parker, chairman and CEO of American Airlines Group, Inc., the parent company of American Airlines, sent a letter asking for a bailout, which was signed by many union leaders, to Secretary Steve Mnuchin and House and Senate leadership saying, "The investment being sought by our airline is necessary to ensure its continued viability. . . . Governmental assistance, with appropriate conditions, is an essential component of our path to sustainability and recovery." United Airlines sent a letter to all employees that was released to the media, threatening that "if Congress doesn't act on sufficient government support by the end of March," they will begin massive layoffs commensurate with reducing their operation by 60 percent.[3]

The COVID-19 pandemic is undoubtedly hurting the airline industry. The hardship is the product of both direct government action prohibiting or restricting flights and consumers' unwillingness to fly owing to their fears of being infected by the virus or infecting others. Canceled and postponed flights mean sharp declines in revenues but not a reduction in fixed costs. Passengers aren't

This special edition policy brief is intended to promote effective ideas among key decision-makers in response to the COVID-19 pandemic. It has been internally reviewed but not peer reviewed.

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booking many new flights, so there's little revenue coming in. Further, as airlines cancel flights, the costs of refunding tickets that have already been purchased also mount.

However, even if one is sympathetic to the idea of helping industries in times of crisis, the critical question to ask is, Are there more effective ways to resolve a company's financial problems than a taxpayer-funded bailout?

While the airline industry is always fast to request a bailout, such a bailout is rarely appropriate. As far as bailouts go, it is preferable to extend loans to firms than outright grants. Nevertheless, before the government considers any sort of bailout for the airlines, airlines should always first go through the bankruptcy process.

As the United States has seen in the past, airline bankruptcy does not present any significant contagion risk to the economy. Airlines have often flown through bankruptcy successfully—American, Delta, and United have all done it—and airlines that each has merged with have done it as well, in some cases more than once, without jeopardizing airline operation or safety. And any help for workers should address the needs they face independently of which industry they work for.

It is unwise to impose, and especially to rush, many of the Democrats' proposed operational reforms in exchange for the bailout funds. A hasty legislative package, pushed through in an emergency when the industry is weak and voters are panicked, should be kept as limited as possible. The risk is that operational reforms imposed under these circumstances will make the industry worse off once the crisis passes.

NO SYSTEMIC RISK OR SPILLOVER EFFECT

During the Great Recession of 2008, the arguments for a government bailout of banks were that it would prevent a contagion of failure from spreading from bank to bank and to other financial institutions, that businesses wouldn't be able to access capital markets without banks, and that assets would become "frozen" when they were needed most. The tight interconnection between banks, so the argument went, meant that failure of one of them would trigger the failure of many other financial institutions. This consequent collapse of the entire industry would significantly damage the whole economy because the payments system and supply of credit to worthy borrowers (so that businesses could make payroll, entrepreneurs could launch companies, and so forth) would be severely constrained; the economy could possibly collapse.

The probability of this worst-case scenario is debatable, as is whether the method of the bank bailout was appropriate or resulted in even *more* fragility for the system. But none of these arguments in support of a bailout can be made for the airline industry.[4]

The industry does have its own chain of supply, and some spillover can be expected to hit suppliers if the airlines fail. If, for example, Delta and United stop flying, suppliers of aviation fuel must not only lay off workers, but the reduced demand for fuel will mean fewer jobs in oil refineries. Likewise, failed airlines mean less demand for the output of companies that supply food and beverages for flights. These problems are not unique to airlines. The failure of *any* industry entails such effects.

A bailout is unlikely to prevent such spillover effects in any case. Compass Airlines and Trans States Airlines, which have provided contract flying for American, Delta, and United Airlines, have already announced they are shutting down permanently. Airport workers and contract aircraft cleaners are already being laid off—and are unlikely to see any benefit of a bailout. Until passenger demand returns, airlines will defer capital spending on aircraft and airport lounge projects even if they are bailed out.

Meanwhile, airlines may come back for more funding, and quickly. A letter to Senate and House leadership from industry trade association Airlines for America dated March 21, 2020, under the signatures of CEOs of 10 US airlines (including 3 cargo airlines), indicated that "payroll protection grants . . . equaling at least $29 billion" for "750,000 airline professionals" would only prevent layoffs through August 31, 2020. Taking United Airlines's order-of-magnitude suggestion that approximately 60 percent of employees could be furloughed, 450,000 jobs would be saved at a cost of nearly $13,000 per job *per month*.[5] Airline demand is unlikely to fully return this year, so furloughs may still occur once these funds are exhausted, unless airlines receive an additional bailout.

There is no risk of an airline run, as there is with banks, and spillover effects of an airline bankruptcy on other businesses can be expected even if airlines receive a bailout. A bailout of airlines does not protect a linchpin to the economy when demand is already severely depressed, and there is no systemic risk to the economy from an airline failure.

BANKRUPTCY, NOT BAILOUT

Bankruptcy is a more effective way than a bailout to resolve the airline industry's financial problems. Airlines still have access to capital markets and have many durable assets that they can sell or use as collateral to get additional financing, even during a crisis. In the past two weeks, major airlines have raised substantial additional capital: $1 billion for American, $2 billion for United, and $2.6 billion for Delta, giving each carrier approximately $8 billion in liquidity. Each of these three airlines reported between $10 billion and $20 billion in unencumbered assets (the market value of which could be somewhat lower today than when last marked to market).[6] They also earn billions of dollars from the sale of frequent-flyer miles to banks.[7]

Even without selling these lucrative assets, airlines have turned to their co-brand credit-card-issuing partners for liquidity during past challenges. American, United, and Delta have each

presold between $500 million and $1 billion worth of frequent-flyer miles, including during the financial crisis of 2008.[8]

Airlines should be expected to use their substantial assets, which include their multibillion-dollar credit card deals with banks that include JPMorgan Chase, American Express, and Citibank, before entering bankruptcy. These assets also position them well for success should bankruptcy be required.

Unlike the banks before 2008, there is in place an orderly bankruptcy process for airlines—one that has been used successfully many times before. This process allows bankrupt airlines to keep their lights on and fly without jeopardizing the safety of their passengers. The three largest US airlines have all flown successfully through bankruptcy. Yet they still have the planes, the spare parts, the gates, the workforce, and everything else that's needed for them to fly, and they have assets with which to secure additional working capital.

A bankruptcy judge could impose a stay on creditors' claims. Such a stay would, now as in the past, give airlines breathing room until the crisis dissipates. Importantly, the process is fair in that it allows those same airline investors who make good returns during good times to lose money during a crisis, which reflects the decreased value of their investments.

Some people might argue that after the airlines take all these steps, if there is still not enough capital (foreign or domestic) available, airlines could *then* make a case to the government for an injection of cash to fund continued operations during restructuring. Others might argue that bailing out airlines with loans (rather than outright grants), as proposed currently by Treasury and the Senate proposal, is the better way to go. While it is true that some ways of bailing out this industry would be less harmful than others, every way is costly and every way creates distortions and sets a bad precedent.

THE OPPORTUNITY COST OF A BAILOUT

Former Delta Air Lines CEO Richard Anderson, calling subsidies a "threat," declared less than five years ago that "what we've discovered at Delta Air Lines is we compete against a lot of state-owned and state-subsidized enterprises."[9]

The same is true of bailouts. Both bailouts and subsidies are forms of government-granted privilege extended to a few politically connected firms or industries.[10] Both also have some significant costs, many of which are hidden.

When the federal government bails out an industry, it shifts resources away from nonsubsidized industries to the subsidized one. Because politics drives the bailout decision, this shifting of resources is done largely independently of the merit of the industry or of its claims of special dis-

tress. If it were not for the government action, the resources used in bailouts would be directed naturally by the market to other, more productive uses. So while it is easy to see the companies and the jobs that are today saved by bailing out the airlines, we don't know what goods and services are thereby *not* produced and consumed because of the bailout, what non-airline companies *don't* survive because of the bailout, and what jobs *aren't* created and sustained in nonsubsidized industries.

The history of bailouts also suggests that they prop up weak firms long enough to make their dysfunctions worse, thus requiring further intervention in the long run. Economist Bill Shughart, for instance, looked at the history of bank bailouts in the United States and found that

> the record of government bailouts of private financial institutions in the 1930s, of Continental Illinois Bank in 1984 (which cost $8 billion) and of the entire U.S. savings & loan industry in the late 1980s and early 1990s (which cost $125 billion) teaches that emergency loans keep weak institutions alive just long enough for their problems to increase. Bailouts encourage more risk-taking and eliminate the freedom to fail that is just as essential to a free-market economy as the freedom to succeed.[11]

This is true, in part, because bailouts change expectations about this industry and other industries being bailed out again in the future. From the 1971 bailout of Lockheed Aircraft Corporation to the record-setting financial institutions bailouts of the Great Recession, big American companies have built-in expectations about being helped in times of trouble.[12] Unfortunately, the expectation of future bailouts creates incentives for executives of large firms to be less careful about their decision-making and to take more risks. The negative consequences of this behavior likely include higher costs of production, malinvestments, poor managerial decisions—and a further shifting of executives' attention away from meeting the demands of consumers spending their own money and toward lobbying for favors dispensed by politicians spending taxpayers' money.

In the case of airlines, the funding from the Air Transportation Stabilization Board after 9/11 is what kept America West and US Airways flying. American Airlines CEO Doug Parker was the CEO of America West who won government funding to keep that airline afloat. He went on to lead the takeover of US Airways and then American. United Airlines President Scott Kirby, who has been announced to succeed Oscar Munoz as CEO, was a senior America West executive who became president of US Airways and American under Parker. It's precisely their experience with past government bailouts that has colored industry decision-making as it faces the prospect of another bailout. Indeed, the expectation of a bailout appears to be so strong that American has stated that it intends to continue capital spending to add seats to hundreds of domestic narrow-body aircraft at a time when demand for those seats is weakest and the need to conserve cash would otherwise be greatest.

Bailouts also have other costs, in addition to their cost to taxpayers.[13] For instance, scholars have argued that the automobile bailout of 2008 damaged the rule of law by not allowing a bankruptcy procedure to run its course.[14]

NO RIGHT WAY TO BAIL OUT THE AIRLINE INDUSTRY

While airlines should be expected to exhaust their options in the credit markets before receiving a bailout, and equity holders and creditors should shoulder the risk of losses to their investments before turning to taxpayers, the original Treasury request to extend a bailout to airlines in the form of secured loans was better than other bailout options that airlines would have preferred, such as cash grants. In the end, the bailout was a mix of loans and grants.

The theory for structuring the bailout in the form of loans is that solvent companies need financing to get through the COVID-19-related economic shutdown; once healthy, they should be able to pay it back, and taxpayers will not shoulder the cost. Unfortunately, legislators on both sides of the aisle have insisted on pairing the bailouts with demands that will likely make the airlines less efficient once this crisis has passed. Most of the demands did not succeed, but because they are a common feature of most bailouts, they are worth reviewing here.

For instance, imposing minimum-wage mandates, restrictions on executive compensation, and other such business decisions as conditions for the receipt of bailout funds will, ironically, only increase the likelihood that airlines will encounter financial troubles in the future. If airlines are compelled to pay artificially higher wages, their labor expenses will become artificially burdensome and their mix of labor and capital equipment inefficiently biased toward the use of too much capital equipment and too little labor. Similarly, restrictions on executive compensation will diminish airlines' ability to compete for top executive talent—an outcome that cannot help but make airlines less efficient and robust and thus less well equipped to withstand future crises. These consequences mean that airlines will have greater trouble repaying bailout funds, they will be more likely to need a future bailout, and fewer routes will be profitable in the future, meaning less air service for the country.

Various passenger protections were also proposed by consumer advocates as a condition of a bailout, from free checked bags to more leg room on planes. These are the same demands many of these groups made before this crisis, citing now that taxpayers should "get something" in exchange for the bailout. Up to $58 billion in funding is a high price to pay for checked bag fees that run $35 apiece and extra-leg-room seats that are usually priced at less than $100. Airline passengers as a whole tend to have relatively high incomes, making this income redistribution an odd request to make of taxpayers during a crisis.

Commentators from Robert Reich to Mark Cuban have criticized airlines for buying back stock rather than setting aside funds for a rainy day and have called for permanent restrictions on airline stock buybacks as part of a bailout package.[15] If airlines have been insufficiently risk averse, that stems in part from past bailouts themselves, rather than the option to buy back stock. However, with significant profits over the past decade, air travel demand growing only modestly, and capacity restricted at government-owned airports in major cities and in government-managed airspace, additional investment appears to be of lower value than opportunities for investors elsewhere.

Buybacks are a tax-efficient alternative to dividends. Banning buybacks restricts capital from flowing to more valuable uses in the economy. Currently, that capital might be put to better use producing medical equipment and vaccines, for instance.

CONCLUSION

No one should be surprised that the airline industry was the first to ask for a government bailout, considering its long history as a government-protected industry.[16] Today, despite "deregulation" (which largely means that the government no longer tells airlines where they are permitted to fly and how much they should charge), airlines remain intricately intertwined with government as a means of subsidy and protection from competition.

A bailout of airlines funnels taxpayer money to private airline investors and creditors, and it is not necessary to prevent an economic contagion. Many large US airlines have demonstrated an ability to successfully fly through bankruptcy. And bailing out airlines is an inefficient way to protect workers because it focuses on a single industry's employees, and only the most visible of those workers, while ignoring the many airline-industry contractors who have already lost their jobs and won't have work in times of reduced demand.

While airlines should not receive a bailout as a matter of public policy, if politics dictates one, then the process should not become a grab bag of interests and preferred policy prescriptions stapled on in haste. Such bailout packages risk doing long-term damage to the industry that the bailout is trying to save.

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