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THE AIRLINE COMMISSION'S BOOST FOR DEREGULATION

Joe Cobb
John M. Olin Fellow

INTRODUCTION

With the release last month of the final report of the National Commission to Ensure a Strong Competitive Airline Industry, a verdict has been entered against government re-regulation and in favor of economic competition. The way to strengthen the United States airline industry, the Commission says, is to spur greater flexibility and international competition in the industry, not to turn back the clock to regulation.

The Airline Commission was created by Congress in 1992 in response to the financial problems plaguing the airline industry. The Commission was charged with making policy recommendations about the "financial health and future competitiveness of the U.S. airline and aerospace industries."

Although there were worries that the Airline Commission would recommend a government bailout of the industry and a rollback of airline deregulation, the Commission report avoids these pitfalls and makes several valuable recommendations that will improve the efficiency and competitiveness of the U.S. airline industry. Among the most important recommendations:

- ✘ The FAA should be "reinvented" and restructured as an independent federal corporate entity, to permit much-needed technological modernization of the air traffic control system.

- ✘ The current system still suffers from excessive regulation, which imposes unneeded costs on the industry. The report recommends a new, more objective system of cost-benefit analysis as a basis for decisions on regulation, with the use of outside expertise and cost impact data from the airline industry early in the regulatory process. And total regulatory costs to the industry would be constrained within an annual regulatory budget.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

- ✘ The current international system, based on bilateral national agreements, should be entirely renegotiated. The aim of the renegotiation should be to further deregulate international routes and to make it easier for foreign and U.S. airlines to invest jointly in multinational air service. Carriers should be free to make business decisions to serve cities internationally with many fewer governmental restrictions on landing rights on the basis of nationality alone.

The bipartisan Airline Commission has firmly rejected calls to reregulate the airline industry, and it has offered generally sound proposals to strengthen the industry. Congress and the Administration would be wise to move ahead swiftly to implement these recommendations.

THE GENESIS OF THE COMMISSION

With the effects of the 1990-1991 recession lingering into 1992, the U.S. airline industry experienced severe financial problems. The airlines suffered heavy losses. Many of the old criticisms of free markets were raised in favor of renewed government involvement. Cutthroat competition is unfair or even dangerous, it was said, because the travelling public is put at risk when airlines must "cut corners" to make a profit in a highly competitive industry. Moreover, charged critics, industries with high fixed costs need the stability of central planning, or regulation, if they are to survive.

Although the Airline Commission reached a sensible conclusion about re-regulation, there should have been no need for a congressionally mandated, presidentially appointed panel to reach that conclusion. The 1990-1991 economic downturn affected more sectors of the economy than air travel; major corporations such as General Motors and IBM have undergone significant reorganizations without calls for a presidentially appointed commission. The airlines themselves have experienced several episodes of significant financial difficulty in previous recessions—and the existence of fare and route regulation before 1978 did not prevent financial losses. In a market economy, industries often face severe changes. Business planning should be left to business management and their staff economists, not to *ad hoc* study commissions.

Congress established the Airline Commission under Section 204 of the Airport and Airway Safety, Capacity, Noise Improvement and Intermodal Transportation Act of 1992 (P.L. 102-581). President Clinton appointed fifteen voting members in 1993.[1] In addition, five Senators, five Congressmen, and the Chairman of the President's Council of Economic Advisers served as non-voting members. The statute instructed the Commission to investigate a comprehensive range of concerns:

- ✓ Can the industry continue to provide fast and efficient domestic transportation?
- ✓ How can the financial solvency of carriers be improved and can the number of bankruptcies be reduced?

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1 Heritage Foundation Visiting Fellow John Robson, a member of the Airline Commission, discussed the Commission's findings with the author. This study's analysis and conclusions, however, are entirely the author's.

- ✓ Will the industry be likely to share profits or losses over the next five years and does it appear that any carriers will go under during that period?
- ✓ Why has there been a declining number of competitors and increased concentration of market share among the largest carriers?
- ✓ Do competitors have enough capital to purchase the equipment required to continually improve the safety and quality of air travel?
- ✓ Can the industry remain competitive globally?
- ✓ Can the industry accommodate growing aviation traffic?
- ✓ Are airlines providing the highest quality of service at the most competitive price?
- ✓ Can noise be further abated around airports without substantially damaging the competitive positions of carriers?
- ✓ Are there legal impediments to improved competition within the industry?

To be sure, the airline industry has encountered severe financial problems over the past three years. And the industry saw some spectacular bankruptcies in the 1980s, including Pan Am, Eastern, and Continental, due in part to the use of excessive debt financing to fund rapid growth. Nevertheless, the concern in Congress about the condition of the airline industry, as illustrated by the findings in the Airline Commission's authorizing legislation, stands in curious juxtaposition to the clear benefits that have accrued during the fifteen years of growth under deregulation. Among these:[2]

Airline deregulation has created jobs; salaries are higher and fares are lower. Airline industry employees numbered 540,412 in 1992, up from 330,495 in 1982 (a 64 percent increase). Employment in 1992 was down slightly from the 1990 record level of 545,809, but still far above the number during the era of regulation. Overall, industry salaries and wages in 1992 were 5.4 percent higher than in 1991, and up 34 percent since 1982 in nominal dollars. Despite the record losses between 1990 and 1992, average airline employee salaries rose over 4 percent in real terms between 1982 and 1992. Since airline deregulation, overall airfares have declined, adjusted for inflation.

More Americans are flying. Air carriers recorded a total of 474.6 billion revenue passenger miles in 1992, an increase of 6.2 percent over 1991. Industry forecasts expect gains of between 4 percent and 6 percent over 1991.

Airplane load factors are up. In 1992, the industry's average aircraft load factor was 63.8 percent, a new industry record, beating the former high mark of 63.2 percent in 1979. Low ticket prices have stabilized passenger load factors in a range of 60.3 percent to 63.8 percent over the past eight years, despite the large number of new aircraft placed in service.

2 John Stoner, "Commission on Airline Industry Urges Lower Taxes, Streamlining FAA," U.S. Senate Republican Policy Committee *Regulation Watch*, July 20, 1993.

There is increased competition and wider choice for passengers. Researchers Steven A. Morrison and Clifford M. Winston, in a Brookings Institution paper, note that, "Route selection is greater than it was under regulation. Today only 3 percent of passengers fly on routes served by only one airline, down from 9 percent in 1978."[3]

Despite the clear improvement in air service for customers, of course, there are groups in the industry who are less well off—a typical result of tighter competition. Organized labor, in particular, is in a worse position now than fifteen years ago. John F. Peterpaul, a commissioner and Vice President for Transportation of the International Association of Machinists and Aerospace Workers, strongly opposed the conclusions of the majority. His dissenting opinion was published as a 22-page monograph by the IAM&AW. "Airline industry workers," writes Peterpaul, "should have the right to follow their work to a company acquiring part or all of the assets of their former employer.... and new provisions should be enacted to guarantee that any airline employee who is laid-off at one company has an enforceable priority for hiring at any other carrier.... The U.S. government, and specifically the FAA, must take action to maintain high-skill, high-wage employment in the U.S. and provide jobs for American mechanics, technicians, and managers.... "[4]

Some major air carriers, which grew up in a cozy, regulated environment, have faced wrenching changes. These older airlines operated for decades with rigid work rules, and thus higher labor costs than the newer startup airlines, and so have been at a competitive disadvantage. In an attempt to ease some of these problems, the Airline Commission recommended several changes in pension law that would permit more employee ownership and distribution of shares to employees' retirement plans. Among other advantages, these measures would help to bring more labor-management flexibility to some of the airline companies.

THE COMMISSION REPORT

The Airline Commission issued its final report in August. Unfortunately, most media coverage of the report tended to focus on a few questions of particular concern to interested groups, such as the competitive practices of bankrupt airlines. Problems of more general significance, therefore, were not well spotlighted.

The Commission's main proposals:

1) Modernizing the Air Traffic Control System

The recently announced decision by President Clinton to rehire former air traffic controllers fired in 1981 for striking illegally underscores the political nature of an essentially commercial activity conducted by the government. Significantly, the Commission's first conclusion is that the Federal Aviation Administration (FAA), as a government agency, is unable to modernize and fully adapt to the technological needs of air travel. The Commission does not call for total privatization of the FAA. Instead, it says, "The FAA must be reinvented." Vice President Al Gore's task force on government reorganization has embraced this proposal.

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3 "The Evolution of the Airline Industry" (work in progress).

4 *Dissenting Opinion* by Commissioner John F. Peterpaul to the Report of the National Commission to Ensure a Strong Competitive Airline Industry, August 2, 1993.

The FAA is an agency of the U.S. Department of Transportation. The report calls for the FAA to become instead "an independent federal corporate entity," with its expenditures and revenues removed from the federal budget. The new body would be exempt from the rigidities of government procurement and personnel rules, and maintain accounting practices "consistent with best practices in the private sector." It would also be granted the right to raise capital in the manner of a private firm by issuing long-term bonds.

Essentially the Airline Commission makes a distinction between operating the air traffic control system, which the government does poorly, and setting standards for safety and national defense needs, which is a more reasonable role for government. The report tells of the delays and costs in implementing the Aviation System Capital Investment Plan, and it notes the startling fact that the U.S. aviation system has not permitted air traffic control to use the existing satellite navigation system that is available to ships and other surface transportation. Integrating this available technology into air traffic control would vastly improve efficiency and safety, and eliminate costly delays.

One of the difficulties faced by the FAA under its current structure and governmental budgeting rules is that the Airport and Airway Trust Fund's budget surplus is used to mask the federal government's general deficit (in the same way the Social Security surplus is used), rather than being available to support air travel. The reason is that the "unified budget" concept forces all government fiscal operations to share a common bottom line, and so encourages the reduction of services and capital spending throughout government whenever other, unrelated agencies have cost overruns. Privatizing, or "reinventing," the FAA's air traffic control system would solve many of these problems.

2) Reducing the Burden of Regulation

While acknowledging the government's role in regulating safety and establishing standards, the Airline Commission strongly criticizes the way the FAA has carried out this function. Adopting a more coherent approach to safety regulation, it says, would produce sizeable cost savings to the industry and to the public. The Commission cites several examples of the FAA's over-zealous approach to regulation—and abuse of cost-benefit estimates to minimize the appearance of error.

Despite the industry's favorable safety record, billions of dollars in new regulatory costs have been imposed on the airlines. The FAA's $4.5 billion estimate of these costs does not include more than $4 billion the airlines must spend to phase out older, noisier aircraft. The real costs faced by industry probably are more than double that amount. And in addition to the cost of meeting regulatory mandates, the FAA imposes a paperwork burden on the industry equivalent to 6,900 employees working full time, over 14 million hours annually, according to the Office of Management and Budget's Office of Information and Regulatory Affairs.

Safety is an unambiguous concern of most regulations, but the FAA has done little to assure its mandates actually improve safety or do it in a cost-effective way. For example, the Department of Transportation in 1990 began to require a random drug testing rate of 50 percent of all employees. In the three years the program has been in place, less than one-half of one percent of airline employees have tested positive. According to analysis conducted for the Air Transport Association by the Philadelphia-based WEFA Group of econometric forecasters, the regulatory burden could be reduced by $90 million over five years without

threatening safety by reducing the level of random testing to 10 percent.[5] The Airline Commission recommends dropping the test rate to 25 percent immediately and dropping it even further if analysis shows there will be no detrimental effects on safety. The Department of Transportation has already established a test rate of 25 percent for its own safety-related employees.

The FAA's interpretation of its regulatory duty to assure safety may be overreaching as well. An ongoing labor dispute regarding flight time limitations for flight attendants, for example, is the subject of a new regulatory proposal. The FAA has the statutory authority to establish such limitations when necessary for flight safety. It is unclear, however, how flight attendant duty scheduling decisions reduce safety.

There is also a serious question whether the FAA performs cost-benefit studies as a genuine economic inquiry into the wisdom of a regulation or as a post facto rationale. A wide gap is often found between cost estimates used by the FAA and those performed by non-governmental economists. For example, in 1992 the FAA issued regulations for emergency exits to allow smoother passenger evacuation in the event of a crash. American Airlines told the Airline Commission that its costs alone would be $16.6 million due to this rule. The original proposed rule would have cost the industry more than $32 million to make the change, according to American, and over $1 billion in lost revenue because of seating modifications. The rule was modified after strong protests from air carriers, and then the FAA estimated it would then cost only $4.3 million per year.[6]

The FAA often underestimates the costs that a regulation actually imposes. Pending requirements for alcohol testing beyond the current mandate for drug testing, for instance, would require all job applicants and 50 percent of all current employees to be tested each year. Although the government claims the cost would be only $66.6 million over ten years, industry estimates suggest the actual costs would be closer to $1.4 billion over the ten-year period. And when the FAA issued a rule to increase the restrictions on access to secured areas of airports, its cost estimate was $168 million. Since the rule went into effect in 1989, air carriers report they have spent more than $500 million to comply. Moreover, the rule is still not fully implemented. The final cost could be up to $1 billion.[7]

The Airline Commission cites the FAA's own estimates that more than $3.5 billion has been added to airline costs since 1984 as a result of an attempt by regulators to achieve small, incremental improvements in safety through the imposition of new rules and procedures, and suggests an inadequate assessment of the gains relative to the compliance burden.

The Airline Commission recommends an annual regulatory cost budget, except for emergency safety regulations, to force more careful consideration by the government of costs and benefits. Such a budgetary frame of reference would compel regulators to consider the overall cost picture as they look at individual regulatory issues. This proposal is innovative and is supplemented by the suggestion that the FAA be required annually to inform Congress and the Department of Transportation of the costs of their own proposals.

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5 "The Potential Impact of Selected Airline Tax and Regulatory Changes on the U.S. Economy," The WEFA Group, May 1992, p. E-12.

6 Submission to the National Commission to Ensure a Strong Competitive Airline Industry, American Airlines, Inc., June 16, 1993, p. II-3.

7 *Ibid.*, p. I-1.

3) Reducing the Tax Burden

The Commission report makes the point that financial weakness in the airline industry is primarily a self-inflicted wound. Although the 1990-1991 recession was a major factor, the report notes the heavy debt burdens taken on during the long 1983-1989 growth cycle set up the industry for its current financial weakness. Significantly, the Commission roundly rejects any notions of government route or price controls to bolster the balance sheets of air carriers.

Nevertheless, the Commission attacks the perverse way in which federal taxes compound these problems. Taxes can seriously weaken a capital-intensive industry, such as the airlines. From 1990 to 1992, the airline industry lost $10 billion, yet paid $670 million in corporate taxes. "We believe those [tax] provisions violate reasonable principles of common sense and good public policy," the Commission concludes. The Alternative Minimum Tax, the ticket tax and cargo waybill tax, transportation fuel taxes, and a host of other charges add up to more than $5 billion annually in taxes paid by an industry that only once in the past quarter century has achieved the average profit margin for U.S. industry.

Just as the FAA's modernization needs have been sacrificed to other demands in the federal budget, federal tax policy hits passengers and shippers of air freight disproportionately. As part of the disastrous 1990 budget agreement, these taxes were increased by 25 percent, yet none of the new revenue was used to modernize or improve the safety of air travel. Implementing the Airline Commission's proposal to remove the FAA from the unified budget process would permit the rollback of these taxes as well, saving passengers, shippers, and the airlines over $900 million per year.

4) Moving Beyond Nationalism in Air Service

The international air traffic system, put in place in 1944, now consists of 1,200 bilateral agreements among governments covering landing rights and overflight privileges for each other's airlines. Because these arrangements are not multilateral and regulated by a regime such as the General Agreement on Tariffs and Trade (GATT), with general rules applying to all trading partners, governments commonly play favorites and abuse the highly structured system. France and Germany, for instance, currently discriminate against U.S. air carriers, and the Commission cites studies indicating that passengers to both Canada and Japan could enjoy a huge expansion in service from the United States if the bilateral agreement system were changed.

The Airline Commission report recommends that the United States work to create a multinational system both for air services and for ownership of air carriers. The United States is the largest single market and has the most efficient air transportation industry. But under the existing fifty-year-old treaty regime a legal advantage accrues to the rest of the world in serving the U.S. market, holding back the generally more efficient U.S. airlines.

The bilateral system tends to exacerbate the perception of a zero-sum situation, in which every concession a foreign government might grant for increased service by a U.S. air carrier looks like a slice of the market taken away from its own air carriers. In truth, the air service market has demonstrated, through the U.S. domestic example, the same potential to expand through lower costs and scale efficiencies as every other kind of service.

The Commission suggests negotiating regional multinational agreements first, then expanding negotiations to a worldwide basis. It urges the President to appoint an experienced aviation professional to lead these international negotiations, with the rank of ambassador at large.

Just as important as market access, the Commission recommends a major change in the rules governing ownership of U.S. airlines. Specifically, it urges that:

> The Federal Aviation Act be amended to allow the U.S. to negotiate bilateral agreements that permit foreign investors to hold up to 49 percent voting equity in U.S. airlines, providing those bilateral agreements are liberal and contain equivalent opportunities for U.S. airlines; the foreign investor is not government-owned; there are reciprocal investment rights for U.S. airlines, and the investment will advance the national interest and the development of a liberal global regime for air services.

Current law limits foreign ownership in domestic airlines to 25 percent of voting stock. Senator John Danforth, the Missouri Republican, who served as a non-voting member of the Airline Commission, has introduced a bill (S. 771) similar to the Commission's proposal. However, the proposal does not go far enough, because there still would be a cap of 49 percent on the equity share of non-U.S. citizens. There is no reason for this percentage cap. Foreign investors are hardly enemy foreign agents and there is no legitimate reason to limit foreign ownership in airlines any more than the U.S. limits foreign investment in other industries.

5) Declining production of general aviation aircraft.

Whereas sales of small piston-engine airplanes averaged 13,000 per year from 1965 through 1982, product liability insurance costs, among other factors, have reduced this to barely 500 per year today. Over 100,000 jobs have been lost in manufacturing, sales, service, and related industries. The Airline Commission recommends enactment by Congress of a "statute of repose." This would bar claims against small-aircraft manufacturers for defective designs on aircraft more than fifteen years old. Senator Nancy Kassebaum, the Kansas Republican, has introduced legislation (S. 67) addressing this concern, among others.

6) Airlines in Financial Distress.

The report also calls for the creation of a presidentially appointed airline financial advisory committee to advise the Secretary of Transportation when an airline's financial condition poses risks to the public or to the industry.

While that recommendation may seem sensible or innocuous, there would be many dangers inherent in a new regulatory panel with special access to the Secretary of Transportation. In particular, such a body could become a powerful advocate of re-regulation during periods of economic recession.[8]

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8 Commissioner John E. Robson entered a strong dissent to the proposal for a presidentially appointed financial advisory board: "In fact," notes Robson, "it looks dangerously like what the now-defunct Civil Aeronautics Board used to do back when the airline industry was regulated."

CONCLUSION

The National Commission to Ensure a Strong Competitive Airline Industry has published an exemplary report that should dispel any remaining doubts about the wisdom of deregulating the airlines in 1978. If enacted, the proposals to reduce taxes, rationalize the system of safety regulation, and examine the benefits and costs of regulation within a budgeted framework will strengthen the financial condition of the airline industry. Putting the air traffic control system on a commercial basis, with a normal, private-sector capital budgeting system, will permit air travel to stay abreast of communications, navigation, and safety technology—a most important responsibility that the FAA demonstrates cannot be done as well as it should be in the context of the current government bureaucracy.

The need to achieve a truly global air service industry is perhaps the most important conclusion of the Commission, yet at the same time it recognizes the tremendous obstacles that would have to be overcome to attain that goal. Encouraging private, multinational ownership of a few dozen globe-spanning airline corporations, in place of today's politically dominated structure is a subtle and wise step. Cross ownership may represent a "people-to-people" strategy that can break down political rigidities and protectionism.

Congress and the Clinton Administration should take the Commission's recommendations to heart. If they are implemented, the U.S. airline industry can look forward to a more profitable future, and passengers will enjoy even better and more economical travel.

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