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## Opening the Skies

### Put Free Trade in Airline Services on the Transatlantic Trade Agenda

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#### EXECUTIVE SUMMARY

The European Union (EU) and the United States began negotiations for a Transatlantic Trade and Investment Partnership (TTIP) in 2013, with the primary goals of reducing impediments to cross-border trade and investment and achieving greater economic integration between the two economic areas. Independent research organizations project significant economic benefits from an accord for both parties.

Curiously, there has been a near absence of discussion in the TTIP negotiations of freeing trade and investment in commercial airline services. Given the economies of scale and the scope for specialization that increase by enlarging markets, airline services liberalization would markedly increase the gains from an agreement, as the air passenger and cargo industries' supply chains are rife with restrictions.

Commercial air service is an end product, and the restrictions on competition raise costs and, ultimately, prices for passengers. But air transportation is also an intermediate good consumed by businesses in the production of their own goods and services. If the goal of liberalization is to reduce costs and achieve efficiencies that translate into lower prices, better quality, and innovation, then trade and transportation reforms are in many ways inseparable.

In 2007, the United States and the European Union signed an "Open Skies" agreement, which liberalized competition and ownership restrictions, but the supply of domestic air services (flights between two points within the United States or within the EU) is still limited to national carriers, and foreign ownership is still restricted to minority status.

Before the Open Skies agreement, both the United States and Europe enjoyed periods of deregulation in their commercial airline industries, which spawned greater competition, innovation, and consumer choice. Those experiences are instructive for what would likely follow significant liberalization of competition in this sector.

Of course, incumbent interests marshaling various objections to freer trade and investment in commercial air services impede progress to that end. This paper argues that the objections to liberalization lack genuine merit and describes some of the benefits that have emerged as aviation markets have been freed up over the last 35 years. It offers insights into how U.S. airline passengers and transportation-consuming businesses would benefit from opening the domestic air market to competition from foreign carriers. Finally, it urges the U.S. and EU governments to put free trade in commercial air services on the TTIP negotiating agenda.

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## INTRODUCTION

Negotiations for a Transatlantic Trade and Investment Partnership (TTIP) were launched in 2013 with the primary goals of reducing impediments to cross-border trade and investment and achieving greater economic integration between the United States and the European Union (EU). In addition to tackling traditional trade barriers, such as tariffs and subsidies, TTIP negotiators are seeking accord across a range of regulatory and policy issues that penetrate deeply inside the border and that impact transnational investment, commerce, and competition.

Independent research organizations on both sides of the Atlantic project significant economic benefits from an accord for both the United States and European Union. The greatest potential gains are expected to derive from achievement of some degree of regulatory harmonization, coherence, or mutual recognition that enables firms to comply with a single set of regulations and standards when the public health and safety objectives in both jurisdictions are virtually identical. The efficiencies and cost savings associated with adopting one common standard or permitting companies to comply with one or the other set of regulations and standards would translate into lower prices, better quality, and greater choice.

Given the economies of scale and the scope for specialization that increase by enlarging markets, the absence of discussion about liberalizing cross-border trade and investment in commercial airline services in these comprehensive negotiations is a bit curious. Liberalization in this market would offer many additional benefits, as the air passenger and cargo industries are rife with restrictions on route competition, ownership composition, and other supply-chain components that affect the provision of services.

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and delivery of their own goods and services. If the goal of liberalization is to reduce costs and achieve efficiencies that translate into lower prices, better quality, and innovation, then trade and transportation reforms are in many ways inseparable. The inefficiencies caused by restrictions on commercial air service competition are costs to businesses, which are passed down the supply chain to consumers of all products that reflect the cost of air transportation. And that’s no small figure.

Reducing barriers to competition in commercial air services is not a new concept. In 2007, the United States and the European Union signed an “Open Skies” agreement, which liberalized competition and ownership restrictions, but the supply of domestic air services (flights between two points within the United States or within the EU) is still limited to national carriers, and foreign ownership is still restricted to minority status.

Before the Open Skies agreement, both the United States and Europe enjoyed periods of deregulation in their commercial airline industries, which spawned greater competition, innovation, and consumer choice. Those experiences are instructive for what would likely follow significant liberalization of competition in this sector.

Of course, progress to that end is impeded by incumbent interests marshalling various objections to freer trade and investment in commercial air services. Domestic airlines, for one, are not too keen on having competition in their backyard. Airport authorities are not enthusiastic about welcoming the unknown. Labor unions fear diluted bargaining power. Meanwhile, others see international competition and foreign ownership as threats to national security, should air fleets be needed for military purposes in times of national emergencies.

This paper argues that the objections to liberalization lack genuine merit and describes some of the benefits that have emerged as aviation markets have been freed up over the last 35 years. It offers insights into how U.S. airline passengers and transportation-consuming businesses would benefit from opening the do-

mestic air market to competition from foreign carriers. Finally, it urges the U.S. and EU governments to put free trade in commercial air services on the TTIP negotiating agenda.

## THE PARTIAL BENEFITS OF A TRANSATLANTIC TRADE AND INVESTMENT PARTNERSHIP AGREEMENT

The Centre for Economic Policy Research (CEPR) in the United Kingdom estimated in 2013 that a transatlantic agreement focusing only on tariffs would result in annual GDP growth of \$33.3 billion and \$12.5 billion in the EU and United States, respectively, by 2027. If non-tariff barriers to trade were also removed, CEPR's estimated annual benefits increase to \$95–165 billion and \$70–132 billion in the EU and United States, respectively.<sup>1</sup>

With transatlantic tariffs relatively low—averaging about 2 percent in the United States and 4 percent in Europe—most experts see the largest gains coming from harmonization of regulations. Differences in product standards and regulatory burdens of proof require companies to comply with more than one set of rules, which translates into higher costs, as realization of economies of scale is frustrated or denied. Mutually recognizing one another's standards and regulations in some cases and agreeing on a single common set of rules in others would effectively increase the size of the market from a production standpoint. Given similar public health and safety objectives in our comparably advanced economies, there would appear to be broad scope for such cost-saving measures.

In an analogous fashion, economic gains would likely derive from integration of our currently balkanized transatlantic commercial air services market. Yet the idea is not, as of yet, on the negotiating table. Accordingly, the prospective gains cited above underestimate the full potential of a truly liberalizing, comprehensive transatlantic agreement.

Today, significant restrictions on the provision of commercial airline services remain firmly in place. Restrictions on “cabotage”—trans-

porting people or cargo between two points in the same country—largely insulate U.S. carriers from international competition, weakening their incentives to contain costs and to innovate, and ensuring that the costs of these inefficiencies are passed down through supply chains and dumped onto the broader economy.

## TRANSPORTATION AND TRADE REFORM: A PACKAGE DEAL

From the end of World War II until recently, most international efforts to reduce trade barriers focused mainly on traditional matters of tariffs and subsidies, with secondary emphasis placed on non-tariff barriers. Indeed, the General Agreement on Tariffs and Trade (GATT), from its inception in 1947 until the last multilateral trade negotiating round completed under its auspices in 1994 (the “Uruguay Round,” which created the World Trade Organization), concerned itself almost exclusively with tariffs, subsidies, and rules describing the conditions under which governments could deviate from their tariff and subsidy commitments (i.e., their “concessions”).

Liberalization of these administrative trade barriers contributed to an explosion in post-World War II trade growth. But so did other factors, including technological changes in transportation. The introduction of containerization in the late 1960s, alongside the advent of mega-ships and aircraft, afforded greater economies of scale, scope, and density, reducing transportation costs and rendering distance a less formidable obstacle to trade. International transportation was also made more efficient by institutions, such as the “Open Skies” agreements initiated by the United States, which remove fare and capacity controls between pairs of countries, and the forging of common transportation markets in regional blocks such as the European Union. In the context of EU internal aviation, a series of “Packages” initiated in 1987 resulted, by 1997, in all EU airlines having the rights to fly both between and within any member state without any regulatory control over capacity or fares, and to be able to merge

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with one another. At that time, a number of EU states also had individually entered into bilateral Open Skies agreements with the United States, although the United Kingdom, a major player on North Atlantic routes, still operated under a restrictive regime that, for example, limited transatlantic services involving Heathrow airport to two U.S. and two UK carriers.

Although these developments helped reduce the costs associated with physical and administrative barriers to trade, they evolved on a more ad hoc basis than as a part of a concerted effort to rein in the costs of transportation. In contrast, the genesis of what became the Treaty of Paris, formally establishing the European Coal and Steel Community (ECSC) among France, West Germany, Italy, Belgium, Luxembourg, and the Netherlands, in 1951, sought to eliminate internal barriers to trade for a limited range of primary materials. But while the removal of tariffs and quotas were central to ECSC, the explicit objective of the treaty was to liberalize and integrate the member countries' freight railroads, which were integral parts of the region's coal and steel production supply chains.

Although the ECSC reduced the number of explicitly discriminating rates, it was less successful at removing broken rates at borders and rail rates that tapered to favor domestic producers of coal and steel. Broken rates involved charges by distance being different per kilometer on either side of borders, while tapered rates entailed different discounts per kilometer according to whether carriage was designed for export or import traffic as opposed to being between points of domestic production or consumption. As the Nobel Prize-winning trade economist James Meade put it: the effort had merely “removed a few symptoms without curing the underlying malaise.”<sup>2</sup>

Nevertheless, the idea that administrative efforts to free trade cannot fully succeed without parallel efforts to reduce transportation barriers remained prominent in European economic thinking. Indeed, the Treaty of Rome, which established the European Economic Community (EEC) in 1958, had

as one of its two core policies the Common Transport Policy (the other was the Common Agricultural Policy). The aims of the Common Transport Policy were to remove artificial impediments to an ECC-wide transportation infrastructure; to create a level playing field for transportation suppliers in the Community; and, where possible and appropriate, to introduce free trade in transportation services. Given the focus of the EEC on removing trade barriers affecting manufactures and agricultural products, much of the emphasis shifted to international trucking within the Community. However, air and waterborne transportation were explicitly covered.

Progress was slow, in part because the initial emphasis on coordinating national transportation regulations came at the expense of liberalization itself.<sup>3</sup> But in 1986, the Single European Act effectively acted to remove most impediments to trade in goods and services within the then-15-member European Union by 1997. Transportation liberalization was a key element of this initiative, with nearly all internal economic regulations governing prices and supply of transportation services eliminated. According to European Commission estimates, trade within the EU grew from €800 billion in 1992 to €2,800 billion in 2011, with trade between the EU and the rest of the world rising from €500 to €1,500 billion, although of course only part of this can be attributed to the transportation reforms. The number of intra-EU flights also more than doubled, and routes with more than one carrier rose from 93 to 482 by 2011.<sup>4</sup>

## **DEREGULATION AND THE BENEFITS THAT FOLLOWED**

The 1978 Airline Deregulation Act removed most of the economic restrictions controlling fares and market entry for interstate air transportation in the United States. Prior to this legislation the Civil Aeronautics Board (CAB) licensed each route, generally limiting service provision to one carrier, and regulated fares on a cost-plus basis designed to offer a reasonable rate of return to airlines.

This system provided little stimulus for carriers to innovate in terms of the services that were offered or to seek ways of reducing costs. Part of the impetus for reform came from academic studies that highlighted the lower fares offered for intrastate services where market entry and fare setting was unregulated.<sup>5</sup> The issue became of macroeconomic significance with the onset of stagflation, the simultaneous increase in inflation and unemployment in the mid 1970s, when it was appreciated that economic regulation was both keeping prices artificially high in many industries and, in the longer term, stymying innovation in industry. The appointment of Alfred Kahn to head up the CAB, coupled with pressure in the Senate, led by Edward Kennedy, provided the impetus for liberalization of the airline market in 1978.

In a retrospective 2008 speech to the Transportation Research Forum in Boston, Alfred Kahn—often called the “Godfather of deregulation”—offered a commentary on the main challenges facing the U.S. air transportation sector. He asked why the 1978 Airline Deregulation Act was passed. After all, fares had been falling in real terms for well over a decade (see Figure 1), the airlines were making better use of their assets (their average load factors had risen from about 50 percent in the early 1970s to over 60 percent by 1978), and safety had been improving.<sup>6</sup> Why mend something that was not broken? Why risk actions that would raise the ire of those benefiting from the status quo?

Kahn offered that the consumer benefits of the previous decade or so had come through technological change, such as adoption of the jet engine and wide-bodied aircraft, among other things. These gains had worked their way through the system and, with stagflation the dominant economic concern at the time, deregulation was needed if fares were to fall further and ordinary citizens were to enjoy more air travel. As he put it, the world was changing and policy had to reflect this.

Kahn accurately characterized the benefits of liberalization of airline markets in the 1970s. The gains took various forms, including lower real fares, greater fare choices, more ser-

vices, and extended route options. As a result, the number of air travelers rose from 250 million in 1978 to 815 million in 2012.

As for the impact at the micro level, a study by the American Air Transport Association in 1983 found that air fares in the new deregulated environment had fallen by 67 percent compared to those the old regulated regime would have imposed. Looked at another way, over a full business cycle, the inflation-adjusted 1982 constant-dollar-yield, a widely used proxy of average fare for airlines, fell from 12.3 cents in 1978 to 7.9 cents in 1997, reducing airline ticket prices by almost 40 percent over the period.<sup>7</sup>

Even those living in typically underserved smaller communities benefitted. While flights to such locales were cut by over 25 percent between 1970 and 1975, the flexibility and innovation unleashed by the freer market reversed that trend, and by 1983 there were more non-stop flights to small communities than was the case in 1978. On the supply side, the labor force enjoyed more job opportunities; the number of workers in the industry grew by 39 percent between 1976 and 1986.<sup>8</sup>

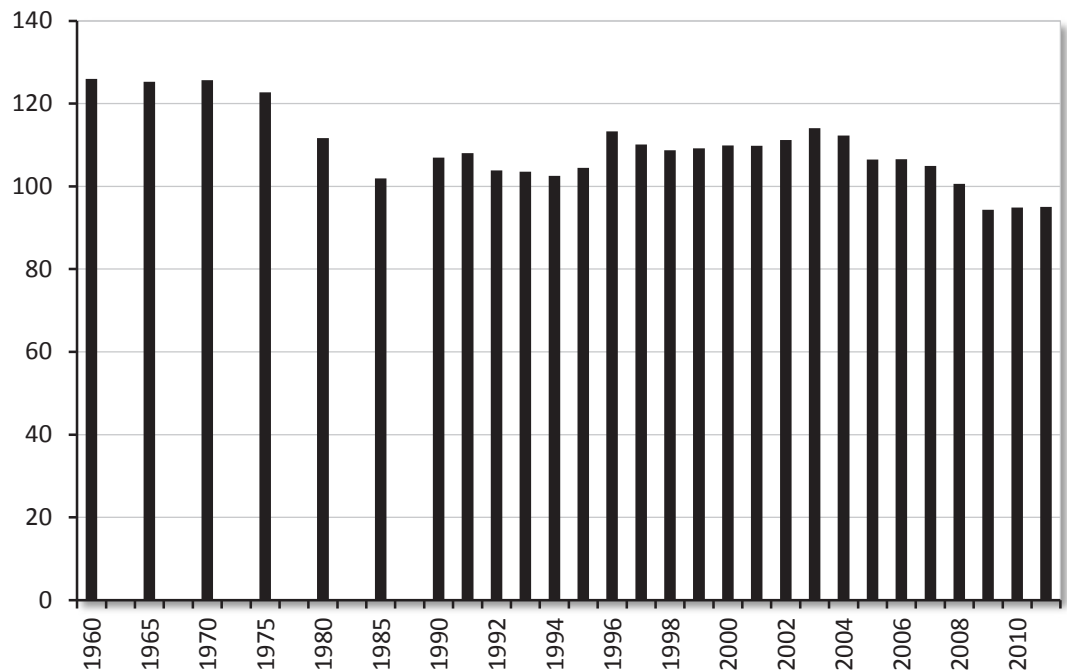
Deregulation essentially changed the airline product sold in the United States. While this was initially the result of the legacy carriers trying to differentiate their product in the domestic market with, for example, American Airlines being particularly innovative in introducing frequent-flyer programs, yield management,<sup>9</sup> computer reservation systems, and two-tier pay structures for employees, it has been the growth in low cost carriers such as Southwest and JetBlue that has recently attracted the most attention—the “Southwest Effect.”<sup>10</sup>

While the longer-term picture has been fairly stable for domestic U.S. fares over recent years (Figure 1), a periodic concern of the media, as much as the traveler, is that airfares can fluctuate considerably from one year to another, and often from month to month. These short-term fluctuations can be influenced both by the performance of the U.S. macro economy on the demand side, and by kerosene prices (which amount to about 35 percent of many airline costs) on the supply side. Added to this, the

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**Figure 1**  
Inflation-Adjusted Average U.S. Domestic Airline Fares Since 1960 (2005 Prices)



Source: U.S. Department of Transportation.

Note: Averages do not include frequent-flyer or “zero fares,” or a few abnormally high reported fares.

services offered when paying the base fare have also changed. Many seats are now wholly “paid for” using loyalty program “miles” or similar awards. There are now extra fees for some services previously included under the base fare, including charges for checked bags and reservation change fees. These are, however, features of a functioning market with suppliers seeking to maximize their returns, while having to contend with rivals doing the same.

The airline industry has also changed in part due to managerial and product innovation. Competition has moved to what is known as the Blue Ocean Strategy in international business, where airlines are creating new demand rather than just fighting over exiting demand.<sup>11</sup>

The partial deregulation of U.S. air transportation in the late 1970s prompted airlines to be more responsive to their customers’ needs. The American public’s revealed preferences were for lower fares, fewer on-board services, and greater choices of routes. The era of deregula-

tion also spawned the growth of UPS, FedEx, and other package services, as express delivery and logistics companies benefited from the combination of greater route options and evolving information systems.

The initial domestic “Big Bang” of U.S. liberalization led many other countries to adopt similar policies. The EU, for example, initiated a series of “Packages” between 1987 and 1997 that now allows EU airlines to provide services anywhere within in the Union at unregulated fares, including cabotage services.<sup>12</sup> The outcome was a 120 percent increase in intra-EU routes between 1992 and 2008 (with an associated increase of 320 percent in the number of routes with more than two competitors); the emergence of low-cost carriers, which now constitute over a third of intra-EU scheduled capacity; and significantly lower fares. In addition, there have been moves to commercialize and improve the efficiency of both airports and air traffic control systems through privatization and corporatiza-

tion—measures that have been pursued less enthusiastically in the United States.

## THE EU–U.S. OPEN SKIES AGREEMENT

U.S. and EU deregulation also prompted further liberalization of international air transportation, beginning with negotiation of more flexible, bilateral “Open Skies” agreements, which gradually broadened into the EU–U.S. Open Skies Agreement in 2007.

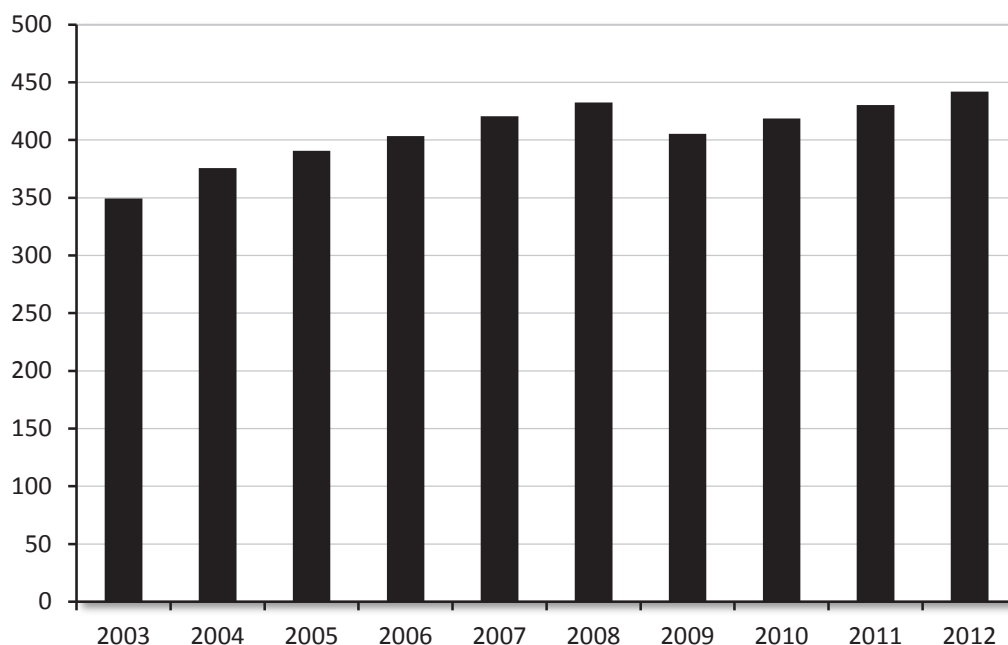
The various Open Skies policies perpetuated the growth of international networks, including the formation of strategic alliances, and, ultimately, mega-network competition.<sup>13</sup> This process begat fare reductions in cases where allied airlines with integrated schedules could improve economies of scope, while being kept efficient by mega-network competition between alliances.

The multilateral EU–U.S. Agreement permits EU and U.S. airlines to fly from any point in the EU (and some other European countries,

such as Norway) to any point in the United States. U.S. airlines are also permitted to fly between countries within the EU. While it is premature to say how much of the growth in transatlantic air services demand is attributable to the agreement—especially since changes in short-term demand are predominantly explained by changes in national incomes—Figure 2 suggests that Open Skies has had some impact on the growth of transatlantic traffic.

Although forecasting such an impact is imprecise, an ex ante study by the Brattle Group, which modeled removal of all foreign ownership and cabotage restrictions, as well as fully opening the transatlantic route, found that Open Skies would potentially increase annual transatlantic passenger traffic by 4.1 to 11 million with an increase in economic output in directly related industries, such as airlines and airports, of €3.6 to €8.1 billion.<sup>14</sup> Booz Allen Hamilton, updating the Brattle Group’s study, estimated 26 million new passengers would be created over the first five years of implementation, resulting in 77,000 and 81,000 new jobs over the period.<sup>15</sup>

**Figure 2**  
North Atlantic Development of Traffic (Revenue per Passenger Kilometers, \$ Billions)



Source: Boeing Commercial Airplane, *Current Market Outlook 2013* (Boeing: Seattle, 2013).

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Ultimately, the agreement reduced some barriers to trade in commercial airline services. But it is a stand-alone initiative not linked to any other aspects of trade. Its main purpose was to address and resolve common challenges facing parties on both sides of the Atlantic, stemming from the increasing integration of the complex network of services being provided through strategic alliances between large EU and U.S. commercial airlines. These alliances were often created as a response to trade restrictions that prevented airlines from merging or in other ways integrating their financial structures. Some airlines, such as American Airlines and British Airways, were prevented from forming an alliance because of disputes between the U.S. and UK governments over their bilateral air service agreement (Called Bermuda II) that, in particular, limited access by U.S. carriers to London’s Heathrow Airport. There were also legal disputes within the EU concerning the legitimacy of the Open Skies agreements that countries such as Germany and the Netherlands had each independently reached with the United States.<sup>16</sup>

The 2007 Open Skies agreement was also considered, in Europe, an opportunity to tidy up a set of ad hoc bilateral air-service agreements between the United States and individual EU member states that had grown since the first major transatlantic bilateral agreement in 1992 between the United States and the Netherlands.

### **U.S. REFORMS HAVE RUN THEIR COURSE**

In the 35 years since the beginning of airline deregulation, U.S. air travel has been transformed from an “experience” for upper-income Americans into an almost everyday mode of transportation for the middle class. The deregulation of the 1970s led to a considerable increase in services, including the capacity of travelers to access a wider range of destinations through the hub-and-spoke system of routings that took hold. But many of these changes arrived in the first two decades of deregulation.

Over the past decade, the forces of competition have stagnated as domestic airlines have merged, carriers have become more homogeneous, and international strategic alliances have formed. Fare levels have, at best, flattened out over the past decade, simply bubbling along with trends in fuel prices, and there have been signs of network contractions with services being withdrawn from secondary hubs and smaller aircraft being used. These patterns are most notable on thinner and shorter routes.<sup>17</sup>

What happened? Low-cost airlines were particularly important in delivering change to the commercial air-service markets. Their early structural impacts on the industry—especially the “Southwest Effect”—are well documented.<sup>18</sup> Despite their initial innovations, these airlines are now largely indistinguishable from their U.S. legacy counterparts. Many abandoned their original, no-frills business models and now differ significantly from the leading European low-cost carrier, Ryanair, which retains most of those original features. Accordingly, the sharp edge of competition that U.S. low-cost carriers once presented to the legacy airlines has been significantly blunted, and the pattern of fares and services offered by U.S. airlines since the mid-2000s reflects these changes.

Moreover, there has been a wave of mergers as domestic carriers have sought to further benefit from the economies of scale of hub-and-spoke operations. But in doing so, the airlines have been shedding shorter, high fare/higher cost routes and reducing services at many secondary hubs. Thus while fares, even adjusted for baggage and rebooking fees, have on average fluctuated in line with fuel prices, many people who formerly had service are now unable to get it at any price. While it is true that some of the routes abandoned by the larger airlines are being filled by smaller, low-cost carriers, a void still exists.

Alfred Kahn warned of the market power of large airlines in a deregulated industry, and that’s what we have today. There were 10 major U.S. airlines in 1979, but mergers and bank-



ruptcies have left only United (16.0 percent of the domestic passenger miles in 2012), Delta (16.3 percent), American (21.1 percent, including U.S. Airways, with which it merged in 2013), Southwest (15.1 percent), and a handful of low-cost carriers. Southwest's fares are now often as high or higher than those of the legacy carriers, and its services are similar.

The largest 29 airports in the U.S. lost 8.8 percent of their scheduled flights between 2007 and 2012, but the decline was 21.3 percent for smaller airports and 26 percent for medium-sized airports.<sup>19</sup> In addition, the average return-flight distance has risen from 2,279 miles in 2007 to 2,319 miles in 2010 and to 2,356 miles in 2013.

The reduction in capacity and the variety of routes offered affects the services available, as well as average fares. Fares on thinner routes, because of the lack of economies of density, often exceed those where demand is higher. Smaller aircraft are generally used, and overhead costs have a more limited base over which to be spread. The result is that the fare revenues collected when thin routes are closed fall more than in proportion to the decline in passengers carried, thus pulling down the average fare across the entire network. Thus one of the reasons why the short-term fare increases often noted in the media are actually being contained is because there are increases in longer, more fuel-efficient routes at the expense of fewer, less fuel-efficient shorter routes.

In the post-1978 deregulated environment, U.S. carriers were aggressive, and new service elements emerged. But recently foreign airlines have taken the lead in terms of service structures and cost savings. Studies comparing the domestic fares of U.S. low-cost airlines with their European counterparts indicate that the fares of Ryanair, easyJet and the like are generally below those of supposed low-cost U.S. airlines, let alone those of legacy airlines. They make consistent profits providing return services of 1,000 miles or so—half the U.S. airline average—at those lower fares. Moreover, these kinds of services are the types that have been cut back in the United States.

But the 1978 Airline Deregulation Act did nothing to open up the market to international competition. Foreign ownership remained limited. U.S. carriers still had to be “American citizens.” And while subsequent initiatives to develop Open Skies provided a more liberal international framework for U.S. airlines, the domestic market has remained protected—to the detriment of business and the traveling public.

### **INTERNATIONAL TRADE AND INVESTMENT IN COMMERCIAL AIR SERVICES**

An important reason for the aforementioned problems is that we are still quite a distance from a deregulated airline environment in the United States. Perhaps most noteworthy is that non-U.S. airlines cannot compete with U.S. carriers on domestic routes. Restrictions on cabotage services protect incumbent U.S. carriers from the full force of competition in the same way that U.S. manufacturing firms were protected in the 1970s, when their costs drifted higher than their foreign competitors' and their products became inferior.

The specifics of aviation cabotage can be traced back to the Jones (Merchant Marine) Act of 1920, which limits U.S. coastal traffic to American-built and registered vessels, with largely American crews and an American captain. This notion of cabotage, the carriage of passenger, cargo, and mail between two points within a territory for compensation or hire, was essentially extended to airlines when their strategic and economic importance was recognized following World War II.<sup>20</sup> This situation has remained fundamentally the same ever since. The aviation side is not quite so restricted; U.S. airlines, for example, do not have to use hardware produced in the country. The insistence on cabotage regulation is not unique to the United States, and European countries practiced it before the full implementation of the Single European Market in 1997.

Cocooning a national market seldom leads to the efficient provision of services or to in-

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novation. It deprives U.S. travelers of the benefits of competition and runs counter to the TTIP’s objective of achieving transatlantic economic integration. The economic arguments for removing these restrictions on foreign competition are compelling.

First, competition increases the likelihood that airline service will become more responsive to consumer demands, inspiring greater availability of flights, more competitive prices, fewer delays, and a more natural evolution of hybrid products and services to cater to changing tastes and demands. Of course, this does not mean ubiquitous services at all times of the day, but it does mean a better match between the willingness of potential travelers to pay for a particular flight, and there being a reasonable chance of getting a seat on that flight without being exploited by the airline.

Second, air transportation is not only a final product sold directly to end-user consumers. It is also, importantly, an intermediate input, paid for and consumed by businesses in the course of supplying their own goods and services. According to the International Air Transport Association, between 35 and 40 percent of the value of world trade is transported by air, so this is not a trivial matter.<sup>21</sup> And that figure does not account for the cost of business travel, which also gets passed down the supply chain and is ultimately borne by consumers.

Competition in the cargo market takes a number of dimensions. Specialized cargo planes carry much of the traffic, especially larger items and express packages of the type carried by FedEx, but a large part is also moved in the belly-holds of passenger aircraft. The complementary nature of this latter feature often allows larger aircraft to be used, making more air extensive services available than separate passenger and cargo movement would justify. The competition between air services is thus an overlapping one involving the combined economics of both passenger and cargo markets. Limiting competition in one or both elements inevitably reduces the synergies that can be created.

Accordingly, international competition for

U.S. domestic routes will reduce the cost of doing business in the United States. Lower air transportation costs reduce the cost of goods and services sold for businesses, keeping their prices in check, raising their profits, and creating more value-added and employment opportunities in the United States.

Third, whenever there is a proposed domestic merger, U.S. antitrust authorities are summoned to determine the likely impact on market share and competition. So actions that might be optimal for the shareholders of two firms can be blocked because federal authorities conclude that the action is not in the public interest. This is a self-manufactured problem: by restricting competition in the industry to firms with certain characteristics, the likelihood of a merger having an adverse impact on competition is far greater. Opening domestic routes to foreign carriers would significantly alleviate concerns about market and pricing power and extinguish the need for drawn-out Justice Department and Federal Trade Commission reviews.

Fourth is the matter of foreign investment in U.S. airlines. This issue is legally separate but operationally entwined with cabotage. While differences currently exist between countries, the general rule is that foreign equity investment in a U.S. airline is capped at 49 percent, and voting shares are limited to 25 percent. But why deprive U.S.-based carriers of the institutional knowledge and best practices of foreign companies and investors who have had success in their home markets, and who want to take their model global? Foreign investment in U.S. industries has historically raised the average performance in those industries across a variety of relevant metrics, including value-added, profits, capital investment, research and development expenditures, worker compensation, charitable contributions, and added tax revenue.

So why has it not happened? Why are politicians reluctant to let U.S. carriers face foreign competition? Why is cabotage not on the current TTIP agenda? Why do investment restrictions persist?

We have already mentioned the Jones (Merchant Marine) Act of 1920. In addition, the 1944 Chicago Convention on International Civil Aviation produced an international agreement recognizing that governments had sovereignty over their domestic air space. Although there was no agreement about how to exercise that sovereignty, the general idea was that governments would reserve the domestic market for their own national airlines, while agreeing to competition in international services through bilateral agreements, generally ordaining one “flag carrier” from each nation. This situation has remained fundamentally the same ever since.

Cabotage is a relatively new idea in air transportation. In the past, technology limited the length of commercial flights and the costs of flying for the general public were prohibitive, thus suppressing demand. The advent of jet and wide-bodied aircraft increased the demand for international travel, and with this came an interest by airlines in serving foreign markets.

It turns out that incumbent airlines are powerful lobbyists, as are the labor unions with whom they contract. American airports are also currently largely protected from some of the more aggressive business tactics found in other countries that have forced airport fees down. For example, the approach of EU low-cost carriers such as Ryanair is to move into little-used airports that compete with higher-cost nearby larger facilities. Hence we find Bergamo Milan, Frankfurt Hahn, London Stansted, and Reus Barcelona all some distance from the major city cited. Once in an airport, and with the airport dependent on the carrier, European low-cost carriers are hard in negotiating subsequent landing and other fees. The managerial challenges of airports in countering this can be considerable.<sup>22</sup>

Meanwhile, the military gives the airlines another incentive to oppose foreign cabotage. The military fears loss of airlift capacity in times of national emergencies and wants to have the domestic capacity necessary to fight wars on two fronts. Currently that capacity is

guaranteed under the Civil Reserve Air Fleet (CRAF) program, which in turn benefits the airlines by providing revenues under the Fly America Act, which requires that all air travel funded by the U.S. government be on U.S.-flagged airlines.

In a recent report, the U.S. Government Accountability Office questioned the need for this sort of capacity protection. The CRAF has seldom been deployed, and while considerable amounts of personnel and equipment were moved by it during the Gulf War in 1990 and the Iraq War in 2003, it only provided 95 passenger and 63 cargo aircraft for Operation Desert Shield and Storm.<sup>23</sup> Whether allowing greater foreign investment in the U.S. commercial fleet will result in increased or reduced reserve capacity is unclear. But requiring 500 airplanes—as the CRAF program now does—seems excessive. Other countries have more flexible arrangements and still manage to meet their military lift needs.

Labor also fears that foreign airlines would reduce union bargaining power, and thus the terms of employment for pilots, flight attendants, machinists, and other organized workers. Union opposition persists despite the numerous concessions that labor has made over recent years under the current regime to keep domestic carriers in business, as airlines have entered and exited Chapter 11 bankruptcy and consolidated. It should also be seen in the context of a rapidly tightening labor market. The demand for pilots in particular is increasing rapidly as large new markets, such as China and South America, expand.

Some have argued that cabotage restrictions have had minimal effects. The costs of entering the U.S. market are prohibitive, it is claimed, and airlines will simply not offer services. So why go through the process of formally permitting competition? This may well be true for the larger foreign legacy airlines that are closely integrated with the U.S. legacy partners in the three major strategic alliances—oneworld, SkyTeam, and Star Alliance. They already enjoy the feed from existing U.S. domestic services, and would seem unlikely to

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want to disrupt these arrangements to compete in the U.S. market.

It is the large and especially the low-cost carriers that would seem more likely to seek cabotage rights. Their experiences are mainly in shorter, simpler haul markets in which a standardized fleet can be used as opposed to an international hub-and-spoke service system.

Moreover, likely entrants—from Europe, in particular—already have experience of scheduled operations that are likely to offset some of the learning costs. Airline markets are heterogeneous, but there are also numerous common features that extend across them. The nature of many of the low-cost carriers’ routes in Europe (and many other countries, for that matter), while differing in detail from those in the United States, have similarities: after all, they are served by similar aircraft types, and there is a growing internationalization in the airline labor market.

But, if it is true that allowing foreign competition would produce little impact on U.S. passengers, then why prevent it?

### **IMPLEMENTATION OF FREE TRADE AND INVESTMENT: JUST DO IT**

If and when there is enough support for free trade in airline services in the TTIP, the next hurdle will be agreeing to the choice of transition mechanism. The air transportation reforms of the late 1970s were essentially a “Big Bang,” with changes introduced and implemented over a very short period of time. This contrasts to the gradualism that has characterized some other cases, most notably the European Union airline market, where reforms were implemented in a series of three Packages.<sup>24</sup>

The advantage of the U.S. approach is that the transition costs imposed on airlines and passengers, while significant, is relatively short-term. There will be some stranded costs as airlines modify their activities and adjust schedules, fleets, and crew composition, but these adjustments will be made quickly.<sup>25</sup>

In contrast, a more incremental approach reduces short-term disruptions, but increases the time before the benefits of reform begin to flow. The system is also more prone to capture and manipulation as the various stages of the process proceed, allowing incumbents to protect their vested interests to the disadvantage of new entrants. This, for example, was seen in Europe with airlines such as Olympic and Alitalia receiving numerous tranches of state aid to restructure as the effects of deregulation took hold.

In addition to the idea of simply opening the market and letting foreign carriers compete directly in the U.S. airline market, a number of interim or partial approaches have been suggested. One option within TTIP would be to allow foreign carriers to tender for currently subsidized services that come under the Essential Air Services (EAS) and Small Community Air Service Development Programs (SCASDP). The former provides subsidies to airlines serving communities that are deemed unlikely to otherwise receive scheduled air services. Congress appropriated \$190 million for the program in 2011, and in 2012 limited subsidies to the 150 or so communities that already receive them, trimming about a dozen from the program after a year if they were within 175 miles of a hub airport and averaged fewer than 10 passengers a day. The SCASDP, initiated in 2000, is not limited to providing basic air-carrier subsidies but rather involves financial assistance for marketing programs, additional personnel, studies, and aircraft acquisitions. Over its first eight years, the program’s grants ranged from \$20,000 to nearly \$1.6 million, with the current authorization at \$6 million per year through 2015.

The problem with opening these programs to European airlines is that market entry would be unlikely to occur—and certainly not on a scale to produce any large impact on fares or service. The subsidies are short-term, and there is no guarantee of renewal, making entry an unlikely commercial proposition. The larger and commercially stronger European airlines would also not be interested in such

thin routes and, in particular, with the hardware stipulations involved, such as 19-seat aircraft in the case of EAS.<sup>26</sup> Ryanair, for example, almost exclusively uses Boeing 737-800 aircraft with 189 seats in each, and easyJet uses Airbus A319s and 320s with 156 and 180 seats, respectively. In addition, there is no network of services under EAS and SCASDP, but rather a network of independent links that do not conform to any of the linear, hub-and-spoke, or radial-route patterns that provided commercial success for short-haul operation.

Another current concern is the provision of adequate air services to larger cities that have lost their hub status. It has been suggested that markets that served as hubs prior to the recent consolidations of U.S. carriers should be opened to foreign airlines to not only provide additional services, but also to see what types of foreign carriers would enter a fully open market. Clifford Winston, for example, has argued along these lines.<sup>27</sup>

The difficulty is that foreign airlines, even if more efficient than their U.S. counterparts, are unlikely to be attracted to markets that have not been profitable for U.S. airlines. The argument that providing such services would provide feed for the international routes of foreign carriers is also hardly persuasive. The long-haul carriers into and out of the United States tend to be high-cost legacy airlines, such as British Airways, Lufthansa, Air France, Qantas, and JAL—not Ryanair or easyJet. Furthermore, most of the major foreign carriers serving the U.S. market belong to a strategic alliance and likely would already be receiving feed from many of the defunct domestic routes from their partners.

But there is also a more fundamental issue with this incremental approach: it can be seen as the thin end of a wedge to reregulation. For it to operate, there would need to be a separation of those airline markets that are to be open to foreign carriers from those that are to remain the preserve of domestic carriers. This demarcation would not be based on any economic principles, but rather it would be inevitably determined by some regulator in a

manner akin to the way routes were licensed before 1978. How this could be done is not immediately clear. For example, when any airline currently de-hubs from an airport, it seldom withdraws all services and, in addition, other domestic carriers may take up some of the slots to complement their own networks. The regulatory body would need to make judgments as to whether the outcome met the requirement for allowing foreign carriers in. In economic terms, such a decision would essentially be arbitrary.

Not only is it unclear how this vexing issue would be resolved, but the airline industry is dynamic, and regulatory agencies have not proved fleet-footed enough keep up. Political interference would also seem inevitable. The boundaries between foreign-allowed and foreign-banned routes would hardly likely be determined on efficiency considerations alone. Indeed, it is unlikely that politicians in districts where low-cost foreign carriers have been barred would win an election on the slogan: “Vote for me, I guarantee to keep your air fares high!”

The best approach to opening the U.S. market to foreign airline competition is to open it without caveat and in one “Big Bang.” While a sudden and dramatic change to regulations like the 1978 Airline Deregulation Act can impose stranded costs associated with redundant equipment and labor, it avoids the problems of gradualism whereby entrenched interests can capture the process of change.

## CONCLUSION

Domestic reforms in the 1970s, and subsequent bilateral and multilateral actions, partially liberalized the U.S. airline markets. The most important restriction remaining is the ban on foreign competition in the domestic market. Strong intellectual arguments in favor of ending the restrictions—reinforced by recent trends in the U.S. airline market and the types of services now provided in Europe—should be marshalled to push for this reform in the TTIP negotiations. Given its purpose

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and scope, the TTIP should logically include language to remove barriers to international trade in air services between and within the agreement’s signatories.

U.S. domestic air travelers benefitted from their country being the first mover in deregulation, which spawned lower fares and consumer-driven service spin-offs some 15 to 20 years before they were enjoyed in other markets. Reforms in Europe only fully materialized in 1997. But the world has changed, and so have the demands of consumers and the business models adopted by the airlines. Although they were not perfect, the 1978 reforms in the U.S. meant that market forces delivered many of the sorts of air services travelers wanted, with the institutional structures, ranging from low-cost airlines to computer reservation systems, to deliver them.

Yet remaining regulations still limit competition and, thus, the ability of travelers to enjoy even lower fares and a wider range of services.

Moreover, taking globalization and its implications into account, the U.S. air transportation market cannot be treated in isolation. The effects of initiatives such as the bilateral Open Skies agreements and the creation of the EU-U.S. Open Skies over the Atlantic have provided a taste of the benefits—to travelers and the broader U.S. economy—that will come from free international trade in air services. A comprehensive TTIP that achieves its architects’ goals would put in place the infrastructure that facilitates the establishment of a fully integrated market for air services. Failing that goal would leave too much economic potential on the cutting-room floor.

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