Airline Deregulation

Twenty Years of Success and Counting

by John E. Robson

On 24 October 1978, President Carter signed the Airline Deregulation Act. That date will stand as a Red-Letter day in the history of America's commercial aviation industry affecting the hundreds of millions of people who fly in the United States each year. The Act, an initiative begun in the Ford administration, jettisoned a system of absolute government control over airline fares and service that literally had Washington bureaucrats telling each airline exactly where it could fly and exactly how much—or how little—it could charge. In its place came a robust, competitive system that relies on market forces to set the price, quantity, and quality of air service in the United States. Thanks in large part to that deregulation, America's airline system is now the envy of the world, a competitive and efficient system that provides more service, to more people, to more cities, at lower prices than ever before.

However, twenty years after that historic transportation policy milestone, the federal government is trying to poke its regulatory fingers back in the airline business. The unfortunate efforts to reimpose government guidance on a thriving open market come despite overwhelming evidence that airline deregulation has worked well for two decades and, most importantly, continues to work well today.

Responding to complaints by some start-up low-fare airlines about what they consider predatory practices by the big carriers, the Department of Transportation (DOT) recently proposed guidelines that could limit the maximum number of seats that an airline can offer on particular routes and forbid them from dropping their prices below certain levels, all in the name of establishing "fair" competition. These guidelines strike at the underpinnings of market freedom by attempting to prescribe both the number of airline seats in a market and their price. The recently announced partnerships between a number of major airlines involving various forms of service sharing and cooperation likely will add fuel to the federal government's urge to regulate.

Congress has also entered the fray with a dozen proposals: some nibble at the regulatory edges while others would create substantial regulatory regimes. House Speaker Gingrich has said some form of airline legislation is likely to pass in 1998. But even a small step toward reregulation would be a step in the wrong direction. Legislative and executive branch seeds have a troubling history of growing into weeds that choke industries.

The high-profile political attention is perplexing to those of us who pioneered airline deregulation and continue to take pride in its success. It is especially paradoxical since flawed public programs, like Amtrak or welfare, are perpetuated for decades at immense taxpayer expense, while some in government seem intent on meddling with a private economic system that is a demonstrable success. Every free market has imperfections from time to time that are, in most cases, ultimately corrected by market forces.

By every reliable measure, the American public has benefitted from airline deregulation. More people are flying today than ever before, and the vast majority of American travelers are far better off than they were when government bureaucrats regulated the airlines under a system that artificially propped up fares while stifling innovation and competition.

THE ORIGINS OF DEREGULATION

From 1938 to 1978, decisions regarding airline service and fares were made by five presidential appointees on the now-abolished Civil Aeronautics Board (CAB). Created to help protect the public and maintain order in the rapidly growing field of commercial aviation, the CAB was also launched with the blessing of the existing carriers that, in the immortal 1938 comment to Congress of one airline executive, wanted protection from "destructive competition."

As airline regulation evolved, the carriers were treated like regulated utilities. The CAB became a textbook case of how the regulatory process can overwhelm substance and how regulation protected the airlines from competition at the expense of consumers and competitors. The CAB would hold extensive and elaborately-staged hearings on nearly every single request regarding routes or prices, including requests by existing and new carriers to start additional service between two given cities. Those hearings were the regulatory equivalent of the "kabuki dance," elaborate in their choreography and often predictably scripted in their outcome. More often than not, requests to establish new routes were denied or approved with restriction.

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Further, the process was expensive and time-consuming. In a widely-cited example of the CAB process at its worst, it took the board eight years to give Continental Airlines permission to fly between San Diego and Denver.

That bureaucratic process was far removed from the hurly-burly of the marketplace and much more subject to internal regulatory politics than to market forces. While a carrier's cost for short trips is much higher than for long trips, the CAB typically set short-haul fares artificially low so that per mile fares were competitive with other modes of transportation such as trains and automobiles, and essentially uniform across the system. The cost of that subsidy was passed along to long distance travelers who paid fares that were pegged artificially high. Moreover, there was no price competition under regulation. All this made air travel such an unaffordable luxury for most Americans that planes would fly with few passengers.

BY 1975, THE AIRLINE INDUSTRY WAS LIKE A FORTY-YEAR OLD STILL LIVING AT HOME WITH HIS PARENTS.

Over time, the tangled and cumbersome regulatory process began to resemble procedural spaghetti. The board's judicial process and trappings seemed inappropriate for the type of economic decisions the CAB was making. It had become a Hollywood set for the preservation of the belief that the regulatory process was scientific, nonpolitical, and judicial in character. That perception of the system rested on the CAB's mystique of expertise and specialized knowledge. But many decisions in fact were arbitrary. The staff would often struggle to craft an order that presented a plausible rationale for some position the board had reached for reasons that had nothing to do with economic or regulatory theory. Those reasons included precedent—a favorite of some members—or politics.

That regulatory process provided little incentive for airline executives to seek better, less costly ways to serve consumers. Regulators and executives spent time and energy on hundreds of penny ante issues, for example, whether the CAB would allow the employees of two affiliated airlines to wear similar uniforms. There was little time for reflection by the regulators or the airlines about the basic merits of regulation. Shielded from competition, airline executives spend great energy and resources on mastering the regulatory process rather than the marketplace.

Civil aviation in the United States did grow, not because of the CAB, but in spite of it, especially after World War II. That is because as the country grew more affluent, demands for travel services grew as well. Further, improved technology made air travel faster, safer, and cheaper.

By the time President Ford appointed me as the CAB chairman in 1975, the airline industry was like a forty-year old still living at home with his parents. And like an overbearing parent, the CAB was the sole determiner of airline costs allowable for calculating fare levels and, therefore, fare levels themselves. If CAB cost controls had grown stricter and tighter to keep some fares down, the airlines would have become full-fledged public utilities.

The watershed reform came in April 1976 when the CAB unanimously announced its support for deregulation, becoming the first regulatory agency to acknowledge the fundamental deficiencies of the regulatory system it administered, thereby triggering its own abolition. The CAB's reputation as a first class, nonpolitical, impartial regulator, and the respect it enjoyed for its expertise in commercial aviation, made its embrace of deregulation a politically powerful statement for a major policy change. In a 180-degree turnaround, policymakers came to agree that the airlines could serve consumers better if the intrusive regulatory structure were dismantled, thereby replacing government regulators with market forces as the arbiter of fares and service.

EVALUATING DEREGULATION

Two decades ago, supporters of the status quo predicted that deregulation would result in higher airfares, poorer quality service, and a deterioration of safety. Supporters of deregulation understood that the new aviation free market would not unfold without some pain. They predicted that a deregulated environment would likely produce new carriers while some established airlines failed. Some communities would gain air service and some would lose it. Prices would go up in some markets and down in others. Those predictions proved correct, but by any measure, deregulation has been a success.

Lower fares. Measured in a variety of ways, airfares have consistently fallen under deregulation. Some economists have found that fares are 22 percent lower today than they would have been if the industry had stayed under government control. But in April 1998 Northeastern University economist Steven Morrison, a leading authority on the economics of the airline industry, testified before the Senate Judiciary Committee that 1997 air fares, adjusted for inflation, were 40 percent lower than they were before deregulation.

Since 1990, consumer prices in general have risen 20 percent faster than have average airline prices. Morrison and Brookings Institution economist Clifford Winston, in their 1995 study,"The Evolution of the Airline Industry," pegged the annual savings to air travelers at $12.4 billion thanks to deregulation. They also estimated that because of more convenient flights and a more efficient route system, passengers save another $10.3 billion each year in reduced travel time. Those savings were enjoyed by passengers at both the smallest and the largest airlines.

More passengers and service. A dramatic rise in passenger traffic reflects the fact that airline tickets are an economical, competitive value within reach of most American pocketbooks. In 1978, 275 million people flew on domestic carriers. In 1997, that number had more than doubled to 600 million passengers. On 12 February 1998, David Z. Plavin, president of the Airports Council International, cited Federal Aviation Administration (FAA) projects indicating that 740 million people will fly domestic airlines by 2002, and nearly 900 million by 2005—if the nation invests enough money in its aviation infrastructure to accommodate that type of growth.

A 1996 General Accounting Office (GAO) report entitled "Changes in Airfares, Service, and Safety Since Airline Deregulation" cited a dramatic improvement in service once airlines were allowed to compete for customers in a free market. The report found that departures in 1995, compared to 1978, were up by 50 percent for small airports, 57 percent for midsized ones, and 68 percent for large ones.

More competition and jobs. Competition is keener than it was before deregulation despite a number of mergers and some highly publicized bankruptcies. One way to measure competition is by looking at routes. According to Morrison's Senate testimony, the average number of carriers per route has jumped 30 percent since 1977. Twenty-three new airlines have launched service in the last five years, and in 1997, airlines that entered the market since 1978 held an all-time high 18 percent share of the market. In 1979, less than 30 percent of the nation's airline passengers lived in markets served by three or more competitors. In 1996, that number had shot up to 70 percent. There is also somewhat less concentration in market share. Today, for example, the five largest airlines have a 68 percent share of the market, slightly less than they had in the days of regulation, while the next five have increased their market share from 20 to 23 percent.

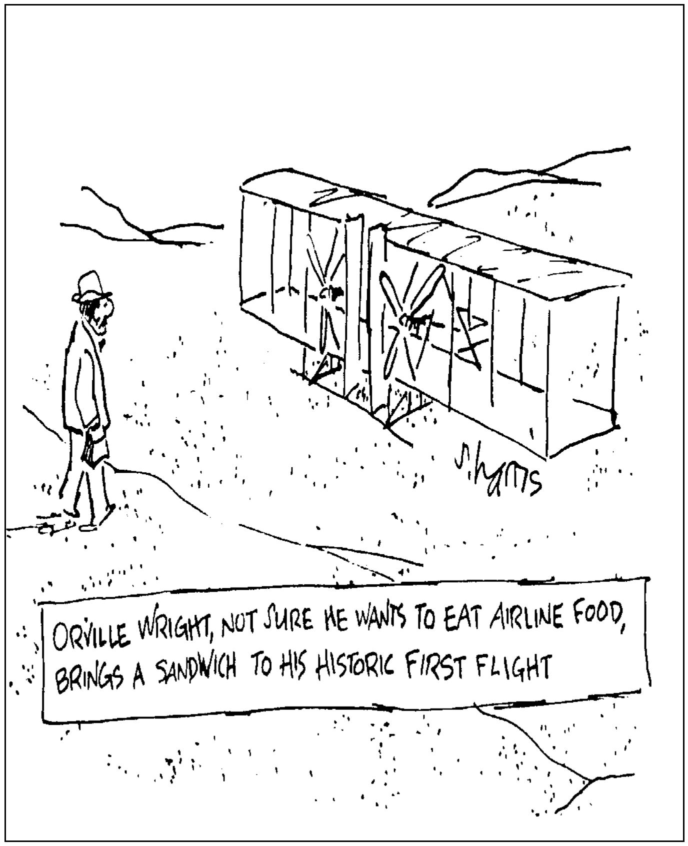
The growth of the airline industry also has created new jobs. According to the Air Transport Association, 530,000 Americans are directly employed today by U.S. airlines, a 50 percent increase since 1978.

More service for smaller communities. During their last decade under government regulation, the airlines abandoned—with CAB approval—routes serving many small and midsized communities. In the twenty years since then, competition has brought enhanced service to those markets, primarily aboard small, economical turbo-prop planes. Since 1978, the number of flights to smaller communities is up more than 50 percent. The 1996 GAO study looked at eighty-seven small to midsized markets and found that sixty-five enjoyed a combination of lower fares and better service under deregulation. Some communities, however, have yet to see those benefits. That is not surprising. After all, many routes before deregulation were unprofitable.

Airline executives, however, maintain that a new generation of fifty-seat, regional jet aircraft developed by companies like Embraer and Bombardier now coming into use will further improve air service to smaller communities, including those that have not yet benefited fully from deregulation. The ability of those jets to fly farther, faster, and at less cost than turboprops will allow carriers to serve a growing list of smaller cities from their hub airports.

THE HUB AND SPOKE NETWORK

One important catalyst behind the industry's success over the past twenty years is the airlines' development of hub and spoke networks, an efficient and cost-effective way to transport people quickly to a large number of destinations. Under the CAB, carriers were assigned linear routes, forcing them to fly turnaround service between City A and City B, usually with intermediate stops. Unless your destination was City B or one of the few stops along the way, you had no reason to be on the plane. That fact, along with high fares, explains why in 1977 the average flight took off with only 55 percent of its seats filled.



After deregulation, market competition forced the airlines to come up with a more efficient way of using their fleets in order to compete for customers on the basis of low cost, convenient, and attractive service. The airlines' answer was a network of spokes feeding flights into and out of hub airports such as New York, St. Louis, Minneapolis, Chicago, and Atlanta. Under that system, planes not only carry passengers bound for hub cities, but for the hundreds of other destinations reachable from the hub, allowing airlines to multiply the service that they are able to offer consumers. For example, an airline that uses twenty-five planes to connect twenty-five City As to twenty-five City Bs will only serve twenty-five city-pairs. In a hub-and-spoke system, those same planes can be flown from twenty-five places on one side of the hub to twenty-five on the other—providing one stop transportation between 675 city-pairs (twenty-five cities times twenty-five cities, plus direct flights from fifty cities to the hub).

The hub-and-spoke system allows consumers to enjoy more choices in departure and arrival times, and a far greater choice of destinations. The hubs, in turn, have become an important and dynamic source of jobs and revenue in their communities.

Today, however, hubs are also at the center of an ongoing debate over the highly-emotional issue of fares, a debate that rages around two seemingly contradictory views: fares are too high; fares are too low.

First, consider the "too high" issue. Across the United States there are a handful of hub airports dominated by one or two carriers. They include airports in Atlanta (Delta), Denver (United), Detroit (Northwest), St. Louis (TWA), and Chicago (American, United). In his Senate testimony, Morrison noted that fares at what he called the "average" dominated airport are 21 percent higher than at all other airports, a phenomenon the press, politicians, and the public have recently lavished with considerable attention. But Morrison also notes that while travelers at some dominated hubs are paying higher fares, they are also enjoying the advantages of an airport's hub status. Hub airports, he found, offer nonstop flights to nearly twice as many cities as nonhubs, and at least 25 percent more daily departures to each city they serve.

CONSUMERS ALWAYS BENEFIT WHEN COMPANIES ARE ABLE TO SAY, "WE WILL NOT BE UNDERSOLD"

But even at dominated hubs, consumers are paying less than they would pay without deregulation. For example, Morrison notes that fares at dominated airports are still 18 percent lower than they would have been if the industry had remained regulated. That is important information for government officials to consider before they attempt to distort the marketplace with new regulation. Where fares seem suspiciously high, officials have an obligation to find out why. Are the higher fares the result of unfair competition? If so, the Justice Department has the broad authority and considerable expertise to remedy the situation by vigorously enforcing the antitrust laws now on the books. Are there other restraints at those airports that might restrict competition, like limits on infrastructure or air traffic control capacity? If so, there are other solutions that should be considered that do not involve regulation.

In any market as complex as a nationwide transportation system there will always be instances where competition is not equal or perfect at all times in all places. But that calls for a case-by-case analysis and, where necessary, a case-by-case solution. It does not mean the entire system is broken and in need of a government-mandated repair.

The same type of analysis may explain why in certain instances, fares are falling to what some consider anticompetitive levels, or are "too low." One of the reasons air fares have declined over the past twenty years is the practice of established carriers to fight aggressively for customers by meeting the competitive challenge of new rivals in the marketplace. When any carrier—new or established, large or small—enters a market for the first time, it changes the competitive dynamics. Airlines already serving the market have little choice but to respond, whether the new rival is a so-called "upstart" or a well-established carrier. And the most basic competitive response—for an airline or any business—is to match price.

That is the way free markets are designed to work. Consumers always benefit when companies are able to say, "We will not be undersold!" Or, as stated in the 1986 Supreme Court decision in *Matsushita Elec. Industries v. Zenith Radio*, "Cutting prices in order to increase business is the very essence of competition."

Over the years, this dynamic has sorted out winners from losers in countless market battles. Where they cannot compete because of higher costs or other factors, established airlines have abandoned routes to lower-cost competitors. Southwest Airlines, for example, with its reliable, no frills service between a select number of cities, has earned a large share of some markets at the expense of older, more established rivals. In other cases, established carriers have met the challenge posed by new entrants, winning public approval based on competitive price, superior on-board service, and reliability. When that happens, new entrants have either left the market or continued to compete, sometimes elsewhere.

Whether new entrants are forced out of a market altogether or establish operations nearby, consumers are given choices—after enjoying few under deregulation—and they exercise those choices based on what type of service best suits their needs.

EBB AND FLOW OF ENTRANTS

But such market dynamics and consumer benefits will be in jeopardy if the government, even in the name of competition, turns back the clock on deregulation. The history of deregulation has been one of constant ebb-and-flow in the fortunes of established and new carriers alike. In the days immediately after deregulation, the newcomers were seen as the "can't miss" wave of the future. They were leaner, smarter, and more innovative—for example, People's Express—than their older rivals. By 1985, new carriers had already jumped to a 17 percent market share.

Some of the industry's oldest and proudest names were unable to survive. Both Eastern Airlines and Braniff closed in 1989, and Pan American shut down in 1990. But the market was still very much at work. Other established airlines took difficult steps to increase efficiency and competitiveness, steps that enabled them to regain much of their lost market share. Among the initial new, smaller entrants to leave the market were Air Florida (opened in 1979, closed in 1983), New York Air (opened in 1980, closed in 1986), and People's Express (opened in 1981, closed in 1986). Was the battle over? Not by a long shot. A second wave of new entrants joined the fray. They included Air South, Frontier, Kiwi, and Valujet. And by 1996 they had rebuilt their share of the market to 18 percent.

United Airlines Chairman and CEO Gerald Greenwald likened new airlines to new-born sea turtles trying to make their way to the sea: some will make it and some will not. When new entrants fail they may do so for a variety of reasons which include: inexperienced management, unrealistic business plans, lack of solid financial backing, public doubts about their reliability, and a poorly conceived pricing structure.

THE PRICE OF SUCCESS

Airline pricing is a complex and dynamic process, a constantly changing calculation based on the ever-changing supply and demand for seats. Recently retired American Airlines Chairman Robert Crandall underscored that point when he commented: "One of the many aspirations of every airline executive is rubber airplanes—which could be stretched for Friday afternoon flights and shrunk for midweek and early-morning flights." In the absence of rubber planes, the airlines offer a variety of fares on the same flight, in effect balancing a fixed supply of seats with the demand different passengers put on those seats. Although the outcome of that process often confuses and sometimes frustrates passengers, it's the basic reason the vacationer in 10A probably paid less than the business traveler in 10B.

NO LEGISLATION, NO MATTER HOW WELL-CRAFTED, CAN GUARANTEE AN AIRLINE WHAT IT REALLY NEEDS TO BE SUCCESSFUL: EXPERIENCED MANAGEMENT, SMART BUSINESS PLANS, ADEQUATE CAPITAL, AND A STRONG ECONOMY.

The airline is able to "reward" the vacation flier with a discounted fare in exchange for concessions by the traveler, like making the reservation well in advance, forgoing the right to change the ticket, staying over a Saturday night, or traveling on a lower-demand midweek flight. Today, an estimated 90 percent of all passengers fly on some type of discounted ticket, with 70 percent of them enjoying price discounts of 50 percent or more. What's in this arrangement for the airlines? The assurance that a significant number of seats on every flight will be occupied. Last year, the average flight was 70 percent full, a post-World War II high.

But the airlines also have to keep a supply of seats available for a highly-valued group of travelers that tends to make plans at the last minute—the business flier. The market puts a higher dollar value on those seats, partly to reflect the airline's gamble in holding them open for as long as possible. If the seat is still empty at take-off, the airline loses its gamble along with any revenue the seat might have generated. But the higher price also reflects a premium paid by the business flier for maximum flexibility to make and change plans right up until flight time. And when the economy is strong, as it is today, the demand for those business seats skyrockets, sending their price up. If there were rubber airplanes today, the carriers would likely be stretching them to accommodate more business travelers. In their absence, it's the fares that are elastic.

With the advent of the Internet, airlines are taking additional steps to see that all seats on certain flights will be full and offer "electronic" travelers with flexible schedules and excellent prices. For example, every Tuesday TWA lists on its website bargain roundtrip rates on specific flights, usually leaving on the upcoming Saturday and returning on the next Monday or Tuesday. Travelers in the United States thus might take a long weekend in Milan, Italy or Lisbon, Portugal for only a few hundred dollars.

Price and service competition is also helped by growing competition in metropolitan regions between carriers at different airports. For example, Southwest Airlines does not want to compete with major airlines flying out of Chicago's hub, O'Hare Airport. Thus it uses nearby Midway Airport for its low-fare service. In the Washington, D.C. area, Reagan National Airport, which mainly carries domestic travelers, and Dulles International Airport in Virginia are now facing stiff competition from carriers using Baltimore-Washington International in Maryland. Other regions have similar competition between airports; Logan in Boston faces competition from Providence, Rhode Island; the three major New York City area airports compete with one another; Los Angeles International faces several competitors; and different airports serve numerous cities in Florida, most within a few hour's drive of one another.

That is how a highly dynamic, competitive, and notoriously cyclical marketplace is supposed to work. That is also how it worked in the early 1990s to the detriment of the airlines when the economy was in a recessionary "down" cycle and demand for airline seats fell dramatically. Businesses sent fewer people on the road, vacationers stayed home or traveled by car, and airfares sank. As a result, the airline industry lost more than $13 billion between 1990 and 1994, more money than the entire industry had made since the first flight of the Wright brothers. But as the airlines reeled under the traumas of financial hemorrhaging, bankruptcies, and layoffs, the government stayed in its rightful place—on the sidelines. There were no offers to build an artificial floor under falling fares in order to help struggling carriers survive. Some carriers failed. Those that survived are today stronger, better managed, more innovative and more efficient. But historically—and even today—when the airlines are doing well financially, their return on equity lags well behind that of most major industries.

GOVERNMENT MISCHIEF

Over the past twenty years, the aviation free market reflected advances in technology, changing customer demand, and the cyclical nature of the United States and global economies. Unwarranted action by the DOT and Congress would disrupt that market system, replacing dynamic forces with legislative or regulatory edicts. No legislation, no matter how well-crafted, can guarantee an airline what it really needs to be successful: experienced management, smart business plans, adequate capital, and a strong economy.

Yet the list of legislative proposals keeps growing. One Senate bill (S.1013), for example, would create a new government subsidy program to help finance jet service to small and medium-sized communities. A House bill (H.R.3312) would create a new commission to review airline pricing strategies. Such a body has the potential to become either a meddlesome kibitzer in the affairs of the airline industry or a Trojan horse for airline reregulation. Neither is a welcome prospect. Another Senate bill (S.1331) would redistribute takeoff and landing slots at the four heavily congested, and thus slot-controlled airports—O'Hare, LaGuardia, JFK, and Ronald Reagan Washington National. He proposes taking slots from the major carriers that currently hold them and auctioning them to new entrants. The senator's goal, he says, is to increase competition and enhance service to smaller markets from the four controlled airports.

The issue of slots touches on many elements in the larger debate over deregulation itself. While unrestricted access to all airports is everyone's preference, that is not always possible. Certain airports are congested due to limited runway space and air traffic control capacity. There is no way to accommodate more flights without creating gridlock or jeopardizing safety.

Some believe, however, that if new entrants gain access to airports by taking away slots from their current holders, the result would be the opposite of what many expect. An airline forced to give up slots will not cut from among its most popular and productive routes. Rather, it would eliminate those routes that generate the least revenue, most likely dropping flights to smaller communities. It is also dubious to expect that the new entrant would voluntarily use its new slots to serve those small markets. Instead it will likely add more flights to compete on already well-served routes.

CONSTRUCTIVE APPROACHES

One solution to the congestion problem would be to improve the aviation infrastructure so that slot rationing is no longer needed. David Z. Plavin, president of the Airports Council International, argues that additional funds should be spent on airports. He calls the air transportation system "the linchpin of our national and local economies," fueling more than $400 billion in economic activity each year. Plavin cites a DOT study that shows for every one billion dollars invested in airport development, approximately fifty-thousand jobs are created and sustained. Every day, Plavin says, U.S. airports generate $85 million in taxes, more than $1 billion in national economic activity and more than $425 million in salaries. But he warns that this economic engine will stall unless the nation's airports are expanded to accommodate the projected growth in air travel. As he told the Senate Commerce Committee in February, "We cannot afford the billions of dollars in annual delay costs and lost productivity to the airlines, air travelers and businesses, nor can we afford to weaken our economic competitiveness abroad, by settling for an inefficient and inadequate air transportation system."

The same can be said for the urgent need to invest in a complete modernization of our outdated and overworked Air Traffic Control system (ATC), a vacuum tube relic in a microchip world. The system's glaring inadequacies are largely to blame for traffic limits at some airports as well as the costly amounts of time and fuel wasted as planes wait for clearance to land. The cost of all this—wasted fuel, lost time, and rationing of limited air space capacity—is ultimately passed on to the traveling public through the airlines' fare structure. If Congress really wants to have a positive impact on airline competition, it should take the difficult step of demanding, funding, and overseeing a long-overdue upgrade of the air traffic control system by the Federal Aviation Administration. Or it could explore ways to commercialize the system as has been done in Canada, Switzerland, and other countries. That will do more to boost competition and lower fares than DOT guidelines or regulatory legislation can do.

But above all, DOT and Congress should resist the urge to meddle with deregulation by trying to craft their version of a "perfect" marketplace. No market provides, at all times, every consumer or interest group with exactly what they want for the price they want to pay. There are always going to be ups and downs, economic cycles, and competitors afraid to face legitimate competition. The one clear lesson we learned from airline regulation is that no regulatory body, no matter how smart, hard-working, or well-intended, can keep up with something as fast moving and dynamic as the commercial airline system. No regulatory body can do a better job of pricing fares or figuring out where and when people ought to fly than can the airlines and their passengers. Twenty years after it was first implemented, airline deregulation remains a public policy success story, a bold experiment that is more than fulfilling its promises to consumers and the airline industry.

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