# PART 4: THE AIRLINE INDUSTRY

## STRUCTURAL CHANGES IN INTERNATIONAL AVIATION

Vicki L. Golich, The Pennsylvania State University

To some, liberalization, deregulation, and privatization were new buzzwords of the 1980s. However, as the old saying goes, "The more things change, the more they remain the same." Throughout the history of attempts to create management schemes for international air transport, someone has always been an advocate of an "open skies" principle. As early as 1910, at a meeting of international lawyers, such a policy was proposed, only to be thwarted by the United Kingdom's recognition that air vehicles were useful to the conduct of war. Parliament passed the British Aerial Navigation Act, which gave the Home Secretary complete power to regulate the entry of foreign aircraft and to proscribe zones over which foreign aircraft were not allowed to fly. The European continent followed suit, and the principle of airspace sovereignty was firmly established.

Following the Second World War, the United States sought a more market-oriented air transport system. However, then, as I suspect now, most of the world distrusted America's motives. As Christer Jönsson, a Swedish international relations scholar wrote in an article entitled "Sphere of Flying,"

'Survival of the fittest' in international aviation inevitably entails 'survival of the fattest,' and there [was] widespread apprehension that the American preaching of laissez-faire really [meant] 'laissez-nous-faire.'[1]

Historical and theoretical perspective suggests three salient factors should be considered when implementing economic liberalization policies at either the domestic or international level.[2] First, the market economy guru, Adam Smith, argued that one of government's primary functions was to provide the infrastructure that would facilitate trade.[3] He specifically mentioned transportation systems, namely roads, canals, harbors, and safety on the high seas. Second, government intervention has often been the facilitator of economic development. This is more clearly the case in Europe and Japan than in the United States. Third, aviation has always been subject to government control because of its perceived synergy with national security and usefulness in achieving other national interest goals. Some aspects of air transport will always be subject to government control, e.g., safety and environmental regulations, and, at least for the short- to medium-term, airport and air traffic control capacity. It is probably safe to say nations will only reluctantly yield sovereignty where they still exercise it.[4]

Nevertheless, in 1978, the United States adopted a new, competitive international aviation policy with the goal of liberalizing the air services market.[5] The policy involved a three part strategy. First, domestic deregulation to create financially sound and competitive airlines. Although the promise to the American people was for more perfect competition fostered by the entry of several new airlines, the result has been the development of a relatively small number of large carriers with extensive national and international air transportation networks.[6] The market share of the five largest U.S. airlines has grown from 63.5 percent in 1978 to 85.9 percent in 1988.[7] Of the world's top 25 airlines, nine are American; three are in the top four. The remainder are spread fairly evenly across the globe, except for the African and South American continents.[8] As U.S. carriers have expanded their own international networks, they have ceased to provide connections to and from gateway points in the United States for foreign airlines, decreasing the potential competitiveness of the latter.[9] Europeans are concerned not only about the direct negative effects they have felt as a result of this policy, but also about the potential indirect effects of transnational rationalization of air transport services, congestion on high density routes and at airports, and loss of service to small cities or otherwise less desirable locations.[10]

Second, the United States signed liberal agreements with The Netherlands, Belgium, the United Kingdom, and the Federal Republic of Germany in an effort to divert price-sensitive traffic away from restrictive countries and their national flag carriers.[11] This tactic was particularly effective because of the efficient surface transportation network available in Europe. It also undermined IATA's role as the forum for developing fare structures "that minimized the threat of traffic diversion based on price competition."[12]

Third, in a more direct attack on IATA authority, the Civil Aeronautics Board initiated a review of IATA's antitrust immunity in June 1978 in spite of protest from the Departments of State and Transportation as well as virtually every foreign country. Eventually, the prohibition on IATA rate-setting was restricted to North Atlantic routes.

Although the United States initially encountered stiff opposition to liberalizing air transport services, OECD states now seem more willing to adopt the market-oriented strategy for dividing traffic in order to benefit from the comparative advantage each holds in the industry sector, based on market size and desirability, technological sophistication, management skills, and so forth. In 1982, nine European countries agreed to placing wider fare bands around IATA reference fares for North Atlantic routes in exchange for a U.S. agreement to extend the antitrust waiver for IATA participation.[13] This was followed more recently by a more restrictive policy announced in December 1989 by the European Community Council of Transport Ministers, which outlined the following principles: double disapproval pricing, liberalization of capacity sharing arrangements, and cabotage.

The United States may have opened Pandora's Box when it began liberalizing international air transport. While world traffic is expected to grow at an average rate of 6 percent through the 1990s, the U.S. market is expected to grow only 4.8 percent. The largest growth is expected to take place in the Pacific region, including a 9.1 percent increase in traffic between Europe and the Orient.[14] In 1978, Pan Am and TWA carried 64.2 percent of U.S. international passengers; in 1988, these venerable, but now vulnerable, flagship carriers transported only 43 percent. During that same decade, U.S. carriers increased their passenger payload by only 2 percent, although international traffic was growing by 6 percent.

The European market will be dynamic during its adjustment to 1992 and could hold three significant bargaining chips at the negotiation table with the United States. First, its airlines already have more extensive route systems in Asia and Africa, where traffic is expected to expand the most dramatically, if not in Latin America where U.S. airlines dominate. Second, once unified into a single market, Europeans may claim intra-European Community travel as domestic and demand to trade cabotage rights for similar privileges in the United States. Third, the melting of the Iron Curtain will likely result in expanded air transportation needs within the European continent. Close ties remain among the peoples within these previously artificially separated blocs.

Several barriers remain to block the implementation of a liberal air transport market, ranging from intangibles like political prestige and national pride to the logistical nightmares involved in integrating disparate regulatory (viz., air traffic control systems or safety certification standards) and legal (viz., anti-trust laws) systems, and restrictions in ancillary domestic markets (ie., food service, maintenance, computer reservations systems).

My comments have concentrated on changes in international air transport services. The ramifications of these changes spread far and wide. Aircraft manufacturers are ultimately dependent on their airline consumers for purchases and profits. Airports and air traffic control systems must accommodate changes in air transport patterns. Governments must coordinate efforts to ensure safety and efficiency.

The following papers by four experts in international aviation who can shed light on some of these issues. They represent both the public and private sectors as well as different elements of the international air transport picture.

*References*


1) Jonsson, Christer, "Sphere of Flying: The Politics of International Aviation," *International Organization*, Spring 1981, p. 288; see also Alan P. Dobson, "The Other Air Battle: The American Pursuit of Post-War Civil Aviation Rights," *The Historical Journal*, Volume 28 Number 2, 1985, p . 439 and Vicki L. Golich, *The Politics and Economicsof the International Commercial Aviation Safety Regime*, Doctoral Dissertation for the School of International Relations, University of Southern California, October 1984, pp. 122-3.

2) Of course, economists recognize that since the eighteenth and nineteenth centuries economic theories have been used "to explain and justify a market system." Alfred E. Kahn, "Surprises of Deregulation," *The American Economic Review*, Volume 78 Number 2, May 1988, p. 317; emphasis is his.

3) Charles P. Kindleberger, "Government and International Trade," Princeton Essays in International Finance, No. 129, Camden, NJ: International Finance Section, Princeton University Press, July 1978, pp. 3, 12; Stephen D. Krasner, "Structural Causes and Regime Consequences: Regimes as Intervening Variables," *International Organization*, Volume 36 Number 2, Spring 1982, p. 198.

4) B. Wilkins appropriately points out that "analyses supporting deregulation have not addressed the industry as a whole ....The airline industry, indeed the entire aerospace industry, so intermingles the 'public' and 'private' that while the industry is not 'socialist,' it is not 'private enterprise' either"; "Airline Deregulation: Neoclassical Theory as Public Policy," *Journal of Economic Issues*, Volume 18, Number 2, June 1984, pp. 424-5. As I have noted elsewhere, the synergy among state political, military, and economic goals makes it difficult to leave the industry open to the vagaries of the market. See Vicki L. Golich, *The Political Economy of International Air Safety: Design for Disaster?* (London, England: Macmillan Press, Ltd., 1989).

5) Daniel M. Kasper, *Deregulation and Globalization: Liberalizing International Trade in Air Services* (Cambridge, MA: Ballinger Publishing Co., 1988), p. 75.

6) Kasper, p. 37. See also Melvin A. Brenner, "Airline Deregulation -- A Case Study in Public Policy Failure," *Transporation Law Journal*, Volume 16, 1988, pp. 182-3; Michael Levine, "Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy," *Yale Journal on Regulation*, April 1987, p. 423; and Kahn, "Airline Deregulation -- A Mixed Bag," *Transportation Law Journal*, Volume 16, 1988, pp. 230-1.

7) Christopher Fotos, "Heavy Debt Could Put Airlines At Risk If Traffic Growth Slows," *Aviation Week and Space Technology*, March 20, 1989, pp. 203-6.

8) *Air Transport World*, "The World's Top 25 Airlines," June 1988, p. 54.

9) Kasper, p. 88.

10) *Economist*, "Pricing Open Closed Skies," November 3, 1984, p. 73; Kahn, "Surprises of Deregulation," pp. 316-22. For a particularly poignant statement of these concerns see Jonsson, p. 288.

11) Kasper, p. 76.

12) Kasper, p. 77.

13) Kasper, p. 207.

14) "New Routes Will Develop to Meet Demand for International Service," *Aviation Week and Space Technology*, March 20, 1989, p. 26.

## HOW DEREGULATION WILL CHANGE THE STRUCTURE OF THE INTERNATIONAL AIRLINE INDUSTRY

Daniel Kasper, Harbridge House

Some of the things I am going to say would have been controversial when I first started saying them three or four years ago. They are substantially less so today; and I suspect, if this meeting were to reconvene three years from now, they would be viewed as pretty much ho-hum. I will leave that, however, to our collective judgments three years hence.

By way of introduction, I served as Director of International Aviation at the United States Civil Aeronautics Board and was one of the architects of the U.S. strategy for liberalizing international aviation. Therefore many of the things that I will describe today were either initiatives that we took or the results of those initiatives. I am both an insider and outsider. As an insider, I am looking at the subject both from my days at the Civil Aeronautics Board and from my current position where I consult with major international airlines on questions such as the "impact of 1992" and what the structure of the industry is going to be in a few years. As an outsider, I look at the subject from the time when I taught at universities and studied the airline industry. So I come to this with some 20 years of both academic and hands-on experience.

Because of the time limitations, I am going to eliminate some of the detail in my presentation. I will make some assertions that I ask you to accept, at least for purposes of argument. I would be more than happy to give as much detail, as you would like, either in the question and answer period or after the presentation.

### THE RISE OF MULTINATIONAL AIRLINES

By 2000, and perhaps substantially sooner, most of the world's scheduled airline services will be provided by a score or fewer of major multinational airlines. In short, ten years from now the world's commercial airline industry will be made up of fewer, larger airlines that will have global on-line service or something very much akin to it. Furthermore, these carriers, unlike the carriers today, will be multinational. They will be owned and operated as multinational firms are in other industries.

For an industry that until quite recently could be accurately described as a series of local monopolies connected by a series of equally protected international routes, this is a striking transformation. I submit to you that transformation is already well under way.

The reasons for the change are really quite clear. The economic forces unleashed by U.S. domestic airline deregulation and the companion policy on competitive