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Impacts of Airline Deregulation

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Airline deregulation had an immediate and long-term impact on airlines, airports, manufacturers, and the traveling public.

Commercial aviation was the first transportation mode in the United States to be deregulated. In 1977, air cargo rates and services were deregulated by an act of Congress; the next year—and after simmering debate among industry leaders, economic prognosticators, and government regulators—Congress passed the Airline Deregulation Act of 1978, which deregulated passenger aviation fares and services. Together, this legislation unleashed decades of upheaval and adjustments as the airline industry morphed from a protected, regulated business environment to a largely unregulated marketplace.

Impacts rippled throughout the aviation industry, affecting all stakeholders—airlines, airports, airplane and engine manufacturers, investors, travel agents, shippers, and the traveling public. Winners and losers came and went as the industry responded to the demands of the new marketplace. Seldom has an industry seen its regulations and business practices change so dramatically in such a short period.

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President Jimmy Carter signed the Airline Deregulation Act in 1978, freeing passenger airlines to control their fares and services.

The vast experiment in laissez-faire economics was emulated in rail and in other surface transportation modes long before its results were apparent in the aviation industry. Most analysts and observers declared deregulation in general a success, even though the process left many victims in its wake. Shareholders lost billions of dollars, employees were laid off, small towns lost services, and many old and new companies went bankrupt or were absorbed by others.

In the airline industry, fares and rates decreased significantly, load factors skyrocketed, more people began to travel, seats became smaller and less comfortable, and tightening security created additional burdens for travelers. All these changes occurred as the industry achieved unprecedented levels of safety—surprising many of deregulation's early detractors.

Because deregulation was and still is an experiment, declaring it a success cannot be done objectively; that is, no one can be sure how the deregulated industries would have evolved in its absence. It is difficult, however, to imagine that the many pricing and service innovations that followed deregulation would have been matched in a regulated structure.

Expectations of Change

Historically, U.S. transportation policy emerged from the belief that transportation was necessary to support commerce. The basic regulatory structure that was created for the railroads in the late 19th century eventually was adapted for aviation, resulting in government regulation of virtually every aspect of the airline business. Essentially, that meant that any proposed change in fare level, route structure, or ownership had to be approved by the federal Civil Aeronautics Board (CAB), whose predecessor was created by an act of Congress in 1938 and was the precursor to the Federal Aviation Administration (FAA). The approval process, which required administrative and judicial reviews, could take many months—and sometimes years.

The primary objective of airline deregulation was market-focused. Many economists argued that the regulatory environment created and administered by CAB limited competition to the detriment of travelers, resulting in high prices and unresponsive service.

It still is a matter of debate whether these outcomes were intentional objectives of regulatory policy or merely were the result of the CAB approval

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In the years following the Airline Deregulation Act, many employees lost their jobs, and some airlines went bankrupt —including one of the largest, Pan Am.

Photo: Harris & Ewing, Library of Congress

Civil Aeronautics Authority chair Edward Nobel (*center*) meets with Aviation Safety Board chair Sumter Smith (*right*). The two groups merged in 1940 to form CAB.

Photo: Southwest

Because Southwest Airlines flew only within the state of Texas, it was not subject to federal regulation. The success of the Southwest business model bolstered the argument for airline deregulation.

process, but the issues were real. Economists also argued that deregulation would bring about a more robust airline industry, whose profitability had been eroded because of the high inflation and oil prices of the 1970s as well as general economic malaise.

Toward Legislation

Southwest Airlines' low fares and rapid growth in the unregulated intrastate Texas market were cited as an example of how interstate deregulation could benefit consumers by unleashing a raft of new airlines with different price and service offerings. To many observers, the contrast between Southwest—a darling of Wall Street and passenger favorite—and the declining mainline interstate carriers was a sufficient argument for deregulation.

Deregulating the entire airline industry, it was argued, would lead to more passenger demand and, eventually, to a more dynamic and profitable industry. By the end of the 1970s, many economists convinced Congress of the benefits of deregulation and garnered bipartisan support.

In his opening statement of congressional hearings on the subject, Senator Edward Kennedy of Massachusetts said, "Regulators all too often encourage or approve unreasonably high prices, inadequate service, and anticompetitive behavior. The cost of this regulation is always passed on to the consumer. And that cost is astronomical" (*1*).

During these hearings and leading up to deregulation itself, many longtime members of the commercial aviation industry raised concerns about possible adverse effects of deregulation: reduced safety, industry consolidation, the loss of small community services, and harm to airline workers.

Most airlines, airport authorities, and airplane and engine manufacturers opposed deregulation. Robert Crandall, then-president of American Airlines, argued regularly that the result of deregulation would be the dominance of the industry by a few very large airlines with significant pricing power.[1]

[1] The author worked directly with Robert Crandall during this period.

Photo: White House Staff Photographers, National Archives and Records Administration

Senator Edward Kennedy became the Senate's most ardent deregulation ally, cosponsoring the Airline Deregulation Act that Carter would sign.

Photo: RHL Images, Wikimedia

Deregulation opened opportunities for new airline business models, some of which were successful and some of which ultimately failed—like People Express, which focused on low fares, good service, and an employee-owned concept.

As a result, Congress included several specific requirements in the Airline Deregulation Act that were intended to assuage and mitigate these concerns. In retrospect, the most important of these requirements was that a federal agency—what is now the FAA—continue to oversee all aspects of airline safety.

Initial Effects

New Business Models

Immediately after the 1978 act was passed, airlines began to adapt to their new world. Within the first two years, many new airlines were formed. Nearly all the new start-ups focused on a low-fare business model, some unashamedly emulating Southwest and others following new business models, exemplifying the predicted market diversity and dynamism.

An example of a new business model was People Express Airlines, founded in 1980 by longtime airline executive Don Burr. Its business strategy focused on a "low-fare with good service" concept. The airline also made every employee an owner, each with the power to make operational decisions. People Express grew rapidly, both organically and through acquisitions; its bubble burst, however, when its debt load got too big and its workforce reached a size that hindered the coordinated decision making needed for efficient operations.

New Route Systems

The longstanding incumbent airlines adapted their route systems and aircraft fleets to enhance their survival and profitability in markets that had become highly competitive. The winning adaptation turned out to be the creation of the hub-and-spoke network, pioneered by American Airlines.

American had just moved its headquarters from New York City to Dallas, adjacent to the new but underutilized Dallas–Fort Worth (DFW) airport. American took advantage of DFW's excess capacity to develop the first truly successful hub. Although it was originally done to lower overhead, American's relocation fortuitously enabled its hub strategy to succeed with the full support of corporate leadership.

It did not take long for other airlines to emulate American's strategy. Together they created hubs in Cincinnati; Dulles, near Washington, D.C.; St. Louis, Missouri; Denver; Raleigh; Charlotte; Pittsburgh; Minneapolis; Detroit; Nashville; and Salt Lake City. Existing hubs in Atlanta and Chicago

American Airlines formed the first successful large hub at DFW airport, adapting routes for profitability.

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Outsourcing services—catering, buy-on-board, and packaged snacks—enabled airlines to reduce labor costs but also resulted in large-scale layoffs.

also were strengthened. Some airlines attempted to create minihubs—such as in Dayton, Ohio—but eventually only a few major hubs were successful.

Pricing Concepts

American also introduced yield management, a variable pricing scheme concept first developed by Boeing to maximize the amount of money collected from passenger ticket sales on each flight. Sophisticated tools allowed American—and, eventually, almost every other airline—to price seats on the same flight at different levels, using fares restrictions to segment passengers. Today, most airlines consider yield management to be a critical core capability.

Intermediate Effects

Five to ten years after the Airline Deregulation Act passed, its biggest impact could be seen on airline–labor relations. Although industry leaders and labor groups argued for high wage rates, outsiders generally acknowledged that industry wages were above economically justifiable levels. The root of the high wage rates dated back to the early 1960s, when CAB allowed airlines to raise fares as wages rose. This reduced the incentive for management to negotiate aggressively with labor unions.

By the 1980s, the incumbent carriers had to reduce employee wages or staff levels to stay competitive with new entrants. Outsourcing of services became a main strategy for labor cost reduction, resulting in large-scale layoffs of unionized airline employees. Competition between incumbent airlines and new start-ups gutted many companies' balance sheets, and shareholders and bondholders suffered as the failing carriers either went into bankruptcy or were absorbed by other carriers. Mergers picked up in the late 1980s and have continued through the present.

Approximately 10 years after deregulation, the advent of RJs, or efficient regional jets with fewer than 75 seats, enabled another strategy. Mainline airlines set up subsidiary airlines that were not covered by their union contracts and ordered a large number of RJs to operate from their hubs.

Contracts negotiated with pilots' unions resulted in two-tier wage structures. Although each contract differed, some common themes emerged: pilots whose careers started before deregulation retained their high wages; newly hired pilots working directly for the mainline carriers generally were paid at lower rates, and the pilots hired to fly the RJs earned even lower wages.

The entrance of the RJs cemented the success of the hubs, as the airplanes' smaller sizes allowed them to match service with passenger demand more effectively and to provide additional destinations.

Open Skies Agreements

During the 1990s and the promulgation of federally negotiated "open skies" agreements with many foreign countries, U.S. airlines deployed three tactics to pursue international markets: 1) route expansion to new international markets, 2) mergers with other airlines, and 3) alliances with foreign airline partners.

Examples of these alliances included the following:

- Oneworld Alliance: American acquired TWA and partnered with British Airways, Cathay Pacific, Japan Airlines, and others;
- SkyTeam Alliance: Delta Air Lines absorbed Pan Am and partnered with Air France–KLM; and
- Star Alliance: United Airlines partnered with Lufthansa, All Nippon Airways, and others.

Photo: Tomás Del Coro, Flickr

American Airlines' regional jet subsidiary, American Eagle. By operating regional jets, major airlines can bypass union contracts.

Photo: Tomas Hawk, Flickr

By unbundling—charging separate fees for services like checking bags or selecting seats—airlines avoid the federal ticket tax.

Each alliance fortified its own hubs and international airfares began to increase, leading many to view the alliances as harmful to international competition. Long-haul business flying became especially pricey as airlines began to compete for the deep pockets of international business travelers by focusing on service (that is, schedules and amenities). This competition continues today.

Unbundling

Several tactics introduced in response to new industry entrants and low-cost carriers would survive to become part of the mainstream airline business model. Among the most significant of these was unbundling, or the introduction of ancillary fees in addition to and separate from the price of an airline ticket.

Some arguments suggest that unbundling is a successful strategy because air travelers tend to buy tickets based on lowest ticket price, ignoring the additional fees associated with such things as checking a bag or selecting a seat. Although there is some truth to this belief, a seldom-mentioned contributor to strategy's success is that the airlines are able to avoid federal ticket tax on these fees and charges.

Avoiding federal ticket tax puts an incremental 7.5 percent of collected monies into an airline's profit column instead of into the national Aviation Trust Fund. That fund is primarily made up of federally mandated taxes on airline tickets and is the principal source of money for airport facility expansion and for FAA air traffic operations and modernization.

Industry in Transformation

Throughout this intermediate period, airports often found themselves in one of two camps. Larger airports had sufficient traffic to maintain service levels and were able to grow and improve. Smaller airports that had been supported by regulated cross-subsidization suffered from poor or no service.

The Airline Deregulation Act provided subsidies for smaller airports for a short time; although Congress extended this support at lower funding levels, many communities saw their air service levels dwindle. In the places that kept these services, the fares often were substantially higher than comparable fares on routes between larger cities.

In 1991, as this process was playing out, Alfred Kahn wrote

> Airline deregulation has worked. It would be ironic if, by misdiagnosing our present discontents, we were to return to policies of protectionism and centralized planning at the very time when countries as dissimilar as China, the Soviet Union, Chile, Australia, France, Spain, and Poland are all discovering the superiority of the free market (*2*).

Photo: Gregor Gruber, Flickr

Although services for the general airline passenger have decreased, travelers willing to pay premium fares can still experience luxurious accommodations.

Although his observation has proven to be correct, it is apparent that the airline industry at the time was still in transformation.

Long-Term Effects

The dot-com bust in the early 2000s once again caused an economic struggle for airlines. The events of 9/11 accelerated the consolidation of the airlines into the few carriers that dominate today. The surviving carriers, along with their alliance partners, focused on financial survival in the following years. By the time the financial crisis hit in 2008, airlines had restored their balance sheets to profitability, transformed their fleets to a market-appropriate mix, and increased load factors to unanticipated levels.

Deregulation naysayers remained, however. In June 2008, Crandall was asked to comment:

> America's airline system has greatly deteriorated. Our airlines, once world leaders, are now laggards in every category, including fleet age, service quality, and international reputation. Fewer and fewer flights are on time. Airport congestion has become a staple of late-night comedy shows. An ever-higher percentage of bags are lost or sent to the wrong airports. Last-minute seats are harder and harder to find. Passenger complaints have skyrocketed. Airline service, by any standard, has become unacceptable (*3*).

The U.S. airline industry has morphed into an oligopoly. At this time, further consolidation appears unlikely; even under the current business-friendly presidential administration, concerns are being raised about too much consolidation in the aviation industry. Various air passenger groups have begun to argue for regulation of air services, at least in regard to personal space and amenities on the aircraft.

As the airlines continue to focus on cost reductions, aircraft interiors have become less and less comfortable for the typical traveler, and this has led to a highly segmented consumer market. Business travelers and passengers willing to pay premium airfares still enjoy the creature comforts associated with the early days of jet travel, but passengers in the back of the plane suffer from tight seating, tiny restrooms, packed rows, and minimal service. Inten-

Photo: Altus, Flickr

California's John Wayne Airport is located 35 miles south of Los Angeles. The fares at smaller airports tend to be higher than their close-city counterparts.

PHOTO: MICHAEL KAPPEL, FLICKR

Airport terminals have evolved from transportation hubs to centers for shopping, dining, and even art galleries.

tionally or not, airline pricing and marketing behavior has trained the air traveler to expect discomfort when flying, as well as service charges for any type of ancillary activity.

Interestingly, the airline industry has become consistently profitable—in contrast to much of its history—since recovering from 9/11 and its immediate aftermath. Longtime industry observers scratch their heads as to whether this is the new normal or merely a manifestation of the current long economic recovery since the Great Recession in the late 2000s.

The industry's financial stability is global, not just domestic, and this has led to large backlogs of new airplanes on order with manufacturers. Boeing, Airbus, Bombardier, and Embraer are experiencing five- to seven-year production backlogs.

Successful Legacy

Was deregulation successful? By virtually all measures, the answer is yes; however, today's system bears little resemblance to the aviation future described by deregulation advocates in the 1970s.

Although Crandall's prediction of a few large airlines dominating the market was correct, the journey was different than he anticipated. Collectively, air travelers have benefited from substantially lower fares. Passenger volumes have grown considerably, both domestically and internationally. Airlines and aircraft manufacturers are profitable. Major airports have become shopping malls in addition to transportation hubs. The airline industry is the safest mode of transportation by far. After years of layoffs, staff shortages are causing industry wages to go up as airlines strive to continue growth. The remaining aircraft manufacturers are rolling out new aircraft at a record pace.

It is not clear, however, that current levels of market diversity exactly match the vision of early deregulation advocates. Airlines made profits since the beginning of the economic recovery, but airline startups were few and far in between. New marketing ideas were scarce as the airlines continued to hone costs and reduce waste. After consolidation, airlines' financial power enabled them to compete extremely aggressively with any new entrants to the market.

It appears that a balance may recently have been reached in the domestic marketplace; that is, the market now consists of a small set of operating airlines. Alliances have proliferated across the globe, creating a consistent worldwide marketplace. Does this represent a stable market? Ask that question again in another 20 years.

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