

# Trouble in the Sky

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**Harvard Model  
Congress Asia**

## INTRODUCTION

Traditionally the Federal Government has heavily regulated airline industry. In an effort to limit competition in the industry, the Civil Aeronautics Board dictated routes and fares from 1938 to 1978—limiting the airline industry to only sixteen airline companies. Clearly this made air traffic control smooth and painless; but it also limited the ability of the airlines to respond to consumer demands. Additionally limited expansion of routes led to high fares.

But in 1978 the government deregulated fares and routes. Almost overnight the airline industry's growth exploded. Fares dropped and the number of customers grew at incredible rates: the total number of passengers more than doubled in the first 12 years. Now, virtually all Americans can afford to fly.

Unfortunately this growth has not been without problem: the deregulation of airlines has posed grave problems to consumers and businesses alike. Airline profits have been largely inconsistent, and have generally declined since September 11, 2001. Aeronautical congestion, flight delays, and high demand for flights only compound the problem. Even more disturbing is many expect demand for flights to triple in the next 10 years, with passenger numbers increasing 60%.

Many and varied are the proposed solutions to this impending difficulty. Congress is attempting to lay the foundation for a solution with S 1300: the Aviation Investment and Modernization Act of 2007. More of a preparatory bill than anything else, this act includes provisions for passenger protection against surcharges and establishes bureaucratic structures for the implementation of future change. The groundwork has been laid; but it is merely foundation upon which a structure is to rest. It is then altogether clear that the airline industry needs not short term remedy, but long term reform. In order to actually reform the industry Congress must look further than the simple and straightforward. As a result all American taxpayers will reap the benefits of the creativity and ingenuity inherent to your Congress.



## EXPLANATION OF THE PROBLEM

### *History of the Problem*

#### *Civil Aeronautics Authority*

Established in 1938, this regulatory body governed the skies for forty years. It was split into two agencies, the Civil Aeronautics Board (CAB) and the Civil Aeronautics Administration (CAA) in 1940. The CAA was responsible for air traffic control (ATC) and safety enforcement, while the CAB was responsible for economic regulation of airlines and safety regulation. The difference in safety responsibilities means the CAA was responsible for enforcing the safety measures the CAB decided on.

The CAB, as the economic regulator of air travel, restricted the number of airline corporations to a maximum of 16, at any given time, and also implemented a point-to-point traffic control system. As with railroads, such a system was not centralized, but rather just took passengers directly from one point to another, no matter the size or geographic location of the airport. The CAB also set all fares and routes for the airlines, meaning that it became very hard for airline companies to adjust for consumer demand. For example, a low-cost airline (World Airways) applied for permission to start a Los Angeles-New York route; six years later, the application was rejected because it was “stale.” This bureaucratic complacency characterized much of the reign of the CAB, which is a large part of the reason the CAB was ultimately terminated in 1978.

#### *Federal Aviation Act of 1958 and the Federal Aviation Agency*

The Federal Aviation Act formed the Federal Aviation Agency (FAA) in 1958. This act replaced the CAA with the FAA, passing all safety regulation responsibilities from the CAB to the FAA as well. The FAA now had sole control of safety regulation and enforcement, including control of the ATC system. However, the CAB still controlled routes and fares. The role of the FAA has evolved extensively since 1958, especially with the creation of the Department of Transportation (DoT) in 1967. It should be noted that the FAA was renamed the Federal Aviation Administration at this time, though the acronym conveniently remained the same.

The FAA’s responsibilities grew to encompass civil aviation security with the beginning of hijackings in the 1960s (this role was shifted to the Homeland Security Department after 9/11), as well as environmental concerns and noise pollution. Following deregulation and the termination of the CAB in 1978, the FAA has become to primary regulating body for the airline industry.

#### *Airline Deregulation Act of 1978*



Following a reactionary trend against the price controls that were so prevalent in the 1970s, this act eliminated price controls on fares for domestic flight service in 1978 and ultimately terminated the CAB in 1985. By this time, many politicians and economists believed that one cause of the stagflation in the mid-1970s was the effect that price controls have on economic markets. By distorting the prices that work for a given market, price controls prevent the most efficient outcome from being reached. By removing price controls, Congress aimed to open the airline industry to competition, and thus improve service and prices for consumers.

The act was, however, opposed by the airline companies. Given their virtually guaranteed profits (the CAB was obligated to ensure the airlines a reasonable income), and the dangers of increased competition to those profits, the older, established airlines fought against industry deregulation. Once a large company has captured a large share of the market, it is always reluctant to let go of it; this is a perfect example of that.

Ultimately, however, the act provided positive results. Inflation-adjusted fares decreased 40% from 1978 to 2005, and the number of passengers increased dramatically. While nine major airlines and at least 100 smaller ones have gone bankrupt since 1978, this reflects more the intense competition in providing service to customers rather than instability in the system. It also reflects how inefficient many of the large companies were pre-regulation, in that they were not able to stay profitable without the government guaranteeing their profits.

To ensure that service to small communities remained, legislators also created the Essential Air Service (EAS) program to subsidize flights to small communities that would otherwise not be profitable to airline companies because of low numbers of customers. Currently, the EAS subsidized flights to one hundred and forty rural communities across the United States, with the most subsidized states including Montana, Kansas, Nebraska, and West Virginia.

This radical departure from previous policies also had the effect of ending the point-to-point system that was a trademark of the CAB's reign. With deregulation, airline companies (starting with Delta in Atlanta) found it more efficient to develop large "hub" airports, with smaller destinations serving as "spokes" in a "spoke-and-hub" system. Essentially, there are a handful of immense airports; such as Dallas-Fort Worth, Chicago O'Hare, Atlanta, and Los Angeles; that service the more regional airports around them. For someone in, for example, Sacramento, California, to fly to Albany, New York, would require a flight from Sacramento to Los Angeles, then one to New York City, then one to Albany. While this might seem inefficient at first glance, imagine how unprofitable it would be for an airline to maintain constant flights



between Sacramento and Albany; there simply are not enough customers to make it profitable. The spoke-and-hub system makes it possible for people to fly anywhere in the United States, often with numerous choices of what time and of which airline to fly. This flexibility has made it possible for airlines to more efficiently utilize their fleets, lowering costs, opening the airways to millions of new customers who can now afford air service.

### ***Recent Developments***

#### *Problems in the Industry*

After its post-9/11 slump, the airline industry seems to be back on relatively firm footing. In 2006, airlines netted a profit of over \$3 billion, though it should be noted that this is a relatively low rate of return. The average US business gets returns of 5.4% to 6.7%, while the best returns ever achieved by the airline industry (in 1997-1999) were between 4.3% and 4.7%. The return in 2006 was about 1.9%, and in the years 2001-2005, the industry netted a \$35 billion *loss*, with a number of giant carriers filing bankruptcy.

One of the largest problems facing the industry is the antiquated traffic control system still used by the FAA. Under the current system, airliners must follow a network of ground-based signaling beacons called “vors,” establishing what could be equated with a large system of highways in the sky. Virtually all air traffic must travel on one of these established routes. However, there is a vast amount of sky out there, and the technology exists to allow pilots to “free fly,” or take whatever route is fastest and most fuel efficient. Some estimates state that fuel consumption (a major cost to airlines) would drop between 10% and 15% if the system was overhauled. Highly automated technology also exists that could dramatically reduce the need for air traffic controllers.

Another very significant issue that Congress monitors very closely is the matter of monopolies in the industry. The airline industry is very top-heavy, meaning a handful of corporations dominate a large share of the market. Given the recent financial troubles of many airlines and the nature of the industry, some of these giant carriers have looked into merging, with some even going so far as to begin the paperwork. Some critics claim that one merger by two major carriers would necessarily cause a couple of counterbalancing mergers, which would ultimately end with three megacarriers controlling about 75% of the flights.

### ***Focus of Debate***

As with many issues, this one cannot be clearly cut into a liberal versus conservative divide. Rather, many congressmen will vote for the policy that will be best for their state. For example, a congressman from Montana would never vote to reduce funds for the EAS, which subsi-



dizes eight airports in that state. However, there are some trends that will help you evaluate your own stance.

### *Conservative View*

As the party of smaller government, Republicans for the most part will be very strongly against government re-regulation and will be very much in favor of allowing the airline industry to work things out for itself, which it has given an indication of being able and willing to do. Conservatives would point to the dramatic reduction in fares and the increased competition between carriers as evidence of the success of deregulation, and point to the fears of the General Accounting Office (GAO) that a return to regulation would likely reverse those trends. Republicans would also point to the success of private companies operating in roles that are traditionally reserved for the government (toll road operations, prisons, etc.), and more specifically the privatization of ATC in countries such as Canada and New Zealand.

As for the merger aspect of the debate, conservatives would point out that many mergers of large corporations in the past have not hurt consumers. The oil industry is a great example, as it is an industry with high costs and low returns that requires massive investments to produce reasonable profit, much like the airline industry. The oil industry is dominated by about five major corporations, yet this has largely been to the benefit of the consumer. The principle of economies of scale means that the larger a corporation is, the lower the prices it can offer as costs are reduced. Using this principle, some economists believe that fewer, larger companies might actually offer superior service at a lower cost, as long as there are no restrictions on new airlines entering the market and antitrust legislation is enforced, especially since international airlines are free to operate within the United States. They would also point out that these airlines have only been able to maintain a large market share by offering lower prices and better service than competitors.

### *Liberal View*

Liberals tend to trust the government to regulate industries to the benefit of consumers, and the airline industry is no different. Despite the reduction in fares witnessed after 1978, liberals would argue that this does not necessarily mean that a government body could not have affected the same result. Rather, the failures of the CAB could be remedied in a future body, instead of completely disposing of the idea.

In addition, future mergers made possible by deregulation threaten to reduce competition in the industry, which would raise fares and decrease incentives for airlines to become more efficient as consumers would have less choice in carriers. Liberals feel that further (or at



least continued) deregulation could bring about the control of the market by about three megacarriers, which they strongly feel would be harmful to the consumer. Evidence of this could be drawn from the practice of reducing fares to squeeze out competitors, then following with higher fares, which has been fairly common in the industry. Since 1978 over 100 small operators have declared bankruptcy, evidence of the cutthroat nature of the large carriers.

### *Presidential View*

At present, President Bush is most concerned with the flight delays and “the overcrowded airspaces.” The Bush Administration thinks it ideal if the airlines themselves would voluntarily cut down the number of flights they have flying at the most crowded times in the most crowded airports but also proclaims that it will implement rules if need be. Some possible solutions that the Bush Administration has considered are capping the number of flights during the busiest times of the day and suggesting that airports charge the airlines more expensive rates to fly out at these times. Also, President Bush focuses on passenger treatment. There has been talk in Congress about “passenger rights” legislation, stipulating that airlines must provide passengers more information about delayed flights and compensate them for any inconveniences, for example.

## **INTEREST GROUP PERSPECTIVES**

### ***The Cato Institute***

The Cato Institute, a libertarian think tank, remains strongly in favor of deregulation. It acknowledges all current problems: congestion, delays, no service to small cities, etc., but claims that the solution is not more government, but less. It sees further deregulation as the best solution. In a recent policy paper, the institute writes:

“Airline deregulation has been an enormous policy success. It has made air travel routinely affordable to the vast majority of Americans. It has created many thousands of additional jobs in a continually expanding industry. These gains are threatened by well-meaning but ill-conceived attempts to improve airline competition by new controls on which airlines can fly when and where. What is needed, instead, is to finish the job of deregulation, removing the remaining nonmarket elements of the air travel system to permit competition



to work even more effectively in the 21st century.”

### ***The Sierra Club***

The Sierra Club would support measures that would lead to reduced fuel usage. This would include implementation of technology that allows pilots to free fly, which would save significantly on fuel. Conversely, the amount of additional air traffic that would be accommodated using the new system would likely more than overcome the expected 10% to 15% reduction in fuel usage from free flight. While the Sierra Club recognizes the importance of air travel to our nations economy, it would like to see a reduction in the use of small private jets (which are extremely fuel-inefficient), and opening up our nation’s skies would certainly do the opposite.

## **POSSIBLE SOLUTIONS**

There are a range of solutions available to policymakers which deal with the problems in the airline industry, and the solutions listed below should be viewed more as frameworks within which more specific policies can be created rather than policies themselves. A successful program will likely adapt the suggestions made below and find some kind of middle ground. An essential question must be answered by policymakers: Who do you trust more to provide the best solution, the government or the airline industry?

### ***S 1300: The Aviation Investment and Modernization Act of 2007***

This bill, sponsored Senator Rockefeller (D-WV) and Senator Lott (R-MS), aims to jumpstart the modernization program for the FAA. The FAA estimates that between \$15 and \$22 billion will be needed to fully modernize; this bill authorizes \$1.5 billion for modernization over four years. In addition, the bill implements a \$25 “user fee” on aircraft that use the ATC system (with a large number of exceptions); this will generate about \$400 million a year, with about \$370 million of that coming from commercial airlines, and all of those funds would be tagged for investment in modernization. It also works to ensure that smaller airports continue to benefit from the EAS program (it actually increases funds by \$6 million) and that they are not left out of the future expansion of the industry.

### ***Private Control of the ATC System***

Another possible solution would be to commercialize the ATC system, a measure that has been implemented in different forms in various countries, like Canada, and in some limited forms in the United States. For example, Nav Canada was established in 1996 as a



private non-profit corporation to handle all of Canada's ATC needs. Nav Canada has dramatically reduced costs while improving both safety and congestion at Canada's airport. Some believe that a similar system would work in the United States. In fact, a number of smaller control towers are contracted to private companies; not only have these towers cut costs by about 50%, but they've also maintained safety records as good or better than federally-run towers.

Privatization has worked well in a number of sectors, including the prison system. However, there are also examples of companies banding together to find a private solution, as would be necessary for a privatized ATC system. For example, the Green Dot program in Germany was created when the government mandated that all companies were responsible for having all of their packaging recycled. The project was huge; can you imagine how difficult it would be for Coca-Cola to find, recover, and dispose of all of its bottles? However, the disparate industries came together and founded a corporation named Green Dot, and by agreeing to pay certain amounts for volume to Green Dot, they had found a solution to their problem. This led to not only an effective solution, but Green Dot actually turns a profit and has developed incredible new technologies for recycling. The incentives for private corporations to reduce costs and become more efficient are much greater than it is for bureaucratic agencies.

ATC might work in a similar way. If all the airlines came together in mutual interest and formed a private corporation to perform ATC duties, it is quite possible that this would be an efficient way to deal with this problem, as the airlines have an interest in increasing the amount of passengers that can be carried by decreasing congestion, cutting costs (which equals lower fares), and in maintaining the highest possible safety standards. The government could also form such a corporation, and give it wide latitude in its actions to avoid bureaucratic complacency.

### ***Reregulation***

Dramatically different from the previous solution, it is a solution that is gathering some bipartisan support in Congress. For example, Senator Stevens (R-AK) said, "I hear this from very conservative people in my state, they're asking for re-regulation of the airlines because of lack of service." Even though re-regulation would primarily be supported by Democrats, even some Republicans (especially though from states with rural airports) might be in favor of some form of re-regulation if the industry continues to consolidate and congestion continues to get out of control. Proponents of this strategy point out that small communities have not benefited nearly as much as the larger hub airports, and that a return to the older system would leave air traffic less vulnerable to weather conditions or security holdups as it is in the current spoke-and-hub system.



Essentially, government oversight would give Congress the ability to closely monitor the amount of service that the airliners are offering to consumers, as well as ensure that large carriers do not squeeze out smaller, low-cost airlines. There have been examples of large carriers temporarily lowering fares below cost, temporarily incurring losses, to squeeze out a competitor, and then raising their rates back to normal or even higher rates. Government regulation would make practices like this much more difficult, and would ensure that small communities would receive adequate service.

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## **QUESTIONS A BILL SHOULD ADDRESS**

There is a wide spectrum of perspectives on this issue, and so it is difficult to say which side's opinions will play out with the optimal outcome. The main question here is whether the government should take control of and regulate the airline industry. Would it be more profitable and economically efficient to privatize the industry? Many liberals argue that from an economic standpoint, this option will cause the greatest benefit in the end. If the government were to regulate airlines, how should they do it? Should the consumers be wary of potential mergers and what will that do to ticket prices? How will regulation or lack thereof, affect flight delays? Another important to address is the issue of funding. How will the United States governmental budget be affected if the government were to take the airline industry under its wing? As you can see, congressmen, there are a great number of questions for you to consider. Decisions such as this one will affect you, as well as the rest of the United States' citizens, in your daily lives, on your next trip home.

## **SUMMARY AND CONCLUSION**

It is nearly impossible to deny that the airline industry is facing a crisis. But recognizing the problem is the easy part. How to act, Congress must decide. As members of the United States Congress, your duty is clear and critical: you must prioritize the problems facing the airline industry and develop a solution that you feel not only ensures the American consumer a fair deal, but also ensures profits for large airline companies. With powerful lobbying groups in the fray, numerous will be the competing interests. But the challenge as a United States Congressman or Congresswoman is to decide which interest—or which creative combination of ideas—would be best for your State, and your Nation. That challenge is now yours while the citizens of America wait for action.



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## GLOSSARY

- ATC* – air traffic control  
*CAA* – Civil Aeronautics Administration  
*CAB* – Civil Aeronautics Board  
*DoT* – Department of Transportation  
*EAS* – Essential Air Service  
*FAA* – Federal Aviation Agency  
*GAO* – General Accounting Office

