HOOVER INSTITUTION

HOOVER DIGEST
1999 No. 2

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Flying Friendlier Skies

In an earlier life, John E. Robson helped to deregulate the American airline industry. The industry has flourished ever since. Yet the industry's very success has prompted calls for reregulation, to Robson's considerable chagrin. How deregulation worked—and why reregulation wouldn't.

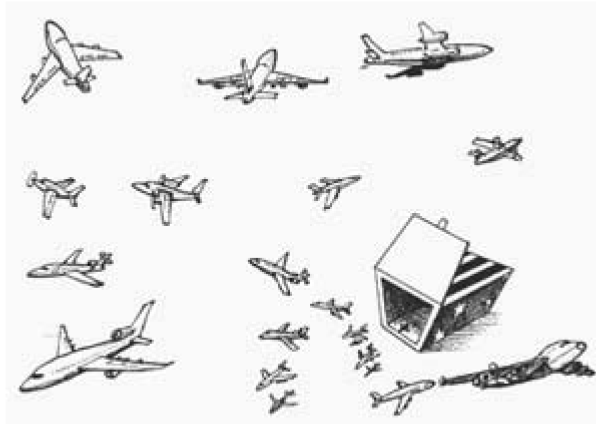

Illustration by Ismael Roldan

On October 24, 1978—a red-letter day for the hundreds of millions of people who fly in the United States each year—President Jimmy Carter signed the Airline Deregulation Act. The act, which began as an initiative in the Ford administration, jettisoned a system that 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 airlines provide more service, to more people, to more cities, at lower prices than ever before.

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

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 protect the public and maintain order in the rapidly growing field of commercial aviation, the CAB was 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, protected from competition at the expense of consumers and competitors. The CAB held 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 often predictably scripted in their outcome. More often than not, requests to establish new routes were denied or approved with restrictions. Further, the process was expensive and time consuming; it took the CAB eight years to give Continental Airlines permission to fly between San Diego and Denver.

That bureaucratic process was more subject to internal regulatory politics than to market forces. A carrier’s per-mile cost is much higher for short trips than for long trips, but the CAB set short-haul fares artificially low so as to be competitive with other modes of transportation such as trains and automobiles. The cost of that subsidy was passed along to long-distance travelers, who paid fares that were artificially high. Moreover, there was no price competition, making air travel an unaffordable luxury for most Americans.

In one notorious case before deregulation, it took regulators eight years to allow Continental Airlines to fly between San Diego and Denver.

Over time, the tangled and cumbersome regulatory process began to seem inappropriate for the type of economic decisions the CAB was making. The CAB worked to preserve the belief that the regulatory process was scientific, nonpolitical, and judicial in character, resting on the CAB’s mystique of expertise and specialized knowledge. But many decisions in fact were arbitrary. The staff would often struggle to present a plausible rationale for some position the board had reached for reasons—including precedent or politics—that had nothing to do with economic or regulatory theory.

Regulators and airline executives spent time and energy on hundreds of penny-ante issues, such as whether the CAB would allow the employees of two affiliated airlines to wear similar uniforms, leaving

little time for reflection by the regulators or the airlines about the basic merits of regulation. Shielded from competition, airline executives spent their energy and resources mastering the regulatory process rather than the marketplace.

Civil aviation in the United States grew in spite of the CAB, especially after World War II, because, as the country grew more affluent, demands for travel services grew as well. Further, improved technology made air travel faster, safer, and more efficient.

By the time President Gerald Ford appointed me CAB chairman in 1975, the CAB was the sole determiner of airline costs allowable for calculating fare levels and, therefore, fare levels themselves. And it seemed to me that if CAB cost controls were to continue to grow stricter and tighter to keep fares down, the airlines would become full-fledged public utilities. The alternative was to look to market forces to become the regulator of commercial aviation.

In April 1976 the CAB unanimously announced its support for deregulation, becoming the first regulatory agency to acknowledge the fundamental deficiencies of the system it administered, thereby triggering its own abolition. The CAB's embrace of deregulation made a politically powerful statement. In a 180-degree turnaround, policymakers and Congress came to agree that the airlines could serve consumers better if the intrusive regulatory structure were replaced by market forces.

EVALUATING DEREGULATION

Two decades ago, supporters of the status quo predicted that deregulation would result in higher airfares, poorer service, and lower safety standards. Supporters of deregulation understood 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 the following critical measures, deregulation has been a success.

Lower fares. Measured in a variety of ways, airfares have consistently fallen. Economists calculate that fares are lower today than they would have been if the industry had stayed under government control by significant percentages. For example, 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 airfares, adjusted for inflation, were 40 percent

lower than before deregulation. Morrison and Brookings Institution economist Clifford Winston have pegged the annual savings to air travelers at $12.4 billion.

More passengers and service. Airline tickets are now an economical, competitive value within reach of most American pocketbooks, as indicated by the increased number of air travelers. In 1978, 275 million people flew on domestic carriers. In 1997, that number had more than doubled, to 600 million passengers. According to Federal Aviation Administration estimates, 740 million people will fly domestic airlines in 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 found that departures in 1995, compared with 1978, were up by 50 percent for small airports, 57 percent for midsized ones, and 68 percent for large ones.

More competition and jobs. Despite a number of mergers and some highly publicized bankruptcies, competition is keener. According to Morrison's Senate testimony, the average number of carriers per route has jumped 30 percent since 1977. More than twenty new airlines have been launched in the last six years, and, in 1997, airlines established after deregulation held an 18 percent share of the market. In 1979, fewer than 30 percent of the nation's airline passengers lived in markets served by three or more competitors; in 1996, that number 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 has also 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—primarily small, economical turboprop planes—has brought greater frequency of service to many of those markets. Since 1978, the number of flights to smaller communities has gone 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.

THE **HUB**-AND-**SPOKE** NETWORK

The industry's success over the past twenty years is partly the result of the 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 compete for customers on the basis of low-cost, convenient, and attractive service. Their answer was a network of spokes feeding flights into and out of **hub** airports such as New York, Saint Louis, Minneapolis, Chicago, and Atlanta. Under that system, planes carry passengers bound not only for **hub** cities but for the hundreds of other destinations reachable from the **hub**, multiplying the services that airlines 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 pairs of cities. 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 cities (twenty-five cities times twenty-five cities, plus direct flights from fifty cities to the **hub**).

EBB AND FLOW OF ENTRANTS

The history of deregulation has seen the fortunes of both established and new carriers alike ebb and flow. In the days immediately after deregulation, the newcomers—the "can't miss" wave of the future—were leaner, smarter, and more innovative (for example, **People Express**) than their older rivals. By 1985, new carriers had already jumped to a 17 percent market share. But some of these new, smaller entrants left the market, including Air Florida (opened in 1979, closed in 1983), New York Air (opened in 1980, merged in 1986), and **People Express** (opened in 1981, merged in 1986). Was the battle over? Not by a long shot. A second wave of new entrants, including Air South, Frontier, Kiwi, and Valujet, by 1996 had rebuilt its share of the market to 18 percent.

United Airlines chairman and CEO Gerald Greenwald likened new airlines to newborn sea turtles trying to make their way to the sea: Some will make it and some will not. New entrants fail 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.

Some of the industry's oldest and proudest names were also unable to survive. Both Eastern Airlines and Braniff closed in 1989, and Pan American shut down in 1990. But other established airlines took difficult steps that enabled them to regain much of their lost market share.

THE PRICE OF SUCCESS

Airline pricing is a complex and dynamic process based on the ever-changing supply and demand for seats. Commented retired American Airlines chairman Robert Crandall, "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." Absent rubber planes, the airlines offer a variety of fares on the same flight, balancing a fixed supply of seats with the demand different passengers put on those seats, meaning that the vacationer in 10A probably paid less than the business traveler in 10B.

The airline rewards the vacation flier with a discounted fare in exchange for 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. In 1997, the average flight was 70 percent full, a post–World War II high.

But the airlines also keep a supply of seats available for a highly valued group of travelers that tends to make plans at the last minute—the business fliers, who pay for the flexibility to make and change plans right up until flight time. The higher dollar value on those seats partly reflects the airlines' gamble in holding them open for as long as possible. If the seat is still empty at takeoff, the airlines lose. When the economy is strong, as it is today, however, the demand for those business seats skyrockets, sending their price up. If there were rubber airplanes today, the carriers would 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 ensure that all seats on certain flights will be full by offering cut-rate, last-minute fares on-line to travelers with flexible schedules. For example, every Tuesday TWA lists on its web site bargain round-trip rates on specific flights, usually leaving on the upcoming Saturday and returning on the next Monday or Tuesday. U.S. travelers thus might take a long weekend in Milan, Italy, or Lisbon, Portugal, for only a few hundred dollars.

Prices and services are also helped by growing competition in metropolitan regions between carriers at different airports. For example, **Southwest** Airlines, which does not want to compete with major airlines flying out of Chicago's **hub**, O'Hare Airport, 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: 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 hours' drive of one another. That is how a highly dynamic, competitive, and notoriously cyclic marketplace is supposed to work.

GOVERNMENT MISCHIEF

During the past twenty years, the aviation free market reflected advances in technology, changing customer demand, and the cyclic nature of the United States and global economies. Unwarranted action by the Department of Transportation (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 experienced management, smart business plans, adequate capital, or a strong economy.

Yet the list of legislative proposals keeps growing. One Senate bill, for example, would create a new government subsidy program to help finance jet service to small and medium-sized communities. A House bill 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.

CONSTRUCTIVE APPROACHES

One solution to the congestion and new-entrant problems would be to improve the aviation infrastructure and thereby increase capacity and expand competitive opportunity. David Z. Plavin, president of the Airports Council International, arguing that additional funds should be spent on airports, 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 showing that 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 1998, "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 a complete modernization of our outdated and overworked air traffic control system, whose glaring inadequacies are largely to blame for traffic limits at some airports as well as the 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. If Congress wants to have a positive impact on airline competition, it should demand, fund, and oversee 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. Upgrading or commercializing or both will do more to boost competition and lower fares than DOT guidelines or regulatory legislation.

But, above all, DOT and Congress should resist the urge to craft their version of a "perfect" marketplace. No market provides, at all times, every consumer or interest group with exactly what it wants for the price it wants to pay. Ups and downs, economic cycles, and companies afraid to face legitimate competition will always be with us. But the one clear lesson we learned from airline regulation is that no regulatory body, no matter how smart, hardworking, 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 the airlines and their passengers. Twenty years after it was first

implemented, airline deregulation remains a public policy success story, a bold experiment that has more than fulfilled its promises to consumers and the airline industry.

Excerpted from "Airline Deregulation: Twenty Years of Success and Counting," in *Regulation*, Spring 1998.

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