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CHANGES IN AIR TRANSPORT POLICY:  
THE PROBLEM OF REGULATING A MARKET IN TRANSITION

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## CHANGES IN AIR TRANSPORT POLICY:

### THE PROBLEM OF REGULATING A MARKET IN TRANSITION

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1.1 Air transport presumably is considered an important activity by governments. They devote considerable effort to its development and regulation. They spend considerable sums of public money in investments and even subsidies. Many governments declare that the growth of air transport is one of their policy objectives and even if they do not, air transport cannot help growing.

The result of all this is not only that growth is a decisive characteristic of air transport but also that this growth is bringing about important changes in the economic characteristics of this industry. At the risk of stressing the obvious let me very briefly sum up the most striking developments:

- Air transport is no longer a luxury article enjoyed by the happy few or top managers, it has become, in several parts of the world, a household good. If anyone still doubts this, let him look at the average income of the leisure traveller, for instance in my country, the Netherlands, where this development was relatively slow to take place. In 1980 this was Dfl. 24.800, just below the so-called modal income.
- Postwar development of civil air transport started in a few markets only, the United States domestic market of course being the foremost example. Nowadays it is a worldwide phenomenon. The most striking sign of this is, I believe, the ICAO list of states whose airlines performed more than 100 million tonne-kilometers. In 1979 three developing countries were among the first 15 and 6 among the first 20. There was a total of 45 developing countries on the list against 15 in 1970.
- Growth in air transport has had as its normal corollary an increasing differentiation of the product, varying with geographical differences but especially with market segments: long haul, short haul, business, leisure and commuter types of activity.

1.2 It is interesting to note the reaction of governments to this development which presumably was at least in principle in conformity with the growth objective of their policies. In the past this reaction has almost invariably been characterized by reluctant acceptance or on the contrary systematic defense of the status quo or at best some spasmodic flings at partial liberalization. I will quote a few examples.

When diversification of demand produced strong potential growth in the low-price market segment governments adopted a kind of charter regime which was intended to contain its development but which produced the opposite result.

Partly through the flexibility of that regime as opposed to the regulations for scheduled services and partly through a high degree of non-enforcement of the rules a de facto liberalization took place which led to a rather artificial division of the market between scheduled and non-scheduled operations. At one time some 25% of the North Atlantic market was operated under this regime. Within Europe today non-scheduled operations count for something in the same order. This may look like a success, if only it was what governments intended. It was not, it just happened.

Other liberalizing developments sometimes took place with governments actually opposing them: one has only to recall how Sir Freddie Laker got his first operating permit for the North Atlantic through court action.

On the other end of the scale one sees an ever-tightening web of restrictions on scheduled services, realized through the classic instrument of the bilateral air agreement. The most striking sign of this development is the enthusiasm with which many states embrace the so-called pre-determination type of system which subjects any change in the supply side of the market, whether routes, capacity or tariffs, to prior agreement between the two governments concerned. Another sure symptom of increasing restrictiveness is the virtual disappearance of so-called fifth freedom traffic, traffic carried between two points neither of which is situated in the airline's home state.

1.3 Looking at the overall picture resulting from this brief sketch one is at a loss to explain the rationale of most governments' policies. One is inclined to ask: is there a rationale? Surely the combination of professed interest in growth, fundamental changes in the market, increasing restrictions and virtual, if non-intentional liberalization in some sectors looks like an odd mixture.

I believe it is justified to conclude that most governments' policies are a bit of a muddle. They got stuck with objectives and instruments which were developed in entirely different circumstances and nobody offered a new set when they were needed. In many cases adaptation to change has come about in an indirect way, because market forces proved stronger than regulations and it looks if many governments are silently happy with that state of affairs because it saves them a lot of trouble.

Part of the explanation could be that there is so little sign of intellectual effort concerning the development of air transport policies around the world. While in many other sectors of economic life at a national as well as at an international level there has been a constant production of stimulating ideas about the organization of the world's economy and about government policy in this respect, very little of the kind is to be found in aviation. Apart from a number of American studies, several British White Papers and an occasional IATA report there is to my knowledge practically nothing. There just does not seem to be any demand for it.

This leads me to the conclusion, that although the air transport market is developing rapidly, the regulatory situation is on the contrary characterized by an extreme rigidity. This discrepancy causes either the maintaining of outdated structures which are not any longer adapted to the market or explosive developments with unpredictable effects.

2.1 Now of course, the question should be put whether all this matters so much. If governments and peoples feel that they can live with this situation, why make such fuss? The answer to this question is, I believe, twofold.

Firstly, the inadequacies of the existing system present great risks for international air transport. If we can agree that one of the main objectives of present day air transport policies should be to stimulate the greatest possible efficiency of the air transport system, the prevailing regulatory situation lacks any guarantee that it actually contributes to that end. On

the contrary its practice provides disturbing evidence that it may well do the opposite. This should be a ground for great concern as rising costs and increasing tasks make the efficiency objective one of the most important. At other occasions I have pointed out the striking discrepancy between the considerable efforts which government put into attaining efficiency in all other parts of the air transport system, such as airports, aircraft and air traffic control, and the apparent lack of interest for the economic part of the system.

Secondly, I do believe that one can find a growing disenchantment with the present system. It no longer provides the answers many governments are looking for. Some of them are involved in laborious discussions with their parliaments and public opinion in general in which they try to justify the existing levels of tariffs and the differences with levels in other parts of the world. Others have the greatest difficulty in keeping out new companies which pretend that they can operate at lower costs. Governments in the developing regions of the world are bitterly and, I believe, justly complaining of the low level of services to and from their countries, but the workings of the ancient bilateral system prohibit the fullest possible exploration of the market by their airlines which should be able to combine to the maximum smaller trickles of traffic into viable services. At the same time many governments have increasing problems in coping with the heavy demand which numerous bilateral negotiations are making on their available manpower and talent.

These considerations justify in my view an effort to re-think some parts of the system.

2.2 In fact that is what some authorities are already doing, witness a number of developments of the last few years. I will name some of them.

- Some countries have made fundamental changes in their national policies. Of course the United States provides the foremost example, but I wonder how many people realize how profound that change was. Other examples are the United Kingdom, but also Chile and Jordan.
- In Europe, the European Commission, the executive body of the European Communities, a few years ago produced a Memorandum in which it set out a number of objectives for a common policy and since then it has presented a proposal on regional air transport and is studying other ones.
- In a wider European circle the European Civil Aviation Conference (ECAC) is preparing a report on innovations in air policy.

All these developments have one thing in common: they all concern the role of competition in the air transport market and they all envisage to increase that role under more or less strict conditions. In this direction obviously lies the problem with the existing system; it provides no valid answer as soon as the state of the market obliges governments to come to grips with the problem of providing stimuli for new developments.

There is something commonplace and at the same time strikingly new about these developments; commonplace because those questions have been studied long ago for other economic activities and they have found their answers, and strikingly new because in the world of aviation until now very few people cared to look into them and even today many people still seem to consider it a dangerous sort of sacrilege.

2.3 Before I risk a foray into the almost forbidden land of speculation about the world's aviation policies I believe that we should get some of the fundamentals straight. Firstly we are used to regard the world's air political system as a uniform one. The fact that such a system has been in existence for many years combined with the fact that in many other respects aviation's regulations through ICAO's admirable record is indeed a worldwide affair tends to make us blind for any diversity which may have developed behind that facade. A striking illustration of this situation is to be found in the two Air Transport Conferences which ICAO has organized in 1977 and 1980 and during which an almost religious fervour was at times displayed aimed at keeping the doctrine pure rather than at discerning economic realities.

While we are thus paying a price for air transport's historical development we should not shrink from facing facts: policy measures and regulations should be geared to actual needs. Conformity and harmony are not one and the same thing.

Secondly we must recognize that although aviation has a highly developed system for developing its technical regulations providing all the necessary institutions and procedures, its institutional equipment and mechanisms for dealing with economic matters are not nearly as developed. If they are needed, we shall have to invent them.

3.1 Having thus braced ourselves for a delicate job we should address ourselves in the first place to the question as to what kind of regulatory regime would best be suited to a particular government's set of interests. I suggest that we try to look into this problem as concretely as possible. The best way I can imagine is to consider two cases, one of an industrialized country confronted with new needs and wanting to introduce the necessary innovations in its policies, and the other of a developing country long dissatisfied with the results of traditional policy and looking for new suggestions.

Let us assume the role of a consultant called in by the governments concerned and try to provide some reasonable advice.

3.2 Case I concerns a highly industrialized country experiencing the usual problems of a society in the post-industrial stage. It is forced to adapt its economic structure to changing economic relationships in the world. Some of its older established industries like those manufacturing steel-based products and textiles are experiencing strong competition from new industries in developing countries and the country in question instead of resorting to protectionist measures is trying to re-orientate its economic activities. It strives after a higher degree of specialization and sophistication. It finds that such development leads inevitably to increased external exchanges: imports and exports, but also travel. It already has a highly mobile population from which there comes an ever increasing demand for new holiday destinations.

Presumably the country in question has at least one international airline, in all probability a stalwart IATA supporter, possessing all the qualities and suffering from all the problems of its sisters: high costs, low yield, eternal haggling about landing rights, complaints about competitors' shares, etcetera.

It also virtually has abandoned non-scheduled operations in the past and is now looking at possibilities of getting back a share in the leisure market.

Our hypothetical government was constantly confronted with the same problems. Occasionally it has to support its airline with some form of subsidy which promptly got it into difficulties with the smaller non-scheduled operators who did not get the same benefits but who did reasonably well anyhow under a largely fictitious set of charter rules.

As a result our government has started wondering whether this state of affairs is really the only possible one. The contrast of its air transport policy with its trade policies becomes a bit too glaring: the latter are directed at slackening quantitative and qualitative restrictions imposed upon international trade, while the former follow the pattern of restrictive bilateral agreements.

3.3 If we are called in to advise that government, our first question should indeed be: do you need all those restrictions?

Are they designed to attain a definite policy objective and if so are they so devised as to present the best possibilities for realizing this? Do you have to support your airline by legal and political means to obtain a fifty percent share in all bilateral relationships? Is it indispensable to forbid a foreign airline to use a bigger or more modern aircraft? Should you really forbid somebody to fly to that provincial capital as long as your own company does not think fit to do it? And if it does take up the operations under some pressure, should you pay the subsidy it immediately claims, while the newcomer at least pretends it can do without?

My suggestion is that our government will find it extremely difficult to answer these questions affirmatively. It will have a paper before it showing that their national airline will go broke if all protective measures are abolished, but that paper suffers from two obvious defects: it resembles closely any paper invariably submitted by an industry which is confronted with the impending abolition of some measure of protection and secondly it studiously avoids tackling the question whether perhaps a slight opening up of the market might also produce some beneficial results, like a more economical approach to internal efficiency and wage increases, or a more imaginative marketing policy.

And here we seem to be at the heart of the government's discontent: it wants its airline to adapt more quickly, more effectively and more successfully to the changing demands put to it and as a consequence it is looking for powerful stimuli to obtain that result.

The consultant in this case may well decide that the government in question is ready to take rather drastic steps, such as abandoning in practice the use of the protective machinery provided for in its bilateral agreements or in its national legislation. However it requires more than one government to keep the ball rolling. Therefore if our government really is intent on innovating the conditions under which its international air transport is operating, it will have to look for partners.

A second problem is that the airline in question may not be ideally adapted to face a more competitive situation. The abolition of the protective measures which it probably had come to like and to which its commercial policy was geared may come to it as a shock. Moreover one does not know what reactions other airlines and other governments will have. Will they try to retaliate by making life difficult for the carrier or its government? Complete disarmament is therefore only possible when these questions have been cleared up.

3.4 Let us assume that a real experiment gets started. A number of other countries are ready to participate and progressively they are adopting a more liberal regime in their mutual relationships. Maybe that is the end of the story and they all live happily thereafter. Maybe however problems arise, problems of transition for instance or an economic recession hitting the airlines badly. Governments then will be called upon by their parliaments to limit the damage and if they act unilaterally that could be the end of the experiment.

In my opinion it can be safely held that for innovations in the present international regime to be durable, governments will have to establish a set of rules which on the one hand gives adequate mutual guarantees for the maintenance of the system and on the other provides for mechanisms in case of an emergency.

I am suggesting the following elements.

- Firstly, a liberalized system will work better if more countries are involved. It may not be sufficient to link up a number of bilateral agreements; very soon questions involving more than two countries will arise. I am referring for instance to questions concerning fifth freedom traffic. Consequently new instruments will have to be developed providing a multilateral framework.
- Secondly, before any farther reaching provisions are considered, governments could develop the use of joint consultations, not in this case to announce new restrictions, as is the rule now but to analyze developments, obtain information and make it available to all interested parties. Consultations of this kind would introduce a new element in international aviation mechanisms. Again, however, it should be observed that such kind of consultations have since long been quite common in other sectors especially where bilateral relationships were a characteristic feature.
- Governments undoubtedly will have to develop this instrument. One valuable improvement might consist of contributing expert advice to the fact-finding process. A standing expert committee which annually reviews the market and comments on airline plans could stimulate a constructive dialogue.
- It is to be expected that if an experiment is to take place at all, some governments will insist on retaining their powers of intervention regarding tariffs and capacity. Of course these should in principle not be used unilaterally as such action might decisively discourage the partners to continue the experiment. The potential risk of such action therefore creates an inherent instability in the system and if the latter is to endure it will be inevitable that common rules of a binding nature replace the possibility of unilateral intervention.

In this respect a choice must be made. Rules governing the action of authorities on the market may be limited to a simple prohibition of intervention unless a number of well-defined conditions are fulfilled. This would amount to the insertion of an escape-clause into the instrument regulating the experiment.

The application of such clause could also be made part of a more elaborate procedure including preliminary consultations, independent fact-finding and arbitration. Governments will have to make up their minds as to the degree of sophistication they would require.

Perhaps it is significant that existing agreements of a liberal type usually only contain a prohibition of predatory practices without defining them. Obviously the states concerned have felt that they could rely upon the normal consultation processes for any remedial action they may need. Until now it has not been proven that this is not sufficient. Nevertheless it may be expected that less adventurous governments will insist on the inclusion of stronger safeguards.

- If it proves possible to interest a sufficient number of governments (and I indicated already that this would change the opportunities for improving the efficiency of the system considerably), it becomes necessary to develop a multilateral framework for their co-operation. Such framework does not exist yet. I can only refer to the proposal which the Netherlands made some time ago to the United States concerning a draft for a so-called plurilateral agreement. For the sake of time I must resist the temptation to go into detail, but the proposal has recently been published.

Even if the framework is there the problem of some states insisting on more sophisticated escape-clauses, to which I already referred, will arise sooner in a multilateral context. I believe that in the end a well-developed procedure rather than instant use escape-clauses will provide the only way out. When a party claims to suffer from a special problem, it is reasonable to take that complaint seriously, but it is equally reasonable to have it examined before exceptions to the common system are allowed. Therefore, after the development of a general framework for a multilateral system, rules and procedures for precautionary or remedial action will have to be drafted.

- At some stage the question may arise whether common systems should be developed on a regional basis taking into account the state of development of a particular market. This may or may not be desirable; the establishment of artificial divisions should be avoided.
- At the end of the road there may lie common institutions responsible for overseeing the proper working of agreed mechanisms. The most likely environment for such evolution can probably be found in the European Communities, which already possess in principle an institutional framework and the necessary experience in other fields.

3.5 Much remains to be worked out if we continue to study the case of the industrialized state wishing to streamline its air transport policies in order to stimulate efficiency. One thing, however, is certain and that is that the present bilateral system, as it has developed after World War II, is rapidly becoming out-dated for this purpose. Neither the way in which it is applied today, nor its very limited possibilities of taking into account the need for a wider look at the operation of the system make it an acceptable solution for the future. In fact nowadays it has become the ideal instrument for restriction and protection, more than for development and improvement of efficiency.



4.1 It is time to turn to our second example, the case of a developing country possessing an international airline but growing dissatisfied with the level of services it is getting. This is a country which fully subscribes to the conclusions of the ICAO Secretariat, such as are to be found in, for instance, its report on International Air Transport in Africa 1979. In this report it is said that "air transport is called on to play a special role in the development process" and that air transport "has become the primary form of international passenger transport in the region".

At the same time the country in question is concerned about other findings which I quote from the report on Africa, but could be illustrated with other examples as well. For instance, only 20% of the more than 2,500 possible intra-regional country-pair links were provided with through-plane service (p. 35). The recent yields on intra-regional routes were much higher than the world average and they had increased considerably faster than in the world as a whole (p. 67), but still for scheduled passenger transport within the region the financial situation was not satisfactory (p. 69).

Small wonder therefore that our government feels that something should be done. It participates actively in discussions at a regional level about an improvement of the situation but it gets restless at the lack of concrete results. A recommendation like the one adopted by African Civil Aviation Commission in 1977 encouraging member states to promote the mutual exchange of fifth freedom traffic rights among themselves (Recommendation S 5-18) leaves our government with a number of unanswered questions. If presumably such recommendation means that fifth freedom rights are important for the development of the network, why should a condition of exchange be imposed which obviously limits severely its possibilities of implementation?

Consequently our government is shopping around for a fresh approach. It has noted with some jealousy the impressive records of airlines in some other developing countries and it is seeking outside advice.

4.2 If again we assume for a moment our fictitious consultant's role we must prepare ourselves for a different approach: very little preparatory studies are available on the most appropriate system of regulating the air transport market in developing countries. The importance of air transport for those countries is generally recognized, as we have seen, but as far as the regime is concerned nothing more original than the classic bilateral system is available.

At least one basic fact should be kept in mind. There is general recognition that in a developing economy with its infant industries temporary protective measures may be justified. Of course there always is a risk that unprofitable activities may be continued which absorb too large a proportion of scarce productive resources which could better be used elsewhere. But in principle changing the regime in a developing economy is different from the same maneuver in a highly industrialized environment.

We will therefore accept more easily a number of preliminary conditions such as a minimum of commercial viability. This may involve important practical questions which we cannot discuss here, such as managerial standards, financing and even political burdens.

On the other hand it is at least as important that the government concerned is aware of the interaction between some of these conditions and a change of regulations.

Managerial standards may not improve, unless it is really necessary because of increasing competition. Increased cooperation between airlines and authorities may not come about, unless all parties concerned are forced to realize the negative effects of artificial limitations like prohibitions of fifth freedom traffic and the like.

Governments of developing countries face an acute dilemma, which is different from the problem elsewhere: the smaller the economic basis for the airline is, the greater is the importance of exploiting every single opportunity the market may offer, but at the same time the stronger the temptation of relying on protective and therefore restrictive measures is.

If this leads to a vicious circle, it should be broken and if we ask ourselves: how? the answer may come as a surprise. One hardly imagines any other method of introducing change than the one I described above for the case of an industrialized economy: abolishing protective regulations while at the same time providing adequate safeguards against major upheavals. Maybe in the case of developing economies the opening up of markets will be more gradual and some conditions will in the beginning be stricter, but fundamentally no other method is available.

4.3 In the case of developing economies as in the one of the industrialized countries one must come to the conclusion that the limitations and disadvantages of the existing bilateral system of regulating international air transport are becoming too great for the implementation of a policy directed at efficient expansion. The system offers little prospect for the improvements which most developing economies need even more than industrialized ones.

5. I must conclude my analysis of market regulation in international air transport. I expect some people to believe that I have been too severe and not sufficiently realistic. After all, they will say, air transport can show magnificent accomplishments and anyhow, who is prepared to change the existing regime?

To a certain extent I accept those criticisms. Of course, air transport has done a good job in the past and it would be foolish to deny that opposition to change is strong. But the starting point of my analysis was that nowadays governments are formulating new policy objectives and sooner or later they will want to examine whether the existing type of regulations for international air transport or the manner in which they are usually applied, are compatible with those objectives. As you have seen my definite conclusion is that they are not and I notice an increasing number of signs that this conclusion is shared by others. Of course, if we would go on repeating after each other that change is not possible, our critics may prove right at least for a long time to come. On the other hand, people like you who are devoting a great deal of intellectual effort to understanding the mechanisms at work, will increasingly want to establish the real merits of existing systems and possible alternatives. That is how change starts. I do not believe that such process can be halted.

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