Medwell Online
Pakistan Journal of Social Sciences 5 (4): 300-305, 2008
ISSN: 1683-8831
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The Privatization of the Airline Industry

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Abstract: Government control over the airline industry (runways, airports, security, routes) has been a moral and economic disaster since its very inception. This should occasion no surprise, at least since the fall of the Berlin Wall and the disintegration of the USSR due to socialism, for, even though government control over airlines occurs in the ostensibly free market US, it still constitutes socialism and if there is anything we have learned from these experiences it is that socialism simply does not work. Competition and private property rights maximize human welfare in every realm of human action they are allowed to operate and airlines are certainly no exception to this general rule.

Key words: Airline socialism, prices, incentives, competition

INTRODUCTION

The United States airline industry has been plagued with government involvement since the Civil Aeronautics Act of 1938 and continues to be infringed upon by governmental policy. The supposed goal of the government has been the maximization of consumer welfare, however its policies and regulations have been counterproductive. It is our intention to demonstrate that the United States government's actions, thus far, have failed to maximize both consumer and producer welfare and to provide a concrete understanding of why there should be no future involvement of the government in the airline industry. It is our hypothesis that the entire airline industry should be privatized, including the airports, runways, air trafficking rights and security, in order to maximize the welfare of both producers and consumers. This was true before the advent of 9/11 and the subsequent need for heightened security. The case for privatization is even stronger in the aftermath of that horrendous event.

HISTORY

It is important to understand the effects that government intervention has had on the airline industry. The first regulation passed by Congress regarding the airline industry was the Civil Aeronautics Act of 1938 (http://www.centennialofflight.gov/essay/Government_Role/FAA_History/POL8.htm) which gave the Civil Aeronautics Board (CAB) the rights to control route entry and exit of air carriers, regulate fares, award subsidies, control mergers and inter-carrier agreements (Goetz and Sutton, 1997). This law was intended to protect the U.S. airline industry from "destructive competition" but in reality it represented a Marxist view of centralized planning of the economy. Its effect was to eliminate any market mechanism to determine price for airline services which resulted in a highly inefficient industry. In 1978, Congress passed the Airline Deregulation Act (http://en.wikipedia.org/wiki/Airline_Deregulation_Act), which prevented CAB from controlling entry and exit, fares, subsidies and mergers (Goetz and Sutton, 1997).

One of the finest hours played by empirically oriented economists concerned airline price deregulation. The bureaucrats had denied that their regulations were responsible for the high cost of air travel. Fortunately, intra state air trips were not subject to their control and there were two states, California and Texas, big enough such that flights within them were of comparable distance to much interstate travel. Thanks to several comparisons of inter and intra state air travel, it was demonstrated that the latter-without benefit of bureaucratic control-was far cheaper (States Jaskow, 2005; Kahn, 1988; McKenzie, 1991; Morrison and Winston, 1989; TRB, 1991).

> However, I think that it is fair to say that if the only empirical evidence available had been the analyses by Douglas and Miller and others which were soon being used to simulate the effects of deregulation on prices and welfare, airline deregulation would have been a tough sell politically. Policymakers were more heavily influenced by the results from what was regarded as a natural experiment. In the early 1970s, prices and entry of interstate airlines were regulated by the CAB as described above.

> However, the states retained regulatory authority over intra-state airlines. Texas and California (large states from both geographic and population perspectives) had intra-state commercial airlines that were exempt from CAB regulation. These states had decided not to regulate intra-state airline prices or entry (aside from safety consideration). Thus, Texas and California were viewed as a "natural experiment" with deregulation.

> Policymakers were able to compare airfares between CAB regulated city-pairs and comparable fares in arguably unregulated intra-state routes in Texas and California.

And in the view of the CBO (1988):

> Academic critics began questioning the need for economic regulation of the airline industry in the 1960s. It was not until the mid-1970s, however, that the congress seriously considered changing the regulatory regime. A number of factors motivated a congressional inquiry. Most notably, for a number of years, fares in markets served by intrastate carriers in California and Texas had been significantly lower than in otherwise similar interstate markets. Only carriers providing interstate service were subject to CAB regulation.

AIRPORT OWNERSHIP AND CONTROL

The trend that occurred during the mid 80's was the adoption by the major airlines of hub-based networks. This occurs when an airline centralizes its operations out of one primary airport in order to increase flight frequency and fill more seats. The nature of a hub-based operation is to schedule many incoming flights arrivals at around the same time and then to schedule many departing flights after these arrivals. The result of this is that the runways and terminals of the airport are filled with the hub-airline's planes and thereby drive out competitor's entry (Borenstein, 1992). The hubs were thought to be anticompetitive because major carriers could use monopoly prices at domestic hubs in order to subsidize discounted fares in the more competitive markets, thus limiting entry and exit of competition (Goetz and Sutton, 1997). Mergers were thought to create barriers of entry because they gave major carriers a harmful competitive advantage over smaller firms.

But the strategies used to expand market shares are neither anticompetitive nor barriers to entry. The reason for loss of competition in the airport is not due to mergers and acquisitions of airlines but rather, given present pricing policies, the lack of capacity in publicly owned airports. If airports were privatized then the market would optimally determine the amount of terminals and runways necessary at any given location.

Some suggest that airports are natural monopolies and expansion is difficult because of the large externalities that airports create. In reality, these are examples of government collusion enticed by special interest groups to implement policies that disrupt the free hand of the market. The only way that a "natural" monopoly can occur is because of government intervention in the market. The problem lies in the government's failure to allow a price to be placed on scarce urban resources (DiLorenzo, 1996). Public airports lack the ability of the free market mechanism to set a price for utilization of terminals, runways and airspace.

The market is also inhibited from determining the expansion of airports. If there are spatial limitations such that only one firm could operate in a certain geographical region this still does not constitute a natural monopoly, because the firm must still compete with other travel suppliers. In the past, major carriers have entered into agreements with the government to prevent the expansion of facilities in majority-in-interest clauses (Borenstein, 1992). These agreements demonstrate the collusion that disrupts the free market mechanism and are the cause of the natural monopoly. The only way to achieve a free market price that reflects true opportunity costs and leads to optimal levels of 'duplication' is through free exchange in a genuinely free market, a sheer impossibility without private property and free markets (DiLorenzo, 1996). If the airports were privatized, there would be no monopoly and the market would tend to properly determine the number and size of airports.

EXTERNALITIES

Externalities are one of the so-called market failures (Cowen, 1988), which, presumably, call upon government to rectify shortcomings of free enterprise. These shortcomings, purportedly, come in two versions: positive and negative. In the first case, private entrepreneurs cannot capture all the spill over or third party gains their activities confer on others and subsequently, engage in them to an insufficient degree, calling for government subsidies to encourage them to do more; or, for direct state action in this regard. The paradigm case of this is education. It supposedly benefits not only students, directly, but everyone else, indirectly, by reducing crime, or promoting better political choices.

A moment's reflection will show the fallacy of this line of reasoning. First, much of these benefits are very subjective. One man's meat is another's poison. An awful lot of higher education consists of feminism, queer studies, black studies, socialism, Marxism, obscurantism, relativism, English literature and sociology. It is no accident that agitation for rent control, minimum wages and against sweat shops is most popular in places with high proportions of student voters: the People's Republics of Santa Monica, Ann Arbor, Manhattan and Cambridge. These bits of economic illiteracy attest to the mis-education taking place in modern universities. An inordinate amount of elementary education consists of brainwashing in similar directions (Anderson, 2006a, b; Provenzo, 2006; Rothbard, 1972; Vuk, 2006; Young and Block, 1999). The case for taxing education seems about as strong for the one about subsidizing it, contrary to the argument from positive externalities.

The second case, negative externalities, constitutes no market failure either. The paradigm example here is the factory that emits smoke onto the persons and property of its neighbors. But this is no market failure; it is a failure alright, but of government, not capitalists. To wit, it is the failure of the state, the self styled defender of private property rights, to apply the law against trespass to smoke particles (Rothbard, 1982).

How does all this play out with regard to airport expansion. So as long as the expansion and creation of the airport are not physically harming others or invading their personal property it should not be banned by law. However, often times the government intercedes in the placement of airports because of supposed externalities. From 1977-1990, domestic air travel increased by 120%. During this time, no new airports were built, while expansion of existing airports was greatly hampered by environmental concerns and local zoning and noise restrictions (Borenstein, 1992). These restrictions on expansion set by the government should be rescinded because they don't cause physical harm, nor invade private property. These limitations have prevented the free market mechanism from efficiently allocating scarce resources. Consequently, a shortage of runways, terminals and airports developed from these unwise governmental policies.

PEAK LOAD PRICING

Public airports operate inefficiently because they fail to implement peak-load pricing. This strategy flattens the demand for a good or service through differentiated pricing based off the amount of demand at certain times. The ideal is to charge higher prices at peak times and lower prices when demand is low. If the airports were privatized, an effective manager would apply peak-load pricing to its runway and terminal operations. If he did not, he would court bankruptcy. This would be entirely more effective than the flat rate that publicly owned airports now offer to airlines, because it would allow the market to allocate resources efficiently. It cannot be denied that some few public airports have implemented peak-load pricing by making take off and landing a transferable property right (Borenstein, 1992). However, it didn't really eliminate the congestion of airports because of limitations on airport expansion. In a privatized airport, the firm would be able to respond to the incentive of expanding the airport if congestion still occurred with peak-load pricing.

Any ski resort that failed to charge more for winter occupancy than summer, any restaurant that priced lunch higher than dinner, would soon be consigned to the dust heap of economics through competitive pressures. Only government can keep operating at the same old lemonade stand year after year without availing itself of peak load pricing. Here are the views of Rothbard (1995) on this matter:

> … (in) 1984, … it came to light that the public was suffering under a 73% increase in the number of delayed flights compared to the previous year. To the Federal Aviation Agency (FAA) and other agencies of government, the villain of the piece was clear. Its own imposed quotas on the number of flights at the nation's airports had been lifted at the beginning of the year and in response to this deregulation, the short-sighted airlines, each pursuing its own profits, over-scheduled their flights in the highly remunerative peak hours of the day. The congestion and delays occurred at these hours, largely at the biggest and most used airports. The FAA soon made it clear that it was prepared to impose detailed, minute-by-minute maximum limits on takeoffs and landings at each airport and threatened to do so if the airlines themselves did not come up with an acceptable plan. Under this bludgeoning, the airlines came up with a 'voluntary' plan that was duly approved at the end of October, a plan that imposed maximum quotas of flights at the peak hours. Government-business cooperation had supposedly triumphed once more.

The real saga, however, is considerably less cheering. From the beginning of the airline industry until 1978, the Civil Aeronautics Board (CAB) imposed a coerced cartelization on the industry, parcelling (sic) out routes to favored airlines and severely limiting competition and keeping fares far above the free-market price. Largely due to the efforts of CAB chairman and economist Alfred E. Kahn, the Airline Deregulation Act was passed in 1978, deregulating routes, flights and prices and abolishing the CAB at the end of 1984.

What has really happened is that the FAA, previously limited to safety regulation and the nationalization of air traffic control services, has since then moved in to take up the torch of cartelization lost by the CAB. When President Reagan fired the air-traffic controllers during the PATCO strike in 1981, a little- heralded consequence was that the FAA stepped in to impose coerced maximum flights at the various airports, all in the name of rationing scarce air-

Furthermore, the quotas are now in force at the six top airports. Leading the parade in calling for the controls was Eastern Airlines, whose services using Kennedy and LaGuardia airports have, in recent years, been outcompeted by scrappy new People's Express, whose operations have vaulted Newark Airport from a virtual ghost airport to one of the top six (along with LaGuardia, Kennedy, Denver, Atlanta and O'Hare at Chicago). In imposing the ‘voluntary’

But, in any case, was the peak hour congestion a case of market failure? Whenever economists see a shortage, they are trained to look immediately for the maximum price control below the free-market price. And sure enough, this is what has happened. We must realize that all commercial airports in this country are government-owned and operated-all by local governments except Dulles and National which are owned by the federal government. And governments are not interested, as is private enterprise, in rational pricing, that is, in a pricing that achieves the greatest profits. Other political considerations invariably take over. And so every airport charges fees for its ‘slots’ (landing and takeoff spots on its runways) far below the market-

take off spots on its runways) far below the market-clearing price that would be achieved under private ownership. Hence congestion occurs at valuable peak hours, with private corporate jets taking up space from which they would obviously be out-competed by the large commercial airliners.

The only genuine solution to airport congestion is to allow market-clearing pricing, with far higher slot fees at peak than at non-peak hours. And this would accomplish the task while encouraging rather than crippling competition by the compulsory rationing of underpriced slots imposed by the FAA. But such rational pricing will only be achieved when airports are privatized--taken out of the inefficient and political control of government.

BAIL OUTS

Government policy on bailing out failing airline industries through the bankruptcy courts violates the rules of free enterprise. One reason the government intervenes with a struggling airline is to prevent the market from becoming more centralized. But this intervention only harms the industry because firms that are being run inefficiently are no longer confronted by the market mechanism that keeps them in check. This is harmful because major airlines are able to take risks in their operations and pricing in order to regain market share that they wouldn’t normally be able to take because they would be out of business.

Essentially governmental policy has the opposite effect, far from preventing the market from becoming centralized, this is the exact result. The major carriers are given a financial “security blanket” to operate from which allows them to engage in non-competitive pricing. The firms are being run inefficiently and yet are still able to compete. Whereas a smaller firm that faces bankruptcy is less likely to be bailed out by government funding. Thus the market becomes more centralized by bankruptcy courts because larger inefficient firms are able to stay in business and maintain large market shares, while smaller inefficient firm are run out of business. This was evident in the period of 1983-1988, when more than 200 airlines folded or were absorbed and the major carriers increased their industry-wide concentration. Then in the period of 1990-1993 three major airlines (Continental, TWA and American West) were bailed out through the bankruptcy courts (Goetz and Sutton, 1997). In order to maintain an

efficient open-market system it is important that bankruptcy courts are prevented from bailing out failing airline firms. Were the government to have followed this ghastly policy in a previous epoch, the horse and buggy industry would still be with us.

SECURITY

Finally, the government has prohibited the free market competition in the airport industry by passing laws that require that airport security be regulated and operated by the government. The federal control of airport security results in less efficient production and eliminates the market force that drives innovation to improve security. In the free market, competing companies create pressure for innovation in security methods and technology and for low prices. The lack of competition in the airline industry removes this incentive because the government survival does not depend on its service (Johnson, 2006). If private firms controlled security, the nature of competition between airports would force them to maintain competitively sufficient measures of security (Rahn, 2001). This would lead to efficient security that would potentially allow companies to achieve better profit margins. Although, the security would be driven by efficiency and profit motivations, passenger security would still be in the best interest of the company in order to maintain its competitive edge. Securing airports in the free market would require cooperation, but airports would have economic incentive to cooperate (Johnson, 2006).

Another issue with privatization of airport security is that there would be no uniform standard of security. Therefore, the privatization of airport security would not compromise the security of passengers. Rather the market incentives would stimulate the most effective means of security. The point is, here, that if every airport is forced into adopting the same security measures, all terrorists need do is understand any one set up and they have carte blanch to every airport in the country. In contrast, under private enterprise, with many different companies in the industry, entree for the marauders will be far more difficult, even under ceteris paribus assumptions that private and public security is otherwise on a par. It is the difference between every house in town being protected by the exact same lock, where one key fits all and the more ordinary situation where each homeowner has a different lock.

But we cannot blithely assume that public and private protection are equivalent to each other. Where would you rather meet someone for a tete-a-tete in the evening: At Disney World, or at some public space such as New York City's Central Park or New Orleans' Audubon Park? Of course, you w ould prefer to meet under the far more safe private auspices. Nor is this just an accident, a coincidence. There is good and sufficient reason for private amenities to be better protected than public ones: when failures occur and they always do, there is an automatic profit and loss feedback mechanism continually at work in the private sector. Those who err, suffer financially. If they do so badly enough, they are consigned to the dustbin of economics: bankruptcy. In sharp contrast, there is no such process functioning in the so called public sector. Does the mayor, or the city parks commissioner, lose money when a mugging occurs on a public street or in a public park? Do they even pay a political price four years later at the next election? To ask these questions is to answer them.

It is no accident in this regard that the authorities charged with our airport safety would make a fetish about prohibiting, of all things, nail clippers. Had any private company come up with such a hare brained scheme, they would have been quickly laughed into the oblivion they so richly would have deserved. But no one laughs at the government bureaucrats charged with such idiocy; to do so means risking the loss of your flight.

AIR-TRAFFIC CONTROL

Air-traffic control, too, should be privatized. There is nothing unique about this service such that it belongs in the realm of the state. Coordination of air traffic can better and more cheaply accomplished by private enterprise than bureaucratic socialism. There is always the general case for private rather than public provision: the market test of profit and loss weeds out inefficiency. But with regard to air-traffic control there is the specific point that this service is simply too vital to the air transport industry to be left in the hands of the institution responsible for the nail clipper fiasco, the postal service and other such stupendous errors. As Rothbard (1995) states.

> There is also another important area to be privatized. Air-traffic control services are a compulsory monopoly of the federal government, under the aegis of the FAA. Even though the FAA promised to be back to pre-strike air-traffic control capacity by 1983, it stillemploys 19% fewer air-traffic controllers than before the strike, all trying to handle 6% greater traffic.
>
> Once again, the genuine solution is to privatize air-traffic control. There is no real reason why pilots, aircraft companies and all other aspects of the airline industry can be private, but that somehow air control must always remain a nationalized service. Upon the privatization of air control, it will be possible to send the FAA to join the CAB in the forgotten scrap heap of history.

CONCLUSION

The airline industry would most efficiently maximize consumer and producer welfare if all governmental policies associated with it were eliminated. The government's past and current regulations have inhibited the free market mechanism from efficient allocation of resources. Although the focus of most of the governmental policy has been on securing consumer welfare, its effects have been harmful to both consumers and producers. The privatization of all aspects of the industry is the most effective way to ensure that the free enterprise market system can efficiently allocate scarce resources and maximize consumer and producer welfare.

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