Airline deregulation in the United States of America

Desregulamentação aérea nos Estados Unidos

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ABSTRACT: *This paper is aimed at conducting a detailed analysis on the government regulation and deregulation of the airline industry in the United States of America. Given the rapid growth in size and influence of the airline business in the USA, the federal government established a set of rules and regulations to steer the industry in what was believed to be the right direction. Lack of deeper understanding of the intricacies surrounding the industry led to increasing dissatisfaction amongst the airlines. The deregulation has come as a solution for a lot of problems, but it has also been deemed as a curse for airlines and passengers alike. Through a literature review, this paper discusses the real consequences of the airline deregulation in the USA and how it has influenced how people fly in America.*

KEYWORDS: *aviation; airline regulation; airline deregulation; United States.*

RESUMO: *Este artigo apresenta uma análise detalhada sobre a regulamentação e desregulamentação da indústria aeroviária nos Estados Unidos da América. Dado o rápido crescimento tanto em tamanho quanto em influência das companhias aéreas nos EUA, o governo federal estabeleceu leis e regulamentações para posicionar a indústria no que se acreditava ser a direção correta. A ausência de um profundo entendimento das particularidades da indústria aeroviária resultou em uma crescente insatisfação entre as companhias aéreas. A desregulamentação veio como uma solução para muitos problemas, mas também tem sido considerada como uma maldição tanto para companhias aéreas como para passageiros. Através de uma revisão da literatura, esse artigo discute as reais consequências da desregulamentação aérea nos EUA e como isso tem influenciado a maneira como as pessoas voam na America.*

PALAVRAS-CHAVE: *aviação; regulamentação aérea; desregulamentação aérea; Estados Unidos.*

1 Introduction

Since its inception, the airline industry in the United States has proven to be a thriving and extremely resilient system. During its initial upswing, the airline industry required some supervisory support from the federal government, which attempted to fortify its frail economy after the Great Depression in the 1930s. The government regulation steered the industry in the right direction but also generated dissatisfaction amongst certain elements of the system.

In light of those circumstances, the Airline Deregulation Act of 1978 came to provide the growing industry with new directions and opportunities to fly even higher. It was a fresh breath of air, as it engendered substantial improvements in the system. However, it also became a source for profound harm to some of those involved in the aviation industry.

It was unarguable that the consequences of the airline deregulation varied greatly. Every passenger was affected in a different way, either positively or negatively. Therefore, this paper was aimed at studying the government regulation and, most importantly, the deregulation of the airline industry in the United States of America as well as the effects it triggered, which has definitely changed the way we travel.

2 Regulation and deregulation: Definitions

The term *regulation* could essentially be defined as the “act of regulating or the state of being regulated” (THE FREE DICTIONARY, 2012). Nevertheless, this definition neither specified the source or agent of regulation nor clarified the possible outcomes of such practice. In an attempt to provide the term with a more accurate and distinct definition, Merriam-Webster (2012) explained that *regulation* could be understood as “a rule or order issued by an executive authority or regulatory agency of a government and having a force of law.”

Conversely, the term *deregulation* could be grossly defined as the “act of removing restrictions and regulations” (MERRIAM-WEBSTER, 2012). Kane (1996, p. 37), in his pursuit to describe the term, clarified that “the prefix ‘de’ means separation, reversing or undoing an action or freeing from a rule.” *Deregulation*, therefore, could be generally understood as the complete opposite of regulation, representing a departure from any sort of influence and enactment from the government.

Those two terms were extensively discussed in context in the following sections of this research paper, which analyzed the trajectory of the airline industry in the United States both with and without regulatory influence of the federal government. Whether regulated or deregulated, the airline industry required extra attention from decision-makers given its vulnerability to external factors, which are often unpredictable.

3 Market regulation in the United States

During much of the 1800s, the United States adopted a *laissez-fair* system, wherein any intervention from the government on economic affairs was practically non-existent. This system was based on the orthodox neoclassical economic theory, which preached that the government should not intervene through regulation under any circumstance in a harmonically competitive market given that the market was inherently not susceptible to monopoly (GOETZ and VOWLES, 2009).

In a monopolistic system, the market for a product or service was predominantly controlled by one single seller, who determined the price to be paid for the product or service. This idea was thoroughly disregarded by neoclassical economic models, as they firmly believed in the concept of pure competition, through which a significant number of buyers and sellers traded standardized and similar products and services in an environment where no one could really exercise full control of prices (GOETZ and VOWLES, 2009).

The *laissez-faire* system adopted by the government in the United States allowed private business organizations to make their own decisions regarding economic matters, which led to a Darwinistic period centered on the survival of the fittest. During this period, large companies abusively dominated the various industrial segments, such as railroads, communications, and banking, generating a monopolistic (and at times, oligopolistic) system and contradicting the idea of pure competition (GOETZ and VOWLES, 2009).

The developments resulting from the *laissez-faire* regime led the government to question the need for market regulation, given the significant abuse of some private organizations in economic matters and the high degree of public interest concerning these matters. According to Goetz and Vowles (2009), the railroad industry was one of the first to undergo government regulation. The influence of the government on that industry was validated by the Interstate Commerce Act of 1887, which regulated railroad rates, entry, and exit.

With the Great Depression of the 1930s, the government gradually established a regulatory system in an attempt to strengthen all segments of the economy. It had particularly been spending a considerable amount of money in the airline industry with subsidies to the fledgling air carriers, which started and failed at a fast pace given its emerging and struggling technology and the weak surrounding economic environment. Those challenges resulted in catastrophic safety records. Those concerns led the US Congress to implement the 1938 Civil Aeronautics, which created the Civil Aeronautics Authority (GOETZ and VOWLES, 2009).

Later denominated Civil Aeronautics Board (CAB), the agency was responsible for encouraging and developing the air transportation system in the country. It fostered safety and economic growth and regulated route entry and exit, airfares, possible mergers and acquisitions, as well as subsidies in an attempt to support and foment the growing airline industry (GOETZ and VOWLES, 2009).

The CAB restructured the whole airline industry across the country by democratically redistributing routes to the existing air carriers based on the size and profitability of the markets to be served. The environment created by the government regulation through the CAB provided the stability and the support the airline industry needed to flourish for the following forty years. However, as time went by, the essence of the regulation did not seem to keep up to the growth and fulfill the increasing demands of the industry, which led to pockets of dissatisfaction within the business, requiring aggressive changes in the whole system.

4 Airline deregulation in the United States

The 1938 Civil Aeronautics Act and the establishment of the Civil Aeronautics Authority (later, Civil Aeronautics Board) provided the ground on which the airline industry found resources for its development. It served the industry well for many years until inefficiencies started to be observed. The CAB proved to be inflexible concerning changes in pricing, entry, and exit, which led the airlines to compete based on quality of service instead of price (GOETZ and VOWLES, 2009).

During the 1970s, those concerns, fuelled by increasing dissatisfaction from specific segments of the system, led to economic studies aimed at reexamining the efficacy of the existing regulated airline industry. Those studies highlighted the irrelevance of regulation given that there were no economies of scale or barriers to entry in the industry. Some of these studies cited the unregulated intrastate airline systems in California and Texas, which were able to offer lower fares when compared the regulated air carriers (GOETZ and VOWLES, 2009).

The works towards deregulation of the airline industry were initiated by President Gerald Ford and continued by President Jimmy Carter, who designated Alfred Kahn as Chairman of the CAB, a deregulation advocate. In 1975, Senator Edward Kennedy headed a series of investigations of the regulatory strategies executed by the CAB and their repercussions upon the airline industry (KANE, 1996). Congressional hearings led by Senator Kennedy and assisted by Supreme Court Justice Stephen Breyer facilitated the process towards deregulation.

According to Kane (1996), between 1975 and 1979, CAB made gradual adjustments for deregulation involving mainly scheduled operating flights and new entry; rules related to charter and entry; pricing; agreements, antitrust, and control relationships; and air taxis, commuters, and Air Freight Forwarders. Those actions culminated with the promulgation of the Airline Deregulation Act in October 24, 1978, which called for the removal of CAB jurisdiction over fares, entry, and exit (KANE, 1996).

The main purpose of the act could be found in its opening paragraph, which read that the Airline Deregulation Act of 1978 was expected to “encourage, develop, and attain an air transportation system which relies on competitive market forces to determine the quality, variety, and price of air services, and for other purposes” (AIRLINE DEREGULATION ACT, 1978).

The 1978 Airline Deregulation Act consisted essentially of substantial changes to the 1958 Federal Aviation Act and sections of the Airport and Airway Development Act of 1970. It also called for the sunset of the CAB in December 1984, whose authority over mergers and acquisitions was transferred to the Department of Transportation and later to the Antitrust Division of the Department of Justice. Until this date, those changes resulted in new dynamics affecting in different ways all segments involved in the airline industry in the United States (KANE, 1996).

5 Effects of the Airline Deregulation Act of 1978

Since its establishment, the Airline Deregulation Act of 1978 has caused and witnessed many changes in the US airline industry, mainly involving the growth and retrenchment of air carriers in distinguished phases.

Between 1978 and 1983, the industry registered a substantial number of new entrants in a variety of markets previously protected by the CAB. The main airlines operating 87% of these markets before deregulation (namely American, Braniff, Continental, Delta, Eastern, Northwest, Pan Am, TWA, United, and Western) witnessed their presence decline to 75% as a result of the growth of regional airlines, intrastate airlines, and charter airlines, as well as the establishment of new airlines (GOETZ and VOWLES, 2009).

A sequence of mergers, acquisitions, and bankruptcies between 1983 and 1993 resulted in improved performance of legacy airlines, which regained concentration and market share. Consequently, big organizations like American, Continental, Delta, Northwest, United, and US Airways were successful in developing revolutionary marketing strategies such as the implementation of computer reservation systems (CRS) and frequent flyer programs. Smaller air carriers were inevitably unable to compete with the legacy airlines, which eventually acquired some of the former (GOETZ and VOWLES, 2009).

The mid-late 1990s witnessed a wave of new entrants such as Frontier, JetBlue, Kiwi, Midway, Reno, Spirit, Valujet/AirTran, Vanguard, and Western Pacific. These young airlines, in conjunction with other small air carriers such as Southwest and ATA, managed to steal a considerable amount of market share from the legacy air carriers. However, the remarkably strong economy of the late 1990s led to an increased demand in air transportation, which resulted in steady recovery from the big airlines (GOETZ and VOWLES, 2009).

The first decade of the new millennium was rather stormy to the legacy airlines. First, the terrorist attacks on September 11, 2001 triggered a four-day shutdown of the airline system followed by an extended period of low demand due to economic downturn. According to Goetz and Vowles (2009), “this ‘perfect storm’ of events led to the loss of nearly $35 billion from 2001 to 2005 (US Air Transport Association, 2006), by far the largest losses ever for the airline industry” (p. 254). Conversely, the so-called low-cost carriers (LCC) Southwest and JetBlue presented a remarkable performance given the circumstances surrounding the airline industry at the time.

However, the most recent economic downturn, in 2008, led to a sharp increase in fuel prices, which hit the entire market and caused fatal damage to some air carriers, such as Aloha Airlines, ATA, and Skybus Airlines, reassuring us all of the vulnerability deeply ingrained in the airline industry.

5.1 Positive effects

Despite the instability of the airline industry in the past few decades, the overall sentiment is that the Airline Deregulation Act of 1978 brought many benefits to all those involved, mainly the passengers. Essentially, consumers are the biggest beneficiary of the competition amongst air carriers, which resulted in lower fares as well as far-reaching and – supposedly – better services.

In his book "Air Transportation," Kane (1996) listed the major benefits of the airline deregulation in the United States, mainly that:

1. Airline fares rose in a far lower rate when compared to that of inflation;
2. Airlines made more discounted fares available in the market;
3. Fares to small city airports proved to be only 3% higher than those to larger cities, unlike previously thought;
4. Both airlines and passengers have saved a significant amount of money after deregulation.

In fact, the airline deregulation triggered significant restructuring in the industry. One of the most notable results of the deregulation was the widespread development of hub and spoke networks. Airlines developed hub and spoke networks in an attempt to serve more markets with the same amount of fleet than if they offered only direct, point-to-point service. Airlines with hub and spoke systems have the chance to retain their passengers all the way to their final destinations instead of handing them off to other air carriers (KANE, 1996).

Another positive effect of the airline deregulation in the United States was the establishment of new carriers. As previously described in this work, the years following the promulgation of the 1978 Airline Deregulation Act witnessed the expressive flux of new airlines joining – and sometimes positioning themselves against – the legacy air carriers. According to Kane (1996), in 1978, "there were 36 carriers certified under Section 401 of the Federal Aviation Act for scheduled service with large aircraft (defined as planes seating 60 or more passengers). By 1984, there were 123 such carriers" (p. 53).

Regardless of their performance throughout the years, the simple establishment of new airlines, in conjunction with the expansion of legacy air carriers, led to intense competition in the airline industry. The passengers, consequently, became the biggest beneficiary in those dynamics and had a wider selection of carriers from which to choose in their travels. The very same competition amongst new and established air carriers resulted in a significant drop in the ticket price, which was one of the biggest hopes driving Senator Edward Kennedy in his pursuit for airline deregulation. Low fares led to a substantial growth in air travel, which helped the industry flourish throughout the years (KANE, 1996).

The deregulation of the airline industry also fomented the development of certain marketing strategies within the low fare frenzy, such as the frequent flyer programs, which were developed to acknowledge and reward repeat passengers for their loyalty to the airlines. The rewards initially included free tickets and upgrades to premium cabins. Most recently, frequent flyers enrolled in these programs became eligible to accrue and spend miles in other products and services within the airline industry, such as duty free and on-board shopping, as well as within other industries, like tourism and banking (KANE, 1996).

The development of computer reservation systems (CRS) may also be credited to the airline deregulation. In their attempt to innovate and strengthen their position as competitors between themselves and the new entrants, legacy airlines developed their own CRS. Essentially created to help airlines and travel agents keep track of fare and service changes, CRSs also help air carriers and travel agents to “efficiently process the millions of passengers who fly each day” (KANE, 1996, p. 55).

Last but not least, the airline deregulation in the United States paved the way to the development of code sharing agreements, mainly between legacy and regional air carriers. Fruit of the hub and spoke systems, the code share agreements usually tie regional carriers into their partner’s marketing and frequent flier programs and coordinate schedules for the convenience of passengers as though the involved airlines were one.

The effects mentioned above were in fact the bright side of the airline deregulation and, under many circumstances, positively changed the way we travel today. Through many angles, the airline deregulation was unquestionably an improvement to the whole system generating growth and development all around.

5.2 Negative effects

The consensus on the positive effects of the 1978 Airline Deregulation Act in the United States may be easily outshone by the negative consequences of this law. Despite the growth in air traffic facilitated by lower fares, innovative marketing strategies, and expanded airline network, the deregulation resulted in many challenges the airline industry did not face while still regulated.

The hub and spoke networks, which are highly profitable for many airlines, have actually resulted in concentrated centers, providing hub airlines with extensive economies of scope. According to Goetz (2002), economies of scope are “forces that result in declines in unit costs as the scope of a firm’s activity increases. In the airline industry, economies of scope are realized when an airline expands its route network and realizes increasing benefits relative to costs” (p. 3).

By developing hub and spoke networks, airlines gain significant economies of traffic density through the ever-increasing number of passengers being processed in the network system, and, consequently, obtain more market share. These dynamics contradict the initial supporting argument that there are no economies of scale or scope in the airline deregulation and the industry would be equally shared by all its components.

On the heels of the economies of scope and scale, the airline deregulation resulted in significant problems concerning fares. There has been a considerable difference between fares in shorter-distance, less-travelled routes and longer-distance, heavily trafficked markets. According to Goetz and Vowles (2009), passengers travelling from concentrated hubs, wherein a single carrier dominates at least 60% of the market, generally pay higher fares. Goetz and Vowles (2009) also noted that there has been a consistent decline in the service offered by the airlines, whether they are legacy or low-cost carriers.

Those differences in the price of airfares and the quality of service may be easily identified in distinctive spatial forms as cities in certain regions have received inferior service and higher fares than other cities. While cities in the Southwest and West Coast have received lower airfares and more extensive network, cities located in the Southeast, upper Midwest, and areas of the Northeast have experienced higher fares and less regular service (GOETZ and VOWLES, 2009).

Regions like the Southeast, upper Midwest, and Northeast of the United States have seen average ticket price consistently rise in the years following the deregulation of the airline industry. Those regions were called *pockets of pain* given the expensive airfares and the decline in air service. Passengers flying to or from cities like Greensboro, NC; Norfolk, VA; and Buffalo, NY paid on average 30% more from 1994 to 1998. This pattern may be essentially attributed to the lack of service from low-cost airlines, such as Southwest and JetBlue, and to the predominance of legacy airlines such as Delta and US Airways (GOETZ, 2002).

The lack of service from low-cost airlines, or from any new competitor for that matter, in a specific region is a consequence of barriers to entry imposed by incumbent airlines. Barriers to entry were vehemently disregarded by proponents of airline deregulation as they thought that, without government regulation, airlines could easily acquire or lease aircraft and fly into and out of cities (GOETZ, 2002).

However, those barriers materialized themselves through long-term gate leases at airport that granted access to operating air carriers while barring access to new entrants; computer reservation systems that benefited the legacy airlines that owned them; frequent flyer programs, which drew more passengers to incumbent airlines given their extensive route network; and travel agents, who preferred to do business with legacy airlines given their attractive benefits (GOETZ, 2002). New competitors often found it hard to compete with legacy airlines given the cutthroat environment triggered by those barriers.

Defendants of legacy airlines have declared that established airlines have extensively invested in the expansion of their facilities at airports and have found themselves challenged by new entrants. Consequently, legacy airlines have adopted barriers in an attempt to countermeasure the entry of new competitors as these air carriers have equal access to airports provided by law under Deregulation (KANE, 1996).

Another negative consequence of the airline deregulation in the United States has been the continuous disagreements between airlines and labor unions representing airline staff. According to Kane (1996), unions and airline management representatives have generally very contrasting opinions about the effects triggered by the deregulation. Negotiations between those two groups have become extremely strenuous and have led to many strikes throughout the years.

The negative effects described above have increasingly become part of the routine of travelers and airlines alike. Those effects were a bitter surprise to proponents of government deregulation, who were unable to anticipate any possible negative consequence of the *laissez- faire* regime in the airline industry. Unfortunately, little has been made to mitigate or eliminate those effects, which have significantly altered the horizon of the airlines in the country and let the government to revisit the idea of re-regulating the industry.

6 Final considerations

It is unarguable that the airline industry required expressive actions to alter the archaic and rigid system it had become during its first forty years of existence. Government regulation framed the industry in such a way that if offered no room for growth, which led to constant dissatisfaction amongst many elements within the system. The 1978 Airline Deregulation Act came as a sign of hope by those who aspired new heights for the industry, presenting promising changes to the existing landscape.

As expected, deregulating the airline industry paved the way for the growth of established airlines and new entrants, which flew higher and further than before, offering new services and revamping the way we travel. The positive effects of the airline deregulation can still be felt today through the establishment of aviation as the preferred and most convenient mean of passenger transport, providing on average lower fares, more flights, and good safety record.

Nevertheless, unleashing the airline industry also triggered many negative effects, as predicted by proponents of regulation. By relinquishing power, the government created a *laissez- faire* environment within the industry, which allowed airlines to execute strategies according to their own convenience without considering other elements of the system. The *laissez-faire* regime led to autonomous establishment by the airlines of airfares and services, barriers to entry, predatory competition, as well as to increasing disharmony between union and management.

Government and airlines are to blame for the current situation of the industry. In a rush to change, government failed to conduct a thorough study on the enactment of deregulation and its real consequences to the industry. The entire deregulating process was extremely flawed and shortsighted and literally paved the way to the aforementioned negative results. Left to their own devices in a pursuit of growth, airlines failed to conduct adequate management and solid financial decision-making, which led the industry to become even more vulnerable to economic conditions.

Given the inherently oligopolistic and self-destructive nature of the airline industry, the government should never have relinquished its absolute power to the air carriers. In order to consistently grow, the airline industry requires a certain level of regulatory oversight from a supervisory executive authority, which ideally has the power to adequately intervene when necessary.

Otherwise, everybody loses.

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