Airline Deregulation: Boon or Bust?

by Paul W. Bauer

The Airline Deregulation Act of 1978 took the operational decisions of running an airline (what routes to fly and what fares to charge) away from government regulators and returned them to the airlines.1

Over the last decade, the airlines have used this new freedom to institute a number of fundamental changes in the structure of the industry. Since 1978, discount fares have been more widely used and the variety of restrictions on these fares has increased, frequent flier plans have proliferated, carriers have come and gone, and hub-and-spoke operations have emerged.

This Economic Commentary examines the benefits and problems that have resulted from the deregulation of the airline industry and makes some recommendations for changes in public policy to preserve the benefits and to mitigate the problems.

Federal Reserve Bank of Cleveland

May 1, 1989
The hub-and-spoke route systems now serving a route, fares were lower, but by less and less as the number of carriers in a market increases. Fares decline as additional carriers are added to the route, but only until about four carriers are serving the route.

The increase in the market shares of the largest airlines, resulting from the merger wave of the mid-1980s and the operating agreements of the major carriers with local service airlines, has worried some analysts. Both of these developments have trade-offs between higher operating efficiency and quality of service on one hand and potential anti-competitive effects on the other. Since fares are determined by individual route and airport factors, it is not clear how concerned policymakers should be by the increase in concentration at the national level.

A second source of concern is the increase in concentration at airports with only one carrier offering hub service. Creating what are known as ‘fortress hubs.’ Market shares at such airports tend to oversize the market power that the hub airline has since most of the passengers of the hub airline are only making connections at the airport.

However, these hub airlines usually have sufficient market power so that they can price discriminate between passengers traveling to or from the airport and passengers only making connections at the airport. Boeing (1983) and Butler and Hunt (1987) find that the fare from a rim city to a hub city, plus the fare from that hub city to another rim city, is usually much higher than the connecting fare—through the same hub city—for the flight between the two rim cities. The reason is that there are usually other hub cities where passengers could make connections to go between the two rim cities, but passengers flying to the hub city will most likely have to fly on the airline that has a hub there.

In the meantime, scarce airport resources would be more efficiently utilized if they were priced correctly. If takeoff and landing fees varied by time of day, then price-sensitive passengers would fly off peak, thus reducing the peak demands on the system and freeing up resources for users who value them more highly. This would reduce congestion and increase the margin of safety in the system.

While the majority of travelers have benefited from deregulation, gains have not been distributed evenly. While very few cities have lost air service, some did lose service by major carriers. These cities may be better off with the somewhat reduced concentration in the airline system than they were under relatively infrequent major carrier service. 4

The benefits of lower fares are also not evenly distributed among classes of passengers. Fares tend to be higher on routes served by fewer carriers. In addition, business travelers often cannot fly before the discount fares of a competing airline. While very few cities have lost air service, the airlines have gained considerable market power. Business travelers, who tend to be time-sensitive and price-insensitive, much more than leisure travelers, who tend to be price-sensitive and time-insensitive.

It must be remembered that at the individual route level, concentration has actually fallen slightly since deregulation. A recent Congressional Budget Office study found that the number of carriers per route has actually increased for most types of routes. Currently, an average of 2.5 carriers serve the typical route. Easeing the entry of additional carriers onto routes should continue to be a policy objective, since the industry is not perfectly competitive.

Congestion

The congestion of the air traffic control system should be viewed as evidence of the success of deregulation. Put another way, if fares were set higher, fewer travelers would fly and there would be less congestion. This would hardly be a welfare-enhancing public policy. The evidence is for a strong positive relationship between airfare and other amenities being cut back, since most passengers have revealed a preference for lower fares even at the expense of lower quality.

Requiring airlines to publish their on-time performance records provides passengers with better information with which to plan their trips. On balance, it was a positive development, however, it has led the airlines to change their behavior in ways that are not necessarily optimal. First, since the on-time arrival rate refers to the plane, not to the passengers, airlines may not wait as long for connecting passengers on delayed incoming flights as they used to in order to preserve their “on-time” performance. Another problem is that on-time arrival rate marks the true extent of the congestion problem. One way airlines increased their on-time arrival rate was by adding time to their flight schedules into congested airports. These scheduled congestion delays result in millions of lost man-hours in the course of a year.

The safety dimension of service quality is a more serious issue. To date, there have been fewer accidents per passenger-mile since deregulation. With rigorous enforcement of the existing FAA safety regulations and with a modernization of the air traffic control system, there is every reason to expect this trend to continue.

Conclusions

The effective public policy must be based on a sound understanding of the forces driving the changes in the airline industry after deregulation. The benefits of airline deregulation have been substantial, but they have not been uniformly distributed among passengers and between cities. Care must be taken to preserve the benefits to travelers.

Informed enforcement of the antitrust laws should be sufficient to preserve competition at the route level. So far, even with the wave of mergers in the mid-1980s, there are still more carriers per route on average than in 1983 and certainly more than there were under CAB regulation. Steps to make acquisition of gate space and takeoff and landing slots easier would also help reduce the market power an airline has at its hub.

Though safety will always be a concern, there have been fewer accidents per passenger-mile since deregulation. With rigorous enforcement of the existing FAA safety regulations and with a modernization of the air traffic control system, there is every reason to expect this trend to continue.
The hub-and-spoke route systems now serve the majority of the nation's traffic. Two decades into the age of semiconductors, the air traffic situation is no different. Proponents of deregulation never intended for the government to slacken its efforts in regulating the safety of the industry. In fact, government regulation of safety is more important in a deregulated environment than it was in a regulated environment, since the financial consideration of an airline may influence its safety choices (such as spending on maintenance and pilot training). Under deregulation, the FAA should be even more vigilant.

**Conclusion**

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Informed enforcement of the antitrust laws should be sufficient to preserve competition at the market level. So far, with the wave of mergers in the mid-1980s, there are still more carriers per route than there were eight years ago, while there are many more planes in commercial service.

In the meantime, scarce airport resources would be more efficiently utilized if they were priced correctly. If takeoff and landing fees varied by time of day, then price-sensitive passengers would fly off-peak, thus reducing the peak demands on the system and freeing up resources for users who value them more highly. This would reduce congestion and increase the margins of safety in the system.

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Footnotes
1. For a short description of the airline industry under CAB regulation and the early years of deregulation see Bauer (1986).

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Deregulation of the airline industry has produced wide-ranging changes that have created benefits and some problems for the public. The promotion of safety, high-quality performance, and beneficial competition within the industry should be a goal of public policy. These policy goals, however, must be based on a sound understanding of the market forces behind the post-deregulation changes in the airline industry.