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REPORT OF THE CAB SPECIAL STAFF ON REGULATORY REFORM: GENERAL CONCLUSION AND PRINCIPAL RECOMMENDATIONS—

EXECUTIVE SUMMARY

THE GENERAL conclusion of the Special Staff on Regulatory Reform is that protective entry control, exit control, and public utility-type price regulation under the Federal Aviation Act are not justified by the underlying cost and demand characteristics of commercial air transportation. The industry is naturally competitive, not monopolistic. In the absence of economic regulation, it is clear that monopoly abuses would not occur. Service quality and price would be highly responsive to demand because of the immediate threat of new entry even in markets served by a single carrier. Most important for the long term, the possibility of new entry will assure that the system will be composed of highly efficient carriers able to adapt readily to changing conditions.

The present system of regulation causes higher than necessary costs and prices (which in turn suppress demand), weakens the ability of carriers to respond to market demand and other constantly changing conditions, narrows the range of price/quality choices to the user, and thus produces a misallocation of the nation's economic resources.

These undesirable effects outweigh the benefits of such regulation. Market demand and not protective regulation is very largely responsible for the size and extent of the present airline system, except for some directly subsidized service. Neither the provision of uneconomic service nor the toleration of unnecessarily high costs due to inefficient conduct by airlines and airline labor can be considered benefits; to the extent some small amount of nonsubsidized uneconomic service is provided by reason of license requirements, passengers in other markets are being overcharged and demand depressed; and the user, as well as the overall economy, is similarly

paying for inefficiencies—excessive service, labor and other costs—resulting from government policies designed to ensure the stability and artificially determine the market share of particular airlines through protective regulation.

Economic inefficiencies deriving from protective regulation are for the most part not the product of the CAB administration of the law, but of the law itself. Over the years the CAB has administered both rate and route policy liberally, but this is not likely to continue if market growth and carrier fortunes decline because of external conditions. On the contrary, it is possible that regulation will become more restrictive and thereby increase inefficiencies. Real improvement in economic efficiency can come only if protective regulation is eliminated or materially reduced. On the other hand, it is important to recognize that tinkering with the regulatory regime while preserving its fundamental features may be ineffective or produce perverse consequences.

Accordingly, the Special Staff *recommends* that protective entry, exit and public utility-type price control in domestic air transportation be eliminated within three to five years by statutory amendment to the Federal Aviation Act. Because closed entry is the *sine qua non* of economic regulation from the point of view of the airlines and allied interests, open entry is in one sense tantamount to “deregulation.”

The Special Staff does not, however, advocate removing other Federal controls. On the contrary, those features of airline regulation which appear to be required to protect the public interest should be maintained and strengthened. In addition, new requirements to assure the maintenance of safe operations should be adopted, and measures should be taken to prevent or ameliorate market imperfections caused by external factors relating to airports, the fuel allocation program and State regulation.

For the promotion of safety, it is recommended that temporary licenses for airlines be issued upon proof of financial fitness, that renewal be based on continuing proof of financial fitness, and that FAA surveillance be strengthened. The government should also be empowered to promulgate insurance and bonding requirements, as well as other measures reasonably necessary to assure that safety levels are not degraded by reason of the economic condition of individual airlines.

Subsidized small community service should be maintained by means of low-bid contracts awarded to operationally and financially qualified carriers. By this means, uneconomic service which appears to be genuinely necessary in the public interest can be maintained at a cost far less than that now incurred for the subsidization of local service airlines. Authority over antitrust matters, including predatory conduct and mergers, should be retained or expanded; and carriers should continue to be required to file and adhere to both tariffs and schedules, as well as to report financial, traffic, and performance data for public dissemination.

The precise scope and language of these legislative proposals should be worked out by an independent public body, such as the proposed National Commission on Regulatory Reform, which would report directly to the Congress. Such a body would also determine whether the regulatory functions above described should remain in the CAB or be performed by other agencies. A transition period of three to five years will provide time for the Commission to work out the legislation, for Congressional consideration of the proposals, and for the airlines and allied interests to prepare for the more competitive environment that has been recommended.

Pending implementation of the principal recommendation, above, *and independently of that recommendation if it is not effected*, it is proposed that the Board support a legislative program and pursue certain prescribed policies in the administration of its principal regulatory functions. These proposals have been formulated to be consistent with the principal statutory purpose of the existing regime of protective regulation and at the same time: (i) increase the price/quality options available to the American traveling and shipping public; (ii) encourage greater efficiency through price competition and regulatory actions which will keep price, and therefore costs, lower than they would otherwise be; and (iii) open defined sectors or zones of air transportation to regulation by market forces by removing entry and price controls in order to stimulate price competition, innovation and new services.

The interim proposal is in two parts, as follows:

- (1) *Statutory and other changes designed to create or widen less regulated zones*

The Board should press for legislation designed to authorize it to:

—Open entry for supplemental (charter only) carriers (subject to continuing proof of financial fitness) and gradually liberalize charter rules under legislation giving the Board authority to define “charters” as any full-up operation;¹

—Open entry for all-cargo carriers (subject to continuing proof of financial fitness) and eliminate price controls in respect to domestic cargo air transportation in stages over a period of two years;

—Establish a low-bid contract system for the provision of small community subsidized air service² (or any other uneconomic service that is deemed to be required); and simultaneously (a) commence a gradual phase-out of certificated local service carrier small community operations and subsidy, and (b) allow economically unregulated commuter carriers to use aircraft of up to fifty-five revenue seats (instead of the present thirty).

(2) *Discretionary policy changes*

The Board should administer rate, route, charter, and other policies so as to preserve the financial integrity of existing carriers, and also:

—Consider whether to establish ceiling fares under which carriers could reduce prices in response to competitive and other changing conditions subject to prohibitions against unlawful discrimination, predatory conduct, and causing other carriers to be placed in financial jeopardy;

—Continue to perfect and expand domestic passenger fare standards with a view to creating incentives (as opposed to mandatory requirements) for greater carrier efficiency, and utilize these to determine the ceiling, if a ceiling approach is adopted;

—Gradually liberalize charter rules consistently with the development of normal fare ceilings to widen the price/quality choice for consumers, and thus encourage price

¹ The latter is a current Board proposal.

² This was proposed by the Board in 1972 and 1973, but no legislative action was taken.

competition for discretionary travel between supplemental and scheduled carriers;

—Expand route authority in accordance with demand and to permit congested large-hub airports to be by-passed, perfect the authority of local service carriers in on-line markets, approve new competitive authority to correct deficiencies or to improve services, and to the extent feasible, select the most efficient carrier among competing applicants; and

—Continue to discourage or disapprove mergers between large or viable carriers.

July 22, 1975

