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A RECONSIDERATION OF FEDERAL CONTROL OF ENTRY INTO AIR TRANSPORTATION

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THERE are at least two good reasons why the present is a particularly appropriate time for a thorough reconsideration of the program of economic regulation which has governed civil air transportation in this country for the last seventeen years. First, the high level of general business activity and the accompanying prosperity of the airlines furnish a propitious atmosphere for the abandonment of restrictionist policies adopted in the depression years and minimize the resulting possible hardships to vested interests. No doubt the acceptance of protectionism in hard times rests on a profoundly mistaken view of the causes and proper remedies of business fluctuations. Nevertheless, it should surely be easier to liberalize government policy at a time when competition does not take on the aspect of a one-way street to general bankruptcy. Indeed, the matter is one of some urgency: if we do not take advantage of favorable times to effect liberalization, protectionism may gradually spread throughout the economy by a sort of ratchet action motivated by the customary ups and downs of business activity. An "apparent trend" toward restrictive regulation has recently been brought to the attention of the Attorney General by the National Committee appointed by him to study the antitrust laws;¹ some of the Committee went farther, to favor "a general recommendation to Congress that the trend toward regulation should be checked or even reversed";² and one member, who took a broader view of the Committee's terms of reference than did the others, strongly urged review of such measures as the Motor Carrier and Civil Aeronautics Acts, which were adopted in "a time of desperation when we nearly abandoned free competition entirely in favor of industry self-regulation under NRA."³

¹ *Report of the Attorney General's National Committee to Study the Anti-trust Laws* (Washington, U.S.G.P.O., 1955), p. 269.

² *Ibid.*

³ *Ibid.*, pp. 288-289. In view of the striking similarity between the economic characteristics of the motor carrier industry and those of air transportation, it is significant for the present inquiry that several of the Committee favored "specifying the motor carrier industry as an example of unnecessary restriction of competition through regulation of entry and minimum rates" (p. 269).

SUBSIDY AND ECONOMIC POLICY

Second, the very considerable amount of study which has been devoted to the air transport subsidy problem since the war has made it clear that, at least in most of the domestic field, the national interest does not require the kind of financial support by the government which raises difficulties in connection with economic policy; and that even in international operations a considerable increase in economic freedom is not only possible but highly desirable from the government's own standpoint. This reexamination of the support program has recently culminated in the report of the Air Coordinating Committee on *Civil Air Policy*⁴ which proposes the termination of direct-payment support to air carriers with certain limited exceptions mainly in international operations.

The Committee recommends (1) that schedules be immediately established "for the orderly reduction, and withdrawal where appropriate, of domestic air carrier subsidy support";⁵ (2) that carriers capable of "sustained" (?) self-sufficiency be made ineligible for further direct subvention;⁶ and (3) in the absence of "compelling public interest considerations to the contrary," that support be withdrawn from any operation without "reasonable prospect for economic self-sufficiency in the foreseeable future"⁷ notwithstanding the existence of a certificate of public convenience and necessity authorizing this operation.⁸ As to international operations, the Committee concludes that direct-payment support may be required for a long period of time. Even here, however, it is clearly brought out that the national interest not only does not require but is not best served by a virtually unlimited commitment to support a given carrier or any part of its services.⁹

These conclusions clear the way for important changes in economic policy in both the foreign and the domestic fields. They represent a definite rejection of the proposition which was apparently basic to both the subsidy and regulatory features of the Civil Aeronautics Act: that the national interest with respect to commercial air transport could be identified with permanent profits for individual air carriers.¹⁰ In only one respect does the A. C. C. report attempt to link the national interest with the profits of particular carriers, namely, in its suggestion that excess profits on some routes be deliberately fostered in order to finance uneconomic services on others. This suggestion will be more fully discussed later on.

⁴ *Civil Air Policy*, A Report by the Air Coordinating Committee by Direction of the President (Washington, U.S.G.P.O., 1954).

⁵ *Ibid.*, p. 11.

⁶ *Ibid.*, p. 9.

⁷ *Ibid.*, p. 7.

⁸ *Ibid.*, p. 9.

⁹ *Ibid.*, pp. 9-10.

¹⁰ On this point, see Lucile S. Keyes, *Federal Control of Entry into Air Transportation* (Cambridge, Harvard University Press, 1951). Consider also the following remark in *Civil Air Policy*, p. 8: "The Government's main interest in subsidizing air transportation is to assure service adequate for the public and national interests rather than to preserve any individual carrier."

It should not be supposed that the present regulatory program was ever actually justified by the existence of a national promotional policy with respect to air transport, or that the liberalization of economic policy had to await the development of the industry to a point where promotion would no longer be necessary. The need-rate program, with its broad implications for the proper scope of government control over the business decisions of the carriers and for the enforced limitation of competition among firms which under this program had almost literally nothing to lose, was never the most desirable or appropriate means of providing support. The government, like other purchasers of air transport service, has always stood to gain by the most efficient possible performance of the subsidized service, which in turn could only result from the maximum of free competition consistent with the mechanics of subsidization. Moreover, there is little doubt that a support program not involving a virtual guarantee of individual carrier profits could have been developed at any time in the past; that such a program could have been a more effective way of accomplishing any really justifiable policy of promotion; and that one of the main points in its favor would have been the greater scope for competition which it would have permitted. There are many types of promotional program whose administration does not involve any restriction on the competitive activity of the subsidized firms. Among these are tax remission, government financing of essential research, free or below-cost airways, and other devices whose cost does not increase with the number or capacity of firms participating in the subsidized activity. Some other forms of promotion, such as direct payments to carriers, do necessitate some limitation on the number of firms subsidized at any given time, but not only do not rule out but require for maximum effectiveness a periodic opportunity for review of commitments to particular firms and possible replacement by others.

No promotional program justifies protection of the revenues of subsidized firms from unsubsidized competition. If from an activity comparable to that subsidized, such competition may well mean that support is not really necessary. To the extent that such competition adds to the expense of necessary support, it is a legitimate addition to the cost of the program and should not be obscured or shifted to protective regulation. Furthermore, because a certain amount of "dead loss" to existing and potential air transport users will almost certainly result from protective regulation, the cost of support to the community as a whole will in all probability be greater as compared with subsidization without protection. In this respect, support through protection is similar to "internal subsidization," which is discussed below.

Thus neither a change in the independent viability of air transport nor a shift in national objectives was necessary to pave the way for a more liberal economic policy, as regards both the administration of the subsidy and the treatment of market competition with the subsidized firms. What was necessary was a long overdue look at the defects

of basic air transport policy. If the existing program is due any praise for its past performance, it is only because of the possible political unavailability of superior alternatives. In this connection, let us not forget the relative unpopularity in 1938 of any serious consideration of national defense needs, to say nothing of attempts to get adequate appropriations for these needs, as compared with the reception given to measures presented, like the Civil Aeronautics Act, as means of correcting the allegedly wasteful and unreasonable effects of competition by the benevolent hand of state intervention.

The A. C. C. report clearly recognizes the possibility of liberalizing the administration of the support program in the international field, despite the anticipated necessity for direct subvention for an indefinite period. The Committee's recommendation of a thorough overhaul of the present system of unlimited commitments to particular carriers, its suggestion that this system might be replaced by "administration of subsidies in the form of fixed-term contracts, in which the Board would specify the maximum amount of the Government's subsidy commitments,"¹¹ and its proposal that careful consideration be given to "whether the service can be rendered by other United States carriers with less or no subsidy"¹² evidently represent a genuine attempt at broadening the role of competition in the future administration of direct-payment subsidy. As has been noted, however, this method of support by its very nature requires an exclusive commitment to particular carriers at least on a temporary basis. It also tends to lend weight to (unjustified) arguments for regulatory restrictions on unsubsidized competition on grounds of government economy. This consideration might possibly explain the Committee's failure to recommend the liberalization of economic regulation in the international sphere. Even these complications should soon be largely absent in domestic air transport, where it is now recognized that direct subvention is generally unnecessary.

PRESENT STATUS OF THE CASE FOR ENTRY CONTROL

Oddly enough, the A. C. C. report contains no proposal for greater economic freedom in domestic operations. For its failure to recommend liberalization of entry control under the Civil Aeronautics Act, the Committee advances three reasons: (1) that experience has shown that the continuation of the present policy is necessary "to assure the maintenance of sound economic conditions, capable of supporting on a stable basis an adequate level of essential public service"; (2) that carrier profits on "strong routes" must be protected in order "to offset losses on weak routes"; and (3) that protection of carrier profits is needed to enable the government to "discharge its public obligation to minimize subsidy expenditures."¹³ As we have seen, the third point

¹¹ *Civil Air Policy*, p. 10.

¹² *Ibid.*, p. 7.

¹³ *Ibid.*, pp. 18-19.

is both generally unacceptable and presumably irrelevant for that large part of the domestic field where direct subvention is to be dropped: in the report, government economy reenters the domestic picture only as the motivation of a scheme for enabling the government to avoid the cost of supporting any remaining uneconomic segments. The issues raised by this scheme are essentially the same as those involved in point (2), which will be one of the main centers of attention in this section. Also discussed will be other arguments bearing on the problem of entry control, among these being the Committee's point (1) regarding "sound economic conditions." In conclusion, certain short-run policy problems will be briefly treated in the light of the preceding discussion.

As a result of a study undertaken some years ago,¹⁴ the present writer concluded that no available evidence or argument showed a need for the existing type of Federal control over entry into air transport markets, though it was conceivable that future experience might show that some limitation on competitive freedom would be necessary to safeguard a desirable degree of regularity in air transport service. Since that time, experience has served to confirm the conclusion and remove the qualification, which was never anything more than the recognition of a possibility that could not then be definitely denied. As might indeed have been expected, competitive pressures in the air transport field are a powerful force working toward rather than away from greater regularity of service, which is a pattern naturally imposed by market demand.¹⁵ Even had experience proved the contrary, this could hardly have justified the present type of certification, which is geared to the protection of the revenues of individual air carriers. A compulsory commitment to adhere to published schedules except after a certain period of notice—perhaps enforced by a device such as certificate revocation—would seem to be a much more satisfactory solution.

It is not surprising, therefore, that the argument for protective certification based on regularity of service is no longer fashionable. The same can be said for the once-popular arguments that protective entry control was necessary to preserve desirable standards in the treatment of employees and in safety of operation. In both cases, this relative unpopularity is no doubt partly due to the very large and conspicuous effort which has gone into the development of more direct methods of preserving these standards. It may also be due, however, to a growing realization of the implications of these arguments, which in fact must either fail or prove too much. If the protection of individual carrier profits from competitive inroads is necessary to preserve labor and safety standards, this can only mean that any threat of loss, without regard to origin, cannot be tolerated in the air transport field. There is surely no reason to suppose that hard times due to competi-

¹⁴ Cited in note 10 above.

¹⁵ See, for example, the discussion of exempted air transport operations in *Civil Air Policy*, p. 20.

tion should have any more drastic consequences for airline employees and passengers than hard times due to any other type of decline in demand for any carrier's services or to overexpansion resulting from bad judgment. Thus if this type of argument is valid, it proves the necessity of a government guarantee of carrier profits, and, as a logical consequence, the inappropriateness of the industry for private ownership since there can be no private risk.

Recent Views On Regulatory Control

There is, however, a familiar echo of 1937-38 in assertions like the following, which is in fact of surprisingly recent vintage:

"The principle of controlled entry is widely applied in other forms of transportation, as well as in other types of public utilities. In all of these fields, as in air transportation, it has been found that the public interest requires a pattern of regulatory control, to assure the maintenance of sound economic conditions, capable of supporting on a stable basis an adequate level of essential public service."¹⁶

If we define "sound economic conditions" in a given line of business to mean the permanent profitability of every firm in that line, then there is little doubt that one way of promoting these conditions (though not of assuring them) is the use of governmental power to quash any serious competition, both from new firms and among the fortunate incumbents. One has only to state this definition, however, to realize that it is quite unacceptable. It has of course never been found that protective regulation is essential to assure continued provision of an adequate supply of air transport services, any more than it is necessary to secure an adequate supply of soap, doorknobs, or automobiles.

Assertions like that quoted above, which in the old days were customarily backed up by references to railroad rate wars and competitive bidding for air mail contracts under an administrative system which could not possibly have produced satisfactory results, is now related to a claim that protection of carriers' excess revenues in profitable markets is justified in order to enable them to serve non-paying classes of traffic. Indeed, this claim now forms whatever economic content remains in the still-used formula that air transport is a "public utility": a remarkable, if understandable, metamorphosis since the days when "public utility" treatment generally found its economic justification in the desirability of avoiding waste of large amounts of fixed resources and in the peculiarities of certain products which made unified management essential to maximum satisfaction of demand. The metamorphosis is understandable for several reasons, one being the fact that the old forms of the argument were such obvious misfits for air transportation, and another being the point that the argument did not in either form justify a policy aimed toward protection or against competition as such. For example, it furnished no rationale for any

¹⁶ *Civil Air Policy*, p. 18.

control over the entry into the market served by the regulated firm or firms of companies producing technologically dissimilar substitutes.

The mere application of the term "public utility" to air transportation adds nothing in the way of economic substance to the argument for protectionism. Nevertheless, the phrase is currently used in its capacity as legal category in an attempt to show that precedent supports regulatory protection for purposes of internal subsidization—i. e. the financing of uneconomic operations as parasites on services capable of self-sufficiency. For example:

"Every form of transportation involves services which have varying degrees of economic strength. Normally, however, in forms of transportation where subsidy is not available, the carriers themselves support their unprofitable services through earnings derived on their profitable routes. This is consistent with the normal public utility concept in which the furnishing of needed, but unprofitable, service is part of the obligation assumed by a carrier in exchange for the franchise it receives on its more profitable routes."¹⁷

And again:

"In keeping with the normal public utility concept, certificated carriers have a statutory obligation to maintain all authorized services needed by the public on both strong and weak routes. . . . If carriers are to provide the full scale of services needed by the public with minimum reliance on Federal subsidy, they must be able to earn sufficient profits on strong routes to offset losses on weak routes."¹⁸

This sort of contention would perhaps carry more weight—at least in some circles—if it were in fact the carriers (that is, their stockholders) who would pay for the support of uneconomic services. But it is quite obviously not the stockholders but the users of the profitable services who would foot the bill: the argument for protectionism must rest on the assumption that, if there were no state intervention, these users would be furnished the same service at a lower price. There is no justification for saddling a random section of the travelling public with the cost of this support.

Burdening One Class of Traffic

Furthermore, the suggested practice, far from being "consistent with the normal public utility concept" is entirely in opposition to the overwhelming weight of precedent in this field. In all the various forms in which the problem presents itself to a regulatory commission, the actual burdening of one class of traffic in order to provide below-cost service to another is in the great majority of cases rejected as contrary to public policy. For example, as Dr. I. L. Sharfman has noted, it has been the general practice of the Interstate Commerce Commission from the very beginning to refuse to permit the fixing of rates "so low as to impose a burden on other traffic,"¹⁹ and in this view

¹⁷ *Ibid.*, p. 8.

¹⁸ *Ibid.*, p. 18.

¹⁹ *Rates and Charges on Food Products*, 3 I.C.R. 93, 104 (1890) cited in I. L. Sharfman, *The Interstate Commerce Commission* (New York, The Commonwealth Fund, 1936), Part III, Volume B, p. 444.

the Commission has had consistent judicial support.²⁰ The special obligation of the public utility or common carrier to serve all on equal terms is not an obligation to serve at a loss. What is denied to these firms is not the right to cover specific costs but rather the right, normally possessed by other businesses, to refuse to deal with any prospective customer for any reason or for no reason, as a matter of personal discretion. Apparent exceptions to this highly sensible rule are mainly to be found in the relatively minor field of State regulation of public utility abandonments of parts of their operations. Even here, a losing service will not generally be ordered continued unless the burden to the system is very small and the service of considerable significance to the affected community.²¹ In view of the strength of local protests in many such cases, the surprising thing is perhaps the extent to which the regulators have resisted pressures making for internal subsidization. Moreover, it is quite certain that this exception is merely a means of preventing hardship (where this can be done at not too great a cost) to vested interests rather than a policy deliberately planned as a "normal" *quid pro quo* for a franchise. This is clearly shown by the customary recognized limit on the power of Commissions to order extensions of service: in general, the use of this power is limited to situations where it appears that the ordered extension will promptly earn its way and not burden the rest of the system.²² In the regulation of railroad abandonments under the Interstate Commerce Act, though the leading judicial pronouncements leave open some degree of regu-

²⁰ To illustrate: *Norfolk and Western Ry. Co. v. West Virginia*, 236 U.S. 605, 609 (1915): "... it would not be contended that the State might require passengers to be carried for nothing, or that it could justify such action by placing upon the shippers of goods the burden of excessive charges in order to supply an adequate return for the carrier's entire service. And, on the same principle, it would also appear to be outside the field of reasonable adjustment that the State should demand the carriage of passengers at a rate so low that it would not defray the cost of their transportation, when the entire traffic under the rate was considered, or would provide only a nominal reward in addition to cost."

Northern Pacific Ry. Co. v. State of North Dakota, 236 U.S. 585, 598 (1915): "In substance, the argument is that the rate was imposed to aid in the development of a local industry and thus to confer a benefit upon the people of the State. The importance to the community of its deposits of lignite coal, the infancy of the industry, and the advantages to be gained by increasing the consumption of this coal and making the community less dependent upon fuel supplies imported into the State, are emphasized. But while local interests serve as a motive for enforcing reasonable rates, it would be a very different matter to say that the State may compel the carrier to maintain a rate upon a particular commodity that is less than reasonable, or—as might equally well be asserted—to carry gratuitously, in order to build up a local enterprise. That would be to go outside the carrier's undertaking, and outside the field of reasonable supervision of the conduct of its business, and would be equivalent to an appropriation of the property to public uses upon terms to which the carrier had in no way agreed. It does not aid the argument to urge that the State may permit the carrier to make good its loss by charges for other transportation. If other rates are exorbitant, they may be reduced. Certainly, it could not be said that the carrier may be required to charge excessive rates to some in order that others might be served at a rate unreasonably low. That would be but arbitrary action. We cannot reach the conclusion that the rate in question is to be supported upon the ground of public policy if, upon the facts found, it should be deemed to be less than reasonable." (Emphasis supplied.)

²¹ See, for example, C. Woody Thompson and Wendell R. Smith, *Public Utility Economics* (New York, McGraw-Hill, 1941), pp. 448-449.

²² *Ibid.*, pp. 443-444.

latory discretion for the recognition of local user interests in the continuation of a losing service which can be supported by the system as a whole, the record of Commission action strongly suggests that the continuance of unprofitable services is in fact not ordered unless there is good evidence that they will cease to be unprofitable in a relatively short time; in many cases, Commission decisions denying permission to abandon have been reversed when the earnings situation failed to improve.²³

Internal subsidization would be equally contrary to past policy under the Civil Aeronautics Act, where neither Congress nor Board has ever manifested any intention of putting such a program into effect. As a matter of fact, the Board was never given the power to order extensions of service to new routes, whether profitable or unprofitable. It is simply unthinkable that a program of regulation whose *raison d'être* was internal subsidization should have been drawn up without the inclusion of this power (which, incidentally, had been given to the Interstate Commerce Commission with respect to railroads as early as 1920). If there are at present points or routes on air carrier systems that really do result in a burden on other traffic, they have resulted from mistakes rather than deliberate policy. These mistakes, if any, can not now be reinterpreted as enlightened decisions and cited in support of restrictive regulation.

Possibly some misinterpretation of precedent has arisen from the fact that many regulated businesses—in common with a great many that are not regulated—normally serve various classes of customer at prices which contribute respectively more or less than a pro-rata share to the coverage of general overhead. So far from being a burden on the more profitable classes, however, this practice, since it permits the coverage of some of the overhead by purchases which would not be made at a price equal to fully-allocated cost, is in general a means of relief for the former group, given normal profits for the firm as a whole.

If a policy of internal subsidization should be adopted, it might well result in some saving of government funds where some special necessity or political convenience dictated the continuance of a losing service. As has been indicated, the cost of supporting such a service would be neither magically erased nor shifted to the beneficiary of a public franchise. But this is not all. Because the higher price charged for the profitable service will in all probability result not only in excess earnings in this line but also in the loss of some traffic which would have travelled at a lower rate, *the cost of support to the community as a whole will almost surely be increased as compared with that sustained under a program of direct subsidization.* This is because the decline in traffic involves some loss to the shipping or travelling public without any accompanying contribution to the earnings of the carrier.

²³ This question is discussed at somewhat greater length in Lucile S. Keyes, "Passenger Fare Policies of the Civil Aeronautics Board," 18 *Journal of Air Law and Commerce* 46 (1951).

Finally, and perhaps of the greatest importance, there is the question of general precedent. If the argument for protective regulation to finance internal subsidization is accorded respectability in connection with air transportation, it may be applied with great plausibility to a large number of industries with similar economic characteristics. The prospect is even less reassuring if there is general acceptance of the view that a price policy resulting in unequal per-unit contributions to overhead is evidence of the "normal" existence of internal subsidization.

CONCLUSION AND RECOMMENDATIONS

In sum, the arguments now fashionable in support of regulatory protection appear to be if anything less impressive than those current seventeen years ago; moreover, it appears that no more acceptable arguments are about to present themselves. As evidence for this, we may cite the crucial importance now generally attributed to the internal subsidization argument by the proponents of protectionism. Consider, for example, the following statement in a recent study prepared by the staff of the Senate Commerce Committee (emphasis supplied):

"Service which is not self-supporting can be continued only if it is supported, either by subsidy, or by the profits from routes which are self-supporting. That is the choice which must be made—unless service on non-self-supporting routes is to be abandoned.

"To abandon service on all routes which are not self-supporting would mean abandonment of the objectives of the Civil Aeronautics Act. If that were to be done, *the whole system of regulation set up by the act should also be abandoned* and the carriers, certificated and uncertificated, *should be released from their present restraints and permitted to compete freely*. Free enterprise should be permitted to determine the amount of competition and the service to be rendered."²⁴

On the other hand, there is no reason to suppose that the old and well-known case for free competition has lost any of its force in the interim,²⁵ or that the assignment of a protective aim to the regulators has become any more conducive to the proper functioning of either regulation or management.²⁶ Indeed, had there been any need for a specific demonstration of the benefits of free competition in air transportation, it would have been providentially fulfilled by the postwar experience with noncertificated carriers. Therefore, the Congress should promptly provide for the abolition of entry control geared to the protection of carrier revenues.

It may well be that this aim can be most satisfactorily accomplished through a Congressional policy declaration affecting the working

²⁴ *Aviation Study* Prepared for the Committee on Interstate and Foreign Commerce, Senate Document No. 163, 83d Congress, 2d Session, 1955, p. 48.

²⁵ See, for example, Keyes, *Federal Control of Entry into Air Transportation*, and "National Policy Towards Commercial Aviation—Some Basic Problems," *16 Journal of Air Law and Commerce* 280 (1949).

²⁶ This practice forfeits some of the main advantages of regulated private ownership as compared with government ownership. On this point, see Lucile S. Keyes, "Some Controversial Aspects of the Public Corporation," *Political Science Quarterly*, March, 1955.

criteria of the regulatory agency rather than through outright rescission of the certification requirement itself. As has been noted, this requirement may possibly prove in the long run to be the best available means of carrying out certain objectives other than protection. The power to withdraw authority to operate would appear to be a most effective weapon of enforcement for any type of regulation. In addition, as a strictly temporary expedient to decrease opposition on grounds of government economy, it may be desirable to synchronize the removal of protection with the termination of need-rate subsidy in the various sectors of domestic air transport. Such a program might well be accomplished by a continuation of the Board's powers of certification together with a progressive liberalization of their administration. Great care should be taken, however, to make Congressional intent in such a policy declaration entirely clear, in order to minimize the chance that faulty administration might prevent the actual elimination of all the anticompetitive elements of entry control. Moreover, no time should be lost in putting the new policy into effect: first, to insure the continuation of noncertificated services now operating on subsidy-free routes, and, second, to avoid the possibility that the now self-supporting certificated carriers might slip back to a subsidized status before the Board should put an end to their eligibility for subvention.

The continuation of protection cannot be defended as a permanent or long-run method of reducing government expenses in connection with any type of subsidy. With respect to international air transport, as the A. C. C. report suggests, attention should immediately be directed to the formulation of a support program free from the objectionable features of that now in operation. The institution of this program on any given route might mark the most acceptable occasion for the removal of protection with respect to services on that route.