The Illusion of Air Line Subsidy

Carleton Putnam
NO phantom of the public imagination is more easy to understand, more difficult to combat, and yet more essentially false, than the illusion of air line subsidy. It haunts the halls of Congress, stalks through the press, directs the pen of scholars, and beguiles the hurried thoughts of the average man. In a recent issue of this JOURNAL an elaborate structure of analysis was built in its name, starting with an assumption on which all else depended but which was never itself examined. The purpose of this article is to examine it, and to provide an amulet for readers who would be defended against such phantoms in the future.

Let us begin by realizing that there are those who have much to gain when the ghost walks and who struggle artfully for its perpetuation. The railroads, having received more than six times the "subsidy" attributed to the air lines, and the water carriers, having had twelve times as much, find nothing graceless in conjuring it to rise beside the cradle of the infant brother. The bootleg air lines—and by bootleg air lines are meant operators who hold themselves out to the public as air lines but to the law as something else—partake in the ritual. And there are among the scheduled carriers a few large companies that eschewed pointing at shadows in their younger days but see nothing Punic in pointing to them now when doing so may serve to embarrass or destroy competitors.

These groups have on their side the increasing tendency of Government officials to be so harassed with a variety of problems that no time remains for a careful study of any, together with what Clifton Fadiman has called "the decline of attention" on the part of the public in recent decades to matters requiring self-induced cerebration. The writer will try to adapt himself to these conditions but begs the reader to remember that the nature of the subject precludes his doing so completely.

2 For studies on this subject developed by the writer, see Hearings before the Committee on Interstate and Foreign Commerce, U.S. Senate, 81st Congress, 1st Session, Pursuant to S. Res. 50 (hereafter cited as S. Res. 50), Part 1, pp. 456-468, 486-487 (1949).
A Helpful Analogy

It will be helpful to start with an analogy which may at first seem an over-simplification but which contains all the essentials of the matter. Each morning a postman brings letters to a residence and for this service receives a salary. No one has thought of calling the salary a subsidy. But upon a certain morning the householder at the residence makes the postman a proposition. If the postman will stop on his route at the neighborhood grocery and bring the householder’s daily groceries with the mail, the householder will undertake to pay the postman a certain sum for his trouble. This proposition the postman accepts, with the proviso that he will deduct the certain sum from his salary, thereby reducing the cost to the Post Office of delivering the letters. Is it now proper to say that the postman’s salary has become a subsidy? Rather does it not seem that the postman has done something on behalf of the Government which makes the transaction the diametric opposite? Has he not reduced the expense of a service which otherwise would have cost the Government more to the exact extent of the householder’s contribution?

The analogy to the relation between the air lines and the Post Office is complete in every respect. There is no difference in any essential factor save that the Government itself urged upon the “postman” and the “householder” the cost-reducing transaction. The first air mail was carried by the Government in Government mail planes. Then the Government made contracts with private individuals to carry the mail. Thereafter it became the practice for these contractors to carry passengers also, and they were urged to do so by the Government, in order to reduce the cost of carrying the mail. At no time was this thought of as a subsidy, any more than the payment of a letter or rural-free-delivery carrier’s salary was thought of as a subsidy. Why, then, and at what point, does the further development of the passenger business turn the payment for carriage of air mail into a subsidy?

It is this writer’s belief that nowhere in the annals of government can there be found a more skillful device, a more thorough procedure, to protect the federal treasury against any jot of subsidy to the air lines than that contained in Sec. 406 (b) of the Civil Aeronautics Act. The whole effort of a five-man judicial board and a staff of hundreds is bent to the task of draining out the last possible penny of payment to any air line over and above the clearly, honestly, and efficiently incurred costs of carrying the mail, minus the net income from other sources which the Board demands the air line cultivate as diligently as it cultivates economy of operations. It is as if a Board were set up to supervise every activity of our postman, to make sure all possible groceries were carried, that all receipts from this source were deducted from salary, and that any claims for larger mail sacks were carefully scrutinized.
Genesis of the Illusion

At this point, the victims of the subsidy illusion customarily answer that we are regarding the form rather than the substance, that the air lines have long since passed beyond the letter-carrier stage and must be treated as we now treat the railroads, that commercial business is the primary business of the air lines and the mail a minor matter, and that there is no distinction in substance between land-grant aids to the railroads in the mid-nineteenth century, or other Government subsidies, and the aid channelled through mail payments to the air lines.

Let us consider this answer sympathetically. If subsidy starts at a certain place on the scale of relative volume, how do we logically find it? Is it at 40% or 50% or 60% or 90% or 73% of passenger-load predominance? We cannot come to allocated cost devices yet, nor until we transform the postman into something else. Do we accomplish this by legislative fiat, and if so, what principles guide the legislators? Is it a "judgment figure"? Can certified public accountants settle it, or shall we call in management engineers? If a Yale lawyer says it is a matter of route segment analysis, and a Harvard Business School study indicates it is a question of air line systems, shall we call in arbitrators or refer the issue to the circuit court?

A moment's consideration should reveal the hopelessly unscientific nature of this approach, the hit-or-miss thinking it involves, and we begin to understand why the matter today is in such confusion. Clarification begins with definition, and before we proceed further, it may be wise to attempt a definition of subsidy. The following is offered as reasonable: a subsidy is the tendering of something for less than its economic equivalent at the time of the transaction. Consider the railroad land grants. Millions of acres of land were tendered the railroads, without any regard to the immediate cost of railroad building or operation, for the sake of the long-term development of the country. No one disputes the policy. But there was no economic or other equivalent at the time of the transaction. Hence we rightly refer to this as a subsidy. Or consider the carriage of second-class mail for less than the cost of the service. There is no economic equivalent for this, either at the time of the transaction or later. So, clearly, this is a subsidy. Or take the payment to farmers of a support price for surplus food. Here something is tendered which is more than the economic equivalent of what is received, now or later. All these things fall easily within the scope of our definition.

But what of mail payments to the air lines? Here the Post Office Department pays the carriers, on an account-rendered basis, for services already performed at a price fixed by the CAB as the filtered equivalent of the actual cost of carrying the mail, reduced by the extent to which

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8 But we cannot overlook the fact that for every user of the non-mail services there are fifty users of the mail service. From the point of view of a democracy, when the diffusion of the use is considered against dead weight in the planes, the mail service is fifty times more important than the other services.
the income from other services exceeds the added cost of producing it. This, if anything, is the subsidy process in reverse. The Post Office pays less than it would be compelled to pay under any other circumstances — half to three-quarters what it would pay if it carried the mail in its own mail planes. Clearly, the *quid pro quo* is "at the time of the transaction." The only area of possible debate revolves around the issue of "economic" equivalence, and it is here we come to grips with the phantom in its most seductive form.

The Allocated Cost Approach

For, at this point, the accountants enter with formulas they habitually apply to open commercial transactions, the most insidious of which is the concept of allocated costs. On an air line, this concept consists of removing from the carrier's expenses all direct costs possibly attributable to other services and then dividing the remaining costs in the ratio the ton-miles of mail carried bear to the ton-miles in other service. The result as to mail is then called "the cost of carrying the mail," and any further payment needed to keep the carrier in business, after his other income is considered, is called "subsidy." There may be some minor variations in the concept, a *soupçon* may be added for serving small towns, and a *je ne sais quoi* for operations after midnight, but by and large we can safely refer to the concept as the ton-mile allocation approach and the result, in the minds of the accountants, as the true cost of carrying the mail.

But now we face an enigma. Let us illustrate it by a simple case. Suppose we apply the ton-mile allocation approach to a certain air line and discover that the "cost" of carrying the mail is 10¢ and of the other services 90¢. But the income obtainable from the other services does not, and cannot, approach 90¢. Consequently, unless the mail pays more than 10¢, nothing moves — there is no service, no mail is carried. Under these circumstances, how can 10¢ be said to represent the true cost of carrying the mail? If it did, the mail could move. *Can it be possible to pay the true cost of moving something and yet have it remain economically impossible to move it?* Obviously, we cannot arrive at the true cost of carrying the mail until it becomes economically possible to move the mail, and this point cannot be reached until the gap between the non-mail revenues and the total cost is closed.

Or let us approach the subject from the opposite angle. Eliminating legal restrictions that do not bear upon the issue, let us assume an air line operator, confronted by an allocation formula that stigmatizes part of his mail pay as subsidy, wishes to avoid the stigma. Accordingly, he discontinues everything except his mail service. Immediately *all* his costs must be allocated to carrying the mail, so the subsidy disappears. But the cost to the Government increases! *Can something be a subsidy at 10¢ a mile, and not a subsidy at 20¢?* Again, obviously not.

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4 The writer makes the assumption, he believes properly for the purpose of this discussion, that the public would be entitled to a reasonable replica of the mail service it presently enjoys as regards both speed and frequency.
The ton-mile allocation concept collapses for the very reason that there is no economic equivalence between payment on an allocated cost basis and the service actually rendered. Equivalence is not reached until payment and true cost are in balance. Ton-mile allocated cost is not true cost— if it were, movement of the mail would be economically possible. The true cost is found when, by its payment, movement can begin. And, by definition, the payment of true cost cannot be subsidy.

Broadening the Analysis

It follows that the analysis must be broadened to make sure the service could not be obtained more cheaply and as adequately by other means. This includes making certain first that the cost of the ancillary services is covered by their income, and secondly that no other form or vehicle of transportation can duplicate the end result for less money. It is clear, for example, that it would be cheaper for the Post Office to carry first-class mail by truck than to support a railroad system stripped of all other functions than the carriage of mail and, consequently, if the Government were to undertake to close the gap between mail and non-mail revenues on the rails, this would be a subsidy. But it is equally clear both that the ancillary services more than cover their added cost in the air and that it would not be cheaper for the Government to fly mail otherwise than in a skeletonized air line service, if the standard service were not available.\footnote{To put the point another way, if the non-mail revenues of the railroads pay only their added costs, the remaining plant is out of all proportion to the needs of the mail service, whereas when the non-mail services of the air lines pay their added cost, the remaining plant is essential to the air mail service.}

Let us beware here of falling into any fallacies as regards the passenger business. We have seen that the allocated cost theory fails because, except in the most isolated cases, the cost assigned to the mail on a ton-mile allocation basis prohibits a transaction. But it does not follow that when, on the same basis, the passenger is charged less, he is subsidized. The Government pays nothing additional to or for the movement of the passenger. It gains by his movement. We cannot classify as subsidy a transaction which not only does not involve any additional payment but actually saves the Government money.

A clearer view of this situation will be obtained if we refer again to our definition of subsidy. It may seem at first blush as if the passenger were being tendered something for less than its economic equivalent, but note that the basic tender is to the user of the air mail service and that the only tender to the passenger is the tender of the added service for which the passenger pays more than the added cost.\footnote{Note further that the only tender the Government makes is to the user of the air mail service, that the tender to the passenger is made by the air line, which initiates all price and service controls bearing upon this transaction, provides at its own discretion the added service, and for it charges the passenger more than the added cost. The Government tenders nothing to the passenger in the legal sense, and nothing in the economic sense which it has not already been compelled to tender \textit{in toto} to the user of the air mail service in the initial transaction.} The same rea-
soning is applicable to the user of air freight and air express. All of these services might perhaps be regarded as ancillary parasites upon the tender to the user of the air mail service, but not as objects of subsidy themselves. Even as parasites their nature is peculiar, for they give while they gain.

**Subsidy to Air Mail Users**

The major point has now begun to emerge. If we assume that the Post Office Department's Cost Ascertainment Report is based on sound principles of accounting, we find the Government suffering a net loss on the operation of the air mail service: Somebody must be subsidized. Who is it?

In such a situation, it would seem only natural to suspect that the subsidy in the case might be to the users of air mail. And applying the tools already developed it becomes plain that the only party to whom something is being tendered for less than its economic equivalent at the time of the transaction is the purchaser of the air mail stamp. The air lines are no more involved in this subsidy than are the workmen who build the house a man gives to his son. The man pays the workmen, but the gift is to the son. No other gift is involved.  

This illuminating fact has a decisive bearing upon the whole air line controversy. One cannot segregate a subsidy to the air lines when the subsidy is to someone else. The place to segregate a subsidy is in the spot where it occurs. If the subsidy is to the users of the air mail service, the place to study it, and to segregate it, is not in the accounting offices of the air lines, or in the CAB, but in the Post Office Department. The payments to the air lines, like the wages to the workmen, need be considered only once, and for what they are, as an element of true cost to which is added a proration of the Post Office Department's overhead, the sum then being balanced against the income from air mail postal revenues. If the result is a deficit, the deficit is the measure of the subsidy. Air line studies and cost allocations become meaningless.

**Significance of the Distinction**

Once this truth is accepted, the weary years and the useless expenditure of money and energy that would otherwise go to the futile effort to materialize a phantom are forestalled. But it seems as if the truth dawns on the victims of the illusion in two stages. The first comes with the realization that the subsidy is to the users of the air mail service, the

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7 Although the Chairman of the CAB appears at the moment to have taken inconsistent positions in the matter, the following extract from his testimony before the Senate Interstate and Foreign Commerce Committee is of interest:

*Mr. O'Connell:* "... It may be well to point out that provided the carrier's management is honest, economical and efficient, the payment by the Government of the amount necessary to meet the needs of the carrier and to furnish it with a return on its investment is not a subsidy to the carrier. Rather it is a subsidy to the persons who use the air service. ..."

*Senator Tobey:* "Pardon me for interrupting you. I was interested in that last qualification about its being a subsidy for the public. Of course it is. ..."
second when the significance of this fact is appreciated. One must guard against the assumption that a subsidy to the users of air mail and a subsidy to the air lines are in any way related as far as segregation, or anything else, is concerned. Government officials appear at times reluctantly to accept the true nature of the subsidy, while still pressing for some sort of mail pay segregation, a position which a moment's thought will show to be untenable. If the subsidy is to the users of the air mail service, all mail payments to the air lines are true cost payments and there is nothing to be segregated.

The following equations may assist in making this point clear. If \( R \) = air mail postal revenues, \( C \) = air line costs, \( O \) = prorated Post Office Department overhead, and \( S_1 \) = subsidy to the users of the air mail service, then

\[
(C + O) - R = S_1
\]

For the purpose of this equation, air line costs and air line mail rates must be considered synonymous, so that the equation may finally be written

\[
(M + O) - R = S_1
\]

where \( M \) equals the total mail payments to the air carriers.

This equation bears no relation whatever to any equation that might be written under the air line subsidy illusion. Such an equation would necessarily read

\[
C - (R_n + Ac) = S_2
\]

where \( C \) equals the total costs of any air line, \( R_n \) = non-mail air line revenues, \( Ac \) = the ton-mile allocated cost of carrying the mail, and \( S_2 \) = subsidy to the air line. This equation is sterile because, as we have seen, \( Ac \) does not represent true cost in the majority of situations. When it does, \( S_2 \) disappears, since in such situations the terms must be related by

\[
C > R_n + Ac
\]

In any case, the absurdity of assuming identity in the two equations (2) and (3), which have only one out of four terms in common, is obvious.

**Related Misconceptions**

One may wonder at the slow and painful release of the mind from the enslavement of the air line subsidy illusion until one remembers the desperate purpose of those who seek to perpetuate it. Once this illusion goes, the way is open for the collapse of the whole fabric of fantasy that has been erected by the enemies of the air lines since the war, under cover of which every conceivable means has been taken to embarrass air line managements, stigmatize air line mail pay, and otherwise discount the achievements of air transportation. Magazine and newspaper articles have poured in a flood from the presses of the country, editorials have followed, commentators have joined the chorus, all
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deploining the financial weakness of the air lines, their heavy subsidy, their bewildered managements, and their "increasing dependence on Government." In consequence, air line stocks have crashed on the exchanges, and the general impression prevails that the air lines are a sick, sore, and sorry segment of the economy.

This is precisely what the surface transportation interests want. It perfectly suits the purpose of the bootleg air lines. A few large legitimate carriers see in such chaotic thinking the possibility of loot among the smaller scheduled companies. To dispel these fantasies must be for them an irreparable unmasking. Almost anything is worth doing to perpetuate them, regardless of the dishonesty involved.

And much dishonesty has been involved. He who wakes from the dream of air line subsidy will be amazed at the extent of his misleading. Laying aside the question of subsidy itself, let us consider just a few of the collateral deceits:

1. Instead of an "increasing dependence on Government," the fact is that the air lines in the last ten years have achieved a 65% reduction in their charge to the Government for the carriage of the mails.

2. Instead of profligacy of management, the fact is that the air lines in the last ten years have cut seat-mile costs in half.

3. Instead of a burden to the taxpayer, the fact is that the air lines through the air mail service have, up to 1948, earned back for the taxpayer $54,000,000 more than the true added costs of the service to the Post Office Department. Since the overhead would have had to continue in any case, the taxpayer at the time of the study was $54,000,000 ahead in cash because of the air mail service.

4. Instead of a relatively costly subsidy to the air lines, the fact is that the actual subsidy to users of the air mail, including Post Office Department prorates, has amounted in thirty years to about half what the subsidy to the users of second-class mail amounts to in one year.

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8 Other contributing factors to this misconception have been considered by the writer in the Winter 1949 issue of AIR AFFAIRS, pp. 491-492.
9 Adjusted for the change in the value of the dollar.
10 Idem.
11 By added costs are meant not simply "direct" costs, or costs allocated under the Act of June 9, 1930; the writer, with the help of the Cost Ascertainment Division of the Post Office Department, has screened all overhead of the Department and retained every expense which by any possibility might not have been incurred if there had never been an air mail service. See S. Res. 50, Part 1 of Hearings, pp. 458-461, Part 3, pp. 1340-1342.
12 Idem, Part 3 of Hearings, pp. 1318-1319. Here the Postmaster General says: "As shown in the statistical exhibits attached to this statement, the total deficit incurred from the inauguration of the first air mail service in 1918 up to the close of the fiscal year 1948 amounts to $107,488,430 for both the foreign and domestic service. This may be regarded as an investment over the 30-year period." On page 1296, he says: "The present (annual) subsidy on second-class mail is about $207,000,000. The present (annual) subsidy on third-class mail is about $139,000,000. The present (annual) subsidy on the penny postal card is about $67,000,000. The present (annual) subsidy on fourth-class mail is about $82,000,000. ... So far as the financial condition of the postal service is concerned, the so-called air mail subsidy is the least subsidy we have."
The record on these points alone surpasses beyond doubt the record of any other form of transportation in the history of this country or the world. Neither the railroads nor the water carriers can touch it. As the phantom retreats into the shadows and the truth dawns upon the mind, the shameful misrepresentations and the outright calumny visited upon the air transport industry since the war are disclosed. It is a question which is the more shocking — the traducement of the air lines or the gullibility of the public, the press, and the Congress in their acceptance of the defamation. Any fair-minded examination of the record will reveal an achievement worthy of the highest praise by any standards. That the air lines for so long have been tendered just the opposite will remain one of the paradoxes of history.

**Additional Economic Off-sets to the Air Mail Subsidy**

Because of its many non-economic aspects and the difficulty of close statistical analysis, the contribution of the air lines to the national defense has thus far been omitted from this paper. But in evaluating the economic offsets to the public of the relatively small subsidy to the users of air mail, it cannot be entirely ignored. The writer is authorized by the Office of Public Information, Headquarters Military Air Transport Service, to quote the following statement:

Direct relationships between the civil air carriers and MATS are always misleading because the function of the civil carriers is to provide commercial airlift, whereas the function of MATS is to maintain a nucleus prepared for great expansion to meet military requirements in time of war. In peace-time, MATS military airlift is only a by-product in MATS preparedness for war. Both the civil operators and MATS intend that their combined resources shall be used to the best national advantage in time of war. Today the combined resources of both are short of the war requirement. Consequently, if there were no civil airlines in operation, there would obviously be a very great increase in the military budget required to replace the war potential represented by the civil capacity.

The exact amount of such increase, either percentage wise or on a dollar basis, is impossible to estimate because the total absence of the civil airlines would affect far more than the air transport functions of the Military Air Transport Service and the other military agencies equipped with transport aircraft.

The cost of MATS air transport functions during the fiscal year 1949 was $82,527,051. As of 31 October 1949 there were 263 major transport aircraft (C-46, C-47, C-54, C-74, C-82, C-97, C-118 and C-121) assigned to the Air Transport Division of the Military Air Transport Service.

For comparative purposes it may be noted that the commercial air lines of the United States maintain a fleet of 1083 planes of equivalent

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13 The Appropriations Committees of Congress decry the “increasing appropriations for air mail,” but mention is never made of the fact that the Post Office today, by comparison with pre-war years, is getting five times the mail carried for only three times the money, while paying twice the pre-war price for everything else. Nor is mention made of the subsidy to second, third, or fourth-class mail, or rural free delivery, or the penny postcard.
categories in constant activity, with a full complement of pilots and mechanics. The reader may estimate for himself the extent of the "very great increase in the military budget required to replace the war potential represented by the civil capacity" by relating 263 planes to 1083 planes, and $82,527,051 to his estimate. The approach is rough but suggestive. The figure may then be placed beside the $27,000,000 annual subsidy currently assigned to the air mail service by the Post Office Department.

Another factor difficult of analysis is the dollar value of the time saved to the passengers of the air lines by comparison with travel by rail. Studies have been undertaken in this area on the assumption that the average air line passenger earns a salary of $4,000 annually, and preliminary results indicate a total saving to the national economy of not less than $130,000,000 a year, after allowance has been made for the added cost of the air ticket.

Perhaps no contribution to the general welfare has had larger significance or received less attention than this subject. The writer believes Mr. Bennett deserves great credit for introducing it to research workers in the field of air line economics. It embraces a concept, however, which extends beyond the range of economics and is succinctly expressed by the phrase, "making a neighborhood of the nation." Countless social gains are involved when horizons are at once made broader and more accessible. Many of the gains can be expressed in monetary terms, but many cannot.

CONCLUSION

By way, then, of summation, we find an air transport industry required by law to earn every cent of the pay it receives from the Government in the performance of a function involving a subsidy to the users of air mail of some $27,000,000 a year. By comparison, the subsidy to second-class mail is $207,000,000, to third-class mail $139,000,000, to fourth-class mail $82,000,000, and to the penny postcard $57,000,000. The cost of rural free delivery cannot be estimated. As immediate economic offsets to the subsidy to the users of air mail are the factors mentioned in the preceding paragraphs, plus the intangible value of developing a new transport industry of incalculable future possibilities.

Reference has already been made to the relative status of air transport in American transportation history, as regards both payments received from, and speed and quantity of earnbacks to, the Government. We have seen that the cost to the Government of carrying the mails has declined 65% in the last ten years and that the peacetime trend has been steadily downward, so that within the foreseeable future the air lines may be earning a profit for the Government on the air mail service.

14 Analysis begun by J. Bennett of Washington, D.C.
The Essential Question

In the face of these various factors, the question inevitably must be asked: What justification exists for the current rash of investigations and proposed changes in the Civil Aeronautics Act? One can understand a desire to change a law when results under it have been doubtful. It is hard to understand such a desire when results have been superlatively good. Can the taxpayer or the industry afford a Roman holiday every few years for the eager young men on the staffs of Government commissions and committees, ably assisted by interests which stand to gain by disruption? The interminable analyses and re-analyses of airline accounts and statistics by Government bodies, permanent and temporary, are expensive to both the industry and the taxpayer.

Moreover, most of the proposed new legislation would tend to make the temporary analyses permanent. For example, while the writer cannot see how, by any stretch of the imagination, Government payments to the airlines can ever be termed subsidy, other approaches to these payments may be rationalized which would still involve cost allocations. It is the writer's opinion, after fifteen years of experience with the keeping of airline accounts, statistics, and other records for the Government, that further to complicate the existing requirements would be more time-consuming and expensive than could be justified by any conceivable benefit to be expected from it. It is suggested to men and women, whether in the Government, in universities or elsewhere, who wish to exercise their wits and social theories on experimental legislation, that they do so otherwise than at the expense of a successful industry and a successful Act.

It is also devoutly to be hoped that the dispelling of the illusion of airline subsidy, the envisioning of whatever subsidy exists as a subsidy to the users of the air mail service, the significance of this distinction, and the minor nature of the air mail subsidy in relation to other subsidies may commence a process which will purge the public consciousness of the countless collateral fallacies grown in the rank shadows of the major phantom. Such a purge is long overdue. Noticeable damage has been done the industry and its stockholders, its personnel and all who dedicated themselves to its future at the close of the war. The temper of management has become restrictive, the confidence of investors has been undermined, and the morale of employees has been lowered. This is not only an unsuitable reward to visit upon air transport but an unwholesome atmosphere in which to expect any pioneer enterprise to progress. The air lines of the United States have done their fair share in the public interest, and will continue to do so if the public is fair to them.