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SUBSIDIES AND COMPETITION AS FACTORS IN AIR TRANSPORT POLICY*

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IN April 1949 the Senate Committee on Interstate and Foreign Commerce began to hold a series of hearings for the purpose of investigating the financial stability and operational efficiency of the air-line industry. These hearings continued through June 1949 and were resumed again for two days in January of this year. Subsequently, a document of some 2,500 pages has been published containing the testimony of 86 persons, in addition to considerable correspondence and miscellaneous data.

The purpose of the investigation, as revealed in the letter signed by Senator Edwin C. Johnson, Chairman of the Committee, inviting witnesses to appear was "to learn why, in a period of unprecedented prosperity, the air-line industry is in such poor financial condition."

The letter further asked: "Can it be explained by excessive competition? Is it poor management and loose, easy-going financial policies? Are there too many vice presidents with unlimited expense accounts and too elaborate downtown ticket offices? Is it the continuing impact of postwar reconversion and expansion? Has it resulted from administrative practices by the Civil Aeronautics Board or the Civil Aeronautics Administration? Is it due to policies laid down by Congress?"¹ These and other questions were asked.

* Paper prepared for the Annual Meeting of the American Economic Association, Chicago, Illinois, December 27, 1950.

¹ *Air-line Industry Investigation*. Hearings pursuant to S. Res. 50 before the Committee on Interstate and Foreign Commerce, United States Senate, 81st Congress, 1st and 2nd Sessions (April 11, 1949-Jan. 31, 1950) p. 2.

SUBSIDY AND COMPETITION ARE MAJOR ISSUES

Review of the testimony collected during the "Air-line Industry Investigation" finds two major issues continually crowding other problems of public policy from the scene. The first is the question of *subsidy* — to what extent should commercial air transportation be promoted by means of public aids or subsidies? The second is the question of *competition* — to what extent should competition be restricted in commercial air transportation? At the risk of neglecting other important areas of public policy toward air commerce, it seems desirable because of their pre-eminence to limit this discussion to a brief consideration of these two areas of great controversy.

Inasmuch as freedom from government support and freedom from government control are often considered essential to the preservation of the American system of private enterprise, we may well consider the possible short-run and long-run effects of surrendering these freedoms to a considerable extent in our public policy toward commercial aviation. It has been said that the price of security is the loss of freedom. Thus, there is a distinct relationship between government subsidy and government control — not only of competition but of many other things. He who accepts subsidy must accept government control.

Competition may be restricted in transportation even without regard to the question of subsidy. Since 1920 railroad competition has been subject to government restrictions and the same has been true of motor carrier competition since 1935. These restrictions of free competition in transportation have been based on a fairly recent development in the philosophy of transportation regulation, namely, protection of the carrier from "excessive" or "destructive" competition. Because this is a far cry from the original public policy of encouraging carrier competition and restricting monopoly, it represents a highly controversial question. The question resolves itself to whether, like railroads, air lines shall be treated as *public utilities* and subjected to the full gamut of public utility controls, or whether they will serve the public better and achieve greater prosperity if treated as relatively free competitive enterprises performing a public service.

NATURE AND EXTENT OF AIR TRANSPORT SUBSIDIES

What is subsidy? What is public aid? Are these two things equivalent? While the two terms are frequently used interchangeably, there might be some advantage to making a distinction between them. Fundamentally, a subsidy is a gift — a one-way transaction, without provision for repayment. Public aids, on the other hand, are often in the nature of temporary grants or loans — two-way transactions, with definite provision for reimbursement of the public treasury. It is important to note that *public aids may include subsidies* as well as temporary

aids which are eventually repaid in some tangible way. Thus "public aid" is a broader term than "subsidy."^{1a}

A recent study entitled *Subsidies to Transportation* by Burton N. Behling, states that "in addition to the element of direct subsidy included in air-mail payments to the domestic and U.S. flag international airlines, these carriers also are subsidized (indirectly) by the provision of airport and airway facilities and other navigation aids."² The airlines have also benefited from government aeronautical research and development and this type of aid may become more important if Congress decides to finance the development of "prototype" aircraft for both civil and military purposes.

In order to assist an infant air transport industry, Congress in 1938 authorized the payment of subsidies, in the form of air-mail pay, to meet the legitimate financial needs of the certificated air carriers.³ The valid measure of the amount of subsidy to the carriers receiving air-mail payments is the excess of such payments over the costs to the carriers of rendering the air-mail service, including a reasonable allowance for return on investment.⁴ In recent years air-mail payments have increased substantially—from \$46 million to all air carriers in 1946 to \$112 million in 1949. In addition, in 1949 the carriers received \$30 million in retroactive mail pay to cover their losses before 1949. When various witnesses were asked how much of the air-mail pay represented subsidy, no one could say. Estimates ranged from 40 to 60 per cent.⁵ The problem was sized up thus by Postmaster General Donaldson:

"The total cost for both domestic and foreign air mail this year . . . is, in round numbers, about \$120 million, and by the highest stretch of the imagination you could not presume to state that the subsidy would be more than half of that, if that much . . . I have my doubts about the subsidy being more than around \$35 million, but nobody has yet determined what is the fair and reasonable rate we should pay for this service that is performed for us, and until

^{1a} See *U.S. Federal Coordinator of Transportation, Public Aids to Transportation*, Vol. 1 p. 4 footnotes and the sentence: "It became clear early in . . . this series of studies that the term 'subsidy,' unless given a much broader meaning than it commonly conveys, would not suffice to cover the varied forms which (public) aid to transportation has taken." (Italics supplied.) On the other hand, the *U.S. Board of Investigation and Research, Public Aids to Domestic Transportation* (p. 53) does not clear up the confusion when it says "There appears to be no significant difference between 'public aid' and 'subsidy,' and hence the two terms are used interchangeably . . ." Webster's International Dictionary emphasizes the *gift* aspect of subsidies. RFC loans and Federal land grants to railroads are good examples of public aids, but since they involved definite terms for recompense to the government, they cannot be considered gifts or as having any likeness whatsoever to the ordinary concept of subsidies, viz., agricultural subsidies.

² Behling, Burton N. *Subsidies to Transportation*, Library of Congress, Legislative Reference Service, Public Affairs Bulletin, No. 86, August 1950, p. 30.

³ Article by Senator Edwin C. Johnson, "Proposed Senate Action on Air Mail Subsidies" 17 *J. Air L. & Com.* 253 (Summer 1950).

⁴ U. S. Board of Investigation and Research. *Public Aids to Domestic Transportation* (H. Doc. 159, 79th Cong. 1st sess., staff report, p. 75).

⁵ Article by Senator Edwin C. Johnson, *op. cit.* p. 254.

somebody determines what we ought to pay the air carrier for the service he performs for us and what is the right rate of pay we should pay him, then and only then can you separate the subsidy from the total payment."⁶

There has come to be general agreement not only among committees of Congress and government agencies concerned, but also among some of the scheduled air-mail carriers that subsidy should be separated from mail pay. For instance, President E. V. Rickenbacker of Eastern Air Lines told the Senate Interstate and Foreign Commerce Committee:

"A tragic error which has been committed by the CAB and by many of the leaders of the industry has been the assumption that Section 2 and Section 406—the mail pay section—of the act have set air transportation apart from all other businesses and have made it immune to the grim necessities of sound business practices and have promised it a blank check and have guaranteed each air carrier a livelihood at the expense of the taxpayers."⁷

In an interim report submitted May 5, 1950 to the Senate Appropriations Committee, Senator Johnson recommended that subsidy be separated from air mail payments. However, he suggested that the direct subsidy for domestic air transportation "should be specifically identified and presented to Congress on a community basis." His report referred to significant evidence collected by his committee that, in general, airlines carrying only a long-haul business and servicing but a few high-density points could operate profitably without direct subsidy.⁸ Thus considerable attention is currently being given to the subsidy element in air-mail pay. But, what about the indirect subsidies to commercial air transportation through provision of airways and airports at public expense?

Taxpayers of the United States have an investment of about one and one-half billion dollars in civil airports. Of the larger airports, which are financed by Federal, State and local appropriations, only a handful are self-supporting even to the extent of returning out-of-pocket operating and maintenance expenses.⁹ The Federal Aid Airport Program for the 1951 fiscal year involves a total expenditure of \$51 million of which \$25 million is Federal funds and \$26 million are state and local funds.¹⁰

From its inception in 1925 through the year 1949 total expenditures on the Federal Airways System amounted to \$478 million of

⁶ *Air-Line Industry Investigation, op. cit.* pp. 1296, 1298.

⁷ *Ibid.* p. 1112.

⁸ *Separation of Air Mail Pay from Subsidy*, Committee print reproduced in 17 *J. Air L. & Com.* 333-346 (Summer 1950). See also address by Edw. C. Sweeney, "Identification of Air Mail Subsidy and Its Effect on Airline Communities," 17 *J. Air L. & Com.* 459 (Autumn 1950).

⁹ *Air-line Industry Investigation*. (Testimony of D. W. Rentzel, Administrator of Civil Aeronautics, April 14, 1949) p. 177.

¹⁰ *Competitive Transportation Review*, Association of American Railroads, November 1950, p. 10.

which nearly three-fourths was for operation and maintenance and the remainder was classed as "cost of establishment."¹¹ According to the Federal budget, expenditures for the development, installation, and operation of airway facilities are estimated at \$136 million for the fiscal year 1951. As now projected, the system of electronic airway navigation aids under the so-called SC-31 program is expected to require 15 years for completion and will cost an estimated \$1,113,000,000.¹²

The problem in connection with airport and airway aids is to determine the proper shares attributable to the several classes of beneficiaries — government and the military, private flying, and commercial airlines. Then arises the question of suitable user charges. To date the air lines have paid no user charges for the Federal airways facilities and other navigation aids. However, the Civil Aeronautics Administration has proposed that "the initial step toward making the Federal Airways self-supporting beginning in 1953, with a tax of 1.5 cents per gallon on high-octane aviation gasoline." The estimated return from such a tax would be \$8,500,000 annually.¹³

Commercial air lines ordinarily pay airport landing fees at rates determined by negotiations between the municipality and the carrier. Through landing fees and other revenue sources, including terminal building concessions, it is believed that, within a comparatively few years, the majority of the large terminal-type airports can be made self-supporting.¹⁴ In June this year a spokesman for the United States Chamber of Commerce recommended to a House subcommittee that the Federal Airport Act should be amended to exclude local and personal flying airports, and all airport buildings and land, from participation in federal aid and make it clear that federal-aid funds should not be made available for airport maintenance. The funds, he added, should be restricted to the federal share of costs of grading, drainage, runway construction, lighting and radio aids to navigation at airports of interstate importance.¹⁵

INFANT INDUSTRY AND DEFENSE CONSIDERATIONS

Direct air-mail subsidies and indirect airway and airport aids to air commerce have been justified on the two grounds of infant industry and national defense. It has long been a tradition in this country to encourage the early growth of desired transport techniques through public aids and subsidies. While there is feeling in some quarters that commercial air transportation is no longer an infant industry and has passed the stage of "coddling and wet nursing," the defense argument

¹¹ Dearing, Charles L. and Wilfred Owen. *National Transportation Policy*. Wash. D. C., Brookings Institution, 1949, p. 21.

¹² Behling, Burton N. *op. cit.* p. 43.

¹³ *Ibid.* p. 44.

¹⁴ Bollinger, Lynn L., Alan Passen and Robert McElfresh, *Terminal Airport Financing and Management*. Division of Research, Graduate School of Business Administration, Harvard University, Cambridge, 1946, p. 4.

¹⁵ *Competitive Transportation Review*, *op. cit.*, July 1950, p. 9.

nevertheless still weighs heavily. To appreciate this we need only refer to the *Report of the Congressional Aviation Policy Board* (1948) which states:

"Airway facilities which give scheduled dependability to civil air lines also give tactical dependability to military air forces. Airports which serve the burden of national and international traffic also can base tactical or strategic combat squadrons. Transport fleets which serve commerce in peace can tie together tactical and administrative requirements in war."

From the military viewpoint, it would seem that an industry with the maximum number of modern planes and trained personnel is desired as a potential reservoir to draw upon in an emergency.¹⁶

In view of defense considerations it may seem academic to anticipate a self-sustaining system of commercial air transport in the near future. Nevertheless, this should not be abandoned as a long-term goal. In the meantime it seems highly desirable to make a reasonable attempt to *earmark and budget* those public funds devoted to air commerce on behalf of national defense. There are questions of economics which cannot be overlooked in the *logistics* of all-out modern war. As stated by the Secretary of Defense in his report for 1948: "One of the great problems from which the Military Establishment cannot divorce itself is the complex one of securing proper balance between military necessities and national solvency. The capacity for making war is not separable from economics any more than it is from diplomacy."

REGULATION OF COMPETITION

How much competition is desirable in commercial air transportation? Is excessive competition responsible for the postwar financial difficulties of the airlines? If competition is to be controlled, what standards should guide such control? What effects might result from modifying or relinquishing some of the present controls over competition? What effects might result from continuing or intensifying present restrictions on competition?

Many airline witnesses appearing during the Senate Air-line Industry Investigation have criticized the Civil Aeronautics Board for excessive "duplication and triplication of routes" resulting from overly liberal issuance of certificates of public convenience and necessity.¹⁷ However, the Chairman of the Board took the position that over-optimism with regard to the postwar expansion of the air transport market was not solely confined to the Civil Aeronautics Board.¹⁸ Had not the carriers who now complained of excessive competition been the very carriers who had requested and received the majority of the additional

¹⁶ *Air-line Industry Investigation*, op. cit., statement by Richard Hellman, p. 2124.

¹⁷ *Ibid.*, pp. 671, 742, and 1127 (Testimony of Messrs. Patterson, Smith, and Rickenbacker).

¹⁸ *Ibid.*, p. 55 and 60.

routes approved by the Board after lengthy hearings? Suppose the market had expanded and the Board had been extremely conservative in approving new routes and route extensions, would the Board then have been guilty of stifling a dynamic industry or encouraging monopolistic tendencies? Hindsight is always better than foresight.

What policy has been prescribed by the Congress with regard to regulation of competition in air transportation? The Declaration of Policy in the Civil Aeronautics Act (Section 2) directs the Board to consider the matter of competition as follows: "(c) The promotion of adequate, economical and efficient service by air carriers at reasonable charges, without unjust discriminations, undue preferences or advantages, or unfair or destructive competitive practices; (d) Competition to the extent necessary to assure the sound development of an air transportation system properly adapted to the needs of the foreign and domestic commerce of the United States, of the Postal Service and of the national defense." It is clear from this that our public policy favors competition with the exception of *unfair or destructive competitive practices*. Congress left it to the Board to determine the *extent* of competition necessary to assure the sound development of air transportation.

THE ROUTE PATTERN

The present air route pattern is the result of competition and the combined judgment of the Post Office Department and the Civil Aeronautics Board. Competitive bidding for air mail contracts produced the basic pattern of the 39,267-mile domestic system in 1938 which constituted the so-called "grandfather routes" inherited by the Civil Aeronautics Board from the Post Office Department. Subsequently, competitive applications for certificates of public convenience and necessity awarded upon basis of the judgment of the Board caused the domestic routes to expand from 39,000 miles to 146,000 miles and the international and overseas routes from 31,000 miles to 210,000 miles.¹⁹ Eloquent testimony, copious briefs and a most convincing array of exhibits were showered on the Board. The public, represented by chambers of commerce, frequently asked leave to intervene, always in favor of new routes or route extensions proposed. About the only opposition came from other air carriers whose motives were somewhat transparent. Statistical trends pointed upward. It is not surprising that the Civil Aeronautics Board found its "sales resistance" no match for such enthusiasm.

Now, however, the tide has turned: competition in air transportation is believed by many to be *excessive*. But, how much competition is just the right amount? How much is too much? At the present time, we have 16 common carrier trunk lines, 17 feeder lines, and 2 helicopter services operating under "permanent" or "temporary" cer-

¹⁹ Adams, Russell B., "The Air Route Pattern Problem." 17 J. of Air L. & Com. 127 (Spring 1950).

tificates.²⁰ We also have a considerable number of non-scheduled so-called "irregular air carriers" providing low-price "aircoach" service and three certificated air-freight carriers. Neither the irregulars nor the air-freight carriers receive any air mail subsidy. While this list is not complete, it may be said to fairly represent the amount of competition now present in the air transport system of the United States. Is this too much competition? Are there now too many air carriers? Would it be sound public policy to "freeze" the existing competitive pattern of common carriers? Should the existing domestic route pattern serving some 600 cities be established as the permanent inflexible sovereignty of the existing certificate-holders? Shall the future competitive pattern be static or dynamic? Shall all newcomers, even when not desirous of mail subsidy, be considered to be undesirable "interlopers" molesting the tranquillity and stability of the protected oligopoly of "pioneers"? Shall the wings of commercial flying be clipped in order to accomplish a *public utility status* in air transportation by legislative fiat in spite of the fact that air transportation lacks the economic characteristics of typical public utility industries?

SHALL AIR TRANSPORT BE REGULATED AS A PUBLIC UTILITY?

Today, the public utility concept has become so broad as to practically defy clear definition. The term is used to cover a variety of unlike situations. Unfortunately, the indiscriminate use of the term *public utility* has led to the assumption that all so-called public utilities should be subjected to the same type of public regulation. Thus, not only railroads but motor, water, and air carriers are loosely called public utilities despite vast differences between the economic characteristics of these transportation industries as compared with the typical characteristics of gas, electric power, and telephone utilities.

The traditional purpose of public utility regulation was to protect the consumers from the results of the "natural monopoly" characteristics of railroads as well as gas, electric and telephone utilities. Yet the philosophy of railroad regulation still attempts to enforce competition between railroads, whereas in the gas, electric, and telephone utilities our regulatory policy long ago abandoned enforced competition in favor of closely regulated monopoly or duopoly. Still the railroads had (until 1920 at least) sufficient monopoly power to justify similar types of controls as were applied to the other monopolistic utilities.

After 1920, Federal regulation of railroads took on the somewhat contradictory policy of *protection to existing carriers* (at least in "lip service") combined with traditional restraint of monopoly by enforcement of competition and control of prices and services. *Government then took on the role of entrepreneur as well as that of policeman.* As is well known, railroads are today so completely regulated as to have

²⁰ Article by Senator Edwin C. Johnson, *op. cit.* p. 253.

lost nearly all of the prerogatives of management essential to competitive private enterprise.

In 1935, largely upon the recommendation of the railroads and certain government agencies, the Motor Carrier Act was passed containing nearly all of the contradictory elements which had developed during the previous half century of railroad regulation. Then in 1938 the Civil Aeronautics Act was passed containing control of entry and many other provisions literally copied from the Motor Carrier Act. It is significant that both of these laws were passed with the declared purpose of *stabilizing* both the motor carrier and air carrier industries. Conditions in each of these new transport industries prior to Federal regulation were said to be "chaotic." Yet neither motor nor air transportation regulation was the result of the public clamor which demanded restrictive regulation of the railroads. Perhaps the shipping and traveling public preferred the so-called "chaos" of free competition as compared with the "stability of government control." Very significantly it was not the public, but the larger and stronger of the existing air carriers in 1938, who asked a most obliging Federal Government to assume the same dual role of entrepreneur and policeman which it had been performing for the railroads since 1920. Temporary security was won by the sacrifice of future freedom.

Yet the Congress in the Civil Aeronautics Act was unable to reach the conclusion that air transportation conformed to the ordinary concept of a public utility. The Congress "was trying to evolve a type of regulation which would keep the benefits of competition. It was attempting to combine the best features of the regulation of public utilities and competition under the private enterprise system."²¹

As stated by former Chairman O'Connell of the Civil Aeronautics Board:

"There are at least some reasons to believe that the inevitability of the monopoly idea is not as present (in the air transport industry) as in some types of industries . . . You do not have the terrific amount of fixed capital investment . . . in the aviation business, which is involved in electric-light plants or other utilities, as well as the railroads. The capital investment is very small."²²

It may be added that, while it requires more capital to engage in air transport than in motor transport, the amount in either case is minuscule as compared with that required to build a railroad or a gas plant. Actually it may be said that the *only* way to achieve conditions approaching monopoly in air transport is by closely restricting entry to this industry.

²¹ *Air-line Industry Investigation, op. cit.*, Joseph J. O'Connell, Chairman of the Civil Aeronautics Board in reply to Senator Bricker, who had said, "A public utility generally is considered to be more efficient if it is not competitive . . . Competition in the public utility field is always inefficient if you have sufficient and adequate public regulation," p. 53.

²² *Ibid.*, p. 54.

PUBLIC UTILITY REGULATION VS. RESPONSIBLE FREE COMPETITION

The largest part of the investment in an airline consists of aircraft, which, being of fairly standard design, are an extremely mobile form of capital. This facilitates both the entrance and exit of capital from the industry in contrast to the great immobility of railroad and utility plant capital. Another significant difference between the airlines which Senator Johnson calls "quasi-utilities"²³ and the typical utility industries is the ratio of fixed and variable costs. As presently operated, by far the largest proportion of airline costs is variable — a very small proportion is fixed. Ordinary public utilities, on the other hand, are faced with a large element of fixed cost. The desire for combination, to achieve large-scale efficiency and decreasing costs, plus a strong motive for discriminatory pricing are thus logical in the ordinary utilities and in the railroad business. These economic characteristics are not evident to any appreciable extent in the air transport industry of the present day.

Aside from the element of monopoly control present in public utility regulation, there are also practical *physical limitations* which argue against competitive gas mains, power lines, or street car lines down city streets. While the physical limitations of a single airport and its approaches are undeniably limited, the limitations against *additional* airports are more often economic than physical. Furthermore, the majority of our airports today are substantially under-utilized. It is certain that most airports would welcome *more* competitive air transport services in place of restricted competition. Can anyone think of a single case of a municipality objecting to the Civil Aeronautics Board certifying additional air carriers to serve its airport or airports? As for the airspace, is there any medium available to domestic and world commerce which is as limitless? Here again, economic limitations, it would appear, are more controlling than physical limitations.

New electronic aids to air navigation, including the omnidirectional ranges (of which 294 are now in operation of a planned 409) will make possible relatively unobstructed traffic between domestic air terminals and promise to vastly improve the safety and dependability of air transportation.²⁴ The "omnirange" provides a large number of courses. Allowing a course width of 15 degrees, for example, there are 24 flight paths to or from the range.

Since neither natural monopoly considerations nor physical limitations argue against relatively free competition in air transportation, we are left with the question of which policy will yield the greatest fruits — public utility regulation or *responsible free competition*. It is believed by the writer that *responsible* free competition is vastly superior to irresponsible, uncontrolled competition. It is also believed to be

²³ Article by Senator Edwin C. Johnson, *op. cit.*, p. 257.

²⁴ *Air-line Industry Investigation*, *op. cit.*, statement by D. W. Rentzel, Administrator, Civil Aeronautics Administration, pp. 1,944 and 1,945.

superior to competition *arbitrarily* restricted by considerations other than those of safe conduct and financial responsibility.²⁵

CONCLUSION

It may be concluded that public policy toward commercial air transportation needs re-examination especially with regard to subsidy and restriction of competition. Perhaps the problem today is not too much competition but *too much subsidized competition*. Responsible free competition cannot succeed as long as the solvency of all competitors is guaranteed by the government. The first step — that of separating subsidy from air mail pay — is already under way. Perhaps this will lead to eventual solution of the subsidy problem. The next step should be the recognition that air transportation is not inherently the type of industry which should be subjected to traditional railroad or public utility regulation. Can responsible, fair competition ever be excessive? Granted — opening the door to ambitious but responsible newcomers may constantly threaten the stability of the “pioneers” — but will it not over the years improve the stability and virility of the air transport industry? Restraint of competition, on the other hand, inevitably leads to the substitution of bureaucratic controls for managerial freedom and initiative. In the long run it may easily lead to the socialization of transport. Maximum competition, only restricted to insure fairness and responsibility, has been the key to the great accomplishments of the American system of private enterprise. Let us consider carefully before abandoning this principle in our public policy toward commercial air transportation.

²⁵ An interesting sidelight on this is revealed by the following excerpts from a telegram to the Civil Aeronautics Board signed by Governor Ernest Gruening of Alaska: “. . . air transportation is indispensable to the life and economy of Alaska. The regular certificated carriers have not and do not begin to take care of Alaska's needs . . . Alaska is absolutely dependent upon the service now provided by the non-scheduled and irregular carriers. It would be a crippling blow to our entire economy to restrict them.” (*Air-line Industry Investigation, op. cit.*, p. 1,197.) It may well be that the Alaskan conditions referred to here are unique and temporary in some respects.