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# THE QUESTION OF U.S. AIR MAIL SUBSIDY\*

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I have chosen to write about air mail subsidy at this time because it is a question that is referred to often — and usually critically — but rarely factually. It is not a new subject because it existed from the very beginning of our first scheduled air transportation. Even the question of transportation subsidy itself — long before the aviation world knew of it — was as old as history.

I must confess that I found it somewhat reassuring recently when I read that the early Phoenicians, in developing their first ocean commerce, were forced to depend “. . . on allotments from the King” to assist them economically because earnings from their early voyages were not great enough to bear all development costs. I have even found evidence of hidden subsidies in the operation of the early camel caravans of the East which received “donations” from regional rulers in the form of food and shelter and armed guards so as to assist in developing a safe trade route to the sea. And finally, the need and presence of subsidy was even more noticeable in the development of world commerce by the British Merchant Marine in the 18th and 19th centuries. British commercial domination of the seas would never have developed without subsidies in the form of tariffs, the omni-present protection of the British Navy, tax relief in shipbuilding, and many other forms of donations and hidden subsidies from the Government.

But significantly, all three of these transportation systems — the ocean trade of the Phoenicians; operation of the caravan trade routes, of the East; and the development of the British Merchant Marine — had one thing in common in addition to receiving subsidy. Each of these transportation systems, which were originally conceived to promote trade and travel for profit, inevitably became instruments of their nation's foreign policy: they became a great force and power in the economic strength and in the national defense of their countries. As they developed foreign commerce they also developed techniques to increase the speed and capacity of their transportation systems, while at the same time they developed a trained manpower pool to operate it. This resulted in a skilled and immediately available transportation

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\* Revised and expanded from address given before the Wings Club in New York, October 17, 1951.

force in the event of war or other national emergency. The same is true today of air transportation, perhaps even more than it has been of any other form of transportation yet developed.

From the very beginning, the growth of American industrial power and production was interrelated with the parallel development of transportation. The great systems of transportation which made possible the growth of our commerce and industry did not just happen; they were conceived and operated by private companies but much of the early cost of development was met by various types of subsidy from our democratic Federal Government working hand in hand with our system of private enterprise.

The element of subsidy was present and made possible the early building of such transportation systems as the post roads of colonial New England, the construction of the Erie Canal across New York State and the many other canals which today link America's lakes and rivers in a great network of inland waterways. And I have even heard it whispered that the magnificent pioneering development of the railroads, which first united our nation from coast to coast, also received subsidy assistance from the Federal Government.

Indeed, our national transportation systems could not have developed without the financial support of subsidy — whether in the form of land grants, waterway rights or mail payments. It was subsidy from the Federal Government that made it possible for these transportation systems to get started and to grow when — like the Phoenicians thousands of years before — they found that their earnings alone were not enough.

Nevertheless, in the business of transportation, particularly air transportation, the word "subsidy" has somehow developed a connotation of inefficiency. Perhaps the stigma of subsidy will be eliminated when the public realizes more clearly that all of this Government aid is not given primarily for the benefit of the air carriers but for the benefit of the traveler, the shipper, the user of the mails and the many communities served.

The entire question of United States air mail subsidy is not a new economic question; it is, rather, a proven method of assisting in developing a new form of transportation which our democratic government long ago worked out with other transportation systems of private enterprise. The goal of this pact between the Federal Government and the development of a new transportation system is this: that when the first development period is over there will come a time when the element of subsidy — through good management and increased revenues — will cease to exist, and the cost of operation, and the profits derived from the operation, will be obtained solely from the money the carrier receives for transporting persons and property.

Therefore, I believe the critics of subsidy in air transportation should be told that this has always been the goal of development of the

commercial airlines of the United States. I believe the time has come also when I should reemphasize that the Big Four<sup>1</sup> domestic air carriers of the United States which presently carry nearly 80 percent of our domestic air mail load, have now reached the position of operating without any subsidy mail pay from the United States Government.

Moreover, I believe the public should be reminded that scheduled air transportation by private companies in the United States is only 25 years old — and that its current major economic and technical achievements have occurred well within the memory of most of us.

Beginning in 1926, we witnessed the birth of privately operated commercial air transportation. In that year the airlines of the United States carried about 5800 passengers, but by 1950 the unparalleled growth and expansion of civil aviation resulted in our airlines carrying more than 18 million persons! I believe that the achievement of the Big Four airlines of the United States in reaching economic self-sufficiency without subsidy in a period of 25 years time is an economic and technical feat worthy of praise rather than criticism. I know of no other transportation utility of this nation which achieved economic self-sufficiency without mail pay subsidy in so short a period of time. Moreover, I am confident that many of our other airlines will join the Big Four in this non-subsidy category of operation in the future.

#### HISTORICAL DEVELOPMENT OF METHODS OF ESTABLISHING AIR MAIL RATE COMPENSATION

In order to better understand the present situation concerning the subsidy of air transportation, it is necessary to understand how it all began. Participation by the Federal Government, both in direct flight operations and later in economic assistance through the form of subsidy, started with the very first air mail flight. Everyone who has followed the development of American aviation is familiar with those epic years when the United States Post Office Department sponsored and developed a system of air mail transportation utilizing World War I surplus DeHavillands and Jennies as flight equipment. The history of those years from 1918 to 1926 and the exploits of the pilots who flew the first transcontinental night air mail — gallant men such as Jack Knight and Ham Hamilton and others — have become legendary.

But it was not then, and it is not now, a part of the philosophy of American democratic government to nationalize any form of transportation. And so it came about in 1926 that the Government decided to let out contracts to private operators for the purpose of transporting "persons, property and mail" by air over specific routes between specific cities of the nation. The Post Office Department, which had carried the direct burden of financial and operational support, bowed out and private enterprise took over and began the development of the

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<sup>1</sup> American Airlines, Inc.; Eastern Air Lines, Inc.; Trans World Airlines, Inc.; United Air Lines, Inc.

commercial air transportation system we have today. It wasn't much of a system in the beginning. A great many of the route segments were not flown at night. Nevertheless, our privately operated air transportation system was flying 128 aircraft which carried more than one and a half million pounds of mail and more than 8,500 passengers in that first calendar year of 1927, which was celebrated above all the other years of our early civil aviation because it marked the flight of Lindbergh to Paris.

The contracts between the air transport operators and the Government were soundly based on laws enacted by the Congress which made it possible, through the element of subsidy, for private companies to carry mail and passengers, pay continuing development costs, and still receive a reasonable profit on their investment. The first of those air mail bills<sup>2</sup> — which became known as the Kelly Act after its sponsor — was passed on February 2, 1925 and was described as an act “. . . to encourage commercial aviation and to authorize the Postmaster General to contract for Air Mail Service.” The point of greatest interest in the Kelly Act to private companies desiring to enter the air transportation business was the fact that this bill provided that the air carrier operator would be paid up to four-fifths of the revenues derived from air mail.

In October of 1925, the Post Office Department awarded the first bids on air mail routes authorized under the Kelly Act. The five original private air mail contractors were Colonial Airlines, Robertson Airlines, National Air Transport, Western Air Express and Varney Speed Lines. These carriers formed the nuclei of some of the great air transportation company systems of today; Colonial became part of the present American Airlines System; National Air Transport and Varney became part of United's System; and Western Air Express became part of TWA.

However, the honor of carrying the first domestic air mail by private contract went to Henry Ford, the motor car manufacturer, who was holder of Contract Air Mail Routes Nos. 6 and 7, which the Post Office awarded a few weeks after the five original contracts. Ford had begun air service operations out of Detroit to Chicago and Cleveland in April of 1925, carrying company freight exclusively. Consequently, Ford's airline was in readiness for immediate action and it took only a few weeks to arrange air mail schedules, which were inaugurated on February 15, 1926 from Detroit to Cleveland.

However, before the year 1926 was over it had become apparent that some adjustment must be made in the formula of mail payment to the air carriers because few of them were able to make any money under the existing rates. Under the Kelly Act of 1925, the amount of four-fifths of the postage revenue received by the Airlines was figured on a “tallying system” which made it necessary to count each piece of

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<sup>2</sup> H.R. 7064 introduced by Representative Clyde Kelly.

mail every time mail bags were transferred from one carrier to another. Inasmuch as tallying each stamp to ascertain the postal revenue was a slow and expensive process, the operators requested a more efficient method of computing mail payments. Consequently, Congress passed the first amendment to the Kelly Act of 1925, modifying the mail payment formula to make *weight* of mail carried rather than postal revenue the basis of payments.

In 1928, Congressman Kelly sponsored a second amendment to the original Contract Air Mail Act of 1925, which provided for a reduction of the postal rate to 5c an ounce, with a net result highly profitable to the airlines. This reduction in postal rates decreased air mail revenue but it increased the volume of mail carried by the airlines. Inasmuch as the carriers were then being paid by the weight of mail carried, airline income nearly doubled until on some routes carriers actually received more for transporting mail than the Government received in postal revenue.

Moreover, the effect of this second amendment to the Kelly Act made it more profitable to carry mail than passengers, and consequently passenger traffic was neglected and the development of passenger aircraft proceeded slowly. During this early period of development the economic fact of air transportation life was simply this: mail was cheaper to handle and more profitable than passengers. In order to correct this situation, it became necessary to alter the Kelly Act a third time, which amendment became known as the McNary-Watres Bill.<sup>3</sup>

The main provision of the McNary-Watres amendment changed the method of computing mail payments from the old pound-per-mile-rate basis to an amount-of-space-available basis. The McNary-Watres amendment was an outright subsidy but it stimulated passenger operations because the carriers began to install seats to attract passenger traffic to use up space not occupied by mail. This resulted in stimulating new passenger aircraft design and the Post Office Department even offered extra payment to airlines willing to use multi-engine cabin planes, two-way radio, and other aids to navigation to further assist in stimulating passenger air transportation.

#### GROWING NEED TO SEPARATE SERVICE MAIL PAY FROM SUBSIDY

I have cited the Kelly Act and its subsequent amendments in some detail in order to point out that even in the very beginning years of air transportation we were having trouble developing a method or formula for establishing mail rate compensation for air carriers. And significantly all methods devised for the payment of air mail compensation had one singular lack: none provided for a separation identifying the monies paid out for the *service* of carrying the mail and the monies paid out as *subsidy*.

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<sup>3</sup> Sponsored by Senator Charles D. McNary of Oregon and Congressman Laurence H. Watres of Pennsylvania; approved April 29, 1930.

The passage of the Civil Aeronautics Act of 1938, did not change this situation. The Board was primarily concerned in the few immediate pre-war years with determining fair and reasonable mail compensation for the carriers and with the adjudication of new route cases. During the war years the situation was so completely abnormal — with half the domestic air transport fleet at one time in military service — that the Board did not attempt to establish a mail rate formula that would provide a measure of division between service rates and subsidy rates.

Following the end of the war, however, the Board became keenly aware of the need to separate service payments and subsidy payments from the whole mail payment. It became apparent almost immediately that there were many methods in the minds of many men as to how this should be achieved: I might say that formulas on how to determine the subsidy separation cropped up all over the air transport industry. In the meantime, the Congress, under the able leadership of Senator Edwin Johnson of Colorado, Chairman of the Committee on Interstate and Foreign Commerce of the U.S. Senate, had instituted a preliminary study by a private management consultant firm to prepare for legislation effecting a separation of service and subsidy payment in mail to the carriers.<sup>4</sup>

In the meantime, although the Board had been proceeding with a long-time mail rate case involving the Big Four airlines which it initiated on February 21, 1949, looking toward the establishment of a rate that would contain no element of subsidy. After lengthy meetings and discussions between the staffs of the various carriers and the Board, general conclusions were reached and on August 7, 1951, the Board announced a mail payment rate for the Big Four of 45c a ton-mile, beginning January 1, 1951 and projected into the future. Each of the Big Four had been receiving mail compensation on a temporary basis, pending this final determination of their mail payments, and the Board's decision in this case resulted in the Big Four carriers repaying the U. S. Government about five million dollars.

Consequently this amount became due and owing to the government upon finalization of the 45c mail rate proposed by the Board, which was found to be strictly a "service" rate and entirely free of any subsidy to these carriers.

During the course of working out an equitable solution for a subsidy-free mail rate for the Big Four carriers, ways and means of establishing such a rate were developed and proved of tremendous importance to the subsidy action subsequently taken by the Board. About one month before the Board issued its 45c per ton-mile rate for the Big Four, I wrote Senator Johnson in July, 1951 and informed him that the Board would go forward as rapidly as possible with the separation of the compensatory and subsidy elements of mail pay. In

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<sup>4</sup> See, Edwin C. Johnson, "Committee Report to the Senate on Separation of Air-Mail Pay from Subsidy," 18 J. Air Law & Com. 320 (1951).

that letter I proposed that the Board would submit to the President and the Congress a special report providing an administrative separation of the compensatory and subsidy elements of mail pay for the domestic mail carriers as of September 30, 1951, and I am pleased to be able to admit that we met that deadline.

#### CAB ADMINISTRATIVE SEPARATION OF SUBSIDY FROM SERVICE MAIL PAY

Before describing the administrative separation of service mail payments from subsidy mail payments which has been effected by the Civil Aeronautics Board — and which I consider to be one of the most important decisions ever rendered by the Board — I should like to explain very briefly some of the background.

It is sometimes difficult for those of us connected with the business of air transportation, to realize that many people are unaware that a substantial portion of the compensation paid to the airlines for the carriage of mail really has nothing to do with the *service* of transporting the mail but is granted by the government as a direct aid to assist in developing a sound transportation system to serve national objectives. As a matter of fact the word "subsidy" is not found anywhere in the Civil Aeronautics Act of 1938, under which all of American civil aviation functions. However, Section 406 (b) of the Civil Aeronautics Act directs the Board to consider:

" . . . . the *need* for each such air carrier for compensation for the transportation of mail sufficient to insure the performance of such service, and, together with all other revenue of the air carrier, to enable such air carrier under honest, economical, and efficient management, to maintain and continue the development of air transportation to the extent and of the character and quality required for the commerce of the United States, the Postal Service, and the national defense."

The unusual wording here evident in the Act is the inclusion of the "need" factor in fixing mail rates which places the entire burden of making up the air carriers' deficits on their whole operations on the U. S. Post Office Department.

Mail rates for domestic carriers, as fixed under the Civil Aeronautics Act, are adjudicated currently as follows: a formal hearing by the Board is provided to determine whether the carrier has conducted its operations in an honest and prudent manner in fulfillment of the duties required under the carrier's permanent certificate of public convenience and necessity — and to the extent that it has so conducted itself, the Board will recognize for mail-rate-making purposes the operating expenses and revenues received from non-mail services.

After the operating deficit has been determined, there will then be added to it an amount sufficient to cover a reasonable return on the investment of the carrier, (usually 7 percent after taxes for past periods) and this total sum will be expressed in terms of miles flown,



mail carried, or some other suitable standard. In a like manner, a temporary mail rate for the future is determined, except that estimates must be made as to operating results. The mail rate orders or opinions of the Board never contained a breakdown of the money awarded as to service rates required for carrying the mail — and the subsidy rate over and above the service rate.

Nevertheless, the Board believes, with the Congress, that the time has come to clearly identify the subsidy element of mail pay for the domestic air carriers, and while our domestic airline industry has not yet reached a peak of development, its strength as a factor of national defense and its service to the people has come a long way in the 13 years since the passage of the Civil Aeronautics Act of 1938, as the following tabulation shows:

	1938	1951
Number of Airlines	16	40
Route miles in operation	38,757	103,237
2-engine aircraft	229	528
4-engine aircraft	0	315
Helicopters	0	11
Aircraft Fleet Cost	\$22,919,000	\$346,116,000
Revenue Ton-Miles	51,619,000	1,117,846,000
Revenue Passenger-Miles	423,000,000	9,311,000,000
Commercial Revenues	\$27,047,000	\$570,587,000
Communities Served	182	588
Total Annual Ton-Mile Capacity Available for Commercial and National Defense Requirements	194,947,000	2,861,997,000

The tremendous growth of domestic air transportation in the 13 years since passage of the Civil Aeronautics Act, and its current economic vigor, makes 1951 an appropriate time to effect an administrative separation of service mail payments and subsidy mail payments. The airline industry of the United States is no longer a fledgling; it is reaching early maturity. The detailed disclosure of subsidy amounts paid to each air carrier will, I am confident, furnish an impetus and a greater opportunity to both the government and the air carrier industry to appraise more closely what has been accomplished and what direction and scope our planning for the future should follow. I believe that with identification of the specific amount of subsidy paid to each carrier there will develop a concurrent awareness of the cost added to the operation of specific routes and service, and because of this there will be greater likelihood of remedial action in the public interest.

It is the primary and immediate responsibility of the Board not only to evaluate the service furnished by the domestic airlines in light

of the objectives of the Act, but to reckon with the cost to the U. S. Government. On the one hand the Act requires that an air transportation system must be broad in scope and strong in its operation; but the Act also requires that it be an economical system. To that end certain mergers, or interchanges, or joint use of facilities or curtailment of service of certain route segments, or more realistic pricing of commercial air service may be indicated.

There is another factor, also, in the need to separate the service rate from the subsidy rate in airline payments that must not be overlooked. At the present time the Post Office Department is charged with substantial outlays of money to meet the mail payments to air carriers set by the Civil Aeronautics Board. Obviously, with the subsidy element present the Post Office is paying for something completely unrelated to the service of transporting mail. The Post Office Department is the biggest business which our government conducts and its accounting should be such as to let the Congress and the public know the actual cost of conducting it. And so long as subsidy is blanketed — or hidden — into the Post Office accounts and appropriations, an accurate, economic evaluation of the job that the Post Office Department is doing becomes increasingly difficult.

And so the Board, aware of all these many factors of interest, established an administrative separation of service mail pay from subsidy mail pay. Time will tell the extent to which we may have to alter — on the basis of actual experience — these definitions. I do believe, however, that we have developed a method of arriving at service pay for our air carriers which is equitable to all concerned.

The separation of service mail pay from subsidy mail pay which the Board has established does not mean that our domestic air carrier mail payments will be ruthlessly reduced; it means only that the Board and the Congress, the airline industry and the public will know for the first time in our transportation history the amount of money it costs to operate airlines for carrying the mail and the amount it costs in subsidy to provide additional development costs.

In the Board's administrative separation report, we separated service mail pay from subsidy mail pay on the basis of actual figures supplied by the carriers for the fiscal year 1951. By using these figures we determined that of the total domestic mail pay of \$61,934,000 approximately \$27,369,000 was service pay and \$34,565,000 subsidy pay. For the next two fiscal years — that is 1952 and 1953 — the Board estimated that the total amount of domestic mail payments would be slightly above 57 million dollars for 1952 and almost 66 million for 1953. However, the subsidy for these two future fiscal years is estimated to decline from the \$34,565,000 figure for 1951 to \$24,134,000 for 1953 — or slightly more than 30 percent, which the Board believes is most encouraging.

I shall not attempt to break down the method of determination

that we followed in establishing the service mail pay on a mail-ton-mile basis for our domestic air carriers as the Report is printed in full elsewhere in this issue of the *Journal*.<sup>5</sup> However, I should like to point out that we determined the unit costs of an air carrier to these basic operating figures: (1) length of traffic haul and average distance between stops; (2) density of traffic; (3) and volume of operations. Consequently, the Board determined, after extensive analyses, that revenue ton-miles per station is the best available composite measure of determining unit cost, which we achieved by dividing revenue ton-miles flown during fiscal 1951 by the average number of stations serviced during this period. Extensive staff study over the years also disclosed that it was better to arrange for the grouping of carriers to arrive at a service rate because grouping permits the averaging of costs which tends to minimize deviations between the reported cost of individual carriers and results in simplicity of presentation. Consequently, in the Board's administrative separation we established seven domestic air carrier groups with applicable service rates for each group for three fiscal years, 1951, 1952 and 1953. We fully expect that a number of these carriers will move from higher service rates to lower service rates within the next few years.

In my letter to Senator Johnson last July I point out that it was also the Board's intention to release a report not later than June 30, 1952 setting forth an administrative separation of service mail pay and subsidy mail pay for U. S. air carriers in international, overseas and territorial operations. Thus, in future years the Board may be able to issue an annual report separating service mail payments from subsidy mail payments for the entire U. S. air carrier industry. Each such report will present a separation for the preceding fiscal year based on actual results and known figures and a separation for the next two succeeding fiscal years on a projected basis.

#### BOARD'S ADMINISTRATIVE SEPARATION SUGGESTS MERGERS AND CONSOLIDATIONS

The Board's Administrative Separation of Subsidy Payments from Total Mail Payments will highlight the carriers requiring the greatest Federal support. Both the carrier and the Government can then examine the situation of the high subsidy carriers with greater attention than heretofore with the idea of developing ways and means to reduce the subsidy and still maintain adequate air service in the public interest.

One of the methods that may be followed up after the administrative separation plan has been applied to the carrier is for the Board to suggest a merger, consolidation, an acquisition of control, or a route

<sup>5</sup> "Administrative Separation of Subsidy from Total Mail Payments to Domestic Air Carriers," by the Civil Aeronautics Board, Sept. 1951; copies may be obtained from the Public Information Section, Civil Aeronautics Board, Washington 25, D.C. See page 441 *infra*.

transfer that might be in the public interest and meet the requirements of the public convenience and necessity.

On October 23, 1951 the Board took action suggesting the merger of Continental Air Lines, Inc. and Mid-Continent Airlines, Inc., two trunkline air carriers operating in the middle western region of the United States. In the Show Cause Order issued by the Board it was pointed out that a combination of Continental and Mid-Continent into one trunkline would probably result in annual savings of around one million dollars in subsidy mail payments.

Applying the criteria of the Board's administrative separation plan to these two carriers shows that they now require a combined subsidy — operating as individual carriers — of more than 2½ million dollars annually and that this need for subsidy will continue during fiscal 1952 and 1953. The Board also pointed out that continuing studies have demonstrated that a domestic trunkline's ability to achieve financial self-sufficiency tends to be directly related to its size and that its unit costs tend to be inversely related to traffic volume. A combination of Continental and Mid-Continent would create a trunkline significantly larger in size and have a substantially larger traffic potential than either company alone. Moreover, such a merger would not materially affect the airline competition in the midwestern area because Continental and Mid-Continent have direct one-line competition along less than five route segments.

Moreover, it appears that both Continental and Mid-Continent have been and are now receiving a total amount of mail subsidy in excess of the amount required to compensate them for the service of transporting mail and that this dependence on the Government for subsidy may be lessened by the proposed merger. It also appears that the public would receive, at less cost, services equivalent or superior to those it now receives through the operation of these carriers as separate entities.

Thus the Board issued its Show Cause Order to find out why the integration of Continental and Mid-Continent's routes into a single unified system would not be in the public interest, both from efficiency of operation, public service, and to achieve a reduction in subsidy mail payments from the Federal Government.

I believe that any article on U.S. mail subsidy — because of the controversial and little-known factors involved — necessarily becomes a rather uninteresting exposition on air transportation economics. But I believe also that by establishing the administrative separation of service mail pay from subsidy mail pay the Civil Aeronautics Board has recognized the maturity of the fastest growing transportation medium in the world. I believe the Board's action will make it possible for the Congress and the people and the airline industry to know exactly the worth of this tremendous transportation force that even now is providing unparalleled logistic strength to our national defense. I believe

the Board's administrative separation of service mail pay and subsidy mail pay — although it may be altered in a plus or minus direction — as subsequent study dictates — will make impossible any criticism of subsidy pay based on inaccurate and misleading, and sometimes wild guesses.

It took subsidy money from 1926 to 1938 to launch American air transportation; it took subsidy money to continue its efficient development in the public interest and in the national defense from 1938 to 1951. It may take continued subsidy for some of our carriers in the years ahead if we are to continue to expand and serve our nation in air transportation nationally and internationally, and if that subsidy amount is required under honest and efficient management it will be paid. But in the meantime, with every passing year, American air transportation is achieving its own place in the sun with decreasing cost to the government and with complete economic self-sufficiency without subsidy as its permanent goal.