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A PROPOSAL FOR CONTROL OF LOCAL SERVICE SUBSIDIES

By Howard Ralph Swaine†

I. Reasons for the Proposal

The Civil Aeronautics Board initiated the local service experiment twenty years ago in order to determine the extent of the market for feeder and local air services and the costs of producing these services.¹ Permanent certification of the local airlines in 1955² effectively ended the experimental period. The market for local and feeder air services has not developed as rapidly as the carriers and the Civil Aeronautics Board had hoped it would. The cost of providing the air services to the small communities has been higher than originally anticipated. Expected cost savings—for example, acquisition of a small, economical, short haul aircraft—did not develop. While the proportion of revenues derived from subsidy has decreased relative to commercial revenues, the total amount of subsidy funds received rose steadily up to 1964, when it showed a slight decrease. The local airlines remain dependent upon the federal government, not only for their certificates, but for a large and essential part of their income. During 1964 subsidy payments averaged 26.0 per cent of total revenues for the local service carriers, ranging from a low of 15.0 per cent for Mohawk Airlines to a high of 38.2 per cent for West Coast Airlines.³ The outlook for subsidy-free operation of the local service airlines within the next decade is unfavorable.

Subsidy costs for local air services averaged 2.94 cents per passenger mile in 1964.⁴ This is a gross average which includes revenue passenger miles on the non-subsidized local service routes, thereby understating the subsidy cost per passenger mile. The 1964 average fare per passenger mile on local airlines was 7.54 cents. Therefore, the combined cost (air fare plus subsidy) was about 10.48 cents per passenger mile, of which the passenger paid 72 per cent and the government paid 28 per cent. This cost can be compared to the following average 1964 commercial revenue rates:

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per passenger mile for competitors: Class I Railroads—First Class, 3.91 cents; Coach, 3.00 cents and Class I Motor Buses—2.74 cents. It can be seen that the Government pays about the same amount in subsidy per local service passenger mile as the total cost (paid by the passengers) per passenger mile of the competitive modes.

The high costs of local air services are not simply the result of poor institutional arrangements or grossly inefficient producers. The high costs are rooted in the nature of the services performed. Given the present and foreseeable technology of aircraft, it is not economical or commercially profitable to operate aircraft over the local air routes, stopping every 100 miles or so to board a few passengers who will travel only a short distance on the airline's routes. The initial cost of the airplane, its high cost in terms of fuel and maintenance, and the high wage costs of two pilots per aircraft, when combined with the local service route and traffic characteristics, make economical operations impossible.

There is no escape from the basic fact that most local air services are too costly to be commercially self-supporting, given present technology and consumer demand. Because these services are clearly uneconomical, the case for retaining them must rest on political and social grounds. There has been no clear and timely congressional guidance as to the quantity and quality of local air service to be supported as a matter of public policy. Despite the lack of guidance, it seems clear from the passage of legislation (particularly subsidy appropriations) that Congress intends to continue to subsidize local air services. Beyond this general statement, however, the aims and intentions of Congress remain unclear.

The lack of a clear statement of public policy goals hampers the Civil Aeronautics Board in its attempt to carry out the will of Congress. The local service carriers encounter difficulties in planning for future operations. However, Congress is not entirely to blame for this unsatisfactory situation. Present methods of subsidy administration operate to obscure rather than to clarify the specific costs and benefits of this government program. Because subsidy policies have been directed more toward maintenance of the airline firms rather than toward particular air services, there are no adequate means of weighing the costs of particular air services against the benefits received. Attention to the subsidy needs of the airlines obscures the costs of particular air services. Therefore, Congress lacks the type of information required for making sound decisions on subsidy matters. One of the purposes of the proposal outlined below is to develop a system of subsidy administration which will make available better information on the costs and benefits of these services.

If it is accepted that local air service is to continue to be subsidized by the federal government, how then can efficient use of funds be made in carrying out this public policy? The method of subsidy payment should

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be divorced from the consideration of the welfare of the individual firm producing the service. Government concern over the firm's economic health weakens private incentives to efficient production. Attention must be focused on the transportation function to be performed—that of providing airline service to small communities—in order to properly carry out public policy. Subsidy payments should be closely tied to, and be a function of, the service desired by Congress.

The method of subsidization should be arranged to make use of competition and the producers' competitive drives. In other words, the Government should attempt to make widespread use of economic incentives in dealing with the airlines. If the administrative rules contain sufficient economic incentives, the airlines will find that it is to their interest to abide by the rules, thus decreasing problems of enforcement. Competition can also assist in minimizing the subsidy costs of any given level of local air services. In order to encourage competition, the Government should provide opportunities for the entry of new firms into the scheduled airline industry.

Subsidy costs should not vary with private decisions to expand or contract the amount and quality of services produced. Unless definite limits to subsidization are drawn, an airline will have an incentive to expand and perform more services. Each airline will attempt to expand the number of cities served, to buy more modern equipment and to give each city the "best" air service through frequent (but half empty) flights. The amount of public funds to be devoted to local air transportation is clearly a political decision. Many alternatives can be presented for congressional consideration, but Congress must exercise the power to set the quantity and quality of services to be supported by the taxpayers.

The method of subsidy determination and payment should be kept simple in order to facilitate understanding and ease of administration. This is desirable from the standpoint of reducing the costs of administration and limiting the possibility of distortions in the allocation of resources caused by unnecessary rules and regulations. The method should involve as little supervision over the details of a firm's day-to-day operations as possible.

Under present methods of subsidy administration the government does not possess the tools for rational and efficient control of payments. The class rate subsidy program is a substantial improvement over previous methods of payment, but in practice it is likely to be used to preserve the financial integrity of the firms rather than to be directed toward economical purchase of air services. Because the class rate is based upon average needs per available seat mile, it is impossible to determine the subsidy costs of particular routes or services. There are no means to minimize the subsidy costs of any given amount of air services, or alternatively, to maximize the air service received for any subsidy expenditure.

If new firms were allowed to enter the local service industry, the new firms would cause an increase in payments under present methods of
Therefore, freedom of entry has been limited in order to conserve subsidy funds and competition has been severely restricted at all levels except in the initial award of routes. In addition, present methods of payment require substantial government involvement in what are ordinarily considered to be areas of private management and decision-making.

The area airport and "use it or lose it" policies are generally sound and useful but both fail to alter the basic situation. The certification of third level carriers on the same basis as existing local carriers would represent a perpetuation of the present unsatisfactory situation.

Internal subsidization policies merely shift the subsidy burden from the federal taxpayers to airline patrons on profitable routes. In so doing, the problems and costs are obscured with the result that Congress and the Civil Aeronautics Board have less information and control than under present arrangements. The airlines would require a high degree of monopoly in profitable markets in order to generate funds for a program of internal subsidization. This would raise the problem of forcing trunkline withdrawal from profitable routes. Finally, internal subsidies cause misallocations of resources by monopoly pricing on profitable routes.

New local service aircraft designed for the low density routes will continue to be purchased in the coming decade because of the obsolescence of the DC-3 aircraft. However, considering present technology and costs, the new aircraft hold little promise of substantially lowering subsidy payments and would do nothing to solve other problems.

Subsidies are paid to the local service airlines in order to induce them to provide the scheduled air services desired by Congress and the Civil Aeronautics Board. The Board seems to have assumed that the payment of subsidies to the local carriers rules out competition between local airlines because competition would raise the total subsidy requirements. This conclusion is correct with regard to the present methods of subsidy payment wherein the federal government undertakes the support of firms in return for air services performed. Two or more firms operating on a given route would increase the subsidy requirements because the firms would be competing for commercial revenues that could not support a single airline. However, it is not correct to conclude that all competition between local service carriers must be avoided. Such a conclusion is based upon the results of a single method of subsidy administration. It neglects alternative means of subsidy payment and alternative ways of injecting elements of competition into the local airline industry.

Subsidization of the local air services can be divorced from the considerations of the welfare of the firms by causing payments to exist as a more direct function of the services performed. This requires a concentration on the services performed rather than on the firms performing the services. If the provision of service becomes the main concern, then firms can leave the industry—by voluntary choice or through operation of the market mechanism—without necessarily disrupting the air services.

*For a discussion of some of the problems involved in certifying new carriers see Elliott, Development of Third Level Air Transportation, 29 J. Air L. & Com. 182 (1963).
Alternative methods of providing public support for local air services do not require that there be direct competition in the commercial markets. One alternative is to provide for confrontation of the firms in competition for the government subsidies and monopoly grants. At present, the carriers are given monopoly grants of local air routes which are of essentially unlimited duration. If these grants were to expire periodically and the firms were to face competition for renewals of grants, then a degree of competition would be injected into the industry. The fact that competition between airlines is not feasible at the consumer (air passenger) level should not be allowed to rule out all competition in the local airline industry. The discussion below will be directed toward one means of introducing competition into the granting of monopoly routes.

II. The Proposal

The basic feature of this proposal is the division of the existing local service routes into two categories. The first category would consist of those relatively profitable routes which the present local service airlines are willing to operate without the benefit of direct federal subsidy payments. The second category would consist of the remaining local service routes which would continue to be subsidized by federal funds.

With respect to the first category of routes, each existing local service airline would be granted an option to acquire, on a subsidy-free basis, every route and route segment that it presently serves. Such routes would be operated without subsidy for a certain minimum period of time and for an indefinite maximum period of time. Thus, the local carriers would have an opportunity to retain all of the routes which, in their judgment, were commercially profitable. There would be no recourse to subsidy support if a route proved to be unprofitable to an airline. No federal support could be given to a local airline except under the provisions for competitive bidding.

As routes were rejected by present operators, they would fall into the second route category: those to be opened to competitive bidding. These routes would continue to be subsidized by federal funds but with four important qualifications. First, the subsidy payment for these routes would be a single fixed sum paid for services performed under contract. The amount of the payment would not increase or decrease during the term of the contract despite possible changes in costs and/or revenues. Second, the contracts for the local air services would be let on a competitive bid basis. The winning bid would be the one which offered to perform the stated services for the least amount of direct federal subsidy payment.

Third, the bidding on air service contracts would not be limited to the existing thirteen local service airlines but would be open to firms not presently holding airline certificates of public convenience and necessity. The local service carrier which had rejected a route on a subsidy-free basis would be free to bid on that route along with other local service carriers and non-certificated airline firms. A new firm could enter the industry if it was able to perform the contracted service at the lowest direct subsidy
cost to the Government. Evidence of such ability would be the submission of the lowest bid.⁹

Fourth, a route contract would cover the purchase of air services for a limited period of time—for example, two or three years. At the end of the contract period, the route would again be opened to competitive bidding. However, a firm that was awarded a route on a low bid would be allowed the option to acquire that route without government payments at the end of the contract period. If the airline exercised this option, it would be permanently certified (for that single route only) in the same manner as the original operators’ options. The route certificate would clearly indicate ineligibility for federal support. If, at a later time, government support became necessary, the route would be required to go back into the bidding process with no priority to the operator. The option for certification would be important for two reasons. First, it would provide a means for entry into the ranks of the permanently certificated sector of the industry. Second, the provision would give the contractor an incentive for quick development of the route so as to be able to acquire the route on a permanent basis without risking its loss in a future round of bidding.

The Civil Aeronautics Board would have to specify the services to be performed under each separate route contract. This specification would include the exact route to be flown and each of the cities (and airports) to be serviced. The number of daily flights between each point, the minimum number of passenger seats to be available, and the maximum air fare would also be specified in the call for bids. Beyond these specifications, an airline would be free to make alterations in schedules and fares in order to find the most economical levels, given its particular cost and revenue situation. The number of required flights should be set very low—probably no more than two round trips per day—in order to conserve public funds. Because any resulting increases in profits would accrue to the operator of the route, he would have an incentive to increase flight frequencies if they were justified by traffic. If the local air services were adequately specified in contracts, and the contracts were awarded on the basis of competitive bidding, then the term “airline subsidy” would become inappropriate. Government payments to the local carriers would be simply purchases of air services, similar to government purchases of other goods and services.

Each bidder for a route contract would state the total dollar amount of government payment in return for which he would perform the services called for in the contract. The airline awarded the contract would bear all costs of performing the services and would retain all passenger, cargo, and service mail revenues, as well as the contract payments.

The payment to the contractor would be a fixed amount and in no circumstance would it be open to change, alteration, or negotiation by either party to the contract. If the winning bidder, after commencing

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⁹ New airlines would be required to meet the safety standards applicable to all commercial airlines. Contract performance guarantees might also be required, either through the use of performance bonds or by a system of delayed payments designed to give the Government ample warning of non-performance in advance of payments.
operations, found that costs exceeded his total revenues on that route, he
would have to bear all losses during the life of the contract. If the situation
developed that the operator was making unusually high profits—no matter
how high—and the Board felt that it could obtain the services at a lower
cost, the Government would have no recourse during the life of the
contract.

Subsequent adjustment of bid prices would cancel out the beneficial
effects of competitive bidding and make the bidding process meaningless.
This was the actual experience under the Air Mail Act of 1934\(^\text{10}\) which
called for competitive bidding on air mail contracts. Route contracts were
let for a one-year period but were subject to indefinite extension without
new bidding. This had the effect of a monopoly grant with government
subsidy. The competitive bidding provision lost its meaning by the addition
of a clause which allowed non-competitive negotiation of higher rates after
the contract was let. Nicholson summarized this in the following manner:

Another section nullified the effects of competitive bidding by allowing the
Interstate Commerce Commission to adjust rates upward so that the costs of
successful low bidders were eventually covered. All that a prospective bid-
der need do, therefore, was to obtain sufficient resources to continue operations
until the Commission adjusted his successful bid to cover his costs.\(^\text{11}\)

This proposal for use of competitive bidding is not a new or novel
approach. The Government has often used the competitive bidding pro-
cess on fixed price contracts for the purchase of goods and services. In
fact, the central idea of this proposal was derived from a brief discussion
in congressional hearings of the competitive bidding system used by the
Post Office Department for its star routes (rural delivery and the trans-
portation of mail between small towns).\(^\text{12}\) The local carriers have often
claimed an analogy between their services and rural delivery of mail. This
led the author to examine the results which might be expected from a
system of competitive bidding on local air services and how such bidding
might be arranged.

Competitive bidding in the airline industry also has been suggested by
at least two authors. Lucile Sheppard Keyes suggested the application of
competitive bidding to the promotion of commercial services in the inter-
national air transport field. Mrs. Keyes wrote:

Here the number of firms and the particular firms to receive aid should be
chosen on the basis of minimum cost to the Government for performing the
desired service. Such a choice could best be made by a periodic process of
competitive bidding, each firm being given the opportunity to specify the
lowest payment it would accept for performing all of \([\text{sic}]\) any part of the
desired service. It should be emphasized that the justified exclusion of par-
ticular firms from the subsidized market is merely a temporary one, and that

\(^{10}\) 48 Stat. 933 (1934).

\(^{11}\) Nicholson, Air Transportation Management 28 (1951). For additional background on early
air mail contracts see \(\text{id.}\) at 7-28; Caves, Air Transport and Its Regulators 123-21, 382-87
(1962); Report of Antitrust Subcomm., House Comm. on the Judiciary, 84th Cong., 2d Sess.,
Airlines 8-14 (Comm. Print 1957).

\(^{12}\) House Comm. on Appropriations, 87th Cong., 2d Sess., Treasury-Post Office Departments
maximum efficiency requires that no firms be excluded from the process of competitive bidding.13

A second author, John R. Meyer, suggested the use of competitive bidding to purchase another type of air service.14 Meyer defined three inter-city commercial air travel markets. The first market was for air travel among the 100 largest airports. This market was capable of supporting competition between two or more airlines. The second market consisted of the next 100 to 150 largest airports. Meyer felt that the second level markets could not support competition between two airlines and, therefore, were "natural monopoly" markets. The third market included the remaining 250 airports served by scheduled airlines. This market could not support even one carrier without government subsidies.

Meyer suggested that the existing local service carriers be restricted to the "natural monopoly" second level market. He felt that subsidies to the local service carriers would probably continue because many of the second level routes received service from more than one carrier. He hoped that such duplications of service would eventually be eliminated. Meyer also cited large, complicated aircraft and high frequency of service as contributing to subsidy needs. The third level market, serving the 250 smallest airports, would be opened to bidding. New third level carriers would bid for routes in this market. Meyer suggested specifying the quality and frequency of service, the rates, and the equipment to be used.

It is difficult to evaluate Meyer's suggestions because he was not primarily concerned with local air services and, consequently, his discussion of this area was quite brief. Certain differences between Meyer's plan and the proposal given here stand out. Meyer would apply competitive bidding only to the third level market. This would reduce but not eliminate subsidies to the existing local service carriers. The proposal outlined in this paper would require competitive bidding before any local service subsidy (or "payment") could be made. Meyer would require rigorous specification of frequency of service and equipment to be used. The present proposal would set only minimum specifications for these items. Finally, Meyer would deliberately set up a third class of carriers below the trunklines and local carriers now in existence. The present proposal would permit entry of this type of carrier but would not create a separate category. Existing local carriers would be able to bid on routes in competition with these carriers.

III. Evaluation of the Proposal

In the following sections the proposal is evaluated in terms of its relation to public policy goals, the Civil Aeronautics Board, new entrants, and the existing local service carriers. While it is recognized that there is considerable overlap among these topics, the division is convenient for purposes of discussion.

13 Keyes, Federal Control of Entry into Air Transportation 359-60 (1951). See also id. at 82-83, 98.
A. Public Policy Goals

The principal purpose of this proposed method of subsidy administration is to meet the congressional desire for air service to small communities and to do so in an economical and efficient manner. The proposal is designed, in part, to provide the Government with better means of controlling the quantity and quality of local air services to be supported with public funds.

The proposal's contribution to control of subsidy is the information it would make available to decision-makers. Greater knowledge would be available as to the amount of government costs and where such costs are incurred (routes, city size, traffic quantities, and geographic distribution). It should facilitate tracing the real costs of air services to the beneficiaries of the service. Computations of subsidy per route, per passenger, and per passenger mile can be made under the present system of subsidy payment. However, these computations do not reflect the true economic costs of the services for the costs are incurred in a rigorously controlled market without benefit of competitive tests. As long as reimbursements are made to airlines on a “need” basis, the alternative costs of performing the services cannot be determined. Basing payments on a “class need” does not overcome this deficiency since comparisons can only be made within a select group, all of whom might be high cost producers.

Control should not be interpreted solely in terms of reducing subsidy expenditures. Reductions (or increases) in the amount of public funds devoted to local air service are policy decisions to be made by Congress. These decisions can be made in a rational manner only after a careful weighing of the costs and benefits of the airline services both internally (with one another) and externally (with alternative government expenditures and with non-governmental employment of the economic resources).

Subsidy advocates may find that explicit subsidy payments for each route are embarrassing. The simple act of publishing contract awards can contribute to greater public awareness. Governmental efficiency and economy will be encouraged by increased public understanding of this expenditure of tax monies.

This proposal is designed to minimize the cost to the Government for whatever quantity and quality of air service Congress sees fit to subsidize. Competitive bidding for routes, combined with freer entry, will ensure that the Government obtains services on each particular route at the lowest possible subsidy cost. The Government has the assurance that it cannot go to another seller and purchase the air services at a lower price.

It is conceivable, of course, that bids would be received from only one or two firms on some routes. This might result in higher costs than would be obtainable in future rounds of bidding for those routes. But an airline bidding on a route would have no assurance that it would be the only bidder. Thus the bid entered by a firm can be presumed to represent the the minimum price for which that firm is willing to perform the service. Relative lack of bidders may be an indication of the “undesirability” of a route but no matter how undesirable the route may be, there will always be some firms willing to perform the stated service at some price level.
The provision for competitive bidding would provide a clear-cut and economic basis for the choice of the carrier to receive the contract award. In other words, the bidding process would serve as a means of rationing Government business. The cost of the bidding process to the Government should not be large if the administration of the plan is kept simple.

The costs of entering bids should not be burdensome to individual firms. The present method of awarding routes can be quite costly to the firms. One factor which might increase costs is the necessity to rebid every two or three years. However, after the initial round of route awards, bidding should be less expensive because a new bid would merely require a revision in data and estimates. Airlines would no longer be forced to prepare elaborate justifications for their selection to operate a route rather than a competitor. They would need only arrive at their “asking price.” Bidding arrangements should be kept simple since the costs of bidding will be reflected in the prices bid, this being a cost applicable to all firms engaging in this enterprise.

A brief explanation may be in order as to why the trunkline carriers should not be considered eligible to bid on the local service routes. The award of a local service route to a trunkline would give that trunkline a unique advantage over its competitors in that it would be able to route local service passengers over its own trunk routes on the continuing portion of their journeys. This problem would not be solved by competitive bidding for local service routes. Competition for a local service route might develop between two trunklines. As each attempted to prevent its rival from acquiring the route and the additional traffic, bids might be driven below the marginal costs of the service. This type of competitive rivalry is undesirable because the winning trunkline would attempt to cover its losses by charging high fares on its monopoly routes elsewhere. Even though the Civil Aeronautics Board has the power to regulate air fares, it would be difficult to determine if a trunkline were attempting to increase fares on a monopoly route in order to cover losses from a low bid on a local service route.

There may be some danger of this type of rivalry developing between two local service carriers. However, the local service airlines would not have the profitable long haul, monopoly routes on which they could obtain revenues to cover bid losses. The local carriers would operate two types of routes: those obtained by competitive bidding and those taken on a subsidy-free basis. Neither type of route would be likely to generate enough revenue to permit deliberate below-cost bids. Furthermore, because each local service carrier operates in a fairly restricted geographical region, they do not meet one another in direct competition to the extent that trunklines do.

Would this proposal result in badly fragmented routes—particularly those put up for bid—which are so economically weak as to result in poor service? There are no indications that disjointed routes, poor connections, and inconvenient scheduling would result from the proposal. It would be in the self-interest of each airline to build routes with good connections
and convenient schedules. Traffic gains and losses would directly affect the commercial revenues received by the firm. Since the contract payment to an airline would be independent of revenues actually received, any gains realized as a result of better air service would belong to the firm. These revenue changes could greatly increase or decrease a firm’s profits because the marginal costs of additional passengers (assuming available seats) are very low once a flight is scheduled.

In addition to traffic potentials, an airline would certainly consider the costs of operating the routes. The length of the route, the degree of interconnection with other routes operated by the firm, the availability and scheduling of equipment and other operational factors would be taken into account. A scattered patch-work of route segments is not likely to make economic sense to an airline.

Route specification is a difficult problem requiring judgments subject to error. It would not be a crippling problem for this proposal, because the same route problems exist under present methods of regulation. In fact, subsidizing the routes instead of the particular firms performing the services should allow improvement through more rapid route adjustments. Because the contracts would be awarded for a limited period of time, the routes should be more amenable to change as contracts expire. An airline awarded a contract could be allowed some range of freedom to sell its rights to a route, subject to CAB approval. This flexibility would assist in making better route adjustments.

B. The Civil Aeronautics Board

While no method of handling subsidies should be adopted or rejected merely for the convenience of the Civil Aeronautics Board and its staff, it is important to examine this proposal to ascertain whether it might constitute an administrative burden which would result in the breakdown of the plan or in substantially increased costs.

It is obvious that the Board would have more firms to supervise and regulate as a result of the provisions for freer entry into air transportation. Since it is not known how many firms would actually enter, the workload cannot be estimated with any accuracy. Under the proposed system the costs involved in the regulation of each airline should be lower despite the additional cost of recurrent bidding on routes.

The fixed Government payment plus the contract performance guarantees would open the way for the Board to withdraw from supervision of airline management. The Board would no longer bear the consequences of poor decisions by airline managements. The amount of Government payment would be independent of the financial results of operations during the term of the contract. The airlines would reap the gains and suffer the losses resulting from their decisions. Therefore, expenditure controls on salaries, equipment, and general expenses could be eliminated. Government auditors would no longer be required to determine if expenses were properly chargeable to the Government under subsidy regulations.

The Civil Aeronautics Board would have to make certain that the serv-
ices specified in the contract were being performed. This portion of the supervision could be accomplished without detailed inspections. Complaints from passengers and from communities served would provide a more complete check on performance than could be accomplished by dozens of government inspectors.

C. New Entrants

One of the more significant features of the proposal is that it would allow new firms to enter the local service industry. Firms would be allowed to enter the industry insofar as they were able to offer competitive prices for the services opened to bidding. They would enter on terms favorable to the Government, offering services at a lower cost to the Government, rather than as financial burdens.

The opportunity to enter is desirable by itself. The fewer the industries in which entry is restricted by government regulation, the more economic freedom individuals will have—particularly with respect to the employment of the economic resources they command.

There is no evidence that the general attitude of Congress has been favorable to a reduction in the number of firms in the airline industry. To the contrary, the compulsory directive to the Board to give permanent certificates to the local service carriers\(^6\) would seem to indicate that Congress, at least at that time (1955), desired a larger number of firms in the airline industry—especially in view of the unanimous vote for that legislation.

The actual number of new firms that would enter the industry and the portion of subsidized routes they would actually capture can only be a matter of conjecture. The important points are that they would be given notice of an opportunity to enter and that their entry would be determined by their economic efficiency in performing a stated service in air transport. Their entry or non-entry would not be decided in the abstract deliberations of a board which sat in judgment of their fitness, willingness, and ability to serve. The standards of judgment can be interpreted to allow the entry of any firm, including the most inefficient; but they are more likely to be used to prevent the entry of new firms and to maintain the status quo. It is difficult to prove to a government agency that public convenience and necessity require new entrants. Therefore, it is important to base entry on less abstract terms and conditions. In this proposal the criterion for entrance would be simple: to contract to perform a stated service at a lower price than all other bidders.

Many firms have indicated a desire to enter the scheduled airline business.\(^6\) The extent to which they would continue their pressure for entry under the proposed system cannot be foreseen. The requirement of “meeting and beating” the competition for a route may diminish the desire of some firms to gain entry. Offsetting this is the attraction of new firms, not now petitioning for entry, by the provision of an opportunity to enter.

\(^6\) See Elliott, supra note 8 and Petition of National Association of Third Level Airlines before the CAB, CAB Docket No. 14977 (15 Jan. 1964).
Under the proposed plan the size of a new firm would not need to be large. A firm might start with a single route segment serving only two small cities. An operator would not have to purchase aircraft, the major capital item used in the business. A great variety of aircraft are available for lease on a short term (monthly) basis. Therefore, aircraft acquisition should not present large financial problems to potential entrants. Aircraft maintenance could be performed by outside firms so that no large investment in these facilities would be required, while fuel and flight crew costs will vary directly with the volume of operations.

Competitive bidding should be no more destructive in the local airline industry than in other industries where government agencies and private firms make use of competitive bidding to determine the lowest cost source of supply. The type of destruction expected would be of a socially useful type, that of destruction of firms or competitors—but not the destruction of competition itself. The destruction of firms would take place only where firms prove to be clearly less efficient producers of air service than their competitors. Firms would be forced to meet the tests of a market place to a greater extent than at present. Offsetting their greater rights to fail would be their greater rights to prosper.

D. Existing Local Service Airlines

The proposal outlined above would have a large impact on the thirteen local service carriers now in existence. It is difficult to predict the full effects on the carriers because some of the effects would depend upon courses of action chosen by the carriers. Nevertheless, there are certain features of the proposal which would be advantageous to the operators of the existing local service airlines. From an economist's viewpoint, the proposal would not necessarily be less desirable even if there were no advantages to the present local airlines. However, the fact that there would be some advantages may serve to attract airline support or to soften their opposition.

The local service airlines would not be "destroyed" by adoption of the proposed new method of subsidy administration. This proposal would give the airlines an opportunity to retain all of their present routes which, in their judgment, are commercially profitable. An airline would merely elect to take such routes without benefit of Government payments. Of course, the economic characteristics of routes given to the carriers are the basic determinates of the ability or inability to operate free of subsidy support. Nevertheless, the choice of a carrier to operate such a route was made by the Board and there seems to be no particularly good reason to attempt to reverse such decisions.

The option of retaining routes to be operated without federal support would be an attractive feature to the Government as well as to the airlines. It would ensure that these routes would not collect subsidy. At the present time local airlines operate a few routes on what is claimed to be a subsidy-

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17 Advertisements regularly appear in American Aviation and Aviation Week offering DC-3 aircraft for lease for as little as $985 per month or $48 per hour, including maintenance. Smaller aircraft are also available.
free basis. There are other routes which could probably be operated without subsidy if carriers were given more freedom to adjust flight frequencies, fares, and equipment. However, because of problems of cost allocations of overhead and indirect expense items, it is impossible to determine precisely which, if any, routes are actually subsidy-free at this time. The best indication of subsidy-free operation of a route would come when a carrier accepted a route without government payment—provided that all government payments to the airline (for other routes) were fixed dollar amounts determined by competitive bidding. This method of payment would do away completely with problems of cost allocations of a dubious nature. Variations in cost allocations could not shift a part of the cost of an unsubsidized route to a subsidized route for reimbursement by the Government. The amount of payment would be fixed and, therefore, insensitive to accounting practices.

The airlines would have to be prepared to weather periods of declining traffic which resulted in financial losses because there would be no recourse to subsidy support. A carrier would have to operate a non-subsidized route until it petitioned the Civil Aeronautics Board to advertise the route for bids. Subsidy could be paid only after bidding had taken place, and the carrier would risk losing the route to a lower bidder. If the proposal outlined here were to be adopted, equitable treatment of the carriers would seem to require that trunklines be declared ineligible for subsidy. Otherwise, the trunklines would be able to collect subsidies during business reversals while the local service carriers could not obtain such public support.

In addition to the opportunity to acquire the most desirable routes on a non-subsidized basis, the present local service operators would have distinct, though generally temporary, advantages in the bidding for government supported routes. These advantages, discussed below, would act as a cushion against sharp curtailment of the operations of the thirteen existing airlines.

The present operators of the local service routes possess organized and going concerns. They have personnel trained in the operation of the routes which would be opened to bidding and the ground facilities required for carrying on the business. They also have at their disposal the aircraft to perform the services. Even though their equipment is not well suited to the low density, short haul operations, they do not face the acquisition costs of aircraft.

If the established airlines lose a large number of routes to new entrants, their losses on capital investment in flight equipment would not be catastrophic. The local airlines still own a large number of DC-3 aircraft. The DC-3 aircraft were relatively inexpensive when purchased, and their residual value after many years of use is quite low. The local carriers are already retiring their DC-3 aircraft and the loss of routes would merely accelerate the rate in many instances. Also, this type of capital equipment is quite mobile and can be transferred to other employments. There might
be a market for some of the aircraft among new firms winning route awards.

The existing operators could make use of the name and reputation acquired by past operations and advertising to gain larger revenues than a new firm would initially enjoy. Thus an established firm could often submit lower bids than a new firm without a known name and reputation. Finally, the existing operators of local service routes would have an intimate knowledge of the market, its peculiarities, strengths, and weaknesses. Fuller background knowledge could mean the loss of some routes if new firms with less knowledge mistakenly bid too low. But this indicates that the present operators would have a greater probability of profitable operation at the price bid on the routes they did obtain. Some of the advantages enjoyed by an airline in bidding for its old routes would carry over into bidding competition for routes they have never operated. This would be especially true of routes which were adjacent to their other operations, e.g., routes with common terminal cities.

The local airlines are called subsidized firms even though the subsidy does not principally accrue to their benefit. Under this proposed method of subsidy administration the government payments would not be airline subsidies. The air routes and passengers would continue to be subsidized, but the airlines, having received their contracts through open bidding, would not be subsidized. A local airline could choose to operate without any government payments within a short time by simply not bidding on any routes. This policy would sharply reduce the employment and revenues of most firms. The decisions on bidding would be made by the stockholders and management of the firm involved after consideration of the firm's equipment, routes, and financial situation. Airline management would have more freedom to determine future courses of action.

Another advantage of this proposal would be the greater degree of freedom the airlines would have in the management of their operations. Relaxation of government controls on expenditures for salaries, equipment, and other general expenses was mentioned above in the section on benefits to the Civil Aeronautics Board. Relaxation of controls over subsidy reimbursable expenditures would also benefit the airlines. Under present methods of subsidy payment an airline not only must determine if an expenditure is "good business," but it must also attempt to determine whether an expenditure is wise from the standpoint of subsidy reimbursement policies. This is particularly important in the area of aircraft purchases.

Although the Civil Aeronautics Board cannot directly control aircraft purchases, it has a very strong influence on aircraft choice in two ways. First, in setting subsidy rates the Board can determine the amount of subsidy an airline will earn with a particular type of aircraft. There is nothing to prevent the Board from differentiating rates to influence aircraft choice. A second method by which the CAB can influence an airline's choice of aircraft is the Board's power to recommend approval or denial of a carrier's application to the Secretary of Commerce for equip-
ment loan guarantees. This method of influencing aircraft choice is neither as powerful nor as direct as the setting of subsidy rates.

Equipment decisions properly belong in the area reserved for private decision except in regard to minimum requirements for safety. Free experimentation with various types of equipment should be allowed. The Civil Aeronautics Board and Congress should be concerned with defining the service to be performed, leaving private management free to seek the most efficient means of performing the service desired.

If this proposal were to be adopted, the CAB would have an assurance from the market place that the winning bid was the lowest price obtainable. Therefore, the amount or purpose of particular expenses would be of no concern to the Government. The airlines would gain greater flexibility in the management of their operations.

Of course, it must be noted that firms would wish to exercise prudence in their expenditures to forestall a finding by the Board that maximum fares should be lowered in monopoly markets or that additional competition should be certified. The proposed plan does not leave the Board powerless to act but simply relieves it of the burden of constant supervision of management affairs.

Given the new method of subsidy administration, large differences in the growth rates and prosperity of the carriers would be expected, just as differences arise from the present class subsidy rate. In some instances, revenues might decline. The differences in growth rates would arise from diverse sources. One source would be the quality of airline management. Another important source would be the "natural" endowment of routes the firms now operate—their geographical setting and the prosperity of the regions served. One new factor would arise under the suggested plan: the quantity and quality of competition each firm faces in the bidding process.

The present local service operators may object to this proposal on the grounds that they have not enjoyed the same treatment from the Government as the trunklines received in their struggle toward self-sufficiency. Generally speaking, the trunklines were carried on subsidy from the time of the initiation of the Civil Aeronautics Board in 1938 until each firm became self-sufficient. The proposed plan would not do this for the local airlines.

There is no guarantee that the present local airline companies would receive any direct government payments in the future with the exception of routes won by low bids. One rationale for the difference in treatment is that the trunklines were unopposed in the market for rapid passenger transportation over long distances. The trunklines were faced with growing markets which had future potential for subsidy-free operations. The local airlines, on the other hand, are operating in markets with relatively less airline growth potential. The local airlines face formidable competition in terms of speed, cost, and convenience from buses and private automobiles over the short haul distances. Only a few local service routes are sheltered from surface transport competition by geographical barriers. Barring a radical improvement in aircraft technology or a wholesale shift
in travel patterns, most local service routes will remain commercially unprofitable for many years to come. Therefore, the local service routes, but not the companies, must continue to be subsidized by the Government for the foreseeable future.

Despite the advantages to the existing local service carriers cited above, the thirteen local service airlines are not likely to give up willingly their preferential position. But the public interest in the efficient expenditure of public funds devoted to local air services is of paramount importance. It is difficult to conclude that the present system of local service subsidy administration and payment is the best possible approach to this goal.