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THE FETISH OF SEPARATING SUBSIDY FROM AIR MAIL PAYMENTS

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SINCE the convening of the eightieth Congress in early 1947 a strong movement has been afoot for legislation directing the Civil Aeronautics Board to separate formally subsidy from the compensation air carriers receive for transporting mail. This pressure — not surprising in light of the dismal post war airline depression — culminated in the House and Senate approving separate bills each requiring the Board to make a clear distinction between subsidy grants and mail payments. To placate Congress the CAB in 1951 and again in 1952 issued "subsidy separation reports." The Board's studies however were in no way to effect "... the total amount of mail compensation paid or to be paid to each air carrier..." With the separation completed and the passing of the industry's financial distress, the strong Congressional demand for separation subsided and although the eighty-third Congress saw separation bills introduced in both Houses, legislation requiring a formal division appeared unlikely. This is how matters stood on May 1, 1953. In the ensuing month however two Circuit Court decisions and a Presidential Reorganization Plan were destined to give "subsidy separation" a significance wisely avoided by Congress.

In these two decisions the Court ruled that the Board must give proper weight to all air transport income before awarding mail rates containing a subsidy element. Thus the Court decided that the amount of income earned by Chicago and Southern Air Lines in excess of the 8% considered adequate by the Board on domestic operations should offset the subsidy needed for serving international routes. Using the same logic the Court concluded that profit realized by Western Air Lines from a route and equipment sale should be applied to reduce the subsidy needs of the carrier. On June 1, shortly after the two Circuit Court decisions, President Eisenhower, eager to avoid a repetition of the 1½ billion dollar 1952 postal deficit, submitted to Congress Reorganization Plan No. 10 of 1953. The purpose of this plan is to make the Civil Aeronautics Board, rather than the Post Office Department, responsible for paying the subsidy authorized by the former agency. In other words the compensation element is to come from Post Office Department funds while subsidy payments would be supplied from the budget of the Civil Aeronautics Board. In the message accompanying the Reorganization Plan, President Eisenhower acknowledged the CAB's "separation reports," but recommended "...
this reorganization plan should not preclude the consideration by the Congress of legislation to effect refinement and modifications in the basic law of this field. One such change, for example, would be an amendment of the Civil Aeronautics Act to provide specifically that compensatory rates for mail transportation should be based upon the cost of rendering mail service, plus a fair return." The President continued . . . "I believe it would be appropriate to establish the cost as a matter of definite legislative policy."

In the light of recent judicial and executive action an examination of aviation policy with a particular emphasis on subsidy appears warranted.

**Policy Trend**

Commercial aviation receives two types of government assistance and for want of better terminology these may be designated as direct and indirect aid. Direct aid is generally thought of as that bounty conferred through the medium of air-mail payment. Indirect assistance is provided in the form of government construction, maintenance and operation of airport and airway facilities, and while the federal government bears all costs incident to the airways, both federal and local agencies contribute to the development of airport facilities. In recent years failure of airports to produce adequate revenue to cover operating costs, much less maintenance and interest expense, has brought mounting pressure for the air carriers to pay higher fees for the use of airport facilities. In conjunction with the move for higher airport fees, air lines are censured for failing to pay their fair share of the cost of building and operating the airways. Those who urge increased airport charges and the imposition of an airway tax do not always consider some of the more obvious ramifications of such proposals. It is not to be doubted that raising airport fees and increasing aviation taxes would produce additional revenue helpful to the coverage of expenses incident to the operation and maintenance of these facilities. The value of this plan as a means of shifting the cost of these facilities from the taxpayer to the user of air service may, however, be more apparent than real. The imposition of significantly higher charges for the use of these public-provided facilities will cause carrier management to seek out new sources of revenue, which may very well take the form of enlarged mail payments. It appears, therefore, that direct subsidy, i.e., assistance extended in the form of air mail payments, must be dealt with before any successful program reducing

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8 Federal appropriations 1945-1951 for the establishment of navigation facilities totaling upward of $103,902,000 indicates the extent of public assistance necessary to existing airway installations. Civil Aeronautics Administration, *CAA Statistical Handbook of Civil Aviation*, (1949 and 1950). It is estimated that the microwave all weather system will cost the federal government in excess of another billion dollars.

9 The 1951 airport plan called for aggregate local and federal expenditures of $661,975,000. *Ibid.* p. 15.
indirect subsidy, i.e., aid granted in the form of construction and operation of airports and airways can be effected.\textsuperscript{5}

Direct subsidy means many things to many people and has meant different things at different times. The framers of the Air Mail Act of 1925, the initial legislation enabling private contractors to transport mail, saw the possible danger of according subsidy through air mail payments. This statute, in order to minimize the postal deficit and restrict direct assistance provided that the carriers were not to receive more than 80 per cent of postal receipts. Subsidy, as conceived in the late 1920's was the amount of tax money required to cover the financial losses the Post Office Department suffered in rendering air mail service. Although subsequent amendments dispensed with provisions inhibiting the extension of direct aid, the net deficit theory — post office expenditures in excess of postal revenues for the handling and transporting air mail — was accepted until the early 1930's. At this time, the net deficit concept of subsidy was replaced by the proposition that the extent of subsidy can only be measured by deducting the "fair mail rate" from the actual rate paid the carriers and multiplying the difference by the number of units shipped.\textsuperscript{6} Along with discarding the net postal deficit as a measure of direct subsidy, the adherents of the "fair rate" doctrine established a technique purporting to permit the determination of the fair compensation for mail carriage.\textsuperscript{7}

To those unfamiliar with thought developed on overhead cost, the allocation system proposed by this group of writers may appear as a simple and logical means of finding the "just remuneration" for transporting mail. But to those familiar with accounting principles and rate theory, the patent faults of determining rates on the basis of cost alone should be quite apparent. Yet this is not entirely true. A number of writers, clearly aware of the difficulties of allocating common costs to several classes of traffic and showing an appreciation of orthodox rate theory, appear willing to adopt this approach as a means of determining the magnitude of direct subsidy extended the industry. Both the Federal Coordinator of Transportation\textsuperscript{8} and the Board of In-

\textsuperscript{5} The Civil Aeronautics Board took cognizance of the inter-relationship of these two types of aid when it rejected a carrier's request to establish airway installations. The Board rightfully pointed out the cost of these facilities might ultimately be borne by the government through increased air mail payments. \textit{Braniff Airways}, 2 CAB 227. (1940).

\textsuperscript{6} The subsidy obtained by applying the "fair rate" doctrine is always greater than the financial losses reported by the Post Office Department on air-mail operations. During the recent war, the Post Office reported sizeable profits on air mail operations while studies applying the "fair rate" technique denoted the extension of large subsidies during this period.

\textsuperscript{7} Perhaps the first to develop this concept systematically was Paul T. David in his \textit{Economics of Air Mail Transportation}, (Brookings Institution, Washington, 1933). For the most complete criticism of the net deficit theory see F. A. Spencer, \textit{Air Mail Pay and the Government}, (Brookings Institution, Washington, 1941).

\textsuperscript{8} \textit{Public Aids to Transportation}, 4 vols., (1940).
vestigation and Research arrived at their estimates of direct subsidy by using cost allocation formulas. Continued confidence in this methodology is reflected in more recent government studies, the journals, transportation texts and was an important factor which all but led Congress to enacting legislation requiring the Board to distinguish formally between subsidy awards and compensation payments. The overwhelming weight favoring separation caused the CAB reluctantly to issue a “subsidy separation” report for administrative purposes only.\(^9\)

**Theoretical Framework for Determining Air Mail Rates**

The key to obtaining a reasonable estimate of the subsidy extended is to be found in securing a fair rate for the transportation of mail. Once such a rate is established, subsidy is readily calculated by deducting the fair rate from the actual rate and multiplying the difference by the number of units shipped. As a corollary, subsidy calculations may be exaggerated, understated, or accurate depending upon the success realized in gaining the proper mail rate. It further follows that an evaluation of existing “subsidy separation” procedures should consider the efficacy of the various methods for producing truly fair mail rates.\(^10\)

To do this it is essential to give some attention to the cost structure of the industry.

The fact that a considerable portion of the carriers’ costs are common to the carriage of all types of traffic casts some doubt on the applicability of cost allocation as a useful device for determining realistic mail rates.\(^11\) Certainly, common costs may be apportioned by weight, by space, or — as cost accountants so often do in other industries — by the relative direct costs of each type of traffic. But unless each class of traffic is capable of bearing a pro rata share of indirect expenses, this kind of distribution lends little, if any, assistance in establishing rates. In fixing rates and fares the aggregate revenue earned from the sale of all services must, if the carrier is to continue operations without significant modifications, equal the total cost of production; and the price of each service should at least cover the prime or direct expenses incident to it. It does not follow, however, that each type of traffic will contribute its apportioned share of common costs because the quantity of indirect expenses that each class of traf-

\(^9\) *Public Aid to Domestic Transportation*, House Document No. 159, 79th Congress 1st Session (1944).

\(^10\) Initially at least, the Board opposed “subsidy separation.” Testimony of the Chairman of the Civil Aeronautics Board before the Senate Committee on Interstate and Foreign Commerce (81st Session, 1st Session) on *Hearings pursuant to Senate Resolution 50* clearly demonstrates the Board’s early resistance to such a project. pp. 135-156.

fic will ultimately bear depends finally on the demand for air service. In short, whenever common costs are present, demand or non-cost factors are paramount in establishing rates and fares. Hence, charges for each class of traffic which yield maximum contributions to common costs are advantageous to all air transport users even though revenue from some classes of traffic may be insufficient to cover direct plus apportioned indirect expenses. The acceptance of these principles leads one to conclude that segregation of compensatory air-mail pay from subsidy grants cannot be accomplished without giving some consideration to the demand for service. While one may be in sympathy with those who point to the difficulty of measuring the value of air service, it is a basic truth that valid subsidy measurement cannot be obtained without some knowledge of the demand for air transportation. As a means of gaining some insight into the demand for air transportation let us observe the procedure followed by industry in establishing rates and fares.

Charges on non-mail traffic result from the full play of the market mechanism. It is a logical endeavor for each carrier to establish rates and fares on non-mail traffic which management believes will bring a maximum contribution to indirect costs. Accepting this as a reasonable supposition our remaining concern involves estimating the demand for air-mail transportation. Although this task is made difficult by the Post Office Department being intermediate to the producer and the ultimate consumer, such an arrangement does not preclude certain penetrating observations bearing on this problem. It is well known that rapid shipment is the single peculiar advantage air transportation offers the letter sender and this advantage grows in significance as the distance the letter travels increases. It is to be expected therefore that air mail demand will be greatest and most inelastic for long distance service. This being the case, it is not surprising to see carriers, such as the "Big Four," flying between remote points transporting the overwhelming majority of the mail while carriers having a smaller scope receive only light mail shipments. Such an obvious generalization is no assistance unless it can be applied to specific situations and to some extent this is possible without entering the realm of speculation. If, for the moment, we assume a given Post Office Department handling

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13 So long as the carrier does not earn more than a reasonable return.
14 With the restriction that rates and fares must be just and reasonable.
15 The writer is aware that the trunklines offer service, because of the rigidities of the regulatory process or because of long run anticipations, which do not cover direct costs. These instances are not of sufficient consequences as to negate the value our basic proposition. With local carriers it may be something of a different matter. It is not impossible that these lines may sell a sizeable portion of non-mail traffic at less than prime costs. The bearing this has on the separation issue will be shown in a subsequent section of this paper.
16 It is estimated that approximately 80% of the mail ton-miles were produced by the "Big Four" in 1951. Calculations from CAB Administrative Separation of Subsidy From Total Mail Payments to Domestic Air Carriers. Op. Cit. Appendix A. Length of haul is, of course, only one of the features causing these carriers to experience heavy mail traffic.
cost for each ton mile of mail and we further assume one demand schedule for all air mail service, it is possible to evolve certain principles relevant to the separation issue.\textsuperscript{17}

In 1951 the Post Office Department realized $1.70 for every ton-mile transported by the carriers. In the same period it was estimated the Post Office Department incurred, exclusive of payments to the carriers, mail handling costs of $0.84 per ton-mile.\textsuperscript{18} The difference between these two figures, $0.86 per ton-mile, could have been paid to the carrier without the Post Office Department suffering any losses on air mail service. To put this another way, we know that the 1951 users were willing to pay at least $0.86 to air carriers for every ton-mile of service sold.\textsuperscript{19} Since there is a tendency for charges on non-mail traffic to be set at most profitable levels and since we know that mail users are willing to pay at least $0.86 per ton-mile of service, orthodox rate theory would lead one to conclude that any line receiving less than $0.86 per ton-mile operates without the benefit of government aid. The application of this standard which gives weight to both cost and demand factors produces results quite dissimilar from those obtained when cost factors alone are used as a basis for determining sub-

\begin{table}
\centering
\caption{Estimates of Direct Subsidy Awarded, 1951\textsuperscript{a}}
\begin{tabular}{lcccc}
\hline
\textbf{Carrier Group} & \textbf{Postal Revenue generated at $0.86 per ton-mile} & \textbf{Payment to Carriers} & \textbf{Estimated Subsidy} & \textbf{CAB Subsidy Estimate} \\
\hline
Group I & $37,207,040 & $23,111,000 & ($14,096,040)\textsuperscript{b} & $3,641,000 \\
Group II & 8,363,500 & 14,430,000 & 6,066,500 & 9,276,000 \\
Group III & 924,500 & 6,734,000 & 5,809,500 & 5,926,000 \\
Group IV & 206,400 & 3,749,000 & 3,542,000 & 3,550,000 \\
Group V & 249,400 & 9,072,000 & 8,822,000 & 8,841,000 \\
Group VI & 32,950 & 5,854,000 & 5,462,000 & 5,488,000 \\
Group VII & 32,960 & 1,500,000 & 1,467,360 & 1,253,000 \\
\hline
\end{tabular}
\end{table}

\textsuperscript{a} Source: Calculated from Civil Aeronautics Board Administrative Separation of Subsidy from Total Mail Payments to Domestic Air Carriers. September 1951.

\textsuperscript{b} Postal income exceeded cost of service by this amount for mail transported by lines in this group.

\textsuperscript{17} Post Office handling costs are of a terminal or fixed nature and will decline proportionately as the length of the shipment increases. The demand for air-mail service can be expected to be greater and more inelastic for the longer shipment. Hence our suppositions above tend to distort our conclusions relative to the ton-mile non-subsidy remuneration available to each class of carrier. The bias will be downward for transcontinental lines and upward for regional carriers. Thus the elimination of the distortion would, rather than invalidating our conclusions, confirm our result.

\textsuperscript{18} Data used in this section computed from material contained in Civil Aeronautic Board Administrative Separation of Subsidy From Total Mail Payment to Domestic Air Carriers, Op. Cit. Appendix A.

\textsuperscript{19} It is quite probable, of course, that many users would be willing to pay more than this amount. This could be determined only by experimenting with postage rates.
SEPARATING SUBSIDY FROM AIR MAIL PAYMENTS

Subsidy awarded. For example, the Board estimated that the "Big Four" in 1951 were accorded subsidy payments of $3,641,000 whereas the above analysis would indicate that these carriers received no assistance in this year. When the air-mail users paid at least $0.86 and the carriers received $0.53 for this service it appears unwarranted to state that these lines were subsidized. Table I compares the subsidy computed by the Board with that obtained by applying the formula developed in this paper. It is evident that the Board's complete reliance in cost factors has overemphasized the aid extended to strong lines, i.e., carriers in Groups I, II, and III and underemphasized the bounty granted to weak groups. It is also to be noted that the mail carried by the stronger lines contributes to the support of mail shipped over weak routes. Table I shows that at $0.86 per ton-mile, Group I carriers generate $37,207,040 of revenue over and above Post Office handling expense. Yet these carriers received only $23,111,000 in mail remunerations, leaving the Post Office Department with $14,096,040 in excess of total expenses on these operations. On the other hand, at existing postal rates, the demand for the service offered by Group V carriers does not afford revenue equal to all costs and these carriers may be said to be subsidized to the extent of $8,822,600.20

Subsidy Separation As An Analytical Tool

The separation procedure developed in this paper, while not purporting to permit accurate calculations relative to the subsidy granted, denotes the weakness of the Board's separation technique and also clearly points out a theoretically correct subsidy may be obtained only if the Board applies the following criteria: (1) Is each type of non-mail traffic covering direct costs and making the maximum contribution to indirect expense? (2) Is carrier mail pay in excess of the amount users are willing to pay for air mail service?

Since there is wide divergence in rates paid to the different carriers, it would be necessary for the Board to apply these standards to the operations of each carrier. At this point the magnitude of the task as well as inexactness of the result to be expected must produce some speculation as to the real value of "subsidy separation." It is to be remembered that separation at best is merely a bookkeeping process which is to yield information helpful to the formation of public policy. But will a separation provide any really new information?

In 1953 nine of the domestic carriers received $0.53 or less for every ton-mile of mail carried. Our simple analysis would indicate that there is no subsidy being granted to these lines and the operations conducted by these lines are economically sound. But what of the other some 20 carriers operating? Without giving thought to the amount

20 Since some of this payment is offset by "profits" on air mail shipment over strong lines, complete accuracy requires pointing out that part of the payment is subsidy while the remaining portion springs from discrimination against mail users shipping over the strong lines.
of subsidy conferred, it is quite possible to adjudge the soundness of
the policy fostering these carriers simply by observing the mail rates
these lines receive for transporting mail. The Board estimated that
the ten local carriers in Group V would receive an average compensa-
tion per ton-mile of mail of $27.00 and $24.00 for the years 1952 and
1953 respectively. One carrier was paid $41.50 while another's need
was $301.00 for transporting a ton-of-mail. Although information of
this nature has always been available, it seems to be the consensus that
sound policy decisions cannot be reached without determining the pre-
cise amount of subsidy conferred in the industry. It is submitted that
this is a weak excuse for justifying unsound practices.

When a line receives $27.00 a ton-mile for transporting mail over
a route served almost equally as fast by surface transportation, it hardly
appears necessary to establish a highly complex accounting system to
determine the economic soundness of the route. The Board estimates
that $20.00 of the $27.00 paid the carrier represents subsidy while a
figure of $26.00 would be obtained by the analysis developed in this
paper. At this point one is tempted to query: What is the difference if
the subsidy is $26.00, $20.00, $15.00, or $10.00 per ton-mile? The mail
rate itself, when compared to what the users are willing to pay for the
service, clearly demonstrates that the service these lines render is highly
uneconomical in nature and barring other significant factors should be
discontinued.

The fact that "subsidy separation" hold little promise of providing
anything not generally known suggests that those favoring such a pro-
cedure cherish the belief that it will prove useful in curbing the ten-
dency of the industry to develop excess capacity and at the same time
impel the carriers to adjust more rapidly to short-run fluctuations in
demand. Such a wish is of course quite unrealistic for the forces re-
sponsible for uneconomical operations are not so much the size of the
mail payment, but rather the method of administering mail compen-
sation. A mere system designed to record facts, no matter how elabo-
rate, cannot per se be expected to instill the incentive necessary to
change. Although a discussion of the policy changes necessary to pro-
moting a system consistent with the public interest is beyond the scope
of this paper, it is well to note that "subsidy separation" is not likely
to enlarge significantly the ample supply of data available to policy-
makers.

CONCLUSIONS

Several observations are to be drawn from this discussion. First,
the CAB in establishing policy and the courts when interpreting the
laws must be alert to the theoretical infirmities of the Board's separa-
tion process. Second, separation is not likely to produce any new and
valuable information helpful to the formulation of public policy and
third and more important the Board's present policy of urging the
expansion of air transportation in the area of least advantage is detrimental to development of air transportation in the area of greatest advantage. Air transportation's competitive advantage is least on short, low-population-density routes and greatest on long, high-population-density routes and it is therefore not surprising to see the Post Office Department record "profits" on transcontinental service only to see this agency report financial losses on mail carried by the local carriers. If these local carriers were no longer supported, the Post Office Department would show a "profit" on air-mail service and the question of "subsidy separation" would be less significant. Moreover, the elimination of these carriers would be conducive to a reduction in air-mail postal rates and thereby accelerating the expansion of the industry where it enjoys the greatest competitive advantage. Such a step would reverse the policy which inhibits the exploitation of the heavy demand for long-haul air transportation and has advanced commercial aviation where consumers manifest little desire for the service.