Airline Deregulation: Boon or Bust?

by Paul W. Bauer

The Airline Deregulation Act of 1978 took the operational decisions of running an airline (what routes to fly and what fares to charge) away from government regulators and returned them to the airlines. 1

Over the last decade, the airlines have used this newfound freedom to institute a number of fundamental changes in the structure of the industry. Since 1978, discount fares have been more widely used and the variety of restrictions on these fares has increased, frequent flier plans have proliferated, carriers have come and gone, and hub-and-spoke operations have emerged.

This Economic Commentary examines the benefits and problems that have resulting from the deregulation of the airline industry and makes some recommendations for changes in public policy to preserve the benefits and to mitigate the problems.

The gains in operating efficiency brought about by competition were largely passed on to travelers in the form of lower fares and more frequent flights. Although fares have risen some in the past year, average revenue per passenger declined 30 percent in real terms between 1976 and 1987. Some of the price reduction came at the expense of more restrictions on tickets (not fully refundable, for example, requiring advance purchase, or requiring a stay over a Saturday night). About 90 percent of passengers now fly on discount tickets at an average discount of 60 percent off the "regular" coach fare according to the Air Transport Association.

Deregulation of the airline industry has produced wide-ranging changes that have created benefits and some problems for the public. The promotion of safety, high-quality performance, and beneficial competition within the industry should be a goal of public policy. These policy goals, however, must be based on a sound understanding of the market forces behind the post-deregulation changes in the airline industry.

1 See Bauer (1986).

Footnotes
1. For a short description of the airline industry under CAB regulation and the early years of deregulation see Bauer (1986).

References
Bauer, Paul W., "Don't Panic": A Primer on Airline Deregulation," Economic Commentary, Federal Reserve Bank of Cleveland, IVQ:86.


Kahn, Alfred E., "I Would Do It Again," Regulation, 1988, 2.


... and the fares they could charge. Air-fares could only compete with one another by offering higher quality service than their rivals. Since the CAB— also charged with promoting the industry—would raise fares to cover higher operating costs to ensure the financial health of the industry, there was little incentive for the airlines to work to hold costs down. The result was higher fares and higher quality of service than the average traveler preferred. 2

In a deregulated market, airlines have had to adopt productivity-enhancing techniques, such as the hub-and-spoke route networks, to stay competitive. As a result, labor productivity has increased greatly. Since deregulation, the number of workers in the industry has increased only 48 percent, while the number of passengers flown has increased 86 percent and the number of miles flown has increased 109 percent.

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The hub-and-spoke route systems now used by the airlines have resulted in more frequent flights. Most destinations can now be reached with, at most, a one-stop flight; densely traveled routes still receive nonstop service. 

In recent research looking at the determinants of direct fares to Cleveland, Bauzer and Zaporra (1989) found that for each additional carrier serving a route, fares were lower, but by less and less as the number of carriers in a market increases. Fares decline as additional carriers are added to the route, but only until about four carriers are serving the route. The increase in the national market shares of the largest airlines, resulting from the merger wave of the mid-1980s and the operating agreements of the major carriers with local service airlines, has worried some analysts. Both of these developments have trade-offs between higher operating efficiency and quality of service on one hand and potential anti-competitive effects on the other. Since fares are determined by individual route and airport factors, it is not clear how concerned policymakers should be by the increase in concentration at the national level.

A second source of concern is the increase in concentration at airports with only one carrier offering hub service: creating what are known as "fortress hubs." Market shares at such airports tend to oversize the market power that the hub airline has since most of the passengers of the hub airline are only making connections at the airport. However, these hub airlines usually have sufficient market power so that they can price discriminate between passengers traveling to or from the airport and passengers only making connections at the airport. 

In short, there is a useful role for government to play in preserving and expanding the benefits brought about by airline deregulation, but government regulation of the routes airlines can fly and the fares they can charge is not good policy. Government enforcement of existing safety, antitrust, and consumer protection laws is beneficial. Government investment in improving the air traffic control system (airports and air traffic control) is essential.