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Avoiding the Maple Syrup Solution: Comments on the Restructuring of Canada's Airline Industry

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Avoiding the Maple Syrup Solution

Executive Summary

There is no denying that the Canadian airline industry is going through a very difficult period. The current situation has produced calls for intervention by the federal government from many quarters including shareholders and potential shareholders, employee groups, and Parliamentarians. We agree that policy and legislative changes are needed, but believe that most of the recommendations made to the Minister of Transport by these groups, and most of the initiatives that the Minister has thus far indicated an interest in pursuing, are wrong-headed. In our view, the Minister's focus on the health of the Canadian carriers is misplaced. It is the well-being of Canadian air travellers that should be the subject of the Minister's concern.

The central goal of the federal government's policy-making relating to any restructuring should be the achievement of an economically efficient industry. Efficiency demands, first, that services should be produced at the lowest cost consistent with the desired quality and safety levels, and second, that the "right" amount of the services should be produced. This generally requires that prices be set at competitive levels. Efficiency is a critical goal, not as an end in itself, but because it is a central means to higher-order ends, namely, an abundant and growing economy. Thus, to protect the interests of air travellers and to ensure an efficient industry, the federal government should consider and use all the possible policy levers available to it to facilitate the growth of competition for the dominant (near monopoly) air carrier that may emerge from the restructuring process.

It is hard to exaggerate the importance of barriers to entry in understanding the degree to which a market is likely to be competitive. If barriers are very low, even a true monopolist cannot exploit its customers by raising prices and/or reducing the quality of service.

In his letter to the Minister (on October 22, 1999), the Commissioner of Competition highlighted a number of important barriers to entry over which the government has some control. Relaxing or removing these barriers would have a very beneficial effect on competition. These barriers include the restriction on foreign ownership of Canadian carriers, the 10 percent ownership rule for Air Canada, the scarcity of good take-off and landing slots and terminal facilities at some airports, the current rules governing the computerized reservation systems, various restrictions in international bilateral agreements, and the strict rules on how large a foreign market must be before a second Canadian carrier is approved to serve it. In addition, the Commissioner identified a number of strategies that the government could consider to reduce barriers created by the firms in the industry. These strategies include opening up established frequent flier programs to new entrants, requiring code-sharing and interlining agreements requested by new entrants, restrictions on the use of travel agent commission overrides, and new legislation to control predatory conduct.

Restrictions on foreign ownership of Canadian carriers may protect certain domestic interests but they are inefficient for a number of reasons. For example, they raise costs of production by attenuating the pressures of competition and, second, they raise prices paid by domestic consumers. Nevertheless, the Minister seems determined to maintain these barriers in what we call his "maple syrup solution." He has not explained why is it better for Canadians to be exploited by Bay Street investors than to fly at lower

fares with better service on a carrier financed by Wall Street. An examination of the airline industry in Canada, and all industrialized countries, reveals it to be little more than a fleet of intercity buses with wings. That does not mean that the performance of the industry is unimportant to Canadians—but that is true of many industries. What we are urging is realism in thinking about our airline industry. While there are no grand, strategic considerations here, there are important matters about which Parliament (indeed all Canadians) should be concerned, namely, the future price of air travel, the availability of air service to remote communities, the frequency of service (since time is very important to business travellers), the quality of ancillary services (but no more or less than people are willing to pay for), and the rate of innovation and the diffusion of innovations deemed valuable to travellers.

Significantly, eliminating the controls on foreign ownership (and cabotage) does not mean that the federal government will not or could not exercise notable controls over the industry. For example, the federal safety regulation regime is unchanged (as it is properly independent of economic regulation). The Competition Act applies to all rivals operating in Canada, regardless of ownership. And in the event of a national emergency, the federal government, by Cabinet order, could seize any aircraft on the ground in Canada and direct its use as it sees fit.

Another barrier to entry that should be addressed is the prohibition of cabotage—even if it must be done unilaterally. In essence, cabotage involves a foreign air carrier offering service between two or more points *within* Canada. While no "silver bullet," permitting cabotage will allow Canadian air travellers on at least a few routes to benefit from increased competition. If unilateral cabotage cannot be supported, the Transport Committee should endorse the Commissioner's proposal for modified sixth freedom rights. This would allow US carriers to offer one-stop service across Canada via US hubs.

Policy makers should be leery of promises by the proponents of any restructuring deal that very few jobs will be lost if their proposal is implemented. It cannot be true that Canada is too small for two national and international airlines, and also that it is necessary for the one big airline to retain almost the same number of employees as presently work for Air Canada and Canadian Airlines International (CAI). If there is as much wasteful duplication as some people have suggested, a large number of jobs should be lost. If not, Canada will have the worst of all possible worlds—an inefficient, bloated, near-monopolist.

As we should expect, the airline unions are determined to protect their members' interests at all costs. That is their job. What is not expected is to have the lead minister on the airline restructuring issue indicate that the central objective of government policy is to protect the dominant (near-monopoly) air carrier that will result from the restructuring. It may be desirable to share the cost to employees of restructuring more widely by means of government assistance to help them move to other jobs, but supporting these workers by maintaining surplus jobs is unfair and inefficient: unfair in the sense that air travellers alone pay the unnecessarily high costs, and inefficient because those costs continue indefinitely. It should also be pointed out that a competitive industry will typically produce more output than a monopolized one, suggesting that employment levels may eventually be higher if we can foster a competitive industry, as has been the experience in the United States.

Finally, there appears to be an alternative worth exploring, namely, the restructuring (or re-engineering) of CAI while under protection from its creditors. If CAI were to secure protection from its creditors, most of the corporate capability—in its equipment, its

organization and the skills of its people—will remain. The question which merits more attention from policy makers is whether current CAI owners and managers, or others in their places, can make more of the airline given temporary protection. Note that what we have in mind might involve a complete redesign of CAI, including changes to its route structure, choice of hubs, and the overall scale of the airline. We do not pretend to have the answers to these questions, but we do believe they merit further study. There are examples of airlines in the United States, such as Continental, TWA, and America West, that have gone through such a process and emerged as stronger competitors.

Introduction[1]

Three points should be noted at the outset. First, W.T. Stanbury served as an advisor to the Commissioner of Competition in the preparation of his report on the Canadian airline industry[2] between mid-August and October, 1999. Second, the views expressed here, it must be emphasized, are our own and should not be attributed to the Competition Bureau or to our employer, the University of British Columbia. Third, this submission does not address or evaluate Air Canada's proposal for restructuring Air Canada and Canadian Airlines International (CAI).[3] Without far more data than are in the public domain, it is not possible to conduct a proper assessment.

This submission focuses on a few key policy levers available to the federal government to deal with the expected dominant or near-monopoly carrier that will emerge from the process now underway. These policy levers have been set out by the Commissioner of Competition (1999) and we endorse his recommendations. The core of this presentation is the matter of foreign ownership and cabotage or modified sixth freedom rights[4] as antidotes to the power of the emerging dominant carrier which will be able to exploit Canadian air travellers.

The structure of the paper is as follows. "The Central Problem" identifies the main facets of the key problem facing federal policy makers relating to the restructuring of the airline industry in Canada. "Focusing on a Few, Vital Objectives" proposes that policy makers focus on attaining an efficient Canadian airline industry—which we argue demands that they concentrate much more on protecting and advancing the interests of Canadian air travellers. "Importance of Barriers to Entry" explains how the barriers to entry in a restructured airline industry can affect its competitiveness.

"Does Foreign Ownership Really Matter?" notes that if the 25 percent limit is not changed it will be far easier for the near-monopoly carrier to exploit Canadian air travellers. "Why the Ban on Foreign Ownership and Control?" tries to understand why the Minister of Transport immediately ruled out changes in federal policy on foreign ownership and on cabotage. "The Case for Unilateral Action on Cabotage" sets out the case for unilateral action on this issue. "Protecting Jobs is Both Inefficient and Unfair" explains why the pressures to protect the jobs of airline workers will result in inefficiency and will be unfair to air travellers. "A Possible Alternative to a Domestic Monopoly" discusses an alternative to a near-monopoly on domestic routes: the restructuring of Canadian Airlines International while under protection from creditors. The short section "Conclusions" ends the study.

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1 Presented to the House of Commons Standing Committee on Transport, on November 17, 1999, via videoconference call from Vancouver. Both authors are also affiliated with the SFU-UBC Centre for the Study of Government and Business. We are indebted to Margot Priest for very helpful comments as well as to other persons who must remain anonymous.

2 See Commissioner of Competition (1999).

3 On November 5, 1999, in light of an adverse court ruling, Onex announced that it was dropping its bid for Air Canada and CAI (see Fitzpatrick & Jack, 1999; Cattaneo & Howes, 1999). Note that Onex appears to have left the door open to another bid if Ottawa removes the 10 percent limit on a shareholder's holdings of voting shares in Air Canada (see Marotte, 1999a, p. A4).

4 Cabotage is the right of an airline to carry local traffic in a foreign market in the course of international travel. Modified sixth freedom rights would allow US carriers to offer one-stop service across Canada via a US hub. See "The Case for Unilateral Action on Cabotage" below.

The Central Problem

The central problem facing Canadian policy makers relating to the restructuring of the airline industry has several interrelated facets:

- A single, highly-dominant (near monopoly) air carrier will likely replace the duopoly of large-network carriers in Canada.
- This dominant (near-monopoly) carrier will operate behind *high* barriers to entry (although niche-type entry into charter-type air services will be fairly easy).
- Many of the key barriers are government-created, e.g., the ban on cabotage, and 25 percent limit on foreign ownership.
- The Minister of Transport (1999b) has announced in his statement to this Committee that these key government-created barriers are sacrosanct, i.e., are not subject to discussion.

The leaders of a wide variety of interests (directly or indirectly) support imposing or keeping in place a variety of restrictions on current or potential competition because such constraints are likely to deliver economic (and/or political) benefits to his/her constituency. The lists of interests include the pilots,[5] other unionized employees, the Quebec government,[6] foreign airlines (members of the alliances of which Air Canada and CAI are members), cultural and economic nationalists,[7] and others.

The interests of the most important "stakeholder" of all—Canadian air travellers—have been all but forgotten, particularly by the Minister of Transport.[8] Despite some pious rhetoric to the contrary, air travellers are being set up as the victim in everyone's scenario because they are unorganized and so their voice is not being heard in the policy process.[9] They will be paying the bill for the various actions leading to and reinforcing the market power of the dominant carrier.

It must be emphasized that airline travellers can be exploited in a host of ways *other* than by spectacular increases in fares which might cause negative political feedback. These methods of exploitation include the following:

- fewer discount seats. (At present, some 90 percent of travellers obtain a discounted fare.[10]),
- "shallower" discounts from the unrestricted economy fare (e.g., instead of the lowest fare for Vancouver-Toronto being $469, it could be $699),
- reduced frequencies on many routes (city-pairs).[11] This is of most concern to business travellers for whom reduced total travel time is generally more important than the higher fares,
- poor service by airline personnel.[12] (The traveller's frustration will be compounded by the inability to "vote with their feet" and take one's business to a rival.), and

5 See Winsor (1999).

6 See McNish & McCarthy (1999).

7 See Lalonde (1999).

8 Their interests have been considered by a few columnists, e.g., Coyne (1999), Thorsell (1999), Simpson (1999).

9 We note that the Consumers Association of Canada and Halifax-based Maritime Marlin Travel have voiced concerns about the interests of Canadian air travellers.

10 See Commissioner of Competition (1999, p. 6).

11 In most cases, larger jet aircraft have lower average per seat mile costs—so there may be efficiency gains here.

- reduced benefits from frequent flyer programs. (The dominant carrier will be able to unilaterally reduce the benefits from future flights and also "devalue" accumulated points.)

At the same time, the dominant carrier *may not* be generating excess profits. Why? Because the higher levels of revenues could simply be absorbed into higher costs. It may increase its costs to placate the demands of organized and vocal interest groups:[13] pilots, unionized employees, and also the federal government (which appears ready to impose a number of cost-increasing conditions on the dominant carrier during the restructuring, although none of these will benefit the air travellers).[14] Effective competition forces firms to be as efficient as possible.

Focusing on a Few, Vital Objectives

In the face of a complex and confusing situation it is useful to do two things. First, identify the *few*, vital goals which public policy should serve. Second, it is very important to continue to focus on those few goals when confronted with alarms and seductive demands by a wide variety of interests that *their* goals be of paramount concern.

Very few goals should be chosen because as the number rises two things happen—the likelihood of conflicts among the goals increases greatly, and second, it is more likely that the goals will be only vaguely defined and so make the effects of policy decisions harder to assess.

We suggest that the central goal of the federal government's policy-making relating to the restructuring of the Canadian airline industry be the achievement of an economically efficient industry. Efficiency, as we use the term here, requires two conditions. First, services should be produced at the lowest cost consistent with the desired quality and safety levels (i.e., resources should not be wasted in production). This is sometimes referred to as "technical efficiency" or "productive efficiency" by economists. Second, the "right" amount of the services should be produced. This generally requires that prices be set at competitive levels so that a contrived monopolistic scarcity does not artificially restrict trade. This is part of what economists refer to as allocative efficiency. It demands that policy makers focus on the well-being of travellers who, unlike shareholders and employee groups, have no coordinated representation.

Why is efficiency, with its focus here on the well-being of consumers, *the* goal? The focus on the economic well-being of Canada's air travellers recognizes that consumption is the logical end of all economic activity. If the well-being of consumers is not a central concern, an economic system is a failure because it has failed to deliver the goods to those in whose name the economy functions. (Think of the centrally-planned economies of eastern Europe and the former USSR.) Over 200 years ago Adam Smith explained to policy makers that they should attend to the interests of producers only to the extent that the interests of consumers are advanced. It is clear from experience in all industries that owners, employees,

12 This was one of the consequences of Air Canada's monopoly on the transcontinental route from 1937 to 1959. Why will the future be any different?

13 When firms with market power fail to operate at the lowest attainable costs, economists refer to this as "X-inefficiency" or technical inefficiency. The key issue in the airline restructuring is whether the dominant (near-monopoly) carrier will be free to reduce employment (and capacity) as fast and as much as it would want to do to reduce its costs to the lowest attainable level. See "Protecting Jobs is Both Inefficient and Unfair" below.

14 The Minister of Transport (1999b) has indicated that certain conditions will be imposed on the dominant air carrier. See also Department of Transport (1999).

suppliers and others can do very well by serving the interests of customers. It is also clear that private restraints on competition and/or government protectionism are inimical to the interests of consumers—we have only to reflect on the performance of the Canadian and American airline industries under detailed economic regulation and under deregulation (lower fares, faster growth, more frequent service, far greater opportunity for people of modest incomes to enjoy air travel).[15]

Efficiency is a critical goal, not as an end in itself but because it is a central means to higher-order ends, namely an abundant and growing economy. It is the primary means to raise our standard of living—by better allocating resources today and over time by improvements in productivity, largely through innovation. A rising standard of living means people live better lives in many ways—including being healthier.

High prices for air travel (i.e., those above what would prevail under competition) are not today simply a tax on rich individuals or corporate travel expense accounts.[16] Deregulation greatly widened the market for air travel when the airlines began to practice yield management and offer a variety of discounted fares (with "fences").[17] Thus the visiting friends and relatives (VFR) market expanded enormously.

There is no good argument for failing to protect the interests of air travellers using all available policy levers. In 1889, the first competition legislation in Canada was passed by Parliament to stop firms from colluding to "rook" consumers (see Gorecki & Stanbury, 1984). The restructuring of Canada's airline industry should not be an occasion for government policy actions that focus on producer interests (the owners and employees of the air carrier(s)) rather than the interests of air travellers.

What follows from this choice of objectives is quite straightforward. The federal government should consider and use all the possible policy levers available to it to facilitate the growth of competition to face the dominant (near monopoly) air carrier that may emerge from the restructuring process.[18] Failure to support competition will, logically, result in one of two consequences: the systematic exploitation of air travellers, or the reimposition of economic regulation to try to protect consumers (although this has apparently been ruled out by the federal government).

By focusing on stimulating actual or potential competition by reducing barriers to both new entry and the expansion of existing carriers (e.g., the handful of charter carriers[19] and WestJet), the federal government will *also* create pressures on the dominant carrier to be efficient.

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15 See, for example, Oum, Stanbury, and Tretheway (1991a) (1991b). For another view, see Goldenberg (1994).

16 The narrow definition of "business travellers," those persons travelling on Business Class or full-fare Economy-class tickets paid by the employer, accounts for about 10 percent of all air travellers. However, business travel is increasingly being combined with leisure, and some employees and professionals are able to obtain discount fares (with "fences") for business travel. Thus, a broader definition might well indicate that "business travellers" account for 30 to 40 percent of all passengers. Of course, the average yield (revenue per passenger mile) from business travellers is well above that for other travellers, most of whom fly on some type of discount fare. Other information from well-informed industry sources indicates that for 20 to 35 percent of air trips the purpose is "business only," while for 50 to 60 percent it is for "leisure only." some 25 to 30 percent of travellers have an income under $50,000. At the same time, US data indicate that persons who travel by air more than 12 times a year account for some 40 percent of airline revenues.

17 "Fences" refer to the conditions imposed by the airline, e.g., must stay over Saturday night, must book the flight x days in advance, etc.

18 The Commissioner of Competition (1999) has sought to do this in his report to the Minister of Transport.

In summary, effective competition keeps both costs and fares down and forces rivals to attend closely to the interests of customers. This is what improves the overall economic well-being of Canadians—something Canadian governments have not been able to do in recent years in terms of real, after-tax, per capita incomes.

Importance of Barriers to Entry

It is hard to exaggerate the importance of barriers to entry in understanding the degree to which a market is likely to be competitive.[20] If barriers are very low, even a true monopolist can't exploit its customers by raising prices and/or reducing the quality of service. The prophylactic effect of low barriers to entry can occur even if entry does *not* occur. The serious *threat of entry* is often enough to force the dominant firm to act *as if* more competition was present in the industry.

Barriers can usefully be grouped into three categories:

- those created by nature (and are exogenous to government policy and industry participants),[21]
- those created by government(s)—such as limits on foreign ownership,
- those created by firms in the industry—such as efforts to bar entry of competitors by bouts of anti-competitive behaviour.

In his report to the Minister of Transport, the Commissioner of Competition (1999, p. 1) stated that the ban on cabotage and the 25 percent limit on foreign ownership of Canadian air carriers were "the largest regulatory barriers to entry into the airline industry." These are government-created barriers.

With respect, the Minister's decision to "take these policy levers off the table" at the outset of the review process (e.g., in his letter to the Competition Bureau of August 30, 1999, and in his statement of October 26, 1999)[22] fails to reckon with the opportunity cost of such a move. It is highly likely that Canada will soon have a near monopoly air carrier for its domestic routes and a single carrier representing Canada on its international routes (including almost all routes to the US).[23]

Dominant or near-monopoly firms, protected by high barriers to entry, unfailingly exploit their market power. This takes a variety of forms:

- prices above the competitive level,
- less variety than consumers want and are willing to pay for,
- costs that are above the lowest attainable level—perhaps in the form of too many employees and/or paying wages and benefits above the competitive level,

19 Their licence to operate is no different from scheduled airlines. The difference lies in their business strategy. See Commissioner of Competition (1999, p. 5).

20 See Ross (1999), Gilbert (1989), Geroski, Gilbert and Jacquemin (1990).

21 Note that such barriers are not immutable. Technological change often alters them, e.g., long distance telephony was once a natural monopoly. By the 1970s, new means of transmission greatly reduced the importance of economies of scale as a barrier to entry.

22 See Minister of Transport (1999a), (1999b).

23 Note that access to transborder routes is much easier under the 1995 "Open Skies" bilateral which has been a great success. See New York Times Service (1999).

- poorer service than would prevail in an effectively competitive industry, and
- (possibly) cross-subsidization in an effort to curry political favour to retain government-created barriers to entry.[24]

In general, competition policy focuses on barriers created or maintained by firms. In most cases, competition policy cannot address barriers to entry created by government. For example, the "regulated conduct defence"—established by the courts—provides that where constitutionally valid provincial or federal regulation requires or authorizes restraints on competition, the Competition Act does not apply. For example, government-mandated cartels in the form of supply-management schemes for some agricultural products (chickens, milk, eggs, turkeys) are beyond the reach of the Competition Act.

We suggest that the federal government's role is to help create an economic environment where there are strong incentives for producers of all kinds to serve the interest of consumers—Canadian air travellers in this case. The best way to put such incentives in place is to encourage competition—whether domestic or foreign. The late Chinese Premier Deng Xiaoping put it his way: It doesn't matter if the cat is black or white—so long as it catches mice." How many Canadian air travellers care that foreign investors own the company? What Canadian travellers want is low fares, frequent flights, as well as good service in the cabin and on the ground. The best way to get that result is with competition.

If Canadian Airlines International can't continue to compete with Air Canada, that is unfortunate for its investors, creditors, employees and customers.[25] But CAI's failure (or near failure) is *not* proof that competition in the airline industry is economically impracticable in Canada.[26] The point for policy makers is to minimize barriers to entry so that other competitors can see if they can do a better job. Competition is often a painful process—particularly for the losers. But because one major competitor can no longer stay in the game does not mean the industry is a "natural monopoly," or the foreign competition should be excluded, or—worse—that the remaining dominant firm should be *protected* in any way from domestic or foreign competition. (We address the possible restructuring of CAI in "A Possible Alternative to a Domestic Monopoly" below).

In its letter to the Minister of Transport, the Commissioner of Competition (1999) highlighted a number of important barriers to entry over which the government has some control. Relaxing or removing these barriers would have a beneficial effect on competition. These barriers include the following:

- the restriction on foreign ownership of Canadian carriers,
- the 10 percent ownership rule for Air Canada,
- the scarcity of good takeoff and landing slots and terminal facilities at some airports,
- the current rules governing the CRS systems,
- lack of fifth freedom (excessive restrictions in bilateral agreements) and modified sixth free-

24 John Baldwin (1975) showed that in the 1950s and 1960s, Air Canada (then TransCanada Airlines), engaged in cross-subsidies by incurring losses serving certain smaller cities with larger aircraft (offset by higher margins on higher frequency long-haul routes) in order to curry favour with the regulator and the federal government as owner.

25 See the column by Eric Reguly (1999a).

26 At least part of CAI's difficulties are due to poor management, albeit in the face of starting the duopoly game in a financially weaker position and having to respond to the allegedly predatory conduct of Air Canada in 1991-1992.

dom rights for domestic and foreign carriers, and

- strict rules on how large a foreign market must be before a second Canadian carrier is approved to serve it.

The Competition Bureau also identified a number of strategies that the government could consider to reduce barriers created by the firms in the industry. These strategies include:

- "opening up" established frequent flier programs to new entrants,
- requiring code-sharing and interlining agreements requested by new entrants,
- restrictions on the use of travel agent commission overrides,
- new legislation to control predatory behaviour, and
- restrictions on how the dominant carrier must dispose of surplus equipment.

In our view, the Competition Bureau was correct to place so much emphasis on barriers to entry in its advice to the Minister of Transport. Short of re-regulation, lowering barriers to entry would be the only policy lever left for policy makers to counteract the monopolistic tendencies of a dominant carrier.

Does Foreign Ownership Really Matter?

The answer to this question is yes—but not for the reasons nationalists usually suggest. Constraints on foreign ownership (of less than legal or effective control) of airlines (or in other sectors) are a means by which competition is restricted and certain domestic interests are protected and so earn more than they would in highly competitive markets.

The protection of domestic firms in the name of nationalism has several notable characteristics: (a) it raises costs of production (by attenuating the pressures of competition); (b) it raises prices paid by domestic consumers (they become pigeons to be plucked); (c) protectionism may well generate higher and/or more stable incomes for domestic owners and employees—all at the expense of consumers;[27] and (d) it reduces the protected domestic firm's ability to compete abroad (a contradiction in the age of globalization).

In his statement to this Committee on October 26, 1999, the Minister of Transport (1999b) indicated that his "vision" for the Canadian airline industry was one that "is owned and controlled by Canadians." He announced that "There will be no reduction in Canadian ownership and control requirements." He gave no explanation or justification for this position. He did not acknowledge that such a policy will have high costs for Canadian air travellers—for they are the ones who will bear the burden of this policy.

With respect, we believe that the Minister of Transport is wrong on this point. If he persists in his position he may condemn future Canadian air travellers to years of exploitation by the Canadian-owned and controlled dominant carrier.[28] He has not explained why is it better for Canadians to be exploited by Bay Street investors than to fly at lower fares with better service on a carrier financed by Wall Street. We believe that Canadians expect that cabinet ministers will provide the reasons for their policy actions. Indeed, the whole point of the daily question period in the House of Commons is to force them to do so.

27 The moral legitimacy of the resulting income transfer is highly questionable.

28 For similar views, see Simpson (1999), Coyne (1999), Thorsell (1999), Corcoran (1999), Drohan (1999), and Laver (1999).

But what could possibly justify retaining the 25 percent limit on foreigners' ownership of shares in Canadian air carriers and the requirement of "effective control" by Canadians? Is it because the commercial airline industry is of *strategic* significance? The Minister of Transport (1999b) calls it a "key industry" and says that it "is not just another service sector." Rather, "air services are a vital feature of our ability to meet our personal, commercial and national objectives."

Is this convincing? Sir Freddie Laker, knighted for being a pioneer in the business of supplying low-cost air travel to ordinary folks, described the airline business as one of "putting bums on seats." It is true that a strike by a dominant air carrier, as Canada will soon have, would create serious economic costs. But that unpleasant prospect is an argument to doing everything to see that more competition would prevail in the industry.

An unvarnished, hence unromantic, examination of the airline industry in Canada and all industrialized countries indicates that it is now essentially a producer of commodity-grade services[29] using familiar technologies in a highly routinized fashion. In other words, the Canadian airline industry is little more than a fleet of intercity buses with wings (subject to strict safety requirements).

That does not mean that the performance of the industry is unimportant to Canadians—but that is true of many industries. (What would we do without food, medicine or even clothing?) Indeed, the performance of certain "invisible" industries is vastly more important to the health of Canadians than is the airline industry, e.g., urban sewer systems, clean water, and the public health inspection system.

What we are urging is *realism* in thinking about our airline industry. There are no grand, strategic considerations here. But there are important matters about which Parliament (indeed all Canadians) should be concerned, namely

- the future price of air travel (not just the level of fares—the list price—but also yields or average revenue per seat mile, which depends on the number of discount seats and the extent of the discounts below the standard economy fare),[30]
- the availability of air service to remote communities,[31]
- the frequency of service (since time is very important to business travellers),
- the quality of ancillary services (but no more or less than people are willing to pay for), and
- the rate of innovation and the diffusion of innovations deemed valuable to travellers.

The best means to achieve the optimal level of these more mundane but very important matters is through effective competition. When the actual level of domestic competition is inadequate (as the Commissioner of Competition (1999) indicates it will be), then it is logical to seek competition from foreign sources (see also Hart, 1999). This could take a number of forms: (a) foreign ownership (and control) of air carriers which serve domestic routes (already foreign carriers serve Canadians on international and transborder routes under a host of bilateral agreements!);

29 Of course, the service and comfort in Business Class is superior to that in Economy—but more business travellers are treating business class as a mobile office, as the use of laptop computers while flying indicates.

30 Some 90 percent of passengers travel on a discount fare of some type (Commissioner of Competition, 1999, p. 6).

31 They are not likely to be affected. Because these markets are so small they are usually served by only one air carrier at present (and at high fares with few discount seats).

(b) cabotage—whereby a foreign airline offers service between two or more domestic points in conjunction with international service, or modified sixth freedom routing as was proposed by the Commissioner of Competition (1999, p. 20).

Eliminating the controls on foreign ownership (and cabotage) does *not* mean that the federal government will not or could not exercise notable controls over the industry. For example, the federal safety regulation regime is unchanged (as it is properly independent of economic regulation). The Competition Act applies to all rivals operating in Canada, regardless of ownership. (Indeed, the Bureau has recently obtained convictions for conspiracies created entirely *outside* of Canada.) If there were a national emergency, the federal government, by Cabinet order, could seize *any* aircraft on the ground in Canada and direct its use as it sees fit.

The current stringent limit on the foreign ownership of airlines in Canada (25 percent of voting shares and *effective* control) flies in the face (no pun intended) of all the rhetoric of free trade and globalization of economic activity. If goods and services and even people can more freely move across borders, why shouldn't Canada permit foreigners to invest in—even own all the shares of—the airlines which serve Canada's cities?

What is evil, dangerous or adverse to the public interest about flying between Vancouver and Toronto, or Halifax to St. John's, or Winnipeg to Thunder Bay on an airline owned entirely by foreigners (provided all Canada's safety requirements are met)? Note that foreign-owned carriers serving routes in Canada would be domiciled in Canada, use Canadian crews, and the ground staff would be Canadians.

The only plausible case for domestic ownership and control of an airline relates to carrier(s) which handle international routes (including those to the US). Access to such routes is granted by national governments as parties to bilateral agreements. That is why Australia requires those airlines it names in bilateral agreements to have majority Australian ownership. With respect to carriers flying *only* domestic routes, Australia imposes *no limit* on foreign ownership.[32] The Commissioner of Competition (1999, p. 26) has proposed a similar policy for Canada. The Minister of Transport (1999b) has given no explanation why such a policy would not work for Canada. Indeed, it could work very well for Canada—particularly in light of the need to encourage competition for the dominant carrier that will emerge out of the restructuring process.

Why the Ban on Foreign Ownership and Control?

Therefore, we must ask—why is the government apparently so concerned with foreign ownership? We believe there are two main reasons. First, the government appears to see this policy as part of a larger appeal to nationalists. It gives the illusion that the federal government is taking strong action to protect an undefined "Canadian way of life" (whatever that is). It is designed to appeal to a significant but declining number of people who fear foreign competition—particularly from the US. It is also an appeal to a symbol—something to cling to in a dynamic and often confusing world.[33] It is an illusion and a potentially very costly one for Canadian air travellers.

The essence of nationalism is that it makes it easier for those who control national governments to mobilize power and control (or at least greatly influence) large numbers of people. It promotes and

32 Ansett Australia is a domestic carrier which may fly only within Australia and can be 100 percent foreign-owned. Currently, it is 50 percent owned by Air New Zealand. Ansett International is 49 percent owned by Ansett Australia and 51 percent owned by Australian institutional investors. It has been awarded a number of long-range international routes.

harnesses group feeling (see Davidson & Rees-Mogg, 1997, pp. 133-134). Unfortunately, keeping the constraint on foreign ownership is *costly*, although the costs are diffused and largely hidden and fall on unorganized interests, namely air travellers.

The second reason, we believe, was revealed in a statement the Minister of Transport, Mr. Collenette, made to reporters on October 28, 1999.

> I don't think we can allow any element of foreign competition in Canada, whether it's via foreign-owned, Canadian-operated company or under cabotage. Maybe in some time, in a number of years, if the new dominant carrier becomes mature enough that it can withstand that kind of competition... (But) it would be very foolhardy for any government to try to set up a new regime, encourage domestic competition and then allow this new carrier to have to compete against some of the huge airlines of the world. This would put the new carrier in a terrible position. (*National Post*, October 28, 1999, pp. C1, C5)

This reason for not eliminating the constraints on foreign ownership is based on a deep confusion about the real goals of public policy in this case. Surely the Minister of Transport should not see his role (and that of the federal government) as protecting the interests of the shareholders (and employees) of the new dominant (near-monopoly) carrier. With respect, with his "maple syrup solution" he is confusing means and ends in failing to focus on the *well-being of Canadian air travellers*. Producer interests are important only to the extent that they help to advance the interests of consumers.

The whole point of an airline industry (indeed, *any* industry) is to deliver what *consumers* want. The assumption is that producers are to get rich, not by market power, or government protection from foreign rivals, but by serving consumers better than their rivals, i.e., lower prices, better service, greater innovation. That is what Nortel has done in a highly competitive industry.

In short, the Minister of Transport has got the policy logic *reversed*. He wants to protect the near-monopolist rather than Canadian consumers (air travellers).[34] The end of economic policy is consumer well-being. The means is the complex process of investment, production, and distribution. Production is not an end in itself—it is the means to make consumers better off. The Minister should recognize this fact and change his policy accordingly.

Canadian nationalism in almost every case it is used (explicitly or implicitly) to justify some government policy has the following effects: It reduces economic efficiency and so it imposes an economic burden on both nationalists and non-nationalists. It restricts choice—non-nationalists can't avoid being burdened by the policy. The "shadow price" of nationalism is hidden or hard to determine before or even after the decision.

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33 Not surprisingly, the rivals for control of the dominant carrier played the nationalism card to the hilt. For example, on November 2, 1999, Onex published a full-page ad in major Canadian newspapers with the following headline: "The Germans and Americans Are About to Pick Themselves Up a Great Airline [i.e., Air Canada] for Peanuts. Problem is, It's Your Airline" (see *Vancouver Sun*, p. A16). Another full-page ad by Onex on November 1, 1999 (see *Financial Post*, p. C4) accused Air Canada's management of selling the airline's "soul to Lufthansa and United Airlines. They put key financial and operational decisions into their hands. They sold you out." The *National Post's* headline on October 29, 1999 was "Onex tries to Canadianize merger bid."

34 See the columns by Jeffrey Simpson (1999), Ross Laver (1999), William Thorsell (1999), Andrew Coyne (1999), and the editorial by Terence Corcoran (1999).

Nationalism reinforces decision making based on emotion rather than logical analysis.

The Case for Unilateral Action on Cabotage

In essence, cabotage involves a foreign air carrier offering service between two or more points *within* Canada, i.e., a British Airways flight from London to Edmonton (and then to Vancouver) could pick up passengers in Edmonton and take them to Vancouver; and on the return flight it might fly Vancouver-Toronto-London and so compete on the domestic transcon route Vancouver-Toronto.

It should be apparent that Canada can eliminate a government-created barrier to entry by permitting cabotage and thereby increase the likelihood that there will be more competition on *some* domestic routes.[35]

The key point is this: Canadian air travellers stand to benefit via increased competition on domestic routes even if Canada takes the action unilaterally. There is no need to negotiate new bilaterals which permit Canadian carriers to engage in cabotage in other countries (notably the US).[36]

Indeed, potential exploitable Canadian travellers should not have to wait (possibly decades) for reciprocal cabotage rights to be negotiated. Remember, the problem is market power on domestic routes (the exploitation of Canadian air travellers), not gaining more market opportunities for the dominant carrier in foreign markets!

The case for unilateral cabotage is strong when the domestic market is utterly dominated by one airline. Note, however, unilateral cabotage is *not* a "silver bullet." It may increase competition on about a dozen city-pairs, notably (a) various combinations of cities along the east-west trancon "corridor," from Vancouver to St. John's or Halifax, (b) a few cities in north-south alignment with over-the-pole routes to and from Europe (e.g., London or Paris to Edmonton-Calgary-Vancouver), and (c) a few cities between Europe and the East coast and central Canada (e.g., Toronto-Halifax-St. John's-London/Paris/Amsterdam). Even so, why not use this policy lever to help to constrain the market power of the dominant carrier where it is possible to do so? At least some Canadian air travellers will benefit from competition.

Note that is possible to permit cabotage on a *limited* basis in terms of cities served, frequency of service and so forth. The danger here is that government will end up regulating—and that it will do so with the objective of protecting the dominant domestic carrier.

If unilateral cabotage cannot be supported, the Committee should endorse the Commissioner of Competition's (1999, p. 20) proposal for modified sixth freedom rights. This would allow US carriers to offer one-stop service across Canada such as Vancouver to Minneapolis (or Chicago) to Toronto (or Ottawa or Montreal or even Halifax).[37]

35 See Canada Royal Commission on National Passenger Transportation (1992).

36 We acknowledge that it is most unlikely that Canada could persuade other nations to agree to cabotage on a reciprocal basis due to the power of entrenched economic interests in other countries.

37 We note that Northwest already serves all Canadian cities larger than Regina, plus a number of smaller ones, e.g., London, Ontario. With modified sixth freedom rights, it might well serve even more cities in Canada.

Protecting Jobs is Both Inefficient and Unfair

Policy makers should be very leery of promises by the proponents of any restructuring deal that very few jobs will be lost if their proposal is implemented. It simply can't be true that "Canada is too small for two national and international airlines," *and* also that it is necessary for the "one big airline" (OBA) to employ almost the same number of people as now work for Air Canada and CAI combined. If there is as much "wasteful duplication" as some people have suggested, then a large number of jobs should be lost shortly after the OBA is established. If *not*, then Canada will have the worst of all possible worlds—an inefficient, bloated, near-monopolist.

If this occurs, market power which usually results in higher profits (and a small amount of deadweight loss) will be used to absorb higher average costs than would prevail under competition. If the OBA is protected from more efficient foreign carriers—as the Minister of Transport apparently plans to do by not allowing foreign entry or cabotage—not only will Canadian air travellers be exploited, but also the OBA will become *less* capable of holding its own on international routes where it *will* face serious competition in most cases.[38] Since international routes (including those to the US) account for over one-half the revenues of all Canadian air carriers, this is a most unpalatable prospect.

No one should be so naïve as to believe that the OBA will be able to operate efficiently on international routes, and inefficiently (e.g., too many employees) on domestic ones. To compete, the OBA will have to match the fares, service, and schedules of its rival(s) on international routes. If (as expected) its costs are *not* competitive—then the dominant (and bloated) carrier will further exploit its domestic passengers. In other words, it will "tax" domestic travellers to "cross-subsidize" its international routes. Surely, this would be intolerable.

Another related consequence of the OBA will be an increase in the power of unions representing various groups of OBA employees—from the pilots to the baggage handlers. With almost no competition in the domestic market and no regulation of fares or yields, there will be fewer constraints on how much the unions will be able to extract from the OBA.

It should be recalled that in the days of detailed economic regulation of the airlines in Canada and the US, the airlines' shareholders did not get rich, although on average they did better than have Air Canada and CAI shareholders since deregulation in 1988.[39] It was the unions (including pilots) that captured most of the economic benefits from regulation—at the expense of air travellers. Studies showed that unionized employees of the airlines doing jobs closely comparable to those in unregulated industries (e.g., secretaries, clerks, skilled mechanics) were paid significantly more in the airline industry. No doubt the unions would like to return to those "good old days."[40] Only this time there will be no regulator limiting increases in fares or yields.

It seems clear that the airline unions are determined to protect their members' interests at all costs. The leader of one union promoted the idea of an industry-wide strike to get what he wants. What he wants in terms of protecting his members' jobs or high severance payments can only come out of the hides of Canada's air travellers.

38 See Commissioner of Competition (1999, p. 6).

39 The National Transportation Act of 1987 came into effect on January 1, 1988. See Oum et al. (1991a), (1991b).

40 Unions are not the only ones nostalgic for the old days of air travel. See the column by Dalton Camp (1999).

We also saw the full-page ads in major newspapers on October 30, 1999 paid for by the Canadian Auto Workers.[41] The headline was "Chrétien—Stop the Turbulence." The CAW "solution" is "one company with effective Canadian control" operating "Two Airlines flying Domestic and International routes."[42] The two-colour ads—which probably cost about $20,000 in *each* major city—demanded that the federal government "protect airline workers, their families and communities" by ensuring that "investors…commit to Restructure by Attrition…no forced layoffs, equality of wages, benefits and working conditions, no forced relocations, protection of seniority rights at each airline, [and] no transfer of work south of the border or offshore." Thus the union was advancing the economic interests of its members in an open manner, also appealing to Canadian nationalism. Such rent-seeking is expected of unions whose job it is to protect their members.[43]

What is not expected is to have the lead minister on the airline restructuring issue (Mr. Collenette) indicate that the central objective of government policy is to protect the dominant (near-monopoly) air carrier that will result from the restructuring.

Any deal which promises very few layoffs, particularly if it is a condition of the federal government allowing the deal to be completed, will be *unfair* to air travellers. It is they who finance the excess jobs or generous severance settlements. Why is it ethical for the federal government to sanction such an arrangement? The airline employees' jobs exist because travellers are willing to buy tickets, not the other way round. In a *competitive* environment, air travellers *could not* be burdened by inefficiency (e.g., too many employees), nor generous exit payments to employees.

It may be desirable to share the cost to employees of restructuring more widely by means of government assistance to help laid-off employees make the transition to other jobs. This approach has two advantages. First, it shares the cost of a policy action among all taxpayers. Second, it ensures that air travellers are not burdened with *ongoing excess costs* because the airline has not been forced to reduce costs to the lowest attainable level.

It should also be pointed out that a competitive industry will typically produce more output than a monopolized one. This suggests that employment levels will be enhanced if we can foster a competitive industry. While a monopoly that guarantees jobs might seem like a nice way to protect employment through a restructuring, in the long run there will be more jobs in an efficient competitive market place. Evidence of this fact comes from the United States which has seen employment levels in the airline industry grow considerably under deregulation (see Morrison and Winston, 1986).

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41 See, for example, *Vancouver Sun*, October 30, 1999, p. D16; *Financial Post*, October 30, 1999, p. C20.

42 See also the full-page ad by the International Association of Machinists and Aerospace Workers in the *Globe and Mail* on November 8, 1999, p. A8. It advocated an "air transport workers' bill of rights." The key "right" is that there be no involuntary layoffs.

43 A few days later Onex made a deal with Buzz Hargrove, head of the CAW (which represents 10,000 of 39,000 employees at the two airlines), under which there will be no layoffs at either airline until at least March 31, 2002 and none of the union's members at the main carriers will be forced to relocate. As a result, the CAW indicated its support for the Onex proposal (Melnbardis, 1999, p. D2; Fitzpatrick et al, 1999, p. C1; Reguly, 1999b). The next day, however, Mr. Hargrove was strongly criticized by members of his union for failing to consult them and for failing to remain neutral in the battle. See Stevenson (1999).

A Possible Alternative to a Domestic Monopoly

The scenarios considered so far see the emergence of a near monopoly air carrier with Air Canada and CAI coming under common ownership. But there appears to be an alternative worth exploring, namely, the restructuring of CAI while under protection from its creditors.

We acknowledge that if Canadian does not secure additional financing it may well fail in the next year (see Marotte, 1999b). However, in our view, the economic consequences of such a failure—to the extent they have been considered at all—have been distorted. Even if Canadian does fail, it does not follow that Air Canada should be permitted by the federal government to buy its best assets.

If CAI were to secure protection from creditors it will not immediately fall off the face of the earth. Much of the corporate capability—in its equipment, its organization, and the skills of its people—will remain. And the market is not collapsing—there will still be just as many passengers needing transportation. As the Asian economies improve, in fact, some of Canadian's best markets will be growing.

The question which merits more attention from policy makers is whether current CAI owners and managers can make more of the airline given temporary protection from creditors. And if not the current team, can someone else take the Canadian assets and use them more effectively so as to create a viable carrier? Note that what we have called restructuring might better be called "re-engineering," since it would likely involve significant changes in CAI's route structure, target market segments, choice of hubs, and overall scale of the airline. It would also likely require significant changes in the financing of CAI. We do not pretend to have the answers to the questions we have posed, but we do believe that these questions merit careful study.

There are examples in which distressed firms have been successfully reborn, some even from the airline industry. Continental Airlines in the United States has twice sought court protection from creditors and is now a healthy carrier. TWA is also rebounding after a difficult period, as is America West.

Consistent with this approach, the Competition Bureau will not automatically approve mergers in which strong firms buy out failing firms if the failure of the firm could ultimately lead to a more competitive outcome where new ownership of some or all of the failed firm's assets provides new competition.

We want to stress that we are not advocating a "let Canadian fail" policy,[44] we simply think that the "restructuring under protection from creditors" option should be studied. We admit that it will be costly. Bankruptcy proceedings have a way of destroying a significant fraction of corporate value.[45] And the experience of Eastern Airlines' failed attempt at restructuring informs us that other firms in the industry can suffer if the distressed carrier, supported by court protection, ruins the market with below-cost fares (see Weiss and Wruck, 1998). Whatever the costs of this alternative, they need to be compared to the costs of a monopolized industry.

Conclusions

It is vital that the Commons Transport Committee strongly urge the Minister of Transport to change the positions he has adopted on foreign owner-

44 Several commentators have suggested that this is Air Canada's preferred strategy. See, for example, Foster (1999).

45 In reality, most of the value of the shareholder's investment in CAI has already disappeared, according to the stock market.

ship, cabotage and the apparent desire to protect the emerging dominant carrier.

Public policy should focus on protecting the interests of Canadian air travellers (not air carriers, their shareholders, and employees), and on encouraging economic efficiency.

The best ways to achieve these goals are

(a) to adopt the recommendations of the Commissioner of Competition (1999),

(b) to eliminate the limit on ownership of carriers that serve only domestic routes,

(c) to permit cabotage on a unilateral basis, and

(d) to carefully assess the option of restructuring Canadian Airlines International while under protection from its creditors.

The Minister of Transport is to be commended for announcing the three-part review process of any merger or acquisition of major airlines on October 26, 1999.[46] Such a merge or racquisition will be reviewed by the Competition Bureau (re: competitive aspects), Canadian Transportation Agency (re: ownership and control requirements), and the Minister of Transport (re: public policy objectives). Then the Minister of Transport will determine what conditions will be attached to the deal. If these are met, the deal will be recommended to the Cabinet.

These conditions could be quite elaborate, and therein lies our concern. For example, they could involve various protections for employees, ensuring minimal levels of service on some routes, and even limits on fares.[47] These conditions could, in effect, involve ongoing regulation of the dominant (near-monopoly) carrier. If so, this raises new concerns about the nature of the regulatory regime which may be established as a result of the Minister's review process.

There is a real danger that economic regulation will, in fact, be reintroduced. But it may well take the form of the Minister of Transport being the regulator rather than a specialized regulatory agency with a reasonably well defined statutory mandate.

While the old days of detailed economic regulation produced inefficiency and fares above the competitive level, it was conducted by a quasi-independent agency, drawing on skilled staff, under a set of rules spelled out in a statute and regulations. While there was plenty of means with which the Minister of Transport could shape policy, the system was reasonably transparent. If even limited economic regulation is to be reintroduced, it seems wise for the federal government to avail itself of the virtues of a specialized, quasi-independent regulatory agency operating under clear rules established in statute and subordinate legislation. Further, except where specifically authorized, all restraints of trade in the airline industry should be subject to the Competition Act (which should include new provisions regarding predatory conduct).

46 See Minister of Transport (1999b, "Backgrounder"), and Department of Transport (1999).

47 See Gherson, (1999).

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