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**Book Review — Digitized Version**

[Book Review of] Williams, George: The airline industry and the impact of deregulation, Altershot, Ashgate, 1993

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education are important fields of government action. Many analysts, however, would not agree that the policies of the pre-eighties have had no impact on the eighties. Rather, the crisis of the eighties can only be understood referring to international policies in the pre-phase which was led by a strong desire for industrialization. In my opinion, the book still makes some valuable points concerning the ongoing discussion of development strategies, though, it raises some outdated arguments.

Ernst-August Nuppenau

**Williams, George, *The Airline Industry and the Impact of Deregulation*. Altershot, Brookfield 1993. Ashgate. XII, 188 pp.**

On January 1st, 1993, the EC Commission implemented the so-called “third package” for the liberalization of the European air transport sector. Since this date, the EC airlines are allowed to serve any city-pair between two Community member states and to compete on fares and capacity on cross-border services, without regulatory restrictions. While these changes in the traditional regulatory framework are far-reaching, there is still a lack of consensus between observers of this industry what will be the future prospects of the liberalized European air transport sector. This serves as the background for George Williams’ book, in which he analyzes the past experiences which were made with liberalized air transport markets in the United States, Western Europe, Canada and Australia.

Chapters 1 to 3 deal with the evolution of the market structure after the deregulation of the US airline industry in 1978. The analysis starts with a look back to the era of tight economic regulation of this sector. The traditional regulatory framework consisted mainly of a system of restricted route entry, coupled with a rate-of return price regulation. The carriers’ actions had therefore been limited to the field of service competition, this resulted in low load factors and poor financial performance of the carriers. The proponents of deregulation expected a much improved performance of the airline industry once the regulatory restrictions would have been removed, resulting in lower fares and better service standards. The intellectual background for deregulation was the “Theory of Contestable Markets”, which predicted that an abuse of market power in liberalized markets by incumbents would be unlikely to emerge because of the small degree of sunk costs inherent in the industry.

What did really happen in the markets after the passing of the deregulation act by the U.S. Congress in 1978? In the early years after deregulation, many new entrants entered the scene, which led to fierce price and service competition. To respond to the new competitive pressures, the incumbents had to develop new strategic weapons for survival against their new vital competitors; and they managed it well. At the beginning of the 1990s, the US air transport sector was dominated by a small number of large “mega” carriers. The only other airlines that have survived are those that have been serving specific market niches. Of crucial importance for the success of the trunk carriers was the restructuring of their networks, the growing importance of computerized reservation systems, the inauguration of frequent-flyer programs and the growing number of code-sharing agreements between trunk and commuter airlines. All these strategies aim on extracting the maximum of consumer rents for the airlines and to raise rivals’ costs. The success of these strategies mainly relied on the exploitation of economies of scope and scale inherent in this industry. The net impact has been to provide positions for market dominance to a small number of very large carriers. Nevertheless, although the present structure of the US airline market is characterized by tight oligo-

polies, on the whole George Williams judges the deregulation to have been successful: To date the average fares are some 15 per cent lower than could have been expected if the traditional regulatory regime had still been in force. However, although the vast majority of U.S. domestic passengers have benefitted, not all passengers are better off under deregulation. Especially the high-yield passengers who live in hub cities nowadays have to pay considerably higher fares than before deregulation.

In Chapter 4, the author turns to the more gradual approach of liberalization in Western Europe. At the beginning, Williams points to the different characteristics between the US and the Western European market, and warns to simply transform the US experience into expectations about the likely outcome in liberalized air transport markets in Europe. The most basic of these differences are the existence of 22 autonomous states in Western Europe, the size of the Western European air transport market, which is much smaller than its US equivalent, and the strong market position of European charter carriers. Traditionally, the air transport sector in Europe was characterized by a system of bilateral agreements between sovereign states. George Williams intensively describes the process of partial liberalization in Europe, starting with the slow erosion of the traditional regulatory regime in the 1970s, that was due to the growing competitive pressures from charter operations, and ending with the Commission's proposals for the so-called "third package" of liberalization. How did incumbents react to the changing regulatory conditions? Extensive hub-and-spoke route systems were already established in European air transport. The main strategic response of the European carriers to the opening of the markets for new competition has been the elimination or neutralizing of potentially powerful competitors through mergers, alliances and code-sharing agreements.

The liberalization of Canada's airline industry took place between 1979 and 1988 (Chapter 5). Formerly, there had been a strong demarcation in service between trunk airlines. The function of the regional carriers had been to supply services to supplement the trunk activities of the two national carriers but not to offer competition against them. Again, as in the United States and in Europe, the unlocking of the market led to a rapid absorption of Canada's regional air carriers by the two trunk carriers. The two relevant features of the Australian airline industry had been the total separation of international and domestic services and the adoption of a "two airline policy" covering internal interstate services. As a result of the removal of the restrictions on route entry and capacity determination in 1987, only one of the many prospective entrants had actually materialized. This airline survived for only one year.

Thus, the evolution of the market structure in deregulated airline markets have shown a strong trend towards consolidation of the industry. This raises the question if there is some justification for reregulation. In Chapter 6, Williams turns to this topic, drawing a coherent line from the justification of regulation policy as an instrument to prevent consumers to be exploited by monopolistic firms, the materializing trend of ever-widening the regulatory control, and the changing attitudes of economists to regulatory practices as became apparent in Stigler's "Capture Theory", leading to the "Theory of Contestable Markets". After referring to these paradigms, Williams states that whether to completely deregulate an industry depends critically on the ability of incumbents to establish barriers to entry in an otherwise free marketplace.

Chapter 7 deals with the prospects for competition in a global marketplace. On a global scale, trends of international consolidation of the industry through cross-border acquisitions and global alliances have become apparent. The author feels that the formation of worldwide alliances is likely to result in less competitive pressures, although the extent to which the industry will become really global is as yet unclear.

Pointing to the past experiences with liberalized airline markets, George Williams is concerned about the preservation of competition in a deregulated marketplace. He

recognizes, however, that to turn back to the traditional tools of economic regulation is not an appropriate answer, given the distortions that it caused. Instead what will be needed, Williams states, will be some form of regulatory policy which allows the authorities a flexible response to the dynamics of the markets. In Chapter 9, Williams presents his idea how to achieve this goal: He advocates the use of franchising route licenses. Licenses would come up for renewal, and be tendered for, every few years. This instrument works as follows: The regulatory authority franchises route licenses for particular city-pairs. Every airline can bid for a route, except airlines which were engaged in predatory practices prior to the tendering process. The author thinks that the danger to lose a lucrative route in the next tendering round will be a sufficient threat to prevent the carriers from engaging in predatory behavior.

George Williams' book presents a comprehensive and careful overview of past experiences with liberalized air transport markets. The message is that economies of scope are an important characteristic of the airline industry which creates a strong trend for unregulated markets to evolve "naturally" oligopolistic. What I have missed, however, when reading the book, was a deeper analysis of the important welfare implications associated with economies of scope and density: One might have hoped for more details on the potential trade-off between efficiency (in a static sense) and competition. This would have given the reader some idea of how to evaluate specific problems that evolve in the competitive marketplace. Let me give an example: A computerized reservation system enables the airline owning it to fine-tune its pricing schemes and flight schedules, but also to make the information biased for consumers. Information which is not available to competitors but only for the CRS-owning airline is, of course, a specific barrier to entry, but information itself is a valuable tool to optimize the supply of air transport services. I would have welcomed if the author had pointed more clearly to both sides of the medal, and had further discussed how to avoid the negative effects of using computerized reservation systems as a tool to erect entry barriers, while preserving the social benefits that spring from these systems. For example, it might have been worthwhile to consider separation of ownership from their use by the same airline.

The idea to use route franchises as an instrument to ensure a pro-competitive environment, is interesting and worthwhile to debate. But I get the feeling that George Williams stops where the real problems of implementing a system of route franchising begin. Probably the most important question in this context is how to identify predatory behavior. It is well known that a characteristic feature in air transport is joint production and that marginal costs are nearly zero for an additional passenger once a route has been established. What are the implications for the detection of predatory practices? Another problem is how to determine the airport slots which are necessary to operate a route. If the regulatory authority would assign certain slots to specific routes, as the author proposes, the air transport system might lose a considerable degree of flexibility in how to use scarce airport (and air traffic control) infrastructure. Another shortcoming of the book is that the author concentrates on the idea of route franchising without discussing alternative pro-competitive policies; e.g. opening up the European market for foreign carriers. It would have had much appeal to compare alternative policy strategies.

Though, in my opinion the book remains too descriptive where it could have been more analytic, it is still worth to be read by those interested in the airline industry who need compact and comprehensive information about the experiences with liberalized air transport markets. It might also serve as a point for further research into questions dealing with the problem how to ensure a competitive environment in unregulated air transport markets (as well as others), which are characterized by economies of scope.

Hartmut Wolf