Aviation in Transition:

Challenges & Opportunities of Liberalization

Session 3: Liberalized Airline Ownership and Control

Good for Consumers, Airlines and the United States

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Liberalizing U.S. Foreign Ownership Restrictions:
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Liberalizing the foreign-ownership restrictions that govern U.S. civil aviation is a promising policy option whose time is ripe. The idea of lifting the cap that the United States places on foreign ownership (25% of voting stake and 49% of nonvoting equity) has been discussed for a number of years. The main arguments against increasing or eliminating the cap are: civil aviation's perceived role in national security, safety and accountability worries, the potential for foreign-government interference in U.S. aviation, the expectation that labor would object to eliminating foreign-ownership rules and the fact that the bilateral aviation agreement system could limit the international rights of a majority foreign-owned airline. These arguments have different degrees of validity, but each can be overcome.

The public and national interest arguments favoring elimination of the U.S. foreign-ownership cap are far more compelling than those against it. The United States and those who travel to, from and within it would benefit from the robust competition that foreign investment could provide. Labor similarly stands to gain from the potential for new investment, better-financed airline employers and a more efficient industry. The United States might also see other aviation partners eliminate their foreign-ownership restrictions in response to a U.S. policy change.

Concerns about safety, the availability of aircraft to meet wartime needs and other competitive and regulatory concerns can be addressed through less intrusive means than restrictions on foreign ownership. These options include new Department of Transportation (DOT) and Federal Aviation Administration (FAA) rules and Department of Justice oversight of competition concerns. Existing restrictions have some valid goals, such as safeguarding national security and ensuring safety. Nonetheless, a rigorous review shows that these goals can be achieved through focused regulatory mechanisms. Moreover, in today's global economy, liberalized foreign ownership and investment permeates virtually every other industrial and service sector. In such an environment, the burden of justifying continued narrow restrictions on foreign ownership in the aviation sector properly rests on those who would perpetuate these outmoded market constraints.

The Work of Deregulation and "Open Skies" Remains Unfinished

The United States has been a world leader in promoting liberal international trade and investment rules. Its WTO and OECD membership attest to that record, as does its vigorous pursuit of regional trade agreements like NAFTA. With the complicity of the industry, aviation has been left behind in many areas. It has been excluded from international trade agreements, leaving aviation saddled with the archaic bilateral structure. Yet the U.S. government's policy decisions to deregulate the industry 25 years ago and to create space for greater international competition through negotiating "open-skies" and other liberal aviation agreements created a field in which U.S. aviation could operate with some freedom. The job of creating a policy environment that allows the U.S. industry to flourish domestically and internationally remains unfinished.

The Success of Airline Alliances Illustrates the Benefits of International Integration

International alliances have permitted carriers – U.S. and non-U.S. – to work around restrictive foreign ownership and control laws, the almost-universal prohibition of cabotage (in the absence of which a foreign carrier could offer domestic service) and the limits imposed by bilateral agreements. Over the past decade, carriers have fully exploited the opportunities that alliances provide to work around archaic rules. Through creating alliances, carriers have rationalized the routes they serve and offer broad market coverage and well-priced convenient service. The U.S. DOT concluded, "[a]lliance-based networks are the principal driving force behind transatlantic price reductions and traffic gains".[1] It also found that alliances have created:

- Better, more competitive service;
- Price reductions;
- Local and national economic development flowing from increased air service; and
- Network expansion created by increased feed.[2]

Contractual alliances do not, however, allow carriers to achieve the integration benefits that would flow from the full integration that would arise from permitting large foreign equity shares in U.S. carriers. While alliances have brought significant benefits to carriers and travelers, allowing foreign ownership offers the possibility of achieving additional price, service and efficiency improvements by encouraging the free flow of capital, permitting alliance deepening and facilitating the exchange of expertise and technology.

Why U.S. Carriers Could Benefit From Liberalized Foreign Ownership Rules

From the airline perspective, removing the foreign ownership cap holds real promise for generating investment, deepening strategic alliances and increasing the pace of innovation. Investment, integration and innovation would give carriers the opportunity to produce an attractive, well-priced service for the traveler and to reward their shareholders.

The airline industry is notoriously capital-intensive. Its financial cycles are pronounced and highly positively correlated with the economic cycles of home markets. Welcoming foreign investment in U.S. airlines would help to address carriers' chronic need for investment and permit geographical risk-sharing that is part of any foreign investment decision.

[1] United States Department of Transportation, Office of the Secretary. International Aviation Developments, Second Report, Washington D.C. October 2000.
[2] United States Department of Transportation, Office of the Secretary, International Aviation Developments, Global Deregulation Takes Off, Washington D.C. December 1999.

Access to foreign capital also holds the potential to draw more domestic capital to the U.S. aviation industry. If foreign entities were allowed to own or take a majority stake in U.S. carriers, U.S. carriers would enjoy greater asset prices since domestic buyers would confront greater competition. In addition, eliminating the foreign-ownership cap would guarantee economic efficiency by ensuring that the purchaser – whether domestic or not – could make the best use of an airline's assets.

Academic work on equity markets shows a strong link between foreigners' trading and local market returns. Net purchases by foreigners have been shown to result in a permanent reduction in the cost of equity capital.[3] The large size of the U.S. capital market does not justify the United States keeping investment in airlines closed, especially since the best investor or partner is often a member of the same industry, albeit a citizen in another country. Very few U.S. industries other than aviation suffer from foreign-ownership restrictions.[4] In fact, the Daimler-Chrysler deal serves as an example of foreign strategic participation not only in a key U.S. industry but also a U.S. industrial giant.

Lifting ownership restrictions would allow carriers to give up a smaller share of ownership for the same amount of capital and would permit them to use more valuable stock in potential mergers or acquisitions. While the financial effect of permitting greater foreign investment in U.S. carriers remains untested, Qantas chairman Margaret Jackson has said publicly that the Australian government's rejection of increasing that country's foreign-ownership cap would increase Qantas' capital costs by up to two percent.[5] A more open U.S. policy toward foreign investment could also create greater international investment possibilities for U.S. carriers.[6]

Obstacles to Foreign Ownership and Control of U.S. Airlines

It is telling that the law regulating foreign participation in the U.S. airline industry is 45 years old. During those four and a-half decades the United States and most of the world has embraced foreign direct investment,[7] broad trade liberalization and a decrease in non-tariff barriers to trade. In contrast, investment in U.S. airlines remains controlled by the Federal Aviation Act of 1958,[8] which limits air carriage of passengers and freight in the United States to aircraft registered in the United States. Registration is limited to U.S. citizens, partnerships in which all partners are U.S. citizens or U.S. registered corporations in which the CEO and two-thirds of the directors are U.S. citizens and 75% of the stock is held or controlled by U.S. citizens. Certificates of public convenience and necessity, required for operation as a domestic carrier, are also limited to U.S. citizens.

[3] Dahlquist, M and Robersson, G. "Foreigners' Trading and Price Effects Across Firms," September 25, 2001. It is difficult to quantify the effect of foreign-ownership restrictions on U.S. carriers since most countries impose foreign ownership restrictions on their carriers.
[4] The Communications Act of 1934, 47 U.S.C. § 310(b), prohibits the Federal Communications Commission from granting radio or television broadcast licenses to foreign governments, individuals, corporations or other entities.
[5] News from Travelbiz.com.au, August 28, 2002.
[6] Geoff Dixon, CEO of Qantas, was recently reported to have indicated the carrier's interest in acquiring a 25% stake in oneworld alliance partner, American Airlines. *The West Australian*, February 24, 2003.
[7] In fact, foreign direct investment rose from 2% of gross capital formation in 1980 to 14% in 1999. UNCTAD, World Investment Report 2000.
[8] 49 U.S.C. §§ 40101-49101 and 41101. See also, 14 C.F.R. §§ 211-298.

The most common arguments against increasing foreign ownership of U.S. carriers are:

- Aviation is a component of national security and the U.S. Department of Defense (DOD) depends on U.S.-owned carriers for transportation needs through the Civil Reserve Air Fleet (CRAF) program;

- Permitting foreign ownership would undermine safety and make airlines less accountable to U.S. regulators;

- U.S. labor groups would object to liberalizing rules; and

- Existing bilateral air services agreements do not envision granting international rights to foreign-owned airlines.

The First Issue to Resolve: Civil Reserve Air Fleet (CRAF)

DOD concerns about whether aircraft belonging to a majority foreign-owned carrier in the United States would be available to participate in the Civil Reserve Air Fleet during emergencies are frequently raised as an impediment to relaxing foreign ownership limits.[9] In fact, these concerns should be allayed by existing regulatory requirements and by the fact that the DOD's needs are modest and well addressed.

The DOD offers U.S. airlines the opportunity to register aircraft and crew for emergency use. To encourage participation, the U.S. government gives carriers that participate in this program access to government contracts. These incentives ensure that U.S.-owned airlines can easily address the DOD's emergency and defense needs. The introduction of foreign ownership need not threaten the CRAF program.

The 2003 order to mobilize the Civil Reserve Air Fleet was only the second time in the CRAF's 52-year history that the DOD has made use of this program.[10] Currently the total number of aircraft committed to the program accounts for about 15% of all U.S.-owned commercial aircraft and the U.S. General Accounting Office found in late 2002 that there are more aircraft committed to the fleet than are needed to fill wartime requirements identified by the DOD.[11]

Any concerns that a foreign-owned airline in the United States would not be accountable to the U.S. government should be allayed by the fact that the United States would require that any U.S. airline be licensed in the United States, regardless of its ownership. Most likely, such an airline would be run as a U.S. subsidiary. As a U.S.-flagged carrier, any such carrier would bear the same responsibilities as any other U.S. flagged carrier, regardless of the nationality of its owners.

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[9] The CRAF was established by Executive Order No. 10219, 16 *Federal Register* 1983 (Feb 28, 1951) and reaffirmed by the National Airlift Policy, National Security Decision Directive 280, June 24, 1987.
[10] AP article, Feb 10, 2003. The first mobilization of CRAF was during the Desert Storm period in the 1990s.
[11] United States General Accounting Office, Civil Reserve Air Fleet Can Respond as Planned, but Incentives May Need Revamping, Washington D.C. December 2002.

Preserving Safety, Accountability and the U.S. Public Interest

The strong safety oversight of U.S. carriers by regulatory agencies is a cornerstone of the U.S. civil aviation system. There is no reason that foreign ownership would change the relationship between carriers and U.S. authorities. In fact it could be a competitive advantage for a carrier to enjoy the seal of approval from the FAA, which could permit full foreign ownership and control with the following requirements:

- Require ongoing public interest certification;

- Seek a review process prior to purchase that would ensure that potential purchasers' decisions are not driven by foreign-government owners; and

- Require foreign-owned carriers be run as U.S. subsidiaries and make them subject to the same requirements as U.S.-owned carriers.

Labor Concerns

Many of labor's concerns, fundamentally regarding potential job loss to foreign workers, can also be addressed by existing and potential regulatory mechanisms. Barring foreign ownership of U.S. carriers is unnecessary to address labor's legitimate concerns. Relaxation of foreign ownership limits would not relieve foreign-owned airlines from the requirement to be "certificated" as U.S. airlines by the Department of Transportation. Regardless of ownership, carriers would need to become U.S. airlines, even if they were subsidiaries of a foreign airline. This required public interest certification, which is subject to ongoing review, subsumes a requirement that U.S. carriers have adequate staffing by those qualified to work in the United States and who are trained and licensed to U.S. standards. In addition, immigration law requires U.S. carrier employees to be legally qualified to work in the United States.

In addition to the legal constraints on wholesale substitution of foreign labor, in fact, according to a recent study there is only minimal wage disparity between U.S. and European carrier employees.[12] In addition, job protection measures are legitimate subjects of labor-management discussion in the context of any change in control of an airline.

Foreign Ownership Challenges the Bilateral Structure

The limits of bilateral air-services agreements are a major challenge to liberalizing existing foreign-ownership rules both in the United States and elsewhere. The bilateral structure does not envision the establishment of a foreign owned or controlled airline in signatory states.

Even if national laws were changed to permit foreign ownership and control and if the United States wished to extend the rights available to its carriers under a bilateral agreement, the bilateral structure would still present an impediment to full enjoyment of international rights. The other signatory to a bilateral agreement with the United States would almost certainly reject the extension of rights to what it would consider a third-country – or perhaps stateless – carrier.

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[12] Moselle, B., Reitzes, J., Robyn, D., and Horn, J., The Economic Impact of an EU-US Open Aviation Area, December 2002.

This issue would arise only for international carriers; carriers that operate only domestically would be unaffected by the limits of the bilateral model.[13] Among the possibilities for addressing this hurdle would be amending bilaterals and seeking foreign-ownership liberalization as part of a wider aviation agreement, such as a trans-Atlantic open aviation area.

The United States Should Take a Leadership Role

It is clear that objections to foreign ownership of U.S. airlines based on safety, national security and labor concerns can be overcome. The law establishing the cap was written almost 50 years ago in a very different political and economic time. The U.S. government has played a critical role in opening up the international aviation system. At a time when the U.S. airline industry is in crisis and needs investment and ideas, the United States should again demonstrate leadership by permitting foreign ownership in U.S. carriers.[14]

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[13] Australia imposes no foreign ownership restriction on domestic airlines but requires airlines it names in bilateral agreements to have majority Australian ownership.

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