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# The ‘three pillars of stagnation’: challenges for air transport reform

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**Abstract:** Various aspects of trade and investment in air transport services are regulated by a series of bilateral agreements in which rights of market access are exchanged. Industry commentators have identified this system and the associated national ownership rules as well as the prevailing attitude of competition authorities (on merger policy and on airport pricing) as the most important factors limiting adjustment in the international air transport industry. These ‘pillars of stagnation’ are examined here. Features of the bilateral agreements in aviation that are similar to those of other preferential trading agreements are noted and linked to the slow pace of policy reform in this industry. The three ‘pillars’ are not independent, and effective liberalization of trade and investment in air transport services depends on complementary regulatory reform. Options are presented on ways in which these changes might be designed and introduced, and in what sequence that might be done. Air transport services are currently excluded from the WTO’s General Agreement on Trade in Services (GATS), and an important enquiry is how multilateral commitments recorded in the GATS might support reform.

## Introduction

The ‘three pillars of stagnation’ is a phrase used by Giovanni Bisignani, Director General of the International Air Transport Association, to refer to the bilateral

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system for exchanging traffic rights in air transport, the associated national ownership rules and the attitude of competition authorities. He regards these as the most important factors limiting change and a return to profitability in the international air transport industry.<sup>1</sup>

Access to markets is negotiated bilaterally in this sector. This approach limits the extent of free riding within those negotiations. However, the coverage of bilateral agreements does not necessarily match the scope of the markets in which airlines designated under such agreements compete. Changes in the competitive structure of markets through route proliferation and higher levels of density have forced adjustment on many carriers, and have led to some reform of the bilateral system. The theme of this paper is that more extensive reform is valuable and that a multilateral approach to its management is now likely to be effective, despite the traditional concern about free riding in aviation. There are both public policy and political economy reasons for this, including the nature of the policy changes that are important, the shift in industry opinion evident in Bisignani's remarks, and the stronger influence of new interest groups in policy choices in the sector.

Commentators have been heard to assert that extending the coverage of the GATS to air transport 'won't be seen in my lifetime'. Yet industry views are shifting. Changes in the attitudes of those subject to regulation increase the likelihood of reform. Other reformist interests in this sector are now stronger, including tourism services suppliers as well as private airport operators and investors. Some governments however remain concerned about liberalization, reflecting either their perception of the interests of local airlines or their concern about the risk of predatory behaviour by foreign governments or carriers in more open markets.

In this paper we review Bisignani's assessment of the three pillars. We begin with comments on the most important characteristics of the policy environment. We note that most of the business activity of airlines is excluded from WTO agreements. We review the industry's recent profitability and note results of research which assesses the extent and impact of protection applying to trade and investment in the industry. We note that, while relatively highly protected, civil aviation records a poor profit performance, and we discuss the implications of this situation for airline interests in reform.

We also comment on the relative importance of each of the 'three pillars' for this situation, and then discuss different ways in which the agreements and processes of the WTO might be amended to make a contribution to reform of the air transport sector.

### **The regulatory system and other impediments to trade and investment<sup>2</sup>**

Trade and investment in air transport services is subject to a variety of impediments, some relating to 'sins of commission' by governments in the application of

<sup>1</sup> <http://www.iata.org/pressroom/speeches/2003-03-22-01.htm> (accessed 16 September 2005).

<sup>2</sup> This section is based on Findlay (2003) and on parts of Findlay and Goldstein (2004).

their regulatory arrangements, and some to 'sins of omission' due to the lack of policy responses to some problems.<sup>3</sup> The nature of these impediments and the treatment of air transport in the WTO are discussed in this section. We then turn to a review of IATA DG Giovanni Bisignani's three pillars.

### *Regulatory arrangements*

The regulation of international trade in air transport services involves an elaborate structure of bilateral agreements (there are over 3500 such agreements), which fix a set of rules to identify the airlines of the contracting parties with the rights to fly on each route, determine the capacity that can be provided by each of those designated airlines, and limit the capacity that can be offered by airlines from third countries.

The system therefore imposes a set of country-specific quotas in each market, where markets are defined in terms of routes between pairs of countries and in terms of the two-way traffic flow. Competition on each route is limited to those suppliers designated by the relevant bilateral air services agreements. When privately owned, effective ownership and control of the designated carriers must rest in the countries negotiating the agreement.<sup>4</sup>

There are four modes of supplying services, as defined in the GATS:<sup>5</sup>

- cross-border supply.
- consumption abroad.
- commercial presence.
- presence of natural persons.

Options relevant to air transport within the first three modes of supply are listed in Table 1. A bilateral agreement would affect all options for cross-border supply (option A) because they

1. put limits on access in option A1: the capacity available to carriers based in one of the end points of a route is often restricted.
2. put limits on access in option A2: only those carriers allocated rights under the bilateral agreement are allowed to pick up passengers on a route and rights of access to third parties are usually tightly constrained.
3. ban A3: cabotage (point-to-point carriage of domestic passengers by international airlines) as part of an international network is not permitted.

A bilateral agreement would generally ban all options that depended on commercial establishment by a foreign carrier, since the designation of a carrier based in a

<sup>3</sup> Warren and Findlay (2000) provide further discussion of the types of 'sin'.

<sup>4</sup> Descriptions of the system is provided by the Australian Productivity Commission (1998) and WTO (2000 and 2001a).

<sup>5</sup> The distinction between cross-border supply and consumption abroad is not so clear for transport services. An airline that picks up or sets down a customer at the customer's own home base is regarded here as involved in cross-border supply. Consumption abroad occurs when the customer is travelling between points away from home.

Table 1. Modes of supply of international air transport

Mode of Supply	Examples in air transport
Cross-border Supply	A1 Cross-border supply on international routes (including a stop in the home base): e.g. Malaysian Airlines operating out of Malaysia picks up Australians on Malaysia-Australia routes
	A2 Cross-Border supply on international routes (not including a stop in the home base) e.g. Malaysian Airlines picks up Australians on New Zealand–Australia routes (as part of sequence with an origin or destination in Malaysia).
	A3 Cross-border supply on domestic routes: e.g. Malaysian Airlines carries Australians on domestic routes in Australia
Consumption Abroad	B Consumption abroad on international routes: e.g. local consumers buy tickets offshore
Commercial Presence	C1 Commercial presence adjacent to consumers to supply international market: e.g. Malaysian Airlines establishes an Australian operation to carry Australians (and others) on routes to and from Australia
	C2 Commercial presence adjacent to consumers to supply domestic market; e.g. Malaysian Airlines establishes an Australian operation to supply routes within Australia
	C3 Commercial presence offshore not adjacent to consumers: e.g. Malaysian Airlines establishes a business in Indonesia to carry Australians (and others) on routes to and from Australia
Market access by domestic suppliers	D Home-based delivery to international market: e.g. Malaysian Airlines operates on routes to and from Malaysia
	E Home-based delivery to domestic market: e.g. Malaysian Airlines operates on routes within Malaysia

country which is a party to the agreement as having the right to fly under that agreement is usually restricted to those locally owned and controlled (option C: an option like C3 might be sought by a carrier based in a high cost economy which seeks to maintain its competitiveness).

The purchase of tickets offshore by local consumers (option B) is outside the scope of the local regulation, although that transaction is subject to regulation by the end-point countries of the route.

The terms of market access by domestic suppliers also matter (items D and E). Market access in the GATS refers to the terms of access applying to domestic suppliers and not just those applying to foreign suppliers. A bilateral agreement might permit designation of more than one domestic operator in mode D. However option E is a matter for domestic policy.

The movement of people (the fourth mode of supply in the GATS), while not shown in Table 1, is also important, for example, for the movement of airline staff or suppliers of complementary services. This mode is of interest in

Table 2. Freedoms of the air and the modes of supply

Freedom of the air	Definition	Mode of supply (refer Table 1)
First	To overfly one country en-route to another	n.a.
Second	To make a technical stop in another country	n.a.
Third	To carry freight and passengers from the home country to another country	A1, D
Fourth	To carry freight and passengers to the home country from another country	A1, D
Fifth	To carry freight and passengers between two countries by an airline of a third country on a route with an origin or destination in its home country	A2
Sixth	To carry freight and passengers between two countries by an airline of a third country on two routes connecting its home country	Pairs of services associated with A1
Seventh	To carry freight and passengers between two countries by an airline of a third country on a route with no connection in its home country	A2
Eighth	To carry freight and passengers within a country by an airline of another country on a route with an origin or destination in its home country. [Cabotage]	A3 in conjunction with A1
Ninth	To carry freight and passengers within a foreign country with no connection in the home country. [True domestic]	C2 or A3

this industry to developing economy exporters of labour services and also to developed economies where businesses adjust their operations in response to competition.

The international regulatory arrangements restrict market access, by both domestic and foreign carriers. The most-favoured nation principle (MFN) is not satisfied since there is discrimination between foreign suppliers. Nor is the principle of national treatment satisfied since foreign and domestic airlines operate under different conditions, for example in terms of access to domestic markets or ownership conditions.<sup>6</sup>

Market access is now generally exchanged in a series of bilateral agreements and these refer to, or define implicitly, the 'freedoms of the air'. The freedoms of the air can be matched with the modes of delivery of air transport services (Table 2). The major omissions among the freedoms of air are those modes related to commercial presence for servicing international routes (the C options in Table 1).

<sup>6</sup> This example assumes that the 8th and 9th freedoms ie cabotage and 'true domestic' are sufficiently alike.

*Air transport in the WTO*<sup>7</sup>

Commitments associated with air transport under the WTO's General Agreement on Trade in Services (GATS) only apply to three ancillary services – aircraft repair and maintenance, selling and marketing, and computer reservation systems. An annex to the agreement excluded consideration of traffic rights and services related to traffic rights under the GATS. In 2001, the WTO resumed its mandated review of the Annex on Air Transport Services and adopted the guidelines, procedures and work programme for the negotiations on services, including a number of air transport and tourism proposals (ICAO 2002). Proposals for additions to the Annex on Air Transport Services submitted by Members to the Council on Trade in Services (CTS) included ground-handling services; airport management services; leasing or rental services of aircraft without operator; and services auxiliary to all modes of transport when delivered in an air transport context.<sup>8</sup> Airlines may want to include ground services in the Annex to try to create more competitive markets for their provision. Also private investors in airports, now more common, may prefer to widen the coverage of the Annex to include airport management services. However, the 2001 review stalled and ended without conclusion in November 2003, and another was to begin later in 2005.<sup>9</sup>

At the same time, there are general negotiations on services in progress in the WTO and those economies with a strong interest have the option to return to some specific air transport issues through those negotiations, for example proposing the coverage and liberalization of airport services and ground handling.

The presence of another international organization with jurisdiction in the field has complicated the negotiations. The International Civil Aviation Organization (ICAO, a UN body) has requested the WTO to develop a Memorandum of Understanding (MoU) to strengthen cooperation and to help define their respective roles.<sup>10</sup> There has also been discussion in the WTO of a draft GATS Annex on Tourism. A proposal was discussed at the Council on Trade in Services that envisages access to air transport infrastructure and related services on a non-discriminatory basis in addition to concerns for potential regulatory overlap on certain aspects of air transport.<sup>11</sup>

**The first pillar: bilateral restrictions**

Bilateral agreements restrict entry into air transport markets, thereby increasing prices. They could also have the effects of creating rents for incumbents or, as

<sup>7</sup> The discussion of the treatment of air transport in the GATS is extracted from Findlay and Goldstein (2004).

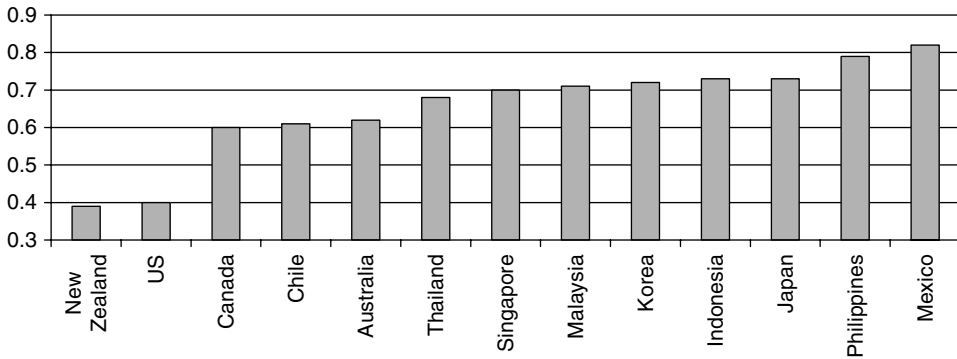
<sup>8</sup> Hubner and Sauv  (2001: 980 and Table 1) examine these proposals.

<sup>9</sup> The outcome of the review is reported in WTO (2003), paragraphs 12–118.

<sup>10</sup> Abeyratne (2001) provides a more detailed discussion of the role of ICAO and its relationship with the WTO.

<sup>11</sup> For more details of the proposed annex and commentary on it, see papers available at [http://www.wto.org/english/tratop\\_e/serv\\_e/symp\\_tourism\\_serv\\_feb01\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/symp_tourism_serv_feb01_e.htm) (accessed 16 September 2005).

Figure 1. Restriction indices for air transport, selected APEC economics



Source: Doove *et al.*, 2001.

discussed further below, the impediments could also increase costs. Doove, Gabbitas, Nguyen-Hong, and Owen (2001) extended earlier OECD work (Gonenc and Nicoletti, 2001) on the impact the agreements on prices. They calculated an index of restrictiveness of air transport policy which included:

- Designation requirements (single, multiple or no restriction)
- Capacity regulation (predetermined, free determination, other formulas)
- Price regulation (various formulas, no requirement)
- Treatment of non-scheduled services

In the index calculation, each component accounted for between 22 and 27 per cent of the score.<sup>12</sup> Components were scored between zero and one, with lower scores corresponding to more liberal regimes, according to the assessments of the research team members. The weighted index value therefore also ranged between 0 and 1.

Figure 1 shows the index values for the Asia Pacific economies. The figure illustrates the wide variation in policy regimes in the region but also shows the relatively restricted nature of the regimes. Of the economies in Figure 1, only the US and New Zealand show a score of less than 0.4. In comparison, apart from Switzerland, the index values for the European countries are all less than 0.4 (for example the UK index value is 0.30 and that for Ireland is 0.21 with Portugal the lowest at 0.14).

Restrictions of the type captured in the index have had a significant impact on airfares. Discount level fares in the Asia Pacific region are estimated to be 12 per cent and 22 per cent higher in the region because of the presence of the restrictions (Doove *et al.* 2001, Table 2.3). Further regulatory reform in this sector would therefore lead to significant price reductions, including in developing countries.

<sup>12</sup> These weights are derived from a factor analysis of the variation in the components of the index. See Gonenc and Nicoletti (2001).



*Rent creating or cost increasing?*

IATA estimates the net financial result for its members for the period 2001–2005 will be a net loss of US\$40b.<sup>13</sup> Some carriers are earning substantial profits, given their locational, financial, structural, or regulatory advantages. However, apparently, this is generally not the case. In the light of the failure of regulated firms to benefit significantly, the argument for reform being made in the industry (and which we represent by DG Bisignani's comments) is not surprising.

Where did the rents go? Some are used up by high cost operators, which continue to survive under the protection of the regulatory system. Their costs are high either because of the relative prices they pay for inputs, or because they operate at levels below those possible by airlines located on the industry 'frontier'. The data reported by Oum and Yu (1998) show the extent of variation in costs between operators. Part of this variation in costs could reflect the rents that are absorbed by the suppliers of inputs, particularly labour, by the airlines and, as discussed further below, by the providers of infrastructure services. The barriers to entry associated with regulation also encourage rent-seeking behaviour by input providers who have sufficient bargaining power.

Reform that has occurred within the regulatory system has increased the levels of competition. The relaxation of restrictions on entry and the designation of more than one carrier, both changes that are now common, have contributed to competition. The density of networks has increased, providing in many cases a larger number of substitute routings between any two end points. Rents are absorbed in this setting by the deliberate creation of excess capacity to deter entry, or by competitive pressures from entrants which lead incumbents to renew their fleets sooner than otherwise.

The restrictions imposed by the regulatory system can also increase costs. Airlines in the current regulatory environment have to construct their networks through a constellation of bilateral agreements. Some pairs of cities that might be served in an efficient network cannot be served because of the restrictions on market access associated with the bilateral agreements. Alliances with other carriers are one response to this problem but they may be a second-best solution because of the many different types of transactions costs incurred.<sup>14</sup>

Johnson *et al.* (2000) modelled the impact of more liberal arrangements in the sector. They found significant cost savings due to competition, which led to higher productivity and to the redesign of networks in more open markets. They found that the former effect was much bigger than the latter and that all the gains were passed on to consumers. Contrary to industry expectations, very little of the gain was retained by the airlines.

<sup>13</sup> <http://www.iata.org/pressroom/pr/2005-04-04-02.htm> (accessed 30 April 2005).

<sup>14</sup> Cooperative arrangements between carriers are reviewed in WTO (2001b). Oum, Park and Zhang (2000) provide an analysis of alliances.

### **The second pillar: ownership restrictions**

Airline agreements are similar to preferential trading agreements and require a rule to establish which businesses are eligible for access to the terms of the agreement, that is, a 'rule of origin'. The 'ownership and control' rule is a critical component of the bilateral agreement for this reason.

Bisignani stresses that the constraints on airline ownership are an impediment to consolidation and to better financial performance in the industry:

Airlines should be free to merge and approach the international financial markets for capital. The wave of globalization must eliminate national ownership limits wherever they represent an obstacle to development. These limits are denying airlines the freedom of action given to all other businesses. Some states may wish to keep a 'golden share' to make sure their national interests are taken into account. Fine! We simply ask these states not to create obstacles for those who wish to liberalize further. They can decide their own timing but they should not be allowed to stop the process. Freedom is really what our industry needs the most.<sup>15</sup>

The ownership rules inhibit the response of incumbent carriers to challenges from competitors. Their concern about these rules has been made more intense by the emergence of a new business model in air transport, that of the low cost carriers. The incumbent full service operators can respond to that threat by stressing their network advantages and will be assisted by a relaxation of ownership rules.

Rules on ownership inhibit new entrants into the business. Costs of operation in air transport vary between countries (Oum and Yu, 1998) and developing economies are internationally competitive in some or all parts of the business. Their areas of specialization are likely to evolve as they develop, for example, shifting from back office functions to flying operations or engineering, as their relative labour costs increase. Their capacity to enter markets for air transport services, or to enter markets for inputs to air transport, is increased by foreign investment in air transport that they host, but the regulatory system impedes that investment.

### **The third pillar: competition policy problems**

Competition policy issues in air transport markets include the response by dominant incumbents to entry by new competitors, abuse of market power by suppliers of services to airlines, provision of subsidies, and the application of merger policy. The effects of airline anti-competitive conduct and of public policy decisions in air transport markets cross over jurisdictional boundaries.

<sup>15</sup> <http://www.iata.org/pressroom/speeches/2003-03-22-01.htm> (accessed 14 February 2004).

Anti-competitive behaviour by incumbents in a market is a special problem where there is no recourse to a regulatory process to resolve disputes about these behaviours. They might include abuse of control of services linked to facilities which are essential to the provision of the service, such as airports and other aspects of these issues which were listed in the 'doing business' section above. Impediments might also be the result of the use of predatory pricing by incumbents, or of deliberate attempts by incumbents to raise the costs of rivals or new entrants.

The abuse of power by services providers to airlines is another issue, the importance of which is apparent in the responses to an industry survey which are summarized in Table 3. The survey covered all-cargo operators, but the responses are relevant to both passenger and cargo operators. The terms on which airlines have access to complementary services, including those which they intend to provide themselves, are a common theme in the responses.

DG Bisignani has expressed his concern about airline exposure to the market power of infrastructure providers:

The airlines are vigorously competing with each other. While this battle continues, they are also the victims of monopoly operators of aviation infrastructure: airports and air traffic management (ATM) companies. The liberalization process has failed to provide a level playing field for all parties in the civil aviation sector. Regulators have not protected the airlines and their passengers from the monopoly infrastructure providers. The marketplace discipline is not there to force airports and ATM companies to be efficient. Some may be tempted to take it easy. They are charging the cost of their inefficiency to the airlines and their customers. And this must end. Airlines can no longer pay for their inefficiency. As monopolies, and often, private monopolies, they can easily abuse that position.<sup>16</sup>

Bisignani also refers to 'dogmatic competition policies (that) also restrict our freedom'.<sup>17</sup> He observes that there are strong competitive forces in the industry, including from the new low-cost carriers. Despite this he notes that regulatory decisions on mergers or alliances are taking a long time and that 'competition authorities, all over the world seem to be over cautious with air transport'. He goes on to ask:

What other global business is more fragmented than air transport? Where are the multi-national players, the Daimler-Chrysler's or the Pharmacia-Upjohn's of air transport? Some industries requiring large investments are fiercely competitive even with just a few very large players. In spite of that, most airline alliance

<sup>16</sup> <http://www.iata.org/pressroom/speeches/2003-03-22-01.htm> (accessed 14 February 2004).

<sup>17</sup> The origins of the bilateral agreements were in the concern that countries might use their control over access to their air space to impede entry by airlines from other countries (Findlay, 1985). That concern about a country's abuse of its regulatory power is now less significant and the industry comments suggest less important than policy on mergers and on access to infrastructure.

Table 3. Impediments to trade and investment in air transport services

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<b>Government regulation at foreign airports</b>
Burdensome legal and administrative arrangements
Difficulty obtaining flight authorization permits
Prohibitions against flying during certain hours
Inefficient take-off or landing slots at congested airports
Operations restricted to less desirable airports
Discriminatory taxes
Excessive fines for violation of regulations
Problems of converting or remitting currency
Excessive taxes
Excessive customs duties on purchased inputs
Cargo sector issues, such as restrictions on multimodal services, customs delays, etc.
<b>Policies and services at foreign airports</b>
Excessive landing fees
Discriminatory landing fees
Discriminatory payment terms (for example, currency in which fees must be paid)
Excessive fuel prices
Discriminatory fuel prices
Fees for which no service is provided
Problems with maintenance and technical support (for example, inability to secure the services required to operate efficiently or inability to operate an airline's own support services)
<b>Ground handling at foreign airports</b>
Handling restrictions
Excessive fees
Discriminatory fees
Ramp handling restrictions
Cargo handling problems (for example, access to warehousing)
Other problems with ground handling (for example, inability to secure the services required to operate efficiently or inability to operate an airlines' own ground handling services)
<b>Local marketing and distribution</b>
Restrictions on local distribution networks
Restrictions on operations of sales businesses (for example, staffing, offices)

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*Source:* Adapted from Tables A3–A6 in WTO (2001d).

projects, or the few merger attempts face long delays ... We need the economies of scale that mergers or acquisitions can provide with the proper competition supervision. Here again, the regulators must take up the challenge of change!<sup>18</sup>

Subsidies and state aid are other important talking points. The EU has proposed to take countervailing action against airlines with extensive state support<sup>19</sup> and has also recently ruled against subsidies provided by regional airports to low cost

<sup>18</sup> <http://www.iata.org/pressroom/speeches/2003-03-22-01.htm> (accessed 14 February 2004).

<sup>19</sup> <http://www.eurunion.org/news/press/2002/2002013.htm> (accessed 14 February 2004).

carriers, which reflect the different choices of strategies adopted by airports with different degrees of market power.<sup>20</sup>

Competition policy choices made in any one country – for example, a merger decision by one regulator – could affect competition in markets in other economies. An access regime applied in one market could affect entry conditions in others. Findlay and Round (2003) find that differences of opinion between countries could arise on the same policy issue, perhaps for political economy reasons, or because of the differences in institutional capacity and the different attitudes taken to the costs of errors in decision making.<sup>21</sup> They suggest that a country at an earlier stage of development may be more willing to accept proposals which turn out to diminish the competitive process, since the assessment of policy makers in that economy may be that the costs of that type of error are short-lived. This may not necessarily be the case. However reducing this error would consume a substantial quantity of relatively scarce policy-making capacity.

A further source of differences of opinion can arise from the methodology employed. Greater weight could be placed on building markets which are efficient in dynamic terms, that is a behavioural approach, compared with a relatively static analysis of the immediate impacts of a proposal to merge or to engage in some other cooperative conduct. The former methodology is also more complex and detailed and can also lead to different assessments of outcomes compared with those based solely on static considerations. The IATA view is apparently that policy makers should adopt the dynamic methodology, by considering the longer-run level of competition in markets. IATA may expect this methodology would lead them to accept more merger proposals than they do now. This methodology is more likely to emerge as experience accumulates in the competition policy authority.

An example occurred in Australia, where the Australian Competition Tribunal overturned a decision of the Australian Competition and Consumer Commission that denied Qantas and Air New Zealand the ability to form a strategic alliance and for Qantas to take a significant equity ownership of Air New Zealand. The Tribunal made its decision largely on the basis of expected future levels of competition in the relevant markets, especially the trans-Tasman market, and used a dynamic and behavioural assessment framework.<sup>22</sup>

<sup>20</sup> 'Whinge Air', *The Economist*, 7 February 2004.

<sup>21</sup> There are two types of errors in assessing a merger for example. One is that a merger will be denied that would not have had anti-competitive effects. Another is that a merger will be approved which does have anti-competitive effects. Lack of resources available to competition authorities to test applications may increase the risk of the second error. Policy makers in a developing country may accept that risk, in return for the lower costs of administration (and in the expectation that any economic profits earned would attract further entry in the long run).

<sup>22</sup> See *Qantas Airways Limited* [2004] ACompT 9; (2004) ATPR 42-027; final reasons delivered 16 May 2005.

Situations in which there are significant differences of opinion could prompt developed countries to offer programs of 'capacity building', that is, cooperative work to share the experience on the application of various methodologies with the institutions at earlier stages of development. However, as Round (2002) explains, the convergence of the design of competition policy and the removal of the differences of opinion in its application both depend on the development of the 'culture of competition' and of the appreciation of its contribution to growth, efficiency, and social welfare.

### Next steps

What IATA DG Bisignani regards as hesitation by competition policy regulators (for example, in response to merger proposals) may reflect their concerns about the consequences of the barriers to entry associated with the bilateral regulatory system. Relaxation of its rules may also relax the attitude of competitor regulators. Even so, competition policy concerns will remain and, as Bisignani himself puts it, 'the paradox is that effective liberalization needs effective regulation'.

How might these changes be designed and introduced, in what sequence, and how might the WTO and its processes assist? Hubner and Sauvé (2001) discuss the prospects of including the air transport sector in commitments under the GATS. They stress that making commitments under the GATS does not necessarily imply liberalization, nor does it require any particular regulatory reform. However they note countries who commit to MFN may become vulnerable to predatory attacks by those who do not do so (p. 977). They also observe that, despite the safeguards which the GATS approach offers, governments may be reluctant to follow this path without 'some kind of protection while the industry globally prepares itself for change' (p. 978).

Before turning to examine reform within the WTO, we note two other paths to reform, one which is reform within the existing bilateral system itself and another which is reform by plurilateral agreement.

### *Bilateral reform*

Reform within the existing bilaterals is now common, for example relaxation of capacity controls and the designation of more than one carrier to operate services. However reform evident to date within the bilateral system does not resolve all of the problems identified and associated with Bisignani's three pillars of stagnation.

Resolving the issues of the three pillars also requires attention to ownership rules. Further reform on ownership rules is possible within the bilateral system. Examples include the emergence of a consensus on the interpretation of 'ownership and control' (for example, a lower threshold level of local equity), movement to recognition of all ownership from a group of countries (for example, ASEAN members and their trading partners accept the designation of any airline with sufficient ownership by nationals from any ASEAN country), or the adoption

of new draft text such as that proposed by ICAO, which is discussed below. The most liberal form of designation would be that sufficient only to permit the application of technical regulation to the operator. The commercial pressures identified earlier may direct the evolution of bilateral agreements and ultimately lead to the relaxation of the 'rule of origin' found in those agreements in a manner which undoes their restrictive effect. However the pace of change would most likely be slow given the requirement for explicit agreement by each trading partner.

Bilateral agreements do contain some provisions for dealing with complaints about 'doing business' matters, but resolving the issues of the three pillars also requires attention to competition policy concerns, and to matters beyond those usually handled within bilateral agreements.

### *Plurilateral reform*

Guidance on a plurilateral approach is available from the report commissioned by the WTO Director General from a Consultative Board on 'The Future of the WTO' (WTO, 2005). Use of plurilateral agreements is one option examined in that report. A small group could develop a plurilateral agreement amongst themselves and invite others to join on the same terms (a 'club' approach), or the whole of the WTO membership could negotiate an agreement from which some members opt out if they wish.

Plurilateral agreements are used in air transport markets. There are examples in Europe<sup>23</sup> and among a group of APEC members.<sup>24</sup> A plurilateral agreement might emerge from negotiations on air transport market access between Europe and the US.<sup>25</sup> However, plurilateral structures do not necessarily build up to global free trade, either because of inconsistencies in their architecture<sup>26</sup> or because of the new interests they create which impede extension of their membership.<sup>27</sup> Plurilateral agreements applied to one sector are even less likely to make progress towards liberalization.

### *Multilateral reform*

Hubner and Sauv e (2001) suggest that the aviation sector could be divided into two parts, the first related to the Freedoms of the Air and the second 'all other components of air transport, including for example ownership and control,

23 The EU arrangements are summarised at [http://europa.eu.int/comm/transport/air/international/dev\\_en.htm](http://europa.eu.int/comm/transport/air/international/dev_en.htm) (accessed 16 February 2005).

24 See the Multilateral Agreement on the Liberalization of International Air Transportation (MALIAT), at <http://www.maliat.govt.nz/> (accessed 16 September 2005).

25 Talks were resumed in September 2005 but sticking points in the discussion are the US position on a cap on 49% foreign ownership of US airlines, and limits on foreign carrier access to domestic routes. See <http://www.atwonline.com/news/other.html?issueDate=9/12/2005> (accessed 16 September 2005).

26 Findlay (2003) identifies a number of problems in the MALIAT model.

27 Andriamananjara (2002, 2003), using a model relevant to air transport markets, explains why plurilateral groups would eventually close entry to new members.

ground-based and reservation services, etc' (p. 979). Members who reach an Understanding on the first component and all those who subscribe to the Understanding would exchange rights among themselves according to the core provisions of the GATS. We make a specific suggestion about how the Understanding might be constructed and we argue for additional commitments with respect to the remaining 'pillars of stagnation', that is, ownership and competition policy. We begin with the latter.

*Domestic regulation, competition policy and cross-border supply*

The GATS contains provisions with respect to monopolies and anti-competitive behaviour, as well as domestic regulation. In telecommunications, Members decided that explicit regulatory principles should be adopted. The Reference Paper on Basic Telecommunications is a result of this approach. That Paper includes a section on competitive safeguards. A similar approach is valuable here, and guidance for developing a paper that is relevant to air transport is available from ICAO, which has drafted 'a model clause on competition safeguards' which lists a number of behaviours that may be anti-competitive in air transport markets. The ICAO model clause also provides for both consultations and dispute resolution with respect to such conduct.<sup>28</sup> The ICAO clause could be combined with other material into a Reference Paper on Air Transport Services. Clauses from the Reference Paper on Basic Telecommunications which are relevant to air transport could be added, for example those on transparency, the independence of regulators, and allocation of scarce resources (which is relevant to slot allocation systems at congested airports). Other ICAO codes, for example on airport pricing, may also be relevant. The Paper would therefore include both principles to be applied to domestic regulation and in some cases detail of the practices of international cooperation (particularly dispute settlement).<sup>29</sup> Members would be invited to sign on to the Reference Paper, in conjunction with their commitments on trade and investment liberalization, as explained below.

Bilateral agreements might be retained to manage only the relationships with non-signatories to the Reference Paper (that is, applying to flights originating in or bound for the territory of the non-signatories). But once a non-signatory changes its position on the new Reference Paper, its bilateral agreements with other signatories would cease to operate.

Members would also have to list any exceptions to their commitments, that is provide a negative list of those activities not covered. This list might initially be dominated by cabotage but at least in that case the matter would be 'on the table' for further negotiation in a multi-sector setting.

<sup>28</sup> See at [http://www.icao.int/icao/en/atb/atconf5/docs/ATConf5\\_conclusions\\_en.pdf](http://www.icao.int/icao/en/atb/atconf5/docs/ATConf5_conclusions_en.pdf) or [http://www.iata.org/NR/ContentConnector/CS2000/Siteinterface/sites/mgr/file/Consolidated\\_Conclusions\\_ATConf5\\_31\\_March.pdf](http://www.iata.org/NR/ContentConnector/CS2000/Siteinterface/sites/mgr/file/Consolidated_Conclusions_ATConf5_31_March.pdf) (accessed 1 May 2005).

<sup>29</sup> Another option is to develop a Reference Paper which applies to all network industries, and an example has been drafted by Nikomborirak and Serafica (2004).



The concern has been that, if a country opens its own markets to cross-border supply, it loses the bargaining power to protect the interests of its own carriers when they seek to fly into other countries. These rights were secured under bilateral agreements. The Reference Paper just discussed provides a degree of security with respect to such matters by its treatment of anti-competitive conduct. Members might therefore be more prepared to make available this form of market opening to those others who have confirmed that they have signed on to the proposed Reference Paper. This condition would be simple to schedule and regular adjustments to lists of eligible trading partners in each Member's GATS schedule could be avoided by making a commitment in this form.

### *Ownership*

Relaxation of rules on the establishment of local operations by foreign carriers also contributes to more open markets. The spirit of the reform in this direction is that (to quote Bisignani) 'we simply ask (some) states not to create obstacles for those who wish to liberalize further'. In that spirit, a Member could schedule new liberal rules on rights of establishment that are relevant to flying operations, including those within local markets (exceptions could also be listed). Trading partners may schedule less liberal rules, but that is a matter for their own assessment and, if necessary, negotiation. All Members could be involved in the design of scheduling conventions or models, even if not all of them immediately adopted the most liberal versions.

As to the form of these new liberal commitments, the industry itself has suggested new rules of ownership. The report of an ICAO conference meeting in 2003 reflects the positions put forward by the airlines themselves (as presented by IATA) on liberalizing national ownership and control rules and separating commercial ownership from regulatory control.<sup>30</sup> The model clause on designation proposed by ICAO includes the following:

#### Article X: Designation and Authorization

1. Each Party shall have the right to designate in writing to the other Party [an airline] [one or more airlines] [as many airlines as it wishes] to operate the agreed services [in accordance with this Agreement] and to withdraw or alter such designation.
2. On receipt of such a designation, and of application from the designated airline, in the form and manner prescribed for operating authorization [and technical permission], each Party shall grant the appropriate operating authorization with minimum procedural delay, provided that:

<sup>30</sup> Consolidated Conclusions, Model Clauses, Recommendations and Declaration of Principles, available at [http://www.icao.int/icao/en/atb/atconf5/docs/ATConf5\\_conclusions\\_en.pdf](http://www.icao.int/icao/en/atb/atconf5/docs/ATConf5_conclusions_en.pdf). The conference also endorsed the multilateral interline system and the existing slot allocation process. See also Chang and Williams (2001) for a discussion of options for changes in ownership rules.

- the designated airline has its principal place of business [and permanent residence] in the territory of the designating Party;
- the Party designating the airline has and maintains effective regulatory control of the airline;
- the Party designating the airline is in compliance with the provisions set forth in Article – (Safety) and Article – (Aviation security); and
- the designated airline is qualified to meet other conditions prescribed under the laws and regulations normally applied to the operation of international air transport services by the Party receiving the designation.

Different criteria can be used to establish 'principal place of business' as required in this clause. These include the presence of an establishment of the enterprise, the location of incorporation, the extent of operations and physical facilities, the payment of income tax, the registration of aircraft, and the employment of nationals in management and operations. These definitions could apply to airline operations owned and controlled by nationals of economies which are not signatories to an agreement.<sup>31</sup>

In a free trade regime the identity of the provider is irrelevant, except that the right to fly would depend on compliance with regulation on technical matters. These matters are also referred to in the ICAO model clause, where designated airlines must have valid operating licenses and meet safety and security standards. But these terms are not discriminatory if as ICAO suggests the relevant standards on which the license would be based are those operating world-wide.

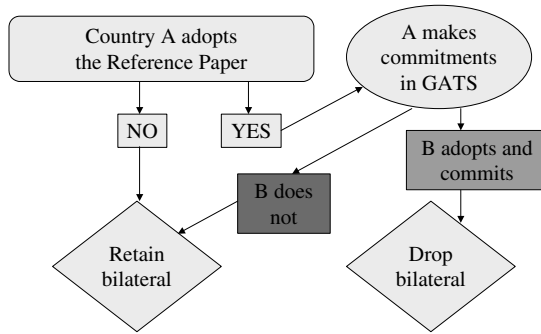
The ICAO draft clause also refers to 'financial health' and 'assurance of service' but these terms can be interpreted as references to consumer protection issues rather than as impediments to trade and investment. Consumer protection is a special issue in these forms of international trade where the consumer is located in one country and the producer is based in another (Round and Tustin, 2005). It is not easy for a consumer in one country to take action against a producer in another: information on how to do so may not be readily available, and the search costs of obtaining the necessary information, and then using it, could be prohibitive. Regulators are often powerless to seek redress due to lack of formal processes to govern such actions between the countries.

### *Sequence of events*

The sequence of events is summarized in Figure 2, where negotiating options between two countries A and B are presented. If A does not adopt the Reference Paper then whatever B does the bilateral is retained. If A adopts the Reference Paper and schedules the associated GATS commitments, then the bilateral is dropped if B matches the actions of A, and otherwise it is retained.

<sup>31</sup> Findlay, Forsyth and King (2005) discuss the application of a variety of relatively liberal rules of origin in the Pacific Islands Air Services Agreement of 2003 (see also [http://www.forumsec.org.fj/division/DEPD/infra/aviation/PIASA\\_final%2004.pdf](http://www.forumsec.org.fj/division/DEPD/infra/aviation/PIASA_final%2004.pdf), access 16 September 2005).

Figure 2. Negotiations between countries A and B



A process of review like that applied to the current Annex continues to be important, since, as just suggested, MFN exemptions are to be scheduled.<sup>32</sup> Further, a review of trends in rules on establishment (and therefore designation) would also be important to encourage convergence to open arrangements. Ideally a path of evolution of these rules should be specified in advance and regular monitoring should be undertaken to establish the distribution of the Membership among the various options, and of their progress towards free trade and investment in air transport services. This is important to deal with the risk that countries might schedule in the GATS commitments on ownership that are less liberal than those in their bilaterals: the most liberal of those could be adopted as the benchmark for scheduled commitments in GATS.

## Conclusion

Rights of access to air transport markets are exchanged under a system of bilateral agreements. Despite the adjustment pressures faced by incumbent airlines, this system has been slow to change. Its costs include a loss of the gains from trade and investment in this sector. The costs of the current system appear to be evident to the airlines themselves. While some reform has occurred within the bilateral system, more extensive changes are valuable and possible. The public policy gains from such changes and the apparent shift in the political economy of policy making in the sector all suggest a multilateral approach to reform can be effective. While industry attitudes are shifting, governments prepared to liberalize remain concerned about the risk of predatory behaviour by airlines of their trading partners who have not committed to reform. The transition from the bilateral system to a GATS-based process proposed here is built on the adoption of a new

<sup>32</sup> New MFN exemptions in GATS require a waiver under Article IX:3 of the WTO Agreement.

Reference Paper on Air Transport Services and the scheduling of new commitments on air transport.

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