Should Airlines be Subsidized in an Emergency? The Libertarian View

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The authors apply the theory of an unhampered market economy to the post-September 11 situation of the airlines in the United States, and argue that a government bailout ill-serves the market, misdirecting resources and retarding a consumer-driven adjustment of supply and demand to reflect the new realities of the marketplace.

Key Words: Airline bailout, economic role of government, market as allocator, entrepreneurial function, effects of government economic intervention, bailouts and employment, trade unions and the airline bailout, market self-regulation.

I. Introduction

Demand for air travel is down in the U.S., and we must ask whether the U.S. government is not giving billions of dollars to an industry that consumers no longer wish to support at previous levels?

The arguments given in favor of the post-September 11 bailout focus on different issues, but the underlying theme in each of them is that there is a role for government to insure the viability of the American economy. Those, like the present authors, who oppose this viewpoint hold that the market itself plays precisely this role through the forces of competition and the allocation mechanisms of price and profit. They maintain that the most important element in the market is the entrepreneur who works to correct any lack of coordination through his self-interested profit-seeking. In taking money away from those who perform this function and giving it to the airlines, politicians disrupt the very economy they are supposedly trying to save. In this article we will consider and several of the most prevalent arguments made in favor of government's subsidizing the airline industry.

1. Unexpected attack

The first argument in favor of subsidies in the present circumstances is that the terrorist attacks on September 11 were an unexpected occurrence. John S. Irons says, "...The events of the past week were an unexpected occurrence and had nothing to do with the fundamental viability of the industry (Irons, p. 1)."

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It goes without saying that the attacks on the World Trade Center and the Pentagon were unexpected. In fact, this was so much so that consumers were unaware of this particular risk associated with flying. However, to argue that surprise events are a reason to subsidize the industry is inherently contradictory. It is impossible to separate the events that happen in an industry from the industry itself. Buyers and sellers are constantly evaluating the costs and benefits of a transaction and thus making decisions that are mutually beneficial. When contracting parties are made aware of a new cost or risk, the parameters of the entire transaction are bound to change.

Ludwig Lachmann stated, "value is not a property inherent in goods, but constitutes a relationship between an appraising mind and the object appraised (Lachman, p. 95)."Using his view of the nature of value, we can see that air travel does not hold a specific value outside of the realm of the person who is (or is not) buying the ticket. Thus, the measurement of this value is subject to change when the perceptions or expectations of that person change (Littlechild, p. 13).That is precisely what happened when terrorists boarded four planes with the express purpose of using them as bombs. Consumers were made aware of the fact that terrorists could and would use commercial airplanes in this way. They could no longer ignore a new and substantial risk of flying in an airplane. The cost and value of air travel has changed. This is evident from the decrease in demand at the same time there has been a significant reduction of ticket prices.1

To bring ticket sales back to the level they were before September 11, ticket prices must fall by an amount comparable to that by which the implicit costs increased, ceteris paribus. Thus, although the events of September 11 were unexpected and had nothing to do with the industry before that date, they intimately affected the viability of the industry afterward. That unexpected events caused a change in the cost of air travel will not change that fact. It is neither just nor practical to make consumers pay for something that they obviously no longer want, certainly not to the same degree as before.

2. Centrality of Air Travel

The argument is made that the airline industry is a vital part of the economy and that we should not allow it to fail. Consider the claim made by Continental Airlines CEO Gordon Bethune, who said, "You're not going to live without this vital part. We are not some machine, some computer. We're a pump just like the heart's a pump, and we need to facilitate and keep our economy going" (cnn.com, ailing airlines, p. 1).

This appeal claims that if the airline industry is allowed to flounder, then the economy will die just as the body dies when the heart stops. Again, we come to a basic error. It is assumed that the economy before September 11 is the same as after September 11.It is true that such swift changes in the nature of our economy are uncommon; but that does not mean that they do not happen. It also does not imply that we should try to restore the economy to its previous state (Hazlitt).The market is in a continuous state of change; when left alone it continuously finds better means of producing more and better goods.[2] If the value of air travel no longer justifies the cost, why do we assume that it is still a vital part of our economy? It is far more accurate to say that it was a vital part of our economy in the past and that we don't know what role it will play in the future. The market coordinates the allocation of resources to the most highly valued goods and services. It does this through prices and it is obvious from cheaper tickets, and fewer of them purchased, that air travel is not as highly valued as it once was, thus not as vital.

By giving the airlines billions of dollars, the government takes resources away from individuals who would spend the money in other ways and forces them to spend it on airlines. Without this forced investment, consumers would use their income on their highest alternative. Maybe it would be the railroads, or rental cars or dinner and a movie in their hometowns, but the resources would go to the industry that consumers value more than airlines. The billions of other people's dollars that the bureaucrats are so generously giving the airline industry is nothing more than a transfer of wealth from taxpayers, and the other industries that they would have voluntarily supported, to the air carriers and their stockholders. The airline industry will benefit only at the expense of other industries (Hazlitt, p. 101).

At one time in American economic history, the horse and buggy industry was riding high. It, too, was "vital" to the national prosperity. Apart from railroads, bicycles and skates, foot power was virtually the only way to move from one place to another. With the "logic" of the vi-

[1]The decrease in ticket prices is a direct result of a downward shift in the demand curve for air travel. As the implicit cost of air travel increases, namely the risk of being in a flying bomb, demand must decrease for all prices along the demand curve.

[2]The mainstream view treats the market as a mechanism by which given goods are produced with given techniques while Littlechild sees the market as an organism that unintentionally creates new goods and techniques by way of individuals seeking profit (Littlechild).

tal industry argument, horses and buggies, too, should have been subsidized.[3] But had the American government followed the subsidy policy that is now being widely advocated for airlines, the effect would have, instead of improving the economy, given it a severe case of arteriosclerosis. According to the doctrine of alternative or opportunity costs, industries can only be subsidized into (continued) existence at the cost of eliminating others. Would we really be better off with horses and buggies and typewriters at the expense of eliminating cars and computers? Hardly.

3. Help the workers

Proponents of the bailout demand subsidies if not for the airlines themselves then for their employees. But this claim, too, is suspect. First of all, it is doubtful that a government subsidy of the airlines will save jobs. As Steven E. Landsburg points out in his article, "Flying Pork Barrels," "Airplanes are flown when it is profitable to fly them, and they are not flown when it is not profitable to fly them. Giving cash to the airlines does not change the profitability of any given flight, so it does not affect any decision about which flights to offer" (Landsburg, p. 1).

In fact, what does influence decisions to fly planes is directly related to demand. With the downward shift in demand, prices are lower as well as the quantity consumed. Profitability of flights has been greatly reduced; thus, airlines are flying fewer routes. With fewer routes to fly, airlines need fewer employees, who will be laid off if demand remains poor. Giving money to the airlines will not change these facts. In fact, some proponents of the bailouts recognize the dilemma and consider it to be a solution for "explicit and enforceable job pledges to ...be built into an air-industry rescue (Donahue, p. 3).[4]"

The problem is that this proposition looks only at the short-run effects as they relate to one group and forgets about the long-run effects on the economy as a whole or even the short-run effects on other groups (Hazlitt, p. 18). Including a clause to ensure employment simply extends the subsidy to the airline employees without solving the problem. It is a direct transfer of wealth from the taxpayers to the airline employees. The transfer is at the expense of the workers in the other industries in

[3] And this goes, as well, for other now extinct or virtually extinct firms, such as typewriters, hula-hoops, candles, etc. Farming used to account for almost our entire employment; now, only a small fraction of the labor for works in this area.

[4] John D. Donahue argues for the bailout by comparing it to the Chrysler bailout. Further arguments from his analysis will be discussed later.

which people would have spent their money and is thus harmful to the economy. If labor is being employed for reasons other than productivity, then capital resources are being kept from industries where they would be most productive. This applies, also, to human resources. Can we really rationalize keeping thousands of people in jobs where they are not needed? It is a harsh fact that the terrorist attacks affected so many people, but keeping workers in jobs where they are not needed helps them only in the short-run at the expense of other people who will not be able to get jobs. In the long run it lowers the standard of living for everyone.[5]

Nor can we ignore the fact that "At big airlines, senior pilots make in excess of $200,000 annually" (Samuelson, 2001).Other salaries in this industry are similarly inflated above market levels. A large part of the bailout to the airlines, then, is really a subsidy to these radically-overpaid employees. That this is but further evidence of the problematic nature of this government plan is not at all an indication of greed, envy, egalitarianism or any other such sentiment. Rather, it stems from opposition to yet another government interference with markets: compulsory unionism. Were it not for such violations of the free society as the Wagner and the Taft-Hartley Acts, it is unlikely that workers' organizations would have been strong enough to compel such stratospheric wage rates (Block, 1991).That the airlines were forced to pay them is responsible for their parlous condition before 9/11/01, and continues to be an obstacle to any rational restructuring of the industry. A bailout would only validate these excessive wages. Without it, either unions would consent to a radical lowering of the salary structure, or, like parasites on a host, they would kill the airlines who consented to these contracts and their place would be taken by firms who could more strongly hold the line against them.

4. Adjustment costs

Another argument for saving the airline industry comes from John Donahue in his article, "Airline Package Harks Back to Chrysler Bailout. "Donahue supports the bailout on the grounds that "airline turmoil threatens consequences beyond the carrier's balance sheets" and that "a complete air-travel meltdown could have grim, far-reaching consequences (p. 2)."

[5] Hazlitt (p. x) states that by forcing people to subsidize employees of any industry, government is keeping them from spending the money in other industries, thus preventing additional employment in those industries.

He implores us to remember the lessons learned in the Chrysler bailout, but he seems to have forgotten them himself. Donahue points out that "bankruptcy isn't oblivion (p. 2)" and he is absolutely right. In fact, this counts against the very point he is making. If bankruptcy does not mean a complete loss of capacity, then what is the argument for saving the airlines in light of the fact that they could simply reorganize under Chapter Eleven? The answer given by Donahue is that adjustment costs should be minimized. The task then becomes to ask: where do adjustment costs come from? If the airline industry went through a momentary slump and the major firms had to reorganize only to come back to the same level of capacity after some time and much effort, then there would be an argument that adjustment costs could possibly outweigh the cost of the bailout. Donahue, indeed, argues that this would be the case (p. 2).

But his argument rests on a false assumption. It posits that anyone, much less bureaucrats, can have the information necessary to determine what the adjustment costs would be. But this is unfounded and is unproven even by the proponents of welfare economics (Hayek, 1948).Furthermore, the adjustment costs would presumably be unjustified if the industry returned relatively quickly to its original state, and that is again an impossible forecast. Without such knowledge, government cannot be expected to make accurate decisions that are in the best interest of the economy. The market will work to minimize adjustment costs through the self-interest of each individual participant.

5. Promoting competition

A most disturbing argument favoring the bailout is that it is an opportunity to create more competition in the airline industry. Thomas (2001) states that the bailout should include provisions that carriers reduce their dominance of particular airports. Citing figures from the Consumer Federation of America, he claims that prices would be reduced by 20% to 50% (p. 2)[6]. The problem is that each airport is treated as an individual unit. Different airlines have dominance at different airports, however, as Thomas himself points out,

> Every flier knows which carrier "owns" which airport: US Airways in Charlotte and Pittsburgh; Delta in Atlanta; American in Miami and Dallas-Fort Worth; United in Denver; Northwest in Detroit; Continental in Houston"(p. 1).[7]

[6] It is interesting that Thomas does not state that the Consumer Federation of America's figures had anything to do with airports specifically. He also uses the phrase "competitive markets" without defining it.

This being the case, airlines are still competing. It does not cost more to fly from Denver on United simply because that airline has a large share of the gates at this airport. In fact, it may cost less to fly directly to Denver on United than it does on airlines that are not based there, because this allows a direct flight.

A subtler and indeed more dangerous point is that government intervention is the solution to perceived market failures (Hummel). The idea that the state is required to solve problems in the market does not recognize the self-regulating mechanism of the latter. Lack of coordination in the market, as shown by shortages or an opportunity to profit, is alleviated through the actions of the profit-seeking entrepreneur who looks for opportunities to fill a consumer need. If, indeed, prices could be cut by 20% to 50% with no negative repercussions on the company, this would imply that the airlines were earning 20% to 50% percent more profits than they would if there were "competition." If so, the profits being earned by the existing firms would draw more business concerns into the industry until those non-equilibrium gains were competed away (Littlechild, p. 23).

Can it properly be claimed that the airline industry has high enough start-up costs and great enough economies of scale that entry into the field is restricted, meaning that smaller new firms that want to compete with larger established firms would not have the means to do so? Not at all. One need only look to Southwest Airlines, which entered the market not long ago and has been the only firm to earn a profit in recent history. Interestingly enough, Southwest achieved this through low costs rather than high prices. Further, and more basically, this argument is fallacious. If in the eyes of potential investors profits are to be made by entering the industry, the so-called "barriers to entry" can be overcome through the aggregation of capital via the stock market. In any case, these "barriers" emanate not from any "market failure," but from the economic fact that the investment phase of some start-ups (e.g., the airlines) is more substantial than that of others (e.g., the shoe-shine business).

Thomas remarks, "any federal bailout of private business... moves

[7] It is also notable that Thomas is associated with the University of Pennsylvania, located near Pittsburgh that is one of the airports owned by US Airways that has announced cutbacks. Thomas uses this as an example of why dominance at airports is harmful but he omits the fact that nearly all of the above mentioned airlines are also announcing cutbacks, so presumably all of the airports would be hurting regardless of dominance.

us further away from capitalism (p. 3)."He is correct; but then he concludes the statement by saying that the action must have a "redeeming feature that ultimately makes the markets work better (p. 3)." In doing so, he contradicts himself.[8] Any government intervention moves us farther away from a free market where resources are allocated according to demand, and there is no exception for a "redeeming feature."

The second problem with such government intervention in the market is the problem of how to make the decisions on what is to be done. We have already spoken about the impossibility of government's having the necessary information to make these decisions with any degree of accuracy. The Air Transportation Board was established by the United States Congress to gather information and decide how to allocate the relief funds (Zuckerman, p. 1).David M. Walker said in his interview with Laurence Zuckerman, "It's clear that the Board will have a considerable amount of discretion (p. 1)."That is, the Board will decide which airlines are eligible to receive the government-guaranteed loans. As thirteen senators wrote to Mitch E. Daniels, this will "put the government in the position of deciding which airlines are worthy of existing and which are not (Zuckerman, p. 3)."However, if the Board decides to allow the loans to be open to all airlines, it will be supporting those that were in financial trouble even before September 11 (Zuckerman, p. 3).It is hopelessly naïve to believe that politics will not play heavily into any decisions that the Board makes.[9]

In spending billions of dollars to insure the survival of the airline industry, the federal government made two grave errors. One, it assumed that it had the knowledge required to determine the best use of taxpayers' money. In doing so, the state has robbed both citizens and the industries they would otherwise have patronized. At the root of every argument in favor of the government bailout of the airline industry is the view that government is more capable of making decisions about what individuals should spend their money on than the individual who has earned the money. Paternalism is a dangerous thing and is indeed incompatible with the idea of a democracy. To assume that adults need someone else to make their decisions for them and then to turn around

[8] Thomas invokes Adam Smith's "invisible hand" in this statement implying that the forced divestiture is an example of this simply because it will create more competition.

[9] According to opensecrets.org the airline industry contributed almost 7 million dollars to political parties in 2000.The highest contributors were American Airlines with $1,415,847 followed closely by Northwest with $1,371,505.United, Delta and US Airways, the others in the top five had significantly lower contributions.

and give those same adults the right of choosing the people who will make these very decisions is the worst kind of faulty logic.

Although all of the arguments focus on another issue, such as ensuring capacity or the importance of airlines to the economy, what the proponents of the bailout are really saying to the American people is, 'Trust me, you'll thank me for this someday. 'Too much trust in government does not usually yield what consumers want. It is much better to put trust in the market where at least it is known who is paying whom to do what.

II. A National Blunder

1. Government largesse

The U.S. government is giving the airline industry five billion dollars outright as well as ten billion in loans to prevent a failure in this sector of the economy. Many believe a rejuvenation of the air carriers is necessary for a recovery of America's faltering economy. However, the practice of subsidizing firms is unwarranted. If the government wishes to maximize the well-being of the economy with the correct policy, it would embrace the philosophy of laissez faire capitalism. A free economy is the only means – both necessary and sufficient – to assure both prosperity and economic justice.

Many problems overwhelmed the air companies well before the September 11 attacks. High operating expenses and a slowing economy were deteriorating the bottom line for nearly every airline. The Airline Handbook states that:

> Each major airline employs a virtual army of pilots, flight attendants, mechanics, baggage handlers, reservation agents, gate agents, security personnel, cooks, cleaners, managers, accountants, lawyers, etc. Computers have enabled airlines to automate many tasks, but there is no changing the fact that they are a service business, where customers require personal attention. More than one-third of the revenue generated each day by the airlines goes to pay its workforce. Labor costs per employee are among the highest of any industry. (*Airline Handbook*, online).

Fuel and excess capacity caused additional problems for the carriers. Gasoline is a substantial part of their total cost. When fuel prices began to rise in 2000, profits began to fall. Another challenge was excess capacity due to a miscalculation of demand for air travel. The Airline Handbook explains this problem:

> Since aircraft purchases take time (often two to three years, if there is a production backlog), airlines also must do some economic forecasting before placing new aircraft orders. This is perhaps the most difficult part of the planning process, because no one knows for certain what economic conditions will be like many months or years into the future. An economic downturn coinciding with the delivery of a large number of expensive new aircraft can cause major financial losses. Conversely, an unanticipated boom in the travel market can mean lost market share for an airline that held back on aircraft purchases while competitors were moving ahead."(*Airline Handbook*, online).

With the unexpected drop in demand, many planes were built that have no current use. Airlines operate on thin profit margins. If a flight's costs are higher than its revenue, the parent company will not long allow it to continue. Otherwise, the company would be operating with a loss. Due to the decrease in demand, profit margins became thinner. As a result, many aircraft were idled. Further, demand for trips from smaller airports has substantially decreased. Therefore numerous flights that had previously been scheduled into the hub airports were no longer operating.

The government in its immense wisdom has decided this vital part of the economy cannot weaken. Its rationale: A stimulus plan, it maintains, is absolutely necessary for the prosperity of the economy. The bailout will keep thousands of airline workers employed, thus reducing the rate of unemployment. Since many firms will not be allowed to fail, numerous alternatives will be available for the passenger due to the increase in supply in the number of airlines available compared to a situation in which some would be allowed to fail. Ticket prices will also be kept down. This, in turn, will increase air travel,[10] thereby increasing the nation's overall commerce.

Such a skewed way of thinking is not grounded in reality and will only create additional problems. If the airlines are not allowed to downsize, a misallocation of resources occurs. Labor and capital are more greatly needed elsewhere, but the subsidy creates an incentive for labor and other inputs to continue work in the airline industry. Here is how Hazlitt analyzes saving a dying industry:

"It is obvious in the case of a subsidy that the taxpayers must lose precisely as much as the X industry gains. It should be equally clear that,

[10] Again, compared to the situation in which no subsidies to the airlines are forthcoming from government.

as a consequence, other industries must lose what the X industry gains. They must pay part of the taxes that are supposed to support the X industry. And customers, because they are taxed to support the X industry, will have that much less income left with which to buy other things. The result must be that other industries on average must be smaller than otherwise in order that the X industry be large.

> But the result of this subsidy is not merely that there has been a transfer of wealth or income, or that other industries have shrunk in the aggregate as much as the X industry has expanded. The result is also that capital and labor are driven out of the industries in which they are more efficiently employed to be diverted to an industry in which they are less efficiently employed"(Hazlitt, 1946, pg. 101).

2. Economics of air transport

Airlines operate under the break-even load factor concept. This is based upon the percentage of seats an airline must sell at a given price level to cover its costs. As expenses increase, so does the break-even point. The bailout had no effect in terms of reducing costs. Therefore, the break-even point did not change. If a flight cannot cover its expenses, then it will not long continue to be scheduled. Because labor has a strong relationship to the number of flights conducted, many of these workers are being laid off in the aftermath of September 11. The airlines do not need the workers so they are let go. Carriers tend to retain those indirectly related to the flights. They constitute fixed costs. However, these firms are labor intensive. If demand is not present, there is no work to perform.

The five billion dollar subsidy hasn't affected the basic economic model. Demand hasn't increased. If anything, the very opposite has happened; and fuel and labor costs have remained high. If a company were considering whether or not to fly one of its planes, it would compare revenue with cost. If the latter outweighed the former, the flight would be grounded. If the company did decide to utilize the route, the airline would be incurring a loss.

Allen Sloan's article in Newsweek states that:

> Airlines are getting money for flights they canceled and to cover expenses such as salaries and fuel they will no longer incur (2001, pg. 65).

The basic principle of Hazlitt's argument still holds. The airlines may be cutting out unnecessary personnel, but they surely must still employ labor that would not otherwise be kept on the books if the airlines had not been subsidized. This labor is, of course, misallocated.

The notion of the airlines being the lynchpin of the economy is vastly overdrawn. People see the carriers sustaining numerous businesses such as tourism. The commonly held notion is that if people quit flying planes, hotels, restaurants, car rentals, etc., will suffer grievously. This cannot be denied. But, if the economy were faltering, then tourism would be one of the first to go under in any case. Aircraft are just a means of transportation. If people reduce their demand for these services, it implies that either they are taking some other form of transportation or have less demand for travel or tourism. Why should the government subsidize something to ensure that supply does not fall if people have reduced their desire for it?

Ten billion dollars in government-backed loans have been granted to the airlines. Many see this as a necessity. Hazlitt (1946, p. 42) wrote:

> The common misconception over credit is that the cost to the government and to taxpayers is less than nothing because it is self-liquidating.

Why is something's being self-liquidating necessarily a bad thing? The answer lies in the nature of financial lending institutions. Private loans originate to convey resources from one party with excess monetary funds to another party with a greater need for them.

Financial institutions act in the same way. They bring together many lenders and borrowers. It is in their interest to direct the funds into the best investment for their customers. This may include the investment with the best rate of return for the amount of risk involved.[11] Financial institutions are going to lend money to parties with the greatest possible rate of return given the level of risk involved. If they had to choose between lending to the airlines and investing elsewhere, they would choose the project with the potential for the most profitable outcome. The airlines asked to borrow money, but the banks did not jump at the opportunity. Indeed, the very opposite was true. This implies a few things. One is that the rate of interest the airlines were offering was too low. Another is the risk involved was too great. A third possibility is that other projects seemed more profitable.

When the state bails out the airlines, funds are being transferred

[11] The institutions represent the wishes of their customers. Some institutions are willing to take extra risk for a greater return. This implies the customers with the funds are willing to take more risks as well.

from their best use to less efficient ones, with a higher chance of failure. When government bureaucrats provide loans with money mulcted from taxpayers, they are taking risks with people's money they would not have undertaken on their own account. It is important to remember that what is really being commandeered is capital, not money. Money is only a medium of exchange. The government is actually diverting capital when it takes on the role of a financial institution. Recipients of government credit obtain their assets at the expense of those who would have been entrusted with private credit. At any point in time, only a limited amount of capital exists. When an organization obtains capital with government-backed loans, it denies organizations who would have received private loans the opportunity to purchase this capital. The result is a misallocation of capital from a low-risk organization to a high-risk one. The government seizes taxpayers' money and subsidizes bad loans[12].

Let's assume no private lending institution would have lent money to the airlines and that all investors would have considered them too high a risk. Loans would have been dispensed in other directions. Since the airlines would not have any additional resources with which to buy extra capital, manufacturers of inputs for the airlines would be forced to downsize. They would release their capital and labor to other industries where demand has increased. In contrast, subsidies misallocate resources.

J.D. Tucille wrote,

> Of all the arguments to be made against using taxpayer money to rescue the airlines from their financial doldrums, perhaps the best was offered by United Airlines itself. Just days after Congress approved a $15 billion bailout package for the industry, with an $802 million grant plus loan guarantees earmarked for United Airlines, its parent company made a down payment on 30 brand-new luxury business jets. (2001 on-line)

Despite this infusion, it is still not profitable to fly the planes. The taxpayers are bearing the costs of the new purchases.

[12] It cannot be denied that it is *possible* for the government to divert money from high to low risk ventures. After all the market is not perfect, and if the state engages in numerous subsidies, some few of them, conceivably, might be an improvement over what would have occurred under free enterprise. However, state subsidies do not benefit from the market's profit and loss survival test. When private entrepreneurs err, they suffer losses and thus are led by Adam Smith's invisible hand to change the error of their ways, or be brought up short by bankruptcy. No such automatic feedback mechanism operates in the public sector. Thus, we may readily expect far better results in the former case than in the latter.

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