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UNIVERSITY OF CALIFORNIA, SAN DIEGO

The Domestic Politics of International Regulatory Policy: The Regulatory Institutions For Trade in Aviation Services

A dissertation submitted in partial satisfaction of the requirements for the degree

Doctor of Philosophy in Political Science

by

John E. Richards

Committee in charge:

Professor David A. Lake, Co-Chair
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1997

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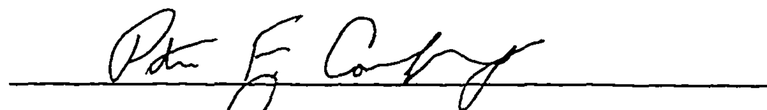

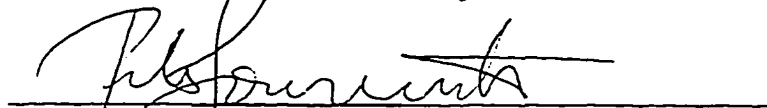

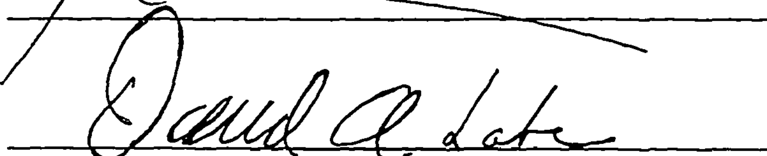

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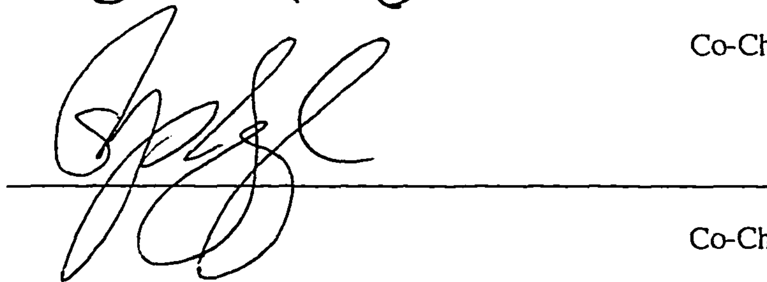

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For Jennifer

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TABLE OF CONTENTS

Signature Page.. iii

Dedication.. iv

Table of Contents.. v

Acknowledgements.. vi

Vita, Publications, and Fields of Study... vii

Abstract.. viii

I. Introduction.. 1

II. The Domestic Political Roots of International Regulatory Rules............... 52

III. The Political Economy of the Bermuda Regime................................. 89

IV. Exporting Competition: Policy Reversal in the U.S............................ 133

V. Bargaining over the Atlantic: U.S.-U.K. Negotiations......................... 204

VI. Holding Up Globalization: The U.S.-Japan Aviation Marketplace........... 284

V. Conclusion.. 359

Bibliography.. 373

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ABSTRACT OF THE DISSERTATION

The Domestic Politics of International Regulatory Policy: The Regulatory Institutions For Trade in Aviation Services

by

John E. Richards

Doctor of Philosophy in Political Science

University of California, San Diego, 1997

Professors David A. Lake and Stephan Haggard, Co-Chairs

In the aftermath of World War II, states created a set of institutions and regulatory arrangements to govern international aviation markets. From 1945 to the late 1970's, the aviation regime provided a set of complicated multilateral and bilateral rules which created a de facto cartel in international aviation services. Supported by powerful domestic constituencies in major aviation states, the Bermuda regime successfully restricted supply and inflated prices to the benefit of particular market participants. In the late 1970's, dramatic changes in the economics and politics of aviation led key governments to question the political logic of the regime. With domestic political interests pressing governments to create more competitive aviation markets, key states attempted to restructure the international marketplace. Today,

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fiercely political inter-negotiations continue to dictate the rules governing international aviation markets.

This dissertation examines the creation, maintainance, and change of the rules governing international aviation service markets. I argue that international rules and the markets they help organize are fundamentally regulatory institutions created by national politicians to provide policies favorable to important domestic constituents. The argument begins with an examination of the preferences of domestic political actors, in particular firms, and highlights the role of these actors in the domestic political process. However, because politicians are responsive to more than just organized interests, the analysis moves from a discussion of societal actors to an analysis of how domestic political institutions shape the incentives of politicians and, in turn, the policy-making process. Throughout, imperfect international markets shape the strategies and preferences of both firms and politicians. Put differently, firm endogenize both domestic politics and international market dynamics when launching strategies, while politicians endogenize international bargaining dynamics when launching strategies designed to secure policy outcomes favorable to domestic constituents. The analysis thus proceeds from the domestic to the international and back to the domestic, with both firms and politicians pursuing their interests within the win-sets defined by domestic political institutions and the imperfect international markets created by existing international institutions.

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Chapter 1: Introduction

1.0 Introduction

In the aftermath of World War II, states created a set of international institutions which dictated the rules governing international aviation markets. Governments set capacity and conditions of services via bilateral government-to-government agreements, while the airlines were delegated authority to set international air fares. Governments also nationalized their airlines, except in the U.S., and relied on their national flag carriers to provide both domestic and international air services for national citizens. These regulatory arrangements produced a de facto cartel which provided high prices and standardized services to consumers everywhere. Regulatory arrangements thus provided national monopolies but homogenized international aviation markets: consumers in the U.S, Europe, and Asia flew on their own national flag carriers but enjoyed identical services and paid identical prices for their tickets. These regulatory rules governed international aviation markets for more than thirty years. In the late 1970's, however, technological, economic, and ultimately political changes led to dissatisfaction with the Bermuda regime. Particular characteristics of the U.S. marketplace meant pressures for reform emerged first in the U.S., and the U.S. adopted a pro-competitive international aviation policy in 1978. Marking a dramatic reversal of more than 30 years of U.S. aviation policy, the new U.S. policy attempted to export domestic aviation deregulation and thereby re-structure international aviation markets. Since then, U.S. efforts at introducing more competition into international aviation markets have met with mixed success: competitive fares and free entry characterize some bilateral markets, while other bilateral markets continue to be governed by restrictive regulatory rules. The

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homogeneity that characterized postwar aviation markets has thus broken down, and individual bilateral markets are now governed by discrete regulatory rules. For both producers and consumers of air services, the emergence of distinct regulatory rules has meant dramatic differences in the production and consumption of international air services. In liberalized markets, airlines have build extensive networks through inter-airline alliances, while consumers benefit from the low fares produced by competitive markets. In markets which remained governed by restrictive regulatory rules, on the other hand, airlines continue to rely on point-to-point rights to service major international hubs and have not concluded major alliances, while consumers are forced to pay high prices for standardized services.

The history of international aviation markets raises a number of important empirical puzzles. Why did states choice to organize international aviation markets as a cartel in the aftermath of World War II? Why were these arrangements stable for over 30 years? Why did the U.S. withdraw support from the postwar arrangements and seek to break the cartel in the late 1970's? Why have U.S. efforts at liberalization been successful in some international markets while failing in others? In other words, why has the homogeneity that characterized postwar aviation markets given way to a diverse set of discrete regulatory arrangements, with different markets governed by different sets of regulatory rules?

In seeking answers to these questions, I address two important questions in the study of international political economy: (1) what is the role of international institutions in organizing international markets? and (2) what is the impact of domestic politics on the rules governing international markets? To date, most of the literature on international institutions begins at the international level and focuses on the impact of international institutions on state behavior (collective goods approaches), and on how

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the distribution of power effects the organization of international markets (distributional approaches). In this study, I argue that this focus on the international level is insufficient for understanding how international markets are organized. Although I do not disagree that international institutions may foster inter-state cooperation or that market power matters for bargaining outcomes, I argue that understanding the domestic political underpinnings of international markets is necessary for explaining the scope and content of these markets.

The failure of systemic approaches to adequately explain the organization of international markets leads me to look for explanations at the domestic political level. To date, the literature on domestic politics has highlighted the impact of the preferences of societal interest groups on the foreign economic policy of states. Although these analyses make important contributions to our understanding of how domestic political interests impact the foreign economic policy of states and the organization of international markets, these approaches are incomplete because they neglect the supply-side of policy choice. Societal interests matter, to be sure, but these interests must be aggregated through the domestic political process in order to produce policy outcomes. Put simply, domestic political institutions matter because they effect how societal preferences are translated into policy outcomes. I thus argue that it is necessary to include both the preferences of societal actors and domestic political institutions to fully understand the domestic politics of international regulatory policy.

Purely domestic-level explanations for international regulatory policy are not completely satisfactory, however, even if we include both the preferences of societal actors and domestic political institutions. Domestic political analyses of international economic policy rest on the assumption of perfectly competitive international markets, and assume firms and governments to be price-takers in international markets.

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However, because regulated international service markets (and an increasing number of international markets in manufactured goods) are highly imperfect, this assumption is problematic for understanding these markets. As numerous prominent economists have pointed out in recent years, international markets are not completely competitive, and individual firms and states have the ability to shape the shape and content of international markets.[1] To date, however, the insights of the literature on strategic trade theory and imperfect markets have not been integrated into how political scientists think about the domestic politics of international markets. However, because domestic actors are strategic and consider international market dynamics when launching strategies, a strict focus on domestic politics misses how imperfect markets, in particular the ability of some firms and nations to unilaterally alter the content of international markets, impact the preferences and strategies of domestic actors.[2] In short, a singular focus on domestic political variables misses an important element of the political underpinnings of the organization of imperfect international markets.

In sum, the argument begins with an examination of the preferences of domestic political actors, in particular firms, and highlights the role of these actors in the domestic political process. However, because politicians are responsive to more than just organized interests, the analysis moves from a discussion of societal actors to an analysis of how domestic political institutions shape the incentives of politicians and, in turn, the policy-making process. Throughout, imperfect international markets shape the strategies and preferences of both firms and politicians, i.e. both firms and politicians consider the impact of international bargaining dynamics in imperfect markets when launching strategies and adopting bargaining positions. Put differently, firm endogenize both domestic politics and international market dynamics when launching strategies, while politicians endogenize international bargaining dynamics

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when launching strategies designed to secure policy outcomes favorable to domestic constituents. The analysis thus proceeds from the domestic to the international and back to the domestic, with both firms and politicians pursuing their interests within the win-sets defined by domestic political institutions and the imperfect international markets created by existing international institutions.

1.1 Empirical Overview: Services

Before undertaking an analysis of international aviation markets, it is useful to briefly highlight the importance of services in the international economy, and to note that international aviation services are part of a larger issue of managing international trade in services--the most fundamental challenge facing the postwar trading system today.[3] Services account for about 70 percent of the gross national product of the industrialized states and up to 50 percent in developing countries. Although only 10 to 15 percent of services are traded internationally, service exports account for over $700 billion per year and constitute 25 to 30 percent of world trade.[4] Trade in services has also been the most dynamic element in the international trading system in the last fifteen years, growing at 7.7 percent per annum between 1980 and 1993, as compared to 4.9 percent for manufactured goods.[5] At the beginning of the 1990's, services accounted for more than 50 percent of OECD countries foreign direct investment outflows.[6] While dramatic, these figures actually underestimate the central role of services in the global economy as many services are hidden within the terms of manufacturing contracts, and thus do not appear in official services trade statistics. Moreover, trade statistics alone do not fully reveal the importance of services for how firms compete and how international markets are organized.[7] Far-reaching changes have already taken place in the organization and location of the production of services,

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and recent trade agreements--NAFTA in North America, the Maastricht Treaty in Europe, various treaties in Latin America, drastic economic reform in the former Soviet sphere, and new arrangements in Asia--will only contribute to greater economic openness and freer trade. The concurrent globalization of production networks and expansion of the role of multinational corporations (MNCs) in the global economy has only increased the number of domestic service providers which have entered international markets.[8]

While services are the fastest growing and most dynamic sector of the global economy, services also represent the most difficult trade issues facing the advanced industrialized states, as continuing disputes over telecommunications, aviation, and banking amply illustrate. In the immediate postwar era, services were governed by restrictive, sector-specific institutions that produced local monopolies connected by restrictive international markets. Governments intervened extensively in both domestic and international services markets, with many services government owned and regulated as public utilities.[9] Considered to be inconsequential for international trade and treated as invisibles in balance of payments accounting, services were largely ignored by policy makers, and were not even considered an international trade issue until the 1970's. Thus, while successive GATT rounds during the 1950's and 1960's reduced barriers to trade in manufactured goods, international trade in services remained small and constrained by strict international regulatory rules.

As the importance of services to the economies of the advanced industrialized states increased, however, services emerged from obscurity to become an important issue on the international economic agenda.[10] In the early 1970's, the emergence of the alleged post-industrial society focused both academic and government attention on services, with the concept of international trade in services appearing for the first time

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in 1972.[11] The growth of MNCs and the deepening of international interdependence only increased the importance of services for conducting international business.

Once services emerged as the largest sector of the economies of the advanced industrialized states, the restrictive rules and regulations governing trade in services set up after World War II came under intense scrutiny. In the face of increasing criticism, defenders of the traditional regimes maintained that their activities had no economic effects as they simply provided technical assistance to help states coordinate the provision of services. While opponents of reform argued that the rules governing international service markets were technical questions rather than economic issues with distributional implications, increased attention and new information regarding the potential for trade in services revealed the high economic costs of the traditional service regimes. MNCs and large providers of services in domestic markets in particular realized the benefits of liberalizing the existing regulatory regimes. Advocates of reform were especially prominent in the U.S., where large numbers of MNCs and extensive domestic deregulation created powerful constituencies for altering existing international regulatory arrangements. Indeed, Pan Am and other large U.S. MNCs were leaders in the effort to get services onto the U.S. policy agenda in the early 1970's.[12] Although the forces of reform emerged in other OECD countries, they were most prominent in the U.S., which was the leading proponent of liberalizing international service markets.

In sum, the growing share of services in the economies of the advanced industrialized states brought increased attention to services and subsequently led to efforts to alter existing methods of organizing both domestic and international service markets. Led by the U.S., many of the advanced industrialized states significantly deregulated their domestic service markets and pressed for liberalization of the

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international service markets.[13] Although trade in services remains highly regulated, the forces of reform have obtained significant victories and have fundamentally restructured the institutions governing international service markets, notably in financial services,[14] telecommunications,[15] and aviation services.[16] The question facing governments is how far they will allow reform to go.

1.2 Why Aviation Services?

Aviation services are at the heart of any modern service economy, and both influence and are influenced by international economic developments.[17] Air traffic has doubled in each of the past three decades, and the increasing globalization of production networks and economic activity promises to increase both the demand for and the value of international aviation services.[18] Likewise, increased disposable income and leisure time have also increased the importance of aviation as the key input for the world's largest industry, tourism. The importance of aviation services as an intermediary for all major industries makes aviation, likes telecommunications, one of the industries at the core of global economy activity.

The stakes involved in commercial aviation services are enormous. In a global economy of $16 trillion, commercial aviation directly or indirectly accounts for $1 trillion.[19] In the U.S., it is estimated that aviation services account for $54 billion of GDP, less than motor vehicles and equipment ($68 billion) but more than petroleum and coal products ($48 billion).[20] Put differently, it estimated that passenger air services directly and indirectly account for up to 9 million jobs in the U.S.[21] In both the U.S. and the EU, it is estimated that the direct and indirect effects of the aviation industry account for around six percent of the GDP--translating into 8.8 million jobs in the U.S. economy.[22] While current statistics are impressive, the rate of growth in

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aviation markets promises to make aviation an increasingly important sector of the advanced industrialized economies. In the next 15 years, for example, aviation services are expected to grow at 6 percent per annum, with the majority of this growth coming in international aviation services, particularly in Asia.[23]

In addition to the economic importance of the aviation industry, the historical pattern of regulation in aviation services is representative of a number of service industries, and examining the industry provides a representative sample for understanding the politics underpinning the organization of most international service markets in the postwar period. Like other service industries, aviation services was oriented toward the domestic market and competition was limited in both the domestic and international markets.[24] With international services seen as a luxury good and universal domestic service as the paramount concern of the system, international services subsidized domestic route structures and thereby afforded universal domestic service at reasonable prices.[25] As in telecommunications, financial services, and insurance, the regulations governing postwar aviation markets thus produced national monopolies protected by a de facto international cartel. With the national markets strictly regulated to produce the desired cross-subsidies to ensure the proper subsidies for important constituents, politicians organized in markets ways consistent with their electoral imperatives. These restrictive regulations governed trade in international aviation services until the mid-1970's, when the U.S. and other states began to re-structure both domestic and international aviation markets. Since then, the U.S. has successfully liberalized some bilateral markets while others have remained governed by restrictive rules. Where liberalization has taken place, airlines have build extensive networks through inter-airline alliances, while consumers have benefited from the low fares produced by competitive markets. In markets which remain governed by

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restrictive regulatory rules, on the other hand, airlines continue to rely on point-to-point rights to service major international hubs and have not concluded major alliances, and consumers continue to pay high prices for standardized services.

To summarize, aviation services are important in their own right and are representative of a number of other service industries. Given the dominant role of services in the economies of both the advanced industrialized states and the developing countries, understanding the political underpinnings of the organization of international service markets has important economic and political implications. Thinking about the organization of international service markets, however, gives rise to a number of difficult questions. Why are international service markets organized in particular ways? Do international institutions contribute to the organization and functioning of these markets? How? What impact do these arrangements have on marketplace participants? When and why do the international institutions set up to govern international markets change? In seeking to answer these questions, I turn to the literature on international institutions and foreign economic policy.

1.3 Theoretical Overview

Explanations for international regulatory policy have come in two different guises: (1) analyses which find answers at the international level, and (2) analyses which seek to demonstrate the impact of domestic politics on the shape and content of international markets. Scholars who work at the international level have tended to concentrate on how the distribution of power effects the organization of international markets and on demonstrating the impact of international institutions on state behavior. For these analyses, international institutions matter because they set the rules governing international markets and thus define the rules of international exchange. Scholars in the

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second tradition, on the other hand, draw on existing economic models and seek to demonstrate how societal actors influence the foreign economic policies of states. Unfortunately, except for the two-level game literature, the two literatures rarely directly address each other.[26] In what follows, I discuss the respective literatures in turn, and argue that neither purely systemic nor purely domestic political arguments adequately account for the regulation of imperfect international markets. In particular, I argue that both approaches either omit or mis-specify key variables driving the supply of international regulatory policy. I conclude by arguing that only by paying close attention to how existing international institutions and international market dynamics shape the strategies and preferences of domestic political actors can we understand how domestic politics effects the organization of international regulated markets.

1.3.1 International Explanations

The study of international institutions emerged as a central focus of theoretical and empirical work in the late 1970's. Despite conceptual problems and definitional difficulties, the literature on institutions grew quickly and a number of different approaches to regimes emerged.[27] Although the arguments are diverse, I distinguish two approaches to international institutions.[28] The first approach stresses the collective benefits which institutions generate for all member states, and highlights the role of international institutions in coordinating state behavior and thereby helping states overcome the collective action problems inherent in international cooperation. The second approach stresses the distributional impact of international institutions and the impact of state power on the shape and content of international markets. Uniting both approaches is the belief that international institutions define the rules of international

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markets and thus effect the behavior of firms and states in these markets.[29] I discuss each in turn.

Collective goods approaches have dominated the literature on international institutions.[30] Viewing regimes as efficiency-enhancing institutions which provide utility gains for all players in the game, collective goods explanations of international institutions are primarily concerned with the efficiency-enhancing attributes of regimes and the collective benefits which they generate. Drawing on the language and intellectual tools of transaction costs economics, the new institutionalism, and functionalism,[31] these explanations argue that international institutions facilitate inter-state cooperation by reducing transaction costs, facilitating monitoring of state adherence to international agreements, and encouraging issue-linkage between issue areas. With collective action seen as the major hurdle to international cooperation, international institutions are important because they reduce uncertainty and informational asymmetries, and thus correct problems of market failure. Ultimately, international institutions facilitate the resolution of coordination and collaboration problems that render international cooperation problematic, and thus directly contribute to emergence of inter-state cooperation.[32] As Keohane notes, "the mere existence of common interests in not enough: institutions that reduce uncertainty and limit asymmetries in information must also exist."[33] In sum, international institutions matter because they facilitate inter-state cooperation and thus alter the shape and content of international markets from would have been the case absent the institution.

Like normative approaches to regulation, collective goods analyses begin with an implicit assumption that the purpose of international institutions is to maximize some efficiency or welfare function, and the analysis proceeds by demonstrating how international institutions provide such benefits.[34] By formulating their analysis in this

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way, however, the actual formation and persistence of international institutions is not rendered problematic: the realization of potential gains from coordination translate into the creation and maintenance of regimes. In one variant of the theory of hegemonic stability, for example, the hegemon provides the collective goods necessary for international cooperation because she benefits.[35] Likewise, in addressing questions of institutional design and efficacy, collective goods analyses do not ask why particular rules are chosen but rather focus on how institutions mechanisms might be designed to secure the most efficient outcomes.[36] However, because collective goods analysis of international institutions do not make the supply of regimes problematic, their analyses rest solely on demand-side dynamics: international institutions are created and maintained because states find them useful and therefore demand their creation.[37] Like all demand-side arguments, however, these analyses cannot account for the ultimate supply of international policy. The analyses inform us when states are likely to coordinate their activities and organize international markets (when the gains from coordination are high), but these approaches cannot tell us anything about the shape and content of the marketplace.[38] As Keohane himself admits, the emergence of regimes depends not only on the potential for gains through coordination but on a host of other factors. Precisely what these other factors are and how they matter for institutional creation and persistence, however, is left unspecified. This leaves collective goods approaches unable to provide any insight into why specific institutions are created, and why international markets are organized in particular ways. This is problematic because many different regime rules are consistent with solving collective action problems, yet only one particular international institution is ultimately created.[39] Why choose one institution rather than another? Functionalist

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approaches to regimes are silent on this question, and as a result cannot account for the why international markets are organized in particular ways.

In sum, collective goods approaches fail to explain the substantive content of international institutions (and thus international markets) because they focus on the role of market failure as the primary impetus for the creation and persistence of international institutions. As Moe has argued in the context of domestic political institutions, however, political institutions serve two distinct purposes.[40] On the one hand, they help actors overcome collective action problems; on the other hand, they are instruments of redistribution. Collective goods approaches to regimes highlight the former while ignoring the latter; in so doing, they ignore the distributional impact of international institutions at both the international and domestic levels.[41] Although efficient institutional designs may be desirable from some vantage point (efficient in the sense that they help states overcome collective action problems), the basic fact is that institutional rules do not simply fall from the sky. Institutions are choice variables which are self-consciously created by states quite simply institutional rules shape the scope and content of international markets and thus have distributional effects. In other words, states seek to create institutions which benefit their interests quite simply because institutions matter for who wins and loses from international economic exchange.

But what do states want from international institutions, and what accounts for state preferences regarding the organization of international markets? To date, two sets of analyses have attempted to provide answers to these questions: realist analyses of international institutions, which find answers in the distribution of power in the international system, and scholars of domestic politics, who find answers in domestic politics. As we shall see below, neither realist nor domestic political analysis provide a

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satisfactory explanation for international regulatory policy. However, these two literatures do highlight importance of particular variables for understanding international markets. In so doing, these approaches also nicely clarify the problems of omission and mis-specification which plague neo-liberal institutionalist analysis: realist analyses point to the neo-liberal mis-specification of the international arena by highlighting the role of power and coercion in international bargaining, while domestic political analysis correctly note the omission of domestic political variables in neo-liberal analysis. Before addressing the problems raised by the omission of domestic politics, I address the mis-specification problems highlighted by realist approaches to international institutions.

In response to the failure of neo-liberal analyses to note the importance of power in the creation of international institutions, the second approach to international regimes stresses the role of power and the distribution of power in the international system in the creation and maintenance of international institutions. Arguing that the primary effects of international institutions are distributional, this approach highlights the gains which accrue to some states at the expense of others as a result of international regimes. Closely associated with realist approaches to international relations, this approach highlights the role of powerful states in the creation of regimes and the disproportional gains from cooperation which accrue to these states.[42] Powerful states are able to impose their preferences on weaker states, with institutional outcomes reflecting the relative power capabilities of states. In one variant of the theory of hegemonic stability, for example, the most powerful state in the international system bears the costs of creating international institutions which benefit all states, but the hegemon enjoys a disproportionate share of these benefits.[43] Other realists approaches to international institutions have also argued that international institutions

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can be understood as distributional instruments used by powerful states to secure a disproportionate share of the gains from international economic exchange. As Krasner has noted, the question for realists is not whether or not states can create institutions to reach the Pareto-frontier, but rather what point along the frontier will be chosen--precisely because powerful states will seek to create institutions which result in outcomes at points along the Pareto-frontier which are favorable to them.[44] Ultimately, realists find answers to questions about international institutions and the markets they organize in the distribution of power in the international system.

The emphasis on the national interest and state power in distributional analyses is problematic for understanding the creation and maintenance of international institutions. Put bluntly, realist conceptions of the national interest and power are so vague as to lack explanatory leverage. What is the national interest and how can it be operationalized a priori? Likewise, how do we know when one state is more powerful than another without resort to observed empirical outcomes? In their analyses of international economic institutions, for example, realists have argued that states pursue the national interest by pursuing outcomes consistent with the interests of domestic firms.[45] Why and how the interests of firms represent the national interest is not clear, however. Although realists have long argued that mercantilism in international political economy is the analog of realism in security studies, it is not as clear that mercantilism translates into representing the interests of particular firms.[46] Which firms represent the national interest? In an analytic sleight of hand, realists have adopted a simple interest group politics model or state capture model and argued that pursuing the interests of particular domestic firms in the international economic arena is equivalent to pursuing the national interest. But do realist models predict that states pursue the

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interests of particular firms or a broader notion of the national interest? Likewise, how does the national interest translate into concrete bargaining positions?

Lacking clear models of the national interest, realist analyses of regimes are forced to utilize national power as the key variable to the rules governing international markets. Like most realist explanations of international relations, however, realist approaches to international regimes lack clear measures of power. As a result, power is usually ascribed based on observed empirical outcomes. The argument thus becomes a tautology, however, as power is ascribed based on observed empirical outcomes and these outcomes are explained in terms of power. To be sure, market power matters in explaining bargaining outcomes, particularly in imperfect international markets where some firms and governments can exercise market power to shift the shape and content of international markets (and thereby change the costs and benefits of policy choices in less powerful states). But exactly how international market power effects regime commitments by less powerful states is a function of how market power interacts with domestic politics in weaker states. In other words, power does not translate into the ability of powerful states to dictate the organization of international markets to less powerful states.

Ultimately, realist analyses are correct in stressing the distributional impact of international institutions and the impact of international market power on bargaining outcomes. However, because realist analyses lack clear models of state preferences and rely on vague notions of capabilities to explain bargaining outcomes, any number of regime outcomes are usually consistent with powerful states creating regimes in pursuit of the "national interest."[47] Realists are thus correct in re-defining the international environment in a way which allows for power relationships to impact the creation of international institutions, but they under-specify how power actually

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impacts international regimes. Moreover, like neo-liberal approaches to international institutions, realist approaches also omit the impact of domestic politics on the shape and content of international markets. Suffering from problems of mis-specification and ommission, realist approaches to international institutions ultimately fare no better than collective goods approaches in explaining the scope and content of international institutions and the organization of international markets.

To illustrate, the stress on the impact of national power on regime change and international bargaining outcomes cannot explain the creation of the institutions governing the international aviation marketplace after World War II, nor can it explain how these institutions have changed in the past twenty years. In the immediate postwar period, the U.S. was by far the most powerful nation in the world and U.S. airlines controlled 72 percent of world air travel. Seeking to create international aviation markets for U.S. airlines to take advantage of their superiority, the U.S. government pressed for the creation of institutions which would create competitive international aviation markets. Despite U.S. dominance and pressure, however, the U.S. was unable to create its desired international aviation marketplace.[48] Likewise, U.S. efforts to re-organize international aviation markets in the past twenty years are only now beginning to bear fruit, despite the fact that the U.S. accounted for between 40 and 50 percent of total aviation traffic during the period. More importantly, the pace and scope of recent liberalization has been dictated by domestic politics in foreign partners, not U.S. pressure to create more competition international markets. In the case of aviation, then, the most powerful nation, or hegemon, has been unable to organize the international aviation market in ways favorable to its interests.

1.3.2 Domestic Political Explanations

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The failure of systemic approaches to account for the international institutions governing international aviation markets and the organization of these markets leads me to domestic political explanations. Although a large number of specific arguments have proliferated to account for how domestic politics shape the foreign economic policies of states, I distinguish two basic approaches. The first approach highlights the demands of domestic political actors and the impact of these demands on the foreign economic policy of states. Often drawing on neoclassical economics for their models of interest group preferences, these analyses argue that understanding the preferences of domestic political actors are the key to understanding foreign economic policy.[49] Although different scholars have concentrated on different units of analysis in the domestic political arena (i.e. firms, sectors, classes), the basic argument is similar: the preferences of domestic political actors translate into the foreign economic policies of states.[50] While the first approach stresses the demand-side of policy choice, the second approach highlights the impact of government incentives and domestic political institutions on the supply of foreign economic policy. Often drawing on analyses of domestic political institutions drawn from the formal literature in American politics, analysts in this tradition have argued that understanding how the preferences of societal groups are aggregated in the policy-making process is crucial for understanding the foreign economic policies of states.[51] In what follows, I discuss demand-side arguments before turning my attention to analyses which stress the supply-side of policy-making. Before proceeding, however, it is important to note that the two approaches are not mutually exclusive, and in practice many scholars employ both demand and supply-side reasoning to account for foreign economic policies. Nonetheless, for purposes of exposition it is useful to organize the literature in this way.

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Demand-side explanations have dominated the foreign economic policy literature.[52] Although different analysts make different assumptions about the organization of domestic political economies and therefore focus on different units of analysis (i.e. factors of production, classes, sectors, or firms), analyses in this tradition proceed along a common path: the analyses delineate the interests of domestic economic actors, and then proceed to argue that these interests are the driving force behind foreign economic policy. The most prominent attempt in this research tradition has been in the open-economy or macro framework, which is epitomized in the work of Rogowski and Frieden.[53] Relying on neoclassical assumptions about how changes in international market prices effect the preferences of domestic political actors, both Rogowski and Frieden view domestic political debates over foreign economic policy as driven primarily by international market forces. As Bates writes, "both...view international markets as fundamental determinants of domestic political conflicts."[54] Two fundamental assumptions thus underpin the open-economy macro approach: (1) politicians are agents of economic interests and do not significantly impact policy outcomes, and (2) domestic politics is derivative of international market forces.

While open-economy approaches are the most prominent demand-side models, other scholars view international market forces as important but ascribe a greater role to other domestic political variables. For Gourevitch, for example, international market forces are important, but the domestic political coalition-building process shapes how international market forces and the economic interests of important societal groups translate into concrete policy outcomes.[55] In other words, the preferences of economic interests do not automatically translate into policy outcomes, nor is domestic politics simply derivative of international market forces. Likewise, Milner sees firms as competing in international markets, but looks to the particular market positioning of

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firms in both domestic and international markets to account for their preferences regarding foreign economic policy.[56] Underlying both approaches, however, is the view that the interests of domestic political actors are the primary variable explaining the foreign economic policies of states.

Although demand-side models represent an important contribution to our understanding of how domestic politics shapes the foreign economic policy of states and the organization of international markets, these approaches are unable to explain the organization of international aviation markets: demand-side theories cannot explain why the international aviation marketplace was set up as a de facto cartel in the immediate post-war era, the reversal of U.S. international aviation policy in the late 1970's, or the global trend toward more competitive international aviation markets since then. In the immediate postwar era, neither Pan Am nor U.S. domestic airlines sought to create the restrictive Bermuda regime, yet the need to secure international partners ultimately led to the creation of a highly regulated international marketplace. Likewise, in the politics surrounding the reversal of U.S. international aviation policy in the late 1970's, the two major U.S. international airlines (Pan Am and TWA) opposed the policy reversal; nonetheless, Carter issued a new international aviation policy statement, and Congress gave the new policy statutory backing with legislative action in 1979. In terms of the recent move toward more competitive international aviation markets, incumbent national flag carriers have consistently opposed liberalization of international markets. Despite this opposition from these highly concentrated and politically important interest groups, liberalization of trade in aviation services has occurred on the North Atlantic, the EU has announced a series of liberalization packages designed to increase competition on intra-EC routes, and even Japan has allowed All-Nippon Airways (ANA) to compete with Japan Airlines (JAL)

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on international routes. All of the aforementioned examples illustrate a simple point: the organization of international aviation markets cannot be understood by purely demand-side approaches.

The failure of demand-side theories to account for the organization of international aviation markets stems from two theoretical problems, problems which stem from the two key assumptions of the open economy framework noted above. The first problem with these approaches stems from the assumption that the demands of economic interests automatically translate into policy outcomes. Economic interests are important actors in the domestic political process, to be sure, but the challenge is specifying which societal groups are important without reference to observed policy choices. As the large literature on institutions has amply demonstrated, different domestic political institutions aggregate the preferences of voters in different ways and shape the policy-making process in important ways.[57] In short, because institutions shape the interests to which politicians are responsible and the structure and process of policy-making, specifying the demand side of policy choice is not enough to understand policy outcomes. This is especially true as supply-side dynamics also condition firm strategies and the policies demanded by interest groups.[58] By ignoring domestic political institutions and the impact of these institutions on the incentives of politicians and the structure and process of policy-making, demand-side approaches provide only a partial explanation for the foreign economic policy of states.

My second criticism of demand-driven models revolves around the assumption that domestic economic actors and states are price-takers in international markets.[59] In short, because demand-side approaches to foreign policy view the international market as exogenous, they take international market forces as a fixed constraint and seek to demonstrate how these forces shape domestic political cleavages and policy-making.[60]

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As the literature on strategic trade theory has demonstrated, however, imperfect international markets mean that particular firms or states may have market power and thus may be able to affect international market prices. Most international service markets, including the international aviation marketplace, are highly imperfect. In aviation, the U.S. has by far the largest market and can utilize its market power to shape the scope and content of international aviation markets. However, because bilateral government-to-government negotiations determine the shape and content of international aviation markets, domestic economic actors involved in aviation negotiations (i.e. airlines) and national governments in major aviation states also have the ability to shape the structure of international aviation markets.[61] This is especially true as existing international institutions allocate voting rights to particular market participants, and thereby provide these actors market power by the structure and decision-making process of international institutions.[62] In aviation, then, governments created particular international institutions, which produced imperfect international markets, as a means to serve the interests of particular domestic constituents. Once created, however, these institutional arrangements provide significant market power to both economic actors and national governments.

Highly imperfect aviation markets and the insights of strategic trade theory lead me to reject open economy explanations for the organization of international aviation markets. Relying on assumptions about perfectly competitive international markets which are violated in international aviation markets, these approaches are unsuitable for explaining the domestic political underpinnings of imperfect international markets. Put differently, these analyses mis-specify the nature of international markets, and are thus unable to adequately explain the domestic politics underpinnings these markets. Ultimately, as I shall argue in chapter two, understanding the domestic politics of

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imperfect international markets requires an understanding of how international bargaining dynamics shape the strategies and preferences of domestic political actors.[63] Open economy approaches take international markets as fixed and exogenous, and are thus unable to provide a satisfactory analysis of these markets.

I have argued above that demand-side, or open economy, approaches to the domestic politics of international markets mis-specify both the domestic political game (by ignoring institutions) and the international market (by taking markets as fixed and exogenous). In seeking to correct the first of these problems, the second approach to understanding how domestic politics impact the organization of international markets concentrates on demonstrating how electoral dynamics and domestic political institutions shape the policy-making process in systematic ways and therefore impact the foreign policies of states. Drawing on the insights of scholars in comparative and American politics, supply-side approaches make two distinct arguments about how domestic political institutions shape the policy-making process: (1) domestic political institutions set the rules of electoral competition and thus shape the electoral coalitions to which politicians are responsible,[64] and (2) domestic political institutions dictate the structure and process of policy-making, and thus shape policy outcomes in systematic ways.[65] The first set of arguments stress the impact of domestic political institutions on the incentives faced by politicians, while the second set of arguments highlight how the structure and process of domestic institutions shapes policy outcomes in important ways.[66] Overall, supply-side approaches argue that electoral competition is more complicated than simple interest-group pluralist models would suggest, and argue that policy-making cannot simply be derived from the preferences interest groups.[67]

Supply-side approaches have provided a valuable complement to the dominant demand-side models. As we will see in chapter two, I pay particular attention to the

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impact of domestic political institutions on the electoral strategies of domestic politicians, and the impact of these electoral strategies on policy choice. But it is important to note that supply-side analysis cannot by themselves explain policy outcomes. Indeed, most supply-side analyses self-consciously do not seek to explain particular policy outcomes, but rather attempt to demonstrate the impact of institutional variables on an exogenous and fixed set of preferences.[68] Most institutional analysis thus take preferences as exogenous, and seek to demonstrate how different institutional structures shape policy outcomes.[69] The intellectual experiment inherent in institutional analysis is thus as follows: assume that preferences are similar across cases, and the proceed to demonstrate how institutional variables shape policy outcomes.[70] This can be problematic, however, when the preferences of domestic societal actors interact with institutions. Gourevitch has called the problem of dis-entangling the relationship between institutions and preferences the governance problem in international relations, and points to many of the difficulties inherent in seeking to delineate the independent impact of preferences or institutions on policy outcomes.[71] Put differently, it is often not possible to carry out the pure conceptual thought experiment suggested by the strategic choice approach to institutions.[72] In such situations, even institutionally-centered arguments must highlight the preferences of domestic political actors as the starting point of any analysis which seeks to explain foreign economic policy outcomes.

Because institutional analysis must begin with the preferences of societal actors, I argue that it is necessary to include both the preferences of domestic political actors and domestic political institutions in order to understand the domestic underpinnings of regulated international markets. In making this argument, I build upon existing models in the literature on endogenous tariff theory, regulatory policy,

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and foreign economic policy which highlight both the demand-side and supply-side of policy choice. In endogenous tariff theory, for example, politicians provide particularistic policies (in the form of protection) to interest groups up to the point at which the diffuse costs of protection, in terms of votes, outweigh the benefits of concentrated protection.[73] Likewise, regulatory scholars often argue that broad electoral concerns shape the supply of regulatory policy in important ways. Becker, for example, argues that interest groups prefer efficient regulatory structures because efficient structures minimize dead-weight losses and therefore are less likely to evoke political action by groups bearing the costs of regulatory arrangements.[74] Public choice analysis to international institutions rest on similar analysis when they attempt to account for the supply of international policy.[75] Finally, Verdier provides a nuanced argument how the saliency of political issues shapes the political costs and benefits of policies which benefit narrow constituents at the expense of more broad constituencies.[76] Verdier also highlights the importance of supply-side dynamics for understanding firm strategies and the policies demanded by interest groups, a point to which we shall return to and modify in chapter two. Uniting all these approaches is an underlying electoral model which suggests that electoral politics are the key to understanding the policy-making process and the supply of policy. In other words, it is necessary to examine both the demand and supply-side of policy choice to adequately explain policy outcomes.

I seek to build on existing analyses rooted in electoral politics by more carefully specifying both the demands of societal actors and the incentives facing national politicians. The problem with existing electoral analysis is the lack of a clear model of politics, or any attempt to clearly define the supply-side of policy choice. Thus, although these analyses correctly note how that broad electoral dynamics shape

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both the supply of policy and the strategies of domestic economic actors, the domestic political game is inadequately specified, and these analyses are ultimately diffuse in their analysis of precisely how the supply-side of policy-choice shapes policy outcomes. By more precisely delineating the impact of domestic political institutions on the calculations of interests groups and the incentives of politicians vis-a-vis foreign economic policy, I seek to provide a more complete model of the electoral bases of international markets.

More carefully specifying both the demand and supply side of policy choice to provide a more complete analysis of the electoral roots of international regulatory policy is not sufficient, however, for understanding the domestic political roots of imperfect international markets. As noted above in the my discussion of the challenges posed by strategic trade theory for demand-side approaches to foreign economic policy, a singular focus on domestic political variables ignores the impact of imperfect international markets on the preferences and strategies of domestic economic actors and national politicians. The same criticism applies to all purely domestic approaches, even well-constructed electoral models which include both demand- and supply-side variables.[77] This is not a new insight, as scholars have long noted that simply extrapolating from domestic politics to regime outcomes is problematic due to the intervening impact of international bargaining on regime commitments.[78] However, noting that international bargaining and international market forces matter and delineating both theoretically and empirically precisely how international bargaining dynamics interact with domestic politics are two distinct matters.

To summarize, existing approaches to understanding international institutions and the markets they help organize suffer from problems of both mis-specification and omission. Neo-liberal approaches mis-specify the international arena by ignoring the

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role of power in the creation of international regimes, and omit domestic politics entirely. Realist approaches, on the other hand, concentrate exclusively on the impact of power on the organization of international markets, but their theoretical constructs are so vague as to lack explanatory leverage. Like neo-liberals, they also ignore the impact of domestic politics on international markets. Domestic-level approaches suffer similar problems: open-economy macro arguments mis-specify the domestic political game by ignoring institutions and omit the international marketplace by taking it as a fixed constraint. Although institutional and electoral analysis seek to correct open-economy analyses by including domestic institutions in their analyses, these argument also omit the impact of imperfect international markets on domestic actors, and thus provide an incomplete analysis of the domestic political game. Ultimately, these problems mean that existing approaches can help us understand some aspects of international regulatory policy, but are less useful for understanding why particular regulatory institutions and rules are constructed rather than others.

1.4 The Argument in Brief

I argue that international institutions are fundamentally regulatory structures designed to serve the interests of domestic constituents.[79] Like political economy approaches to domestic regulatory structures and international organizations, I highlight the distributional consequences of regulated international markets and the resultant domestic political bargaining over the institutional rules governing these markets.[80] The argument stresses the impact of domestic politics on the scope and functions of international regimes and argues that international institutions are fundamentally distributional institutions which reflect and re-enforce domestic regulatory structures.[81] The analysis also highlights the role of international bargaining

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dynamics in shaping the preferences and strategies of domestic economic actors and national politicians as they pursue their interests in imperfect international markets.

The emphasis on international explanations for international institutions has obscured our understanding of the domestic political roots of regulated international markets. International institutions delineate the shape and content of international markets and thus produce market outcomes which benefit certain actors at the expense of others. This is especially true in services, where particular international rules have significant distributional effects in the marketplace. However, precisely because international institutions have distributional implications both between and within countries, international rules and institutions must be supported by the proper domestic coalitions.[82] As Moe and Caldwell have noted in the context of domestic institutions, "structural politics is interest group politics."[83] The same holds true internationally: international institutions emerge from highly politicized inter-state bargaining, and particular institutional rules reflect the preferences of domestic political actors and the politicians which represent them.

Understanding the content of international institutions and the markets they organize thus requires understanding what national politicians want from international rules. Assuming that political leaders are motivated primarily be re-election, I argue that governments create international institutions and thereby organize international markets to supply policies to important domestic constituents. As political actors primarily concerned with the electoral consequences of policy choices, politicians are responsive to the demands of interest groups and firms. Easier to organize and the source of campaign finances, organized interests are important actors in the political process.[84] As noted above, however, pure demand-side are problematic because they fail to incorporate the supply-side of policy choice. I thus include domestic political

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institutions in the analysis. Domestic political institutions, notably electoral rules and the division of powers, are important because they set the rules to electoral competition and thus shape the electoral coalitions to which politicians are responsible.[85] Put simply, domestic political institutions shape the political strategies necessary to secure electoral success and thus condition policy outcomes in systematic ways.[86] International regulatory policy is thus the result of the efforts of politicians to gain and retain political office with the structure of domestic political institutions. The efforts of domestic politicians to organize international markets in ways which provide benefits to particular constituents at the expense of others ultimately leads politicians to construct international institutions to structure international markets. When technological, economic, and political changes undermine existing domestic political bargains, politicians will attempt to re-structure international institutions in ways consistent with new domestic political imperatives.

While domestic politics set the basic parameters of what states want from international regulatory regimes, understanding how international constraints interact with domestic politics is crucial to understanding international bargaining outcomes. In particular, I argue that international market forces, the preferences of other states, and the rules to the status quo (i.e. the rules and decision-making procedures of existing international institutions) shape international bargaining outcomes and thus the preferences and strategies of domestic economic actors and national politicians. In short, because these international variables (hereafter international bargaining dynamics) allocate market power to particular actors and thus condition the strategies pursued by both firms and governments, these variables are crucial for understanding the domestic political bases of international regulatory policy. I thus include these variables in the analysis.

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In sum, the argument begins with an examination of the preferences of domestic political actors, in particular firms, and highlights the role of these actors in the domestic political process. However, because politicians are responsive to more than just organized interests, the analysis moves from a discussion of societal actors to an analysis of how domestic political institutions shape the incentives of politicians and, in turn, the policy-making process. Throughout, imperfect international markets shape the strategies and preferences of both firms and politicians, i.e. both firms and politicians consider the impact of international bargaining dynamics in imperfect markets when launching strategies and adopting bargaining positions. Put differently, firm endogenize both domestic politics and international market dynamics when launching strategies, while politicians endogenize international bargaining dynamics when launching strategies designed to secure policy outcomes favorable to domestic constituents. The analysis thus proceeds from the domestic to the international and back to the domestic, with both firms and politicians pursuing their interests within the win-sets defined by domestic political institutions and the imperfect international markets created by existing international institutions.

In sum, I am interested in explaining the rules governing international aviation markets. In order to explain these rules, I examine the institutional arrangements which states construct to set the rules these markets. I argue that the institutional arrangements governing international markets can be understood as inter-state regulatory bargains. Although collective goods analyses have helped us understand when states are likely to construct institutions and coordinate international markets, these approaches have missed the domestic political bargains underlying international institutions and which are mirrored in the structure and process of international institutions. Institutional creation is a fundamentally political process driven primarily

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by distributional considerations. Put simply, international institutions are created to organize international markets in ways acceptable to domestic political coalitions. States with significant market power attempt to create and reformulate international institutions when the current structure of international markets no longer produce outcomes consistent with domestic political prerogatives.[87] Meanwhile, because governments and firms look at institutional arrangements with a fairly good idea of what structure and process imply for policy outcomes, questions of institutional design engender fierce politicking at both the domestic and international levels; particular institutional structures are a result of this highly politicized inter-state bargaining.

Before continuing, it is useful to clarify what this dissertation seeks to explain, and the relationship between international institutions and international rules. I argue that national governments seek to regulate international markets in ways consistent with domestic regulatory bargains. In other words, governments choice to organize international markets in ways favorable to the domestic political coalitions which they are responsible. The question I ask throughout this dissertation is thus why did governments create a particular set of international rules to govern international aviation markets rather than some other set of rules? What I am interested in explaining, then, is the set of rules governments create to govern international markets. I include two things in my definition of rules: (1) the rights afforded to different classes of economic actors in international markets, and (2) the provisions for changing or altering the existing set of rules. Delineating the rights afforded different economic actors are necessary for answering a number of important questions: Who is allowed to enter the market? Who is not allowed to enter? What are the terms of entry? What types of activities can different classes of economic actors undertake? More broadly, what are the extent of activities included within the market? What is

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specifically excluded? A complete understanding the rules also requires considering what are the rules for changing the rules. Rules and institutions are never permanent, and one key aspect of any set of rules is what are the provisions for altering existing regulatory arrangements. I thus include the provisions governing changes in existing arrangements in my definition of rules.

Once we have defined rules as the rights afforded different economic actors in the marketplace and the provisions governing changes in these rules, it quickly becomes apparent that there are a variety of ways for national governments to establish rules governing international markets: international institutions can be constructed, regional pacts can be signed, and bilateral agreements can be concluded. Although all of these mechanisms are slightly different, all of them establish the rules governing international economic exchange. However, problems of opportunism and collective action mean that states often create international institutions to establish the rules governing international markets.[88] I am thus interested in international institutions for the role they play in establishing the rules to international markets. Put simply, states construct international institutions, and delegate authority to these institutions to govern international markets--i.e. set the rules to international markets. Understanding how international institutions actually govern international markets (i.e. understanding the rules governing international markets) thus requires a detailed analysis of the structure and process of international institutions. Put differently, understanding the structure and process of international institutions is necessary for understanding how institutions set the rules governing international markets. At other times, of course, states may utilize other fora--regional deals and bilateral agreements--to set the rules governing international markets. When states choose these fora for establishing

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marketplace rules, I will examine these agreements to understand the rules governing international markets.

One final note about the rules governing international markets. Defining the relevant dimensions of international rules is difficult, especially when these rules have change dramatically. However, for the purposes of comparison it is useful to employ two sets of analytic descriptions which are useful for understanding how and in what way international rules change. The first analytic concept is whether states use international institutions to dictate international rules, or do so directly through bilateral negotiations. In other words, what are the mechanisms states use to dictate the rules governing international markets? In theory, international institutions and direct state-action lie on a continuum, with plenty of mix and match strategies possible in the middle of this continuum. This analytic construct maps on to international aviation markets in a relatively straightforward way: bilateralism or multilateral institutions. The second construct revolves around the impact of rules on marketplace competition. I distinguish two types of rules: restrictive rules and pro-competitive rules. There are a large number of specific components which make up these categories: rules on entry, how fares will be set, the rules governing foreign investment, whether or not airlines can collude, etc. At various points, these specific components will be highlighted in the discussion, but in general restrictive rules limit entry, allow airlines to set fares, are generally limit marketplace competition and protect incumbent airlines (usually at the expense of consumers) while pro-competitive rules encourage new entry, allow the market to set fares, and generally encourage competition to produce low fares for consumers. With these two dimensions in mind (bilateralism vs. multilateral institutions and restrictive vs. pro-competitive rules) it is possible to delineate how and in what ways international rules have changed.

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1.5 Outline of the Dissertation

In the following chapters, I attempt to provide a theory of international institutions. In so doing, I challenge the dominant conception of regimes as institutions that facilitate inter-state cooperation by facilitating the resolution of collective action problems. Although I agree with the realists that regimes are primarily distributional institutions, I focus on the domestic political underpinnings of international institutions and the markets they help organize. Placing the economic impact and domestic political consequences of international institutions front and center, my analysis offers a domestic political rationale for regime creation, persistence, and change.

In chapter two I offer a theory of international institutions. Drawing upon the intellectual tools of the new economics of organization, I argue that international institutions should be understood as inter-state regulatory bargains which produce policy outcomes favorable to important domestic constituents. The argument stresses the impact of firm preferences, domestic political institutions, and international bargaining dynamics on the domestic political bargains underpinning regulated international markets.

In chapter three I provide an analysis of the postwar aviation marketplace that highlights the distributional consequences of particular institutional rules and stresses the domestic political underpinnings of the strictly regulated Bermuda marketplace. After briefly discussing the postwar bargaining sessions establishing the institutions governing the international marketplace, I discuss the domestic political bargain supporting the de facto cartel produced by Bermuda institutions.[89] The chapter closes with a examination of the forces undermining the stability of the postwar regime and a

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brief discussion of the scope and content of the emerging international aviation marketplace.

The next three chapters use case studies to illustrate the central role of domestic politics and international bargaining dynamics in the organization of international aviation markets. Chapter four examines the domestic politics driving U.S. attempts to export domestic deregulation and re-structure the Bermuda regime. The analysis begins by examining societal demands for a more pro-competitive U.S. international aviation policy, but proceeds to examine how U.S. domestic political institutions influenced the timing and content of policy change, and how international bargaining dynamics influenced the particular bargaining strategies adopted by the U.S. as it attempted to export deregulation to the international marketplace. Chapters six and seven examine the U.S.-U.K. and U.S.-Japan aviation markets, respectively, and seek to delineate how domestic politics and international bargaining dynamics have shaped the scope and content of the respective bilateral aviation markets. In the concluding chapter, I revisit the argument and briefly review my finding in the empirical chapters before discussing how the argument fits within the broader debates in foreign economic policy and international political economy.

1.6 Case Selection and Method

This empirical chapters of this dissertation provide four distinct looks at the organization of international aviation markets. Taken individually and as a whole, the point of the empirical chapters is to provide support for the argument advanced in chapter two. To reiterate, I seek answers to questions about the organization of international markets in this dissertation. In answering these questions, I look to how domestic politics led national governments to create international institutions which

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organized international markets in particular ways. But how do the chapters fit together, and why choice these cases rather than others? The answer to these questions lies in the shape and content of global aviation markets, and in the comparative dimension provided by examining the U.S.-U.K. and U.S.-Japanese markets. I address each of these issues in turn.

Prior to World War II, international aviation markets were so limited that the economic and political impact of how these markets were organized aroused little attention from domestic politicians. As such, the rules governing the post-war aviation markets provide the first example of how states organized international aviation markets. Chapter three thus examines the domestic politics leading to the creation of the Bermuda regime, and examines how Bermuda institutions structured aviation markets in ways that benefited important domestic political constituents in key aviation states. The chapter also discusses broad changes in underlying domestic political coalitions in key states, and demonstrates how these domestic political changes have led states to re-organize international aviation markets.

The next three chapters take up the more specific question of how domestic politics in the U.S., U.K., and Japan have shaped the organization of U.S.-U.K. and U.S.-Japan international aviation markets. The large size and strategic importance of the U.S., U.K., and Japan make these three states crucial for understanding the organization of the major aviation markets of the world. The U.S. is by far the most important state in international aviation markets, and accounts for about 40 percent of global aviation traffic.[90] Moreover, the U.S. was one of the primary architects of the Bermuda regime, and U.S. international aviation policies have been at the center of the changes which have taken place in international aviation markets in the past twenty years. As the first state to face widespread political pressure for re-structuring

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international aviation markets, understanding the forces driving U.S. policy reversal are important for understanding how similar--and different--political processes have played out elsewhere.

Although the U.S. is by far the largest aviation market in the world, the U.K. and Japan are the second and third largest markets in the world, respectively.[91] Perhaps more important than their sheer size, however, is the central role of U.K. and Japan in the trans-Atlantic and trans-Pacific aviation markets.[92] In short, accidents of geography make these nations extremely important in shaping European and Asian aviation markets, respectively. The central importance of London in the global economy and the importance of Heathrow as a hub for global aviation markets makes the U.K. by far the most important aviation market in Europe. Japan occupies a similar position in Asia: it is by far the largest market, and Japan's role in the global economy makes aviation traffic to and from Japan key to understanding the organization of Asian aviation markets. The U.K. and Japan thus occupy similar positions for the two major aviation regions of the world; examining the politics driving the organization of these markets is thus central for understanding the global organization of international aviation markets.

Methodologically, the pair-wise comparison represented by examining the U.K. and Japan also provides an excellent opportunity to test many of the propositions developed in chapter two. The two states occupy similar positions in their respective regional markets (i.e. the major aviation hub), both have parliamentary systems, and both states owned inefficient carriers at the end of the 1970's. Yet the outcomes in the two cases have been widely divergent. In the U.K., BA has become one of the most competitive airlines in the world, the Thatcher government has supported liberalization of both domestic and international aviation markets, and some liberalization has taken

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place in U.S.-U.K. markets. Although the Japanese government has undertaken minor changes in Japanese domestic markets and ANA has been allowed to enter the international marketplace, the Japanese government has refused to liberalize U.S.-Japan markets and Japanese airlines continue to rely on government regulation as protection from more efficient U.S. airlines. Why the divergent outcomes in the face of important similarities?

The pairwise comparison thus allows me to focus on how differences in electoral laws and international market dynamics produced different outcomes in the two cases. In particular, I demonstrate how differences in electoral laws and international bargaining dynamics led U.K. and Japanese airlines to adopt divergent strategies, which in turn altered the domestic political calculus of national politicians. BA and JAL occupied similar positions in the late 1970's: both were highly inefficient state-owned enterprises which relied on government regulation in both domestic and international markets to ensure their economic viability. Following the election of Thatcher, however, BA was re-organized as a competitive airline, was subsequently privatized, and became a firm supporter of U.K. government efforts at liberalizing international aviation markets. JAL, on the other hand, remained inefficient, continued to rely on the Japanese government for protection, and continues to oppose any liberalization of Japanese aviation markets. Divergent firm strategies in the two states meant national politicians in the two states faced distinct political pressures, and subsequently adopted divergent national bargaining positions. The end result, of course, is that the U.S.-Japan market remains extremely restrictive while there has been significant liberalization of U.S.-U.K. aviation markets. The most similar research design thus allows me to draw conclusions about the impact of differences in electoral rules and international bargaining dynamics on the outcomes we observe, and

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thus provide empirical support for the theoretical propositions advanced in chapter two.

The pair-wise comparison provided by comparing the U.K. and Japan in their negotiations with the U.S. is buttressed by direct comparisons with the U.S., which has a very different set of domestic economic actors and domestic political institutions. By examining the comparison between the domestic politics of aviation in the U.S. as compared to Japan and the U.K., I am able to provide support for the hypothesis presented in chapter two regarding the impact of the preferences of societal actors and domestic political institutions on policy outcomes. More specifically, chapters four, five and six clearly demonstrate the importance of the preferences of U.S. airlines on policy outcomes, and that impact of the division of powers on the speed and extent of policy change, and the importance of local interests in the design and speed of this policy change. The U.S.-U.K. chapter also nicely demonstrates how the multiple veto points provided by U.S. domestic institutions have made policy change difficult in light of the allocation of marketplace rights provided by status quo bilateral agreements.

See the discussion in Ronald Rogowski, "Institutions as Constraints on Strategic Choice," in David Lake and Robert Powell, eds., Strategic Choice and International Relations (Princeton: Princeton University Press, forthcoming).

[1] For an introduction to the literature on strategic trade theory, see Elhanan Helpman and Paul Krugman, Market structure and foreign trade: increasing returns, imperfect competition, and the international economy (MIT Press, Cambridge, MA), 1985, Elhanan Helpman and Paul Krugman, Trade policy and market structure (MIT Press, Cambridge, MA), 1989, Paul Krugman, Rethinking international trade (MIT Press, Cambridge, MA), 1990, Paul Krugman, Geography and trade (MIT Press, Cambridge, MA), 1991, Gene Grossman, ed., Imperfect Competition and International Trade (MIT Press. Cambridge, MA), 1994, Paul Krugman and Alasdair Smith, eds. Empirical studies of strategic trade policy (University of Chicago Press, Chicago), 1994, Paul Krugman and Maurice Obstfeld, International economics: theory and policy, 4th edition (Addison-Wesley, Reading. MA), 1997, and Helen Milner and David Yoffie, "Between Free Trade and Protectionism: Strategic Trade Policy and a Theory of Corporate Trade Demands," *International Organization*, Vol. 43, No. 2 (Spring 1989), p. 1-36.

[2] In this study, the U.S., the U.K., and Japan all have market power, although to different degrees and

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in different ways. As we shall in later chapters, the market power of these different states shape the strategies of both firms and national governments in important ways. For now, it is only important to note that the argument does not claim that small states can shape international institutions and the organization of international markets to the same degree that states with significant market are able to.

[3]Services include wholesale and retail trade, transport of freight and people, management consulting, construction, entertainment, communications, information-related activities, business and professional services, banking and financial services, and insurance.

[4]William J. Drake and Kalypso Nicolaidis, "Ideas, Interests, and institutionalization: 'trade in services' and the Uruguay Round," *International Organization*, Vol. 46, No. 1 (Winter 1992), p. 37-100.

[5]The World Bank, Global Economic Prospects and the Developing Countries (The World Bank, Washington D.C.) 1995, as cited in OECD, 1997, p. 29.

[6]OECD, 1997, p. 29.

[7]See P.W. Daniels, Service Industries in the World Economy (Blackwell Publishers, Oxford), 1993. and Albert Bressand and Kalypso Nicolaidis, eds., Strategic Trends in Services: An Inquiry into the Global Service Economy (Harper & Row, New York), 1989.

[8]MNC's now represent about one-third of total global economic activity. World Investment Report 1994: Transnational Corporations, Employment, and the Workplace (United Nations Conference on Trade and Development, Geneva), 1994, as cited in OECD, 1997, p. 28.

[9]Services have been the target of government intervention and regulation which is different in both degree and nature from the regulation of non-service activities. See Brian Hindley and Alasdair Smith, 1984, "Comparative Advantage and Trade in Services," *The World Economy*, Vol. 7, p. 369-389.

[10]See Geza Fetetekuty, International Trade in Services: An Overview and Blueprint for Negotiations (American Enterprise Institute/Ballinger Publishing Co., Cambridge, MA), 1988, and Patrick Messerlin and Karl Sauvant, eds., The Uruguay Round: Services in the World Economy (The World Bank, Washington, D.C.), 1990.

[11]Daniel Bell, The Coming of Post-Industrial Society: A Venture in Social Forecasting (Basic Books, New York), 1973.

[12]On the campaign to place services on the trade agenda, see Geza Feketekuty, "Appendix: The History of a Campaign: How Services Became a Trade Issue," in Geza Feketekuty, International Trade in Services: An Overview and Blueprint for Negotiations (Ballinger, Cambridge, MA), 1988.

[13]Francis Castles, "The Dynamics of Policy Change: What Happened to the English-Speaking Nations in the 1980's," *European Journal of Political Research*, Vol. 18, No. 5 (1990 September), p. 491-513.

[14]See Benjamin Cohen, "Phoenix Risen: The Resurrection of Global Finance, *World Politics* 48, No. 1 (January 1996), p. 268-296.

[15]See Aronson and Cowhey, 1988, and Cowhey, 1990.

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[16]See Kasper, 1988, and Nayar, 1995.

[17]Trade in aviation services is representative of trade in many services industries. See Ethan Weisman. Trade in Services and Imperfect Competition: Application to International Aviation (Kluwer Academic Publishers, Boston, MA), 1990.

[18]Organization for Economic Cooperation and Development. The Future of International Air Transport Policy: Responding to Global Change (OECD, Paris), 1997.

[19]Duane E. Woerth, "International Aviation," in Peter Cappelli, ed., Airline Labor Relations in the Global Era (Cornell University Press, with ILR Press, Ithaca, N.Y.), 1995, p. 41-53.

[20]U.S. Department of Commerce, as cited in Clyde Prestowitz, Jr., Don Hilty, Lawrence Chimerine, and Laura Sweeney, Turbulence over the Pacific (Economics Strategy Institute, Washington D.C.), March 1996, p. vii. These estimates include both direct and indirect effects. The basic components of direct impact are airline operations, airport operations, aircraft manufacturing and general aviation, while the indirect impact is largely based on tourism expenditure. Author's personal communication with Rebecca Rowland, former Air Transport Action Group Analyst, September 9, 1997.

[21]Wilbur Smith Associates, The 1993 Economic Impact of Civil Aviation, as cited in ACCESS U.S.-Japan, The Impact of Increased Passenger Flights to Japan on U.S. Employment (ACCESS U.S.-Japan, Washington D.C.), July 1996, p. 4.

[22]For figures on the E.C., see Alan Dobson, Flying in the Face of Competition: The Policies and Diplomacy of Airline Regulatory Reform in Britain, the USA, and the European Community, 1968-1994 (Avebury Aviation, Aldershot, U.K.), 1995, p. 34. For U.S. figures, see Prestowitz, et. al., 1996, p. viii.

[23]Prestowitz, Hilty, Chimerine, and Sweeney, 1996.

[24]For a discussion of the similarities between aviation and other service industries; see Weisman, 1990.

[25]With the number of domestic passengers dwarfing international travelers, this arrangement was a winner politically, especially given that most international passengers were business or government related (i.e. demand was largely inelastic and had few political repercussions).

[26]On two-level games, see Robert Putnam, "Diplomacy and Domestic Politics: The Logic of Two-Level Games," *International Organization*, Vol. 42. No. 3 (Summer 1988), p. 427-460, and Peter Evans, Harold Jacobson, and Robert Putnam Double-Edged Diplomacy: International Bargaining and Domestic Politics (University of California Press, Berkeley, CA), 1993.

[27]For one categorization of the different approaches to regimes, see Stephan Haggard and Beth Simmons, "Theories of International Regimes," *International Organization* 41, No. 3 (Summer 1987), p. 491-517; for another, see Friedrich Kratochwil and John G. Ruggie, "International Organization: a state of the art on an art of the state," *International Organization* Vol. 40, No. 4, Autumn 1986, pg. 753-775.

[28]The distinction which follows is similar to the distinction made by Knight; see Jack Knight, Institutions and Social Conflict (Cambridge University Press, Cambridge, MA), 1992, p. 4-9.

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[29]Although some distributional analyses of international regimes argue that international institutions are completely epiphenomenal and have no impact of the shape or content of international markets, most analysts agree that international institutions have at least some impact on international markets. See, for example, the discussion in Stephen Krasner, "Structural Causes and Regime Consequences: Regimes as Intervening Variables," in Stephen Krasner, ed., International Regimes (Cornell University Press, Ithaca, NY), 1983, p. 1-22.

[30]The literature is vast. For a sample, see Robert Keohane, After Hegemony: Cooperation and Discord in the World Political Economy (Princeton University Press, Princeton, NJ), 1984, Duncan Snidal, "The limits of hegemonic stability theory," *International Organization*, (Autumn 1985), pg. 579-614, Kenneth Oye, ed., Cooperation Under Anarchy (Princeton University Press, Princeton, N.J.), 1986, and Mark Zacher, Governing Global Networks: International Regimes for Transportation and Communications (Cambridge University Press, Cambridge, MA), 1996.

[31]On transaction cost economics, see Oliver Williamson, Markets and Hierarchies: Analysis and Antitrust Implications (Free Press, New York, NY), 1975. On the new institutionalism, see James March and Johan Olson, "The New Institutionalism: Organizational Factors in Political Life," *American Political Science Review* 78 (September 1984), p. 734-750, and Terry Moe, "The New Economics of Organization," *American Journal of Political Science* 28 (November 1984), p. 739-777. On functionalism, see Arthur Stinchcombe, Constructing Social Theories (Harcourt Brace, New York, NY), 1968.

[32]The distinction between coordination and collaboration is made by Stein. See Arthur Stein, "Coordination and collaboration: regimes in an anarchic world," in Krasner, 1983, p. 115-140.

[33]Keohane, 1984, p. 12-13.

[34]On normative or public-interest theories of regulation, see Paul Joskow and Roger Noll, "Regulation in Theory and Practice: An Overview," in Gary Fromm, ed., Studies in Public Regulation (Cambridge University Press, Cambridge, MA), 1981, Michael Levine and Jennifer L. Florence, "Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis," and Mathew McCubbins, Roger Noll, and Barry Weingast, "Slack, Public Interest, and Structure-Induced Policy," *Journal of Law, Economics, and Organization*, Vol. 6 (Special Issue 1990), p. 167-198 and p. 203-212, respectively. See also David P. Baron, "The economics and politics of regulation: perspectives, agenda, and approaches," in Jeffrey S. Banks and Eric A. Hanushek, eds., Modern Political Economy: Old topics, new directions (Cambridge University Press, Cambridge, MA), 1995, p. 10-62.

[35]Hegemonic stability theory did not initially link international institutions to hegemonic leadership; however, the role of the hegemon in constructing international institutions to provide collective goods was implicit in the analysis and the link was explicitly made in later literature on regimes. See Charles Kindleberger, The World in Depression, 1929-1939 (University of California Press, Berkeley, CA), 1973, Keohane, 1984, Snidal, 1985, and Beth V. Yarbrough and Robert M. Yarbrough, Cooperation and Governance in International Trade (Princeton University Press, Princeton, NJ), 1991.

[36]See Ronald B. Mitchell, "Regime design matters: intentional oil pollution and treaty compliance," *International Organization* 48, No. 3 (Summer 1994), p. 425-458, and Thomas Bernauer, "The effect of international environmental institutions: how we might learn more," *International Organization* 49, No. 2 (Spring 1995), p. 351-377.

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[37]Keohane, 1984. Robert Keohane, "The demand for international regimes," in Krasner, 1983, p. 141-171.

[38]Ruggie makes a similar point in regards to multilateral vs. bilateral regimes and hegemonic stability theory. See John Ruggie, "Multilateralism: The Anatomy of an Institution," in John Ruggie, ed., Multilateralism Matters: The Theory and Praxis of an Institutional Form (Columbia University Press, New York, N.Y.), 1993, p. 3-47. See also Peter Cowhey, "Elect Locally-Order Globally: Domestic Politics and Multilateral Cooperation," in Ruggie, 1993, p. 157-200.

[39]Although functionalist approaches to international regimes drew on the contractual literature to argue that international institutions were necessary to solve collective action problems and thereby generate gains from coordination, they ignored the possibility of using contracts for welfare-reducing arrangements. This is especially true as regimes may be constructed for collusive purposes, with the regime benefiting dominant regime participants at the expense of other states. During the NIEO years, for example, the developing countries complained that the rules of the Bretton Woods system were systematically biased against the developing countries. For an analysis of the Bretton Woods system that is consistent with these complaints, see John G. Ruggie, "International Regimes, transactions, and change: embedded liberalism in the postwar economic order," in Krasner, 1983, p. 195-231.

[40]Terry Moe, "Political Institutions: The Neglected Side of the Story," *Journal of Law, Economics, and Organization*, Vol. 6, (Special Issue 1990), p. 213-266.

[41]Peter Cowhey, "The International Telecommunications Regime: the political roots of regimes for high technology," *International Organization* 44, No. 2 (Spring 1990), p. 169-199, and Stephen Krasner, "Global Communications and National Power: Life on the Pareto Frontier," *World Politics* 43 , No. 3 (April 1991), p. 336-366.

[42]Cowhey's analysis of the telecommunication regime provides a distributional analysis which does not rely on realist arguments. Unlike the realists, who highlight the impact of distributional impact of international rules between countries, Cowhey stresses the impact of domestic politics on international regimes and highlights the distributional impact of regimes within countries. My analysis builds on Cowhey's work. See Cowhey, 1990.

[43]This is the "coercive" version of hegemonic stability theory. For a review of the literature on hegemonic stability, see David Lake, "Leadership, Hegemony, and the International Economy: Naked Emperor or Tattered Monarch With Potential," *International Studies Quarterly*, Vol. 37, No. 4 (December 1993), p. 459-489. For applications to specific regimes, see Krasner, 1991, and Baldev Raj Nayar, "Regimes, power, and international aviation," *International Organization* 49, No. 1 (Winter 1995), p. 139-170.

[44]Krasner, 1991, p. 342-343.

[45]Joseph Grieco, Cooperation Among Nations: Europe, America, and Non-Tariff Barriers to Trade (Cornell University Press, Ithaca, NY), 1990, Krasner, 1991, and Nayar, 1995.

[46]On the relationship between mercantilism and realism, see Robert Gilpin, The Political Economy of International Relations (Princeton University Press, Princeton, NY), 1987.

[47]This critique of realist arguments concerning regime change is similar to the criticism Waltz himself levied against theories of international politics based on human nature: a theory that can explain any number of outcomes is not very useful in understanding and predicting those outcomes. Kenneth

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Waltz, Man, the State, and War: A Theoretical Analysis (Columbia University Press, Columbia, NY), 1959.

[48]Paul Stephen Dempsey, Law & Foreign Policy in International Aviation (Transnational Publishers, Inc. New York), 1987, p. 10.

[49]Peter Gourevitch, Politics in Hard Times: Comparative Responses to International Economic Crises (Cornell University Press, Ithaca, NY), 1986, Jeffry Frieden, Debt, Development, and Democracy (Princeton University Press, Princeton, N.J.), 1991, Ronald Rogowski, Commerce and Coalitions (Princeton University Press, Princeton, N.J.), 1989, and Helen Milner, Resisting Protectionism: Global Industries and the Politics of International Trade (Princeton University Press, Princeton, NJ), 1988.

[50]Some scholars in this tradition are careful in stating that they merely seek to show the impact of international market forces on domestic political coalitions, and that they do not seek to explain particular policy outcomes. In practice, however, almost all scholars in this tradition move from outlining coalitional dynamics to explaining policy outcomes; the argument is thus that societal preferences automatically translate into foreign economic policies.

[51]See, for example, Sharyn O'Halloran, Politics, Process, and American Trade Policy : Congress and the Regulation of Foreign Commerce (Michigan University Press, Ann Arbor, MI), 1990, and Peter Cowhey, "The politics of foreign policy in Japan and the United States," in Peter Cowhey and Mathew McCubbins, eds., Structure and Policy: Japan and the United States (Cambridge University Press, Cambridge, MA), 1995, p. 203-225.

[52]Demand-side explanations have also dominated the literature on regulation. See George Stigler, "The Theory of Economic Regulation," *Bell Journal of Economic and Management Science*, Vol. 2 (1971), p. 3-21, Samuel Peltzman, "Towards a More General Theory of Regulation," Journal of Law and Economics, Vol. 19, (1976), p. 211-240, and Gary Becker, "Public Policies, Pressure Groups, and Dead Weight Costs," *Journal of Public Economics*, Vol. 28, p. 69-85, 1985.

[53]Rogowski, 1989, Frieden, 1991.

[54]Robert Bates, Open-Economy Politics: The Political Economy of the World Coffee Trade (Princeton University Press, Princeton, NJ), 1997, p. 13.

[55]Gourevitch, 1986. See also Peter Gourevitch, "The Second Image Reversed: The International Sources of Domestic Relations," *International Organization*, Vol. 32, No. 4 (August 1978), p. 881-911.

[56]Milner, 1988.

[57]For an overview of the institutionalist research agenda, see Mathew McCubbins and Terry Sullivan, Congress: Structure and Policy (Cambridge University Press, Cambridge, MA), 1987, Rein Taagepeta and Mathew Shugart, Seats and Votes: The Effects and Determinants of Electoral Systems (Yale University Press, New Haven, CT), 1989, Gary Cox, The Efficient Secret (Cambridge University Press, Cambridge, MA), 1987, J. Mark Ramseyer and Frances Rosenbluth, Japan's Political Marketplace (Harvard University Press, Cambridge, MA), 1993, and Cowhey and McCubbins, 1995. See also R. Kent Weaver and Bert Rockman, Do Institutions Matter: Government Capabilities in the United States and Abroad (The Brooking Institution, Washington, D.C.), 1993, and Geoffrey Garrett

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and Peter Lange, "Internationalization and Domestic Institutions," *International Organization*, Vol. 49, No. 4 (Autumn 1995), p. 627-655.

[58]Daniel Verdier, Democracy and International Trade: Britain, France and the United States, 1860-1990 (Princeton University Press, Princeton, N.Y.), 1994. See also Roger Noll, "The Political Foundations of Regulatory Policy," *Journal of Institutional and Theoretical Economics*, 139 (1983), p. 377-404, and Cowhey, 1990.

[59]The discussion provided by Bates in his analysis of the international coffee market was especially useful in clarifying my thoughts on how the literature on strategic trade theory impacts the domestic politics of imperfect international markets. See Bates, 1997.

[60]Although open-economy macro scholars are more explicit about the exogenous nature of international market prices, other scholars in the domestic political tradition do not consider how international market forces may shape the strategies of domestic political actors. Thus, almost all approaches which highlight the demands of domestic political actors rest on the assumptions that domestic economic actors are price-takers in international markets. For exceptions, see Milner and Yoffie. 1989, and the collection of articles in David Yoffie, ed., Beyond Free Trade: Firms, Governments, and Global Competition (Harvard Business School Press, Boston, MA), 1993.

[61]Although economic actors in other states may not share U.S. firms and politicians beliefs about the ability of U.S. policy to drive major changes in the organization of international aviation markets, firms and national politicians in other states do have market power and thus must be strategic when launching international strategies. For a further exposition of this point, see Chp. 2 below.

[62]See Chp. 2 below for a more thorough discussion of this point in the context of international aviation.

[63]The insight that market power is important for international bargaining outcomes and the organization of imperfect international markets is not new. Indeed, the literature on international cartels effectively concludes that market power is necessary for the maintenance of cartels. My approach builds on these insights and attempts to show how market power shapes the strategies and preferences of domestic political actors. Thus, my contribution is not that market power matters for outcomes, but in demonstrating how imperfect markets shape the domestic politics of these imperfect international markets. For an introduction to the literature on cartels and an application to international oil markets, see Deborah L. Spar, The Cooperative Edge: The Internal Politics of International Cartels (Cornell University Press, Ithaca, NY), 1994, Daniel Yergin, The Prize: The Epic Quest for Oil, Money and Power (Touchtone Books, New York, N.Y.), 1992, esp. Part V, and Peter Cowhey, The Problems of Plenty: Energy Policy and International Politics (The University of California Press, Berkeley, CA) 1985. For studies of how market power shapes specific international markets, see also Jonathon Aronson and Peter Cowhey, When Countries Talk: International Trade in Telecommunications Services (Ballinger, Cambridge, MA), 1988, Cowhey, 1990, Daniel Kasper, Deregulation and Globalization: Liberalizing International Trade in Air Services (Ballinger Publishing Company, Cambridge, MA), 1988, and Bates, 1997.

[64]See O'Halloran, 1990, James Lindsay, Congress and the Politics of U.S. Foreign Policy (The Johns Hopkins University Press, Baltimore, MD), 1992, the essays in Cowhey and McCubbins, 1995, and C.S. Eliot Kang, "Regulating Inward Foreign Direct Investment," *International Organization*, Vol. 51, No. 2 (Spring 1997), p. 301-333. For a broad overview of the literature, see Bruce Cain, John Ferejohn, Morris Fiorina, The Personal Vote: Constituency Service and Electoral Independence (Harvard University Press, Cambridge, MA), 1987.

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[65]See Wendy Hansen. "The International Trade Commission and the Politics of Protectionism," *American Political Science Review*, Vol. 84, No. 1 (March 1990), p. 21-46, David Brady and Jongryn Mo, "The U.S. Congress and Trade Policy: An Institutional Approach," Pacific Focus (Fall 1990), Judith Goldstein, Ideas, Institutions, and American Trade Policy," *International Organization*, Vol. 42, No. 1 (Winter 1988), p. 179-218, Judith Goldstein, Ideas, Interests, and American Trade Policy (Cornell University Press, Ithaca, NY), 1993, and Kang, 1997. See also the discussion in Rogowski, in Lake and Powell, forthcoming.

[66]See Ramseyer and Rosenbluth, 1993, Weaver and Rockman, 1993, and Cowhey and McCubbins, 1995.

[67]In effect, open-economy macro approaches are really just re-packaging pluralist theory under a new guise. On pluralist theory, see David Truman, The Governmental Process: Political Interests and Public Opinion (Knopf, New York), 1951. See also Theodore Lowi, The End of Liberalism: The Second Republic of the United States (Norton Books, New York), 1979.

[68]For a discussion of the "component analysis" of rational choice analysis, see Mathew McCubbins and Michael Thies, "Rationality, Positive Political Theory, and the Study of Law." unpublished paper, March 1997.

[69]It is important to note that institutions do not "map" onto particular policy outcomes but rather shape the supply of policy given the preferences of domestic actors.

[70]This is the logic delineate in Rogowski, in Lake and Powell, forthcoming.

[71]Peter Gourevitch, "The Governance Problem in International Relations," in Lake and Powell, forthcoming.

[72]On the strategic choice approach, see Lake and Powell, forthcoming.

[73]On endogenous tariff theory, see Robert Baldwin, The Political Economy of U.S. Import Policy (MIT Press, Cambridge, MA), 1985, and Stephen Magee, William Brock and Leslie Young, Black Hole Tariffs and Endogenous Policy Theory: Political Economy in General Equilibrium (Cambridge University Press, Cambridge, MA), 1989.

[74]On regulation, see Gary Becker, "A Theory of Competition among Pressure Groups for Political Influence," *Quarterly Journal of Economics*, Vol. 98, (1983), p. 371-400, and Noll, 1983, Roger Noll, "Economic Perspectives on the Politics of Regulation," in Richard Schmalensee and Robert Willig, eds., Handbook of Industrial Organization (North-Holland, Amsterdam), 1989, p. 1254-1287. See also Robert Hahn. "The Political Economy of Environmental Regulation: Towards a Unifying Framework," *Public Choice*, Vol. 65, No. 1 (1990), p. 21-47.

[75]On public choice approaches to international institutions, see the essays in Roland Vaubel and Thomas D. Willett, eds., The Political Economy of International Organizations: A Public Choice Approach (Westview Press, Boulder, CO), 1991.

[76]See Verdier. 1994. See also Noll, 1983. More specifically, Verdier argues that increasing the saliency of policy choice increases the political costs of particularism (in terms of votes lost), and thus leads politicians to supply policies designed to appeal to the broad electorate.

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[77]Rather than reiterate the criticism here, the reader is referred to section 1.2.1 above.

[78]See, for example, Haggard and Simmons, 1987.

[79]Regimes are "sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations." See Krasner, 1983, p. 2.

[80]On domestic regulatory structures, see Baron, 1995. On international organizations, see Vaubel and Willett, 1991.

[81]Thinking about international institutions as regulatory structures and delineating the impact of domestic politics on the bargaining positions advocated by different states is analogous to what Moe has called the politics of "structural choice" in domestic politics. See Terry M. Moe, "The Politics of Structural Choice: Towards a Theory of Public Bureaucracy," in O.E. Williamson, ed., Organization Theory: From Chester Barnard to the Present and Beyond (Oxford University Press, New York, NY), 1990, p. 116-153, and Terry M. Moe and Michael Caldwell, "The Institutional Foundations of Democratic Government: A Comparison of Presidential and Parliamentary Systems," *Journal of Institutional and Theoretical Economics*, Vol. 150, No. 1 (1994), p. 171-195.

[82]See Evans, Jacobson, and Putnam, 1993.

[83]Moe and Caldwell, 1994.

[84]On the organization of interest groups, see Mancur Olson, The Logic of Collective Action: Public Goods and the Theory of Groups (Harvard University Press, Cambridge, MA), 1965.

[85]Note that I do not argue that politicians in the U.S., Japan, and Great Britain faced identical constituency pressures. Rather, the question is how these different pressures refracted through the political process to produce bargaining positions and government policies. I do not argue that institutions determined policy or that domestic interest group pressures were identical in all cases; rather, I argue that domestic institutions condition the political importance of domestic actors.

[86]See Cowhey and McCubbins, 1995.

[87]Incremental changes to regime rules minimize the chances for radical reformulation of existing regimes. In aviation, however, rapid economic and political changes in the U.S. made incremental adjustments to the existing regime to fit new economic and political forces impossible.

[88]For how international institutions help states overcome the problems inherent in international cooperation, see Keohane, 1984.

[89]Bernard Hoekman has called the Bermuda regime "a market sharing arrangement." Bernard Hoekman, Market Access and Multilateral Trade Agreements: The Uruguay Round Services Negotiations (Institute of Public Policy Studies, The University of Michigan, Discussion Paper No. 294), p. 24.

[90]This includes both domestic and international traffic.

[91]The U.K. accounts for about 12 percent of global aviation traffic and Japan accounts for about 5

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percent.

[92]The U.K. accounts for 32 percent of all U.S.-European traffic, more than twice as much as the second largest market (Germany). In trans-Pacific markets, Japan is far and away the largest market, although exact figures are not available.

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Chapter 2: The Domestic Political Roots of International Regulatory Rules

2.0 Introduction

International institutions are prevalent wherever states attempt to coordinate their actions. In most areas of international relations, states create institutions to guide their behavior and introduce some order into their interactions. In international political economy, international institutions have occupied a central role because they set the rules governing international economic activity. From the coordination of environmental policies to the rules governing international trade and investment, international institutions set the rules governing international economic exchange and thereby structure international markets in particular ways. International institutions are important, then, simply because they organize international markets and thereby shape the costs and benefits which accrue from international economic exchange. But if markets are political constructs, and international markets especially so, why are particular international institutions created and why do they organize international markets in particular ways?

In the Introduction, I argued that the two dominant approaches to understanding international institutions and the organization of international markets did not help us understand the shape and content of international aviation markets. But what should a theory which seeks to explain international institutions and the international markets they organize be able to explain? In what follows, I argue that such a theory should provide an explanation for the creation, maintenance, and change of both international institutions and

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the markets they regulate.[1] In explaining institutional creation, the theory should address three questions: by what process did the institution emerge, why did it take the particular form that it did, and why did it organize the international marketplace in particular ways? Explaining institutional persistence entails an examination of two key questions: what are the forces supporting the status quo organization of the market and why are opponents of the status unable to alter or modify international institutions to re-structure international markets? Finally, explaining institutional and hence marketplace change requires an examination of the forces undermining existing market rules and a discussion of how new rules and institutions are established. In what follows, I attempt to provide a theory that allows us to answer these questions.

The chapter is organized as follows. The second section seeks to re-conceptualize international institutions as inter-state regulatory bargains created by national politicians to produce policy outcomes advantageous to important domestic constituents. Drawing on a new institutionalist understanding of institutions, I argue that international institutions are regulatory institutions which dictate the rules to international markets and thus organize international markets in particular ways. The second section provides a domestic political model to specify the domestic political bargains supporting international regulatory policy. As noted in the Introduction, the argument is rooted in the preferences of domestic economic actors and the national politicians which represent them, but seeks to demonstrate the impact of international bargaining dynamics on the preferences and strategies of both firms and national politicians in the bargaining surrounding the creation and subsequent change of international institutions. In the third section, I return to a discussion of international institutions and discuss how the approach is useful for understanding the creation, maintenance, and change of international institutions. The final section concludes.

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2.1 A New Institutionalist Approach to International Institutions

Two central questions have motivated the study of institutions in recent years: (1) how are institutions created and (2) how do institutions, once created, shape policy outcomes? Borrowing intellectual tools from the new economics of organization and advancing under the banner of the new institutionalism, the aim of the literature has been to elucidate the role of rational individuals in designing institutions and pursuing their goals within them. Although the new institutionalism has achieved significant prominence in other areas of political science, notably in the study of American politics, the intellectual tools have been relatively underdeveloped in the international relations literature.[2] In this section, I draw on the new institutionalist literature to construct a theory of international institutions that views regimes primarily as distributional institutions designed by states to supply policies beneficial to important domestic constituents. In so doing, I advance three central arguments: (1) international institutions have distributional effects, (2) international institutions are consciously created by governments to produce policy outcomes favorable to domestic interests and (3) the anticipated distributional effects of institutional rules and decision-making procedures shape the preferences and strategies of domestic economic actors and national politicians in both the domestic and international arenas.

As noted in the Introduction, international explanations for international institutions have tended to highlight the collective goods which institutions provide for all states.[3] While there may be overall welfare gains from cooperation, in practice some actors gain more than others. This is true simply because international regulatory policy alters international markets from what would have occurred absent regulation. Put simply, international institutions inherently have distributional consequences

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because they regulate international markets in particular ways and thereby advantage some marketplace participants. Because international institutions have distributional effects, however, the process of creating institutions and organizing international markets is usually contentious. Indeed, it is fights over the distributional effects of competing sets of institutional arrangements which make creating and maintaining international institutions so difficult.[4]

The distributional impact of international institutions are thus at the center of my analysis. It is important to note, however, that I do not claim that institutions are unimportant for helping states overcome collective action problems. Rather, I argue that collective goods analyses of international institutions cannot help us understand the substantive content of international institutions and the markets they regulate. In aviation, for example, the institutional arrangements facilitated inter-state coordination concerning international travel and thereby reduced transaction costs by providing clear rules of conduct; without some sort of regulatory rules to govern international travel, state control over airspace could have imposed very large transaction costs or precluded international air travel altogether. However, a wide variety of particular institutional arrangements and international market rules could have provided these coordinating functions. How, when, where and why were different actors granted economic rights in international aviation markets? Collective goods analyses cannot answer these questions, but answering these questions is necessary for understanding the structure of international aviation markets. In seeking answers, then, I do not dismiss the collective benefits of international institutions but find them unable to answer the questions I am interested in.

Because different institutional rules have different distributional impacts in the marketplace, the preferences and strategies of both domestic economic actors and

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national politicians vis-a-vis regulatory arrangements are shaped by the expected costs and benefits of different institutional rules (as well as the actions of other states). Most international institutions do not emerge spontaneously or drop from the sky: they are created by states and emerge out of intensely political inter-state bargaining. Although the collective gains from cooperation are unlikely to be controversial (i.e. everyone can agree that allowing foreign airlines to land at domestic airports would produce welfare gains), the allocation of economic rights and wealth that result from any new international institutional arrangements will be the source of contention. Indeed, the process of regime creation is usually divisive and conflictual precisely because states disagree over what particular institutional rules will govern international markets. As Knight has noted, "Institutional development is a contest among actors to establish rules that structure outcomes to those equilibria most favorable to them."[5] The central problem in creating or changing international institutions is thus devising domestic political solutions to the inevitable distributional effects of international rules. Domestic political coalitions must be assembled to support particular international regulatory arrangements, the appropriate side-payments must be made, and the necessary policies introduced to garner the support of important constituents.

In creating international institutions, national governments must necessarily delegate some authority to the institution to govern the international marketplace. Delegation always raises problems of opportunism, however. In efforts to ensure that international institutions produce the policy outcomes sought by national politicians, governments seek to establish rules and decision-making procedures within international institutions which bias policy outcomes (in ways sought by national politicians). In other words, because structure and process combine with preferences to produce policy outcomes, national governments seek to structure international

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institutions in ways which bias policy outcomes in ways favorable to salient domestic constituents.[6] In aviation, for example, one of the contentious issues in recent years has been the institutional arrangements governing approval of proposed fare changes. Under the Bermuda regime, bilateral accords usually required both states to approve any proposed fare changes (double-disapproval pricing). More recently, the U.S. has pressed states to conclude agreements in which fare changes only require the approval of one state (country-of-origin pricing). The disagreement over these different institutional rules arises simply because the two decision-making procedures have very different distributional implications. Under Bermuda bilaterals, fare levels were severely biased in favor of the status quo as both states were required to approve any changes in the status quo. Country-of-origin pricing, on the other hand, makes changing prices easier by removing one potential veto on proposed changes. At issue is not the particular institutional rules per se, but the economic consequences which these rules have for domestic interests.

In creating international institutions, however, it is not true that national politicians can always deliver favorable policies to salient constituents. Rather, the point is that by creating institutional arrangements which allocate institutional authority to important domestic actors, national politicians can ensure that important domestic actors are represented in the decision-making process and thereby bias policy outcomes particular ways.[7] In short, because administrative procedures determine who can participate in policy making and on what basis, particular institutional arrangements ensure that the relevant constituents have the opportunity to influence policy outcomes.[8] Structural arrangements enfranchising particular domestic constituencies are also important for overcoming the problems associated with voluntary exchange (trade in economic goods or political logrolls) when there are

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temporal inconsistencies in the provision of benefits from an agreement. Here, actors consciously design institutions to safeguard against opportunism and thereby ensure the future provision of policy outcomes consistent with the terms of the initial bargain. Particular institutional rules are thus part and parcel of the political bargain underpinning the organization of international markets, and these institutional arrangements are a necessary and important part of the bargain itself. As Shepsle has noted, institutions can be understood as "an *ex ante* bargain the objective of which is to enhance various forms of 'cooperation' and to facilitate the enforcement of agreements" (emphasis in original).[9] In short, institutions are commitments to supply future policy outcomes.[10]

So far, I have argued three related points: (a) international institutions have distributional effects; (b) domestic economic actors and national politicians seek to create institutions which advantage them; and (c) the structure and process of international institutions is important because structure and process influence the organization of international markets. These points lead to an obvious question: what determines what type of institutional arrangements and international market structure do national politicians seek to create? The answer, as I shall explore in some detail below, lies in domestic politics.

2.2 Domestic Politics

As noted in the preceding section, the new institutionalism seeks to elucidate the role of rational individuals in designing institutions and pursuing their goals within them. Viewing institutions as the intended outcome of the collective choices of purposive actors, rational choice analyses base their explanation for institutional creation, maintenance, and change on the motivations and preferences of particular

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actors. As such, the question I ask in this section is simple: what are the factors driving the strategies and preferences of national governments vis-a-vis international institutions? In other words, when, why and how do governments create, maintain and change international institutions and thereby organize international markets in particular ways?

This section is divided into two major parts. The first section advances an argument regarding firm preferences vis-a-vis international regulatory arrangements. Seeking to contribute to our understanding of firm strategy and preferences, the analysis highlights the impact of domestic politics and international bargaining dynamics on what firms demand from governments. The second section builds on the first and seeks to ascertain how domestic political institutions and international bargaining dynamics shape the strategies and preferences of national governments vis-a-vis international regulatory institutions. Noting the importance of electoral laws and the division of powers in shaping the electoral coalitions to which politicians must be responsive to secure re-election, I argue that different domestic political institutions advantage different domestic economic actors in the policy-making process and thereby shape the preferences of national politicians vis-a-vis international markets. International bargaining dynamics are also important for national politicians, however, as inter-state bargaining and international market forces shape the strategies which must be pursued to attain their policy goals. Thus, the analysis highlights the impact of international bargaining dynamics on the preferences and strategies of national politicians.

2.2.1 Firms: Preferences and Strategies

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The study of firm preferences has a long history in the literature on the political economy of international trade.[11] With firm demands for protection as the locus of attention, most analysts derive material interests from firm positions in the national or international economy and attribute firm preferences based on these material interests. The major divisions noted in the literature include competitive and uncompetitive firms, importers and exporters, and internationally-focused and domestically-focused firms. Despite this extensive literature, what firms actually demand from governments and the sources of these preferences have been largely ignored. Indeed, as Milner and Yoffie point out, most theories involving firm preferences focus on the demand for protection or free trade rather than on the more general question of the range of corporate demands and the sources of these demands.[12]

Although the competitive position of firms in the marketplace is an important first cut at the preferences and strategies of firms, I argue that domestic politics and international bargaining dynamics are important determinants of the preferences and strategies of firms.[13] Firms choose strategies designed to maximize profits. But profits can be obtained in an infinite number of ways: rents can be captured from government regulation or favorable tariffs, cheap inputs can be secured through free trade, and strategic alliances can generate economies of scope or expand product lines. In aviation, for example, airlines have undertaken a variety of strategies in response to current liberalization of international aviation markets: Air France has retreated into a protected domestic market and positioned itself to defend its home turf, Northwest has led the move toward integrated global alliances, Japan Airlines (JAL) and All-Nippon Airways (ANA) have sought to safeguard their position in intra-Asian markets and rebuff U.S. efforts at liberalization, while British Airways (BA) has introduced new livery and thereby attempted to shed its image as a British company and become the

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world's first truly global airline. Thus, despite similar market positions at the end of the 1970's, BA and JAL adopted very different strategies throughout the 1980's, and occupy very different marketplace positions.

Why do firms choose one strategy over another? In perfectly competitive international markets, firms take marketplace rules as given and seek to position themselves within the fixed parameters that are the marketplace. In imperfect international markets, however, firms face another option: to directly alter the structure of markets, or convince their governments to adopt policies which organize international markets in ways favorable to the firm. In other words, although economics may dominate strategy decisions in perfectly competitive markets, the ability for some firms and governments to shape imperfect international markets means that questions of politics are important determinants of firm strategies in these markets. I argue that firms choose one strategy over another depending on answers to four questions: (1) what are the competitive assets and capabilities of the firm, (2) what strategies are likely to be successful given the domestic political environment,[14] (3) what position the national government is likely to adopt vis-a-vis international regulatory rules, (4) what impact will national bargaining positions have on the shape and content of international markets? Although the four are related, the answer to the first depends primarily on given assets of firms (which may or may not be a function of existing regulatory arrangements), the answer to the second depends primarily on domestic politics, while the answer to the final two depend on both the bargaining positions adopted by national governments and the outcome of inter-state bargaining. Put another way, I argue that firms calculate the political and economic dimensions of international markets and launch strategies which are compatible with the win-set defined by both domestic political competition and international bargaining dynamics.

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Because these win-sets define the range of possible markets which firms will compete in, firms launch strategies with a fairly clear idea of the win-set defined by these parameters.[15] In what follows, I first discuss the impact of domestic politics on firm strategy before turning to a discussion of how international bargaining dynamics shape firm strategies.

2.2.1.1 Firm Strategy and Domestic Politics

Important sources of votes and campaign finances, firms are important players in the domestic political process. The influence of firms over foreign economic policy ultimately depends on the electoral calculus of politicians, however. Put simply, politicians must "grant access" to interest groups for these groups to directly influence policy outcomes.[16] For firms, the need to secure access from political leaders to shape policy outcomes means that political strategies (i.e. lobbying positions) must be tailored to meet the needs of both the firm and politicians. Of course, firms can lobby for whatever policy they want, but this would make no sense in the face of clear political signals that some policies are not politically possible. Why lobby for policies which politicians will obviously not enact?[17] Because politicians are concerned with electoral success--a goal which interest groups cannot deliver unless they help identify a policy bargain likely to be supported by a plurality of voters--firms must consider the broad political landscape when adopting strategies. Put differently, firms understand the win-set which is possible in light of electoral dynamics, and adopt strategies designed to succeed within the parameters of this win-set; both supporters and opponents of policy change thus pursue their interests in terms compatible with the broad electoral landscape.[18]

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Throughout the 1960's and 1970's, for example, BA and JAL occupied similar positions in their respective international aviation markets: both were heavily protected state-owned carriers which relied on their monopoly positions to support inefficient operations. In the early 1980's, however, dramatic changes in electoral dynamics in Great Britain led to a wide divergence in the strategies pursued by BA and JAL. In short, the importance of privatization and deregulation to the Conservative party meant that BA could no longer rely on state subsidies and regulatory relief to protect it from market competition. Thus, in the 1980's, BA pursued a vigorous plan of cost-cutting, undertook significant market-driven reforms, and concluded a series of alliances with airlines around the world. By the time of privatization in 1987, BA had shed as much as one-third of its total work force and was one of the most efficient airlines in the world.[19] In Japan, on the other hand, JAL continued to rely on the LDP to strictly regulated the Japanese domestic market and protect JAL's dominance in international markets. As a result of these divergent strategies, BA and JAL were vastly different airlines by the early 1990's. Thus, despite occupying similar marketplace positions at the end of the 1970's, different domestic political dynamics, in particular dramatic electoral shifts in the U.K., led to the adoption of very different strategies by BA and JAL.[20]

While firms endogenize the domestic political game and thus develop strategies that lie within the win-set defined by domestic politics, firms are not passive actors in the politics surrounding the adoption of national bargaining positions vis-a-vis international regulatory rules. Thus, the political game cannot be considered totally exogenous for firms. In particular, firm strategies and preferences shape the domestic political game in two key ways. First, firms are important domestic political actors which employ voters and contribute to the economic vitality of local economies. In

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short, because firms matter for the electoral success of some politicians, participation in the policy-making process enables firms to directly effect the calculus of domestic politicians. The second way in which firm strategies shape the calculus of national politicians is through the impact of firm strategies on the content of international markets. Although international regulatory rules delineate the rules of the international markets, they do not determine how firms will behave within a particular set of rules.[21] In other words, the structure of international markets is created by both government rules and firm behavior within these rules. But because firm activities in the marketplace (i.e. strategic alliances, charter airlines, equity stakes) are important determinants of the shape and content of the international markets, firm strategies alter the political costs and benefits of international institutions for national politicians, and thus condition the policy choices of national politicians. In Japan, for example, charter operations by JAL and ANA have defused demands for lower international airfares. These firm strategies, combined with the fact that only 7 percent of Japanese have traveled overseas and that much of the leisure travel is on charter flights to Hawaii, has lowered the political costs of strict regulatory control over the international aviation marketplace.[22] Of course, these economic moves are advantageous for JAL and ANA, but the point is that these moves condition the political calculus of Japanese politicians vis-a-vis international aviation markets.

The preceding discussion regarding the impact of domestic politics on firm strategies produces the following hypotheses:

Hypothesis 1: In states with domestic political institutions which provide incentives for national politicians to supply policies geared toward the median voter, firms will couch their preferences in terms compatible with the median voter. In states

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with political institutions which provide incentives for politicians to supply pro-producer policies, firms can openly oppose policies beneficial to the median voter.

Hypothesis 2: In states with parliamentary systems, firms will press their interests directly with regulatory agencies. In presidential systems, firms will tend to rely on the most efficacious point of access.

2.2.1.2 Firm Strategy and International Bargaining Dynamics

So far, I have argued two related points: (1) firms endogenize the domestic political game when adopting strategies, and (2) firms independently shape the political calculus of national politicians vis-a-vis regulated international markets. The first asserts that firms are strategic when lobbying politicians and launching strategies; the second maintains that firm lobbying and marketplace activities shape the political costs and benefits of international regulatory rules and thus condition national bargaining positions. Both of these arguments have been advanced in the context of domestic politics. However, because the parameters of international markets are established by governments through inter-state negotiations, international bargaining dynamics are also important determinants of firm strategies. As Knight points out, "social institutions affect the calculus used by rational actors to assess their potential strategies and to select their rational choice of action. These effects alter the chosen strategies and affects the outcomes..."[23] Ultimately, because the scope and content of international markets are dictated by international negotiations, firms consider international bargaining dynamics when adopting strategies.

To date, the trade policy literature has neglected the question of how international market forces shape firm strategies.[24] But international market forces are important because firms are concerned about competing in international markets and

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seek to position themselves within these markets. However, because international market forces shape the costs and benefits of particular strategies (i.e. a strategy designed for one market may fail in a different market due to different structure of supply or demand), firms must consider the economic and political landscape of international markets before launching strategies. This is particularly true in imperfect markets where some firms and governments can unilaterally alter the structure of international markets by adopting particular strategies. In the late 1970's, for example, the reversal of U.S. international aviation policy fundamentally altered the economics of aviation and forced a number of foreign carriers to adopt new strategies geared for the changed international aviation market. In particular, I argue that international market forces, the preferences of other states, and the rules to the status quo (i.e. the rules and decision-making procedures of existing international institution) shape international bargaining outcomes and thus condition the preferences and strategies of domestic economic actors and national politicians.

International market forces matter because the economic logic of international markets shape the economic costs and benefits of different strategies for both firms and national politicians. Questions of supply and demand, and the potential for regulatory arbitrage are important determinants of the economic costs and benefits of different strategies. In the Pacific, for example, there is no substitute for Japan as a central hub, and thus both Japanese airlines and the Japanese government do not fear that more liberal states in Asia will capture a growing share of intra-Asian traffic. In Europe, on the other hand, the presence of numerous competing hubs on the European continent has forced BA and the U.K. government to liberalize the U.S.-U.K. bilateral to avoid being marginalized in U.S.-European traffic flows. Market forces, in particular the potential for regulatory arbitrage by more liberal states, is thus an

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important component of the international marketplace which domestic actors consider when launching strategies.

The preferences of other states are important because marketplace rules are set by governments in bilateral negotiations. In theory, this means that all major states have market power; in practice, it means that international aviation markets are directly and explicitly structured by governments. Even for firms in powerful states, bilateral air services agreements meant that international markets cannot simply be imposed on unwilling states. The importance of the preferences of other states in determining the structure of international markets within which firms must compete means that firms consider the likely impact of these preferences on the shape and content of international markets, and adopt strategies designed to compete within this market. During the days of IATA, for example, airlines accepted that carriers from all states had to be satisfied with any outcome of IATA fare-setting conferences. Thus, at the meetings of the ad hoc working group on the North Atlantic, carriers met to discuss fares and rates well in advance of the actual fare-setting conferences in order to allow carriers to get a better picture of the views of other airlines and modify their proposals in light of the other airlines proposals.[25]

The rules to the status quo are important in two key ways. The first way the rules to the status quo matter is that they constrain firm behavior and limit the ability of firms to respond to new economic opportunities and challenges. In aviation, for example, international airlines have attempted to achieve network economies (economies of scope) by investing in foreign airlines, but have been hamstrung by regime rules that limit direct foreign investment in national carriers. Prevented from substantial direct foreign investment in national carriers, airlines have concluded complicated strategic alliances that attempted to secure network economies within the

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legal parameters of the existing international rules. As one airline official noted, "alliances are....a reasoned response to an antiquated regulatory system......(and) permit indirect access to restricted markets."[26]

The second way the rules to the status quo matter revolves around the institutional properties of existing regimes. As noted above, the structure and process of international institutions are important because structure and process shape the outcome of international bargaining. This is true because domestic politicians use structure to enfranchise particular sets of constituents and thereby condition marketplace outcomes in particular ways.[27] When seeking to change existing institutions and re-structure international markets, however, existing rules and decision-making procedures allocate political authority to particular actors and thus shape the process of regulatory change. Thus, the institutional properties of existing international regimes in large part determine the political landscape within which firms operate when launching strategies in international markets. Put differently, policy-making is not made tabula rasa and includes both procedural and political antecedents; firms understand what these procedural antecedents mean for likely marketplace rules, and adopt strategies in light of these dynamics.

As early as the 1960's, for example, the U.S. government began to push U.S. carriers to press for lower international fares at IATA fare conferences. But IATA fare conferences were governed by unanimity rules, and U.S. efforts were thus unsuccessful in securing any substantial reductions in international air fares. For U.S. firms, CAB pressure for lower fares led to no changes in their marketplace strategies simply because U.S. firms knew that U.S. government efforts to secure lower fares were unlikely to achieve any results. U.S. airlines thus continued to adopt marketplace strategies that rested on the assumption of high-fare international aviation markets,

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even thought the U.S. government was pushing for lower international fares. Why and how did U.S. airlines make this calculation? In short, the answer lies in the structure and process of IATA: unanimity rules meant foreign airlines could block U.S. pressures.

The preceding discussion on the impact of international bargaining dynamics on firm strategies produces the following hypotheses:

Hypothesis 3: When important political actors in foreign states oppose preferred international rules, firms will launch strategies designed to recruit political allies in foreign states. When important political actors in foreign states support regulatory change, firms will adopt strategies in light of the expected new marketplace rules.

Hypothesis 4: If the rules to the status quo make regulatory change difficult, firms will not expect regulatory change and will launch strategies based on status quo rules. When rules to the status quo make regulatory change likely, firms will adopt strategies in light of the expected marketplace which will result from regulatory change.

Hypothesis 5: When firms do not anticipate that international market forces will force foreign firms and their governments to accept regulatory change, firms will launch strategies in light of status quo marketplace rules. When firms expect international market pressure to force regulatory change, firms will launch strategies to compete under new marketplace rules.

2.2.2 National Governments: Domestic Political Institutions

While firms and other societal actors demand policies, governments supply them. As political actors primarily concerned with the electoral consequences of policy

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choices, politicians supply policies designed to secure electoral success. However, as I discussed above, international regulatory rules have distributional consequences which advantage particular actors at the expense of others. Thus, international regulatory policy cannot necessarily satisfy everyone. Yet government do create, maintain, and change international institutions and the markets they organize; what determines what types of institutions are created and how international markets are structured? The easy answer is that politicians create regimes to satisfy the demands of groups which are important for electoral success. But the challenge is specifying which societal groups are important without reference to observed policy choices. Meanwhile, politicians are not simply concerned with satisfying the demands of interest groups and firms--voters are also an important component of the electoral costs and benefits of policy choices.[28]

Given the problems with demand-side theories noted above, I include domestic political institutions in the analysis. Domestic political institutions, in particular electoral rules and the division of powers, are important because they set the rules to electoral competition and thus shape the electoral coalitions to which politicians are responsible.[29] Most importantly, domestic political institutions shape the political strategies necessary to secure electoral success and thus condition policy outcomes in systematic ways.[30] International regulatory policy is thus the result of the efforts of politicians to gain and retain political office with the structure of domestic political institutions.

Electoral rules are important because they shape electoral strategies (how parties and candidates win re-election) and thus condition both the supply of policy and how policy choices are communicated to constituents. In particular, electoral rules reward some electoral strategies while punishing others (i.e. certain politicians win elections while others lose) and thus provide clear incentives for politicians to supply

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certain types of policies rather than others. The major divide in the literature revolves around the degree to which electoral rules provides incentives for the provision of collective goods (clean air, a strong national defense or economic growth) or particularistic goods (pork-barrel) for electoral survival.[31] Under Japan's single nontransferable-vote (SNTV), for example, legislators rely on particularistic policies to benefit special interests as electoral rules generate incentives to cultivate cadres of loyal supporters.[32] In first-past-the-post systems, on the other hand, electoral rules induce a two-party system built around the pursuit of the median voter.[33] With a plurality necessary to secure electoral victory, parties build party labels by providing collective goods.[34] In the U.K., for example, legislators rely on collective goods party platforms to communicate with voters.[35]

Governments also differ according to the division of powers (i.e. parliamentary versus presidential systems). In presidential systems, divided powers increase both the number of veto points in the policy making process and the importance of particularistic policies for the legislature.[36] Because legislators are unable to reap the electoral rewards for collective policies (because both the president and Congress share responsibility for policy), legislators have incentives to provide local, particularistic policies. In the U.S., for example, legislators have difficulty claiming credit for collective policies which entail the participation of both the executive and the legislature.[37] Given different electoral calendars and different constituencies, the president and the legislature represent different interests and thus present multiple veto points in the policy-making process. Numerous veto points leads to formal and complex arrangements to manage bureaucratic agencies while at the same time making policy reversal more problematic than in unitary systems.[38]

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In parliamentary systems, on the other hand, the fusion of executive and legislative functions makes decision making easier and more flexible. With a single winning coalition controlling both the executive and the legislature, policy reversal is less problematic as there are no veto points to hinder policy making. Meanwhile, with a single principal capable of disciplining wayward agents, politicians can confidently delegate substantial discretionary authority to regulatory agencies.[39] Extensive delegations to opaque bureaucracies also increase the potential for political rents and thus enhance the influence of particularistic interests on policy outcomes.[40]

The preceding discussion on the impact of domestic political institutions on the preferences of national politicians produces the following hypotheses:

Hypothesis 6: When electoral rules provide incentives for politicians to produce policies geared toward the median voter, policy will tend to favor consumers rather than producers. When electoral rules provide incentives for politicians to cater to business interests, policy will tend to favor producers over consumers.

Hypothesis 7: Policy change will come quicker and be more complete in parliamentary systems than in presidential systems.

2.2.2.1 National Governments: International Bargaining Dynamics

I have argued that domestic political institutions shape the electoral coalitions which politicians must satisfy to secure re-election, and thus shape the electoral costs and benefits of policy choices, including international regulatory policy. Domestic political institutions are thus important for understanding the domestic political underpinnings of regulated international markets. However, because regulated international markets emerge from international bargaining, politicians must also consider the impact of international bargaining dynamics when adopting policies and

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launching strategies. I thus argue that international bargaining dynamics also shape the particular policies and bargaining strategies adopted by national politicians. Thus, like firms who calculate the expected outcomes of inter-state bargaining and launch strategies accordingly, politicians endogenize the impact of international bargaining dynamics. Rather than re-state the argument regarding how the international market forces, the preferences of other states, and the rules to the status quo impact the bargaining strategies adopted by national politicians, I refer the reader to the discussion of international bargaining dynamics and firm strategy in section 2.2.1.1 above.

It is important to note, however, that the impact of international bargaining dynamics on national bargaining positions is particularly important in the inter-state bargaining over the policy instruments to be contained in any potential international regime. Because they are interested in policy outcomes rather than institutional structures per se, governments develop substantive bargaining positions with an eye to the basic market outcomes which are desirable. However, because inter-state accords must be implemented by governments and firms, governments consider the problems of implementation and treaty compliance when adopting bargaining positions. In U.S.-U.K. bilateral aviation negotiations, for example, the U.S. has sought to remove all regulatory controls over international fares while the U.K. has sought to include a powerful competition authority with the ability to intervene in the market to set fares. For the U.S., the removal of the potential for government intervention is important because the U.S. fears that the U.K. government could use the competition authority to dampen marketplace competition. Put differently, the U.S. is concerned about future compliance by the U.K., and seeks to construct a regulatory structure with an eye to these future compliance issues.[41]

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In sum, the question facing national governments is simple: what rules and decision-making procedures are necessary for international institutions to produce the desired marketplace outcomes? The institutional requirements for particular market outcomes may not be efficient; indeed, state may create extremely inefficient international rules if these rules provide benefits for salient domestic constituents. Thinking about problems of implementation and compliance necessarily entails a strategic component: what are the preferences of other states that institutional arrangements must guard against (i.e. what types of opportunism must be safeguarded against?) and how will other states operate within a given institutional structure? Thus, in adopting strategies and bargaining positions, states are strategic and consider how issues of adherence and compliance require particular sets of institutional structures and thus result in desired marketplace outcomes.

The preceding discussion on the impact of international bargaining dynamics on firm strategies produces the following hypotheses:

Hypothesis 8: When foreign states oppose preferred policy outcomes, national politicians will adopt bargaining strategies to secure domestic political allies in the foreign state.

Hypothesis 9: When the rules to status quo make regulatory change impossible, national politicians will seek to change these institutions or eliminate their role in international markets. When some parts of international markets are governed by different rules, politicians will launch strategies in areas of international markets least constrained by the rules to the status quo.

Hypothesis 10: When international market forces can be used to alter the preferences of foreign partners vis-a-vis international rules, national politicians will adopt strategies designed to use international arbitrate.

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2.3 The Creation, Maintenance, and Change of International Regulations

As I noted in the Introduction, existing analyses of international institutions provide very little insight into the creation, maintenance, and change of international regulated markets. By providing an understanding of the political bargains underpinning international institutions and the markets they organize, the theory delineated above allows us to explain how, when and where political and economic pressures translate into the creation, maintenance, and change of international regulatory policy. In what follows, I tease out the implications of the argument advanced above for our understanding of institutional creation, maintenance, and change.

2.3.1 Institutional Creation

International institutions are created by states as international extensions of domestic political regulatory bargains. Because international institutions are primarily inter-state regulatory bargains driven by distributional considerations, the economic impact and political consequences of international marketplace rules are the primary impetus for how politicians choose to structure international markets. Because distributional considerations are the primary force driving the creation of international institutions, institutions are designed to produce market outcomes which benefit important domestic political actors. More specifically, national politicians attempt to organize international markets in ways which benefit the electoral coalitions which are necessary for them to secure re-election. Although states with significant market power have disproportionate influence over the shape and content of international markets,

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international regulatory policy emerges from the foreign policies of many states. The fact that international regulatory rules emerge from the foreign policies of many states, in turn, means that international bargaining dynamics are important for understanding the process of institutional creation. Indeed, because regulated markets emerge from these intensely political inter-state bargaining sessions in which national politicians attempt to create regimes which benefit important domestic constituents. Thus, even powerful states must rely on the cooperation of foreign partners to create international institutions.

2.3.2 Institutional Maintenance

If international institutions and the markets they organize are created to serve the interests of domestic coalitions, why are these arrangements so stable? In particular, why do regulated international markets so infrequently change, even in the face of significant technological, economic, and political changes? I argue that international regulatory arrangements are maintained because important domestic political actors benefit from their existence and thus oppose changes in the status quo. Once we understand international institutions as inter-state regulatory bargains, the question of institutional and market stability becomes a question about why status quo arrangements are supported by domestic political actors. I argue that international regulatory institutions persist for three major reasons: (1) individuals, firms, and other economic actors invest in institution-specific capital, (2) the economic and thus political uncertainty stemming from any potential regulatory change, and (3) the structure and process of existing institutional arrangements.[42]

International institutions define the shape and content of international markets. As the rules to the status quo, international institutions thus permit particular behavior

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and preclude others, and thereby structure international markets. Precisely because the rules to the status quo define the range of possible behavior, however, the behavior of individuals, firms and governments is conditioned by existing regulatory rules. Any changes in the status quo, however, upset existing strategies and raise the possibility that investment in institution-specific skills and goods will no longer be valuable. In the U.S., for example, domestic aviation regulation produced firms that lacked managerial skills but were heavily skilled in regulatory politics. Because the rules of the game meant political success in Washington D.C. office translated into marketplace success, regulatory offices were highly skilled while managerial capacity in marketplace activities was neglected. After deregulation, the airlines were unprepared for the new economic environment created by deregulation, and many carriers failed (Braniff, Eastern) as the airlines scrambled to develop the necessary managerial skills.

Because individuals, firms and other economic actors base their strategies on status quo arrangements and develop specific assets, these actors will have incentives to oppose any changes in the existing regime. Regulation necessarily alters the structure of the market from what it would have been absent regulation. As a result, certain actors benefit from regulation while others lose. More importantly, because certain parties benefit from regulation, regulation creates interests who have a stake in the existing set of rules. These actors can be counted on to oppose changes to existing institutions and rules precisely because the status quo is favorable to them.[43] In aviation, as we shall see in chapter three, the Bermuda regime produced marketplace outcomes which benefited the airlines and their employees, airport operators, major financial institutions, and aerospace companies at the expense of consumers and assorted other interests. These beneficiaries were opposed to altering the regime and were able to stifle change for a long time.

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In short, institution-specific investment by firms and other economic actors is an important source of stability for international regulatory arrangements. The introduction of regulation means that particular firms are advantaged over others in the short run. In the long run, however, surviving firms develop specific capabilities or strategies which are specifically designed to succeed under status quo rules. Altering existing arrangements necessarily means these investments would be less valuable or useful for firms. Even actors who are not specifically advantaged by particular international regulatory rules make institution-specific investments and decisions and thus have sunk investments in current regulatory arrangements: consumers fly on particular airlines on particular routes from particular airports while firms establish plants and operations near airports with frequent flights. This is particular true in capital-intensive industries like aviation, where the large sunk costs of networks designed for particular market structures generate widespread pressures against altering regulatory rules given the large sunk costs in the current regime.[44] Ultimately, the very fact that regulatory arrangements alter the marketplace from what it would be absent regulation means that large numbers of economic actors invest substantial resources in institution-specific resources, and these actors can be counted on to oppose changing existing institutional arrangements simply because new rules lessen the value of their current investments.[45]

Under the Bermuda regime, for example, airlines invested in large number of long-haul aircraft suitable for the restrictive rules that governed international markets. As new regulatory rules have made international aviation markets more competitive, however, the structure of aviation markets has changed. As a result, these long-haul fleets are no longer suitable for the short-haul nature of liberalized aviation markets.[46] As the Organization for Economic Cooperation and Development (OECD) notes,

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"(regulatory) change can leave carriers with fleets ill-matched to new market conditions. The natural reaction of those adversely affected is to seek some form of transitional protection so that at least some of the sunk costs may be recovered."[47] More broadly, the Bermuda regime also conditioned which routes airlines requested (and therefore received), which airports became international hubs, and even the intra-firm allocation of resources (i.e. regulatory divisions received a disproportionate share of managerial and financial resources). In London, for example, airlines are loath to abandon Heathrow Airport for the new Stansted Airport partly because they have made significant investments in building up their operations at Heathrow.[48] Likewise, in the late 1970's, BA argued against altering rules on fares and routes as airlines had developed their route networks in light of the existing rules. Thus, BA opposed regulatory changes on the basis that "airlines and their governments have a substantial interest in any modifications in this area."[49]

The second source of resistance to international regulatory change stems from the economic and thus political uncertainty stemming from any potential change. As Fernandez and Rodrik have pointed out, any policy change will engender resistance due to the individual-level uncertainty over the distribution of gains and losses as a result of the policy change.[50] In short, winners under current policies who stand to lose will oppose change are not balanced by the potential winners from the new policy due to the uncertainty surrounding who will win and the extent of the gains which will accrue as a result of the policy change. In aviation, for example, airlines might oppose regulatory change due to uncertainty over whether or not they will be competitive or uncompetitive in a deregulated market. Political opposition to policy change is thus created by the economic uncertainty over the distribution of gains and losses which will result from policy change. In sum, policy change always requires the support of

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potential winners to offset the political weight of would-be losers. But because there is uncertainty over who will win and the size of the gains, even potential winners may support status quo policies. As a result, there is a political bias towards the status quo.

For national politicians, existing international markets are structured so as to produce policy outcomes which are acceptable to salient domestic constituents. Altering these arrangements, however, will necessarily alter the distribution of gains and losses from international economic activity, and will thus require the construction of new domestic political coalitions to any new regulatory arrangements. Thus, politicians face a fundamental political problem when re-structuring existing international markets: how to reverse policy when reversal entails significant current costs to the beneficiaries of the status quo while producing future benefits for interests who are uncertain and often unaware of the potential gains from any new institutional arrangements.[51] In short, politicians are reluctant to alter status quo regulatory rules because current policies are electorally successful while new rules are completely unknown political territory.[52] This is especially true because politicians can also open up new areas of the marketplace, alter particular regulations or simply ignore particular aspects of regulatory rules. By tinkering at the margin, politicians can thus lessen the political costs of status quo arrangements without completely re-structuring existing international markets. In aviation, for example, the U.S. and most European governments liberalized the rules governing charter operations in the mid-1960's and thus effectively lessened consumer pressure for lower international fares while simultaneously maintaining the heavily regulated (and hence profitable) scheduled market for incumbent carriers.

In sum, politicians may oppose policy change as they are unsure over their position as political winners or losers as a result of the policy change. For politicians,

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international institutions and the markets they organize represent congealed political bargains which they are reluctant to change. Because re-structuring international markets requires re-formulating domestic political bargains in the face of substantial transaction costs and electoral uncertainty (i.e. will new arrangements be electorally successful?), politicians prefer to go with what has worked in the past unless there are substantial and clear electoral gains from new arrangements. This is particularly true because new regulatory arrangements threaten the extensive cross-subsidies which characterize almost all regulated markets and thus pose clear political problems for politicians.[53]

The final source of resistance to international regulatory change stems from the structure and process of existing international regulatory arrangements. As noted above, national politicians use the structure of regulatory arrangements to enfranchise salient domestic interests. Once international regulatory arrangements are created, however, the domestic political bargain supporting status quo arrangements is buttressed by the enfranchisement of beneficiaries of the regime in the structure and process of international institutions. In other words, politicians use structure to enfranchise domestic actors, but once in place this structure makes regulatory change difficult unless these enfranchised actors also support policy change. In aviation, for example, most national carriers were allowed to directly participate in the bilateral bargaining sessions that decided the rules to the marketplace. Likewise, the airlines themselves were explicitly delegated authority to set international fares at IATA fare conferences. Thus, the political coalition supporting the postwar regime was organized and enfranchised as a direct result of the creation of international institutions governing the marketplace. This enfranchisement makes subsequent regulatory change difficult, as the regulatory rules are explicitly designed to benefit these interests, and these

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interests are directly enfranchised in the policy-making process as a result of the existing institutions.

The argument I have advanced above regarding regime maintenance provides new insight into neoliberal institutionalist arguments concerning the persistence of regimes. Regimes reflect an underlying political bargain at time T_1; at time T_2, regimes are maintained because firms, economic actors and national politicians have significant stakes in the status quo and thus oppose regime change.[54] Because domestic actors launch strategies in light of the market created by the status quo regime, they support the status quo regime because they have made significant regime-specific investments. Unless major technological changes or other exogenous shocks fundamentally transform the marketplace and change the incentives of the various beneficiaries of the existing regime, political resistance to any regime change will be fierce from those actors with a stake in the status quo. Meanwhile, because re-structuring international markets is not costless nor can the consequences of altering the status quo be perfectly predicted, the uncertainty surrounding any institutional change will further bias outcomes in favor of the status quo.

2.3.3 Institutional Change

The rules governing international markets are necessarily supported by governments, either directly through the creation of particular international institutions or indirectly through tacit support for particular market-based agreements. This government support is conditioned upon domestic political support for status quo arrangements. Maintaining status quo regulatory arrangements becomes problematic, however, when domestic political support for existing international markets falters in states with significant market power. States with significant market power cannot

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simply foist new regulatory rules upon recalcitrant but less powerful states, however, and constructing or altering regimes requires the participation of major market participants. Market and political pressure from powerful market participants is important, to be sure, but the impact of international pressures to reformulate regimes depends on the political calculus of national politicians. In aviation, for example, U.S. pressures to alter the Bermuda regime could have been ignored if governments had been willing to provide uncompetitive national airlines with increasing subsidies to allow them to match the fares of competitive U.S. carriers. However, because U.S. pressure had domestic effects (as low fares were politically salient for both consumers and business while subsidies were politically unpopular due to the severe resource constraints faced by most governments in the late 1970's and early 1980's), U.S. pressure translated into significant liberalization of the Bermuda regime. How U.S. pressure translated into new foreign economic policy in other states, then, was a function of the domestic political calculus of national politicians.

Because domestic politics are the basis on which international regulatory policy is constructed, understanding why, when and how status quo international regulatory arrangements change thus requires elucidating the calculus of national politicians. In highly regulated markets such as aviation, regulatory change is especially likely to occur when beneficiaries of existing regulatory arrangements pressure governments to re-structure international markets. Indeed, because regulation provides "individuals and firms (with) legal rights to the status quo," international regulatory change is unlikely unless major beneficiaries of the status quo press for new regulatory arrangements.[55] In both the U.S. and Britain, for example, airlines were major political forces goading the reformulation of the Bermuda regime, while Japanese airlines have successfully opposed any significant liberalization of Japanese aviation

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markets.[56] Ultimately, domestic political considerations define when and how international institutions and the markets they structure are likely to change. Although international bargaining dynamics and the impact of market power on the calculus of domestic politicians are important for understanding the particular strategies which national politicians adopt to alter existing rules, the roots of regulatory change lie in domestic political dissatisfaction with existing methods of organizing international markets.

2.4 Conclusion

The argument advanced above highlights the institutional properties of international institutions and the distributional consequences of particular regulatory rules. International institutions are inter-state regulatory bargains which emerge from highly politicized inter-state bargaining, and should be understood as regulatory structures driven primarily by domestic politics. International regulatory rules delineate the size and content of the international marketplace and thus produce market outcomes which benefit certain market participants at the expense of others. More importantly, because international regulatory rules have economic effects in the marketplace which in turn have political consequences, the structure and process of international institutions are political questions which must be supported by the proper domestic political coalitions.

Understanding international institutions as inter-state regulatory bargains draws on notions of delegation and agency developed in both economics and political science. National governments collaborate in constructing international institutions--a set of arrangements structuring a particular international market--that have certain economic and therefore political effects. Governments dictate the structure and process

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of decision-making and the range of activities under the purview of the institution. What I argue, then, is that states intentionally create particular international institutions to organize international markets in ways designed to supply particular policy outcomes to domestic constituents. Having made this argument, I go on to argue that attention to the economic impact of international rules and the resultant domestic political action can help us answer the question of why international markets are organized in particular ways rather than others.

Understanding the economic effects and the resulting domestic political consequences of international regulatory rules is central for understanding the creation, maintenance, and change of regulated international markets. When economic and political forces press for institutional creation or change, the central question for politicians revolves around the electoral costs and benefits of altering status quo arrangements. With the electoral calculations of national politicians establishing the parameters of regulatory change, politicians will attempt to create or change international markets only if the political benefits outweigh the costs. International institutions and the market they structure tend to be stable, however, as both firms and governments make institution-specific investments which render altering status quo arrangements costly. Re-structuring international institutions is especially problematic as the beneficiaries of the status quo are politically organized and enfranchised as a result of the regulatory structure itself.

Ultimately, national politicians attempts to re-structure international regulatory arrangements when domestic political bargains underpinning these arrangements unwind. When the domestic coalitions supporting status quo international markets unravel, international rules are in doubt. As we shall see in the preceding chapters, new regulatory arrangements are particular likely when changes in domestic regulatory

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structures, technological developments, or economic changes alter the incentives of important market participants and thus create domestic political support for re-structuring international markets.

For the original statement that all markets are political creations, see Karl Polanyi, The Great Transformation (Beacon Press, Boston, MA), 1944.

[1]Knight argues that understanding institutional creation and change are necessary to explain institutions. Shepsle maintains that institutional selection (creation) and sustenance (maintenance) are the two relevant questions for explaining institutions. I maintain all three are important in the context of international institutions. See Jack Knight, Institutions and Social Conflict (Cambridge University Press, Cambridge, MA), 1992, and Kenneth Shepsle, "Studying Institutions: Some Lessons from the Rational Choice Approach," *Journal of Theoretical Politics*, Vol. 1, No. 2 (April 1989), p. 131-147.

[2]For applications in international relations, see David Lake, "Anarchy, hierarchy, and the variety of international relations," *International Organization*, Vol. 50, No. 1 (Winter 1996), p. 1-33, Beth Yarbrough and Robert Yarbrough, "International institutions and the new economics of organization," *International Organization*, Vol. 44, No. 2 (Spring 1990), p. 235-259, Beth Yarbrough and Robert Yarbrough, Cooperation and Governance in International Trade: The Strategic Organizational Approach (Princeton University Press, Princeton, NJ), 1992, and C.S. Eliot Kang,"Regulating Inward Foreign Direct Investment," *International Organization*, Vol. 51, No. 2 (Spring 1997), p. 301-333.

[3]Robert Keohane, After Hegemony: Cooperation and Discord in the World Political Economy (Princeton University Press, Princeton, N.J.), 1984.

[4]For a similar argument, see James Fearon, "Bargaining, Enforcement, and International Cooperation," Unpublished paper, March 1997.

[5]Knight, 1992, p. 126.

[6]Shepsle, 1989.

[7]Mathew McCubbins and Thomas Schwartz, "Congressional oversight overlooked: police patrols versus fire alarms," *American Journal of Political Science*, Vol. 2, No. 1 (February 1984), p. 165-179, Mathew McCubbins and Talbot Page, "A Theory of Congressional Delegation," in McCubbins and Sullivan, 1987, p. 409-425, Mathew McCubbins, Roger Noll, and Barry Weingast, "Administrative Procedures as Instruments of Political Control," *Journal of Law, Economics, and Organization*, Vol. 3, No. 2 (Fall 1987), p. 243-276, Mathew McCubbins, Roger Noll, and Barry Weingast, "Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies," *Virginia Law Review*, March 1989, p.431-482, and D. Roderick Kiewiet and Mathew McCubbins, The Logic of Delegation: Congressional Parties and the Appropriations Process (Chicago University Press, Chicago, IL), 1991.

[8] McCubbins and Schwartz, 1984, McCubbins and Page, 1987, McCubbins, Noll, and Weingast, 1987, and McCubbins, Noll, and Weingast, 1989.

[9]Shepsle, 1989, p. 139.

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[10]On the importance of structure for cementing political bargains, see Gary Cox and Mathew McCubbins, "Bonding, Structure, and the Stability of Political Parties: Party Government in the House," *Legislative Studies Quarterly*, XIX, No. 2 (May 1994), p. 215-231.

[11]See E. E. Schattschneider, Politics, Pressures, and the Tariff (Prentice-Hall, Englewood Cliffs, N.J.), 1935, Raymond Bauer, Ithiel de Sola Pool, and Lewis Dexter, American Business and Public Policy: The Politics of Foreign Trade (Atherton Press, New York), 1968, John Odell and I.M. Destler, The Politics of Anti-Protection (Institute for International Economics, Washington, DC), 1987, and Helen Milner, Resisting Protectionism: Global Industries and the Politics of International Trade (Princeton University Press, Princeton, NJ), 1988.

[12]Helen Milner and David Yoffie, "Between Free Trade and Protectionism: Strategic Trade Policy and a Theory of Corporate Trade Demands," *International Organization*, Vol. 43, No. 2 (Spring 1989), p. 1-36. For studies which attempt to elucidate the sources of firm preferences, see Vinod Aggarwal, Robert Keohane, and David Yoffie, "The Dynamics of Negotiated Protectionism," *American Political Science Review*, Vol. 81, No. 2 (June 1987), p. 345-366, and Milner, 1988. See also the discussion of firm preferences in Wayne Sandholtz and John Zysman, "Recasting the European Bargain," *World Politics*, Vol. 41, No. 1 (October 1989), p. 95-128.

[13]Following Verdier, I use the term firm strategies to refer to a broad set of political and economic activities which firms undertake in attempting to obtain desired outcomes in the marketplace. Although the term firm preferences has traditionally referred to the trade demands of firms upon government officials (i.e. exporters prefer free trade), it is not limited to these activities. See Daniel Verdier, Democracy and International Trade: Britain, Franc and the United States, 1860-1990 (Princeton University Press, Princeton, N.Y.), 1994.

[14]Verdier, 1994.

[15]Firms in small states may not anticipate international regulatory change as a result of domestic regulatory policies. As a result, their calculations may be slightly different than firms in states with significant market power. For a firm-specific argument, see Milner and Yoffie, 1989.

[16]John Mark Hansen, Gaining Access: Congress and the Farm Lobby, 1919-1981 (Chicago University Press, Chicago), 1991.

[17]For an argument which sees the institutional rules governing the granting of trade protection as endogenous to firm strategy, see Michael Moore and Steven Suranovic, "Lobbying vs. administered protection: Endogenous industry choice and national welfare," *Journal of International Economics*, Vol. 32 (1992), p. 289-303.

[18]Daniel Verdier, "The Politics of Trade Preference Formation: The United States from the Civil War to the New Deal," *Politics and Society*, Vol. 21, No. 4 (December, 1993), p. 363-392, and Peter Cowhey, " 'States' and 'Politics' in American Foreign Economic Policy," in John Odell and Thomas Willett, eds., International Trade Policies: Gains from Exchange between Economics and Political Science (The University of Michigan Press, Ann Arbor, MI), 1990, p. 225-251.

[19]On the effort to transform BA from an inefficient state-owned carrier into a world class airline, see Duncan Campbell-Smith, The British Airways Story: Struggle for Take-Off (Coronet Books, Great Britain), 1986.

[20]On BA's strategy in the 1980's, see "Air raid: British Air's bold global push," *Business Week*, No.

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3280 (August 24, 1992), p. 54-60, "From 'bloody awful' to bloody awesome," *Business Week*, No. 3127 (October 9, 1989), p. 97-99, and *Aviation Week and Space Technology*, January 25, 1993, Vol. 138, No. 4, p. 31.

[21] Jonathon Aronson and Peter Cowhey, Managing the World Economy: The Consequences of Corporate Alliances (Council on Foreign Relations Press, New York), 1993.

[22] For figures, see *Aviation Week and Space Technology*, May 13, 1991, Vol. 134, No. 19, p.36.

[23] Knight, 1992, p. 17.

[24] Although the literature on trade policy has amply demonstrated the impact of international market forces on the trade preferences of domestic actors, this literature concentrates on demonstrating how domestic economic and political struggles are derivative of international market forces. See the discussion above in Chp. 1, Section 1.2.2.

[25] IATA, Agreeing Fares and Rates: A Survey of the Methods and Procedures Used by the Member Airlines of the International Air Transport Association, Second Edition (IATA, Montreal), 1974, p. 25.

[26] Leo van Wijk, Managing Director, KLM Royal Dutch Airlines, as quoted in "Right Ends, Wrong Means," *Air Transport World*, January 1995.

[27] In other words, national politicians use the structure and process of international institutions to stack the deck in favor of salient domestic constituents. On using institutions to favor particular constituents, see Sharyn O'Halloran, Politics, Process, and American trade policy : Congress and the Regulation of Foreign Commerce (Michigan University Press, Ann Arbor, MI), 1990.

[28] This simple insight is the seminal contribution of Downs. See Anthony Downs, An Economic Theory of Democracy (Harper, New York), 1957.

[29] Rein Taagepeta and Mathew Shugart, Seats and Votes: The Effects and Determinants of Electoral Systems (Yale University Press, New Haven, CT), 1989, Gary Cox, The Efficient Secret (Cambridge University Press, Cambridge, MA), 1987, and J. Mark Ramseyer and Frances Rosenbluth, Japan's Political Marketplace (Harvard University Press, Cambridge, MA), 1993.

[30] See Ramseyer and Rosenbluth, 1993, and Cowhey and McCubbins, 1995.

[31] For an excellent review of the literature, see Gary Cox and Mathew McCubbins, , "Structure and Policy: The Institutional Determinants of Policy Outcomes," Paper prepared for The World Bank Conference on Administrative Procedures, June 20-21, 1996, La Jolla, CA.

[32] Ramseyer and Rosenbluth, 1993.

[33] Gary Cox and Frances Rosenbluth, "The structural determinants of electoral cohesiveness: England, Japan, and the United States," in Cowhey and McCubbins, 1995, p. 19-34.

[34] On the difficulties on building a majority coalition based on particularistic policies, see William Riker and Steven Brams, "The Paradox of Vote Trading," *American Political Science Review*, Vol. 67 (December 1973), p. 1235-1247.

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[35]Cox, 1987.

[36] For the development of this point in the context of regulation, see Morris Fiorina and Roger Noll, "Majority Rule Models and Legislative Elections," *Journal of Politics*, 41 (1979), p. 1081-1104, and Roger Noll, "The Political Foundations of Regulatory Policy," *Journal of Institutional and Theoretical Economics*, 139 (1983), p. 377-404.

[37]David Mayhew, Congress: The Electoral Connection (Yale University Press, New Haven, CT), 1974, Cain, Ferejohn, and Fiorina, 1987, and Gary Jacobson, The Politics of Congressional Elections, 3rd Edition (Harper Collins Publishers, New York, N.Y.), 1992.

[38]Randall Calvert, Mark Moran, and Barry Weingast, "Congressional Influence over policymaking: The case of the FTC," in Mathew McCubbins and Terry Sullivan, eds., Congress: Structure and Policy (Cambridge University Press, Cambridge, MA), 1988, p. 493-522, McCubbins, Noll, and Weingast, 1987, and McCubbins, Noll, and Weingast, 1989.

[39]On the problems of delegation, see Kiewiet and McCubbins, 1991, Chp. 2.

[40]Noll, 1983, and Roger Noll and Frances Rosenbluth, "Telecommunications policy: structure, process, outcomes," in Cowhey and McCubbins, p. 119-176. For discussions which explicitly links the ability of bureaucratic agencies to coordinate the claims of rival firms to avoid public political conflict with increased political strength of particularistic interests, see Frances Rosenbluth, Financial Politics in Contemporary Japan (Cornell University Press, Ithaca, NY), 1989, and Louis Pauly, Regulatory Politics in Japan: The Case of Foreign Banking (Cornell University East Asia Papers, No. 45, China-Japan Program, Cornell University, Ithaca, NY), 1987.

[41]Author's interviews with government and industry officials, Washington D.C. and London, 10/96-12/96.

[42]For a discussion of how economic uncertainty leads to a status quo bias, see Raquel Fernandez and Dani Rodrik, "Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty," *American Economic Review*, No. 81 (1991), p. 1146-1155.

[43] This is especially true as potential losses mobilize individual participation in interest groups. See John Mark Hansen, "The Political Economy of Group Membership," *The American Political Science Review*, Vol. 79, No. 1 (March 1985), p. 79-96.

[44]For a discussion of the issues of sunk costs and the problems of adjusting to new international regulatory rules in aviation, see , Organization for Economic Cooperation and Development (OECD), The Future of International Air Transport Policy: Responding to Global Change (OECD, Paris), 1997, Chp. 5.

[45]For a discussion of how regulation is specifically designed to give individuals a legal right to the status quo and thus protect their "investments" in the status quo regulated marketplace, see Bruce Owen and Ronald Braeutigam, The Regulation Game: Strategic Use of the Administrative Process (Ballinger Publishing Co., Cambridge, MA), 1978.

[46]OECD, 1997, p. 104.

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[47]OECD. 1997. p. 104.

[48]"The Unlocking of Heathrow; Cancellation of Time-distribution Rules at London's Main Airport Should Help it Stay the World's Busiest," *Air Transport World*, Vol. 28, No. 9 (September 1991), p. 28-29.

[49]Reply Testimony of Gerald Draper, Director Commercial Operations. British Airways. in CAB Docket No 32851, Exhibit BA-RT-1, p. 12.

[50]Fernandez and Rodrik, 1991.

[51]Becker argues that there is a status-quo bias in all regulatory arrangements because of the need to compensate competing interest groups for losses due to regulatory changes. In other words, regulatory changes imply that beneficiaries of existing policies must be compensated if any regulatory change is possible, and this compensation requirement results in a status quo bias. See Gary Becker, "A Theory of Competition among Pressure Groups for Political Influence," *Quarterly Journal of Economics*, Vol. 98, (1983), p. 371-400.

[52]Politicians also tend to supply favorable policies to existing supporters first rather than enact policies designed to attract uncommitted voters. This fact further exacerbates the risk-averse nature of politicians, and thus makes policy change even less likely. For a formal statement of this argument, see Gary Cox, Mathew McCubbins, and Terry Sullivan, "Policy Choice as an Electoral Investment," *Social Choice and Welfare*, Vol. 1 (October 1984), p. 231-234.

[53]Cross-subsidies exist when one segment of users "subsidizes" the price of a different segment of users. By setting particular regulatory rules, politicians can subsidize politically important users. Removing these subsidizes would increase the price for these important users. Thus, cross-subsidies are an additional political barrier to regulatory change. In the U.S., for example, the major barrier to domestic aviation deregulation revolved around the removal of the cross-subsidy to airlines to provide service to rural communities; once a solution to this problem had been achieved (direct subsidies to air carriers providing service), domestic deregulation was quickly achieved.

[54]Of course, if assets are perfectly fungible, then the costs to moving to any new system will be low. In practice, however, this is unlikely to be the case.

[55]Owen and Braeutigam, 1978, p. 2.

[56]On the U.S., see Daniel Kasper, Deregulation and Globalization: Liberalizing International Trade in Air Services (Ballinger Publishing Company, Cambridge, MA), 1988; on the U.K., see Campbell-Smith, 1986. It is important to note that firms are only one part of the story. For a detailed analysis of the politics of these markets, see chapter 4-6 below.

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Chapter 3: The Political Economy of the Bermuda Regime

3.0 Introduction

In the aftermath of World War II, states created a set of international institutions which dictated the rules governing international aviation markets. Governments set capacity and conditions of services via bilateral government-to-government agreements, while the airlines were delegated authority to set international air fares. Governments also nationalized their airlines, except in the U.S., and relied on their national flag carriers to provide both domestic and international air services for national citizens. These regulatory arrangements produced a de facto cartel which provided high prices and standardized services to consumers everywhere. In the 1970's, however, dramatic changes in aviation technology altered the incentives of important economic interests and ultimately led to substantial support for liberalizing the regime. Important aviation states subsequently attempted to re-structure international aviation markets, and substantial liberalization of international aviation markets has taken place.

The history of the post-war aviation regime raises a number of interesting empirical puzzles. Why did states choice to organize international aviation markets as a cartel in the aftermath of World War II? Why were these arrangements stable for over 30 years? Why did the U.S. withdraw support from the postwar arrangements and seek to break the cartel in the late 1970's? In this chapter, I seek answers to these questions.

I argued in chapter two that international institutions are fundamentally inter-state regulatory bargains created by national politicians to set rules to international

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markets that serve the interests of important domestic political constituents. This suggests that investigations of international institutions and the rules they dictate should focus on the domestic political underpinnings of international institutions and not, as has usually been done in previous literature, on the impact of international institutions on state behavior. In other words, the analysis should focus on how domestic politics impact the rules and decision-making procedures of international institutions and thus structure international markets. This chapter begins my analysis of international aviation markets by examining the rules governing international aviation markets from 1946-1978--i.e. the Bermuda regime.[1]

The analysis is presented in four sections. Section one discusses the bargaining over the institutional arrangements which would govern postwar aviation markets. The section highlights the primacy of economic interests and domestic politics on the bargaining positions of the U.S. and the U.K., and on the regulatory arrangements ultimately created. Section two delineates the regulatory arrangements governing the postwar aviation market in more detail. This section examines the institutions governing the international aviation marketplace and provides a political economy analysis of the economic impact of the international rules dictated by these institutions. The analysis thus outlines to international institutions created by states after World War II, examines ho these institutional arrangements defined the rules of international aviation markets, and examines the economic impact of these rules. Overall, then, the analysis thus emphasizes the economic impact and the resultant domestic political consequences of international regulatory rules.[2] Section three discusses the economic and political forces which undermined the Bermuda regime in the 1970's. The final section concludes.

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Before proceeding, it is worth noting that the analysis is self-consciously broad, and does not attempt to test the specific propositions regarding firm strategy and domestic politics advanced in chapter two. Rather, the analysis is intended to demonstrate four key propositions: (1) domestic politics in key aviation states led to the creation of specific international institutions, (2) these institutions were self-consciously created by governments to establish a particular set of rules in international aviation markets, (3) these rules structured international aviation markets in particular ways, and were designed to benefit important domestic political constituents, and (4) that technological, economic, and political changes emerged in the early 1970's that provided political support for liberalizing international aviation markets. With the regulatory arrangements examined in this chapter as the baseline, later chapters will demonstrate how the arguments concerning firms and national governments advanced in chapter two shape particular international aviation markets.

3.1 Bargaining over Postwar Arrangements

Although intra-European international air travel was governed by the 1919 Paris Convention and the U.S. signed the multilateral Havana Convention governing air services in the Western Hemisphere in 1928, no comprehensive arrangements governing trade in international aviation services existed prior to World War II. Despite the lack of international arrangements, numerous regional aviation organizations and agreements were concluded in the interwar years. These organizations concentrated largely on coordinating the technical aspects of aviation, although the International Air Transport Association (IATA) did undertake commercial activities in Europe. However, only immediately prior to World War II did IATA made

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moves to become a truly international organization by admitting Pan American Airlines.[2]

During the war, the increasing economic importance of international aviation and the clear security implications of aviation prompted concerns concerning postwar aviation arrangements. As early as 1943, Churchill and Roosevelt discussed postwar aviation arrangements while informal discussions between Britain and the Dominions began to take place. These early U.S.-U.K. discussions ultimately led to the Chicago Convention in November 1944.

At Chicago, the representatives of more than 50 states gathered to discuss the structure of the postwar aviation regime.[3] Although New Zealand and Australia, Canada, Great Britain, and the U.S. submitted four distinct proposals, the debate at the Convention quickly broke down into a debate over two fundamental aspects of the postwar international aviation marketplace: the degree of internationalization of the industry and the degree of competition in the marketplace.[4] The proposals put forth by New Zealand and Australia, Canada, and Great Britain all called for some form of internationalization in the industry and limits on international competition. The New Zealand and Australia proposal went furthest, calling for the creation of an international aviation authority which would be responsible for the operation of air services and which would own both the aircraft and the ancillary equipment utilized by the airlines.[5] The Canadian and British proposals both envisioned an international authority akin to the U.S. Civil Aeronautics Board (CAB), with the British even less enthusiastic regarding competition than the Canadian proposal. The aberration was the U.S. proposal, which advocated national ownership and competitive international aviation markets.[6] Faced with divergent plans for the structure of international aviation markets, the Conference quickly broke down into a struggle between the U.S. and the

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U.K. proposals, with the major sticking point revolved around the rights of U.S. airlines to fly from the U.K. to European destinations (i.e. fifth-freedom rights).[7]

i. The U. K.

Afraid that U.S. airlines would quickly dominate both the North Atlantic and intra-European routes if granted extensive fifth-freedom rights, Britain, backed by France, Norway, Portugal, Australia and New Zealand, pushed for a restrictive arrangement which would assure European carriers of sufficient traffic. Arguing that strict regulatory control and micro-management were necessary to ensure the viability of national carriers, Britain pressed for international control of capacity, fares, and landing rights. The British proposal called for an international authority to regulate the number of flights each airline could make, allocate the percentage of traffic each country's airlines could carry in a given region, and even exclude certain countries from particular routes.[8] While U.K. negotiating positions were clearly designed to safeguard U.K. national carriers from more efficient U.S. airlines, the U.K. also saw a regulated international marketplace as key to the development of the international industry as a instrument of national policy. As a British policy document put it, "governments have special interests in the development of air transport and that some kind of regulation of the airlines is necessary to secure these aims of national policy."[9]

When U.S. negotiators balked at the strict regulatory apparatus favored by U.K. negotiators, Britain attempted to create its own multilateral aviation agreement by negotiating a series of agreements with the Dominions to secure a regulated market within the British empire. Although the long range of today's jets makes landing rights less important, the limit range of aircraft and the large number of landings controlled by the British empire in the immediate aftermath of World War II made the British

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attempt to construct a "market-within-a-market" with her colonies a viable strategy. In short, aircraft technology and the vast size of the British empire made the U.K. a necessary partner in any agreement on international aviation.

ii. The U.S.

Prior to World War II, the U.S. government played no role in negotiating international aviation agreements. With Pan Am serving as the de facto "chosen instrument" of the U.S. government, Pan Am negotiated directly with foreign governments for aviation rights.[10] Aviation received considerable attention in the planning for the postwar world, however, and Roosevelt and his advisors maintained that open international aviation markets would help secure the postwar peace. Arguing that aviation was central for both national security and international commerce, Roosevelt hoped a multilateral aviation arrangement would forestall the emergence of the conflictual and monopolistic arrangements which had controlled international aviation before the war.[11]

At Chicago, the U.S., backed by most of the South American countries and The Netherlands,[12] pressed for national control of airlines and a competitive international marketplace. With its airlines left unscathed by the war and controlling 72 percent of world air traffic, the U.S. wanted a competitive international marketplace and extensive fifth freedom rights to take advantage of clear marketplace superiority.[13] While internationalists such as Wendell Wilkie and Vice-President Henry Wallace saw a World Airlines under the control of the United Nations as a key element in the construction of peace in the postwar era, Pan Am and the domestic airlines pressed for national control of airlines and international regulatory arrangements favorable to their interests.[14] With internationalism seen as a winning political strategy and the airlines

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pressing for regulatory arrangements favorable to their interests, the question became how to balance the needs of internationalism while supplying regulatory arrangements satisfactory to the airlines.[15]

For the airlines, the major divide was between Pan Am and the eighteen domestic carriers.[16] The eighteen domestic carriers were unwilling to stand by and watch Pan Am spread its Latin American monopoly to the emergent North Atlantic and the Pacific markets. To make its cause known to the U.S. government and to counter-balance the substantial Congressional support enjoyed by Pan Am, the domestic carriers formed the Airlines Committee for U.S. Air Policy. The primary goals of the domestics were two-fold: (1) entry into the international marketplace, and (2) protection from cut-throat Pan Am competition in both domestic and international markets. Preferring regulated competition over a competitive international marketplace,[17] the domestics preferred hampering Pan Am even if this meant limiting entry into the international marketplace.[18]

Pan Am, on the other hand, had been the de facto chosen instrument of the U.S. government in international aviation since the beginning of scheduled mail service to Latin American in the late 1920's. At Chicago, Pan Am lobbied to maintain the monopoly which Pan Am had enjoyed during the interwar period, and argued that allowing additional U.S. airlines into the international aviation marketplace would hurt U.S. airlines vis-a-vis foreign flag carriers.[19] Although hostile to the entry of the domestics into the international marketplace, Pan Am President Juan Trippe was even more strongly opposed to fare controls which would hamper his ability to offer low fares to undercut any new entrants. Figuring he could drive any new competitors out of the most lucrative markets by offering lower prices, Trippe preferred capacity controls to fare restrictions.[20]

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iii. The Bermuda Compromise

Ultimately, the British and American positions proved irreconcilable. Although the Convention did create the International Civil Aviation Organization (ICAO) and adopted the International Air Services Transit Agreement (IASTA), which established basic safety and technical standards and guaranteed first and second freedoms (the right to transit the airspace of other signatories and to make technical (non-traffic) stops, respectively), no multilateral agreement on air rights was concluded.[21] With no multilateral agreement on such basic issues as capacity and fares, the U.S. and the U.K. turned to bilateral negotiations and the airline industry itself to organize the international aviation marketplace.

Even before the end of the Chicago Convention, airline officials realized that a failure to conclude a multilateral agreement on international fares would allow airlines a much greater role in organizing international aviation markets. Eager to fill this regulatory loophole, airline executives launched the International Air Transport Association in December 1944, and called a meeting of airlines in Havana in April 1945.[22] While the airlines established fare-setting procedures to set international fares at Havana, the U.S. and the U.K. met in Bermuda in January, 1946, to hammer out the terms of their bilateral aviation relationship.

The bilateral agreement which emerged from Bermuda contained key elements to satisfy both the U.S. and the U.K. For Britain, the bilateral limited capacity, fifth-freedom rights, and change of gauge (the ability for U.S. airlines to use a smaller aircraft for the London-Europe leg of a flight), and also provided for IATA control over fares. IATA control over fares was the major British victory at Bermuda.[23] Indeed, because unanimity rules at IATA fare-setting conferences guaranteed that

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prices would be set high enough to maintain even the least competitive airline, the Bermuda agreement secured the economic viability of British carriers. Combined with the restrictions on capacity, fifth-freedom rights, and change of gauge, the Bermuda agreement effectively guaranteed that Pan Am and TWA could not displace British airlines from either North Atlantic or U.K.-European markets.

For the U.S., the Bermuda agreement secured British agreement to the principle of fifth freedom rights and included some limited concessions on capacity restrictions and change of gauge. Initially, Britain had been totally opposed to both fifth-freedom rights and change of gauge, but U.S. bilateral agreements with Holland and Ireland[24] and the linkage between aviation issues and U.S. loan guarantees to cover British balance of payments problems led the U.K. to soften its opposition to fifth-freedom rights and change of gauge provisions.[25] For U.S. airlines, the agreements on fifth-freedom rights and change of gauge provisions were crucial for both technological and economic reasons. Technologically, the limited range of postwar aircraft limited the miles between stops and thus required frequent landing sites. Given its' position off the European continent, London was the obvious and most desirable hub to serve as a stopover for a large number of final European destinations. This was especially true as the U.K. was the largest aviation market, and thus required much larger planes than did other European destinations. As such, U.S. airlines required both fifth-freedom rights and change-of-gauge in order to be competitive with British airlines on both U.S.-U.K. and U.S.-European routes. In securing even limited U.K. agreement on these points, American airlines secured rights to carry U.S.-originating passengers to final continental destinations in aircraft suitable for these markets.

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Despite obtaining significant concessions from the British side, the U.S. ultimately agreed to international regulatory arrangements which created strictly regulated international aviation markets, an outcome very different from initial U.S. proposals for a more competitive international marketplace--hardly an outcome that supports realist arguments about international institutions. U.S. dissatisfaction was especially apparent regarding the fare-setting authority delegated to IATA. Although most scholars argue that the outcome reflected the preferences of the U.K. more closely than the preferences of the U.S., the bargaining outcome actually reflected the domestic political needs of both U.S. and U.K. politicians. In the U.S., the agreement satisfied the interests of both Pan Am and the domestics: Pan Am was allocated the lion's share of international routes, but some domestic carriers were allowed limited entry. Strict regulatory control over entry, and IATA fare-setting conferences also satisfied both Pan Am and the domestics. U.S. regulators restrained direct competition by limiting market entry to a single airline on each route unless market conditions ensured that the route could support multiple U.S. carriers and foreign competition. Coupled with IATA control over fares, U.S. international aviation policy essentially guaranteed the economic viability of both Pan Am and the new entrants. IATA control over fares was particularly popular with U.S. domestic airlines, although both Pan Am also supported the use of IATA to set international fares.[26] In addition to airline support for the Bermuda agreement, the accord was also widely supported in both Congress and the White House.[27] With peaceful commercial development of aviation seen as crucial to avoiding trade wars and thereby contributing to avoiding the economic nationalism which had spawned the Depression and World War II,[28] international aviation was considered an important part of global economic recovery. This was particularly true as U.S. politicians viewed the dollar exports generated by

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international travel as an important, albeit partial, solution to the problems of a worldwide dollar shortage. Thus, the Bermuda regime resonated well with an electorate supportive of international arrangements to secure both economic growth and political security while simultaneously providing an ample supply of private goods for politicians to distribute to local constituencies.[29]

In the U.K., the regime guaranteed the existence of the major British carrier while allowing the newly elected Labour government to obtain the very necessary balance of payments loan from the U.S. Moreover, by allowing the airlines themselves to control fares via IATA, the Bermuda agreement essentially guaranteed the survival of the British international carrier while at the same time lessening the demands which the government-owned carrier might place on the state treasury. Delegation of control over fares to IATA was thus at the heart of U.K. satisfaction with the Bermuda agreement. Meanwhile, fare control served as the ideal compromise between the U.S. and the U.K.: both U.S. domestic airlines and U.K. international airlines supported fare control as a method to guarantee their survival in the face of the low fares which Pan Am's Juan Trippe threatened if the Pan Am monopoly on U.S. international routes was broken.

This section has established that domestic political considerations were the central force driving the bargaining positions adopted by the U.S. and the U.K., and the institutional arrangements provided by the 1946 U.S.-U.K. Bermuda bilateral. As the two most important and largest aviation markets in the world, the Bermuda bilateral quickly became the standard format for all future bilateral agreements, including the provisions delegating fare-setting authority to IATA.[30] These findings demonstrated two key points about the creation of the institutions governing postwar aviation markets: (1) realist explanations cannot explain why the U.S. was unable to secure its

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preferred outcome, and (2) concerns about the economic impact of different marketplace rules, not concerns about the problems of coordinating international market to produce gains for all states, were the central determinants of the bargaining positions adopted by the U.S. and the U.K., and the rules ultimately agreed upon. In the next section, I provide a more detailed analysis of the postwar institutional arrangements and demonstrate the rules dictated by these institutional arrangements. Once we understand how particular institutional rules and decision-making procedures set the rules governing international markets, it is possible to ask questions--and provide answers--about the domestic political bargains underpinning these institutional arrangements--a task I take up this in section 3.3.

3.2 The Bermuda Regime

Although there was always some grumbling regarding the division of spoils, the Bermuda regime governed trade in international aviation services until the mid-1970's. As in other service industries, aviation was governed by a set of regulatory rules which produced local monopolies protected by a de facto international cartel. With entry, capacity, and routes set via bilateral agreements and fares set by IATA, most countries created state-owned national carriers for international air travel and coddled these national carriers through domestic regulatory structures and restrictive international agreements.[31] Meanwhile, because affordable domestic aviation services were the primary goal of international regulations, international traffic subsidized domestic service while trunk lines subsidized local services--thus providing nearly universal domestic service at reasonable prices.[32] In the U.S., for example, the regulatory scheme envisioned by the 1938 Civil Aeronautics Act was designed to

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allow airlines to subsidize money-losing local routes with the profits from long-haul routes.[33]

The importance of national sovereignty over airspace and the point-to-point nature of international air travel made bilateral agreements necessary for international air travel. Clearly, without some arrangements for foreign airlines to flow over sovereign airspace and land at national airports, no international air travel was possible. However, multilateral coordination was also crucial to the development of international air travel. As contradictory bilateral agreements could easily have led to inefficient route patterns, states utilized IATA, the association of international airlines, to coordinate fares and thus prevent individual bilateral agreements from upsetting the regime. More specifically, multilateral fare-setting precluded bilaterals from encouraging traffic diversion and inefficient route structures by preventing counties from setting low fares which would encourage indirect route structures by diverting traffic from more expensive, direct routes.[34] By coupling bilateral agreements with a multilateral fare-setting apparatus, the regime facilitated global coordination while allowing states to maintain domestic monopolies and tightly regulated international markets.

The Regime's Institutions

The central institution of the Bermuda regime were the bilateral agreements modeled on the 1946 U.S.-Great Britain Bermuda I agreement. Arising in the wake of the failure of the Chicago Convention to produce a multilateral accord, the bilaterals dictated terms of entry, exit, and capacity. The bilaterals also included very detailed rules on the nature of services, including the size of planes to be flown, the total number of passengers allowed, and even the times of arrival. Pricing was explicitly

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delegated to IATA in the bilaterals, although rates were still subject to the approval of both states (double approval pricing). All other aspects of the marketplace, including the specific routes to be flown and airports to be used, were dictated in the bilaterals. The bilaterals also usually included private side-agreements between airlines, which generally provided for further capacity restrictions and delineated the terms of revenue sharing (pooling). Many bilaterals also required that foreign carriers utilize the maintenance, service and sales staff of the domestic carrier. Although all airline activities were subject to the ex-post approval of national governments, airlines in essence set the terms of their own traffic and capacity arrangements in consultation with the designated carrier of the other nation.[35] Overall, the bilaterals served to guarantee airline revenues and limit competition on international routes.

Accompanying the Bermuda bilaterals were IATA and the International Civil Aviation Organization (ICAO). In general, ICAO set non-commercial standards while IATA dictated standards on economic issues.[36] ICAO, established at Chicago in 1944 to replace the International Commission for Air Navigation (ICAN), is a multilateral organization responsible for technical coordination in the industry. ICAO, in consultation with IATA and national authorities, is responsible for establishing basic technical standards for communications, navigational and landing aids, airports, flight crew training standards, and even the procedures for airlines to follow to minimize noise pollution.

IATA assists ICAO in establishing technical standards and thereby improving industry coordination and efficiency. Established at Havana in 1945, IATA prescribes guidelines and procedures for passenger and cargo forms, baggage handling, reservations, ticketing, scheduling, and airport handling. IATA also dictates protocols for interlining passengers, undertakes research related to international aviation, and

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licenses travel agents to sell tickets. Finally, IATA maintains a financial clearing center for airlines to settle interline accounts (payments by airlines to each other for services provided to passengers who travel on more than one airline), accounts between airlines and travel agents (the Bank Settlement Plan) and accounts between airlines and cargo agents (the Cargo Account Settlements System).[37]

The most well known role of IATA in international aviation markets are its fare-setting activities.[38] Explicitly granted authority over fares in almost all bilaterals, IATA also established terms of service for almost all aspects of aviation services, including everything from the number of flight attendants to the size of in-flight sandwiches. Indeed, one of the most famous IATA stories emerged when the Scandinavians were accused of cheating by serving smorgasbord rather than standard IATA sandwiches.[39] Although governments retained the right to approve or disapprove IATA fares, de facto this rarely happened until the 1970's. Meanwhile, even in the event of a government veto, IATA retained the right to reconvene and set new fare levels acceptable to governments.[40]

Principles and Norms

The aviation regime rested on the principle that national control of the airlines and regulated international competition were the best way to secure the efficient development of international aviation markets. This reflected a belief that regulation and controlled competition were necessary to avoid excessive competition, take advantage of economies of scale, and thereby ensure the development of reliable and affordable air travel.[41] The principle required local ownership of airlines and restrictive domestic regulatory structures which were necessary to support the de facto

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international cartel. The principle implied three major norms: national sovereignty over airspace, strict reciprocity, and standardized services.

i. National sovereignty

National sovereignty over airspace was the most important norm of the regime.[42] As early as 1919, at the Paris Peace Convention, states agreed that each state was endowed with "complete and exclusive sovereignty over the airspace above its territory."[43] At Chicago, the norm of national sovereignty was further re-enforced when the first two freedoms of the air were established but all other commercial freedoms were left to be negotiated on a bilateral basis. National sovereignty and the subsequent negotiation of landing rights via bilateral agreements allowed regulatory authorities and the airlines they coddled to claim that they provided a public utility rather than an economic service.[44] As Secretary General of the Association of European Airlines Karl-Heinz Neumeister noted,

> It remains a fact that scheduled air transport is a public utility. That means the airline has certain responsibilities, one of which is to provide a service according to a published schedule, irrespective of whether there is sufficient demand for a given flight. With such obligations, it is quite normal to receive some compensation in return. This is usually expressed by limiting the number of airlines on a route.[45]

National sovereignty meant that each nation had to conclude bilateral agreements with foreign partners for the exchange of landing rights. Bilaterals were thus viewed as exchanges of rights between sovereign nations, and airlines were granted landing rights at specified international gateways in exchange for similar privileges in other states. National sovereignty thus re-enforced state involvement in the airline industry and de facto forced governments to guarantee the economic

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survival of national airlines. With entry into international markets determined by bilateral negotiations and the subsequent allocation of routes, the regime rendered airlines totally dependent upon governments (i.e. the allocation of routes) for their livelihood. Meanwhile, states accepted responsibility for the development and growth of international aviation. With the airlines dependent on states for permission to serve international routes and governments dependent on airlines for the growth and development of the international marketplace, government regulators and the airlines became intricately linked. In most states, for example, the local authority allocating airport slots was run by employees of the state airline on loan to the public authority. Thus, although most airlines were already state-owned[46] and relied upon government protection in both domestic and international markets, the regime re-enforced the status quo by making states the gatekeepers of the international marketplace.

ii. Strict Reciprocity

Bilateral negotiations over air rights were guided by the principle that all agreements would be based on the equal exchange of economic benefits. To ensure this, the bilaterals included both public and private arrangements which guaranteed that no national airline could accrue disproportionate gains from inter-state air travel. Strict reciprocity thus entailed granting permission for particular routes and capacities in exchange for commensurate routes and capacities. Permission to compete in the market was not at stake; there was no competition. Rather, strict reciprocity entailed a commitment to allow foreign airlines to fly particular planes into particular airports at particular times in exchange for very similar privileges for national carriers. In short, strict reciprocity guaranteed the viability of national carriers.

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Strict reciprocity also entailed a commitment to completely voluntary arrangements and consensus decision-making. Any and all arrangements provided for either national airline or government veto over the allocation of marketplace rights. This was especially important given the central role of governments in negotiating commercial access to national airspace. As IATA argued in the wake of U.S. attempts to liberalize international aviation markets, "it should be recognized that aviation worldwide is different from most business involving services or commodities....This interdependence implies the need for a common approach toward international relationships rather than confrontation provoked by unilateral action."[47]

iii. Standardized Services

The most well known face of the regime involved the various technical and service standards which were established by IATA and ICAO. As noted above, IATA and ICAO were active in establishing guidelines and procedures for both airlines and passengers that ultimately standardized almost all aspects of international air travel and thus contributed to the growth of international aviation markets. Although the rules governing airline behavior did indeed facilitate the development of international travel and make travel easier for passengers, the rules also ensured that no carrier could obtain unfair competitive advantage while abiding by IATA and ICAO rules. Indeed, IATA fares were set high enough to support the operations of all national air carriers, even carriers with excessively high cost structures.[48] With all IATA airlines offering similar services and at similar prices, the possibilities for competition were few and far between.

Rules and Decision-Making Procedures

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Bilateral agreements established the rules governing international aviation markets. Most bilateral agreements included provisions for only a single airline (single designation) to provide international service, and even multiple designation bilaterals strictly limited the number of airlines on any given route. Meanwhile, even if the bilateral included provisions for multiple designation, airlines were required to obtain permission from their national governments to enter the market. National governments, in turn, were reluctant to allow large numbers of entrants due to the negative impact on incumbent carriers. The bilaterals thus provided that both national governments to any bilateral agreement could block new entry into international markets.[49] Almost all bilaterals explicitly delegated authority over fare-setting to IATA, a move which gave IATA tremendous regulatory power and served to preclude competition and thereby guarantee airline revenues.

While bilaterals provided one set of rules and decision-making procedures, IATA provided a second set of international regulatory rules. IATA used a simple one-airline, one-vote system with unanimity rules.[50] Unanimity obviously meant that any fare schedule required the agreement of all voting airlines before a fare schedule could become effective.[51] By granting veto power to all members, IATA rules made changing existing fare levels extremely difficult quite simply because inefficient airlines could veto any low-fare proposals. In practice, IATA decision-making procedures produced a heavy bias in favor of status quo fares and essentially guaranteed high fares for international travel.

Fare conferences were divided into three geographical areas, with each area having its own fare-setting conference within the larger IATA conference. Importantly, IATA conferences did not set all international air fares, but rather negotiated a basic skeleton of fares upon which all other fares were calculated. Conferences thus set fares

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for a limited number of important routes, and all other fares were calculated based on these negotiated fares (according to strict IATA guidelines). These guidelines, in turn, "attempted to ensure that the results (i.e. fares) are similar for all carries and thus eliminate competitive advantages for journeys by different Member airlines between the same pair of points."[52] In short, fares were set to eliminate the potential for price competition. In addition, in almost all cases airlines were able to place escape clauses which permitted cancellation of agreed-upon fares if there are material changes in the economic conditions which existed when the agreement was signed.[53]

3.3 The Political Economy of Bermuda

The previous section outlined the institutional arrangements governing international aviation markets and outlined how the structure and process of Bermuda institutions set the rules to international aviation markets. To reiterate, the Bermuda regime tightly controlled entry and capacity on both domestic and international routes, allowed airlines to set their own fares, and thus generated monopoly rents for particular marketplace participants. More specifically, the Bermuda regime was a politically-constructed cartel which allowed some marketplace participants to reap large rents. Cartels are hardly efficient economic arrangements, however, and it is difficult to argue that the de facto cartel created by the Bermuda institutions was simply an effort by states to organize international markets in order to provide utility gains for all players in the game. Meanwhile, who received the rents generated by the Bermuda institutions, and why were international aviation markets structured in a way designed to produce these rents? The argument advanced in chapter two leads me to seek answers to this question in the domestic politics of major market participants. This section thus takes up this task, and seeks to outline the broad domestic political

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bargains on which the Bermuda regime rested. Note that I do not argue that the underlying domestic political bargain in all states was identical, just as I did not argue that all states adopted identical aviation policies in the previous section. My point in this section is thus not to delineate policy-making in any particular state, but rather to paint the broad parameters of the political bargain underpinning the Bermuda regime.

The beneficiaries of the Bermuda regime included incumbent carriers, airline employees, aircraft manufacturers and their financial institutions, airport operators, and rural consumers. The most prominent losers included consumers, who were denied the benefits of low-cost vacation travel, large users of international aviation services, notably multinational corporations (MNCs), and tourist interests. Of course, regulatory barriers to entry obviously advantaged incumbents to the disadvantage of potential entrants for both passenger and cargo services.

Incumbent carriers supported the regime because they obtained insulation from competition and were either guaranteed direct state subsidies or were assured rate of return profits by domestic regulators. Airline employees also benefited from this regulatory framework: with acquiescence to union wage demands representing the path of least resistance for airline management (because profits were guaranteed by direct subsidies or rate of return regulatory provisions), airline unions managed to secure higher wages and excess fringe benefits for their members.[54] Indeed, with no competitive pressures for airlines to reduce costs, airline employees were paid substantially more than they would have been paid absent regulation. In the first six years after U.S. domestic deregulation in 1978, for example, real labor costs for U.S. airlines declined by almost 50 percent, with new employees facing different and less bountiful wage structures than existing employees.[55] Likewise, while labor costs accounted for about 42 percent of the total operating costs of U.S. carriers in 1978, the

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figure was some 34 percent by the end of the 1980's.[56] Studies of the impact of deregulation in Europe predict similar consequences for airline employees. It is no surprise that all of the major labor unions were opposed to domestic airline deregulation in the U.S. and have generally opposed all forms of international deregulation.[57]

Aircraft manufacturers and large financial institutions also benefited from the Bermuda regime due to the effect of the regime on the demand for aircraft. In particular, because the Bermuda regime precluded price competition, airlines were forced to compete on service amenities and thus invested much more heavily in aircraft than would have been the case absent regulation.[58] Between 1959 and 1968, for example, almost all the capital stock in the U.S. domestic airline industry was replaced as airlines bought jets at a furious pace.[59] As one long-time industry analyst put it, "the only way to make money in the industry was to buy aircraft."[60] For aircraft manufacturers, regulation thus increased the number of aircraft which airlines purchased. As one industry analyst noted, "the main beneficiaries of regulation may well have been not the airlines themselves but rather their suppliers."[61] Of course, government ownership of most airlines also meant that governments could force airlines to purchase aircraft from domestic aerospace firms, and thus helped spread the benefits of the regime to aircraft companies in most major European states. In Britain, for example, both British European Airways (BEA) and British Overseas Airways Corporation (BOAC) were forced to buy British aircraft even if the airlines were opposed to these purchases.[62]

Financial institutions benefited from the regime for the same reason as aircraft manufacturers: Bermuda regulations guaranteed a steady supply of excellent customers. More specifically, because the large capital investments represented by

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aircraft purchases were usually guaranteed by governments (as most airlines were state-owned), banks could essentially finance these large capital expenditures risk-free. Even privately-owned airlines were good credit risks, with guaranteed rate of return pay regulations and the lack of price competition ensuring that airlines could afford to re-pay the large loans necessary to purchase aircraft. Even in the worst case scenario, the route franchises were seen as valuable assets which provided collateral.

Airport operators and the communities they served also benefited from the ability of airlines to provide the funds necessary for airport construction and operation. In short, the economic viability of carriers ensured by the regime meant airport operators could rely upon the carriers serving an airport to underwrite or guarantee revenue bonds issued to secure the necessary funds for airport construction and improvement. Facing a long time horizon as a result of the regulatory apparatus (i.e. airlines would continue to serve even unprofitable routes due to subsidies), the airlines were happy to guarantee the long-term bond guarantees for airport construction and improvements. As a result, most of the funds which service and amortize airport debt were generated by the airlines, with large airports receiving some 90 percent, medium airports receiving some 65-75 percent, and smaller airports receiving some 25-40 percent of operating revenues from airlines.[63]

Rural consumers were also winners under the Bermuda regime as subsidies for service to small communities ensured aviation services at reasonable prices. With the airlines required by law to provide service on rural routes even if these routes were unprofitable, rural consumers enjoyed much higher levels of service than would have been the case absent regulation. With local service a political winner and international services seen as a luxury good, universal domestic service was a chief aim of the entire regulatory apparatus. With international services subsidizing domestic routes

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structures and long-haul domestic flights subsidizing shorter routes, universal domestic service was provided at reasonable prices.[64] As the number of domestic passengers dwarfed international travelers, the arrangement made political sense, especially since most international demand was inelastic and had few political costs (i.e. most passengers were businessmen or government employees relatively unconcerned with international fares).

Of course, winners from regulation implies losers, and there were plenty of losers under the aviation markets produced by the Bermuda institutions. In particular, the regime disadvantaged potential entrants, consumers, tourism interests, large users of international aviation services (MNCs), and tourist interests. Potential entrants were obviously precluded from entering international markets and thus were heavily disadvantaged under the Bermuda regime. Would-be entrants were especially important in the U.S., as we shall see in the next chapter, but the growth of charter airlines created pressure for less restrictive scheduled markets everywhere. Pressure for new entry became particularly acute as new jet technology, in particular the introduction of the jumbo-jets, made the economics of international aviation markets appear particularly appealing for both charter airlines and domestic carriers.

Consumers and large users of aviation services suffered from the high prices produced by Bermuda institutions. Of course, large users of international aviation services, notably MNCs, and tourist interests were even more disadvantaged by high prices. MNCs were disadvantaged quite simply because they were forced to pay high prices for international travel in order to subsidize inefficient airlines and bloated domestic route networks. While MNCs chafed under high fares and stood to gain from more competitive international aviation markets (in which airlines would be forced to offer lower fares to survive), the tourism industry also stood to gain from lower

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international fares as lower fares would increase demand for their products. Under the Bermuda regime, international tourism was seen as a luxury good; given high aviation prices, demand for tourism was less than it would have been under less restrictive regulatory rules. With aviation one of the major segments of tourist costs, tourism interests stood to gain from lower aviation prices and thus increased demand for their products.[65]

The preceding discussion has sought to outline the domestic political coalition underpinning the Bermuda institutions, and the rules created by these institutions. The goal of this discussion has not been to define domestic political bargains in any individual state, but to provide a broad overview of the domestic political coalitions which benefited from the Bermuda regime. Outlining this coalition, and how coalition members benefited from the rules established by the Bermuda institutions, provides support for the argument advanced in chapter two that international regulatory rules are extensions of domestic political bargains. But a single snap-shot of the domestic political coalition and the resultant international rules is problematic for obvious methodological reasons. In the next section, I seek to redress this problem by outlining the broad changes in domestic politics that emerged in the 1970's, and how these domestic political changes have led to changes in international regulatory rules. I thus answer the empirical puzzle posed at the beginning of this chapter, why did the Bermuda regime crumble after 30 years of stability, by outlining the domestic political forces driving regulatory change. The analysis proceeds by first examining the domestic political forces goading regulatory change before proceeding to a discussion of how these changes have produced major changes in the organization of international aviation markets. Again, the analysis is self-consciously broad, and is intended to

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demonstrate how broad changes in domestic politics led governments to change the rules governing international aviation markets.

3.4 The Politics of Regulatory Change

Although there was always some grumbling over the division of spoils, the Bermuda regime was largely unchallenged until the 1970's.[66] As outlined above, the regulatory arrangements that were the Bermuda regime advantaged important domestic political interests, and national politicians thus saw little need to do more than tinker at the margins of the regulatory rules. In the early 1970's, however, technological and economic changes led to dramatic changes in the preferences of important constituents and thus set the stage for the end of the regime. In particular, the introduction of jumbo jets in the late 1960's, growing numbers of vacation travelers, and U.S. domestic deregulation undermined the domestic political bargain supporting the Bermuda regime. Of particular importance for the collapse of the regime was the dramatic shift in the political bargain underpinning U.S. international aviation policy, a shift which, as we shall see in the next chapter, ultimately undermined the regime. For now, however, it is important only to note that the domestic political shifts which came first in the U.S. occurred elsewhere as well, and that these shifts led national politicians to re-organize international aviation markets.

The introduction of jet technology in the late 1950's set the stage for the end of the Bermuda regime. As I argued above, the high prices imposed by the Bermuda regime were not politically sensitive in the immediate post-war period due to the limited size of the market and the particular structure of demand (i.e. few vacation travelers). The introduction of jet technology, however, substantially lowered airline costs and led to consistent declines in the real cost of international air travel vis-a-vis

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other consumer goods.[67] This was especially true after jumbo jets were introduced in the early 1970's.[68] Combined with rising incomes, the lower costs of jets meant that international air travel became within the means of large numbers of ordinary citizens, and demand for international air travel exploded.[69] The number of passengers on scheduled international airline flights increased from 14 million in 1956 to 23 million in 1960, and international traffic doubled between 1959 and 1965.[70] By 1970, there were 74 million international passengers.[71]

The political importance of the change in the structure of demand revolved around the large increase in the number of vacation travelers. At the beginning of the jet age in 1960, some 60-70 percent of international air travel was accounted for by business; by the late 1970's, this figure had dropped to around 50 percent.[72] Of course, this meant a dramatic increase in the absolute number of vacation travelers, given that overall aviation traffic was growing at about an average of 15 percent per annum throughout the 1960's and 1970's. More important, however, was the increase in political pressure for international regulatory change as vacation travelers became a significant percentage of international passengers. As noted above, the post-war bargain in aviation was political tenable largely because business and government travelers, the vast majority of international aviation passengers in the 1940's and 1950's, were not price sensitive. However, given that the price elasticity of demand for leisure travel is significantly higher than for business travel, demands for lower international fares increased as price conscious consumers became a significant percentage of international passengers.[73] In the U.S., political pressure from consumers for lower prices was especially acute on routes to and from Europe, where large numbers of U.S. ethnic minorities wanted to travel to visit their homelands.[74] Between 1947 and 1968, for example, the number of passengers carried by IATA

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carriers on the North Atlantic increased an average of 21 percent per annum.[75] Between 1959 and 1965, international traffic doubled.[76] Overall, international air travel increased an average of more than 12 percent during the 1960's.[77]

The growth in leisure travelers also altered the incentives of the airlines themselves. In particular, the dramatic growth in the size of aircraft and the high elasticity of demand for leisure travelers (i.e. lower prices would stimulate demand for international leisure travel) had important implications for airline support for the Bermuda regime. The size of aircraft was important quite simply because jets dramatically expanded the number of seats per aircraft and thus forced airlines to expand the size of the market in order to fill the new planes. The high fares produced by the Bermuda institutions would simply not allow airlines to fill the huge new planes, and many airlines began to question the high fare-low volume Bermuda marketplace. This change in airline preferences regarding fare levels were driven by calculations regarding the high price elasticity of leisure travelers: as overall passenger demand became increasingly elastic due to the growing numbers of vacation travelers, lower fares held out the promise for an increase in the total size of the market. By the late 1960's, cheating on fares agreed upon at IATA fare conferences was rampant, and special IATA conferences to address the issue of cheating did nothing to curb widespread fare discounting.[78] The introduction of the Boeing 747 in 1970, which effectively doubled the number of seats available on dense international routes, only exacerbated the problem.[79] With too many seats chasing too few passengers, the high prices agreed upon by IATA no longer served the interests of all the scheduled carriers; airline support for IATA fare-conferences decreased even as the fare conferences themselves became increasingly conflictual.

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While the increase in consumer travelers eroded scheduled airline support for the Bermuda regime, airline dissatisfaction with the postwar regulatory apparatus was exacerbated by new rules governing charter services which allowed charter operations to more effectively compete against scheduled airlines.[80] Although charters were considered an insignificant part of the market in the immediate postwar years, relaxation of the regulations governing charters during the 1960's and early 1970's allowed these carriers to dramatically increase their market share at the expense of scheduled services.[81] Relaxation of the charter rules in the U.S. were especially important and had an immediate impact on the market shares of the scheduled and charter carriers on the North Atlantic.[82] In 1965, non-IATA charter carriers carried 4.5 percent of traffic on the North Atlantic; in 1971, this figure was 19.8 percent.[83] Other figures are even more dramatic: charter carriers accounted for about 25 percent of total trans-Atlantic traffic by 1970, and by 1972 it was estimated that 31 percent of international passenger traffic was carried by the charter carriers.[84] Charter inroads into traffic shares thus created serious disagreements within IATA over the tariff schedules, and further eroded scheduled airline support for the Bermuda regime.[85]

Accompanying scheduled airline dissatisfaction with the Bermuda regime was pressure from potential entrants for entry into the international marketplace. Pressure from potential entrants became particularly important after the introduction of the long-range jumbo jets, which permitted much longer international routes and thereby opened new opportunities for international services. In particular, jumbo jets enabled smaller regional airlines, which had heretofore been unable to offer international services due to the limited range of aircraft, to enter the international marketplace, especially in the U.S. Although would-be entrants were more important in the U.S. than elsewhere,[86] the maturation of domestic aviation markets in most OECD states

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meant small domestic carriers were becoming large enough to enter international markets. This was especially true as the new regulations governing charter operations meant the distinction between scheduled and charter carriers became increasingly blurred--with the result that many international carriers which began as charter operations began to press to enter the international scheduled marketplace.[87]

In addition to waning airline support for the Bermuda regime, the rapid growth of international trade and the increasing use of air freight for transporting goods dramatically increased the costs of the regime for MNCs and thereby generated political pressures for regime change.[88] The use of aviation services to transport cargo underwent spectacular growth in the postwar period: from 1955 to 1968, air freight on the North Atlantic grew at an average annual rate of 27.2 percent, from 10,938 tons in 1955 to 331,049 tons in 1968.[89] In the five year period from 1964-1969, the freight of the top 25 airlines nearly tripled.[90] While impressive, these figures do not reveal the full importance of air cargo for how international production processes are organized and how firms deliver products to global markets. In short, air cargo emerged as a central component of the international production processes of MNCs, particularly in high-tech industries with high value to weight ratios. Ultimately, the high cost of international air freight imposed by IATA led to pressures from both cargo airlines and their customers to reformulate the Bermuda regime.[91]

The final factor undermining the Bermuda regime was an end to the close relationship between domestic aircraft manufacturers and national carriers. In the early post-war years, many European countries maintained their own aerospace firms which produced planes for their national carriers. Although these aircraft were never commercial successes, only with the development of jets, in particular wide-body jets and the Boeing 747, did the U.S. manufacturers come to dominate the market.[92] This

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created a disjuncture in the incentives of the national carriers and the national aircraft manufacturers and undermined support for the Bermuda regime. The dominance of U.S. aircraft technology was particularly important for the preferences of U.S. aircraft manufacturers vis-a-vis international regulatory rules. In short, U.S. aircraft manufacturers realized by the late 1960's that the growth area in aircraft sales would be in the international marketplace.[93] While U.S. airlines were still extremely important customers, the increasing importance of international markets for launching new aircraft meant greater attentiveness to the needs of international markets. Most importantly, U.S. aircraft manufacturers realized that lower international airfares would increase demand for tourism and business travel and thereby increase the demand for commercial aircraft.[94] Thus, although U.S. aircraft manufacturers were major beneficiaries under the Bermuda regime, these manufacturers began to support the reformulation of the Bermuda regime.

Although the forces for reform emerged in most of the advanced industrialized countries, market characteristics, the presence of numerous politically important potential entrants, and the presence of the most advanced aircraft manufacturers made the U.S. a natural leader in the effort to re-structure the Bermuda regime. Widespread consumer pressures for lower air prices only increased political pressure for a more competitive international aviation marketplace. Although the U.S. was the major proponent of restructuring the regime and was the first to press for more competitive international aviation markets in the late 1970's, the forces for regulatory reform emerged in all of the advanced industrialized states, and many nations significantly re-organized their domestic and international aviation markets throughout the 1980's.

The basic political reality for most states has been the fact that the huge inefficiencies created by the Bermuda model of organizing aviation markets has

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allowed politicians to create new political coalitions to support more liberal arrangements in both domestic and international aviation markets. Although definite figures of the gains from liberalization are not available, some estimates provide a sense of the scale of gains from a more liberal regime. In the U.S., a 1978 Department of Transportation Report estimated that U.S. consumer gains of $13-$20 billion would have accrued from a competitive international aviation markets in 1977 alone.[95] More recent studies by the EU estimate that the consumer gains from the completion of the Single European market in aviation would be slightly more than $1 billion per annum, or equivalent to a 10 percent reduction in the price of intra-EU air travel.[96] Other analysts believe this estimate to be excessively conservative, and argue that real gains of $1.5 to $2 billion per annum are better estimates of the gains likely to accrue (from EU liberalization).[97] One recent study of the North Atlantic market estimated that liberalization decreased fares on the North Atlantic by between 35 and 45 percent and increased service accessibility by 55 percent, resulting in consumer gains of some $5.1 billion--an average of $585 per traveler--on the North Atlantic in 1989 alone.[98] In Asia, the cost savings from more competitive Asian aviation markets is estimated to be $152 billion for the period 1997-2010.[99] Although estimates of the actual gains from liberalization in other markets or on a global basis are unavailable, these figures suggest that the gains from global liberalization will be substantial in all markets. These figures only include the gains from lower fares, and do not include the economic gains which would accrue to individual airports and the communities they service from the increased service frequency which would result from liberalization--gains which are estimated to be quite substantial.[100]

While the potential gains from liberalization are huge, U.S. domestic deregulation and the privatization and subsequent turnaround of British Airways (BA)

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demonstrated in very real terms the benefits of more competitive aviation markets. In the wake of these paradigmatic reform efforts, other national governments have slowly (and usually painfully) withdrawn state support from their national airlines even while concluding more liberal bilateral agreements. The EU has launched a three-state package of aviation reform, with meaningful competition set to begin in 1997. Even Japan, which alone among major aviation states refuses to significantly liberalize its aviation markets, has privatized Japan Airlines (JAL) and has allowed more Japanese airlines to enter both domestic and international markets.

In Europe, large traveling publics, significant numbers of MNCs, and widespread dissatisfaction with state ownership and the ensuing demands on state treasuries has led to widespread liberalization of aviation markets. In the U.K., far-reaching reforms have taken place since the early 1980's. Under Thatcher's guidance, the U.K. deregulated its domestic aviation market, pressed for greater intra-EU aviation competition, and significantly liberalized the U.S.-U.K. bilateral marketplace. By the early 1990's, U.K. passengers enjoyed the lowest airfares in the EU, with fares in the U.K. averaging about 30 percent lower than in other EU states.[101] Elsewhere in Europe the pattern has been mixed. Countries with inefficient national carriers, notable France, Italy, Greece, and Spain, have been slow in liberalizing their aviation markets. Most other European countries, in contrast, have signed liberal "Open Skies" agreements with the U.S. and have welcomed more competitive international markets and the resultant globalization of the industry.[102]

In the Pacific, countries with inefficient carriers have tended to resist U.S. calls for greater competition. In Japan, both JAL and All Nippon Airways (ANA) are relatively inefficient and have thus pressed the Japanese government to maintain strict control over the aviation marketplace. Even the limited reform which has taken place--

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the privatization of JAL and additional market entry--has benefited Japanese airlines and not the Japanese consumer.[103] Elsewhere in the Pacific, states with efficient carriers, notably Singapore, and Korea, have encouraged more competition, while states with less efficient airlines have been reluctant to liberalize the international marketplace.

The breakdown of the Bermuda regime and the efforts of key aviation states to re-organize international aviation markets nicely illustrates the impact of domestic politics on the rules governing international markets. As I have attempted to demonstrate above, technological, economic, and hence political changes undermined political support for the Bermuda regime, and led national politicians to reformulate the rules governing international aviation markets in ways compatible with new domestic political contingencies. Depending on domestic politics, some states have been willing to liberalize the Bermuda rules while others have maintained restrictive regulatory control over the marketplace. Indeed, as we shall see in chapters five and six, the scope and content of particular bilateral aviation markets vary widely, with particular bilateral markets reflecting underlying domestic political bargains.

3.5 Conclusion

The postwar international aviation regime combined multilateral fare conferences with bilaterals agreements to maintain a de facto cartel in international aviation markets. This cartel was set up by states after World War II, and persisted for more than thirty years. Cartels are hardly efficient economic arrangements, however, and it is difficult to argue that the cartel created by the Bermuda institutions was simply an effort by states to organize international markets in order to provide utility gains for all players in the game. Indeed, post-war aviation markets were self-consciously

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structured in ways that benefited some marketplace participants at the expense of others. In the early 1970's, however, the political basis of the cartel began to unwind. With the U.S. challenging the role of IATA and seeking to conclude liberal bilateral agreements, international aviation markets have become increasingly competitive in the past twenty years. Although IATA still serves many of the fare-setting powers that it did during its heyday in the 1950's and 1960's on some routes, the powers of IATA have been greatly restricted in the major aviation markets of the world (i.e. routes to and from the U.S.). Likewise, significant liberalization has taken place where U.S. negotiators have found willing foreign partners. Nonetheless, large segments of the international aviation marketplace remain governed by the restrictive Bermuda institutions.

Where governments have agreed to loosen the regulatory rules and create more competitive international markets, the timing and content of liberalization has been dependent on the outcome of highly politicized inter-state bargaining. While national carriers have generally been reluctant to introduce competition, coalitions of large users, potential entrants and consumers have pressed for liberalization of the rules governing international aviation. Put simply, decisions regarding international regulatory rules have been a function of how international market forces interact with domestic politics. Indeed, as we shall see in the next three chapters, the economic impact and domestic political consequences of changes in existing regulatory arrangements have been the driving force behind changes in the institutions governing international aviation markets. When domestic political coalitions to which politicians are responsible support international regulatory change, then such change is likely. On the other hand, international regulatory change is unlikely if dominant domestic

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political coalitions support status quo arrangements. It is to these domestic battles and the resulting international regulatory rules that I now turn.

Because existing studies of international aviation markets employ the term regime in explaining the organization of international aviation markets, I adopt their usage here. Also, the broadly defined term aviation regime is commonly used in international aviation negotiations and planning. For other studies on the Bermuda regime, see Christer Jonsson, International Aviation and the Politics of Regime Change (St. Martin's Press, New York, N.Y.), 1987, Eugene Sochor, The Politics of International Aviation (University of Iowa Press, Iowa City, IA), 1991, Baldev Raj Nayar, "Regimes, power, and international aviation," *International Organization* 49, No. 1 (Winter 1995), p. 139-170, and Alan Dobson, Flying in the Face of Competition: The Policies and Diplomacy of Airline Regulatory Reform in Britain, the USA, and the European Community, 1968-1994 (Avebury Aviation, Aldershot, U.K.), 1995.

[1]On public choice approaches to international organizations, see Roland Vaubel and Thomas Willett, eds., The Political Economy of International Organizations: A Public Choice Approach (Westview Press, Boulder, CO), 1991.

[2]See Jonsson, 1987, p. 88-92, and J.W.S. Brancker, IATA and what it does (A.W. Sijthoff International Publishing Co., Leydon, The Netherlands), 1977, p. 6-9.

[3]For a detailed discussion of the Chicago Convention and U.S.-U.K. bargaining at Bermuda, see Marc L. J. Dierikx, "Shaping World Aviation: Anglo-American Aviation Relations, 1944-1946," *The Journal of air law and commerce*, Vol. 57, No. 3 (Summer 1992), p. 795-840. See also Peter P.C. Haanappel, "Bilateral Air Transport Agreements, 1913-1980," *The International Trade Law Journal*, 1980, p. 241-267.

[4]See Jonsson, 1987, p. 98, and Sochor, 1991, p. 3-16.

[5]U.S. Department of State, Proceedings of the International Civil Aviation Conference, Chicago, Illinois, November 1-December 7, 1944 2 Volumes (U.S. Government Printing Office, Washington, D.C.), 1948, p. 67.

[6]Unlike the U.S. domestic marketplace, where airlines were subject to regulation since the 1938 Civil Aeronautics Act, the U.S. pressed for no regulation of the international marketplace. See William O'Connor, Economic Regulation of the World's Airlines: A Political Analysis (Praeger, New York), 1971, and Dierikx, 1992.

[7]Fifth freedom rights are rights for an airline to pick up passengers in one foreign country and carry these passengers to another foreign country. For example, fifth freedom rights are the right of U.S. carriers to pick up local passengers in London and transport then to Paris on New York-London-Paris flights. For a full discussion of the various freedoms, see Michael Tretheway, International Air Relations From Bilateralism to Multilateralism (Research Paper in International Business Trade and Finance, Faculty of Commerce and Business Administration, University of British Columbia), 1993.

[8]Beatrice Berle and Travis Jacobs, eds., Navigating the Rapids: From the Papers of Adolf A. Berle, 1918-1971 (Harcourt Brace Jovanovich, Inc., New York), 1973, p. 498-509.

[9]Institute of Air and Space Law, Casebook: Government Regulation of Air Transportation, 1981-1982 (McGill University, Montreal, Canada), 1982, as quoted in Louis Gialloreto, Strategic Airline

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Management: The Global War Begins (Pitman Publishing, London. 1988), p. 16.

[10]Only in 1943 did the U.S. government assume responsibility for air service negotiations. See Daniel Kasper, Deregulation and Globalization: Liberalizing International Trade in Air Services (Ballinger Publishing Company, Cambridge, MA), 1987, p. 5.

[11]The head of the U.S. delegation at Chicago, A.A. Berle, asserted that "aviation will have a greater influence on American foreign interests and American foreign policy than any other non-political consideration." Berle and Jacobs, p. 481. For a similar conclusion, see J. Parker van Zandt, Civil Aviation and Peace (The Brookings Institution, Washington, D.C.), 1944.

[12]Dierikx, 1992, p. 813.

[13]Paul Stephen Dempsey, Law & Foreign Policy in International Aviation (Transnational Publishers, Inc. New York), 1987, p. 10.

[14]Sochor, 1991, p. 3-4, Berle and Jacobs, 1973, p. 498-509.

[15]On the domestic political importance of international arrangements in the U.S. in the immediate postwar era, see Peter F. Cowhey, "Elect Locally-Order Globally: Domestic Politics and Multilateral Cooperation," in John Ruggie, ed., Multilateralism Matters: The Theory and Praxis of an Institutional Form (Columbia University Press, New York), 1993, p. 157-200.

[16]See Helen Milner, "The Interaction of Domestic and International Politics: The Anglo-American Oil Negotiations and the International Civil Aviation Negotiations, 1943-1947," in Peter Evans, Harold Jacobson, and Robert Putnam, Double-Edged Diplomacy: International Bargaining and Domestic Politics (University of California Press, Berkeley, CA), 1993, p. 207-232, and Anthony Sampson, Empires of the Sky: The Politics, Contests and Cartels of World Airlines (Random House, New York, N.Y.), 1984, p. 77-82.

[17]Milner, 1993.

[18]Proposals by Pan Am's Chairman Juan Trippe for the creation of a single flag carrier with joint domestic and international carrier (with domestic air, rail, and bus operations) were vehemently opposed by U.S. domestic airlines in 1946. See "Pan American Battles for Survival," *Aviation Week and Space Technology*, October 7, 1974, p. 21-24.

[19]Pan Am argued that foreign airlines were owned and protected by their national governments, and thus the U.S. should favor Pan Am in direct competition with these national flag carriers. Allowing more than one U.S. carrier to serve international routes, Pan Am argued, would thus "weaken" U.S. interests vis-a-vis foreign carriers.

[20]Dierikx, 1992, p. 824-825.

[21]See Dierikx, 1992, and Kasper, 1988, p. 47-50.

[22]Although technically IATA was founded in 1919 as a trade association for European airlines, this early version of the organization is distinct from the post-World War II organization. For a discussion of airline motivations regarding IATA, see Sochor, 1991, p. 13.

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[23]As part of the Bermuda agreement the U.S. CAB agreed to grant anti-trust immunity to U.S. airlines participating in IATA fare-setting conferences. The immunity was renewed periodically until June 15, 1955, when the Board granted antitrust immunity for an indefinite period.

[24]Because these agreements provided generous fifth-freedom rights for U.S. airlines, the bilateral agreements with Holland and Ireland threatened to undermine the dominant position of London and the British Overseas Air Corporation (BOAC) as a gateway to the rest of Europe.

[25]Dierikx, 1992.

[26]Remember that the domestic airlines preferred an industry-run cartel to regulate international markets rather than inter-governmental accords. Pan Am of course supported IATA because it guaranteed high profit margins. See Milner, 1993.

[27]As a Presidential Commission stated in 1947, "We agree with the present Civil Aeronautics Board policy which favors limited competition among American operators on international routes....The policy of regulated competition that has assured the development of our domestic air lines should be followed in our international system." As quoted in Judith Trent, "A History of Halting Moves Toward Open Markets," in Handbook of Airline Economics (Aviation Week Group, Washington, D.C.), 1995, p. 165-173.

[28]See van Zandt, 1944.

[29]Individual international routes are allocated by a quasi-judicial mechanism which allows both Congress and the President to play important roles in the allocation of routes. Meanwhile, because international routes generate substantial income for local communities, the Bermuda regime allowed politicians to distribute private benefits to local communities in addition to the airlines.

[30]Although many bilateral agreements were more restrictive than Bermuda bilaterals, restrictive provisions, notably revenue-sharing agreements, were usually agreed upon in private side-agreements.

[31]The U.S. was an deviant case as numerous carriers operated in the domestic market. However, the manner in which the CAB allocated domestic routes made the U.S. system function similarly to the monopoly model. Likewise, although in many ways Pan Am occupied a similar position in the U.S. to national flag carriers in other countries, the U.S. was the exception as it never created a national carrier and Pan Am was statutory excluded from the domestic market.

[32]For developing nations, subsidizing domestic services was seen as a development issue. In the late 1980's, for example, Philippine Airlines President Leslie Espino openly admitted that 60-70 percent of domestic routes operate at fares below cost but that subsidizing the domestic network of 43 cities was essential for the mobility of the population. See James Gilmartin, The Transpacific Passenger Aviation Market (Southeast Asia Business Papers, No. 9,) 1990, p. 7-8.

[33]New York-Florida Case, 24 CAB 94(1956), New York-Florida Renewal Case, 38 CAB 680 (1963), Reheard 39 CAB 108 (1964), CAB Order 24808 (March 2, 1967). See also A. Lowenfeld, Aviation Law (1981), as cited in William E. Thoms, "The Deregulated Skies-United States "Sunset" Legislation and International Air Travel," *Netherlands International Law Review*, 1984, p. 378-418, exact cite on p. 380-381.

[34]For example, fares were set such that it was impossible for fares to be cheaper to fly from A to B and then on to C rather than directly from A to C. As former president of IATA Knut Hammarskjold

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put it in 1970, "IATA's fare-setting conferences act as a fluid mortar between the bilaterals, allowing continuous minor adjustments to all elements in the entry, pricing, and capacity equations." Knut Hammarskjold, Address in *Final Report of the International Aviation Symposium*, Kingston, Jamaica, 1970, p. 46. as cited in Dresner and Tretheway, 1988, p. 6-7.

[35]See Betsy Gidwitz, The Politics of International Air Transport (Lexington Books, D.C. Heath and Company, Lexington, MA), 1980, p. 50-52, and Martin Dresner and Michael W. Tretheway, "The Changing Role of IATA: Prospects for the Future," *Annals of air and space law*, Vol. 13, No. 1, 1988, p. 3-23.

[36]This began to change slightly in the late 1970's, but remains the norm. See Martin Dresner and Michael Tretheway, "ICAO and the Economic Regulation of International Air Transport," *Annals of air and space law*, Vol. 17, No. 2 (1992), p. 195-211.

[37]For a detailed discussion, see Gordon Ruddick, "The 'Trade Association' Functions, in Credibility and Communication in a New Air Age: Proceedings of the 14th International Air Transport Public Relations Conference (IATA, Montreal), 1979, p. 64-73. See also Brancker, 1977, Peter P.C. Haanappel, Ratemaking in International Air Transport: A Legal Analysis of International Air Fares and Rate (Kluwer, The Netherlands), 1978, p. 33-46, and "The Other Side of IATA: A Public Service at Work," in *IATA Review*, Vol. 13, No. 4 (June-July 1978), p. 5-16.

[38]See Dresner and Tretheway, 1988, and Nawal K. Taneja, U.S. International Aviation Policy (Lexington Books, D.C. Heath and Company, Lexington, MA), 1980, Chp. 4.

[39]Sampson, 1984, p. 93.

[40]Gidwitz, 1980, p. 52.

[41]See Regulatory Reform: report of the C.A.B. special staff (Civil Aeronautics Board, Washington, D.C.), 1975, and Dempsey, 1987. As Cowhey has pointed out, the organization of many international service markets reflected a broader judgment that services were best provided under domestic monopolies connected by restrictive international rules. See Jonathan Aronson and Peter Cowhey, Trade in Services: A Case for Open Markets (American Enterprise Institute for Public Policy Research, Washington D.C), 1984, and Cowhey, 1990.

[42]Jonsson argues that national sovereignty was violated as a result of the IASTA, which established the first two freedoms of the air for all signatories. However, these freedoms were exceptions designed for emergencies; aside from these exceptions, national sovereignty remained a central norm of the regime. See Jonsson, 1987.

[43]As cited in Jonsson, p. 28-29.

[44]Arguments by defenders of the Bermuda regime in the late 1970's were filled with references to the airline industry as a public utility. See the Testimony of Knut Hammersjold, CAB Docket No. 32851, August 20, 1979.

[45]As quoted in Dempsey, 1987, p. 96.

[46]Although in many ways Pan Am occupied a similar position in the U.S. to national flag carriers in other countries, the U.S. is the exception as it never created a national carrier. Even in the U.S.,

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however, the airlines relied upon regulation to ensure economic viability. Indeed, the primary intent of domestic airline regulation was to ensure the continued economic viability of the major carriers. See Report of the C.A.B. special staff, 1975.

[47]IATA Letter to Senator Cannon, in Hearings Before the Senate Subcommittee on Aviation on the International Air Transportation Act of 1978, August 22, 1978 (U.S. Government Printing Office, Washington), 1978, p. 246.

[48]Tretheway, 1993, p. 11.

[49]Paul Stephen Dempsey, "The International Rate and Route Revolution in North Atlantic Passenger Transportation," *Columbia Journal of Transnational Law*, Vol. 17, No. 3 (1978), p. 393-449.

[50]The principle underlying IATA voting rights was that no carrier should be bound by the terms of an agreement unless the airline itself accepted the agreement. See IATA, Agreeing Fares and Rates: A Survey of the Methods and Procedures Used by the Member Airlines of the International Air Transport Association, Second Edition (IATA, Montreal), 1974, p. 18.

[51]IATA, 1974, p. 18.

[52]IATA, 1974.

[53]IATA, 1974, p. 20.

[54]S. Hendricks, "Regulation, Deregulation, and Collective Bargaining in Airlines," *Industrial and Labor Relations Review*, 1980.

[55]Olive Robinson, "Employment Policy and Deregulation in European Air Transport," *Service Industries Journal*, Vol. 14, No. 1 (January 1994), p. 1-19.

[56]Peter Cappelli, ed., Airline Labor Relations in the Global Era (Cornell University Press, with ILR Press, Ithaca, N.Y.), 1995, p. 3.

[57]Alfred Kahn, "Deregulation and Vested Interests: The Case of Airlines," in Roger Noll and Bruce Owen, The Political Economy of Deregulation: Interest Groups in the Regulatory Process (American Enterprise Institute, Washington, D.C.), 1983, p. 132-151.

[58]It is important to note that most analysts believed until the late 1970's that lower prices would lower airline profits and thus decrease demand for aircraft. Once aircraft became larger and leisure travelers grew as a percentage of passengers, aircraft manufacturers became to realize that deregulation would produce lower fares which would stimulate demand for travel and thus increase demand for planes. As we shall see below, however, it was not until the 1970's that aircraft manufacturers began to prefer competitive aviation markets to the stable profits promised by the Bermuda regime. See section 3.4 for a further elaboration of the calculation of aircraft manufacturers.

[59]See Sidney Carroll, "The Market for Commercial Airlines," in Richard E. Caves and Marc J. Roberts, eds., Regulating the Product: Quality and Product (Ballinger Publishing Co., Cambridge, MA), 1975, p. 145-169.

[60]Author's interviews with Bill Kutzke, Washington D.C., 10/24/96 and 10/30/96. From 1968 to

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1979, Kutzke was employed at the CAB where he served as Assistant General Counsel for L.ternational Law and Assistant General Counsel for Litigation in the General Counsel's Office. From 1979 to 1985, Kutzke was Vice President-Airline Planning and Vice President-Washington of Northwest Airlines. Since 1985, Kutzke has worked as a consultant and attorney for numerous airlines.

[61]Pat Hanlon, Global Airlines: Competition in a Transnational Industry (Butterworth-Heinemann, Oxford), 1996, p. 35.

[62]Dobson, 1995, p. 29-30, and A.W.J. Thompson and L.C. Hunter, The Nationalized Transport Industries (Heinemann Educational Books, London), 1973, p. 61-66.

[63]Joseph A. Neiss, "How Concessions Compare for Revenue to the Airport," Airport Services Management, August, 1974, as quoted in Civil Aeronautics Board, Regulatory Reform: report of the C.A.B. special staff, 1975, p. 236.

[64]For evidence regarding cross-subsidies in the U.S., see G. C. Eads, "Competition in the Domestic Trunk Airline Industry: Too Much Or Too Little?" in Almarin Philips, ed., Promoting Competition in Regulated Markets (The Brookings Institution, Washington, DC), 1975.

[65]Aviation arrivals accounted for over seventy percent of all international arrivals in twenty states with over one million tourist visitors in 1990. See World Tourism Organization, Aviation and tourism policies: Balancing the benefits (Routledge, New York, NY), 1994, p. 13.

[66]Academic debates over the merits of regulated vs. competitive aviation markets did emerge in the 1960's and 1970's, but these debates did little to alter existing regulatory arrangements until the late 1970's. For a review of the major issues underlying the debate, see Hanlon, 1996, Chp. 3.

[67]IATA, 1974, p. 95-98, 231.

[68]Between 1974 and 1984, for example, real operating expense per available ton-kilometer for IATA airlines declined by 23 percent. See Eric Maillebiau and Mark Hansen, "Demand and Consumer Welfare Impacts of International Airline Liberalization," *Journal of Transport Economics and Policy*, Vol. XXIX, No. 2 (May 1995), p. 115-136.

[69]In 1951, for example, the average cost of a New York-London round-trip ticket was $611, or 39.6 percent of U.S. per-capita income; by 1965 the fare had dropped to $375, or 17 percent of per capita income. *Aviation Week and Space Technology*, January 23, 1967, 49-50. Likewise, real costs per kilometer-ton in 1990 were one-third of what they were in 1960. See Mark Zacher, with Brent Sutton, Governing Global Networks: International Regimes for Transportation and Communications (Cambridge University Press, Cambridge, MA), 1996, p. 82. The introduction of jets also dramatically increased demand for international travel by substantially reducing travel time. On U.S-Japan routes, for example, the introduction of commercial jets reduced travel time from 18 to 8 hours. See Mark Hansen and Adib Kanafani, "Airline Hubbing and Airport Economics in the Pacific Market," *Transportation Research*, Vol. 24, No. 3 (May 1990), p. 217-230.

[70]IATA various years. Figures available from the author.

[71]IATA various years. Figures available from the author.

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[72]In the immediate postwar years, business accounted for about 80 percent of travel while leisure constituted some 20 percent. Today, those figures are reversed, with 80 percent of international travel accounted for by leisure travel and 20 percent accounted for by business travel. For figures, see Peter Tallon, "European air transport in a holding pattern," *Interavia*, Vol. XXXIV (November 1979, p. 1030-1032, and Hanlon, 1996, p. 18.

[73]For a detailed discussion of the elasticity of demand for international aviation services, see T.H. Oum, W.G. Waters, and J.S. Yong, "Concepts of Price Elasticities of Transport Demand and Recent Empirical Estimates: An Interpretative Survey." *Journal of Transport Economics and Policy*, No. 26 (1992), p. 139-154.

[74]During the 1950's and 1960's, about 50 percent of all U.S. international passengers (except to Canada and Mexico) traveled to Europe.

[75]IATA, World Air Transport Statistics (IATA, Montreal), 1968, p. 41.

[76]IATA, World Air Transport Statistics (IATA, Montreal), various years.

[7] IATA, World Air Transport Statistics (IATA, Montreal), various years. Data available from the author.

[78]"IATA Delegates Facing Major Challenges," *Aviation Week and Space Technology*, September 29 1975, p. 24.

[79]The jets that flew international routes before the 747 were the Boeing 707, the Viscount VC-10, and the McDonnell Douglas DC-8. All three carried between 140-180 passengers, depending on seating configurations. The first 747's carried between 350-420 passengers, again depending on seating configurations.

[80]It is important to note that scheduled airlines were the primary airlines which offered charter services in the early years. In other words, the primary international scheduled carriers (the national flag carriers in most states and Pan Am and TWA in the U.S.) were the major charter carriers until the early 1970's. This first took the form of sales of blocks of seats to consolidators who sold vacation packages, but later scheduled airlines set up their own charter subsidiaries. Thus, the scheduled carriers operating charter flights were supporters of more liberal charter rules and were the major beneficiaries of the new rules governing charters.

[81]In Europe, the rules governing charters were significantly liberalized when the European Civil Aviation Conference (ECAC) concluded a multilateral agreement on charters in 1956. In the U.S., charter operators secured both their legal status and new operating rights in the Supplemental Air Carrier Act of 1962. The ECAC is a multilateral organization based in Paris which represents the civil aviation administrations of 22 European nations. On occasion, the ECAC represents these twenty European states in international negotiations.

[82]Rigas Doganis, Flying Off Course: The Economics of International Airlines (George Allen & Unwin, London), 1985, p. 12-13.

[83]IATA, 1974, p. 59.

[8]Dobson, 1995, p. 29, and Doganis, 1985, p. 13.

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[85] *Air Transport World*, Vol. 7, No. 5 (May 1970), p. 33-34, and *Air Transport World*, Vol. 8, No. 11 (November 1971), p. 38-39.

[86] Potential entrants were more important in the U.S. due to the continental scope of the economy and the absence of a single, government-owned national flag carrier. This meant that there were multiple domestic carriers ready to enter lucrative international markets. See chapter four below for a more detailed discussion of this point.

[87] *Aviation Week and Space Technology*, May 8, 1967, p. 33-47, and *Aviation Week and Space Technology*, December 25, 1967, p. 26-27.

[88] Civil Aeronautics Board Order No. 75-1-46, January 13, 1975, and Civil Aeronautics Board, Docket No. 32851, August 20, 1979.

[89] The North Atlantic was the single most important air freight market during this time period and are also representative of global growth rates. Data are from *Air Transport World*, Vol. 6, No. 5 (May 1969), p. 90.

[90] *Air Transport World*, Vol. 7, No. 10 (October 1970), p. 47-51.

[91] *Aviation Week and Space Technology*, June 12, 1967, 48-63, and *Air Transport World*, Vol. 10, No. 6 (June 1973), p. 21-24.

[92] Between 1955 and 1964, the U.S. share of total commercial air transport orders was 72 percent: between 1965 and 1979, the U.S. share jumped to 88 percent. Data from U.S. Civil Aviation Manufacturing Industry Panel, The Competitive Status of the U.S. Civil Aviation Manufacturing Industry: A Study of the Influences of Technology in Determining International Industrial Competitive Advantage (National Academy Press, Washington, DC), 1985, p. 45.

[93] In 1970, for example, Boeing had $716 million in foreign sales of commercial airliners while not a single airplane was sold in the U.S. See Bauer 1991, p. 288.

[94] It is worth noting that only after the price reductions in 1977-1978 did the belief that the demand for international aviation was inelastic begin to change. Prior to that point, even many airlines believed that lower prices would translate into lower profits. See Klem and Leister, 1979.

[95] See C. Barnekov, International Air Fare Levels: An Evaluation after Three Decades of IATA Rate-Making (Office of Transportation Regulation, U.S. Department of Transportation, DOT-P-50-78-47, Washington, D.C.), 1978.

[96] European Commission, The European Economy (European Commission, Brussels), March 1988.

[97] Francis McGowan and Paul Seabright, "Deregulating European airlines," *Economic Policy*, Vol. 8 (1989), p. 293-344.

[98] Accessibility is defined as "the total annual domestic enplanements at U.S. airports that are gateways" to one of the European countries looked at in the study. See Maillebiau and Hansen, 1995.

[99] Gary Hufbauer and Christopher Findlay, eds., Flying High: Liberalizing Civil Aviation in the Asia Pacific (Institute for International Economics, Washington, D.C.), 1996, p. 23.

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[100]For a discussion of the regional economic impact of increased aviation services in U.S.-Japan markets, see ACCESS U.S.-Japan, Expanding the U.S.-Japan Aviation Market (ACCESS U.S.-Japan, Washington D.C.), 1996, and ACCESS U.S.-Japan, The Impact Of Increased Passenger Flights To Japan On U.S. Employment (ACCESS U.S.-Japan, Washington D.C.), 1996.

[101]Peter Woodman, "Open Skies' Bring Lower Fares to UK," Press Association Newsfile, November 3, 1993, as cited in Daniel Hedlund, "Toward Open Skies: Liberalizing Trade in International Aviation Services," *Minnesota Journal of Global Trade*, Vol. 3, No. 2 (Summer 1994), p. 259-299. See also CAA, November 1993, p. 4.

[102]Open Skies agreements allow any airline of either signatory state to fly from any city in the home country to any city in the foreign partner. In short, free entry. Open Skies agreements also include liberal fare provisions which de facto mean fares are set by open competition in the marketplace. Open Skies bilaterals have been the policy goal of U.S. policy-makers since 1992.

[103]Hirotaka Yamauchi and Takatoshi Ito, "Air Transport Policy in Japan," in Hufbauer and Findlay, 1996, p. 33-61.

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Chapter 4: Exporting Competition: Policy Reversal in the U.S.

4.0 Introduction

The previous chapter outlined the institutions which dictated the rules governing international aviation markets in the postwar era, examined the broad domestic political bargains on which these arrangements rested, and thus elucidated the domestic political roots of the postwar cartel in international aviation services. As discussed in section 3.4, however, domestic political changes undermined political support for the regime in the 1970's, and the rules governing international aviation markets have undergone dramatic change in the past twenty years. As the leader of efforts to introduce more competition into international aviation markets, the U.S. adoption of a pro-competitive international aviation policy in 1978 is the key event in these moves toward more competitive international aviation markets. The U.S. policy reversal is puzzling, however, largely because the U.S. had been one of the major architects of the Bermuda regime, and U.S. policies had consistently supported the regime for over 30 years. In other words, U.S. policy supported the postwar cartel in aviation services throughout the 1950's and 1960's, yet sought to destroy this politically-created cartel in the late 1970's. Why did the U.S. withdraw support from a set of international rules which it had supported for more than 30 years?

This chapter seeks answers to this question by examining the domestic politics driving the reversal of U.S. international aviation policy in the late 1970's. More specifically, this chapter explains why the U.S. adopted a pro-competitive international aviation policy in 1978, and provides answers to more specific questions about the timing and design of this policy and the particular international bargaining strategies

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adopted in pursuit of U.S. policy goals. What I seek to explain then, is why the U.S. sought to create a totally new set of international rules to govern international aviation markets. Put differently, what were the international rules sought by the U.S. and how did the U.S. go about changing existing rules? I argue that exogenous changes in technology, in particular the development of jumbo jets, altered the preferences of key domestic political actors vis-a-vis the Bermuda regime and thereby set the stage for policy change. How these demands translated into policy outcomes, however, depended on the incentives of U.S. national politicians. Delineating demands for policy change, I argue, is thus not sufficient for understanding policy change. I thus include domestic political institutions in the analysis, in particular electoral rules and the division of powers, and detail how these institutions condition the importance of societal demands for politicians. Domestic political institutions thus shaped the timing and design of policy change.

But new domestic political bargains did not dictate any particular international bargaining strategy, however, and a variety of new international aviation policies could have been adopted which were consistent with new domestic political bargains. Put differently, domestic electoral dynamics led U.S. politicians to policy reversal, but the U.S. could not unilaterally re-organize international markets, and was forced to adopt policies designed to secure foreign cooperation with U.S. policy goals. Confronted with the existing set of Bermuda institutions and foreign partners largely unwilling to liberalize aviation markets, the challenge facing the U.S. was how to secure foreign partners for its liberalization efforts. Devising strategies to either convince or pressure foreign partners to liberalize aviation markets thus critically depended on U.S. evaluations of international bargaining dynamics. The analysis thus turns to an examination of international bargaining dynamics to understand why U.S. policy-

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makers adopted particular strategies rather than others in their attempts to liberalize international aviation markets.

The chapter is organized as follows. The first section outlines the implications of the argument presented in chapter two for U.S. international aviation policy. The second section provides a brief empirical overview of U.S. international aviation policy from 1960-1980. Parts three and four discuss the political forces demanding policy change and the supply of policy in the late 1970's, respectively, and demonstrate how U.S. domestic political institutions conditioned the impact of societal demands on policy outcomes. Section five highlights the impact of international bargaining dynamics on the particular bargaining strategies and policies adopted by U.S. decision-makers in pursuit of U.S. policy objectives. The final section concludes.

4.1 Demands, Domestic Institutions, and International Bargaining Dynamics

As I argued in Chapter two, the organization of international markets is driven primarily by domestic politics, but international bargaining dynamics condition the strategies adopted by domestic economic interests and national governments. This section expands on the basic argument and focuses on their implications for U.S. firms, U.S. international aviation policy, and U.S. efforts to change the rules governing international aviation markets.

4.1.1 Firm Strategies and U.S. Domestic Politics

I highlight two effects of U.S. domestic political institutions on firm strategies. First, Congressional attentiveness to the local, distributional impact of policy means

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that local interests use their Congressional representatives to pressure executive agencies for favorable regulatory outcomes. Facing shorter electoral calendars and smaller electoral constituencies than the executive, Congress is more attentive than the executive to the local, short-term distributional impact of national policies. Moreover, because it is harder for Congress to claim credit for broad national policies, Congress tends to rely on distributional favors (i.e. pork barrel) for local interests to a much greater extent than the executive.[1] Congressional incentives are important because they mean that U.S. firms are more likely to be successful in pressuring their Congressional representatives than the executive branch. This is particularly true if firms have concentrated operations, as is the case for airlines. Because firms are more likely to be successful in lobbying their Congressional representatives, firms will tend to lobby Congress rather than the executive branch.[2]

The second way in which U.S. domestic political institutions shape firm strategy revolves around the role of political entrepreneurs and competition for the median voter. As Barry Weingast has pointed out, regulatory policy is an equilibrium which emerges from a game between regulators, interest groups, and politicians.[3] However, limits on time and attention mean that, at times, politicians neglect regulatory policymaking and allow interest groups and regulators to dominate the process. This is satisfactory for politicians because they rely on fire alarms to monitor policy outcomes and keep policy within acceptable bounds (acceptable to the median voter and thus acceptable to politicians).[4] When these fire alarms signal that the current policy equilibrium is politically unacceptable (usually in light of technological and economic changes which generate widespread political support for regulatory change), politicians are forced to assemble new coalitions and cement these new coalitions in the

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structure of any new policy equilibrium. To do so, however, requires political intervention in the regulatory process.

In the U.S., the intervention of politicians into the regulatory process usually emerges from the work of political entrepreneurs. Given rationally ignorant voters, parties cultivate party labels to provide low-cost cues on which voters can make voting decisions.[5] This on-going competition for the median voter between parties, in turn, leads parties to create incentives for individual politicians to become political entrepreneurs and thereby enable parties to capture the political gains from enacting policy on broad policy issues which appeal to the median voter.[6] This is especially true as major public policy issues advantageous for the median voter are extremely important for political parties given the long time horizon of major policy initiatives and the fact that, once enacted, policy choices become part and parcel of the policy package represented by the party label.[7] In short, parties create incentives for individual politicians to address broad public policy issues which are not necessarily directly related to the interests of their constituents. The fact that politicians who fail to address these opportunities will lose to those politicians which respond to the opportunity to improve outcomes for the median voter adds further impetus to the incentives provided by political parties.

Party concerns over securing the electoral gains from broad policy initiatives means the impact of particular interests groups on policy outcomes will diminish when there are large gains to be realized from appealing to the median voter. Put differently, the intrusion of political entrepreneurs raises the political stakes involved in regulatory decision-making and thereby decreases the influence of particular interest groups on the policy-making process. For supporters of new policies, this dynamic means they can expend lobbying efforts in the expectation that their efforts will produce policy

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change. Firms opposed to policy change, on the other hand, will be strategic and stake out positions which do not leave them politically isolated. In other words, firms understand the basic competitive electoral pressures driving U.S. politicians and thus have a good idea of the political forces driving policy change. When conditions are ripe for broad policy change, firms thus cast their preferences in terms which are compatible with the median voter. Firms thus understand the win-set which is possible in light of broad U.S. electoral dynamics and adopt strategies designed to succeed within the parameters of this win-set; both supporters and opponents of policy change thus pursue their interests in terms compatible with the concerns of the median voter.[8]

4.1.2 Firm Strategies and International Bargaining Dynamics

U.S. airlines launch strategies in light of calculations about the shape and content of the international market which likely to emerge from inter-state bargaining. U.S. airlines must thus ask what impact, if any, U.S. policy change will have on the shape and content of international aviation markets. If U.S. policy is unlikely to have any impact on international markets, then U.S. airlines are unlikely to expend great efforts lobbying for an activist U.S. international aviation policy. Why expend effort to alter U.S. policy if foreign governments refuse to re-organize international markets? On the other hand, if U.S. airlines believe U.S. policy can drive changes in international markets, the time, effort, and political capital used in lobbying for a pro-competitive U.S. international aviation policy is likely to prove worthwhile.

In short, international constraints shape the domestic strategies of firms with operations in international markets.[9] In aviation, the huge size and market power of the U.S. meant U.S. airlines expected new U.S. international aviation policies to produce at least some liberalization of aviation markets, and launched strategies in light of these

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calculations. U.S. market power thus increased U.S. domestic airline support for a more liberal U.S. international aviation policy and meant demands for policy change came sooner in the U.S. than elsewhere.

4.1.2 Policy Supply: U.S. Domestic Political Institutions

Although demands for a more liberal U.S. international aviation policy emerged by the early 1970's, the essential question is why, how, and when these demands translated into particular policy outcomes. As I discussed in chapter two, I argue that domestic political institutions, in particular electoral rules and the division of powers, are important for understanding policy supply because they determine the rules of political competition and thus shape the policies politicians must supply in order to achieve electoral success. The first-past-the-post electoral system in the U.S. favors a two-party system built around the pursuit of the median voter.[10] With a majority necessary to secure electoral victory, politicians cannot rely solely on particularistic favors for electoral success.[11] Thus, U.S. politicians utilize collective goods party platforms as a low-cost strategy to supply constituents with desired policy outcomes[12] and develop party labels as an informational cue to communicate policy positions to constituents.[13] Even in Congressional elections, where particularistic policies are more important than in presidential campaigns, party identification is still the best predictor of vote choice.[14] The importance of the party label for winning elections means parties identify and run on important public policy issues rather than relying solely on patronage politics. Policy entrepreneurship is especially important because policy positions become part and parcel of the brand name identity that is the party label; electoral gains or losses thus accrue over many elections.[15]

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While U.S. electoral rules provide incentives to campaign on broad collective goods issues, the division of powers makes particularistic policies important for the electoral success of legislators. With legislators unable to claim credit for policies which entail the participation of both the executive and the legislature,[16] the division of powers creates incentives for legislators to supply particularistic goods for which they can credibly claim responsibility. Short time horizons and small constituencies also provide incentives for U.S. legislators, particularly House members, to package collective policies in order to minimize short-term costs, distribute particularistic favors, and provide side-payments to key constituencies.

To summarize, U.S. domestic political institutions create incentives for national parties to run on collective goods platforms but tilt the legislature toward local, particularistic policies. Thus, the legislature and executive often have competing policy objectives. Ultimately, the executive and legislature utilize the tools at their disposal to secure policies favorable to their constituents: Congress writes rigid and rule-bound delegations of authority to executive agencies while the executive directs bureaucracies to supply policies favored by the executive.[17] Thus, Congress structures the supply of policy to minimize short-term costs and provide particularistic side-payments to key constituents. The President, on the other hand, tends to pursue regulatory policies favorable to her broad national electorate.

4.1.3 Government Strategies and International Bargaining Dynamics

The new U.S. domestic political bargain which emerged in the late 1970's meant the U.S. would press for more competitive international aviation markets, but domestic political bargains did not dictate a particular bargaining strategy. The question of the particular bargaining strategy to adopt thus revolved around questions of

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efficacy: which bargaining strategy would be most effective in achieving U.S. policy goals? Given the need to secure foreign partners to liberalize international markets, U.S. decision-makers considered the impact of international constraints when adopting particular policies and devising bargaining strategies. More specifically, U.S. decision-makers considered the impact of the rules and decision-making procedures of international institutions, international market dynamics, and the preferences of foreign partners vis-a-vis international aviation markets when launching strategies designed to re-structure international aviation marketplace.

Existing regime institutions were important because they provided defenders of the Bermuda regime with institutional vetoes to stifle efforts at restructuring the regime and thus provided statutory and regulatory barriers to regime change. International market forces mattered because particular features of some aviation markets provided opportunities for U.S. actions to shift the preferences of actors in foreign states through direct market pressure. International market forces were also important for understanding the preferences of foreign partners, which were of course important for U.S. strategy simply because reformulating international markets required the participation of foreign governments.

4.2 U.S. International Aviation Policy, 1960-1980

This section provides an overview of U.S. international aviation policy from 1960-1980, an overview which will serve as a backdrop to the analyses in the following three sections. It is important to note that the purpose of this section is not to provide any specific analysis of U.S. international aviation policy, but rather to supply some economic and political facts for the analysis in the following three sections. As

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such, any analysis of how, when, or why particularly policy choices is purposely avoided.

Although U.S. policymakers often maintain that the U.S. has consistently espoused unbridled competition in international aviation markets, in actual fact the U.S. was a central pillar of the Bermuda regime. As we saw in chapter three, U.S. domestic politics were important determinants of the scope and content of the postwar Bermuda agreement, and U.S. international aviation policy was crucial for the maintenance of the regime throughout the 1950's and 1960's. Although the U.S. always differed slightly in that U.S. carriers were not state-owned and multiple carriers flew on international routes, the CAB strictly limited the number of U.S. carriers on any given international route and severely restricted entry of U.S. domestic carriers into the international marketplace.[18] Likewise, the CAB granted IATA fare conferences anti-trust immunity, routinely approved the fares agreed upon at IATA traffic conferences, and granted IATA authority over fares in bilateral agreements.[19]

U.S. support for restrictive international aviation markets began to erode in the early 1960's, however, and the U.S. began to press for more liberal rules governing international charter markets. The initial impetus for more liberal charter rules came from Congress, which significantly liberalized the restrictions on U.S. international charter carriers when it passed the Supplemental Air Carrier Act in 1962. U.S. charter regulations were progressively liberalized throughout the 1960's, and the share of charter airlines in international markets expanded throughout the decade.[20] New rules allowing U.S. charters to operate inclusive tour charters (ITC's) were particularly important for the development of international charter services.[21] First liberalized in 1966, the new rules on ITC's enabled charter carriers to compete with the scheduled carriers for the first time and thereby dramatically increased the ability of charter

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airlines to compete against the scheduled airlines.[22] In addition to liberalizing the rules governing charter operations in the early 1960's, the CAB also began to press U.S. scheduled carriers to push for lower fares at IATA fare conferences.[23], The CAB successfully pressured IATA to introduce economy fares with fare reductions of up to twenty percent in 1958 and repeatedly requested that IATA reduce prices on all major international routes in the early 1960's.[24] By the mid-1960's, the CAB simply made approval of IATA rates conditional upon significant fares reductions.

While liberalization of charter rules created the mass market for international vacations by the late 1960's, the introduction of jumbo jets in the late 1960's resulted in dramatic changes in U.S. international aviation policy. As we shall see in more detail in the next section, the introduction of jumbo jets ultimately altered the preferences of key supporters of the Bermuda regime and thus created widespread pressure for policy change. Although the details of this process are important, they are left to section 4.3 below. For now, it important only to note that the introduction of jumbo jets led to substantial pressure from U.S. airlines for more competitive international aviation markets.

Airlines dissatisfaction with existing U.S. international aviation policy generate widespread debate within the CAB over the proper course of U.S. policy. The ambivalence over the benefits of more competition manifested itself clearly in the trans-Pacific route proceedings. Beginning in 1967, the CAB stressed the importance of low fares in awarding new routes but also set strict limits on any new entry into the international marketplace. In particular, the CAB stressed that route awards would be granted to airlines submitting low-fare proposals, but at the same time limited direct carrier-to-carrier competition and granted new routes to a very limited number of new entrants.[25]

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The debate over the merits of a more pro-competitive international aviation policy spilled out from the CAB into the broader political arena during the Nixon Administration. Following the recommendations of the transitional task force on transportation, the Nixon administration called for a review of international aviation policy in 1969. Transportation Secretary John Volpe was placed in charge of the review, which was to place special emphasis on issues which inhibited the potential for competition or hampered the growth of U.S. airlines. While the Nixon administration considered the possibility of greater competition in international aviation markets, the effects of the capacity-increases wrought by the introduction of the 747, increases in oil prices, and a worldwide recession led to a rapid decline in U.S. incumbent airlines earnings.[26] Thus, the 1970 Nixon policy statement was not clear on the relationship between the benefits of competition and the traditional, restrictive U.S. international aviation policy. Although the policy statement called for more competition and lower prices in international aviation markets, in actual fact the Nixon administration did little to encourage more competition in international aviation markets.[27] However, the Nixon policy did stress the competitive impact of charter carriers on the scheduled marketplace and announced U.S. intentions to include general provisions for charters in future air services agreements.

Overall, U.S. international aviation policy in the early 1970's attempted to use charters as the competitive spur to the scheduled airlines[28] but continued to view international scheduled markets as markets to be carved up by government intervention and subsequently shared between the scheduled airlines of bilateral partners. During the OPEC oil crisis and subsequent recession in 1974-1975, for example, the CAB allowed Pan Am and TWA to swap some routes and rationalize their international route structures in order to reduce direct competition. But U.S. policy also reflected a deep

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uncertainty over the proper way to govern international aviation markets. On the one hand, U.S. policy continued to cater to the demands of the incumbent scheduled carriers and their need for government intervention to limit competition in international markets. On the other hand, the U.S. pressed for more liberal rules governing charter operations and authorized increasing numbers of U.S. domestic carriers to enter the international marketplace. U.S. policy-makers were aware of the ambivalence in U.S. aviation policy; in testimony before the Senate in 1976, CAB Chairman John Robson testified that the CAB must either become a more strict regulatory body or withdraw from regulating aviation markets and give market forces full reign.[29]

In 1976, a Ford Administration policy statement dissipated some of the ambivalence of U.S. policy, and began to tilt toward U.S. policy toward greater reliance on market forces. In particular, the policy statement stated that "market-based decisions should again be adequate to establish rational levels of capacity."[30] The move toward greater reliance on market forces continued in 1977, when the U.S. refused to impose capacity controls in the U.S.-Japan and U.S.-U.K. bilateral markets, despite pressure from Japan and the U.K. for greater government intervention in the respective bilateral markets.[31] Ultimately, foreign pressures for stricter regulation forced U.S. policy-makers to address the ambivalence of U.S. policy, with the U.K. renunciation of the U.S.-U.K. Bermuda I bilateral being particularly important in this regard.[32]

In June 1976, the U.K. denounced the U.S.-U.K. Bermuda I bilateral agreement. Although the denunciation was no surprise, as the U.K. had long been dissatisfied with its airlines share of traffic on U.S.-U.K. routes, the U.K. renunciation and subsequent negotiation provided U.S. policy-makers with the opportunity to ask fundamental questions and undertake policy discussions concerning

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the shape and scope of the international aviation marketplace. With the Bermuda II negotiation with Britain going on in the background, a thorough policy review led the CAB to three conclusions regarding U.S. international aviation policy: (1) the U.S. had to protect the interests of Pan Am and TWA (the incumbent carriers), (2) the U.S. had to provide access (i.e. facilitate entry) for new carriers, and (3) the U.S. had to sign a deal with the U.K.[33]

While the CAB undertook its comprehensive policy review, U.S.-U.K. negotiations were producing only frustration: the U.S. pressed for a more liberal bilateral agreement to replace Bermuda I, while the U.K. stood firm on capacity restraints and the need to limit U.S. airlines fifth-freedom rights to Europe.[34] The clear policy differences created major stumbling blocks for any new agreement, and only after political intervention at the highest levels did the two sides manage to sign a new agreement in June 1977. Known as Bermuda II, the agreement was liberal in the sense that it provided for a phased introduction of new international service from additional U.S. cities to the U.K. over the next six years. On the other hand, the agreement was anti-competitive in that it required the U.S. to give up fifth-freedom rights beyond London, eliminated the potential for multiple designation (more than one U.S. airline on a single route) on almost all U.S.-U.K. routes, and included capacity clauses which limited the growth of the marketplace.

The agreement immediately generated widespread criticism in the U.S., especially in Congress. Numerous cities launched lobbying campaigns against the agreement in Congress or considered legal challenges to the agreement.[35] Of particular import was the removal of international air service from Boston, which created serious pressure from New England Congressional delegations, notably House Speaker Tip O'Neil, to abrogate Bermuda II and introduce a pro-competitive U.S. international

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aviation policy.[36] Consumer groups, including the Aviation Consumer Action Project (ACAP) led by Ralph Nader, expressed similar dissatisfaction with the agreement and considered their own legal challenges.[37] U.S. airlines also criticized the agreement, and began to pressure the U.S. government for a less restrictive U.S. international aviation policy.

Facing widespread criticism of the agreement, the aviation subcommittees in both the House and Senate held hearings on the agreement and the future direction of U.S. international aviation policy. With impending negotiations with Japan lending urgency to the proceedings and the benefits of a more liberal international aviation marketplace being demonstrated by the beginning of the low-fare service offered by Freddy Laker's Skytrain, Congress called upon the administration to press for changes in the agreement and to adopt a more pro-competitive international aviation policy.[38]

In the face of widespread criticism of existing U.S. policy, the Carter administration issued a new international aviation policy statement in August, 1978.[39] The 1978 Carter policy statement marked a dramatic reversal of U.S. international aviation policy. No longer would U.S. international aviation policy support the restrictive Bermuda regime and thereby protect the interests of incumbent U.S. international airlines.[40] The new policy stressed the importance of increased competition and market entry in order to obtain low international air fares for both consumers and shippers. Indeed, Carter argued that "reliance on competitive market forces to the greatest extent possible in our international air transportation agreements will allow the public to receive improved service at low costs that reflect economically viable operations."[41]. The policy statement went on to note that U.S. policy would "work to achieve a system of international air transportation that places its principal reliance on actual and potential competition to determine the variety, quality and price

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of air service. An essential means for carrying out our international air transportation policy will be to allow greater competitive opportunities for U.S. and foreign airlines and to promote new low-cost transportation options for travelers and shippers."[42] More specifically, the statement called for a further liberalization of charter pricing and rules, competitive pricing in scheduled services, expansion of scheduled services through the elimination of restrictions on capacity, frequency, and route and operating rights, multiple designation, increased cities designated to increase passenger and shipper access to international aviation, and the development of competitive international air cargo services.

The Carter policy statement was quickly followed by the adoption of U.S. policies designed to provide greater entry into international markets and thereby generate much greater competition and lower fares in international aviation markets. In particular, the Carter administration utilized a two-pronged strategy to secure U.S. policy goals: (1) sign new, liberal bilaterals with willing foreign partners; and (2) undermine the restrictive institutions that characterized the Bermuda regime. The details of these policy initiatives are discussed below in section 4.5.2.

In 1979, Congress provided Congressional backing to the Carter administration policy when it passed the International Air Transportation Competition Act of 1979 (IATCA). The legislation called for flexible pricing provisions in bilateral agreements, multiple designation in international markets, and for the maximum reliance on competitive market forces in order to achieve low prices and efficient, well-managed U.S. airlines. The provisions of the legislation were more cautious than administration policy, however. Although the opening provisions of IATCA emphasized competition, the bill noted that competition should be encouraged to the extent to which such competition allows U.S. carriers to earn adequate profits and

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attract capital and included a requirement, inserted by the House of Representatives, that the economic health of U.S. carriers be protected.[43] The IATCA also provided for direct Congressional oversight at bilateral negotiations and contained a number of provisions helpful to incumbent U.S. international airlines. In particular, the Act increased the ability of the CAB to respond to unfair or discriminatory foreign trade practices in aviation, empowered the CAB to restrict, without hearing, the operations of foreign carriers, and provided a time frame for acting on formal complaints brought by U.S. airlines.

With Congressional backing, the Carter administration signed a series of liberal bilaterals with willing partners. In addition to the Netherlands, Belgium, and Israel, the U.S. signed liberal bilaterals with Singapore, South Korea, Thailand, Taiwan, and, to a lesser degree, Germany. The U.S.-U.K. bilateral was also amended in 1980 in order to allow greater pricing freedoms. Although each of the bilaterals contained slightly different provisions, the new bilaterals generally sought to secure additional entry for U.S. carriers into the international marketplace, provided for new non-stop international service (for both U.S. and foreign airlines) from additional U.S. cities,[44] and included liberal fare provisions which allowed airlines, rather than governments, to set international fares.

4.3 Demands and Strategies For Policy Change

The broad technological, economic, and ultimately political factors undermining the Bermuda regime were discussed in section 3.4 above, and will not be reiterated here. It is important to note, however, that distinctive features of U.S. aviation markets meant demands for a pro-competitive international aviation policy came earlier and were more successful in prompting policy change in the U.S. than in

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other states. This section examines how these distinctive features of U.S. aviation markets, coupled with broad dissatisfaction with the Bermuda regime, led to demands for policy change. The point of this section is three-fold: (1) to outline the demands for policy change, (2) to elucidate how demands for policy change were conditioned by domestic politics and international bargaining dynamics; and (3) to clearly show that demand-side explanations cannot explain policy outcomes.

Demands for a pro-competitive U.S. international aviation policy stemmed from three basic sources: (1) consumer dissatisfaction with the high fares imposed by the regime, (2) the growing internationalization of the U.S. economy, and (3) pressure from potential entrants, U.S. aircraft manufacturers, and large financial institutions. Consumer pressures for lower international air fares began in the early 1960's. As discussed in chapter three, the political importance of the change in the structure of demand revolved around the large increase in the number of vacation travelers: because vacation travelers are price elastic (unlike business or government travelers), the increase in the number of international vacation travelers generated widespread consumer dissatisfaction with the high prices imposed by the Bermuda regime.

By the early 1970's, consumer pressure for lower fares led to organized attempts to force the CAB to press for lower fares. In 1971, in response to a growing consumer dissatisfaction with airline regulation, Ralph Nader formed the Aviation Consumer Action Project (ACAP) to reduce the cost of international air travel, expand service options, and reduce barriers to efficient carrier operations. Likewise, California Democratic Congressman John Moss formed a group of two dozen legislators (known as the Moss Group) whose sole goal was to stop the CAB from allowing the airlines to gouge consumers. Moss went to court to get the airlines to cough up $256 million in refunds to consumers, funds which he claimed had been overcharged when the CAB

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improperly approved fare increases in 1969.[45] Consumer groups were also firm supporters of the IATCA of 1979 and were particularly vehement in pressing for multiple designation provisions in the legislation.[46]

Broad political suspicion of IATA tariff conferences and constant legal challenges to proposed fare increases undertaken by consumer groups, notably the ACAP, were important in establishing the political boundaries within which scheduled airlines could operate.[47] In 1973, for example, ACAP won an important court case which established the precedent that vague and unsubstantiated CAB concerns about the "chaos" of an open rate situation were insufficient to warrant automatic approval of unjustified IATA price increases.[48] The ruling thus limited the ability of the CAB and U.S. incumbent international airlines to defend IATA and the Bermuda regime without specific justification, and thereby limited the range of strategies which incumbent U.S. international airlines could employ to stifle demands for international regulatory change. The ability of consumer groups to utilize the U.S. legal system to check agency decision-making thus constrained the strategy choices of U.S. scheduled airlines.

The second set of pressures for a pro-competitive U.S. international aviation policy was the growing internationalization of the U.S. economy. As I noted in chapter three, large users of international aviation services were disadvantaged under the Bermuda regime due to the high prices produced by the Bermuda institutions. Although MNCs had been willing to pay slightly higher prices in order to ensure marketplace stability in the early postwar years, the high price of international travel became increasingly problematic as U.S. MNCs expanded their international operations during the 1960's.[49] Dissatisfaction was especially acute regarding international air cargo, where MNCs were forced to pay the exorbitant rates set by

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IATA despite the low prices potentially possible in wide-body jets.[50] With IATA rules forcing international cargo airlines to use small planes and charge high prices, both cargo airlines and their customers suffered gross inefficiencies. In 1977, for example, total efficiency losses to U.S. cargo airlines were estimated to be $57.3 million, 5.1 percent of the industry's gross revenues for the year.[51] The large potential gains from a more efficient system, coupled with the small number of large interests involved in international cargo operations, made both cargo airlines and their customers easy to organize in support of a more pro-competitive U.S. international aviation policy. In the Pacific, for example, The Electronics Shippers were particularly active in the debates over cargo rates as they represented approximately 30 percent of the total air freight in the Pacific during the mid-1970's.[52] Freight forwarders supported a more competitive U.S. international aviation policy.[53]

The final source of pressure for a reversal in U.S. international aviation policy came from U.S. incumbent airlines, potential entrants, U.S. aircraft manufacturers, and large financial institutions. The most distinctive feature of U.S. aviation markets was the number of potential entrants and the fact that these entrants were privately owned.[54] Incumbent dissatisfaction with the Bermuda regime and pressure for new entry from potential entrants both increased dramatically in the late 1960's as a result of the relaxation of charter rules and the introduction of wide-body jets. As noted earlier, relaxation of charter rules allowed charter airlines to offer services comparable to scheduled carriers. More liberal charter rules, coupled with the high elasticity of demand for vacation travelers, meant it was no longer clear that the high fares imposed by IATA were in the interest of U.S. scheduled carriers. Indeed, as demand became increasingly elastic due to the growing numbers of vacation travelers, lower fares held out the promise for an increase in the number of passengers on both charter and

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scheduled flights. Moreover, because U.S. airlines were more efficient than most foreign airlines and carried more vacation travelers than other airlines (because U.S. incomes facilitated international travel for a larger segment of the population), U.S. airlines stood to benefit more than foreign airlines from being allowed to offer lower fares. U.S. incumbent airlines were thus the first scheduled carriers to press for lower fares at IATA fare-conferences. The dissatisfaction of U.S. international airlines only increased after the introduction of the Boeing 747 in 1970 doubled the size of aircraft and thus necessitated a dramatic expansion in the number of vacation travelers to fill the huge planes.[55]

While the introduction of jumbo jets eroded incumbent U.S. airline support for the Bermuda regime, the most significant impact of the new jets revolved around U.S. domestic airlines and the cities they served. In short, the increased range and capacity of the 747 enabled U.S. domestic airlines to offer direct international services from the interior cities where they had major operations.[56] For the domestic airlines, the higher profit rates in the international marketplace and the low costs promised by the jumbo jets also made international services more alluring.[57] U.S. domestic airlines thus began demanding entry into international aviation markets. During a review of U.S. international aviation routes in the Pacific in 1968, for example, the CAB faced intense pressure from domestic airlines for expanded international services.[58] The introduction of jumbo jets also increased pressure from regional, civic, and airports interests for new international services from interior gateways. Because direct international services allowed cities to become major international business centers and thus promised large economic benefits to local economies,[59] these interests began to seriously pressure their Congressional representatives once jumbo jets made these services possible.[60] Local and regional officials repeatedly asked for additional international service from

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both foreign and U.S. international carriers. Representatives from several U.S. cities and states, including Seattle-Tacoma and the Dallas/Ft. Worth Regional Group, visited foreign governments and airlines in the late 1970's in an attempt to secure new aviation services from these foreign airlines. These groups also sought membership on U.S. international aviation negotiating teams.[61]

While domestic airlines pressed to liberalize international aviation markets, U.S. aircraft manufacturers and their financial institutions provided further support for a pro-competitive U.S. international aviation policy. For U.S. aircraft manufacturers, the development of jumbo-jets meant U.S. aerospace firms were able to offer technological advantages that could not be matched by foreign manufacturers.[62] While U.S. airlines were still extremely important customers, the increasing importance of international markets meant U.S. aircraft manufacturers began to be more attentive to the needs of the international marketplace. Moreover, aircraft manufacturers realized that lower international airfares would increase demand for tourism and business travel and thereby increase the demand for commercial aircraft.[63] Thus, although U.S. aircraft manufacturers were major beneficiaries under the Bermuda regime, these manufacturers began to support a pro-competitive U.S. international aviation policy.[64] Likewise, although the financial institutions which financed the massive loans to purchase aircraft had benefited from the Bermuda regime due to guaranteed re-payment, these financial institutions shared the aircraft manufacturers analysis of the trade-offs between a regulated international marketplace and the likely impact of demand for aircraft. Thus, they did not oppose international deregulation.[65]

With these three sets of demands goading U.S. politicians into a more pro-competitive international aviation policy, U.S. politicians made subtle changes in the regulations governing aviation markets in the hopes that these changes would satisfy

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demands for reform. But defenders of the status quo, in particular incumbent U.S. international airlines, were able to stifle serious policy change. Piecemeal changes in U.S. aviation regulations, however, set in motion further economic and political forces which generated additional political pressure for liberalization. Demands for reform thus led to limited domestic policy changes, which in turn unleashed international market forces and ultimately wrought further domestic political changes. Coupled with the introduction of jumbo jets, which dramatically altered the preferences of both international and domestic airlines, limited regulatory changes thus increased demands for reform and exacerbated pressure on U.S. national politicians to adopt a pro-competitive international aviation policy. Policy change could not simply be demanded, however, and the proponents of more competitive aviation markets failed to win major political battles until the late 1970's.

By the 1970's, then, initial demands for reform has produced limited regulatory policy changes, which in turn led to even greater pressure for liberalizing international aviation markets. A broad set of diverse interests thus supported a more pro-competitive U.S. international aviation policy by the early 1970's: consumer and Congressional representatives, potential entrants, aircraft manufacturers, and MNCs all pressed for a reversal of U.S. aviation policy. The crucial questions about these demands noted at the beginning of this section are two-fold: (1) what impact did these demands have on the strategies of U.S. airlines?; and (2) what impact did these demands have on policy choice? I address each of these questions in turn.

For incumbent U.S. international carriers, demands for regulatory change threatened to undermine the regulatory rules on which their economic viability rested. Broad support for more competitive international aviation markets, however, meant bluntly opposing the proponents of reform was politically impossible. Indeed,

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Congressional support for new entry, coupled with the aforementioned consumer pressures for lower prices, effectively prohibited U.S. incumbents from pursuing any strategy designed to maintain the Bermuda regime. Facing these domestic political constraints, Pan Am and TWA did not directly oppose new entry or lower fares in the 1970's. Rather, these carriers attempted to change the terms of the debate and concentrate political attention on the problems facing U.S. airlines in doing business abroad.

Once deregulation became the preferred policy vehicle for demonstrating Democratic party competence in managing the economy, the strategies available to incumbent U.S. international carriers were even more constrained. In the 1978 Hearings on IATCA, for example, both TWA and Pan Am argued that competition did not exist in international aviation markets and that it was not possible to effect change to achieve competition. Thus, TWA did not oppose international deregulation; rather " TWA's fundamental reservation regarding our new international aviation policy is based on the view that a fair competitive market does not, can not and will not exist in international air transportation."[66] In his testimony, Pan Am Chairman William Seawell stated that

> we have no doubt in our minds but what we will face over time an increasing, not decreasing, competition from both other U.S. airlines, supplemental and scheduled.....And we don't shy away from that.....We are not going to hog the world's market. Our basic difficulty centers around what we believe is a naive presumption by the U.S. negotiators that this is indeed an equal opportunity market.[67]

Likewise, despite the fact that Pan Am needed IATA to set international fares due to its far-reaching but sparse route structure, it did not oppose eroding IATA's authority simply because it could not argue that cartels were good for the consumer in the face of widespread political support for lower fares.[68] In short, with domestic politics

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precluding outright opposition to a pro-competitive U.S. international aviation policy, both Pan Am and TWA did not oppose more competition but instead argued that the realities of the international marketplace meant the U.S. should continue to rely on the current restrictive bilaterals and IATA to regulate the marketplace.

Even Pan Am employees, who were arguably the biggest losers from IATCA, were strategic in the lobbying positions they adopted and thus did not directly oppose IATCA. In a letter to the Senate Subcommittee on Aviation, for example, the Director of Legislative Affairs for the Pan Am flight engineers union wrote that "we want to make it clear that we are not intransigently against 'deregulation.' We are very much in favor of permitting international air carriers the flexibility to create new markets, new services, and lower fares. But we believe that the pace of change must be disciplined and controlled in order that the effects of each change can be carefully identified and measured."[69]

Even as TWA and Pan Am attempted to derail legislation backing the CAB's pro-competitive policy, their competitive strategies revealed their belief in the inevitability of international liberalization. In preparation of the expected entry of the domestic carriers into the international marketplace, Pan Am and TWA attempted to build or acquire domestic route networks which would allow them to compete with the new entrants. Despite statutory restrictions which prevented Pan Am from operating in the U.S. domestic marketplace, for example, Pan Am began to press for permission to enter the domestic market in the early 1970's.[70]

In sum, U.S. domestic political dynamics constrained the ability of incumbent international airlines to block efforts to secure more competitive international aviation markets. Neither Pan Am or TWA openly opposed CAB efforts to introduce more competition into international markets and thereby lower fares simply because they

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realized maintaining the status quo was politically impossible. Faced with domestic political support for more competitive international aviation markets, the incumbents did not oppose new entry or low fares, but rather attempted to shift the focus to so-called "doing business issues" even as they prepared for greater competition by attempting to build domestic networks.[71] In other words, the incumbent U.S. international carriers adopted strategies designed to protect their interests--i.e. maintain strict regulatory control over international markets and thereby limit competition--but did so in a manner consistent with the win-set defined by domestic political competition.

The efforts of U.S. domestic carriers to enter the international marketplace also reflected U.S. domestic political dynamics. In particular, the domestic airlines concentrated their lobbying efforts on their Congressional representatives, notably their senators,[72] a lobbying choice which reflected the increased likelihood of success for these firms in Congressional lobbying. U.S. domestic airlines also began to offer petitions in CAB proceedings which attempted to force the CAB to award routes based on fares rather than traditional public interest criteria. Although the CAB was charged to authorize airlines to serve international markets based on public interest criteria, Congressional pressure for lower fares in the late 1970's led the CAB to begin to emphasize the benefits of low fares at the expense of other aspects of the public interest. U.S. domestic airlines took advantage of these Congressional concerns over prices and the resultant CAB sensibilities by submitting bids for routes which highlighted the low fare aspects of their bids. In highlighting the low-fare attributes of their petitions, the domestic airlines thus linked CAB fears of Congressional intervention in regulatory policy-making with the success of the domestic airlines entry into international markets.[73]

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If widespread demands for regulatory change constrained the ability of U.S. incumbent international airlines to lobby against a pro-competitive U.S. international aviation policy, we might expect that demands for policy change were easily successful. Indeed, with the primary beneficiaries of the Bermuda regime unable to openly and directly oppose liberalization of international regulatory rules, and a broad set of interests pressing for policy change, should we not expect quick policy change? Whatever our expectations, no major change in U.S. aviation policy occurred until 1978, despite the fact that all the demands for liberalization outlined above had emerged by 1970. Put simply, demands for a pro-competitive international aviation policy simply did not translate into policy outcomes--a fact which raises questions about the utility of demand-side theories to explain how states organize international aviation markets. Put bluntly, demand-side theories cannot explain the lack of policy change until 1978. The essential question is thus not what societal interests demand from national politicians, but rather when, why and how these societal pressures translate into particular policy outcomes. But what determines the impact of different interests on policy outcomes, how does this influence change over time, and what impact do answers to these questions have on policy outcomes? I seek answers to these questions in the structure of domestic political institutions, a subject to which I now turn.

4.4 Policy Supply: U.S. Domestic Political Institutions

The previous section outlined the preferences of the key actors involved in the politics surrounding U.S. international aviation policy. Two conclusions were drawn from the discussion: (1) demands for policy change were conditioned by the win-set defined by domestic politics, and (2) a singular focus on the demands of societal

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groups could not account for U.S. international aviation policy. This failure, I argue in this section, stems from the failure of demand-side explanations to include domestic political institutions in their analysis. In particular, this section highlights the role of U.S. domestic political institutions in shaping how demands for policy are aggregated and ultimately produce policy outcomes. The central premise of this section is simple: domestic political institutions are important because they aggregate the preferences of domestic actors and thus condition how demands for policy translate into concrete policy outcomes. To demonstrate the argument, the section discusses three major periods in the supply of U.S. international aviation policy: (1) the liberalization of charter rules in the 1960's and early 1970's, (2) early moves toward more liberal scheduled markets in the early and mid-1970's, and (2) the pro-competitive Carter policy. In all three sections, the essential question is why particular policies were chosen rather than others in response to demands for policy. In other words, why is one particular policy chosen from the range of possible policy outcomes?

4.4.1 The liberalization of charter rules

As pressures for lower international air fares began to mount in the early 1960's, there were a variety of potential policy choices for U.S. politicians, including ignoring the complaints altogether. The question facing U.S. politicians was what policy to enact, if any. If U.S. politicians chose to supply policies designed to lower international air fares, there were a variety of avenues which could be taken: anti-trust immunity could be withdrawn from IATA, new entrants could be authorized in order to create more competitive markets and thereby drive down fares, or low fare carriers could be authorized to serve new market segments (i.e. charter airlines). More analytically, the U.S. could have chosen to act within the existing set of international

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rules or seek to change these rules in ways more favorable to U.S. policy goals. Why choose one particular policy rather than another?

For both Congress and the President, the problem in addressing demands for lower prices revolved around the political trade-off between consumers and their allies and U.S. scheduled airlines. Although more competitive international aviation markets would lower fares, it would also harm the interests of U.S. scheduled airlines. For Congress, this was particularly problematic given short electoral calendars and the geographically concentrated nature of airline operations. Congressmen from areas where incumbent U.S. international airlines had major operations opposed pro-competitive aviation policies which threatened to harm U.S. incumbent airlines. For the President, consumer pressures for lower prices were of political import given the paramount electoral importance of the health of the national economy and individual economic well-being for electoral success.[74] Likewise, Congressional concerns over the Democratic party label lent impetus for offering some policy response to consumer pressures.

In 1962, Congress responded by passing the Supplemental Air Carrier Act of 1962. Designed to dampen political pressure for lower international air prices without damaging the interests of the scheduled carriers, the Act loosened the rules governing charter operations and ultimately led to the development of low-cost vacation airlines distinct from the operations of the scheduled carriers.[75] Most importantly, by utilizing new, more liberal charter rules to provide consumers with low-cost international air travel, Congress managed to supply low fares without harming the interests of U.S. scheduled airlines. The new charter rules led to the development of an entirely new segment of the market geared toward exclusively serving the low-cost vacation traveler, and thus did not directly impact the scheduled carriers. Moreover, the

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legislation also provided local benefits in the form of new international gateways, even if these new cities could only offer international charter service.

To be sure, the gradual loosening of charter regulations throughout the 1960's and early 1970's was designed to pressure the scheduled carriers to offer lower fares on politically salient North Atlantic routes.[76] However, the incremental nature of the rule changes and the fact that charter carriers were not allowed to compete directly for the major customers of the scheduled carriers (businessmen) meant that U.S. scheduled carriers had time to adjust their operations to the new competitive realities.[77] Moreover, the CAB argued that greater rights for charter carriers would induce scheduled carriers to begin to offer lower fares and subsequently re-think their preferences vis-a-vis the high-priced Bermuda regime. The threat of passenger diversion thus forced U.S. scheduled carriers to offer lower international fares and thus ensured the continued downward movement of international fares.[78]

As I noted in chapter two, politicians often deal with pressures for regulatory change by expanding markets or opening new segments of the marketplace. U.S. politicians pursued this regulatory strategy in response to demand for lower international fares: U.S. policy continued to support the interests of the scheduled carriers in scheduled markets, but provided new areas for charter carriers to develop and thereby lessen consumer dissatisfaction with high international airfares. Meanwhile, the long-run impact of the policy (i.e. liberal charter rules would force U.S. scheduled airlines to offer lower fares) was consistent with short Congressional time horizons but also provided some collective goods in the form of lower fares. Put differently, the policy minimized the immediate and direct impact on U.S. scheduled carriers while also ensuring a long-term movement toward more competitive international aviation markets.

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4.4.2 Early moves toward more liberal scheduled markets

The Nixon administration announced a new international aviation policy in 1970. Calling for increased competition between U.S. airlines on international routes, the policy stressed the importance of new entry and low fares and continued to encourage the development of charter markets to the extent that charter airlines did not significant damage the economic viability of U.S. scheduled carriers. In a personal note accompanying the 1970 policy, Nixon noted that "the policy is carefully framed to conserve opportunities of all our carriers for continued growth. It is directed realistically at making a new variety of service available to passengers and shippers."[79]

Although the new Nixon policy was clearly more pro-competitive than previous policies, it remained ambivalent on the benefits of competition in international aviation markets. In particular, the Nixon policy stressed the importance of low fares for consumers and shippers, but also noted the importance of considering the economic viability of incumbent U.S. carriers when implementing international aviation policy. Thus, the 1970 policy statement noted that

> the United States should maintain a flexible policy on certifying competition among U.S. carriers on international routes. This policy should take into account the public's need for additional or improved air services.....At the same time, our policy on competition must take account of the economic viability of the additional or improved services, including a consideration of the probable foreign carrier competition and the new factors of charter competition and wide-bodied jets.[80]

U.S. international aviation policy in the early 1970's thus stressed new entry and low fares but continued to underline the importance of maintaining the economic health of incumbent U.S. international carriers. In the Pacific route proceedings in the late 1960's and early 1970's, for example, the CAB stressed the importance of low fares for receiving route awards but also severely limited competition between U.S.

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airlines on particular routes.[81] However, the CAB also stressed that direct carrier-to-carrier competition would be limited and that only a few new entrants would be granted new routes. Furthermore, routes were allocated in order to minimize the impact on U.S. incumbent airlines,[82]

In 1974, Congress passed the Fair Competitive Practices Act (FCPA) and thereby further demonstrated the political power of incumbent international carriers. The Act, which was heartily endorsed by U.S. incumbent carriers, allowed the U.S. government to take action against discriminatory and unfair competitive practices against U.S. air carriers in providing foreign air transportation services. The Act also mandated the so-called Fly-USA rule (which required that all government-financed travelers fly on U.S. carriers), prohibited the solicitation or acceptance of rebates by shippers of air freight, mandated the observance of tariffs by ticket agents, and called for the promotion of travel on U.S. carriers in international air travel. Overall, the Act was written to increase the power of the CAB to intervene in international aviation markets and dictated the CAB to do so in the interests of the incumbent international carriers.

Three features of the preceding discussion of Nixon's international aviation policy are worth noting. First, the Nixon policy continued to support the Bermuda regime and the interests of incumbent international airlines. Although the Nixon administration believed that liberalization would be in the interests of U.S. airlines and that the bilateral system did not adequately serve U.S. interests, the administration believed no alternative fora existed for liberalizing the international market.[83] Thus, the Nixon Administration remained committed to the Bermuda regime and U.S. policy continued to limit competition between U.S. airlines on international routes. Meanwhile, the relationship between the public interest as called for in the CAB

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mandate, and the interests of existing carriers was widely acknowledged and even explicitly noted. In the 1975 CAB special staff report on deregulation, for example, the report proposed regulatory reform that "is designed to effect improvements which are compatible with the fundamental feature of the present regulatory system, i.e., the preservation of the financial well-being of the existing certificated carriers."[84] Likewise, in the American-Pan Am route exchange in 1975, the CAB stated that there is a "direct and substantial relationship between (Pan Am's) financial health and the public interest."[85] Demands for new entry and lower fares thus did not mean an end to the ability of U.S. incumbent carriers to stifle pro-competitive international aviation policies.

Second, U.S. policy continued to encourage charters but continued a policy of strict market segmentation, and was thus explicitly designed to produce low prices for consumers without eroding traffic on scheduled carriers. In contrast to most European nations, the U.S. imposed no price minimum on charter carriers but maintained restrictive regulations dictating the terms of charters (who could fly and for how long) and took enforcement of these rules seriously.[86] In 1972, for example, the CAB raided a Freddy Laker charter on the grounds that passengers did not really belong to the Left Hand Club.[87] Likewise, in 1974, the CAB refused to license Laker's proposed Skytrain scheduled service and vetoed fare decreases proposed by the British Overseas Air Corporation (the precursor to British Airways) and Lufthansa that were designed to compete against charter operators.[88] U.S. regulatory policy thus dictated that the expansion of the charter market was strictly limited to those segments of the market not served by U.S. scheduled carriers. Scheduled carriers were protected as the same time that consumers could enjoy low charter prices. As Freddy Laker was fond of saying, "low fares get votes without costing politicians a cent."[89]

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Third, U.S. policy stressed the importance of new entry from carriers serving cities which had heretofore not received direct international air service. Remember that U.S. international airlines were largely organized around coastal gateways under the Bermuda regime. If this organization of the international marketplace had continued, demands for entry from domestic airlines might have led to new carriers being certified from existing international gateways. However, the involvement of local civic and economic organizations and the importance of local interests for Congress meant demands for new entry led to the supply of new entry from new cities rather than existing gateways.[90] Thus, the domestic airlines allied with local airports and cities to lobby their Congressional representatives, particular the Senate, to pressure the CAB to award new international routes to these carriers and the cities they served.[91] U.S. policy reflected these political dynamics.

4.4.3 The pro-competitive Carter policy

The dramatic shift in U.S. international aviation policy during the Carter administration nicely demonstrates the role of political entrepreneurs and the importance of collective goods for both Congress and the President. As I noted above, the basic demands for regulatory reform had coalesced by the early 1970's. During the Nixon and Ford administrations, however, the supporters of a more pro-competitive U.S. international aviation policy were unsuccessful in obtaining policy change. U.S. scheduled carriers managed to channel Congressional dissatisfaction with existing U.S. international aviation policy into the FCPA of 1974, an Act which increased CAB authority to intervene in international aviation markets and called upon the CAB to use this authority to safeguard the economic well-being of U.S. scheduled carriers. In late 1975, the Ford Administration gave policy effect to the FCPA when

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Transportation Secretary Claude Brinegar announced the Federal Action Plan, which called for reducing capacity on international routes, increased monitoring and enforcement of illegal discounting in international markets, and measures to encourage Americans to fly U.S. airlines--policies designed to benefit incumbent U.S. international carriers to the detriment of competition.

Beginning in 1975 and continuing throughout the Carter administration, however, political entrepreneurs in both Congress and the Administration latched onto deregulation as a broad policy initiative which would combat the political ills associated with stagflation. Stagflation was the pre-eminent issue facing voters in the mid-1970's, and both Democrats and Republicans sought to capture the political gains to be had from associating deregulation with efforts to combat stagflation.[92] As Ford wrote in his memoirs, "rules and regulations...were costing taxpayers an estimated $62.9 billion per year.....were increasing the costs of doing business...and thus contributing to inflation...(and)....stifling American productivity."[93] Ford considered the transportation industries to be the among the most over-regulated industries in the U.S. economy, and made deregulating transportation markets a focus of his efforts at deregulation[94] In September 1976, Ford announced a new U.S. international aviation policy calling for a greater reliance on market forces in order to achieve lower fares in international aviation markets. As Ford noted in his covering letter, the policy sought to achieve "an international economic environment and air transportation structure conducive to healthy competition among all our carriers. We shall rely upon competitive market forces to the greatest extent feasible..."[95]

While Ford offered a new international aviation policy, his efforts were overshadowed by the beginning of hearings on domestic aviation deregulation begun by Senator Ted Kennedy in 1975. The widely-publicized Kennedy hearings on

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aviation deregulation are one of the most remembered instances of political entrepreneurship in Congress. Clearly designed to demonstrate Democratic party concern with consumer interests and establish Congressional possession of the issue, the Kennedy hearings attracted widespread attention in the media and established Congressional Democrats as leading proponents of deregulation. Kennedy signaled his intended audience when he noted on the first day of hearings that "regulators all too often encourage or approve unreasonably high prices, inadequate service, and anti-competitive behavior. The cost of this regulation is also passed on to the consumer. And that cost is astronomical."[96] When some worried that Kennedy might be straying too far from his blue-collar Democratic constituency in pushing deregulation, Kennedy replied that "that's why we are having these hearings. It's so people like you can afford to fly."[97]

Although the Congressional hearings on the deregulation of the domestic aviation industry are the most well-known attempt by Democratic party political entrepreneurs to capture the political benefits generated by deregulation, Democratic party leaders, notably President Carter and key Congressional leaders, were heavily involved throughout the deregulation process. The Carter White House placed top priority on regulatory reform, with Carter himself becoming personally involved in lobbying Congress for the passage of domestic aviation deregulation legislation. Deregulation was thus intended as a policy initiative to demonstrate Democratic party competence in managing U.S. economic affairs.[98] Aviation deregulation was perhaps the most prominent deregulation effort, and Carter himself sought to directly link aviation deregulation with combating stagflation when he appointed Kahn his Counsel on Anti-Inflation after only one year at the helm of the CAB. The White House was also instrumental in assembling a diverse set of interest groups, including Ralph

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Nader's ACAP, the American Conservative Union, the National Association of Manufacturers, the American Farm Bureau Federation, and the National Federation of Independent Business, in support of aviation deregulation.[99] All these efforts were undertaken to secure deregulation of key industries.

Carter's adoption of a pro-competitive international aviation policy cannot be understood in terms of interest-group politics. Although there were a broad set of interest groups in support of international aviation liberalization, there were also key interest groups which supported the status quo, and the timing of policy change also raises doubts about interest-group explanations. In particular, both incumbent U.S. international carriers and the AFL-CIO--one of the most significant supporters of the Democratic Party--opposed the adoption of a pro-competitive international aviation policy.[100] Indeed, the AFL-CIO called the Carter policy "outright madness."[101] Thus, it was not simply interest-group politics that drove U.S. policy; rather, the importance of deregulation as a broad political initiative to demonstrate Democratic competence in managing the economy and ward off the problems of stagflation that provided the political impetus for the significant policy shift. When deregulation came, it took place quickly and was dramatically different than the piecemeal and limited liberalization which characterized international aviation policy during the early 1970's.

The difference between policy outcomes in the early 1970's and during the Carter administration is instructive of the importance of collective goods policies in U.S. politics. As discussed above, widespread pressure for lower fares and new entry into international aviation markets had emerged by the early 1970's, concern over the impact of regulation on economic growth was a primary concern of the Nixon administration, and deregulation had emerged as a political buzzword in Washington by the early 1970's. In response, the Nixon administration launched several policy

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reviews of U.S. international aviation policy while both Congress and the administration introduced numerous deregulation bills. In 1975, the Economic Report of the President criticized the CAB while President Ford sent Congress the pro-deregulation Aviation Act of 1975. Throughout both 1975 and 1976, Ford sent Congress a number of bills which would have substantially reduced the CAB's ability to regulate fares and entry. Despite demands for international liberalization from key interest groups and the efforts of the Ford administration, U.S. incumbent international carriers and labor groups were able to block any moves toward a more pro-competitive international aviation policy. In 1974, these groups even managed to channel Congressional unrest into the aforementioned FCPA.

Once stagflation became a primary concern of Democratic party leaders, however, policy reform came quickly. With stagflation threatening to undermine public confidence in the ability of the Democratic party to manage the economy, deregulation became the policy means whereby politicians would demonstrate their competence in economic matters. Thus, despite opposition from incumbent U.S. international airlines and the AFL-CIO, President Carter launched a new U.S. international aviation policy which greater competition in international aviation markets.

Wrapping his new international aviation policy in the cloak of consumerism, Carter claimed his new policy was designed to secure the maximum benefits for consumers and shippers in international aviation markets. As CAB Chairman Alfred Kahn noted in 1977, "the dramatic change is that we recognize that we should be bargaining not just for the rights of air carriers, but we are bargaining for the interests of consumers....We are not in the business of protecting carriers or conferring monopoly markets on them. We are in the business of serving consumers."[102] In

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1978, Kahn stated that "the cornerstone of (our) approach to international aviation......is our belief that the function of economic policy is to serve consumers rather than protect producers, and that the best way to do this is by promoting competition at home and abroad, rather than cartelization."[103] Meanwhile, Carter's pro-competitive international policy was implemented despite opposition from incumbent U.S. international airlines and labor groups--an anomaly which interest-group based regulatory theories cannot explain.[104] In line with this rhetoric, U.S. negotiating teams were expanded in 1977 to include representatives from both labor and consumer interests. The shift from a focus on the needs of the industry to the importance of consumer interests was complete in 1978 when Carter formally announced his new U.S. international aviation policy. Noting that "maximum consumer benefits are best achieved through the reservation and extension of competition between airlines in a fair marketplace," the Carter policy called for "reliance on competitive market forces to the greatest extent possible in our international air transportation agreements."[105]

Lest there was any doubt about the intended beneficiaries of the new policy, Carter wrote to CAB Chairman Kahn in September 1978 that "I must emphasize that my international aviation policy carries with it a commitment to low fare, competitive international air service for the benefit of American consumers."[106] As Under-Secretary of State Richard Cooper noted in his testimony before Congress, "(the) root principle under this Administration (Carter) means lower fares, more liberal charter rules, expansion of direct service to more cities, as well as the more traditional U.S. goals of freedom to designate several U.S. airlines on a given route, elimination of restrictions on capacity, and removal of discriminatory or unfair practices in international aviation."[107] Thus, the U.S. pressed for greater fare flexibility and

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multiple designation in exchange for granting foreign carriers greater access to interior U.S. gateways. Lower fares would benefit consumers while carriers would obtain additional opportunities to service new markets. The principal early innovations were country-of-origin pricing and liberal charter rules; ensuring full regulatory control over originating traffic, these regulatory changes ensured that downward movement on prices would occur on traffic originating in the U.S.[108]

The immediate impact of the policy was to produce lower fares on politically salient North Atlantic routes, but had little immediate impact on U.S. scheduled airlines. Indeed, like the policies on charters in the 1960's, Carter's policy effectively stressed short-term benefits--low fares and new entry and designation--while the terms of these designations meant incumbent U.S. airlines had time to adjust to new market conditions. At the same time, however, the new policy also provided plenty of local benefits in the form of new route rights and increased access to international markets for U.S. domestic carriers--policy provisions which were formalized in the 1979 IATCA legislation. As noted earlier, the provisions of IATCA were more cautious than the Carter administration policy. Thus, although Congress ratified the pro-competitive Carter policy, concern over the local economic impact of more competitive international aviation markets led Congress to include legislative provisions calling on the executive branch to consider the impact of U.S. carriers and the local communities they serve when making international aviation policy. In particular, the new U.S. international aviation policy sought to introduce competition into international markets by granting permission for new U.S. carriers to service international markets and for new cities to receive direct international service. By authorizing new carriers to fly on international routes and by expanding service to communities which had heretofore not received direct international aviation service, the policy allowed Congress to reap the

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electoral rewards of local particularism as part and parcel of a collective goods policy. As CAB Chairman Marvin Cohen noted in 1982, "the benefits of our policy for Atlanta and many other U.S. cities are extremely important to the development of local economies and industries."[109] Meanwhile, the short time horizon on Congress meant authorizing new carriers from new gateways, rather than new carriers from existing gateways, was good electoral politics as it provided some time for U.S. incumbent carriers to adjust to the new, more competitive marketplace.

4.5 International Bargaining Dynamics and U.S. Bargaining Strategies

The preceding section demonstrated how the electoral incentives produced by U.S. domestic political institutions shaped how, when, and why demands for more competitive U.S. international aviation markets translated into concrete policy outcomes. The discussion took place solely in the context of U.S. domestic politics, however, and there was no discussion of the impact of international bargaining dynamics on U.S. policy choices or bargaining strategies. As I argued in chapter two, however, firms and governments are strategic and endogenize international bargaining dynamics when adopting strategies. Put differently, domestic politics are the source of state preferences vis-a-vis international regimes, but the particular bargaining strategies adopted by governments to obtain desired regulatory arrangements are shape by international bargaining dynamics.

To demonstrate how international bargaining dynamics shape the particular policies and strategies adopted by U.S. policy-makers, this section discusses two major turning points in U.S. international aviation policy: (1) the liberalization of charter rules in the 1960's and early 1970's, and (2) the pro-competitive Carter policy. In both sections, the essential question is why particular policies and bargaining

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strategies are chosen rather than others. In other words, if the goal of U.S. international aviation policy is to achieve more competitive international aviation markets, why is one strategy chosen over all others to achieve this goal?

4.5.1 The liberalization of charter rules

When pressures for lower international air fares became politically salient in the early 1960's, the U.S. government faced a strategic choice of how to achieve low fares in the international arena. But the choice of policy was far from clear: the U.S. could remove anti-trust immunity from IATA, could attempt to allow more market entry, could force U.S. airlines to offer lower fares, and could liberalize charter markets. Initially, the U.S. government sought to force scheduled airlines to offer lower fares and concurrently liberalize the rules governing charter carriers. In 1962, Congress significantly liberalized the rules governing U.S.-originating charters when it passed the Supplemental Air Carrier Act of 1962. In the scheduled marketplace, the U.S. government pressured U.S. scheduled carrier to press for low fares at IATA fare conferences. The first such attempt was in 1963, when the CAB convinced U.S. scheduled carriers to agree, at a pre-conference meeting with the CAB, to block any fares increases at the 1963 IATA fare conference.[110]

At the conference, U.S. carrier efforts to block fare increases were unsuccessful, and new fare increases were agreed upon by IATA. As the Pan Am Chairman noted in regards to U.S. objectives at the conference, "we found that we are not going to get an agreement on (no fare increases)."[111] Dissatisfied with the outcome of the fare conference, the CAB disapproved the fare package--a move which sparked a wave of international criticism.[112] Most European nations officially protested the CAB action and the U.K. threatened to detain U.S. planes violating the new IATA

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fares. Ultimately, the U.S. was forced to back down, and most of the fares agreed upon by IATA were accepted by the U.S.[113]

The 1963 fare conference and subsequent conflict over scheduled fares demonstrated two important points to U.S. policy-makers: (1) IATA unanimity rules meant U.S. carriers were powerless to impose fare levels at IATA conferences, and (2) foreign governments did not share U.S. concern for lower international air fares. As the Chairman of the CAB noted in the aftermath of the 1963 fare crisis, "(we) misjudged the degree of unity of European carriers and had erred in calculating that several would break from the British stand..."[114] With the U.S. unable to dictate fare levels in the scheduled marketplace, the U.S. began to utilize charter carriers as the policy tool to drive down international air fares in both charter and scheduled markets.

Charters were considered an insignificant part of the market in the immediate postwar years, and were thus not governed by the Bermuda institutions: bilateral agreements did not dictate charter carriers rights nor were charter prices set by IATA. Although foreign government permission was required for charter airlines to land overseas, the terms on which charter airlines provided these services was a matter for national regulatory authorities, not bilateral agreements. The fact that charters were not governed by the Bermuda institutions was important because most aspects of charter operations were governed solely by national law, which in turn meant that liberalization of charter rules did not require foreign participation and could pursued simply by unilateral U.S. policy action.[115] Thus, following the failure of U.S. efforts to reduce fares in the scheduled marketplace, the U.S. consistently liberalized the rules governing international charter operations in a deliberate attempt to spur greater competition and lower fares in international scheduled markets.

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In short, international constraints and bargaining dynamics meant that utilizing the Bermuda institutions (i.e. IATA and bilateral negotiations) were unlikely to produce lower international air fares. Yet U.S. domestic politicians faced widespread demands for lower fares, particularly on the North Atlantic. Facing these international constraints, U.S. policymakers adopted the only strategy they could given the structure of international institutions: they gradually liberalized the rules governing international charters throughout the 1960's. With foreign governments committed to protecting their national carriers and thus unwilling to allow more competition in scheduled aviation markets, U.S. policymakers were forced to pursue a policy of unilateralism in that segment of the marketplace which the U.S. had sole control. U.S. strategy to secure a more liberal international aviation marketplace was thus neither dictated solely by constituency demands nor by the electoral calculus of U.S. politicians; although domestic politics set the basic parameters of policy choice and bargaining positions, international bargaining dynamics were important in shaping the particular policy and bargaining positions adopted.

4.5.2 The pro-competitive Carter policy

U.S. domestic politics meant multiple designation and low fares would be the most important objectives of Carter's new international aviation policy. Thus, the pro-competitive Carter policy called for new market entry and a reliance on competitive market forces to drive down international fares. However, other countries did not necessarily share U.S. views on the value of competition between private firms in international aviation markets, and the U.S. push for deregulation in international aviation markets did not necessarily imply that foreign governments would also change their aviation policies. Put simply, U.S. pressure to re-organize international aviation

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markets along more competitive lines could have been ignored if foreign governments had simply refused to re-negotiate new bilaterals. As Transportation Secretary Brock Adams noted in 1978, "the success of the Administration's international aviation policy depends upon our bilateral and multilateral civil aviation relations. We cannot achieve results in a vacuum."[116] The challenge facing U.S. policy-makers was thus to devise a bargaining strategy to induce foreign governments to liberalize their aviation markets.[117] U.S. policies and bargaining strategies to export deregulation were thus explicitly designed to exploit particular international market dynamics or regulatory lacunae to achieve international liberalization, which in practice meant a two-pronged attack on the Bermuda institutions.

The first part of U.S. strategy relied upon the workings of international market forces and relied on the potential for arbitrage in international aviation markets. In particular, the U.S. sought to conclude liberal bilateral agreements with foreign partners with an eye to relying on initial agreements with willing partners to pressure reluctant states to liberalize their bilaterals. In order to convince at least some foreign partners to conclude new bilaterals and open up the possibility for international market forces to pressure reluctant partners, the U.S. offered much more extensive route rights for foreign airlines and began to move away from the Bermuda principle of strict reciprocity. More specifically, the U.S. held out the carrot of additional U.S. gateways if foreign partners would accept the principles of multiple designation, competitive markets, and market-based fare mechanisms. This marked a significant move away from the traditional strict reciprocity of the Bermuda regime and was a clear attempt by the U.S. to make liberalization desirable for some foreign governments and their airlines.

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The first major step in implementing this facet of U.S. bargaining strategy was the U.S-Netherlands bilateral signed in March 1978. The Netherlands figured prominently in the U.S. strategy to liberalize international markets for two reasons: (1) the central geographic location of the Netherlands meant the potential for traffic diversion from other European states might induce further liberalization in Europe, and (2) the Dutch were willing to liberalize their bilateral agreement.[118] As a small country unable to match the scale economies of neighboring European countries, the Dutch national carrier KLM relied on a strong European network centered in Amsterdam to compete with other European airlines. As a result of this competitive position, lower prices on U.S.-Netherlands routes threatened to divert traffic from the national carriers of states which had restrictive bilateral agreements with the U.S. The lack of a large domestic market also meant that KLM stood to gain from additional traffic rights to the U.S. (as these traffic routes would enable KLM to compete more effectively against European airlines with larger domestic markets).

The specific provisions of the bilateral were a radical departure from Bermuda I agreements. The agreement contained new provisions on fares (country of origin pricing), provided extensive fifth-freedom rights for U.S. airlines, provided for multiple designation, and dramatically increased KLM gateways in the U.S. Country-of-origin pricing was particularly important as it changed the rules governing pricing and thus allowed the U.S. to drive down prices for U.S.-originating flights.[119]

The real importance of the U.S.-Netherlands bilateral, however, stemmed from the competitive pressure, via traffic diversion from high fare gateways to low-fare gateways, which the agreement placed on larger, more important aviation states in Europe, notably the U.K., Germany, and France.[120] The competitive threat posed to Lufthansa by lower fares to Amsterdam was particularly acute given that Amsterdam is

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actually closer to many German cities than either Frankfurt or Koln and thus provided an alternative gateway for both inward- and outward-bound traffic. The close geographic proximity of many European destinations and the fact that large numbers of tourists were indifferent between different gateways ultimately meant liberalization in one country threatened diversion from other airlines to the liberalized bilateral market.[121]

The threat of traffic diversion and the resultant erosion of support for restrictive bilateral agreements in other European states was no accident. Indeed, U.S. negotiating strategy reflected a conscious decision to sign liberal bilaterals with key countries and thereby economically pressure the national carriers of other European states. As early as January, 1977, President Ford had sought to use the threat of traffic diversion as a means to pressure the U.K. when he suggested that the CAB should license "more European destinations rather than concentrating on services from U.S. cities to British gateways."[122] Eventually, it was hoped, this strategy would generate pressure from national carriers and other interests for a more liberal bilateral agreement with the U.S., and thus drive most European states to conclude more liberal bilaterals.

In short, the goal of U.S. strategy was to conclude liberal bilateral agreements with key partners and thereby divert traffic from restrictive European countries; this economic arbitrage, so the argument went, would ultimately force restrictive states to re-negotiate their restrictive bilateral agreements.[123] As it turned out, this strategy was largely successful, with both the U.K. and Germany signing new, more liberal agreements with the U.S. by mid-1980. Meanwhile, the liberalization of the German and U.K. bilaterals were also seen as dominoes which might knock over even more resistant markets, notably France and Italy, and thereby produce pan-European liberalization. In testimony in 1978, for example, CAB Chairman Alfred Kahn noted

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that "the German situation...is so strategic, not only because of the size of the market....but also because of the location of Germany and the importance of Germany in the continent."[124]

The second facet of U.S. strategy during the Carter administration was to undermine the fare-setting authority of IATA and replace IATA with more market-based mechanisms for setting fares. In particular, the U.S. sought to erode airline support for IATA and thereby gain political support in foreign partners for alternative fare-setting mechanisms. As noted earlier, the unanimity rules of IATA had long frustrated U.S. attempts to pressure foreign partners to accept lower international fares. Unable to work within IATA to supply lower international air fares, the Carter policy set out to destroy the role of IATA in international aviation markets.

In 1978, the CAB launched a frontal attack on IATA when it issued a Show-Cause Order (SCO) to IATA requiring that IATA "show cause" why it should continue to be receive exemption from U.S. antitrust laws. Although the SCO did not preclude IATA's operation in many markets, the threatened removal of U.S. anti-trust immunity meant that neither U.S. or foreign airlines would be able to participate in IATA fare conferences, unless they relished the prospect of legal action and treble damages in U.S. courts.[125] The SCO unleashed a storm of criticism from foreign governments. Although the legal basis for suing foreign airlines in U.S. courts were not entirely clear, airlines which carried traffic to and from the U.S. and which participated in IATA fares conferences which set fares on these routes clearly faced the potential for legal challenge.[126] In the face of widespread and vehement criticism of the SCO, the U.S. government limited the scope of the SCO investigation and allowed IATA to continue to operate in many international aviation markets. In 1979, the CAB further confined the scope of the investigation to IATA activities on routes to and from the

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U.S., and the SCO was a dead letter even before the U.S. and the European Civil Aviation Conference (ECAC) signed a multilateral fare agreement in 1983.[127]

The SCO, its subsequent withdrawal, and the U.S.-ECAC fare agreement clearly demonstrate the impact of international bargaining dynamics on U.S. bargaining strategies. The initial impetus for the SCO was simple: to eliminate the power of IATA to set international fares and introduce a more market-based mechanism for setting international fares. The widespread criticism of the SCO, however, led U.S. policymakers to re-consider U.S. strategy, in particular whether U.S. policy objectives might be better secured by some other strategy. As the Department of State noted in 1979,

> it is necessary to consider whether U.S. rejection of IATA pricing mechanisms could be counterproductive to the United States' efforts to achieve a deregulated environment and competitive air fares. It could provoke negative and retaliatory foreign government reactions, including routine disapproval of non-IATA fares (already seen as a growing phenomenon); establishment of multilateral, intergovernmental alternatives to IATA (which the African governments are already beginning to do); restriction of U.S. carrier flexibility in non-rate aviation matters such as fifth-freedom operations; and denunciation of existing bilateral agreements and their possible replacement by even more restrictive regimes.[128]

Likewise, the DOT noted that

> there is reason to fear that, were the Board (CAB) to disapprove IATA at this time--thus destroying a traditional and time-honored framework--it could become more difficult to persuade other governments to accept the more innovative elements in our approach to international aviation. Given that the recent liberalization of IATA was prompted in large measure by the impact of U.S. policy, the foreign reaction to Board disapproval at this time might well be a retrenchment--the creation of an alternative mechanism which depends to a much greater extent on government intervention. In such circumstances, the prospect of obtaining agreement to 'mutual disapproval' pricing-a guarantee of genuine price competition-would probably be more difficult. Experience has shown us that unnecessary government intervention in what should be ideally decisions reached as a result of private initiatives does not guarantee the benefits to the consumers that our policy seeks to provide.[129]

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The DOT went on to argue that "a more flexible IATA will provide a worldwide experiment in competition, but within a framework widely acceptable to our foreign partners"[130] By 1982, even Congress realized that the SCO lacked international support and was likely to harm rather than help U.S. policy objectives in international aviation, and thus refused to appropriate funds for implementing the findings of the SCO (the SCO investigation was dropped altogether in 1985).

Part and parcel of the U.S. agreement to drop the SCO was the 1983 U.S.-ECAC fare agreement. Indeed, the U.S.-ECAC agreement was explicitly designed as a compromise between the U.S. and its European partners: the agreement substantially eroded the role of IATA and national governments in setting international air fares, and thereby promised to lower fares in international markets, while at the same time affording some protection for the European state-owned carriers against competition from U.S. carriers.[131] Signing the U.S.-ECAC fare agreement represented a major shift in U.S. strategy for securing lower international fares--from a reliance on domestic anti-trust laws to multilateral cooperation. The forces prodding this shift did not arise within the confines of U.S. domestic politics, however. Unable to simply scrap IATA due to foreign government protests, the U.S. was forced to create a new institutional arrangement to govern prices on the North Atlantic. Institutional innovation thus represented a conscious strategy choice by U.S. policy-makers to secure desired policy objectives.[132] Thus, not only was the agreement an explicit compromise between the U.S. and its European partners, but the U.S.-ECAC agreement is also a clear example of how states utilize institutional tinkering at the international level to organize international markets to achieve desired policy outcomes.

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Both the move to remove IATA from international aviation markets and U.S. efforts to use liberal bilaterals to create international market pressures to force restrictive states to re-structure their bilateral international aviation markets rested upon a similar calculation. U.S. efforts at producing liberalization within the confines of existing Bermuda institutions had failed: IATA unanimity rules meant that foreign airlines could block both the efforts of both U.S. airlines and the CAB to secure lower fares. Likewise, states could simply refuse to re-negotiate their bilateral agreements with the U.S. By removing anti-trust immunity from IATA and by using liberal bilaterals to create international market pressure designed to force reluctant states to liberalize their bilaterals, the U.S. unilaterally moved the reversion point of no liberalization of existing bilaterals. Put simply, U.S. efforts at re-organizing international aviation markets had failed when these markets were regulated by Bermuda institutions. U.S. efforts thus concentrated on gutting these institutions; in so doing, the U.S. was able to change the reversion point (i.e. the outcome) if foreign governments refused to re-structure their bilateral aviation markets. U.S. efforts were thus consciously designed to remove the status quo, i.e. the Bermuda institutions, and then bargain with foreign partners over what the organization of international aviation markets.

4.6 Conclusion

As I argued in chapter two, governments create international institutions and structure international markets in order to supply policies to important domestic constituents. No system of governance is ever perfect, however, and over time technological, economic, and political changes produce pressures to alter existing international regulatory arrangements. Changes in the preferences of key domestic

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economic actors and the political salience of deregulating both domestic and international markets led U.S. politicians to adopt a pro-competitive U.S. international aviation policy and thereby attempt to alter the rules governing international aviation markets. The preferences of societal interests were important in driving policy change, but these interests did not determine either the timing or design of policy change. Rather, policy emerged from the process of political competition, with political parties enacting policies in an effort to win office within the structure of domestic political institutions. Domestic political institutions were thus key in understanding the design and timing of policy choice. But domestic electoral politics were also not sufficient for explaining the particular bargaining strategies and policies adopted by U.S. policy-makers in pursuit of their goals. Indeed, existing international institutions, international market forces, and the preferences of foreign states were important in shaping how U.S. domestic political bargains translated into concrete policy outcomes and rule changes.

This chapter has thus provided evidence for the argument presented in chapter two. Economic growth and changes in technology, I demonstrated, created widespread demands for more liberal international aviation markets. But these demands were insufficient to drive policy change in the face of opposition from beneficiaries of the Bermuda regime. With the division of powers providing numerous veto points for economic actors to block policy change, any liberalization which took place proceeded on a slow schedule and a piecemeal basis. Once deregulation became a prominent issue for U.S. political parties, however, policy change came quickly. Even here, however, I demonstrated the impact of U.S. domestic political institutions by pointing out the local concerns of Congress in the fabric of deregulation policies. Indeed, because aviation routes provide substantial benefits for local economies,

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Congress was most concerned with entry into aviation markets and legislated all new entry into both domestic and international aviation markets prior to the mid-1970's.[133] But new domestic political bargains did not imply any singular international bargaining strategy. My examination of U.S. efforts to liberalize charter markets and the strategy adopted to implement Carter's pro-competitive policy provided evidence for how existing international institutions constrained the ability of U.S. policy-makers to secure policy goals, and how these existing institutions shaped the strategies adopted by U.S. policy-makers.

4.7 Transition: U.S. International Aviation Policy Since 1980

The impact of domestic politics on U.S. efforts to organize international aviation markets did not end with the adoption of Carter's pro-competitive international aviation policy. Although we shall examine U.S. efforts to re-structure the U.S.-U.K and U.S.-Japan in the next two chapters, respectively, it is useful to provide an overview of U.S. international aviation policy since 1980 before addressing the specific dynamics of these two markets. Two facets of U.S. policy since 1980 are of particular importance: (1) the slow re-structuring of international aviation markets which occurred throughout the 1980's; and (2) the dramatic shift in U.S. international bargaining strategy began under the Bush administration. I address each in turn.

When the Reagan Administration entered office, incumbent U.S. international airlines launched a vigorous effort for a return to more protectionist aviation policies.[134] Combined with a well-received report critical of the Carter administration policy (produced by the incumbent international carriers), Congressional criticism, and the demise of Braniff International in 1982, U.S. incumbents were successful in pressuring Reagan to quietly slow the deregulation fervor that characterized the Carter

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years.[135] As CAB Chairman Dan McKinnon noted in 1984, "there is today, I believe, much greater concern within the U.S. government for the long-term health of the U.S. aviation industry. We are now insisting (that) foreign governments live up to agreements they made in return for access to lucrative U.S. markets. U.S. aviation policy has stiffened with demands of a balanced quid pro quo in all future agreements."[136]

While the incumbent international airlines won a brief reprieve in the early Reagan years, the process of liberalization begun under Carter continued to unfold as the economic, institutional, and legal changes wrought by the Carter administration slowly shifted the political and economic balance in favor of the former domestic airlines (against the U.S. incumbent carriers). By 1985, two basic economic and political realities brought on by the policy changes of the Carter years brought about a fundamental turning point in U.S. aviation policy and the structure of international aviation markets. First, the forces of competition unleashed by domestic deregulation had largely played themselves out in the U.S. domestic market and had resulted in substantial market concentration: United, American, and Delta emerged as the major carriers while USAir, Northwest, TWA, Continental (Texas Air), Pan Am, and TWA represented the second tier. These newly enlarged carriers, notably United, American, and Delta (the big three) built hub-and-spoke networks covering the U.S. domestic market and sought to export these networks to the international marketplace.[137] With tremendous economies of scope accruing to carriers able to provide a network able to service a large number of destinations, the domestic carriers set out to internationalize their new domestic structures.[138]

The second factor driving the dramatic change in 1985 was the severe financial trouble of the traditional U.S. international carriers, notably Pan Am and TWA. These

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financial difficulties were no surprise and were largely due to the more competitive international aviation marketplace created by liberalization. With route structures designed around coastal gateways and used to operating in highly cartelized markets, these carriers were simply unable to compete in the more competitive international aviation markets created by the Carter policies. Unable to compete, these carriers began considering selling particular route structures in order to salvage at least part of their operations. Importantly, there was strong political support for these sales because both airlines and the communities they served believed limited sales of assets would provide the capital necessary to allow a truncated form of these airlines to survive.[139] With incumbent airlines looking to sell, domestic carriers unable to get into international markets due to government regulations (i.e. either the U.S. or foreign governments refused to allow greater market entry) and therefore looking to buy access, and strong political support from both U.S. politicians and regulatory agencies, the domestic carriers began to buy the international route structures of the incumbent U.S. airlines.

The first major route acquisition of the international routes of a U.S. incumbent carrier was in 1985, when United purchased Pan Am's Pacific routes for $750 million. Supported by both Pan Am, which believed the cash injection might save the airline, and United, which secured rights to the extremely regulated and therefore lucrative Pacific marketplace, the Pan Am-United deal in the Pacific was only the first in a series of deals which ended the Pan Am-TWA era and saw U.S. domestic carriers expand their domestic networks into international markets. The major route acquisitions involved the purchase of the international routes of the incumbent U.S. carriers by the big three airlines. American bought the Latin American operations of Eastern in 1989, added a Seattle-Tokyo route from Continental in 1990, and acquired

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TWA's London routes in 1991.[140] American also expanded its international network on a route-by-route basis, gaining permission to fly to regional business centers where national flag carriers or incumbent carriers did not offer service and thus foreign governments were willing to allow market entry.[141] United added to its Pacific routes in 1991, when it purchased the London routes of Pan Am.[142] Although Delta was last to enter the international marketplace, it Pan Am's European network in 1991[143] Although they were not as involved in the major route purchases, the second-tier U.S. airlines also expanded their international operations: Northwest, Continental, and USAir added European destinations while Continental expanded its Latin American route structure. Pan Am and TWA, on the other hand, had severe difficulties adjusting to the more competitive international marketplace and were gradually replaced by other carriers.[144]

Developments in the U.S. domestic market thus fundamentally re-altered the structure and competitive landscape of international aviation markets. As I discussed in chapter three, the Bermuda regime produced an international aviation market built around coastal gateways: international airlines deposited international passengers at these coastal gateways, from where domestic airlines carried passengers to their final destinations.[145] Importantly, the market was organized in ways that sought to limit the competitive advantages that might accrue from domestic networks. The large U.S. domestic airlines, in contrast, used their extensive domestic route structures to channel passengers to their regional hubs, and thereby secured significant competitive advantages vis-a-vis their foreign competitors.[146] The competitive advantages of the U.S. carriers was thus exacerbated, and in part due to, the reliance of these carriers on their regional hubs for international gateways and the emergence of tremendous scale and scope economies in a deregulated aviation environment.[147] Faced with more

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competitive U.S. airlines able to channel passengers much more efficiently than the traditional U.S. international airlines, foreign airlines had two choices: press for greater restrictions on the market or attempt to become more efficient in order to compete with the U.S. carriers.[148]

As we shall see in some detail in the next chapter, the basic challenge for foreign carriers posed by the new structure of U.S. international aviation markets revolved around gaining access to the interior U.S. market. For now, it is only important to note that changes in the structure of U.S. domestic markets eventually created serious competitive disadvantages for foreign airlines at the same time it increased U.S. airline pressure for more rights in international markets. More important for our purposes here is the fact that the significant disjuncture between the preferences of foreign airlines and their government and the U.S. airlines and the U.S. government led to a radical innovation in U.S. negotiating strategy--the second key element of U.S. international aviation markets since 1980.

In the face of foreign intransigence and failed efforts in the late 1980's to negotiate more liberal bilateral utilizing the traditional balance-of-benefits approach inherited from the Bermuda regime, U.S. policy-makers radically changed negotiating tactics in the early 1990's. In 1991, Jeff Shane, Deputy Assistant Secretary of State, Transportation Affairs, held a series of seminars with industry officials attempting to build support for a new strategy to open the international aviation marketplace.[149] In short, Shane argued that the current U.S. strategy was unlikely to produce significant liberalization and argued for a radical shift in U.S. policy and bargaining strategies.[150] Following Shane's seminars and extensive discussions, the U.S. announced "Open Skies" as the new U.S. international aviation policy in 1992.[151] Backed by all of the major U.S. airlines, the Open Skies policy called for bilateral agreements which would

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include the following provisions: open entry on all routes, unrestricted capacity and frequency on all routes, including no limits on change of gauge, route flexibility, or fifth-freedom (beyond-rights) traffic, liberal rules of competition for cargo and charter operations, and an explicit "commitment" for nondiscriminatory operation of computer reservation systems.[152] An additional critical feature of the new policy was that the U.S. offered Open Skies agreements to any state willing to offer reciprocal concessions for access for U.S. airlines, regardless of the size of the foreign market.[153]

Since the announcement of Open Skies by the Bush administration, two inter-related trends have characterized U.S. international aviation policy. First, the U.S. government has pressured foreign governments to conclude Open Skies agreements with the U.S. Although the initial policy initiative only resulted in an Open Skies agreement with the Netherlands (signed in October 1992), a new U.S. international aviation policy announced by the Clinton administration in 1994 and a subsequent push for Open Skies agreements produced a spate of Open Skies agreements in Europe. Since the announcement of the new Clinton aviation policy, the U.S. signed Open Skies agreements with the so-called "Nine Dwarves" in 1995 and Germany in 1996.[154] Although the Open Skies initiative has been less successful elsewhere, notably in Asia, where Japan refuses to liberalize the U.S.-Japan accord, significant progress has been made toward U.S. policy objectives.

The second trend characterizing U.S. international aviation policy since 1992 has been the encouragement of international airline alliances as the preferred avenue for liberalizing the international marketplace. In short, the U.S. government has encouraged U.S. airlines to conclude comprehensive alliances with foreign partners and thereby create the political will in both the U.S. and the foreign partner to conclude

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an Open Skies agreement.[155] In sum, the U.S. government has essentially agreed to grant anti-trust immunity to any airline alliance if the national government of the foreign partner signs an Open Skies bilateral with the U.S. The U.S. has thus used the carrot of anti-trust immunity for airline alliances as the central element in encouraging foreign governments to sign Open Skies agreements. With foreign airlines interested in access to the U.S. domestic marketplace and also the huge international networks which U.S. airlines have developed since the mid-1980's, foreign airlines have pressured their governments to sign Open Skies agreements if existing airline alliances receive U.S. anti-trust immunity. By pursuing this bargaining strategy, the U.S. has successfully liberalized large segments of the international aviation marketplace.

For a discussion of Congressional incentives, see Gary Jacobson, The Politics of Congressional Elections, 3rd Edition (Harper Collins Publishers, New York, N.Y.), 1992., and Bruce Cain, John Ferejohn, and Morris Fiorina, The Personal Vote: Constituency Service and Electoral Independence (Harvard University Press, Cambridge, MA), 1987.

[1]David Mayhew, Congress: The Electoral Connection (Yale University Press, New Haven, CT), 1974.

[2]Of course, there is a selection bias in any set of cases which look at which firms lobby Congress or the executive simply because firms which do not expect to secure policy outcomes will not bother to lobby. Note that I do not claim that firms will always choose to use resources to lobby Congress, but suggest a general tendency towards lobbying the legislative branch rather than the executive when firms have concentrated operations.

[3]Barry Weingast, "Regulation, Reregulation, and Deregulation: The Political Foundations of Agency Clientele Relationships," *Law and Contemporary Problems, Special Issue: Managing the Transition to Deregulation*, Vol. 44, No. 1 (Winter 1981), p. 147-177.

[4]Mathew McCubbins and Thomas Schwartz, "Congressional oversight overlooked: police patrols versus fire alarms," *American Journal of Political Science*, Vol. 2, No. 1 (February 1984), p. 165-179.

[5]Samuel Popkin, The Reasoning Voter: Communication and Persuasion in Presidential Campaigns (University of Chicago Press, Chicago, IL), 1991, Anthony Downs, An Economic Theory of Democracy (Harper, New York), 1957, Gary Cox and Mathew McCubbins, Legislative Leviathan: Party Government in the House (University of California Press, Berkeley, CA), 1993, and Jacobson, 1992.

[6]Cox and McCubbins, 1993.

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[7]For a discussion of how "issue ownership" can seriously impact the electoral fortune of politicians in the long-term, see Gary Jacobson, The electoral origins of divided government : competition in U.S. House elections, 1946-1988 (Westview Press, Boulder, CO), 1990.

[8]See the discussion in Peter Cowhey, " 'States' and 'Politics' in American Foreign Economic Policy," in John Odell and Thomas Willett, eds., International Trade Policies: Gains from Exchange between Economics and Political Science (The University of Michigan Press, Ann Arbor, MI), 1990, p. 225-251.

[9]For a slightly different perspective on how international constraints shape firm preferences vis-a-vis national trade policies, see Helen Milner and David Yoffie, "Between free trade and protectionism: strategic trade policy and a theory of corporate trade demands," *International Organization*, Vol. 43, No. 2 (Spring 1989), p. 239-272.

[10]Maurice Duverger, Political Parties: Their Organization and Activity in the Modern State (Wiley and Sons, New York, N.Y.), 1954.

[11]On the difficulties on building a majority coalition based on particularistic policies, see William Riker and Steven Brams, "The Paradox of Vote Trading," *American Political Science Review*, Vol. 67, p. 1235-1247.

[12] Gary Cox, The Efficient Secret: The Cabinet and the development of political parties in Victorian England (Cambridge University Press, Cambridge, MA), 1987, and Gary Cox and Frances Rosenbluth, "The Structural Determinants of Electoral Cohesiveness: England, Japan, and the United States," in Peter Cowhey and Mathew McCubbins, eds., Structure and Policy and Japan and the United States (Cambridge University Press, Cambridge, MA), 1995, p. 19-34.

[13]Downs, 1957, and Popkin, 1991.

[14]Jacobson, 1992, and Cox and McCubbins, 1993.

[15]Cox and McCubbins, 1993, and Peter Cowhey, "The Politics of Foreign Policy in Japan and the United States," in Cowhey and McCubbins, 1995, p. 203-225.

[16]On how credit claiming shapes the strategies of U.S. Congressmen, see Mayhew, 1974, Fiorina and Noll, Morris Fiorina and Roger Noll, "Majority Rule Models and Legislative Elections," *Journal of Politics*, 41 (1979), p. 1081-1104. and Jacobson, 1992.

[17]On how Congress uses procedural rules to structure the work of executive agencies, see Mathew McCubbins, Roger Noll, and Barry Weingast, "Administrative Procedures as Instruments of Political Control," *Journal of Law, Economics, and Organization*, Vol. 3, No. 2 (Fall 1987), p. 243-276, and Mathew McCubbins, Roger Noll, and Barry Weingast, "Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies," *Virginia Law Review*, March 1989, p.431-482. On how the president attempts to direct the bureaucracy and secure policy outcomes she favors, see Terry Moe, "The Politicized Presidency," in John Chubb and Paul Peterson, eds., The New Direction in American Politics, (The Brookings Institution, Washington, D.C.), 1985, p. 235-271.

[18] In general, only one U.S. carrier was allowed to serve a given city-pair. Exceptions were only made if demand was clearly sufficient to justify more than one U.S. airline and a foreign competitor.

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[19]The U.S. CAB granted anti-trust immunity on an annual basis until 1955, when the Board granted anti-trust immunity for an indefinite period.

[20]Supplemental carriers are those carriers which do not provide regularly scheduled services. Initially sold mainly through tour operators, charter carriers usually provide infrequent services to particular destinations rather than the broad range of destinations offered by scheduled airlines. The term supplemental carrier and charter carrier is used interchangeably.

[21]Prior to the 1966 rule change, charters could only provide services to groups of people who belonged to established organizations for six months or more. The new rules allowed charters to sell package tours (ITC's) to anyone and thus removed a major regulatory barrier to charter operations. See Robert Berkvist, "$165 or $230 to Europe?; Dogfight for the Tourist Dollar Is Shaping Up Between Scheduled Carriers and Supplementary Airlines," *The New York Times*, January 1, 1967, Section 10, p. 1, 13. For a good overview of the liberalization of U.S. charter rules, see K. G. J. Pillai, The Air Net: The Case Against the World Aviation Cartel (Grossman Publishers, New York, N.Y.), 1969.

[22]The rules governing charters were initially designed to keep charter traffic from taking passengers from the scheduled carriers. Thus, all aspects of charter operations, including travel times, length of trips, the size of aircraft, and who and where passengers could purchase tickets, were regulated in order to minimize "leakage" from the scheduled carriers to the charters. The regulatory structure reached the point of absurdity in 1971 when the government's air fare police (the CAB) raided a plane carrying members of the "Left Hand Club" to make sure they were really members of the organization.

[2·] In 1965, the CAB issued the following directive to U.S. carriers prior to the IATA annual meeting: "The Board is of the view that there exists a large potential for trans-Atlantic travel of westbound origination which is beyond reach at current levels......For these reasons, the Board would support a proposal along the lines urged by TWA." See CAB, Tentative Statement on Trans-Atlantic Fare Matters that will be reviewed at the IATA Traffic Conference, Bermuda, September, 1965, issued August 2, 1965, p. 2-3, as quoted in Pillai, p. 44.

[24]L.L. Doty, "Airlines Are Bystanders in Fare Dispute," *Aviation Week and Space Technology*, May 27, 1963, p. 34-35. For a broad discussion of CAB efforts to lower international fares, see Pillai, p. xv.

[25]"Board Bureau Urges Intensified Competition in Transpacific Case," *Aviation Week and Space Technology*, August 7, 1967, p. 35-36.

[26]Judith Trent, "A History of Halting Moves Toward Open Markets," in Handbook of Airline Economics (Aviation Week Group, A Division of McGraw-Hill, Washington DC), 1995, p. 165-173.

[27]Alan Dobson, Flying in the Face of Competition: The Policies and Diplomacy of Airline Regulatory Reform in Britain, the USA, and the European Community, 1968-1994 (Avebury Aviation, Aldershot, U.K.), 1995, p. 53.

[28]As Dobson notes, "U.S. policy was committed to nurturing the non-scheduled airline market as a means of promoting both competition and the expansion of the U.S. share of the market." Dobson, 1995, p. 56.

[29]Testimony of John Robson, CAB Chairman, in Regulatory Reform in Air Transportation, Hearings before the Senate Subcommittee on Aviation, 95th Congress, First Sess., March 21, 1977, p. 121-

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249.

[30]International Air Transportation Policy of the United States (U.S. Government Printing Office. Washington D.C.), September 1976.

[31]"Politics Complicate International Outlook," *Aviation Week and Space Technology*. March 21. 1977, p. 157-159. and "U.S. Holds Firm on Japanese Bilateral," *Aviation Week and Space Technology*. July 25. 1977, p. 38.

[32]"Bermuda Pact Sparks Opposition," *Aviation Week and Space Technology*. August 1. 1977. p. 26-27.

[33]Author's interview with William Kutzke.

[34]Fifth freedom rights are rights for an airline to pick up passengers in one foreign country and carry these passengers to another foreign country. For example, fifth freedom rights are the right of U.S. carriers to pick up local passengers in London and transport then to Paris on New York-London-Paris flights. For a full discussion of the various freedoms. see Michael Tretheway, International Air Relations From Bilateralism to Multilateralism (Research Paper in International Business Trade and Finance. Faculty of Commerce and Business Administration, University of British Columbia). 1993.

[35]See "Bermuda Pact Sparks Opposition." *Aviation Week and Space Technology*. August 1. 1977. p. 26-27. and "Carter Requests Dual Designation for Boston." *Aviation Week and Space Technology*, June 5 1978,"p. 22.

[36]See *Aviation Week and Space Technology*. June 5 1978, and Kasper, 1988.

[37]"Bermuda Pact Sparks Opposition," *Aviation Week and Space Technology*. August 1. 1977. p. 26-27.

[38]International Aviation, Hearings Before the Senate Committee of Commerce Subcommittee on Aviation, 95th Congress, 1st session. November 29 and December 1, 1977, Serial No. 95-50, and United States International Aviation Negotiations, Hearings Before the House Committee on Public Works and Transportation Subcommittee on Aviation, 95th Congress, 1st Session, September 29 and October 3, 1977.

[39]U.S. Department of Transportation officials made clear that the new U.S. policy stemmed from the criticism of Bermuda II and that the policy represented a denunciation of the agreement. See *Aviation Daily*, "New International Policy: A Lesson from Bermuda II." May 25, 1978, p. 148.

[40]As CAB Chairman Alfred Kahn noted, "the dramatic change is that we recognize that we should be bargaining not just for the rights of air carriers, but we are bargaining for the interests of consumers." See Testimony of Alfred Kahn, Chairman, Civil Aeronautics Board, in International Aviation, Hearing before the Senate Subcommittee on Aviation of the Committee on Commerce, Science, and Transportation, U.S. Senate, 95th Congress, Final Session on International Aviation, November 29. 1977 (U.S. Government Printing Office, Washington, D.C.) 1978, p. 7.

[41]U.S. Inter-Agency Committee on International Air Transportation Policy, U.S. Policy for the Conduct of International Air Transportation Negotiations (U.S. Government Printing Office, Washington D.C.), August 21. 1978.

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[42]U.S. Inter-Agency Committee on International Air Transportation Policy, 1978.

[43]Stephen Paul Dempsey, Law and Foreign Policy in International Aviation (Transnational Publishers, Inc., New York), 1987, p. 46.

[44]Atlanta, Houston, Dallas, St. Louis, Minneapolis, New Orleans, and Denver all received rights for direct international services during this period.

[45]See Barbara Peterson and James Glab, Rapid Descent: Deregulation and the Shakeout in the Airlines (Simon & Schuster, New York, NY), 1994, p. 32.

[46]Statement of Chris W. Paul, on behalf of Aviation Consumer Action Project, CAB Docket No. 32851, August 20, 1979, and Statement of Cornish Hitchcock, Attorney, Aviation Consumer Action Project, in Hearings Before the Senate Subcommittee on Aviation on the International Air Transportation Act of 1978, August 22, 1978 (U.S. Government Printing Office, Washington), 1978, p. 216-221.

[47]Pillai, 1969.

[48]Pillai vs. CAB, 485 F.2d 1018 (D.C. Cir. 1973), as cited in Statement of Cornish Hitchcock, Attorney, Aviation Consumer Action Project, in Hearings Before the Senate Subcommittee on Aviation on the International Air Transportation Act of 1978, August 22, 1978 (U.S. Government Printing Office, Washington), 1978, p. 223.

[49]On why both firms and individuals might prefer the stability produced by regulation to unbridled market competition, see Bruce Owen and Ronald Braeutigam, The Regulation Game: Strategic Use Of The Administrative Process (Ballinger Press, Cambridge, MA), 1978. See also Jonathan Aronson and Peter Cowhey, Trade in Services: A Case for Open Markets (American Enterprise Institute for Public Policy Research, Washington D.C), 1984.

[50]CAB, Order 75-1-46, January 13, 1975, and *Aviation Week and Space Technology*, June 12, 1967, p. 48-63, and *Air Transport World*, Vol. 10, No. 6 (June 1973), p. 21-24. See also CAB Docket No. 32851, Testimony of the Electronic Shippers, August 20, 1979.

[51]Andrew Carron, Transition to a Free Market: Deregulation of the Air Cargo Industry (The Brookings Institution, Washington, D.C.), 1981, p. 16.

[52] The Electronics Shippers was an organization which representing the following firms: Advanced Micro Devices, Data General, Electronic Memories and Magnetics, Fairchild Camera & Instrument, General Instrument, Hewlett Packard, Intel, Intersil, Litronix, Mostek, National Semiconductor, RCA, Rockwell Microelectronics, and Signetics. See CAB Order 75-1-46, January 13, 1975, p. 7, and Direct Exhibits and Testimony of the Electronics Shippers, CAB Docket No. 32851, August 20, 1979.

[53]Statement of Robert Meiser, Executive Director and Counsel, The International Airforwarder and Agents Association (IAAA), in Hearings before the Subcommittee on Aviation on the International Air Transportation Competition Act of 1978, U.S. Senate, 95th Congress, Second Session on S. 3363, p. 73-77.

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[54]In most states, national carriers were government-owned, concentrated their operations in the capital cities, and provided both domestic and international services.

[55]Prior to the introduction of the Boeing 747, the largest jet aircraft carried between 140-180 passengers while the first 747's carried between 360-490 passengers, depending on configurations. For a discussion of the impact of the 747 on the preferences of U.S. scheduled carriers, see Clive Adams, "Upsurge in Transatlantic Capacity Threatens New Look At Bermuda Agreement," *Air Transport World*, Vol. 7, No. 5 (May 1970), p. 33-34, and Pillai, 1969.

[56]Although Pan Am did not take deliver of the first 747 until 1969, the range and capabilities of the 747 were known in 1966. Author's interview with Bill Kutzke.

[57]See Harold Watkins, "Overseas Profit Rate Lures U.S. Airlines," *Aviation Week and Space Technology*, October 28, 1968, p. 177-186.

[58]See Harold Watkins, "United Takes Dual Position in Application," *Aviation Week and Space Technology*, March 13, 1967, p. 36-49, and Harold Watkins, "American Seeks U.S. Traffic Protection," *Aviation Week and Space Technology*, January 30, 1967, p. 48-54.

[59]The local economic benefits to international air service are huge. See Air Transport Action Group (ATAG), The Economic Benefits of Air Transport: 1992 Data (ATAG, Geneva, Switzerland), 1993, ACCESS U.S.-Japan, The Impact Of Increased Passenger Flights To Japan On U.S. Employment (ACCESS U.S.-Japan, Washington D.C.), 1996, and ACCESS U.S.-Japan, Expanding the U.S.-Japan Aviation Market (ACCESS U.S.-Japan, Washington D.C.), 1996.

[60]Author's interview with Bill Kutzke.

[61] See Richard Klem and Douglas Leister, "The Struggle for a Competitive Market Structure in International Aviation: The Benelux Protocols Take United States a Step Forward," *Law and Policy in International Business*, Vol. 11 (1979), p. 575, and author's interview with Diane Peterson, Senior Vice President, International Affairs, Airports Council International, Washington D.C., October 23, 1996.

[62]Between 1955 and 1964, the U.S. share of total commercial air transport orders was 72 percent; between 1965 and 1979, the U.S. share jumped to 88 percent. Data from U.S. Civil Aviation Manufacturing Industry Panel, The Competitive Status of the U.S. Civil Aviation Manufacturing Industry: A Study of the Influences of Technology in Determining International Industrial Competitive Advantage (National Academy Press, Washington, DC), 1985, p. 45.

[63]It is worth noting that only in mid-late 1970's did the belief that the demand for international aviation was inelastic begin to change. Prior to that point, most airlines believed that lower prices would translate into lower profits. See Klem and Leister 1979.

[64]The importance of international markets only increased after U.S. domestic deregulation, when the uncertainty produced by the deregulated domestic marketplace prevented U.S. airlines from purchasing large numbers of new aircraft. See U.S. Civil Aviation Manufacturing Industry Panel 1985, p. 42.

[65]Statement of Philip Bakes, Civil Aeronautics Board General Counsel, in International Air Transportation Act of 1979, Hearings before the Senate Subcommittee on Aviation, August 21-22, 1979, p. 40. Although large banks had opposed domestic deregulation, they did not oppose international deregulation.

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[66]Statement of Trans World Airways, Inc., in Hearings Before the Senate Subcommittee on Aviation on the International Air Transportation Act of 1978, August 22, 1978 (U.S. Government Printing Office, Washington), 1978, p. 240.

[67]Statement of William Seawell, Chairman, Pan American Airlines, in Hearings Before the Senate Subcommittee on Aviation on the International Air Transportation Act of 1978, August 22, 1978 (U.S. Government Printing Office, Washington), 1978, p. 167.

[68]Author's interviews with Bill Kutzke.

[69]Letter of Richard Smith, Director, Legislative Affairs, FEIA/PAA Chapter, in Hearings Before the Senate Subcommittee on Aviation on the International Air Transportation Act of 1978, August 22, 1978 (U.S. Government Printing Office, Washington), 1978, p. 153.

[70]The entry of the domestic carriers into the international marketplace was problematic for U.S. international carriers due to the potential diversion of passengers from the coastal gateways served by the incumbent carriers. Although TWA, Northwest Orient, and Braniff faced this problem, these carriers were not precluded by law from entering the U.S. domestic marketplace like Pan Am. These carriers were thus not as concerned as Pan Am about the potential competitive impact of new international routes from interior cities.

[71]Author's interviews with Bill Kutzke.

[72]Author's interview with Bill Kutzke.

[73]*Aviation Week and Space Technology*, "Braniff Key Proposal to Advanced Jets," March 27, 1967, p. 33-45, *Aviation Week and Space Technology*, "Continental Cites Regional Identification," May 8, 1967, p. 33-47.

[74]On the importance of the national economy in presidential elections, see Samuel Kernell, 1977, Samuel Kernell, Going Public: New Strategies of Presidential Leadership, 2nd edition (Congressional Quarterly Press, Washington, D.C.), 1993.

[75]As I argued in chapter 2, regulatory regimes are often stable because politicians can open up new areas of the market in response to challenges to existing regulatory arrangements and thereby defuse political support for regulatory change.

[76]When scheduled carriers petitioned the CAB for reduced charter awards, the CAB responded that charter certification was designed to "provide a stimulus to the IATA carriers to develop a fare structure directed at developing a mass market...help assure the continued provision of low-cost air transportation." Trans Atlantic Charter Investigation, CAB Order No. E-22686 (Docket 11908), as quoted in Pillai, 1969, p. 172.

[77]It is important to note that charter rules continued to make it very difficult for non-vacation passengers (i.e. business or government) to fly on charters rather than the scheduled carriers. Thus, although the rules governing charter operations were gradually liberalized, the new rules only allowed the charters to compete for vacation travelers--but continued to prevent high-paying segments of scheduled traffic to leak into the charter market. See Robert Berkvist, "$165 or $230 to Europe?; Dogfight for the Tourist Dollar Is Shaping Up Between Scheduled Carriers and Supplementary Airlines," *The New York Times*, January 1, 1967, Section 10, p. 1, 13.

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[78] Clive Adams, "Upsurge in Transatlantic Capacity Threatens New Look at Bermuda Agreement," *Air Transport World*, Vol. 7, No. 5 (May 1970), 33-34, and "Greatest Industry Pressures Ever Overshadow IATA AGM In Hawaii," *Air Transport World*, Vol. 8, No. 11 (November 1971), 38-39, and Pillai, 1969.

[79] Covering letter of President Nixon in International Air Transportation Policy of the United States (U.S. Government Printing Office, Washington D.C.), June 22, 1970.

[80] Statement of International Air Transportation Policy of the United States (U.S. Government Printing Office, Washington D.C.), June 22, 1970, p. 11.

[81] In the Pacific route proceedings, for example, the CAB noted that routes would be allocated largely based on the type of fare proposed by the airline. See "Board Bureau Urges Intensified Competition in Transpacific Case," *Aviation Week and Space Technology*, August 7, 1967, p. 35-36.

[82] Carter letter rejecting CAB suspension of IATA low fares, as found in United States International Aviation Negotiations, Hearings Before the House Committee on Public Works and Transportation Subcommittee on Aviation, 95th Congress, 1st Session, September 29 and October 3, 1977 p. 93. See also Dobson, 1995, p. 53.

[83] Dobson, 1995, p. 53.

[84] Civil Aeronautics Board, Regulatory Reform: report of the C.A.B. special staff (CAB, Washington, D.C.), 1975, p. 249.

[85] CAB Order No 75-6-152, as quoted in CAB, 1975, p. 249.

[86] Dobson, 1995, p. 51-53. Although the Department of Transportation did set minimum charter fares on international flights in order to give some financial relief to U.S. scheduled carriers for a brief period in the early 1970's, this was the exception rather than the rule.

[87] See Howard Banks, The Rise and Fall of Freddy Laker (Faber and Faber Limited, London), 1982.

[88] Dobson, 1995, p. 62-64.

[89] Peterson and Glab, 1994, p. 49.

[90] Author's interview with William Kutzke.

[91] Author's interview with William Kutzke.

[92] See Derthick and Quirk, 1985.

[9.] Gerald Ford, A Time to Heal: The Autobiography of Gerald R. Ford (Harper and Row, New York), 1979, p. 271.

[94] Ford, 1979, p. 273, and Derthick and Quick, 1985.

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[95]Cover letter of President Ford in International Air Transportation Policy of the United States (U.S. Government Printing Office, Washington D.C.), September 8, 1976.

[96]Anthony Brown, The Politics of Airline Deregulation (University of Tennessee Press, Knoxville, TN), 1987, p. 107.

[97]Peterson and Glab, 1994, p. 45.

[98]See the discussion of how deregulation was chosen as an issue in Stephen Breyer, Regulation and its reform (Harvard University Press, Cambridge, MA), 1982, esp. Chp. 16.

[99]Brown, 1987, p. 103.

[100]See cites in fn. 25.

[101]"Unions Oppose Liberalized Policy," *Aviation Week and Space Technology*, February 6 1978. p. 36.

[102]Testimony of Alfred Kahn, Chairman, Civil Aeronautics Board, to the Senate Subcommittee on Aviation of the Committee on Commerce, Science, and Transportation, U.S. Senate, 95th Congress, Final Session on International Aviation, November 29, 1977 (U.S. Government Printing Office, Washington, D.C.) 1978, p. 7.

[103]As cited in Ramon de Murias, The Economic Regulation of International Air Transport (McFarland & Company, Inc. Jefferson, North Carolina), 1989, p. 154.

[104]See "Unions Oppose Liberalized Policy," *Aviation Week and Space Technology*, April 17 1978, p. 33, Statement of Trans World Airways, Inc., in Hearings Before the Senate Subcommittee on Aviation on the International Air Transportation Act of 1978, August 22, 1978 (U.S. Government Printing Office, Washington), 1978, p. 240, and Statement of William Seawell, Chairman, Pan American Airlines, in Hearings Before the Senate Subcommittee on Aviation on the International Air Transportation Act of 1978, August 22, 1978 (U.S. Government Printing Office, Washington), 1978, p. 167.

[105]U.S. Policy for the Conduct of International Air Transportation Negotiations (U.S. Government Printing Office, Washington D.C.), August 21, 1978.

[106]As quoted in Dobson, p. 159.

[107]Statement of Richard Cooper, Under-Secretary of Economic Affairs, Department of State, in Hearings Before the Senate Subcommittee on Aviation on the International Air Transportation Act of 1978, August 22, 1978 (U.S. Government Printing Office, Washington), 1978, p. 52.

[108]Klem and Leister, 1979.

[109]Testimony of Marvin Cohen, Chairman, CAB, in Hearing on U.S. International Aviation Policy, 1982, p. 574.

[110]Pillai, 1969, p. 81.

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[111] Pillai, 1969, p. 82.

[112] It is also worth noting that the 1963 disapproval was the first time the U.S. had disapproved IATA fares.

[113] *Aviation Week and Space Technology*, "Airlines Are Bystanders in Fare Dispute," May 27, 1963, p. 34-35.

[114] *Aviation Week and Space Technology*, May 20, 1963, p. 39, as quoted in Pillai, 1969, p. 88.

[115] Although national sovereignty meant that foreign regulatory authorities could deny permission for U.S. charters to provide services, in practice this rarely happened.

[116] "International Policy Draws Focus," *Aviation Week and Space Technology*, August 28 1978, p. 23.

[117] Even the first drafts of Carter's pro-competitive policy were edited by the State Department with an eye to securing the cooperation of foreign partners. See "U.S. Readies Stiffer International Policy," *Aviation Week and Space Technology*, September 12 1977, p. 29.

[118] As CAB Chairman Alfred Kahn noted in an interview in October, 1977, the U.S. would "canvass the world, select out the potential partners offering them the most promising of opportunity, and actively seek negotiations with them on a bilateral or multilateral basis." P. Harbison, Liberal Bilateral Agreements of the United States: A Dramatic New Pricing Policy (LL.M. Thesis, McGill University), 1982, as quoted in Christer Jonsson, International Aviation and the Politics of Regime Change (St. Martin's Press, New York, N.Y.), 1987, p. 124. See also Kasper, 1988, Chp. 5.

[119] Under Bermuda I agreements, pricing was usually delegate to IATA but was still done on a so-called "double approval basis." In other words, both governments had to approve of a price for airlines to offer the price in the market. Country-of-origin pricing allowed each individual country to set prices on flights originating in its territory and thus removed one institutional check on low prices.

[120] In the late 1970's, two-thirds of all trans-Atlantic traffic passed through London. As cited in Baldev Raj Nayar, "Regimes, power, and international aviation," *International Organization* 49, No. 1 (Winter 1995), p. 164.

[121] See Mike Levine, "Requested Comments of Negotiation Strategies for Northern and Southern Europe," CAB Memorandum, February, 1979, Kasper, 1988, p. 76, and author's interview with Daniel Kasper, December 1996. Kasper served as Special Assistant to CAB Vice-Chair Elizabeth Bailey in 1979-1980, and served as Director, Bureau of International Aviation from 1980-1983. Since 1983, he has worked as a consultant to a variety of airlines and government agencies.

[122] *Flight*, January 8, 1977, p. 52, as quoted in Dobson, 1995, p. 121.

[123] Kasper, 1988, and author's interview with Kasper, December 1996.

[124] Statement of Alfred Kahn, Chairman, CAB, in The International Air Transportation Competition Act of 1978, Hearings before the Subcommittee on Aviation, U.S. Senate, 95th Congress, Second Session on S. 3363, p. 79-101.

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[125]If anti-trust immunity were revoked, the U.S. effectively made both U.S. and foreign airlines liable for treble damages in U.S. courts. The legal basis for U.S. legal action under the Sherman Antitrust Act against foreign commercial entities is well established in U.S. law, with even state-owned foreign carriers faced the possibility of significant legal expenses and challenges in U.S. courts. See Wilbur Fugate, Foreign commerce and the antitrust laws, 4th ed. (Little, Brown, Boston, MA), 1991.

[126]The legal implications of fare-setting in international aviation markets without anti-trust immunity were dramatically illustrated in the Freddy Laker-British Airways case in the early 1980's. See Duncan Campbell-Smith, The British Airways Story: Struggle for Take-Off (Coronet Books, Great Britain), 1986.

[127]The ECAC is composed of the transport ministers of 22 European nations. and on occasion represents the aviation interests of these nations.

[128]Testimony of the Department of State, CAB Docket No. 32851, August 20, 1979, p. 8-9.

[129]Testimony of Linda Heller Kamm, Acting Deputy Secretary and General Counsel, U.S. DOT, CAB Docket No. 32851, August 24, 1979.

[130]Testimony of Linda Heller Kamm, Acting Deputy Secretary and General Counsel, U.S. DOT, CAB Docket No. 32851, August 24, 1979.

[131]"U.S. could be forced to change negotiating stance away from bilateral approach in international aviation affairs," *Air Transport World*, Vol. 25, No. 5 (May 1988), p. 19.

[132]It is also worth noting that the ECAC had never negotiated as a formal body for its members, nor has it since, nor had the U.S. ever signed a fare agreement of this type before.

[133]Author's interviews with Bill Kutzke, Washington D.C., October 24, 30, 1996. From 1968 to 1979, Kutzke was employed at the CAB where he served as Assistant General Counsel for International Law and Assistant General Counsel for Litigation in the General Counsel's Office. From 1979 to 1985, Kutzke was Vice President-Airline Planning and Vice President-Washington of Northwest Airlines. Since 1985, Kutzke has worked as a consultant and attorney for numerous airlines.

[134]Kasper, 1988, author's interview with Kasper, December 1996, and author's interview with Jeff Shane, Washington D.C., October 29, 1996, and May 23, 1997. Shane was the principal architect of U.S. international aviation policy during the late 1980's and early 1990's. He served Deputy Assistant Secretary of State for Transportation Affairs during the second Reagan administration and served as Assistant Secretary for Policy and International Affairs in the Department of Transportation from 1989-1993.

[135]Author's interviews with Shane, October 29, 1996, and May 23, 1997.

[136]Difficulties in Implementing United States-Korea Aviation Bilateral Agreements, Hearing Before the Subcommittee on Investigations and Oversight of the Committee of Public Works and Transportation, 98th Congress, 2d Sess., 61, (1984), as quoted in Dempsey, 1987, p. 235.

[137]There is a vast literature on the impact of hub-and-spoke systems on all aspects of both domestic and international aviation markets. For overall discussions, see Kasper, 1988 and Daniel Kaplan, "The

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Pursuit of Competition: A Review of U.S. Public Policy In The Airline Industry," in Handbook of Airline Economics (Aviation Week Group, Washington D.C.), 1995, p. 151-164.

[138]On economies of scope, see Ethan Weisman, Trade in Services and Imperfect Competition: Application to International Aviation (Kluwer Academic Publishers, Boston, MA), 1990.

[139]Author's interview with Shane, October 29, 1996, and May 23, 1997. See also John Newhouse, "Air Wars," *The New Yorker*, August 5, 1991, p. 51-66. John Newhouse, "The Battle of the Bailout," *The New Yorker*, January 18, 1993, p. 42-51, and *Aviation Week and Space Technology*, April 22, 1991, Vol. 134, No. 16, p.34.

[140]*BusinessWeek*, "Dogfight: United and American Battle for Global Supremacy," January 21, 1991, p. 56-63.

[141]Author's interview with Carl Nelson, Associate General Counsel, American Airlines, October 17, 21, 1996, Washington D.C.

[142]*BusinessWeek*, "Dogfight: United and American Battle for Global Supremacy," January 21, 1991, p. 56-63.

[143]*Aviation Week and Space Technology*, September 30, Vol. 135, No. 12, p.33.

[144]Pan Am eventually went bankrupt in 1991 while only a severely truncated TWA survives.

[145]This was true because passengers took a domestic carrier to coastal gateways and then switched to an international carrier to the rest of the journey. For a passenger from Colorado bound for London, for example, the passenger would fly on a U.S. domestic carrier to New York and then fly either a U.S. or U.K. airline for the New York-London leg of the journey.

[146]For a similar analysis of the impact of domestic deregulation on the structure of the international aviation marketplace, see Daniel Kasper, "How Deregulation Will Change the Structure of the International Airline Industry," *Transportation Research Circular*, No. 393 (April 1992), p. 42-47.

[147]Author's interviews with numerous industry sources, Washington D.C. and London, October-December, 1996. See also Barry Humphreys, "Economies of density, scale and scope," *Avmark Aviation Economist*, June 1989, p. 10-11, and Kasper, 1992.

[148] Kasper, 1988, and author's interview with various industry sources, Washington D.C., October and November, 1996, and London, November and December, 1996.

[149]Author's interview with Shane, October 29, 1996.

[150]Author's interview with Shane, October 29, 1996.

[151]*Aviation Week and Space Technology*, Vol. 137, No. 7 (August 17, 1992), p. 32.

[152]The agreement also included provisions for doing business issues, including complete control over hard currency receipts and self-control of ground handling operations in the host country. See *Aviation Week and Space Technology*, Vol. 137, No. 7 (August 17, 1992), p. 32.

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[153] The Netherlands was already asking the U.S. to conclude a more liberal bilateral when the new policy was announced.

[154] The "Nine Dwarves" include Austria, Belgium, Denmark, Finland, Iceland, Luxembourg, Norway, Sweden, and Switzerland.

[155] Author's interview with various industry sources, Washington D.C. and London, October-December, 1996. See also, inter alia, *Aviation Daily*, "Antitrust Immunity's Role In International Competition Grows," June 27, 1995, Vol. 320, No. 61; Pg. 505, *Airline Business*, "Immune deficiency syndromes: Airline Alliances," Vol. 12, No. 6 (June 1996), p. 52, and *The Washington Post*, "Airline Accord Tied to Heathrow Access: U.S. Links Approval of American-British Airways Deal to 'Open Skies' Pact," May 22, 1996, p. F2.

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Chapter 5: Bargaining over the Atlantic: U.S.-U.K. Negotiations

"...we have first to get the glamour out of aviation, and secure acceptance of the idea that it is a business like others, and more risky than most."

Lord Boyd-Carpenter, Chairman, British Civil Aviation Authority, 1976

"The most important trade barriers in the aviation sector are established by formal...agreements."

Jeffrey Shane, U.S. Assistant Secretary of Transportation, 1989-1993[1]

5.0 Introduction

As the largest and most important bilateral aviation market in the world, the rules governing the U.S.-U.K. aviation market have been the source of intense political struggle and on-going negotiations for the past ten years. In the U.S., the Bush administration was active in pursuing liberalization of the bilateral marketplace, and the Clinton administration has invested even more political capital in liberalizing U.S.-U.K. aviation markets. In the U.K., the Conservatives under Thatcher and Major have been the leading European proponents of liberalizing international aviation markets, and have repeatedly pushed the U.S. to liberalize the U.S.-U.K. marketplace. In both the U.S. and the U.K., then, governments have adopted pro-competitive international aviation policies and have sought to liberalize the bilateral marketplace, yet only limited liberalization has taken place.

The history of U.S.-U.K. aviation markets raises a number of empirical puzzles which neither purely international or purely domestic explanations can explain.

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Why has the U.S. been unable to simply foist international regulatory change on the U.K.? Why has the U.K. been able to maintain restrictive U.S.-U.K. aviation markets in the face of U.S. pressure and widespread deregulation on the North Atlantic? Most puzzling, why has liberalization proven so difficult when both states have pro-competitive international aviation policies? The failure of U.S. pressure to produce significant policy change in the U.K. undermines approaches which stress the importance of international power for understanding the rules governing international markets. Purely domestic political approaches cannot explain why two states which both advocate liberalized international aviation markets have not liberalized their bilateral market.

In this chapter, I argue that answers to these questions are to be found in how international bargaining dynamics have shaped the preferences and strategies of key domestic political actors in both the U.S. and the U.K., and how these preferences have refracted through domestic political institutions and shaped the political calculations of national politicians. The bargaining positions and strategies adopted by national politicians, in turn, allow me to explain the rules governing U.S.-U.K. international markets. Careful process-tracing of the strategies of domestic firms and the calculations of national politicians thus allow me to explain national bargaining positions, which in turn allow me to explain why particular rules govern U.S.-U.K. international aviation markets.

I argue that peculiar features of U.S.-U.K. aviation markets, in particular the geographic position of the U.K. astride the European continent, the importance of Heathrow as a hub for airline networks, and the large size of the U.K. market, mean U.K. airlines and the U.K. government have been unwilling to accept U.S. definitions of Open Skies and have been able and willing to hold out for more substantial

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liberalization.[2] In the U.S., the importance of the U.K. for U.S. airlines has made access at Heathrow essential, but supplying access to all the major U.S. airlines in a single deal has been problematic. However, because U.S. domestic political institutions provide numerous veto positions for U.S. airlines to block any agreement which they oppose, piecemeal liberalization has proved politically impossible because any minor deal must satisfy all the major airlines or face serious opposition from Congress. Satisfying all the major U.S. airlines is only impossible in light of international market constraints, in particular the limited number of slots at Heathrow. Thus, strong preferences of U.S. airlines and the access of these airlines in the U.S. domestic political process has made piecemeal liberalization impossible, while comprehensive liberalization has proven difficult due to international bargaining constraints. With piecemeal liberalization difficult for U.S. politicians and comprehensive U.S.-style liberalization insufficient for U.K. politicians, liberalization has proved impossible.

The variables explaining the failure of efforts to secure liberalization are the preferences and strategies of the actors, the structure of U.S. domestic politics, and the structure of international markets. The analysis is thus firmly rooted in domestic politics, but examines how international bargaining dynamics have shaped the preferences and strategies of domestic economic actors, and in turn how these strategies have effected the domestic political process. The analysis thus proceeds from domestic firms to the international markets, and then back to the domestic political process to see how these dynamics produce government bargaining positions and international regulatory rules.

The chapter is organized as follows. The first section outlines the implications of the argument presented in chapter two for the U.S.-U.K. market. The second and

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third sections discuss the regulation of aviation markets in the U.K. and provide a brief historical summary of U.S-U.K. aviation market, respectively. The point of these two sections is to provide the necessary background for the discussions of specific bargaining episodes which follow in section four, five, and six. These three sections examine three recent U.S-U.K. negotiations in detail and provide empirical support for the argument presented in section two. The final section concludes.

5.1 The Argument

As I argued in Chapter two, the organization of international markets is driven primarily by domestic politics, but international bargaining dynamics condition the strategies adopted by domestic economic interests and national governments. This section expands on the basic argument and focuses on their implications for U.S.-U.K. international aviation markets.

5.1.1 Domestic Institutional Constraints[3]

The U.K. combines first-past-the-post electoral rules with a parliamentary system. First-past-the-post electoral rules favor majoritarian voting between two major parties and thereby provide incentives for parties to identify and run on prominent public policy issues. With a majority required to win elections, it is difficult to win elections based solely on patronage and particularistic policies. Thus, the electoral system encourages parties to run on electoral platforms centered around collective goods policies which appeal to a broad range of voters. U.K. electoral rules thus provide incentives for the creation of cohesive parties which contest elections on party platforms designed to appeal to the median voter.

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Parliamentary government in the U.K. concentrates decision-making authority in a single body and thereby allows the majority party to dominate policy-making. With no veto gates on policy decisions, policy-making is easier and more flexible than in the U.S., where bicameralism and an independently elected executive produce policy conflict between the legislature and the executive. Parliamentary sovereignty also provides a single principal capable of quickly and easily controlling executive agencies, and U.K. politicians can utilize extensive delegations of authority and rely on informal regulatory proceedings to manage regulated industries. In the U.S., in contrast, different constituencies and divergent electoral calendars produce complex rules governing delegations of authority and ultimately render close firm-government coordination difficult.[4] Parliamentary sovereignty and the resulting structure of delegation to executive agencies thus facilitates close firm involvement in all aspects of the U.K. policy-making process.[5] Parliamentary sovereignty also contributes to the limited role of the U.K. legal system in regulatory policy-making. Unlike in the U.S., where the courts play an important role in regulatory policy-making due to the power of judicial review and liberal rules governing rights of standing, U.K. courts largely follow formal parliamentary instructions and thus play a limited role in U.K. regulatory policy-making.[6]

The structure of U.K. political institutions, and the differences between these institutions and U.S. political institutions, create different incentives for politicians in the two states. Both systems give politicians incentives to provide collective goods for the electoral success of parties, especially when regulatory arrangements are a prominent electoral issue. In the U.S., however, the division of powers means that local, particularistic policies are especially important for legislators, who have difficulty claiming credit for broad collective goods policies.[7] The smaller electoral

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districts of legislators (compared to the president) also makes particularistic policies more important for U.S. legislators than the president. However, the national constituency of the president, combined with the importance of the party label for individual legislators, limits the potential for particularism in the U.S.

Differences in political institutions also mean that firms in the two countries encounter different political landscapes when launching corporate strategies. In both states, the national election system and electoral rules favor majoritarian voting between two major parties and thereby provide incentives for parties to identify and run on prominent public policy issues. Firms in both states thus face limits on their influence over policy outcomes (due to the importance of the median voter for winning elections), especially when regulatory rules become salient issues for large numbers of voters.[8] Given these political dynamics, both U.S. and U.K. firms stake out positions which are consistent with broad political dynamics. The division of powers in the U.S. means government-firm relations play out differently in the two systems, however. In the U.S., the division of powers forces Congress to rely on complex and rule-bound delegations to executive agencies to manage agency loss.[9] As a result, government-firm interactions in the U.S. are governed by procedurally rigid and complex rules, and U.S. firms rely on formal structures to communicate their policy preferences to U.S. regulatory bodies. In the U.K., in contrast, parliamentary sovereignty allows extensive and informal delegations to regulatory agencies and thus facilitates early and continuous inclusion of U.K. firms in the policy-making process. Importantly, extensive delegations to opaque bureaucracies increases the potential for political rents and thus enhances the influence of particularistic interests on policy outcomes.[10] Differences in delegations stemming from the division of powers ultimately produce very different lobbying strategies for U.S. and U.K. firms: U.K.

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firms rely on close and intimate contacts with executive agencies and do not employ the vocal lobbying campaigns that characterize U.S. firms efforts to influence government policy.[11]

The division of powers also matters for the timing and speed of policy change. In the U.S., the division of powers creates numerous veto points and thus makes policy reversal more difficult. With both Congress and the executive having some authority over policy outcomes, any new regulatory arrangements must satisfy a diverse set of interests. This dynamic is exacerbated by the fact that the executive and the legislature consciously design regulatory institutions in ways which ensure that important constituents are able to participate in the policy-making process.[12] In the U.K., on the other hand, the parliamentary system concentrates decision-making authority and thus provides only one veto gate on policy decisions; policy-making is thus easier and more flexible, and regulatory change is likely to occur more quickly.

Differences between U.S. and U.K. legal structures also condition firm strategies in the two systems. Unlike in the U.S., where the power of judicial review and the reality of "separate institutions sharing power" means the courts often play a major role in regulatory policy-making, U.K. courts largely follow formal parliamentary instructions rather than interpret policy, and thus play a limited role in regulatory policy making.[13] Furthermore, international aviation is specifically exempted from U.K. competition laws, so the potential for U.K. courts to play any real role in international aviation regulation is de jure prohibited. The non-existent role of U.K. courts in international aviation markets means that U.K. firms must rely on international agreements for protection against anti-competitive behavior in international markets. U.K. airlines have thus pressed to include legal remedies to international regulatory problems in bilateral aviation agreements.[14] This is particularly

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true for smaller U.K. airlines, which have opposed international deregulation not because they are afraid of competition but due to the lack of protection afforded by U.K. competition laws.[15] U.S. firms, on the other hand, do not require extensive legal provisions in bilateral agreements because strong U.S. anti-trust laws and liberal rules of standing in U.S. courts provide remedies against anti-competitive behavior in international markets.[16] U.S. firms have thus opposed including extensive dispute resolution mechanisms and other provisions for government intervention in bilateral agreements. Strong anti-trust laws and liberal rules of standing in U.S. courts also mean that U.S. firms must be more careful than U.K. firms about concluding international agreements, especially if such agreements potentially violate U.S. anti-trust laws. U.S. firms are thus very careful about engaging in international collaboration and have pressured the U.S. government to include explicit legal authority in bilateral agreements for U.S. airlines to undertake collaborative actions in international markets.[17]

5.1.2 International Constraints

The shape and content of the U.S.-U.K. international aviation market is dictated by the Bermuda II bilateral agreement. Signed in 1977, the bilateral has been the source of bitter dispute between the two countries since. Although the bilateral was amended numerous times in the early 1980's and new rights were added in the early 1990's, the basic features of the bilateral remain intact. Domestic rules and regulations in both states also regulate additional facets of the bilateral market. The relevant facets of U.S.-U.K. aviation markets are three-fold: (1) the problems stemming from limited U.S. access at Heathrow, (2) the constraints on the ability of U.K. carriers to fly routes within the U.S. (i.e. cabotage) or purchase U.S. airlines and thereby gain

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access to interior U.S. traffic, and (3) the key position of Heathrow in U.S.-Europe markets.

The Bermuda II contains provisions which limit the number of U.S. airlines which can fly to Heathrow to two airlines (currently United and American), thus forcing all other U.S. airlines to fly into other London airports, which in practice means Gatwick.[18] The differential access at Heathrow has created major problems for two reasons: (1) the position of Heathrow as the preferred airport for business travelers and (2) the slot-constrained nature of the airport. London is the hub for U.S.-European business travelers, and Heathrow is the preferred airport for these high-paying business travelers. Landing rights at Heathrow has thus been at the core of battles over the rules governing U.S.-U.K. aviation markets: U.S. airlines without rights to Heathrow have screamed to get new rights, while British Airways (BA) and U.S. incumbents have been less than enthusiastic about allowing new entry. The problem is compounded by the fact that Heathrow is slot-constrained, which in practice means that allowing new entry means taking some landing slots away from incumbents and giving them to new entrants.[19] Although EU procedures (EU regulations have governed the allocation of take-off and landing slots at Heathrow since February 1993)[20] are designed to protect the interests of incumbents while at the same time encouraging limited new entry, in practice the slot allocation rules have done little to erode the dominant position of BA at Heathrow.[21] The problem with absolute limits on slots is exacerbated by the fact that all slots are not equally valuable: early-morning and late-night slots do not appeal to high-paying business travelers, while slots at very different times may be undesirable for airlines seeking to offer connecting flights to their customers. The difficult regulatory problems posed by the different rights enjoyed by U.S. carriers and the limited number of slots at Heathrow have

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provoked intense political efforts in both the U.S. and the U.K., and are at the heart of the debate over the regulatory rules governing the U.S.-U.K. aviation market.

The second key feature of U.S.-U.K. aviation markets are U.S. laws which prevent U.K. carriers from effectively competing against the hub-and-spoke networks of the major U.S. airlines. Remember from chapter three that the Bermuda regime organized international markets so that domestic monopolies were connected by restrictive international routes. Part of this structure included domestic laws and regulatory rules which were designed to buttress these international arrangements. In the U.S., as in most countries, domestic laws set limits on foreign direct investment and prevented foreign carriers from carrying U.S. domestic traffic. As long as international aviation markets were organized around coastal gateways and U.S. airlines did not have large domestic networks feeding traffic to these gateways, foreign airlines faced no real competitive disadvantages on international routes. However, the replacement of the traditional U.S. international carriers with the former domestic airlines fundamentally altered this situation: foreign airlines now had to channel passengers to their international gateways in order to compete against the U.S. mega-carriers. This has raised serious competitive problems for foreign airlines, quite simply because they do not have the extensive U.S. domestic airlines that U.S. airlines do. U.K. airlines, for example, have been able to effectively compete for point-to-point traffic but have been far less effective in securing behind-gateway passengers: U.K. airlines carry the majority of passengers (64 percent) traveling only between international gateways and of those passengers connecting at London (61 percent), but U.K. airlines only carry 24 percent of passengers who travel beyond U.S. international gateways.[22] The simple solution to this competitive problem would have been to buy a U.S. domestic carrier or begin to offer services on U.S. domestic

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routes--but these options were precluded by U.S. domestic law. Foreign airlines have sought to overcome these regulatory hurdles by concluding alliances with U.S. airlines, but this has not been easy or painless, as the recent American Airlines-BA saga amply demonstrates. U.S. domestic laws thus complicate the competitive efforts of airlines and the political battles over the organization of U.S.-U.K. international aviation markets.

The final notable aspect of U.S.-U.K. aviation markets is the central importance of Heathrow in global aviation markets. As noted above, the U.S.-U.K. aviation market is the largest in the world--a distinction which stems from the central role of the U.K. in the global economy and the geographic position of the U.K. astride the European continent. As the home to a large number of MNCs and a center of international business activity, particularly U.S. firms operating in European markets, London is one of the major business centers in the world. In addition to the importance of local London traffic (i.e. traffic originating in and bound for London), however, is the fact that London serves as a hub for U.S.-European traffic due to the geographic position of the U.K. astride the European continent. The conclusion from these facts is simple: London is, and will remain, one of the major aviation hubs of the world. The dominant position of the U.K., and in particular Heathrow, in global aviation markets has had two important effects on U.S.-U.K. international aviation markets: (1) U.S. efforts to use international market forces to force the liberalization of the U.S.-U.K. market have been partially, but by no means totally, successful, and (2) the importance of the U.K. for U.S. airlines.

U.S. efforts to use the international arbitrage created by liberal agreements with European countries has made U.K. firms and politicians more willing to accept some liberalization. But the basic fact is that in many ways the U.K. can stave off U.S.

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pressures simply because no alternative exists to Heathrow. BA, for example, has accepted liberalization of the U.S.-U.K. bilateral largely because Open Skies agreements and immunized alliances between major U.S. carriers and European airlines threatened to marginalize Heathrow's central position in U.S.-European aviation markets. At the same time, efforts by BA to maintain its position in global aviation markets have been limited by the realization that there is no way to simply circumvent London. The importance of Heathrow in international aviation markets thus provides the U.K. with significant bargaining leverage vis-a-vis the U.S., and both BA and the U.K. government have demanded important concessions from the U.S. for any comprehensive liberalization of the bilateral. The importance of Heathrow for U.S. airlines only increases the bargaining leverage of the U.K. As the U.K. CAA noted in discussing the potential for further liberalization of U.S.-European aviation markets, "before (liberalization can) happen there will have to be changes which take proper account of the existing advantages accruing to U.S. airlines through their ability to feed their North Atlantic operations from their powerful domestic networks."[23]

The second impact of the dominant position of U.K. aviation markets revolves around the importance of U.S.-U.K. aviation markets for U.S. airlines. As I argued in chapter four, U.S. strategy for securing Open Skies agreements with European states rested on signing liberal bilaterals with some European partners which would in turn threaten restrictive markets with traffic diversion and thus ultimately produce widespread liberalization of the trans-Atlantic marketplace. The U.S.-U.K. market was at the core of the U.S. strategy for liberalizing international aviation markets discussed in chapter four, and no small part of this focus has been the importance of Heathrow for U.S. airlines.[24] This fact has made international negotiations problematic,

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however, as all U.S. airlines consider a presence at Heathrow essential, and it has been very difficult to satisfy all U.S. airlines in any piecemeal liberalization and thus secure U.S. domestic political support for any liberalization.[25] These problems are compounded by the fact that the limited number of slots means that access at Heathrow is truly a zero-sum game and the fact that it is impossible to trade-off access at Heathrow for other rights--because there are simply no rights which are comparable. Thus, U.S. domestic politics, slot constraints, and the importance of Heathrow combine to create a very small bargaining space in which to conclude agreements.

5.2 Aviation Regulation in the U.K.[26]

Nationalized ownership of U.K. airlines and strict government control over U.K. aviation markets were the central pillars of U.K. aviation markets until the late 1970's. In 1939, the British Overseas Air Corporation (BOAC) was formed as a nationalized airline to serve the international aviation needs of the U.K., and British European Airlines (BEA) and British South American Airways (merged with BOAC in 1949) joined BOAC as nationalized U.K. airlines in 1946.[27] Internationally, each airline enjoyed a U.K. monopoly in particular markets while the two airlines shared the domestic marketplace. The nationalized airlines enjoyed a complete monopoly of U.K. scheduled aviation services until 1952, when privately-owned airlines began to offer scheduled services on some routes by entering into associate agreements with BEA and BOAC. Although the role of the independent airlines increased as new route authorities were granted throughout the 1950's, the independents were only allowed to provide scheduled services which did not compete with the nationalized airlines. Charter operations, which had been operated by privately-owned airlines since the end

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of the war, also expanded throughout the 1950's as vacation travelers and continued military contracts provided the demand for these services.

In 1960, the government passed the Civil Aviation Act of 1960 which greatly expanded the freedom of operation for the privately-owned airlines. The Act set up the Air Transport Licensing Board (ATLB), eliminated the monopoly rights of the nationalized carriers on particular routes, and allowed privately-owned carriers to apply for scheduled operating rights on their own behalf.[28] Although the 1960 policy was criticized for the lack of clear policy direction and the government continued to regulate all aspects of U.K. aviation markets, the 1960's did witness a substantial expansion in the role of privately-owned airlines in U.K. aviation markets, even if widespread restrictions remained in place and meaningful competition on both domestic and international routes was extremely limited. By the late 1960's, a clear division of labor had emerged: the privately-owned airlines provided service on regional and local routes, BOAC and BEA accounted for the lion's share of scheduled services on domestic trunk routes and in international markets, and charter operators provided international services for leisure travelers.

Widespread dissatisfaction with this regulatory structure began to emerge in the late 1960's. The first move toward re-structuring U.K. aviation markets was in 1969, when a special parliamentary committee (the Edwards Committee) undertook a review of aviation policy and issued a White Paper calling for widespread changes in U.K. aviation policy.[29] The Report, which subsequently became the basis for the Civil Aviation Act of 1971, called for increased coordination between BEA and BOAC, advocated the creation of a strong private sector British airline, and called for new licensing procedures to encourage U.K. aviation markets to meet the needs of users of air transport services. In short, competition--at a minimum to the extent that the

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Treasury did not have to subsidize the government-owned carriers--was encouraged.[30] In 1970, the government made the first moves toward a viable "second-force" airline in the private sector when it approved the purchase of British United Airways by Caledonian Airways to create British Caledonian Airways.[31]

The 1971 Civil Aviation Act also created the Civil Aviation Authority (CAA) to represent the interests of consumers in U.K. aviation policy.[32] The CAA, which effectively replaced the ATLB, was granted authority to regulate domestic fares and was vested with a variety of research and regulatory responsibilities. The 1971 Act also called on the CAA to ensure that aviation services are provided "at the lowest charges consistent with a high standard of safety...and an economic return to efficient operators....to secure that at least one major British airline which is not controlled by the Airways Board has opportunities to participate in providing...air transport services,....and to further the reasonable interests of users of air transport services."[33] In addition to creating the CAA as the institution vehicle to encourage greater competition and the development a private sector U.K. airlines, the government also began to loosen licensing rules, allowed greater fare flexibility, and generally encouraged private sector airlines to enter U.K. aviation markets. The early 1970's thus brought some limited liberalization to U.K. aviation markets. Despite these changes, however, U.K. aviation markets remained extremely restrictive and the state-owned BA continued to enjoy pride-of-place in policymaking. Indeed, the recession brought on by the oil shocks in 1974, coupled with a Labour government more committed to government intervention in the marketplace, meant the limited reforms of the early 1970's were halted or reversed from 1974 onwards.

One final element of U.K. aviation policy during the 1970's is worth noting: the adoption of traffic distribution rules (TDR's) at London airports in 1977, and the

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inclusion of these TDR's in the U.S.-U.K. bilateral agreement in 1980. The TDR's precluded new entry at Heathrow Airport and forced new entrants to offer service from Gatwick Airport. Although they were part of an overall policy to create a second major London airport at Gatwick and thereby provide the groundwork for a second U.K. airline to compete with BA on international routes, in practice Heathrow remained the preferred airport for business travelers, and airlines forced to fly from Gatwick faced severe competitive disadvantages. The TDR's thus only re-enforced the dominant position of BA in U.K. aviation markets.[34] In 1980, the TDR's were included in an Annex to the U.S.-U.K. bilateral which specifically stated that the U.S. rights at Heathrow belonged to TWA and Pan Am or their corporate successors.

The election of Margaret Thatcher in 1979 brought a dramatic reversal of U.K. aviation policies. Re-structuring domestic and international aviation markets were part of the broad package of market-based economic policies that were at the heart of the Thatcherite economic model, and Thatcher adopted aviation policies designed to decrease the role of state intervention in aviation markets and thereby increase the efficiency of British airlines. Re-structuring U.K. aviation markets proceeded along three major fronts: (1) deregulation of domestic aviation markets; (2) liberalization of international markets; and (3) the privatization of BA.

Deregulation of domestic aviation markets began in earnest with the passage of the Civil Aviation Bill of 1982, an Act which significantly expanded the regulatory powers of the CAA and called on the CAA to facilitate the creation of a competitive, multi-airline domestic aviation marketplace.[35] The CAA subsequently began to foster competition on domestic trunk lines into Heathrow: in 1982, British Midland was licensed to fly Heathrow-Glasgow, Heathrow-Edinburgh in 1983, and Heathrow-Belfast in 1984.[36] Domestic liberalization took a more serious turn in 1984 when a

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government White Paper on Competition in Air Transport eliminated the detailed regulation of fares and liberalized licensing procedures on almost all routes.[37] Although the CAA retained the right to grant route licenses, the procedures only required that airlines show financial fitness and all airlines could participate in route proceedings.[38] Although in practice there have been barriers to the realization of full competition, the new licensing rules have fostered new entry and increased competition on all domestic trunks routes.

While U.K. domestic aviation deregulation occurred quickly, international liberalization has proceeded more slowly, largely due to the problems associated with the privatization of BA. Nonetheless, liberalization of U.K. aviation markets has proceeded along three fronts: (1) signing liberal bilaterals with willing states, largely in Europe; (2) pressing its EU partners for intra-EU liberalization; and (3) relaxing the rules governing fares for U.K.-originating passengers. U.K. efforts at signing liberal bilaterals with European states began in 1984, when the U.K. sign a new bilateral with the Netherlands. International liberalization continued throughout the mid-1980's, as the U.K. signed new liberal bilaterals with Germany (December 1984), Luxembourg, Belgium, Switzerland, and France (1985), and Italy and Ireland (1986).[39] In general, these new agreements eliminated capacity restrictions, liberalized entry provisions, and provided either country of origin or double disapproval fare regimes.[40]

The U.K. also began to press for the liberalization of EU aviation markets, and was instrumental in securing the adoption of the phased liberalization of EU aviation markets adopted in 1987.[41] The first liberalization package, adopted in 1987, relaxed some restrictions on pricing and entry but essentially left the existing bilateral structure intact. The second liberalization package, adopted in July 1990, continued the process begun in the first liberalization package but represented no fundamental break from the

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traditional restrictive, bilateral arrangements. The final liberalization package, which came into effect on January 1, 1993 substantially liberalized the rules governing entry and fares in intra-EU aviation markets; in particular, EU airlines holding an operating license in one member country can enter virtually all intra-EU routes, and governments cannot intervene to set fares to protect national carriers.[42] Complete liberalization is scheduled for 1997, when the remaining restrictions on competition, entry, and fares are scheduled to be removed.[43]

The final aspect of U.K. efforts at international liberalization involving forcing airlines to offer low fares to U.K.-originating passengers. In short, the CAA has consistently intervened in international markets to force airlines to offer low on-demand full price economy fares for U.K.-originating passengers. Given the importance of this fare for how other fares are calculated, this intervention has effectively lowered all classes of economy fares for U.K. passengers.[44] Thus, whether through refusal to allow fare increases or by forcing airlines to offer lower fares, the CAA has significantly lowered, as an explicit matter of policy, economy fares for U.K. travelers.[45] The U.K. also sought to lower fares by encouraging competition between U.K. airlines in international markets. Multiple designation and a multiple-airline policy was adopted as a policy to lower fares through increased competition. A consistently liberal charter policy has also encouraged U.K. scheduled carriers to offer low fares in order to compete for vacation travelers. Following a 1994 report in which the CAA pointed to the International Air Transport Association (IATA) as the key reason for high fares on long-haul routes to and from Europe, the U.K. also began to seriously press EU countries to abandon IATA as the mechanism for setting fares on international routes to and from Europe.[46]

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The privatization of BA was the final avenue by which the Thatcher government re-structured U.K. aviation markets. The privatization of BA was one of the most prominent planks of Thatcher's deregulation and privatization campaign, and her government began to discuss the privatization of BA shortly after taking office in 1979.[47] Although privatization was ultimately postponed until 1987, the Thatcher government forced the airline to undertake extensive reforms and become a much more competitive enterprise in the early 1980's. In 1981, Thatcher appointed industrialist John King as Chairman of BA and gave him the mission of cleaning up the airline and prepare it for privatization. By 1983, King had cut the workforce by 22,000 (from 58,000 to 37,000), eliminated unprofitable routes, and sold off aging aircraft.[48] The airline's cost per unit of production dropped an average of 7.8 percent per annum during 1980-1984, and BA returned to profitability in 1983.[49] With the Thatcher government committed to forcing BA to operate as a commercial enterprise in competitive aviation markets, the end of the cozy relationship between BA and the U.K. government was over even before privatization occurred in January 1987.[50]

One final element of U.K. aviation markets is worth noting before proceeding. Prior to 1984, only domestic air services were subject to general competition law (the Competition Act of 1980). With the adoption of the pro-competitive aviation policy in late 1984, however, the powers of the Office of Fair Trading (OFT) were extended to include the power to investigate anti-competitive behavior in charter markets and to refer monopoly questions in charter and domestic markets to the Monopoly and Mergers Commission (MMC). Although the CAA remained the main regulator for civil aviation (through its licensing powers), the new framework allowed the OFT and MMC to work together to address competition issues in aviation markets. However, the OFT's new powers do not cover international aviation, and competition rules in

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U.K. international aviation markets are subject to the bilateral agreements which in the U.K. have the status as international treaties.[51] In short, although the U.K. MMC has the power to investigate anti-competitive practices in the domestic aviation marketplace, international aviation is exempt from the relevant statute, and international aviation is not governed by anti-competitive legislation in the U.K.[52]

5.3 Historical Overview of the U.S.-U.K. Bilateral

The 1946 U.S.-U.K. Bermuda I bilateral set the pattern for the global array of bilateral agreements that constituted the postwar aviation regime. As examined in detail in chapter three, the Bermuda bilateral combined bilateral control over entry and capacity with IATA fare-setting to strictly regulate the U.S.-U.K. market. In the 1970's, this arrangement came under pressure in both the U.S. and the U.K. In the U.S., as discussed in detail in chapter four, widespread dissatisfaction with the Bermuda regulatory led the U.S. to adopt a pro-competitive international aviation policy in 1978. In the U.K., on the other hand, BA's position as an inefficient state-owned carrier and a greater willingness by the U.K. government to intervene in international markets led the U.K. to press for even strictly regulatory control over international aviation markets. The U.S. thus sought to liberalize bilateral markets, while the U.K. pressed to further regulate the marketplace. Disagreements between the two sides ultimately led the U.K. to renounce the Bermuda I agreement in June 1976.[53]

When negotiations began to conclude a new agreement, the U.K. made it clear that it preferred a more restrictive bilateral while the U.S. announced its preference for a bilateral which encouraged competition and allowed additional U.S. airlines to enter U.S.-U.K. markets.[54] The two states ultimately signed a new bilateral in June 1977,

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which quickly became known as Bermuda II. Widespread criticism of Bermuda II, coupled with the serious political pressure to deregulate both domestic and international aviation markets, led the Carter administration to issue a new international aviation policy statement in August 1978.[55]

As discussed in chapter four, liberalizing the U.K.-U.S. bilateral figured prominently in the efforts of U.S. negotiators to implement the new Carter policy.[56] Although the "encirclement" strategy was less than a complete success, some elements of Bermuda II were indeed liberalized in the late 1970's and early 1980's. The rules governing charters and the pricing provisions of Bermuda II were significantly liberalized in a series of side-letters and Memorandum in early 1978, and Bermuda II was further amended in 1980 to allow even greater pricing freedoms.[57] In 1981, the U.K. CAA issued a Policy Statement affirming that the CAA would not disapprove any low fare proposals, and would refuse to allow economy fares increases.[58] Pricing flexibility was further enhanced in 1983 with a multilateral agreement between the U.S. and the ECAC, which introduced zones of fare flexibility within which governments could not disallow fares offered by airlines.[59]

By the late 1980's, significant pressure for liberalizing Bermuda II emerged in both the U.S. and the U.K. .[60] In the U.K., pressure came from the airlines, including both BA and Virgin Atlantic, and regional airports wishing to expand their international traffic flows.[61] For both Virgin and the regional airports, their interest in liberalization was straightforward: they wished to expand their rights to offer services in the U.S.-U.K. marketplace. For BA, the primary competitive issue revolved not around rights on the North Atlantic but around access to internal U.S. traffic.[62] In the U.S., pressure for liberalizing Bermuda II came mainly from the formerly domestic carriers, but airports and cities were also actively involved in pressuring the U.S.

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government to liberalize the U.S.-U.K. bilateral. The Bush administration was also deeply committed to liberalizing international aviation markets, and gave substantial political support to DOT efforts in this area.

By 1990, both sides agreed that liberalization of Bermuda II was a desirable and politically feasible goal. In December 1989, at the end of discussions about U.S. access to Manchester, the head of the U.S. delegation Charles Angevine raised the possibility of an Open Skies agreement between the U.S. and the U.K.[63] The U.K. immediately took the position that Open Skies was desirable, but insisted that the U.S. consider removing restrictions on cabotage and on foreign direct investment in U.S. airlines. Although U.S. negotiators replied that such issues would require changes in U.S. law which would be unlikely to successfully pass through Congress, negotiations for a broad liberalization of Bermuda II began in January 1990. As of this writing (September 1997), the U.S. and the U.K. have yet to sign an Open Skies agreement. Indeed, although a series of mini-deals have been concluded and the two sides appear close to an "Open Skies" agreement in the context of the AA-BA alliance, the history of recent U.S.-U.K. Open Skies negotiations is a lesson in the difficulty in securing domestic political support for international regulatory rules.

5.3.2 Summary

The previous two sections have provided background on the regulation of aviation markets in the U.K. and the history of U.S.-U.K. aviation markets. Two important conclusions should be clear from these sections: (1) the Thatcher government re-organized U.K. aviation markets along competitive lines and sought to secure lower fares for U.K. passengers, and (2) domestic politics in both the U.S. and the U.K. supported more competitive international aviation markets by the mid-

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1980's. In both the U.S. and U.K., national governments scrapped the Bermuda model of organizing aviation markets during the 1980's: both states deregulated their domestic aviation markets, concluded extremely liberal bilateral agreements with important aviation partners, and signaled their willingness to conclude a U.S.-U.K. Open Skies agreement. Yet no Open Skies agreement has been concluded. In the next three sections, I take up the task of examining three recent U.S.-U.K. bargaining episodes in an effort to understand why liberalization have proven so difficult. As we shall see, I find answers to the puzzle posed by U.S.-U.K. aviation markets in the structure of international aviation markets and the impact of these markets structures on the strategies and preferences of firms in both states, and how these strategies and preferences have made liberalization a politically impossible for the respective governments.

5.4 Liberalization at Heathrow: Introduction

Negotiations to conclude an Open Skies agreement began in January 1990, and continued throughout 1990 with no progress toward an agreement. Although an exchange of notes in August allowed greater U.S. access to U.K. regional airports (Manchester) in exchange for Virgin Atlantic rights to Boston, the two sides remained divided on the question of an Open Skies agreement. In the fall of 1990 (following the invasion of Kuwait and the subsequent collapse of international travel), negotiations resumed when the U.S. approached the U.K. about the possibility of transferring the Heathrow routes of TWA and Pan Am to American and United, respectively.[64] For the U.S. government, a quick sale of the routes to United and American was essential in order to avoid the total collapse of Pan Am and TWA. The transfer of the routes was problematic, however, due to the 1980 Annex to Bermuda II which dictated that U.S.

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rights at Heathrow specifically belonged to Pan Am and TWA, or their corporate successors.

In March, 1991, following months of hectic negotiations as Pan Am and TWA edged closer to bankruptcy, U.S. and U.K. negotiators amended Bermuda II to allow United and American to succeed Pan Am and TWA at Heathrow in exchange for an unprecedented package of rights for U.K. airlines. U.K. airlines were authorized to serve additional U.S. cities, secured beyond rights from the U.S. to Asia, Australia, and Latin America, and seventh freedom rights which allowed them to fly from six European states to the U.S. and beyond via London.[65] U.K. airlines were also granted additional code-sharing rights with U.S. airlines and were given the right to obtain a 49.9 percent stake in European airlines serving the U.S.[66] The U.S. government secured its primary goal of eliminating the TDR's contained in the Bermuda II Annex, and also obtained fifth freedom code-sharing rights for U.S. airlines.[67]

5.4.1 The U.K.: The End of TDR's at Heathrow

The negotiations to allow American and United to replace TWA and Pan Am at Heathrow were foist upon the U.K. by the U.S. government. Indeed, except for changes in U.S. laws governing foreign investment and cabotage--changes which would require U.S. Congressional action--there were very few specific rights that the U.K. government wanted from the U.S. at this particular junction.[68] BA, for example, had doubled the number of cities it served in the United States between 1978 and 1988, and was not even using all the route awards they already had.[69]

5.4.1.1 U.K. Firms and Societal Actors

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Two U.K. airlines provide service in the U.S.-U.K. bilateral marketplace: Virgin Atlantic and BA. For Virgin, the Heathrow succession provided the opportunity to achieve its two most important objectives: rights to serve additional U.S. cities and an end to the TDR's at London airports (which would allow Virgin to fly from Heathrow).[70] In pressing its' position with a U.K. government traditionally biased toward BA, Virgin attempted to draw on widespread political support for a multi-airline policy and the importance of protecting smaller U.K. airlines from the anti-competitive antics of BA. Playing David to BA's Goliath, Virgin argued that meaningful competition in U.S.-U.K. aviation markets required that Virgin be allowed to fly to more U.S. cities from Heathrow to provide a competitive spur to BA. With Virgin Chairman Richard Branson suing BA's Chairman Lord King for libel and Virgin suing BA for anti-competitive behavior (the "Dirty Tricks" campaign) in U.K. courts, Virgin Atlantic received sympathetic hearings in both Parliament and the Department of Transport.[71] Virgin's strategy thus rested on securing widespread political support for its position by linking the removal of the TDR's, for both Virgin and the U.S. airlines, with more competitive aviation markets--an argument that resonated well within a U.K. government wary of being seen to coddle BA.[72]

While Virgin's strategy attempted to link the U.S.-U.K. negotiations with competition issues in U.K. aviation markets and thereby align its position with Conservative Party policies, BA's strategy clearly reflected the importance of domestic politics and international bargaining dynamics.[73] Absent political considerations, BA preferred that United and American not be allowed to replace TWA and Pan Am at Heathrow. BA had benefited from the anemic competition offered by the traditional U.S. carriers in the 1980's, and had been careful not to exacerbate the problems of these carriers in the late 1980's.[74] BA was well aware that the former U.S. domestic

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carriers would be stronger competitors than Pan Am and TWA and would create problems for BA due to their hub-and-spoke networks. BA also benefited from not having to face competition from other U.K. airlines at Heathrow, a monopoly which Virgin linkage of the TDRs to the U.S.-U.K. negotiations endangered. Indeed, BA's privileged position at Heathrow allowed the airline to attract traffic through easier access and better connections, and decreased competition at Heathrow was worth, by some estimates, as much as £50 million per annum to BA.[75] BA did not oppose the succession agreement, however. Why? Understanding firm strategy, as I have repeatedly argued in this dissertation, lies in how domestic politics and international bargaining dynamics constrain corporate strategy by delimiting a win-set within which firms must pursue their interests.

U.K. domestic politics shaped BA's strategy because BA realized that to oppose changes in the TDR's would be linked with opposing competition, a position with very little political support in light of the Conservative Party's public commitment to competitive aviation markets. As noted above, Virgin played this card very strongly and with much success, leaving BA no political support for any position which seemed anti-competitive. Indeed, even though BA was the largest private sector employer in the London area[76] and was the darling of Thatcher privatization efforts, BA calculated that it had no chance to block the succession agreement and did not wish to waste political capital opposing a sure winner. As one BA manager quipped, "as far as the politicians are concerned, there are votes in cheap fares."[77] BA also doubted the willingness of the U.K. government to accept renunciation of the U.S.-U.K. bilateral, an outcome BA thought would result if the succession negotiations failed. Thus, BA believed that the U.K. government would accept almost any agreement rather than

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renunciation, and thus saw no point in opposing the succession deal--especially if this opposition appeared anti-competitive and thereby cost BA political capital.

International bargaining dynamics also shaped BA's position vis-a-vis the Heathrow succession deal in two key ways. First, and most strikingly, BA did not even pursue its main strategic objective--changes in U.S. laws to allow BA access to interior U.S. traffic--because this objective required U.S. Congressional action and was thus not feasible given the short time frame of the negotiations.[78] Second, BA did not attempt to block the succession deal because it calculated that the U.S. would renounce the U.S.-U.K. bilateral if no U.S. carriers were allowed access at Heathrow. This calculation meant attempting to block the succession agreement was not a viable option since it would ultimately result in renunciation. BA thus calculated that the reversion point of no agreement would be U.S. renunciation of the U.S.-U.K. bilateral, and thus adopted a more conciliatory position vis-a-vis the negotiations than its commercial interests dictated. BA's calculation was made quite easy by U.K. government negotiators, who point-blank told BA that the deal was a fait accompli and repeatedly asked BA for a list of rights BA wanted in U.S.-U.K. markets. With the logic of international bargaining dynamics making succession a foregone conclusion, the question for BA was not whether or not it should support or oppose the succession, but rather what benefits could be secured.

5.4.1.2 The U.K. Government: Public Commitments and Private Side-Payments

The public commitments of the Conservative Party to competitive domestic and international aviation markets were the primary political backdrop throughout the negotiations regarding the TDRs at Heathrow. With a commitment to liberal and

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competitive markets the centerpiece of Conservative Party economic policy since 1979, the Conservative party government publicly supported competitive aviation markets. Indeed, Conservative governments under both Thatcher and Major made achieving competitive markets--and thereby providing low fares to U.K. consumers--the central element of aviation policy. Arguing that intra-U.K. airline competition generated lower fares, the Conservative government went out of its way to ensure that smaller U.K. carriers were protected from anti-competitive behavior from BA, and were also accorded special privileges in both domestic and international markets.[79] Political support for the smaller U.K. carriers and charter operators was especially strong as these airlines were the low fare leaders in U.K. aviation markets.

While Conservative party political commitments clearly dictated an end to the TDRs, widespread political action also provided political support for the removal of the TDRs. Indeed, the negotiations surrounding U.S. airline succession at Heathrow were only part of a larger political battle taking place in the U.K. over the TDR programme. Political action demanding the end of the TDR's began building in the mid-1980's when smaller U.K. airlines pressed to end the BA monopoly at Heathrow.[80] Although British Caledonian (until it was acquired by BA in 1987), British Midland, Virgin Atlantic, and U.K. charter operators had long lobbied for the elimination of the TDRs, their arguments gained increasing political currency in the late 1980's as the BA privatization faded into the past and the smaller airlines and charters established themselves as the low-price leaders in U.K. aviation markets. The smaller airlines also gained political support in the late 1980's from London business groups, notably the London Chamber of Commerce, which believed that London was in danger of becoming a commercial backwater unless Heathrow was allowed to expand,

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and argued that "without adequate air-transport services, the ability of London to compete with other European financial and trading centers will be undermined."[81]

The U.S.-U.K. negotiations on corporate succession at Heathrow were thus only part of a broader debate over the political logic of the TDR programme. Ultimately, widespread domestic political support for the end of the TDR's led British Transport Secretary Malcolm Rifkind to abolish the TDRs on March 5, 1991.[82] In so doing, Rifkind noted that the Major government accepted the arguments that competition would be enhanced and the consumer would benefit if the TDRs were eliminated, and committed his government to further removing barriers to competition between U.K. airlines at Heathrow.[83] The TDR programme was thus eliminated (although not the TDRs contained in the Bermuda II Annex) even before the U.S.-U.K. agreement on Heathrow succession was signed on March 11.

U.K. domestic politics dictated the end of the TDRs, but international bargaining dynamics were important in shaping the particular positions adopted by U.K. negotiators.[84] As noted above, U.S. negotiators sought a quick agreement in order to allow TWA and Pan Am to receive the capital promised by the sale of their London routes; as Rifkind noted in the midst of the negotiations, "We're not in a hurry. Our American colleagues are."[85] The massive political pressure in the U.S. for a quick agreement to save Pan Am and TWA had two paradoxical effects on the rights pursued by U.K. negotiators. On the one hand, the pressure for a quick deal allowed U.K. negotiators to ask for--and ultimately receive--an unprecedented range of rights for U.K. airlines. On the other hand, U.K. negotiators could not ask for the rights most coveted by BA and U.K. negotiators--changes in U.S. laws governing investment and cabotage--because of serious opposition to such legal changes within the U.S. airline industry and the fact that any changes in these laws would take

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considerable time (and could thus not be completed within the short time frame available for the negotiations). U.K. negotiators were especially unwilling to ask for politically difficult changes in U.S. laws because they feared the political backlash in the U.S. if U.K. demands delayed the agreement and ultimately led to the collapse of TWA and Pan Am.[86] In light of these U.S. domestic political dynamics, U.K. negotiators gave up on asking for their most preferred rights and instead asked for less controversial rights.

5.4.2 The U.S.: The Politics of Succession

Concluding a quick agreement to allow United and American to purchase the Pan Am and TWA routes was of paramount importance to a Bush administration fearful of TWA and Pan Am going bankrupt, and the primary goal of the U.S. government was to quickly amend the bilateral so that the route sales could go forward. The negotiations were thus primarily driven by the demands of four U.S. airlines, TWA, Pan Am, American, and United, and a U.S. government concerned about the employment effects if the traditional U.S. international carriers went bankrupt.

5.4.2.1 U.S. Firms and Societal Actors

TWA, Pan Am, American and United were the primary U.S. airlines involved in the negotiations. TWA and Pan Am had accepted the bids of American and United, respectively, for their London routes, with final closure of the deals awaiting U.K. government permission for the successions. All four airlines supported any deal which the U.S. government could sign to effect the transfer of Heathrow rights, and were thus willing to grant most of the concessions sought by the U.K. government.[87] As is

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the case for most aviation negotiations, the four supporters filed their positions in petitions at the Department of Transportation (DOT), but the primary effort at shaping the course of the negotiations was through mobilizing their Congressional representatives and the communities these representatives represented.[88] This was especially true once John Danforth (R-MI), who's district included the St. Louis hub of TWA, became actively involved in trying to block the sale of the TWA routes to American. Indeed, once Danforth and the rest of the Missouri congressional delegation began pressuring DOT, both American and United sought out their congressional allies to provide the necessary Congressional support for the deal, and the Congressional delegations from Texas, Illinois, Kansas, and Missouri become an active part of the Washington audience carefully following the negotiations.

While the spotlight centered on the Congressional lobbying efforts of the major protagonists, the remaining U.S. airlines, with the exception of Delta, did not actively oppose the Heathrow succession deal nor any aspect thereof, including the huge array of rights granted to U.K. carriers. The lack of political action is noteworthy mainly because the regulatory changes sought--and eventually obtained--by the U.K. threatened to increase competition in markets served by these airlines. In other words, economic logic dictated that these airlines oppose the Heathrow succession deal, yet Continental, USAir, and Northwest did not seriously opposed the succession deal, and even Delta did not muster all its political forces in opposition to the deal. Why? In short, because U.S. airlines figured that the deal was a foregone conclusion and did not wish to waste political capital on a deal that was a fait accompli.[89] According to Assistant Secretary of Transportation for Policy and International Affairs during the Bush Administration Jeffrey Shane, "there was a juggernaut effect....the rest of the airlines understood that the likelihood of getting in the way of the deal was zero. The

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best option for them was to get something out of the deal."[90] The other U.S. airlines merely sought to complain loud enough to ensure that they acquire some rights in the deal, and did not pressure their Congressional representatives to block the deal or otherwise actively oppose the succession.

5.4.2.2 The U.S. Government: Bankruptcy and Competitive International Aviation Markets

For the Bush administration, the Heathrow succession was driven primarily by the need to avoid the bankruptcy of Pan Am and TWA, the strong support of United and American (the two largest U.S. airlines), and the larger policy of liberalizing international aviation markets. The need to avoid the bankruptcy of Pan Am and TWA and the support of United and American involved both the local impact (i.e. jobs and local economic development) and the symbolic problem of presiding over the death of two more airlines (Eastern Airlines had gone bankrupt in 1990). According to Shane, without a quick deal on the succession to allow the route sales, "TWA and Pan Am would be dead....and politically this was impossible."[91] The local impact in terms of jobs and the role of communities as hubs for international air services meant both the Bush administration and Congressional interests were widely supportive of concluding a successful succession deal. The local communities served by the respective airlines actively supported airline efforts in Congress, and argued that international air services provided widespread economic benefits to the communities served by international airlines. Notwithstanding this lobbying, Congress was also concerned about the competitive impact of the sales, and in particular worried about the dominance American would enjoy from East Coast hubs if it were allowed to purchase all the TWA routes.[92]

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Once the U.S.-U.K. negotiations were completed in March 1991, Congressional concerns over the allocation of routes and the impact of this allocation on competition dominated the debate over the U.S.-London routes.[93] Although the United purchase of Pan Am routes was effected quickly, the TWA route sale ran into serious problems: following the successful completion of U.S.-U.K. negotiations but before the American-TWA deal had cleared the DOT review process, DOT Secretary Samuel Skinner bowed to intense Congressional pressure and denied American Airlines the right to acquire three of the six routes to London that American had contracted to purchase from TWA.[94] With Danforth and nearly 30 members of Congress writing to DOT citing concerns over both competition issues and the impact on their local constituents, DOT officials noted that the sale "would not promote aggressive international competition" and only allowed American to purchase three of the routes.[95] Worried about both the competitive implications of concentration and the local impact of the route sale on TWA, Congressional pressure forced DOT to allocate the TWA routes in a manner that nicely addressed both of these concerns: DOT intervened to limit concentration of international routes among U.S. airlines, and in the process kept TWA as a player in international markets by allowing TWA to retain the part of its route structure which produced about 90% of its available seat miles.[96]

While domestic politics dictated the basic parameters of what deal the U.S. was willing to accept, international bargaining dynamics also shaped the particular bargaining position taken U.S. negotiators. In contrast to most aviation negotiations, the Heathrow negotiation was unusual because the U.S. did not insist on securing relatively equal benefits for all the major U.S. airlines. Because airlines are adept at mobilizing their Congressional supporters to oppose deals which benefit their competitors at their expense and because Congressional opposition is almost always

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sufficient to kill potential aviation agreements, almost all bilateral aviation agreements obtain some new rights for all the major U.S. airlines. True to form, the U.S. government initially sought rights for all U.S. carriers in the Heathrow succession deal by asking for rights for these airlines in London at either Gatwick or Stansted airports. However, the U.S. withdrew the requests for rights except for the succession carriers once the U.K. government signaled that the best possible chance of getting a deal was for the U.S. to limit its demands to the Heathrow TDR's.[97] Such a situation is usually sufficient to kill any potential aviation deal. However, because U.S. negotiators and their political principals in Congress and the Bush administration were cognizant of the positive impact entry by United and American would have on the competitiveness of international markets, the U.S. supported an agreement which was unusual in that it benefited only two of the major U.S. airlines. As Secretary of Transportation Sam Skinner noted, "I wanted two strong carriers going to Heathrow and being ready for (intra-) EC (liberalization) in 1992."[98] In short, there was a conscious decision to get the strongest U.S. carriers into the international marketplace in the belief the entrance of these carriers would secure competitive international aviation markets.[99]

5.4.3 Discussion

Aviation negotiations are complex undertakings, and it is worth pausing briefly to consider the lessons of the preceding discussion. One of the key points of this chapter is to show that existing explanations cannot explain the organization of U.S.-U.K. aviation markets. The key evidence in the preceding discussion undermining both realist and domestic level approaches can be found in the first sentence: despite the fact that both governments supported competitive aviation markets, and the U.S. placed considerable pressure on the U.K. to sign an Open Skies agreement, bilateral

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negotiations in 1990 failed to produce any agreement. The rest of the preceding section has sought to demonstrate evidence for two of the hypothesis outlined in chapter two: (1) how international bargaining dynamics and domestic politics have shaped the preferences and strategies of firms, and (2) how international bargaining dynamics shaped the preferences and strategies of national governments in the U.S. and U.K.

Both U.K. and U.S. firms adopted bargaining positions which endogenized both domestic politics and international bargaining dynamics. In the U.K., Virgin couched its political efforts in terms compatible with competition and median voter interests in the U.K., while BA did not pursue its most preferred objective--changes in U.S. laws governing foreign direct investment and cabotage--in light of both U.K. and U.S. domestic political constraints, and instead asked for less desirable regulatory provisions. In the U.S., the strategies of Northwest, Continental, and Delta also betrayed the importance of domestic political dynamics and calculations about international bargaining outcomes. In short, these firms did not oppose the Heathrow succession because they considered it a fait accompli, and did not wish to waste political capital opposing a done deal. Of course, the underlying economic preferences of the firms, which I argue was not determinative of the strategies eventually taken by these firms, was a function of the old Bermuda rules, in particular the TDRs.

While U.S. and U.K. firms pursued their goals within the win-set defined by domestic political dynamics and international bargaining, national governments in the U.K. and the U.S. also were strategic in their bargaining positions. In the U.K., the Major government did not even bother to ask for its most preferred outcomes in light of U.S. domestic political signals, and instead couched its requests in ways that were acceptable to U.S. national politicians. In the U.S., meanwhile, the government had widespread domestic political support for the deal and pushed for a quick deal. U.S.

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negotiators were cognizant of the long-run impact of the succession, however, and the potential of United and American to provide greater competition in international aviation markets provided further impetus to U.S. efforts to conclude a quick agreement.

5.5 The BA-USAir Investment: Introduction

As part of the Heathrow succession deal, the U.K. secured expanded code-sharing opportunities for U.K. airlines in the U.S. market.[100] These new code-sharing rights allowed U.K. airlines to conclude agreements with U.S. airlines and thus secure access to the U.S. domestic networks operated by these airlines. In June, 1992, BA moved to take advantage of these new code-sharing rights when BA and USAir announced a conditional agreement to forge expansive links between the two airlines. With BA proposing to invest $750 million in exchange for 21 percent of the voting stock of USAir and four seats on USAir's 16-member board, the deal was to be the largest foreign investment in a U.S. airline to date. The proposed alliance quickly led the U.S. and U.K. governments to the negotiating table in an attempt to conclude an Open Skies agreement alongside the BA-USAir deal. However, a massive political effort by United, American, and Delta caused the Bush administration to withdraw support for the deal, and governmental negotiations quickly collapsed. Shortly thereafter, BA withdrew the original offer; BA eventually settled for a $300 million investment and a smaller stake in USAir in the winter of 1993.[101]

5.5.1 The U.K.: BA, Globalization, and Restrictive International Rules

From the mid-1980's onward, the major competitive challenge facing U.K. carriers on the North Atlantic revolved around access to interior U.S. traffic.[102]

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Although both U.K. airlines and the U.K. government realized the importance of these internal networks for competing on the North Atlantic, U.K. airlines were prohibited by U.S. law from operating their own U.S. domestic network or purchasing one of the existing U.S. airlines.[103] For the U.K. government, BA's insistence on access to interior U.S. markets meant securing bilateral routes for the smaller U.K. airlines without a comprehensive revision of Bermuda II was politically impossible (because BA would oppose small deals which added routes but didn't allow BA access to interior traffic), which in turn undermined the ability of the U.K. government to promote intra-U.K. airline competition and thereby produce lower prices for consumers. Securing access to the internal U.S. marketplace thus became the central goal of both airline strategy and government policy.

As early as 1987, when BA launched the first international airline alliance with United Airlines, it was clear that inter-airline alliances would be the manner in which U.K. airlines attempted to circumvent the constraints imposed by existing regulatory rules to secure access to interior U.S. traffic. However, alliances were seen by both BA and the U.K. government as a second-best solution, with both preferring changes in U.S. laws governing cabotage and foreign direct investment to the piecemeal solutions offered by alliances. When the Bush administration signaled that it might loosen its interpretation of the laws governing foreign investment,[104] the U.K. government encouraged BA to conclude an alliance with USAir in the hopes that the agreement would enable the two sides to conclude an Open Skies agreement.[105] BA also hoped that the USAir investment would provide the necessary political backing in the U.S. to overcome the opposition of the Big Three U.S. airlines (United, American, and Delta) and thus lead to an Open Skies agreement.

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5.5.1.1 U.K. Firms and Societal Actors

As early as 1989, BA Chairman Lord King signaled his interest in buying a U.S. airline; worried about what BA saw as the inevitable demise of TWA and Pan Am and the competitive problems faced by British Caledonia, the search for a U.S. partner only increased after the Heathrow succession deal. Indeed, the huge importance of access to interior U.S. traffic for BA meant that such access was the most important goal of BA's international strategy.[106] Although BA's preferred way to offer services to U.S. interior traffic was to purchase and operate its own U.S. domestic airline, BA saw the USAir alliance as a second-best solution to the need to expand its network into U.S. domestic markets.

In concluding the USAir deal, BA was deeply concerned that U.S. domestic political opposition would block the investment. But BA received strong indications from Secretary of Transportation Samuel Skinner that the DOT was willing to be flexible in interpreting the rules governing foreign direct investment, and BA calculated that Bush would approve the deal as the BA investment promised jobs, taxes, and increased airline competition in the U.S. As we shall see below, however, political opposition in the U.S. eventually forced BA to conclude a more limited alliance with USAir. Once the first offer had been rejected by U.S. politicians, BA structured the second deal so that it did not require U.S. DOT approval, and thus could not be blocked by U.S. airlines. BA strategy thus internalized international regulatory constraints (i.e. U.S. laws) and U.S. domestic politics.[107]

While BA was the primary actor in the BA-USAir deal, Virgin also maintained a keen interest in the concurrent government-to-government negotiations. With both the U.S. and the U.K. professing a desire to achieve bilateral liberalization in order to clear the way for the BA-USAir alliance, Virgin lobbied hard to ensure that its'

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interests were represented in any new bilateral. Of particular importance were Virgin efforts to include dispute resolution mechanisms that would enable a settlement panel to make quick decisions regarding anti-competitive behavior in international markets. Virgin's insistence on including particular decision-rules for the proposed settlement panel ultimately became a major issue dividing the U.S. and U.K. governments, and contributed to the collapse of the government-to-government talks in December 1992.[108] Why did Virgin insist on these dispute resolution mechanisms, even to the point that their inclusion contributed to the breakdown of negotiations? The answer, I argue, lies in the fact that U.K. competition laws did not protect Virgin from any potential anti-competitive actions of BA or other large airlines, and thus Virgin needed the inclusion of the dispute resolution mechanisms in order to protect itself against its' larger competitors. Thus, the U.K. domestic legal structure directly contribute to both Virgin's bargaining position and the breakdown of negotiations.

5.5.1.2 The U.K. Government: Bargaining for BA

Shortly after BA announced its original investment in USAir in June, 1992, the U.S. and U.K. governments began negotiations which both sides hoped would lead to an Open Skies agreement.[109] The U.K. government had two objectives in the negotiations: assisting BA greater access to internal U.S. traffic flows, and concluding a more liberal bilateral agreement. To date, these two objectives had been at cross-purposes, as BA had opposed piecemeal liberalization deals that did not include access to interior U.S. traffic. The U.K. government thus saw the BA-USAir deal as an opportunity for the government to obtain BA's support for a broad liberalization of the Bermuda bilateral--a liberalization which would benefit both the smaller U.K. airlines and U.K. consumers.[110]

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The problem facing the U.K. government was that BA's need for access to the U.S. domestic aviation market meant liberalization was politically impossible unless changes in U.S. laws on cabotage and foreign investment were forthcoming. Although U.K. negotiators realized that "even if U.S. negotiators wanted to proceed along this path no quick 'fix' is available,"[111] U.K. negotiators remained fixed on obtaining these changes. Before the beginning of government-to-government talks, however, the Bush administration signaled that the rules on foreign investment might be subject to liberal interpretation, and DOT Secretary Samuel Skinner testified in the Senate that raising the permitted level of foreign ownership would attract additional capital into the industry and stem concentration.[112] Congressional support for changes in U.S. investment laws to halt concentration in U.S. domestic aviation markets also suggested to the U.K. government that the USAir investment might be the vehicle for both a comprehensive liberalization of Bermuda II and changes in U.S. laws. In particular, U.K. negotiators saw the USAir deal as a potential opportunity to muster the necessary domestic political support in the U.S. for the U.S. legal changes sought by the U.K.[113] Once the U.S. government signaled that an Open Skies agreement was out of reach in December 1992, however, BA withdrew the proposed USAir investment the next day, and withdrew support for any bilateral liberalization at the same time.[114] Back to the original political conundrum, the U.K. government scuttled negotiations, and an Open Skies agreement was not concluded.

5.5.2 The U.S.: Foreign Investment, U.S. Airlines, and Competition

In the U.S., the politics of the BA-USAir investment revolved around the political trade-offs between competition and the impact of the BA investment on U.S. airlines. On the pro-competitive side, the BA investment promised USAir a desperately

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needed capital injection and would thus hopefully allow USAir to avoid bankruptcy. The investment and subsequent BA-USAir alliance also promised to make USAir a competitor on the North Atlantic and allow BA to compete much more effectively against the Big Three U.S. airlines. On the other hand, BA's investment in USAir threatened to undermine the competitive advantages the Big Three U.S. airlines enjoyed as a result of their domestic hub-and-spoke networks. These three airlines thus opposed the deal and lobbied hard in Washington to block the deal. For U.S. politicians, the deal thus involved a direct trade-off between a desire for increased competition and the opposition of the major U.S. airlines. With both the Bush and Clinton administrations publicly committed to competitive international aviation markets and Congress deeply concerned over the growing concentration of the U.S. aviation industry and its impact on consumer fares, the deal raised difficult political issues that were not easily resolved.

5.5.2.1 U.S. Firms and Societal Actors

The Big Three U.S. airlines protested the BA investment and called for extensive liberalization of Bermuda II before allowing the investment and subsequent alliance to proceed. Delta and American were particularly vehement in their opposition, and argued that the proposed BA investment and BA-USAir alliance violated U.S. laws on investment and foreign control.[115] In a letter to the DOT, Delta Chairman Ronald Allen wrote that BA "must be seen for what it is-a foreign carrier cloaked in the protection of one of the most restrictive and anti-competitive international aviation regimes in the world, seeking control over a U.S. carrier in violation of our government's current law and policy."[116] Although American Airlines Chairman Robert Crandall did not mention the legality of the proposed agreement, he argued that

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"the U.S. must insist" on greater access to the U.K., increased fifth-freedom rights to Europe, and a change in U.K. regulations allowing U.S. carriers "the same opportunities for foreign ownership and control" that BA sought in the USAir deal. Barring acceptance of the these provisions, Crandall wrote that the U.S. should reject the proposed BA-USAir alliance.[117]

United initially took the position that it might welcome the BA-USAir deal if it could be part of an overall liberalization of Bermuda II. Like BA, United hoped the deal would lead to an Open Skies agreement, and thus adopted a conditional position on the BA-USAir deal: it would support the deal if included as part of an Open Skies agreement, but would otherwise oppose the deal. Although United joined Delta and American in a united public front opposing the deal, privately United took a less strident tone and was willing to support the deal if immediate and complete liberalization of Heathrow could be secured.[118] After BA withdrew the first proposed deal, United Airlines Chairman Stephen Wolf noted that the decision by BA is "a lost opportunity for all concerned. United has expressed from the beginning that the BA proposal afforded a basis to liberalize the outdated and heavily restriction aviation bilateral agreement with the United Kingdom, which would have truly benefited the traveling and shipping public."[119] Once the government-to-government talks collapsed in December, however, United became much more strident in its' opposition to any BA-USAir deal and joined American and Delta in outright opposition to the deal.[120]

While the Big Three U.S. airlines sought to exact the requisite pound of flesh from the U.K., other U.S. airlines were more circumspect in their political action regarding the BA-USAir alliance and the concurrent U.S.-U.K. negotiations. Of course, USAir lobbied hard to secure approval for the deal, and sought to link the deal with the preservation of competition and the avoidance of concentration in U.S.

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aviation markets. Indeed, USAir was initially extremely successful in securing Congressional support for the deal precisely because it linked the BA investment with the survival of USAir and the 47,000 jobs represented by the airline.[121] As New York Senator Alfonse D'Amato wrote in a letter to DOT Secretary Andrew Card in support of the deal, jobs are "the whole issue, no ifs, ands, or buts."[122] Northwest remained relatively quiet throughout the fracas. Northwest's position stemmed from its concern over the potential anti-trust issues arising out of its own alliance with KLM. In short, Northwest was eager to see other airlines involved in intensive alliances quite simply because it feared action against its own alliance with KLM under U.S. anti-trust laws and thought that if additional U.S. airlines were involved in their own alliances then they would not sue Northwest in U.S. courts.[123] With no access at Heathrow, Northwest also stood to benefit from any liberalization of U.S.-U.K. markets.

The divergent positions adopted by U.S. airlines reflected both their unique market positions and their different calculations regarding U.S. domestic politics and international bargaining dynamics. American and Delta both adopted heavy-handed lobbying campaigns against the alliance and in the U.S.-U.K. negotiations on the assumption they could secure concessions from the U.K. government or kill the deal. Northwest's position was a result of its worries regarding U.S. anti-trust laws stemming from its own alliance with KLM and its lack of access at Heathrow. United made the same calculation as BA, and adopted a conditional position in the hope that the USAir deal would provide the requisite political support for a wholesale scrapping of Bermuda II; once this way no longer a possibility, United joined American and Delta in outright opposition to any BA-USAir deal. USAir's decision to enter into the alliance reflected its belief that international services were increasingly necessary for it to survive as an independent carrier in the U.S. domestic market, and that an alliance

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with a foreign carrier was the only way for it to secure access to lucrative international markets.

5.5.2.2 The U.S. Government: Competition, Airlines, and Local Economies

Support for competitive international aviation markets came from both the Bush administration and Congress. The Bush administration considered liberalizing international aviation markets an important policy objective, and lent considerable political support for DOT efforts in this area. Allowing increased foreign investment to alleviate increasing concentration in U.S. aviation markets also enjoyed widespread support within both the Bush and Clinton administrations.[124] Indeed, Bush's Secretary of Transportation Andrew Card recommended to Congress that the laws on foreign investment be changed to allow 49 percent foreign ownership of voting stock.[125] Local politics were also important, with concerns over the potential costs of a USAir bankruptcy enjoying widespread currency, especially in the Clinton administration.[126]

Congressional concern over the BA-USAir deal revolved around two issues: (1) local economic effects stemming from either an Open Skies deal or a USAir bankruptcy, and (2) broader concerns about the impact of concentration on competition in U.S. aviation markets. Congressional support for a USAir-BA deal was headed by House aviation subcommittee Chair James Oberstar (D-MN). Long a critic of fortress hubs and increasing concentration in the industry, Oberstar worried most about the impact of concentration on fares and supported inter-airline alliances because of the pro-competitive impact of these alliances.[127] Although concentration obviously improved the ability of individual U.S. airlines to compete with foreign flag carriers,

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Oberstar was most concerned that concentration led to higher fares for travelers--the only salient issue about aviation markets for most Congressional constituents. In 1991, Oberstar held hearings to investigate the impact of fortress-hubs on fares and to consider re-regulating parts of the industry, and subsequently introduced the Airline Competition Enhancement Act. Oberstar's bill had bipartisan support, with co-sponsors including Robert Roe (D.-N.Y.), Chairman of the Public Works and Transportation Committee.[128] Although the bill took aim at a number of aspects of aviation markets, one of the specific provisions of the bill called for permitting up to 49% foreign ownership of airlines under specific and financially dire circumstances. Nor was Congressional concern over the impact of industry consolidation on fares limited to Oberstar; a series of bills were introduced throughout 1992 designed to reverse the trend toward industry concentration or re-regulate particular aspects of aviation markets. All these bills were aimed at ensuring that consumers "enjoyed the benefits of deregulation" (i.e. low fares). Although Congressional concerns focused on the competitive impact of the BA-USAir deal, local concerns were also important. Worries about the local impact of a potential USAir bankruptcy were particularly prominent for Congressional members from all over the eastern seaboard, where USAir operates a dense network of routes. The Big Three also recruited their Congressional interests to oppose the deal, and these Congressmen actively followed the negotiations.

By late summer 1992, the political parameters of any potential deal began to take shape: the Bush administration announced that approval of the original BA-USAir deal would require liberalizing Bermuda II to the extent that the major U.S. airlines were not overly constrained by international regulatory rules on the North Atlantic--i.e. an Open Skies agreement. Believing that the U.K. government had the requisite

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domestic political support for an Open Skies agreement, the U.S. government took a position that, if successful, would have provided something for everyone: all U.S. carriers would get increased rights in the U.S.-U.K. marketplace, USAir would get its investment, and Congressional concerns regarding the impact of concentration and competition on fares would be alleviated. As it turned out, however, Bush withdrew the deal from consideration during the fall 1992 election campaign, and last minute talks between President Bush and Prime Minister John Major could not find suitable middle ground.[129] With the U.K. unwilling to compromise on increased U.S. airline access at Heathrow and the Bush administration unable to commit to changing U.S. laws on foreign investment, the U.S. scuttled the government-to-government negotiations shortly before Christmas 1992.[130]

5.5.3 Discussion

It is again worth pausing to consider what the preceding discussion tells us about the politics underpinning the rules governing U.S.-U.K. aviation markets. One of the key points of this chapter is to show that existing explanations cannot explain the organization of U.S.-U.K. aviation markets. The key evidence in the preceding discussion undermining both realist and domestic level approaches can be found in the last sentence: despite the fact that both governments supported competitive aviation markets, and the U.S. placed considerable pressure on the U.K. to sign an Open Skies agreement, the bilateral negotiations surrounding the BA-USAir deal failed to produce an Open Skies agreement. The rest of the preceding section sought to demonstrate how international bargaining dynamics and domestic politics have shaped the preferences and strategies of firms, and how these strategies have in turn shaped the domestic politics of bilateral aviation markets. It is worth briefly re-iterating my findings here.

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Both U.K. and U.S. firms adopted bargaining positions which endogenized both domestic politics and international bargaining dynamics. In the U.K., Virgin pushed for international regulatory rules which reflected the lack of anti-trust protection afforded Virgin by U.K. competition laws. Thus, Virgin pushed for strong dispute resolution mechanisms, a position that ultimately contributed to the collapse of government to government talks. While Virgin's strategy in the negotiations was primarily driven by considerations of U.K. legal structures, BA's strategy was largely driven by calculations about U.S. domestic politics and the constraints posed by U.S. laws on foreign direct investment and cabotage. As noted above, BA would have preferred to buy or operate its own U.S. domestic airline, but this option was precluded by U.S. domestic laws inherited from the Bermuda regime. Thus, the BA investment in USAir was carefully constructed in order to secure U.S. domestic approval of the deal; although the initial investment proposal ultimately failed, BA was careful in tailoring specific investment proposals to suit their analysis of U.S. domestic politics. For U.S. airlines, the positions they took were largely driven by existing property rights in U.S.-U.K. aviation markets. Delta opposed the agreement because it wanted liberalization above all else, and feared that no liberalization would be forthcoming if BA secured access to U.S. interior traffic through the USAir alliance. In other words, Delta feared changes in U.K. domestic politics, in particular the end of BA support for comprehensive liberalization, which would result from the USAir deal. United and American opposed the deal because they wanted additional rights but also because they didn't particular increased competition on the North Atlantic. United's position was thus conditional on the outcome of the concurrent government-to-government bargaining, and it supported the BA-USAir deal if an Open Skies agreement could be concluded. The inactivity of Northwest also betrayed calculations

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about U.S. domestic politics, as it hoped additional international alliances would lessen the chances that its own alliance with KLM would come under challenge in U.S. courts.

While U.S. and U.K. firms pursued their goals within the win-set defined by domestic political and international bargaining dynamics, national governments in the U.K. and the U.S. also were strategic in their strategies. In the U.K., the Major government supported the BA investment largely because it calculated that USAir and the Bush administration commitment to competitive international aviation markets would provide the necessary support for a comprehensive liberalization of the U.S.-U.K. bilateral, especially changes in U.S. laws governing foreign direct investment and cabotage. Once Bush backed away from earlier promises to try to change U.S. laws, BA withdrew support from the agreement, and the talks collapsed.

The final collapse of inter-state bargaining, then, was driven by U.S. domestic laws inherited from the Bermuda regime which prevented BA from achieving its strategic goals--and thus prevented the U.K. government from concluding any Open Skies agreement with the U.S. In the U.S., the problem with the deal revolved around the difficulty in satisfying domestic political interests within the parameters defined by international constraints. In short, all the major U.S. airlines wanted into Heathrow, but there were a limited number of slots with which these airlines could be bought off with. Thus, although there was considerable domestic political support for an Open Skies agreement, and both Congress and the Bush administration worried about both the local economic impact and the impact on competition in U.S. aviation markets if USAir went bankrupt, the basic fact was that international constraints shaped the strategies of important U.S. domestic political actors, and ultimately these actors were able to block liberalization.

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5.6 The British Airways-American Airlines Alliance: Prelude to Open Skies?: Introduction

Although BA obtained some access to interior U.S. traffic through its' USAir alliance, BA's primary strategic challenge in the early 1990's remained securing access to interior U.S. passengers. With U.S. laws precluding the purchase of a U.S. domestic airline and the Bush and Clinton administrations encouraging strategic alliances between U.S. airlines and foreign carriers, the message for BA was clear: a strategic alliance with a major U.S. carrier would be the avenue for access to U.S. traffic.[131] Once Northwest, United, and Delta partnered with major European airlines, American Airlines emerged as the obvious choice. Although American had long been opposed to alliances as a means to expand its network, frustration with route-by-route expansion, U.S. government encouragement, and the competitive challenges posed by global alliances ultimately led American to re-consider its' opposition to alliances. With BA's extensive global network promising American a global network to match its expansive U.S. operations and American's extensive U.S. domestic network promising BA access to interior U.S. traffic, the two carriers announced their proposed alliance on June 11 1996.

The proposed BA-American alliance quickly set off a storm of politicking in the U.S., the U.K., and Europe, and led to a series of intense U.S.-U.K. negotiations. In the U.S., the Clinton administration made it clear that anti-trust immunity for the BA-American alliance would have to be accompanied by an Open Skies agreement, including provisions on slots that guaranteed access for additional U.S. carriers at Heathrow and new fifth-freedom rights for U.S. airlines. In the U.K.,

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government negotiators pressed for changes in U.S. laws governing investment and cabotage in exchange for any Open Skies agreement, and argued that no fifth-freedom rights would be forthcoming unless such legal changes were promised.[132] Accompanying these specific regulatory issues were more broad concerns about how to ensure a competitive bilateral aviation marketplace. With BA and American maintaining some 69 percent of the overall U.S.-U.K. market and much higher percentage in some key markets,[133] both governments sought to ensure that other airlines could enter the marketplace and thereby provide sufficient competition.[134] Serious slot constraints at Heathrow, however, meant that providing "meaningful" access at Heathrow for other airlines would entail taking slots away from BA and American.[135] The proposed alliance and concurrent government-to-government negotiations thus became a debate over how many slots were necessary to ensure new entry and competitive markets, and how many slots BA and American were willing to give up to cement their alliance. As of this writing, the proposed BA-AA alliance remains in limbo at the U.S. DOT, while government-to-government negotiations continue.[136]

5.6.1 The U.K.: BA's Global Push

Following the failure of the USAir deal to secure the wholesale liberalization sought by both governments, government-to-government talks resumed in early 1993. In April 1993, U.S. Secretary of Transportation Federico Pena and U.K. Secretary of State for Transport John MacGregor issued a joint Communiqué which emphasized the common goal of liberalizing the Bermuda II bilateral and called for an Open Skies deal within one year. Stating that "we agree there is potential for an agreement," the Communiqué stated that "the aim...is to replace the restrictions in the current air

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services agreement with a regime that enables airlines management to determine the price and supply of air services. Both Governments want to see vigorous but fair competition, offering the public an even wider choice of airlines, routes and fares." [137] Although some liberalization subsequently took place, the need to provide new benefits for all major U.S. airlines in each and every deal ultimately scuttled piecemeal liberalization in 1995.[138] With U.S. domestic politics making liberalization politically difficult for U.S. national governments, both BA and the U.K. government hoped that the proposed BA-American alliance would provide the necessary U.S. domestic political support for a comprehensive Open Skies agreement.

5.6.1.1 U.K. Firms and Societal Actors

BA and Virgin Atlantic were the two U.K. airlines involved in the BA-American alliance negotiations. For BA, the failure of the USAir deal, the poor performance of USAir, and the emergence of comprehensive alliances between major European and U.S. airlines meant that a more extensive and intensive alliance with a major American airline was necessary. Only by being part of an Atlantic and global alliance structure, BA reasoned, could it compete in the international aviation marketplace of the future. The problem for BA's strategic goals, however, lay in the nature of U.S. domestic politics and the existing structure of U.S.-U.K. aviation markets.[139] In terms of U.S. domestic politics, BA learned from the USAir deal that it was necessary to have significant political support in the U.S. for approval of any intensive alliance or any comprehensive liberalization of the Bermuda II bilateral. The problem was thus finding a potential alliance partner and mustering the necessary domestic political support in the U.S. for approval of any deal. The difficulty in securing U.S. domestic political support, meanwhile, was exacerbated by the existing

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structure of U.S.-U.K. international aviation markets. In short, the huge size of the U.S.-U.K. market and the importance of Heathrow for international business travelers made access at Heathrow absolutely essential for U.S. airlines, but Bermuda II and slot constraints at Heathrow made it very difficult to provide new access for U.S. airlines. Existing rules, market size, and infrastructure constraints thus created an imperfect international marketplace which rendered devising a political solution in the U.S. very difficult. No political solution to the problem in the U.S., in turn, meant the continuation of the status quo--and thus meant no BA access to interior U.S. traffic.

BA's strategy in concluding the BA-American alliance was a solution to their competitive dilemma designed to succeed with the constraints presented by U.S. domestic politics and the structure of the international marketplace. Although BA initially argued that the alliance should be quickly approved as other alliances between major European and U.S. airlines (Northwest-KLM, United-Lufthansa, and Delta-Austrian Airlines-Sabena-Swissair) and that the alliance should be kept separate from any Open Skies negotiations, BA accepted that approval of the proposed alliance would require more access for U.S. airlines at Heathrow and the conclusion of an Open Skies agreement. BA also accepted that BA and American would have to give up some of their slots at Heathrow to allow for this new entry. For BA, then, entering into the deal with American was based on a calculation that BA and the U.K. would have to acquiesce to some regulatory changes--which would allow additional U.S. airlines to fly into Heathrow--in order to secure the necessary domestic political support within the U.S.[140]

BA's strategy thus rested on a complicated series of calculations about what regulatory changes were necessary to secure U.S. domestic political support for the proposed BA-American alliance. Although it initially appeared that BA and American

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had calculated correctly about U.S. domestic politics, the other major U.S. airlines mounted a very successful campaign which highlighted the marketplace concentration which would be created by the alliance. Aided by EU regulatory decisions, the discussion about the proposed alliance ultimately broke down to a discussion over how many slots BA and American would actually be required to give up. On the one hand, U.K. regulators called for BA and American to give up 168 weekly slots at Heathrow, a figure that both BA and American tacitly accept. On the other hand, EU regulators and other U.S. airlines claim that BA and American should be required to give up more than 400 slots to ensure meaningful access at Heathrow.[141] For BA, the question posed by the proposed slot allocations was straightforward: what number of slots would BA be willing to give up to cement the alliance? As BA Chief Robert Ayling noted, "there is obviously a point beyond which it is not in the commercial interest of either BA or American to proceed with the deal as currently proposed."[142]

While international bargaining dynamics were the primary constraints on BA's strategy, Virgin's strategy reflected the importance of both U.K. domestic politics and international constraints.[143] Most simply, Virgin Atlantic vigorously opposed the deal and argued that the alliance would result in increased fares and decreased competition, but also sought to link its' opposition to the alliance with broader U.K. public concerns about the impact of the alliance on marketplace competition and international fares. International constraints were also crucial in shaping Virgin's lobbying positions. For Virgin, the BA-American alliance and the concurrent government-to-government negotiations were two separate issues. Virgin opposed the alliance, but supported Open Skies--under particular conditions. In particular, Virgin pressed for changes in U.S. laws governing cabotage and foreign investment and argued for the inclusion of a competition authority in any Open Skies agreement. Although BA,

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Virgin, and the U.K. government had long been united that changes in U.S. laws governing cabotage and investment would be required for a true Open Skies agreement, the proposed American alliance led BA to change its' position and support Open Skies even without changes in U.S. laws. But Virgin still faced the same strategic goal--access to interior U.S. traffic--with no solution except changes in U.S. laws. Virgin also pressed for the inclusion of a competition authority which would have the authority to intervene in the bilateral marketplace to protect against anti-competitive behavior. With U.K. laws providing no protection for Virgin against anti-competitive behavior by BA or other airlines, inclusion of regulatory arrangements to protect Virgin became one of the central goals of Virgin in the negotiations. Ultimately, these two Virgin positions were major sticking points in the negotiations, and contributed to the failure of government-to-government negotiations to produce an Open Skies agreement.

5.6.1.2 The U.K. Government

The U.K. government supported liberalization of the bilateral and saw the BA-American alliance as the vehicle for securing this long-sought goal.[144] With earlier negotiations failing due to the problems associated with increased access for U.S. airlines at Heathrow and the end of U.S. laws governing cabotage and foreign investment, the U.K. government hoped the alliance would provide the necessary political support in both the U.S. and the U.K. to secure liberalization. The political problem for the U.K. government in the negotiations revolved around satisfying the interests of both BA and Virgin Atlantic. In concrete terms, the problem revolved around two issues: (1) how many slots to take away from BA and American and (2) whether or not to press for changes in U.S. laws governing cabotage and investment.

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On both issues, the interests of BA cut against both Virgin and concerns about consumer interests and low fares: BA wanted to give up on efforts to force changes in U.S. laws and wanted to give up a minimum number of slots, while Virgin pressed for changes in U.S. laws and significant numbers of slots.

Given the opposite positions adopted by BA and Virgin Atlantic, interest-group models would predict that BA would be successful in achieving its policy objectives: as the largest private sector employer in the greater London area and the primary U.K. international airline, BA clear represented more economic interests than Virgin Atlantic, which owns less than 10 airplanes. The importance of consumers and broad societal interests for political competition in the U.K., however, meant Virgin's association with lower fares and more competition lent its' efforts widespread political support. Indeed, U.K. negotiators were particularly concerned about the impact of the alliance and any Open Skies agreement on smaller U.K. carriers, and sought to make sure that these low-cost carriers were protected in any potential bilateral agreement. BA demands were thus an important, but by no means the dominant voice in the formulation of U.K. international aviation policy. Indeed, although the U.K. government faced serious political pressure from BA and sought to ensure that the U.K. did not miss the movement towards global aviation networks (i.e. the U.K. government did not wish to have BA emerge as the only major European carrier without a major U.S. alliance partner), concerns over the impact of any agreement on the low-cost smaller U.K. airlines were of paramount importance.

Ultimately, the U.K. government adopted a position in support of the alliance, but required BA to give up some slots and pressed the U.S. government to include a competition authority in the bilateral and to agree to changes in U.S. domestic laws. In August 1996, the House of Commons Select Committee on Transport issued a report

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largely supportive of the proposed BA-American Airlines alliance. Although the report noted that the alliance might have to cede slots at Heathrow if the airport cannot accommodate greater transatlantic competition without some slot adjustments, the Committee stated that the UK should not "miss the boat in moves toward a limited number of global alliances." The committee thus approved the proposed alliance.[145] While the House of Commons approved the alliance, the government also referred the proposed alliance to the OFT, which subsequently concluded that the alliance was not seriously anti-competitive when viewed in terms of Europe-US traffic.[146]

If domestic politics dictated the compromise position adopted by the U.K. government, international bargaining dynamics were also important in shaping the specific positions taken by the U.K. government.[147] In particular, the U.K. government was very conscious of the presence of six major U.S. airlines and that any position taken by the U.K. government must be acceptable to all six of the these airlines.[148] This realization, combined with the learning that took place following the failed USAir deal and the subsequent collapse of the piecemeal liberalization attempts in 1993-1995, led the U.K. government to believe that any liberalization that took place would have to be a comprehensive package which would satisfy all the major U.S. airlines.

In addition to international bargaining dynamics with the U.S., negotiations and legal wrangling with the EU were also important determinants of the strategies and bargaining positions adopted by the U.K. government. Although the EU only has authority over intra-EU aviation, and therefore does not have authority to negotiate bilateral agreements with non-EU states, the EU has been attempting to gain authority for all international aviation negotiations. More importantly, all EU business is subject to EU competition law, and slot allocations at all EU airports are governed by EU

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rules. As a result of these jurisdictional issues, the proposed BA-American alliance became embroiled in a complex dispute with the EU over the proper regulatory authority for the merger and the allocation of slots at Heathrow. Although the details of these discussions and disputes are beyond the scope of this discussion, it is important to note that the U.K. government altered course at important parts in the negotiations and alliance discussions in order to satisfy its' EU partners.

5.6.2 The U.S.: Alliances and Ensuring Competition in International Aviation Markets

U.S. efforts at securing Open Skies agreements with European nations began in March 1992, and the U.K. was the major objective of U.S. efforts at liberalizing trans-Atlantic aviation markets.[149] As discussed in the previous chapter, the U.S. strategy for securing Open Skies agreements revolved around offering anti-trust immunity for strategic alliances between European flag carriers and major U.S. airlines. The announcement of the proposed BA-American alliance thus seemed to bode well for the U.S. strategy: BA dropped its' opposition to an Open Skies agreement which did not include changes in U.S. laws governing cabotage and investment, and the U.K. government continued to support an Open Skies agreement. Domestic politics in both states thus seemed to support an Open Skies agreement, and negotiators set about concluding the deal.

5.6.2.1 U.S. Firms and Societal Actors

USAir and American were the airlines directly involved in the proposed BA-American alliance, but all the major U.S. airlines were actively interested in the U.K.-U.S. market and the implications of the alliance and concurrent government-to-

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government negotiations. For USAir (now US Airways), the implications of the BA-American alliance were clear: the limited alliance between BA and USAir was unimportant to BA, and BA would quickly jettison the alliance once the deal with American had been cemented. The BA-American deal thus threatened to leave USAir without a major international partner, a position which USAir deemed would ultimately lead to serious competitive and financial difficulties. In light of the serious implications of the BA-American alliance for USAir, USAir sued BA and American in U.S. courts in July 1996 on the grounds that the proposed alliance was anti-competitive and violated USAir's agreement with BA. In subsequent months, USAir asserted its' desire to begin operating independently of its' alliance with BA, and applied in August 1996, to offer U.S.-London service in direct competition with BA.[150] In what followed, attempts by USAir executives to speak to BA officials were turned down, with BA representatives asserting that the legal action against BA must be dropped first.

The USAir legal action is interesting because it rested on a calculation that U.S. regulatory authorities were unlikely to grant immunity to a three-way alliance between BA, American, and USAir, and thus USAir believed that the proposed BA-American alliance would reduce USAir to a second-tier player in the alliance. USAir's strategy and preferences regarding the alliance thus rested on a series of calculations about the position of USAir after U.S. regulatory authorities had ruled on the scope of the alliance. This conclusion is interesting, however, because neither BA nor American stated that USAir would become a marginal player. Rather, USAir calculated that U.S. regulatory authorities would define the options for BA and American in such a way that this outcome would be the end result. USAir's strategy thus rested not on straightforward economic interests, as being part of the largest alliance in the world

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might have been advantageous to USAir, but rather on calculations about what U.S. regulatory authorities would allow.

While USAir's calculation about the alliance rested on assumptions about U.S. regulatory authorities, American's strategy rested on complicated decisions about both U.S. domestic politics and the structure of international markets.[151] As noted earlier, American had long been opposed to alliances as the means to expand American's international network. American CEO Robert Crandall was the most vociferous critic of the U.S. Open Skies negotiating strategy, and American relied on internal route growth to expand its' international network throughout the late 1980's and early 1990's. Put simply, absent U.S. domestic and international regulatory constraints, American would have preferred to expand its' network without resorting to an alliance. However, the failure of internal route-by-route expansion, the encouragement of the U.S. government to conclude an alliance, and the emergence of global alliances between the major U.S. airlines and their European and Asian partners led American to consider an alliance with BA. The very fact that American even concluded an alliance thus reflected American's calculations about the political and economic landscape of international aviation markets.

Once American had concluded the proposed alliance with BA, American also accepted that other U.S. airlines would have to be provided additional access at Heathrow in order for the U.S. government to sanction the alliance. Thus, although American stood to gain if no new access were allowed, American accepted that there would be new entry quite simply because it realized that U.S. domestic politics meant it was politically impossible for U.S. regulators to approve the deal unless more slots at Heathrow were made available. Thus, in September 1996, American Chairman Robert Crandall acknowledged that BA and American Airlines would have to give up

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some of their slots at Heathrow Airport in order to allow for more competition in the market.[152] American's calculation also meant that American supported an Open Skies bilateral, quite simply because the U.S. government public position stated that no anti-trust immunity would be forthcoming for alliances unless Open Skies agreements had been signed between the U.S. and the government of the airline in question. These positions, however, cut against American's simple economic interest, for American would have preferred to have maintained a regulated market in which the BA-American alliance could dominate. American thus supported giving away slots and supported an Open Skies agreement even though these cut against American's economic interests. However, U.S. domestic politics dictated that opposing these was politically impossible, and thus American supported these moves.

The positions adopted by United, Delta, and the other U.S. airlines also nicely reflect the impact of both U.S. domestic politics and international bargaining dynamics on firm strategy. For the rest of the U.S. carriers, there were two separate issues in the BA-American alliance negotiations: (1) whether the alliance should be approved by U.S. regulatory authorities, and (2) whether the U.S. should sign an Open Skies agreement with the U.K. In a perfect world, all of the other U.S. airlines would have preferred to disapprove the proposed alliance while concluding an Open Skies agreement. With no access at Heathrow for the other U.S. airlines except United, U.S. airlines were desperate for access at Heathrow. At the same time, however, the BA-American alliance promised to increase competition and erode some of the competitive advantages the other major U.S. carriers enjoyed as a result of their alliances with major European airlines. But these airlines had to pursue their interests within the parameters defined by a U.S. administration and a Congress deeply

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supportive of competitive international aviation markets and committed to a policy of encouraging alliances as the means to secure international liberalization.

U.S. domestic political support for alliances and the liberalization of international aviation markets meant opposing the BA-American deal had to be done on grounds consistent with this broad political bargain. Thus, the major airlines did not directly oppose the deal, but rather argued that the deal was anti-competitive and that approval of the deal would require both an Open Skies agreement and the allocation of a large number of slots at Heathrow. Delta, for example, published a report entitled "British Airways-American Airlines Combination Dooms Competition," which argued that the structure of the bilateral market meant competition was impossible, especially in light of slot constraints at Heathrow. Once taking away slots from BA and American became a potential regulatory fix to the problem of slot constraints, Delta continued to argue that the alliance would reduce competition but now asserted that providing enough slots to other U.S. airlines would provide a mechanism to ensure competitive bilateral markets.

Like Delta, United took the position that it would support the BA-American alliance if it received sufficient Heathrow slots to offer more flights between Chicago and London and if it received permission to share facilities with its alliance partner Lufthansa.[153] United also asserted that BA and American would have the majority of slots at peak times at Heathrow airport, and thus argued that provisions had to be made regarding the allocation of slots at Heathrow for the alliance to be approved. Failure to allocate additional slots to other U.S. airlines, United argued, would decrease competition in the market.[154] United's basic position was that alliances could be good for both airlines and consumers only if sufficient provisions were made to ensure competition in the marketplace, which in practice meant that United be allocated

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additional slots at Heathrow and be allowed to further integrate its' operations with its' alliance partner Lufthansa. Throughout the public posturing and private negotiations, United, like Delta, United adopted language consistent with U.S. governmental concerns about the impact of the alliance on U.S. consumers. Indeed, according to United, "the sole criterion by which to judge an alliance is whether it ultimately benefits the consumer."[155]

Although American, USAir, United, and Delta occupied center stage, the smaller U.S. airlines were also active in the negotiations. Heathrow access was particularly important for TWA, which sought to slots at Heathrow and the right to fly New York-Heathrow to complement its existing operations at Paris and Frankfurt. Likewise, Continental and Northwest had no access to Heathrow, and pushed for the distribution of BA and American slots to themselves. Of course, these airlines advocated these slot allocations in the interests of more competitive international aviation markets--positions taken in light of U.S. domestic political dynamics noted above.

5.6.2.2 The U.S. Government

The major issue facing the Clinton administration in the BA-American alliance and the concurrent government-to-government negotiations revolved around the impact of the alliance on competition in international markets and the rights enjoyed by particular U.S. airlines within these markets. As noted above, the Clinton administration was committed to competitive international aviation markets, and U.S. international aviation policy stressed the use of alliances and anti-trust immunity as the means by which the U.S. would secure partners in liberalizing international aviation markets. Seen in this light, then, the BA-American alliance seemed no different than

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previous alliances between Northwest-KLM, United-Lufthansa, and Delta-Swissair-Sabena-Austrian Airlines: strategic alliances would provide the impetus for negotiations, and the political support for the successful conclusion thereof. Ultimately, however, international bargaining dynamics set this alliance and concurrent government-to-government negotiations apart from earlier, successful liberalization efforts.

International bargaining dynamics complicated the BA-American and concurrent U.S.-U.K. negotiations in three key ways: (1) the importance of Heathrow for all U.S. airlines, (2) slot constraints at Heathrow, and (3) the strong bargaining position of the U.K. and the demands of the U.K. government. Combined, the importance of Heathrow for U.S. airlines and the lack of adequate slots meant that securing the political approval of the major U.S. airlines presented a difficult regulatory problem. All the major U.S. airlines wanted access to Heathrow, but there were limited slots available. This, as noted earlier, quickly led to a debate about how many slots BA and American would be required to give up. But BA and American obviously had limits on how many of their existing slots they were willing to give up. Meanwhile, the U.S. government also desperately wanted an Open Skies agreement to liberalize the largest trans-Atlantic aviation market and thereby secure lower prices and more flights for U.S. consumers.[156] The difficult issue thus revolved around how to balance the demands of the competing U.S. airlines for slots with the limits on the willingness of American and BA to give up slots, and thereby secure an Open Skies agreement.

The strong bargaining position, and the particular bargaining position adopted by the U.K. government as a result of this position, also made the negotiations more problematic than other bilateral negotiations. As noted in section 5.1.2 above, the large

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size of the U.K. market and the key position of the U.K. astride the European continent provide the U.K. with a very favorable position in international aviation markets. The strong position of the U.K. and the importance of the North American market for BA led the U.K. government to press the U.S. to alter U.S. domestic laws governing cabotage and foreign investment in exchange for any Open Skies agreement--demands which other bilateral partners had not made. These demands created political action against the alliance in the U.S., in particular from labor groups which feared that foreign carriers would lead to job losses within the U.S. domestic market, and thereby made these changes even more politically difficult. As of this writing, the bargaining positions taken by the two sides have proved irreconcilable, and the U.S. government has not approved the BA-AA alliance or concluded any comprehensive Open Skies agreement with the U.K. government.

5.6.3 Discussion

The BA-AA alliance and concurrent government-to-government negotiations demonstrate how domestic politics are shaped in important ways by international bargaining dynamics. Both national governments are committed to liberal international aviation markets, but at the same time the imperfect nature of these markets has made securing industry support for liberalization very difficult. Airlines in both states support liberalization, to be sure, but the particular deals which have been struck have not been satisfactory to airlines in both states, a fact which has undermined efforts at liberalization. Firms and national politicians in both states are thus committed to securing liberalization, yet Bermuda II still set the rules to the bilateral market.

The preceding discussion helped understand this situation by outlining how imperfect international aviation markets, in particular the strong bargaining position

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enjoyed by the U.K. and the problems associated with Heathrow, have made securing domestic political support for particular liberalization deals difficult. In the U.K., BA has opposed any liberalization which does not secure access to interior U.S. traffic, preferable via changes in U.S. laws governing cabotage and foreign investment. With the BA-AA alliance, however, BA changed its position and supported Open Skies. Yet Virgin Atlantic, the darling of consumers and smaller U.K. airlines, continued to support Open Skies only if changes in U.S. laws were forthcoming. Moreover, Virgin also pressed for the inclusion of strong dispute resolution mechanisms in any bilateral agreement, a move which the U.S. was deeply displeased with. The U.K. government was thus largely concerned with the interests of Virgin and the impact of the proposed alliance on U.K. consumers in the negotiations, and refused to accept less than serious promises for changes in U.S. laws. In the U.S., meanwhile, all the major U.S. airlines wanted access to Heathrow, and refused to support any agreement which did not provide them this access. The U.S. government thus supported liberalization, but also pressed for the allocation of BA-AA slots to other U.S. airlines. This proposal, of course, raised the question of whether BA or AA would even proceed with the alliance if a large enough number of slots were confiscated, which in turn questioned the political coalition pushing for an Open Skies agreement.

In short, the difficulty has been in providing the necessary entry for all the major U.S. airlines at Heathrow while at the same time securing an agreement supported by BA and smaller U.K. airlines. To date, the empirical sticking point of this situation has been the number of slots which BA and AA will be required to give up to secure regulatory approval for the deal: the major U.S. airlines will support an Open Skies deal if they are allocated a sufficient number of slots at Heathrow, but BA and AA will not support any agreement if it is required to give up too many slots.

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Virgin's insistence on including strong dispute resolution mechanisms in the agreement also undermines U.S. domestic political support for any Open Skies agreement as this raises the potential for government intervention and subsequent stifling of competition in bilateral aviation markets. The point of this discussion is to demonstrate a two-step argument: (1) the particular strategies and preferences of U.S. and U.K. airlines have been a function of international bargaining dynamics, and (2) these strategies and preferences have made assembling the necessary domestic political support for particular liberalization deals difficult in both the U.S. and the U.K., despite the fact that both airlines and national governments are committed to liberalizing bilateral aviation markets. Understanding how international bargaining dynamics shape the strategies of domestic actors thus helps us explain why the U.S.-U.K. bilateral market remains governed by the Bermuda II bilateral.

5.7 Conclusion

The U.S.-U.K. aviation bilateral is a study in frustration. Since the signing of Bermuda II in 1977, both sides have been deeply dissatisfied with the rules governing the bilateral marketplace. Beginning in the early 1980's, both national governments adopted pro-competitive international aviation policies and consistent efforts have been made to conclude an Open Skies agreement since the early 1990's. Domestic political bargains in both states have thus supported bilateral liberalization, but agreeing to a particular deal to liberalize the bilateral marketplace has proven impossible.

One of the central lessons of the previous chapter was that demand-side explanations were unable to explain U.S. international aviation policy. The explanation for U.S. policy, I argued, lay in how U.S. domestic political institutions structured the incentives of U.S. domestic politicians, and how U.S. national politicians pursued

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their policy objectives within the structure defined by international bargaining dynamics. This chapter complements the U.S. chapter by demonstrating that even well-specified domestic political arguments that include domestic political institutions in the analysis cannot explain the organization of international aviation markets. In short, a purely domestic level explanation would have predicted that liberalization of U.S.-U.K. aviation markets would take place quickly and easily. Yet efforts at liberalization have failed.

The failure of purely domestic-level explanations to explain the scope and content of U.S.-U.K. international aviation markets stems from two key variables: (1) the importance of international bargaining dynamics in shaping the preferences and strategies of domestic political actors in both states, and (2) how international bargaining dynamics interact with the structure of domestic political institutions in both states. Existing international institutions allocate property rights and provide economic benefits to particular firms in the marketplace. How these property rights are allocated, in turn, provides the baseline against which all potential new agreements are evaluated. This comparison makes international liberalization problematic, however, when winners under existing systems cannot be compensated under any new regulatory arrangements. In perfectly competitive markets, regulatory solutions can be devised to these political problems (i.e. the requisite side-payments can be devised). In imperfect international markets, however, the win-set defined by domestic politics and international bargaining dynamics may render allocating the proper side-payments impossible. In the U.S.-U.K. marketplace, slot constraints and changes in U.S. laws governing foreign investment and cabotage have been at the core of the debate over the terms of any potential agreement, and have to date prevented the conclusion of an Open Skies agreement. The political problem is thus quite straightforward, but the

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imperfect nature of the marketplace renders a politically viable allocation of these scarce resources very difficult, if not impossible.

The structure of U.S. and U.K. domestic political institutions have also made liberalization difficult. In the U.S., the division of powers creates multiple veto points and thus tends to create a status quo bias. Combined with electoral rules which provides incentives for Congressmen to provide local benefits to their constituents, the division of powers and the resultant veto points have meant that any new liberalization deal must be supported by all of the major U.S. international airlines. Yet structuring liberalization to simultaneously benefit all U.S. airlines has proven difficult due to the slot-constrained nature of Heathrow. Imperfect international markets, combined with multiple veto points, have thus undermined U.S. support for individual liberalization agreements. In the U.K., meanwhile, weak competition laws have meant that smaller U.K. airlines are insistent on including vigorous dispute resolution mechanisms in any agreement, a demand which the U.S. has refused based on its' commitment to limiting the scope for government intervention in international aviation markets.

In sum, existing international rules and the structure of international markets have made devising a particular liberalization agreement difficult, and domestic political institutions in both states have ultimately rendered it impossible. Firms evaluate any new agreement against the status quo and support or oppose any agreement based on this calculation. Existing marketplace rules and the structure of U.K. domestic political institutions thus make concluding any deal difficult. Difficult has become impossible, however, due to the multiple veto points in the U.S. domestic political system.

Lord Boyd-Carpenter, "International Air Transport Policies as Viewed by The United Kingdom," in Nicolas Matte, ed., International Air Transport: Law, Organization, and Policies for the Future (The Carswell Co., Ltd., Toronto), 1976, p. 13-18.

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[1]As quoted in John Newhouse, "Air Wars," *The New Yorker*, August 5, 1991, p. 51-66.

[2] Open Skies agreements allow any airline in either signatory to an Open Skies agreements to fly to any city in the foreign partner. Open Skies agreements also include provisions on fares which ensure that the market sets fares rather than governments. For a discussion of Open Skies, see Michael Levine, "Open Skies: Where did they come from? How can we get them?" Speech at The International Aviation Club, Washington, D.C., September 17, 1996.

[3]U.S. domestic institutions are not outlined here because they were discussed in some detail in chapter four. The reader is referred to section 4.1 for this discussion.

[4]For a discussion of how U.S. domestic political institutions make it difficult for the U.S. government to coordinate with U.S. firms, see Ellis Krauss and Jon Pierre, "Targeting Resources for Industrial Change," in R. Kent Weaver and Bert Rockman, eds., Do Institutions Matter? Government Capabilities in the United States and Abroad, (The Brookings Institution, Washington D.C.). 1993, p. 151-186.

[5]For a discussion of how the division of power shapes the structure of executive agencies (bureaucracies), see Terry Moe and Michael Caldwell, "The Institutional Foundations of Democratic Government: A Comparison of Presidential and Parliamentary Systems," *Journal of Institutional and Theoretical Economics*, Vol. 150, No. 1 (1994), p. 171-195.

[6]In the U.S., divided powers mean that U.S. courts are often forced to adjudicate disputes between legislative intent and executive implementation. Given parliamentary sovereignty, however, any court decision can be over-ruled by simple parliamentary vote. Given this situation, the U.K. legal systems tends to rely on formal rules as dictated by the government. See P.S. Atiyah and R.S. Summers, Form and Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory, and Legal Institutions (Clarendon Press, Oxford), 1987.

[7]David Mayhew, Congress: The Electoral Connection (Yale University Press, New Haven, CT), 1974.

[8]For a discussion of how firms endogenize the domestic political game but does not discuss how particular institutions shape this game, see Daniel Verdier, "The Politics of Trade Preference Formation: The United States from the Civil War to the New Deal," *Politics and Society*, Vol. 21, No. 4 (December, 1993), p. 363-392, and Daniel Verdier, Democracy and International Trade: Britain, Franc and the United States, 1860-1990 (Princeton University Press, Princeton, N.Y.), 1994.

[9]For a discussion of the importance of structure in Congressional delegations to executive agencies, see Randall Calvert, Mathew McCubbins, and Barry Weingast, "A Theory of Political Control and Agency Discretion," *American Journal of Political Science*, Vol. 33, No. 3 (August 1989), p. 588-611, Mathew McCubbins, Roger Noll, and Barry Weingast, "Administrative procedures as instruments of political control," *Journal of Law and Economics*, No. 3 (1987), p. 243-277, and Mathew McCubbins, Roger Noll, and Barry Weingast, "Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies," *Virginia Law Review*, March 1989, p.431-482. See also Terry Moe "The Politicized Presidency," in John Chubb and Paul Peterson, eds., The New Direction in American Politics, (The Brookings Institution, Washington, D.C.), 1985, p. 235-271.

[10]Roger Noll, "The Political Foundations of Regulatory Policy," *Journal of Institutional and Theoretical Economics*, 139 (1983), p. 377-404, and Roger Noll and Frances Rosenbluth,

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"Telecommunications policy: structure, process, outcomes," in Cowhey and McCubbins, p. 119-176. For discussions which explicitly links the ability of bureaucratic agencies to coordinate the claims of rival firms to avoid public political conflict with increased political strength of particularistic interests, see Frances Rosenbluth, Financial Politics in Contemporary Japan (Cornell University Press, Ithaca, NY), 1989, and Louis Pauly, Regulatory Politics in Japan: The Case of Foreign Banking (Cornell University East Asia Papers, No. 45, China-Japan Program, Cornell University, Ithaca, NY), 1987.

[11]Author's interview with Tony Fortnam, Vice-President, Government & Industry Affairs, British Airways, Washington D.C, 10/18/96, 10/25/96, and London, 12/5/97, and Mike Hall, Head of International Relations, British Airways, London, 11/28/96, and 12/5/96. Before joining BA in 1995, Fortnam served as U.K. Counselor for Transport in Washington D.C. from 1993-1995, and was Head of International Aviation for North America at the U.K. Department of Transportation during the 1980's. For a similar point, see Kal Ralstiala, "Domestic Institutions and International Regulatory Cooperation: Comparative Responses to the Convention on Biological Diversity," *World Politics*, Vol. 49, No. 4 (July 1997), p. 482-509.

[12]On the use of structure by the president, see Terry Moe and Scott Wilson, "Presidents and the Politics of Structure," *Law and Contemporary Problems: Regulating Regulation: The Political Economy of Administrative Procedures and Regulatory Instruments*, Vol. 57, No. 2 (Spring 1994), p. 1-44; on Congress, see McCubbins, Noll, and Weingast, 1987, and McCubbins, Noll, and Weingast, 1989.

[13]In the U.S., divided powers mean that U.S. courts are often forced to adjudicate disputes between legislative intent and executive implementation. Given parliamentary sovereignty, however, any court decision can be over-ruled by simple parliamentary vote. Given this situation, the entire U.K. legal systems tends to rely on formal rules as dictated by the government. See Atiyah and Summers, 1987.

[14]Author's interview with Barry Humphreys, Director of Government & External Affairs, Virgin Atlantic Airways, Crawley, U.K., 11/27/96, and 11/29/96. Before joining Virgin Atlantic, Humphreys was Head of Air Services Policy and Industry Affairs at the U.K. CAA.

[15]Civil Aviation Authority, Airline Competition Policy (CAP 500) (CAA, London), 1984. See also the discussion in B. J. Graham, "The Regulation of deregulation: A comment on the liberalization of the U.K.'s scheduled airline industry," *Journal of Transport Geography*, Vol. 1, No. 2 (June 1993), p. 125-131. The U.K. has also consistently pressed for strict protection against anti-competitive behavior in EU aviation regulations. See Civil Aviation Authority, Airline Competition in the Single European Market (CAP 623) (CAA, London), November 1993, and Civil Aviation Authority, The Single European Aviation Market: Progress So Far (CAP 654) (CAA, London), September 1995.

[16]For a discussion of U.S. anti-trust laws and their applicability in international aviation, see Patricia Barlow, Aviation Antitrust: The Extraterritorial Application of the United States Antitrust Laws and International Air Transportation (Kluwer, The Netherlands), 1988.

[17]The most common method for achieving relief from U.S. laws has been anti-trust immunity for inter-airline alliances. In the early days of global alliances, there was some uncertainty over the legal liabilities of anti-trust immunity in bilateral markets in which the bilaterals did not contain specific provisions providing relief from U.S. anti-trust laws. After the KLM-Northwest alliance, for example, Northwest pressed the U.S. government to approve additional immunized alliances as it worried about legal action under U.S. anti-trust law as the U.S.-Netherlands bilateral did not contain provisions relating to anti-trust matters. Author's interview with David Mishkin, Vice President, International

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and Regulatory Affairs, Northwest Airlines, Washington D.C., 9/12/96, and 10/29/96.

[18]As we shall see below, the Bermuda II provisions on entry at Heathrow were supported by domestic rules on traffic distribution TDRs). Even after the TDRs were changed, however, the constraints imposed by Bermuda II were still in place.

[19]In order for airlines to offer services to particular airports, time for landing and take-off must be secured. Known as slots, these take-off and landing times are extremely important as they determine the timing and type of services which airlines can provide. Because bilateral rights to enter a particular market mean nothing if new entrants cannot secure slots at desirable times, the issue of slots becomes part and parcel of the political process rather than merely an administrative issue.

[20]EU regulations allow incumbent carriers to keep their existing slot allocations under "grandfather rights," but dictate that 50 percent of all new slots that become available must be allocated for new entrants and also including special provisions for new slots on routes where less than three carriers served the existing route.

[21]Because most new entrants are allocated slots at extremely undesirable times (before 7 am or after 9 pm), real competition has not been encouraged despite regulatory rules designed to encourage entry. EU slot allocation rules are currently under review. See Civil Aviation Authority, Slot Allocation: A Proposal for Europe's Airports (CAP 644) (CAA, London), February 1995.

[22]Civil Aviation Authority, Airline Competition on European Long Haul Routes (CAP 639) (Civil Aviation Authority, London), November, 1994, p. 6.

[23]CAA, November, 1994, p. 16.

[24]The discussion of U.S. strategies in trans-Atlantic markets can be found in section 4.5.2.

[25]Because the U.S. political system provides multiple veto points on policy, individual U.S. airlines can use their political access to veto any agreements which disadvantages them (compared to the status quo).

[26]The regulatory framework in aviation in the U.S. is omitted here as it is discussed in some detail in the preceding chapter.

[27]A.W.J. Thompson and L.C. Hunter, The Nationalized Transport Industries (Heinemann Educational Books, London), 1973, Chp. 2.

[28]Thompson and Hunter, 1973, p. 45.

[29]U.K. Department of Transport, British Air Transport in the Seventies: Reports of the Committee of Enquiry into Civil Air Transport (HMSO, London), 1969.

[30]For a more detailed discussion of the Edwards Report and ensuing policy changes, see Alan Dobson, Flying in the Face of Competition: The Politics and Diplomacy of Airline Regulatory Reform in Britain, the USA and the European Community, 1968-1994 (Avebury Aviation, Aldershot, U.K.), 1995, p. 29-36.

[31] The government effectively encourage a merger between the two largest independent operators and

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transferred routes from BEA and BOAC to British Caledonian. Thompson and Hunter, 1973, p. 53.

[32]Boyd-Carpenter, 1976.

[33]Department of Trade and Industry, Civil Aviation Policy Guidance (HMSO, London), 1972, p. 1.

[34]Load factors (percentage of seats filled) from Gatwick are about 20 percent lower than on comparable flights from Heathrow. Author's interview with industry officials, 11/96 and 12/96, London. See also CAA, July 1984.

[35]Civil Aviation Authority, Civil Aviation Act of 1982: Statement of policies on air transport licensing, January 1985 (CAP 501) (CAA, London), January, 1985. See also Kenneth Button and Dennis Swann, "European Aviation-The Growing Pains of a Slowly Liberalizing Market," in Kenneth Button and David Pitfield, eds., Transport Deregulation: An International Movement (St. Martin's Press, New York, NY), 1991, p. 93-118.

[36]These three routes are the busiest and thus most important domestic routes.

[37]Government intervention in domestic fares only allowed to protect against anti-competitive behavior, and the new licensing procedures did not apply to particular routes from Heathrow and in the Scottish Highlands.

[38]B.J. Graham, "Deregulation of domestic passenger air transport services in the United Kingdom, 1980-1989: a case study of Northern Ireland," *Environment and Planning: Government and Policy*, Vol. 8 (1990), p. 327-346.

[39]Some agreements were more liberal than others, with the new bilaterals with France and Italy maintaining extensive government controls over both capacity and fares in the respective bilateral markets. For a more detailed discussion of the individual bilaterals, see R. Caves, and C. Higgins, "The Consequences of the Liberalized U.K.-Europe Bilateral Air Service Agreements," *International Journal of Transport Economics*, Vol. XX, No. 1 (February 1993), p. 3-26.

[40]Country of origin pricing rules means the country where flights originate can set fares (and the foreign partner cannot disapprove these fares) while double disapproval fare rules means that a fare can only be disapproved if both parties disapprove of the fare.

[41]The famous European Court of Justice ruling in the Nouvelles Frontieres case establishing that EU competition rules were applicable to aviation was also instrumental in allowing the European Commission to put forward, and the European Council to accept, the three aviation liberalization packages.

[42]Individual EU governments and the EU itself retained the right to intervene in fares to protect against anti-competitive pricing.

[43]Several important limits on competition still remain in intra-EU aviation markets. In particular, non-EU airlines are prohibited from introducing fares lower than those that are already in effect in the market, there is a provision that market access may be restricted if new competition would financially harm the national airline, and European national airlines are given priority for available slots. See CAA, November 1993, and Richard Clarke and Kent Gourdin, "European Aviation Reform and U.S. International Airlines," *Transportation Quarterly*, Vol. 48, No. 3 (Summer 1994), p. 267-273.

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[44] By the early 1990's, U.K. passengers enjoyed the lowest airfares in the EU, with fares in the U.K. averaging about 30 percent lower than in other EU states. CAA actions resulted in lower fares for economy passengers and higher fares for U.K. business travelers, as compared to fares in other European countries. For a detailed discussion of this point and an analysis of fare levels, see CAA. November 1993, and CAA, November 1994, especially Appendix 5.

[45] Peter Woodman, "Open Skies' Bring Lower Fares to UK," Press Association Newsfile, November 3, 1993, as cited in Daniel Hedlund, "Toward Open Skies: Liberalizing Trade in International Aviation Services," *Minnesota Journal of Global Trade*, Vol. 3, No. 2 (Summer 1994), p. 259-299. See also CAA, November 1993, p. 4.

[46] The CAA report noted that "the existence of formal and highly developed fare-fixing machinery works to cement anti-competitive behavior." As cited in James Ott and Raymond Neidl, Airline Odyssey: The Airline Industry's Turbulent Flight Into the Future (McGraw-Hill, New York, N.Y.), 1995, p. 100.

[47] For a detailed discussion of the politics of the BA privatization, see Kyohei Shibata, Privatization of British Airways: Its Management and Politics, 1982-1987 (EUI Working Paper EPU No. 93/9) (European University Institute, Florence), 1993.

[48] Arthur Reed, Airline: The Inside Story of British Airways (BBC Books, London), 1990, p. 28.

[49] Reed, 1990, p. 34. See also "Air Raid: British Air's Bold Global Push," *BusinessWeek*, August 24, 1992, p. 54-61.

[50] As early as 1979, BA committed itself to a commercial strategy aimed at competing in the mass consumer market. See Peter Tallon, "European air transport in a holding pattern," *Interavia*, Vol. XXXIV (November 1979, p. 1030-1032.

[51] CAA, November 1993, p. 67.

[52] The only way in which anti-competitive behavior in international aviation markets can be dealt with in the U.K. is via the route allocation process at the CAA. However, because it would be politically impossible to confiscate routes from incumbent airlines for anti-competitive behavior, this process at best provides extremely limited protection against anti-competitive behavior.

[53] For a more detailed discussion of the U.K. renunciation, see Kasper, 1988, p. 75-76, and Dobson, 1995, Chp. 6.

[54] All aviation bilaterals contain provisions specifying how the signatories can withdraw from the agreement, with one year being the standard time period for renunciation and subsequent negotiation. In the interim, and in the event that no new bilateral can be concluded at the end of the one year negotiation period, the regulatory rules in effect at the time of renunciation continue to govern the bilateral aviation marketplace. Thus, renunciation provides a one-year negotiation period for the two parties to reach a new agreement, although in practice it is not uncommon for states to carry on normal bilateral aviation relations even if no bilateral is concluded at the end of the one-year period. Today, for example, the U.S. does not have a bilateral with France, which means the rules in effect when France renounced the agreement are the rules governing the marketplace.

[55] U.S. Department of Transportation officials made clear that the new U.S. policy stemmed from the criticism of Bermuda II and that the policy represented a denunciation of the agreement. See *Aviation*

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Daily, "New International Policy: A Lesson from Bermuda II," May 25, 1978, p. 148.

[56]See chapter four for a theoretical discussion of U.S. strategy in this case. The close geographic proximity of many European destinations and the fact that large numbers of tourists were indifferent between different gateways meant liberalization in one country threatened diversion from other airlines to the liberalized bilateral market. See Levine, 1979, Kasper, 1988, p. 76, and author's interview with Kasper, December 1996.

[57]For a more detailed discussion of the new pricing rules and charter provisions, see Dobson, 1995, p. 161-163.

[58]Author's interview with Raymond Colegate, London, 12/6/96. Colegate served on the Board of the CAA for almost twenty years before retiring in the early 1990's.

[59]Since 1991, when the U.S.-ECAC MOU expired and was not replaced by a new agreement, fares have been regulated by the U.S. and U.K. governments, although in practice neither side has intervened very often and there is some evidence that fares would have been higher absent government intervention. See CAA, November 1994, p. 209.

[60]As part of the original Bermuda II agreement, capacity levels were re-negotiated in 1986. Although some limited liberalization did occur, the basic low fares-controlled capacity arrangement designed to protect U.K. airlines continued to govern the market.

[61]Manchester and the all-cargo airport at Prestwick in Scotland (Silicon Glen) were particularly active in seeking to expand their international services. Author's interview with Barry Humphreys, Crawley, 10/27/96 and 10/29/96.

[62]Author's interview with Tony Fortnam, Washington D.C, 10/18/96 and 10/25/96.

[63]Dobson, 1995, p. 208-210.

[64]United and American made their route offers for Pan Am and TWA, respectively, in October, 1990.

[65]Seventh freedom rights are the right for a carrier to fly passengers from one foreign country to another foreign country. In this case, for example, seventh freedom rights meant U.K. airlines would be able to fly passengers from the six European states to the U.S., without ever having picked up or dropped off passengers in the U.K. For a detailed discussion of the specific rights secured for U.K. airlines, see *Aviation Week and Space Technology*, March 18, 1991, Vol. 134, No. 11, p.31-32. For a discussion of the various aviation rights, see Michael Tretheway, International Air Relations From Bilateralism to Multilateralism (Research Paper in International Business Trade and Finance, Faculty of Commerce and Business Administration, University of British Columbia), 1993.

[66]Code-sharing is the practice of assigning a single flight number in computer reservation systems (CRSs) to different parts of a journey, even if these different parts are flown by different airlines. On a flight from Chicago to Frankfurt via London, for example, code-sharing would allow German and U.S. computers to show a single flight number and be booked on a "single airline" even if United flew the Chicago-London leg and Lufthansa flew the London-Frankfurt flight.

[67]These rights allowed U.S. airlines to code-share with foreign airlines, U.K. or otherwise, on flights from the U.K. to third countries, and vice-versa. Thus, for example, United could code-share with Lufthansa on Lufthansa flights in the U.K.-Germany bilateral marketplace. These rights have been

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important for U.S. airlines in concluding marketing arrangements with European airlines.

[68]It is worth noting that although BA subsequently used the code-sharing rights obtained in the Heathrow deal in its alliance with USAir, these rights were not obtained by BA with an eye to the subsequent USAir deal. Indeed, BA only asked the U.K. government to acquire the code-sharing rights because the U.K. government explicitly asked BA to request something given the extreme weakness of the U.S. position. Author's interview with Tony Fortnam, Washington D.C, 10/18/96, 10/25/96, and Mike Hall, London, 11/28/96 and 12/5/96.

[69]Barbara Peterson and James Glab, Rapid Descent: Deregulation and the Shakeout in the Airlines (Simon & Schuster, New York, NY), 1994, p. 282, and Barry Humphreys, "The North Atlantic: A European Perspective," *ITA Magazine*, No. 65 (January-February 1991), p. 3-12.

[70]At the beginning of the negotiations. Virgin served Miami, New York, and Los Angeles from Gatwick.

[71]On the "Dirty Tricks" campaign and how Virgin Atlantic's political strategy attempted to link Virgin's marketplace success with the competitiveness of U.K. aviation markets, see Martyn Gregory, Dirty Tricks: British Airways' secret war against Virgin Atlantic (Warner Books, London), 1996.

[72]Author's interview with Barry Humphreys, Crawley, U.K. 11/27/96 and 11/29/96.

[73]The following discussion of BA strategy draws on the author's interviews with Tony Fortnam, Washington D.C., 10/18/96, 10/25/96, and London, 12/5/97, and Mike Hall, London, 11/28/96, and 12/5/96.

[74]The difficulties encountered by British Caledonian in competing against the former U.S. domestic airlines on U.S.-Gatwick routes made it quite clear that BA benefited from facing TWA and Pan Am on its North Atlantic routes.

[75]Mark Ashworth and Peter Forsyth, Civil Aviation Policy and the Privatisation of British Airways (The Institute for Fiscal Studies, London), 1984, p. 13.

[76]Newhouse, 1991.

[77]As quoted in Reed, 1990, p. 144.

[78]Although Congress had considered making such legal changes, opposition from airline unions, major airlines, and other industry groups meant any legislative action would not be quick. See Thomas Grant, "Foreign Takeovers of United States Airlines: Free Trade Process, Problems, and Progress," *Harvard Journal on Legislation*, Vol. 31, No. 1 (Winter 1994), p. 63-151.

[79]Author's interview with Judith Ritchie and Graham Pendlebury, U.K. Department of Transport, International Aviation Directorate, London, 11/25/96 and 12/2/96.

[80]The TDRs forced smaller U.K. carriers or any new entrants to fly from Gatwick.

[81]"The Unlocking of Heathrow; Cancellation of Time-distribution Rules at London's Main Airport Should Help it Stay the World's Busiest," *Air Transport World*, Vol. 28, No. 9 (September 1991), p. 28-29.

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[82]Transport Secretary Cecil Parkinson had asked the U.K. CAA for a recommendation on the TDRs in September, 1990, and the CAA had recommended their elimination in January, 1991. See *The Economist*, January 12, 1991, Vol. 318, No. 7689, p. 49-50, *Aviation Week and Space Technology*, March 11, 1991, Vol. 134, No. 10, p. 27, and "Taking Flight at Heathrow," *The Economist*, March 9, 1991, p. 66.

[83]In particular, Rifkind announced that the government would allow charter carriers to serve Heathrow (and thus compete directly against scheduled carriers) and would also seek to remove slot allocation procedures which favored BA at the expense of smaller U.K. airlines. This was important as the removal of TDRs did not obviate the need for carriers to apply for slots through the airport scheduling committee. See *Aviation Week & Space Technology*, Vol. 134, No. 11 (April 1, 1991), p. 31-32.

[84]This paragraph draws on the author's interviews with Tony Fortnam, Washington D.C., 10/18/96, 10/25/96, and London. 12/5/96, Mike Hall, London, 11/28/96, and 12/5/96, and Jeffry Shane. Washington D.C., 10/29/96 and 5/23/97. See also Newhouse, 1991.

[85]Newhouse, 1991, p. 53.

[86]On March 8, 1991, Pan Am had to pay $150 million to Banker's Trust or face immediate bankruptcy. Thus, the U.S. side had to complete negotiations by that date to effect the American purchase of Pan Am's routes and thus provide Pan Am the funds to pay Banker's Trust. Banker's Trust eventually gave Pan Am a short extension and the deal was completed on March 11, 1991.

[87]Although American CEO Robert Crandall criticized the agreement after it was signed, he did not do so prior to the successful conclusion of the negotiations.

[88]As airlines are large employers in geographically distinct areas and international hubs have very positive effects in terms of local economic development, both Senators and House members assiduously pursue the interests of their local airlines. See Newhouse, 1991, for a thorough account of how Congressional interests shaped the Heathrow negotiations.

[89]Newhouse, 1991.

[90]Author's interview with Jeffrey Shane, May 23, 1997.

[91]Author's interview with Jeffry Shane, May 23, 1997.

[92]*Aviation Week and Space Technology*, April 22, 1991, Vol. 134, No. 16, p.34.

[93]Congressional intervention continued because United and American still had to secure approval from the U.S. DOT to finalize the route sales and begin services on the routes.

[94]Skinner approved the sale of TWA's New York-, Boston-, and Los Angeles-London routes but disapproved the sale of its London routes from St. Louis, Philadelphia, and Baltimore.

[95]Competitive concerns arose because American would have been authorized to service London from five of the nine East Coast gateways, while United Airlines would have offered service from two gateways and all other U.S. carriers would be limited to one gateway each. See *Aviation Week and Space Technology*, April 22, 1991, Vol. 134, No. 16, p.34.

[96]*Aviation Week and Space Technology*, April 22, 1991, Vol. 134, No. 16, p.34.

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[97]Newhouse, 1991.

[98]As quoted in Newhouse, 1991, p. 54.

[99]Author's interview with David Traynham, Professional Staff Member for Aviation, House Committee on Transportation & Infrastructure, Washington D.C., 10/28/96. See also John Newhouse, "The Battle of the Bailout," *The New Yorker*, January 18, 1993.

[100]Code-sharing agreements are important for two key reasons: (1) CRSs are biased toward on-line connections, so that flights on a single airline appeared first on travel agents' screens; and (2) passengers prefer to fly on a single airline rather than change airlines. For an extensive discussion of the historical development of code-sharing agreements and their implications for competition, see Barry Humphreys, "The implications of international code sharing," *Journal of Air Transport Management*, Vol. 1, No. 4 (1994), p. 195-207.

[101]The agreement eventually concluded called for USAir to sell its U.S.-U.K. routes and included provisions for BA and USAir to jointly market some flights. Most importantly, the agreement provided for extensive code-share on a wide array of flights, thereby linking USAir's domestic network with BA's transatlantic gateways. For a detailed discussion of the deal, see *Aviation Week and Space Technology*, January 25, 1993, Vol. 138, No. 4, p. 31.

[102]The North Atlantic accounted for some 60 percent of BA's profits in the late 1980's. For a more detailed discussion of how the forces unleashed by U.S. domestic deregulation ultimately altered the structure of the U.S. domestic marketplace and thereby eroded the competitiveness of foreign airlines serving U.S. international markets, see Kasper, 1988, and Barry Humphreys, "The North Atlantic: A European Perspective," *ITA Magazine*, No. 65 (January/March 1991), p. 3-12. For preliminary statistical results on the impact of U.S. hubs on the competitiveness of U.S. vs. foreign airlines, see Martin Dresner and Robert Windle, "Are U.S. carriers to be feared? Implication of hubbing to North Atlantic Competition," *Transport Policy*, Vol. 2, No. 3 (1995), p. 195-202.

[103]The importance of behind-gateway traffic can be seen in the market share figures for U.S. and U.K. airlines in U.S. hub and non-hub gateways. From U.S. cities where no U.S. airlines have hubs, U.K. airlines compete extremely effectively against U.S. airlines. In markets where U.S. airlines have hubs, U.K. airlines are routinely out-competed by U.S. airlines. These results hold true even controlling for the particular U.S. airline U.K. airlines competed against. For specific figures, see Humphreys, 1991.

[104]In January, 1990, DOT Secretary Samuel Skinner opened the possibility of increased foreign ownership in U.S. airlines and said that foreign investment in a U.S. airline would be tolerated up to 49.9% of total equity. This pledge to loosen the limits on foreign investment was also made during the Heathrow succession negotiations. See "British Airways Gives New Foreign Investment Policy Tepid Response," *Aviation Daily*, January 25, 1990, p. 163, and author's interview with various industry sources, October-December, 1996, Washington D.C. and London.

[105]Author's interview with various industry sources, Washington D.C., and London, 10/96-12/96.

[106]This paragraph draws on author's interview with Tony Fortnam, Washington D.C., 10/18/96, 10/25/96, and London, 12/5/96, Mike Hall, London, 11/28/96, and 12/5/96.

[107]Author's interview with Tony Fortnam, Washington D.C., 10/18/96, 10/25/96, and London, 12/5/96.

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[108]For a discussion of the proposed panel and the position of the U.S. and U.K. governments, see "U.S., U.K. Talks Remain Stuck on London Access Issue," *Aviation Daily*, Vol. 310, No. 30 (November 13, 1992), p. 258.

[109]*Aviation Week and Space Technology*, January 4, 1993, Vol. 138, No. 1, p. 30.

[110]*Aviation Week and Space Technology*, March 22, 1993, Vol. 138, No. 12, p. 32.

[111]Humphreys, 1991, p. 10.

[112]*Aviation Week and Space Technology*, February 25, 1991, Vol. 134, No. 8, p.31. In January, 1993, Transportation Secretary Andrew Card recommended to Congress that the law on foreign investment be changed to allow 49% foreign ownership of voting stock. See *Aviation Week and Space Technology*, January 4, 1993, Vol. 138, No. 1, p. 30.

[113]Author's interview with Tony Fortnam, Washington D.C., 10/18/96, 10/25/96, and London, 12/5/96.

[114]*Aviation Week and Space Technology*, January 4, 1993, Vol. 138, No. 1, p. 30.

[115]The original BA-USAir deal called for BA to acquire 44% of total equity and 25% of USAir stock with voting rights. U.S. airlines thus argued that the super-majority section of the agreement would give BA control over USAir and thus violate the intent of the statute guiding foreign ownership rights. See Grant, 1994, and *Aviation Week and Space Technology*, February 1, 1993, Vol. 138, No. 5, p. 29.

[116]As quoted in *Aviation Week and Space Technology*, Vol. 137, No. 6 (August 10, 1992), p. 31.

[117]As quoted in *Aviation Week and Space Technology*, Vol. 137, No. 6 (August 10, 1992), p. 31.

[118]Newhouse, 1993.

[119]As quoted in *Aviation Week and Space Technology*, Vol. 137, No. 6 (August 10, 1992), p. 31.

[120]The Big Three lobbied both the Bush and Clinton administrations at the highest levels. For an overview of these activities, see *Aviation Week and Space Technology*, February 8, 1993, Vol. 138, No. 6, p. 29, and "Airlines Fighting USAir deal; American, others hire politically savvy lawyers," *The Dallas Morning News*, November 11, 1992, p. 1A.

[121]See "Battle Lines Drawn in USAir Deal," *The New York Times*, October 3, 1992, p. 35.

[122]As quoted in "Battle Lines Drawn in USAir Deal," *The New York Times*, October 3, 1992, p. 35.

[123]Author's interview with David Mishkin, Washington D.C., 9/12/96, and 10/29/96.

[124]*Aviation Week and Space Technology*, February 8, 1993, Vol. 138, No. 6, p. 28.

[125]*Aviation Week and Space Technology*, January 4, 1993, Vol. 138, No. 1, p. 30, and *Aviation Week and Space Technology*, February 25, 1991, Vol. 134, No. 8, p.31.

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[126]*Business Week*, March 29, 1993, p. 106.

[127]Author's interview with David Traynham, Washington D.C., 10/28/96.

[128]*Aviation Week and Space Technology*, May 20, Vol. 134, No. 20, p.34.

[129]"USAir-British Airways Talks Stall; Bush, Major Fail to Reach an Accord on Investment Proposal," *The Washington Post*, December 21, 1992, and "Bush to Reject BA Links with USAir," *The London Times*, December 17, 1992.

[130]*Aviation Week and Space Technology*, January 4, 1993, Vol. 138, No. 1, p. 30.

[131]There are a wide variety of airline cooperative agreements, ranging from such mundane issues as baggage handling to full-scale strategic alliances. Strategic alliances usually refers to a very intense level of cooperation, and has usually required U.S. government exemption from U.S. anti-trust laws. Intensive alliances must thus secure U.S. regulatory approval, while less expansive alliances do not require U.S. government approval. Because U.S. government approval is required and because more intensive alliances are much more commercially valuable, the U.S. government has used anti-trust immunity as a weapon to pry open international aviation markets.

[132]"Britain warned US will not alter air deal terms," *The Financial Times*, September 17, 1996.

[133]The proposed BA-American alliance would give the merged airline 100 percent of U.S.-U.K. flights from Boston, Miami, Philadelphia, and Seattle, 86 percent in Chicago, 66 percent at New York's JFK Airport, 53 percent from San Francisco, and 50 percent from Los Angeles. Data from Delta AirLines, British Airways-American Airlines Combination Dooms Competition (Delta AirLines), July 1996, p. 3.

[134]*The New York Times*, "British Air-American Pact Meets Resistance," June 5, 1997.

[135]The exact number of slots required to ensure a competitive bilateral aviation markets varies, with BA and American arguing that fewer slots are required for competition than the major U.S. airlines. In other words, both sides present figures which are to their own advantage.

[136]The alliance was originally scheduled to take effect in April 1997.

[137]U.K./U.S. Air Liberalisation Talks: Joint Comminique by John MacGregor and Federico Pena, April 19, 1993. See also *Aviation Week and Space Technology*, April 12, 1993, Vol. 138, No. 17, p. 30.

[138]In 1995, the U.S. government scuttled the second of three "mini-deals" that were designed to lead to more comprehensive liberalization when TWA utilized its Congressional allies to kill the deal. Author's interviews with numerous industry officials, Washington D.C, and London, October-December, 1996.

[139]The following discussion of BA's strategy draws on the author's interviews with Tony Fortnam, Washington D.C., 10/18/96, 10/25/96, and London, 12/5/96, Mike Hall, London, 11/28/96, and 12/5/96.

[140]"Air links," *The Financial Times*, September 17, 1996.

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[141] *The London Times*, "BA confident of American link-up," January 15 1997.

[142] *The London Times*, August 10 1997.

[143] This paragraph draws on the author's interviews with Barry Humphries, 11/27/96, and 11/29/96.

[144] The following discussion draws on the author's interviews with Judith Ritchie and Graham Pendlebury, 11/25/96 and 12/2/96.

[145] BA/American Compact Gets Qualified Support Among U.K. Lawmakers," *World Airline News*, Vol. 6, No. 30 (August 5, 1996).

[146] Airline Alliances: Too Cozy, *The Economist*, Vol. 341, No. 7986 (October 5, 1996).

[147] The following discussion draws on the author's interview with Judith Riche and Graham Pendlebury, 11/25/96 and 12/2/96.

[148] The six airlines are American, Continental, Delta, Northwest, United, and US Airways (formerly USAir).

[149] In 1995. Open Skies agreements were signed with Austria, Belgium, the Czech Republic, Denmark, Finland, Iceland, Luxembourg, Norway, Sweden, and Switzerland.

[150] USAir offers deal in effort to settle action against BA." *The Financial Times*, September 4, 1996.

[151] The following discussion relies on the author's interviews with Carl Nelson, Associate General Counsel, American Airlines, Washington, D.C., 10/17/96 and 10/21/96, and various interviews and communications with Rob Britton, Managing Director-International Affairs, American Airlines.

[152] "Air links," *The Financial Times*, September 17, 1996.

[153] "BA/American Alliance Under Attack," *The Financial Times*, September 13, 1996.

[154] United Airlines, "British Airways/American Airlines Alliance: Consumer Risks or Consumer Rewards? (United Airlines), 1996.

[155] United Airlines, "British Airways/American Airlines Alliance: Consumer Risks or Consumer Rewards? (United Airlines), 1996, p. 7.

[156] The importance of the U.K. bilateral was exacerbated by the fact that Japan pointed to the refusal of the U.K. to liberalize the bilateral on U.S. terms when defending its' own refusal to liberalize the U.S.-Japan bilateral.

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Chapter 6: Holding Up Globalization: The U.S.-Japan Aviation Marketplace

"It's the same old thing. The U.S. wants a completely free market because of a multiplicity of interests. The Japanese have limited interests. We have work inside that box."

Frederick Smith, Chairman, CEO, and President, Federal Express

6.0 Introduction

Since the mid-1970's and increasingly so in recent years, the U.S.-Japan aviation relationship has been extremely contentious. In Japan, the growth of fifth-freedom passengers carried by U.S. airlines[1] and the increased competitiveness of U.S. carriers has steadily eroded the market share of Japan Airlines (JAL), and has led JAL to pressure the Japanese government to renounce the 1952 bilateral and conclude a more restrictive agreement. In the U.S., the pro-competitive international aviation policy begun under Carter and the dramatic expansion of economic activity in the Pacific Rim have created widespread demands for the liberalization of the bilateral. Major U.S. airlines have launched large and sophisticated lobbying efforts, and a diverse array of interests have pressed for increased U.S.-Japan aviation services. The two sides thus find themselves pushing in opposite directions: Japan wants greater regulation and tighter government control over international aviation markets, while the U.S. seeks re-structure U.S.-Japan aviation markets along more competitive lines. With no room for agreement, existing regulatory rules continue to dictate the shape of the marketplace.

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The central goal of this chapter is to elucidate the domestic political roots of U.S.-Japan aviation markets, and to demonstrate how domestic politics are shaped by international bargaining dynamics. In both states, domestic political institutions have played the primary role in establishing the broad bargaining positions. In the U.S., an electoral system which produces incentives for parties to compete for the median voter produced the adoption of a pro-competitive international aviation discussed in chapter four, and similar dynamics dictate U.S. bargaining vis-a-vis the U.S.-Japan marketplace. The importance of low fares and competition is compounded, however, by the widespread uneasiness about the role of Japan in the economic trading system--a fact which has meant that Japan-bashing is good politics in the U.S. In Japan, on the other hand, the electoral system leads politicians to provide pro-producer policies, which in this case means protecting the interests of Japanese airlines by maintaining strict control over the marketplace.

But international bargaining dynamics, in particular the property rights dictated by the 1952 bilateral and the structure of Pacific aviation markets, have shaped the timing and design of policy choice. In brief, these two factors have meant that U.S. efforts to "encircle" Japan with more liberal countries have failed to produce Japanese policy changes, while the political cleavages created by the 1952 bilateral have dictated the strategies adopted by airlines and other societal actors in both states. These strategies, in turn, have shaped the calculations of domestic politicians vis-a-vis the rules governing international aviation markets. The bargaining positions and strategies adopted by national politicians, in turn, allow me to explain the rules governing U.S.-U.K. international markets. Careful process-tracing of the strategies of domestic firms and the calculations of national politicians thus allow me to explain national bargaining positions, which in turn allow me to explain why particular rules govern U.S.-U.K.

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international aviation markets. To summarize, domestic institutions are the key variables explaining the positions adoptions by both sides and thus the rules governing the marketplace, but the existing bilateral agreement and the structure of Pacific aviation markets have shaped the strategies of domestic actors, and thus the timing and design of policy.

The analysis is presented in six sections. The first section outlines the relevant domestic institutional variables and international bargaining constraints. The second and third sections discuss the regulatory framework in Japan and provide an historical summary of the U.S-Japan bilateral, respectively. As in chapter five, the point of these two sections is to provide the necessary background for the discussions of specific bargaining episodes which follow in sections four and five. These two sections examine two recent U.S-Japan negotiations in detail and provide empirical support for the argument presented in section two. The final section concludes.

6.1 The Argument

As I argued in Chapter two, the rules governing international markets are extensions of domestic political bargains, but international bargaining dynamics condition the strategies adopted by domestic economic interests and national governments. This section expands on the basic argument and focuses on their implications for U.S.-Japan international aviation markets.

6.1.1 Domestic Institutional Constraints[2]

Although the Japanese electoral system is in the process of being re-designed, for almost the entire time period under review here Japan combined an electoral system based on single non-transferable vote (SNTV) and multi-member districts with a

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parliamentary system.[3] Japan's electoral rules give candidates a strong incentive to provide narrow, particularistic policies. Because multi-member districts mean that Japanese parties must win more than one seat in each electoral district in order to secure a national majority, Japan's electoral system provides clear disincentives for parties to develop strategies based on issues and collective goods policies.[4] Given strong disincentives for running on policy issues (because even running on an extremely popular issue will in all likelihood not produce a national majority), Japanese parties tend to rely on particularistic policies which allow individual legislators to claim credit for particular policy outcomes. Japanese parliamentarians thus tend to concentrate favors on a very loyal personal vote (some Japanese parliamentarians are elected with less than 10 percent of the vote) and cultivate these voters with extensive patronage and personal favors.[5] Because this strategy requires extensive funding, Japanese politicians curry the favor of Japanese firms by supplying pro-producer policies. Japanese electoral laws thus result in a system in which politicians supply pro-producer policies in exchange for large campaign donations from Japanese corporations, all in order to supply particularistic policies in order to win at the ballot box. The end result is a pro-producer policy bias loaded with widespread rents for many different groups.

While the Japanese electoral system provides incentives to supply pro-producer policies, parliamentary government concentrates decision-making authority in a single body and thus ensures parliamentary dominance in the policy-making process. With no veto gates on policy decisions, policy-making is easier and more flexible than in the U.S. With a single principal capable of quickly and easily disciplining wayward agencies, Japanese politicians utilize extensive delegations of authority and rely on informal regulatory proceedings to manage regulated industries.[6] Unlike in the U.S.,

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where different constituencies and divergent electoral calendars between the executive and legislature produce rule-bound bureaucracies which make close firm-government coordination difficult, parliamentary sovereignty facilitates close firm involvement in all aspects of the policy-making process.[7] Delegation to opaque bureaucracies and reliance on informal regulatory rules thus encourages close government-industry relations and increases the influence of firms over policy outcomes. The Japanese legal system also re-enforces the central role of parliament and the subsequent close firm-government coordination.[8] Unlike in the U.S., where liberal rules of standing and the power of judicial review means the courts often play a major role in regulatory policy-making, Japanese courts have restrictive standing rules and the courts normally grant large discretion to agencies in interpreting statutory mandates.

The structure of Japanese political institutions, and the differences between these institutions and U.S. political institutions, create very different incentives for politicians in the two states. Both electoral systems give the legislature an incentive to provide particularistic policies to narrow interests. In Japan, this is true because of the importance of campaign contributions and the fact that politicians can secure electoral victory with only a small fraction of the total vote cast. In the U.S., the division of powers means that local, particularistic policies are especially important for legislators, who have difficulty claiming credit for broad collective goods policies. The smaller electoral districts of legislators (compared to the president) also makes particularistic policies more important for U.S. legislators than the president. But the importance of the party label for Congressional elections and the broad national constituency of the president place limits the potential for particularism in the U.S., and encourage policies geared toward competing for the median voter.

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The different incentives effects of divergent domestic political institutions also produce different political contexts for firms. In Japan, political institutions afford Japanese firms considerable leverage over policy outcomes. Japanese firms enjoy extensive influence in the policy-making process and rely on subtle, behind-the-scenes discussions with opaque Japanese bureaucracies to press their policy preferences.[9] With consumers afforded little influence over policy-making given the incentives effects of domestic political institutions, Japanese firms can oppose--and block--policy changes even in the face of widespread public opposition. As one Japanese aviation insider has noted, "(Japanese airlines) look to the ministry, not to their customers. They reckon that in the end the MOT (Ministry of Transport) will somehow bail them out."[10] In the U.S., on the other hand, firms confront a complex and rule-bound bureaucracy that responds to pressure from both Congress and the President. Unable to strike behind-the-scenes bargains with the bureaucracy, U.S. firms rely on vocal, public campaigns in pursuit of their interests. Given the geographically concentrated nature of airline operations and the importance of local politics for U.S. legislators, this lobbying often plays out in Congress. The importance of the median voter and the party label in U.S. politics also means that U.S. firms must be much more attentive to broad political dynamics than Japanese firms; U.S. firms are thus much more careful to couch their preferences in ways that are consistent with the concerns of large numbers of voters.

6.1.2 International Constraints

The shape and content of the U.S.-Japan international aviation market is dictated by the 1952 bilateral agreement.[11] Signed shortly after the end of occupation and before any Japanese carriers flew on international routes, the bilateral has been the

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source of bitter dispute between the two countries since the 1970's. Although the bilateral was amended in 1985 and again in 1989, the basic features of the bilateral remain intact. The relevant facts of the 1952 agreement are three-fold: (1) the differential rights enjoyed by different carriers in both the U.S. and Japan, (2) the slot constraints at Narita airport in Tokyo, and (3) the central importance of Japan in U.S.-Asian aviation markets.

Two different types of carriers serve the U.S.-Japan aviation market: incumbent carriers and Memorandum of Understanding (MOU) carriers. In the U.S., United, Northwest, and Federal Express are the incumbent carriers, while American, Delta, and Continental are the MOU carriers. In Japan, JAL is the incumbent carrier while All Nippon Airways (ANA) is the MOU carrier. Incumbent carriers in both states enjoy marketplace rights not afforded MOU carriers: U.S. incumbent carriers are authorized unlimited rights to fly to a wide range of Asian destinations from Japan, and can carry passengers originating in both the U.S. and Japan on these flights (i.e. fifth-freedom rights)[12], and JAL is granted fifth-freedom rights from the U.S. The MOU carriers, in contrast, enjoy rights to serve a small number of cities in the bilateral market, but are granted no beyond-rights.[13] The net effect of these rights is quite simple: U.S. incumbents can compete against Japanese airlines on intra-Asian flights. Political debate within both Japan and the U.S. has been driven by the different rights enjoyed by the incumbents and the MOU carriers: the MOU carriers and their supporters have pressed for liberalization, while incumbents, especially JAL, have been less than enthusiastic about liberalization.

The second key facet of U.S.-Japan aviation markets is the slot-constrained nature of Narita airport in Tokyo. Japan is by far the most important aviation market in Asia, and Tokyo is the only viable hub in Asia. But Narita has a limited number of

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slots, and airlines sometimes have to wait years to offer service to Tokyo even if bilateral agreements allow the service. Landing slots at Narita have thus been at the core of battles over the U.S.-Japan aviation markets: U.S. airlines without rights at Narita have pressed to secure them, while JAL and the Japanese government have been less than enthusiastic about allocating slots to new entrants. Slot constrains are so problematic largely because allocating slots to new entrants in practice means taking some landing slots away from incumbents and giving them to new entrants.[14] Although the recent opening of Kansai international airport in Osaka has reduced some of the pressure on Tokyo, in practice there is still a massive shortage of slots. The problems associated with slots is worsened by the fact that Japan refuses to adhere to internationally recognized IATA procedures for allocating slots, and prefers instead to rely on a discriminatory policy enforced by the Japanese MOT which severely limits the potential for new entrants to secure useful slots.[15]

The final notable aspect of U.S.-Japan aviation markets is the central importance of Tokyo in global aviation markets. As the home to a large number of MNCs and a center of international business activity, Tokyo is one of the major business centers in the world. More importantly than local Tokyo traffic, however, is the fact that Tokyo is the only viable hub for U.S. airlines in Asia due to the geographic position of the Japan astride Asia. In the early 1980's, for example, Braniff launched services to Seoul, Taipei and Hong Kong without a Japanese hub, and quickly had to end services before eventually going bankrupt. Delta also tried to open a hub in Korea in the early 1990's and was quickly forced to withdraw. The conclusion from these facts is simple: Tokyo is the only viable aviation hub in Asia. The dominant position of Japan in U.S.-Asian aviation markets has had two important effects on U.S.-Japan aviation markets: (1) U.S. efforts to use international market

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forces to force the liberalization of U.S.-Japan aviation markets have been unsuccessful, and (2) the importance of Japan for U.S. airlines.

The first point is straightforward: with no alternative to Tokyo due to the geographic position of Japan and the large share of Japanese travelers in U.S.-Asian markets, the potential for traffic diversion away from Tokyo is extremely limited. This has meant that U.S. efforts to use the international arbitrage created by liberal agreements with neighboring Asian countries has failed to produce liberalization. Unlike in Europe, where the threat of traffic diversion to the Netherlands and other liberal continental European markets meant the U.K. had to liberalize some aspects of their international aviation markets or face significant traffic diversion, there is simply no alternative to Japan.

The second point revolves around the importance of U.S.-Japan aviation markets for U.S. airlines and the problem of slot constraints at Narita. In short, all U.S. airlines consider a presence in U.S.-Japan essential for success in growing Pacific aviation markets, but the limited number of slots at Narita make it very difficult to satisfy all U.S. airlines and thus secure U.S. domestic political support for any new U.S.-Japan bilateral. The limited number of slots means that access at Tokyo is truly a zero-sum game and it is impossible to trade-off access at Tokyo for other rights--because there are simply no rights which are comparable. Although other states have resolved the problem of slot constraints by taking away the slots of one national carrier and giving them to another, but this is impossible due to the numerous veto points on policy choice. in the U.S. political system.[16] Thus, U.S. domestic politics, slot constraints, and the importance of Tokyo combine to create a very small bargaining space in which to conclude agreements.

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Underlying the three key facets of U.S.-Japan aviation markets outlined above are the extensive rights accorded both states to intervene in the marketplace and the resulting emphasis on bilateralism as the platform for negotiating aviation agreements. Although U.S. incumbents are not strictly required by the 1952 bilateral to secure Japanese government permission to introduce new flights, increase capacity, or otherwise alter existing flight schedules, in practice Japan has demanded advance notice and has denied numerous applications in recent years. Although the U.S. has not exercised its rights to intervene in recent years, it has threatened to refuse to authorize Japanese airline flights to the U.S. More importantly, the expansive rights accorded both states in the bilateral has meant that bilateralism has been the preferred negotiating forum. In short, neither state has been willing to forego bilateral negotiations in favor of potential multilateral arrangements largely because the current bilateral agreement provides extensive rights for both governments to intervene in the market to secure the interests of their respective firms.[17] However, when either state has believed that multilateral fora, usually either the Orient Airlines Association (OAA) and Asia-Pacific Economic Cooperation (APEC), would provide a more advantageous setting for negotiating the shape and content of aviation markets, both states have sought to utilize these multilateral organizations as the platform for negotiating aviation agreements. These decisions regarding negotiating forum have largely been driven by the calculations regarding the likely outcome of bargaining within different fora, with Japan seeking to create negotiating platforms which support its position and the U.S. seeking to do the same.

6.2 Aviation Regulation in Japan[18]

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In 1951, Japan Airlines was established as a private company and began to serve the domestic market. Two years later, when Japan was allowed to re-enter international aviation markets, the Japanese government became the controlling owner of JAL and the airline was restructured as a government-owned corporation.[19] While JAL maintained a monopoly on international services, several small companies competed in the domestic market. In 1957, the two largest domestic airlines merged to form ANA, which grew to become the dominant domestic carrier by the late 1960's. Following industry consolidation in the 1960's, the remaining two domestic airlines were merged to form Tao Domestic Airlines (TDA) (later Japan Air System) under government directive in 1971.[20]

The consolidation of the industry set the stage for the new regulatory framework introduced in 1970-1972. In November 1970, the Japanese government issued a Cabinet Meeting Resolution which sanctioned the creation of TDA as the third Japanese airline. The new organization of Japanese aviation markets took firmer shape in July 1972, when the MOT issued a directive outlining which markets each of the three major airlines would serve. More specifically, the directive allocated international routes and a few domestic trunk routes to JAL, ANA was given short range international charters and the majority of domestic trunk routes, and TDA was granted permission to fly regional domestic routes and a few domestic trunk routes. JAL was also the international cargo carrier, although provisions were made for the entry of a second international cargo carrier if demand necessitated.[21]

Referred to as the "Aviation Constitution," the 1970 and 1972 Directives granted the MOT authority to award and rescind route licenses (i.e. set capacity) and to set fares in both domestic and international markets. Carriers were also subject to extensive administrative guidance from the MOT. Unlike the U.S. CAB, which had

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particular regulatory functions related to fares and capacity, the MOT retained control over all aspects of Japanese airline policies. MOT administrative guidance thus extended to all business decisions, including fares, personnel decisions, and even including the airlines' annual reports.[22]

The MOT was responsible for setting both domestic and international fares. Domestic air fares were set based on the carriers costs of operations and the railway fare.[23] Recognizing the inter-modal competition with super-express trains, the MOT generally allowed more competitive air fares on routes served by super-express trains as compared to non-train routes. In non-train markets, however, fares were set solely based on carrier costs, which created obvious disincentives for airline efficiency. In general, the MOT set domestic fares in relation to flight distance, but did so in a way that encouraged extensive cross-subsidization of unprofitable local routes in order to facilitate network expansion.[24] Internationally, Japanese carriers participated in IATA fare conferences and IATA fares were routinely approved by the MOT. Japan was also reluctant to accept discount fares and was a staunch defender of the IATA system when it came under attack in the late 1970's.

In both domestic and international markets, discount fares were not permitted and the MOT utilized its regulatory authority over travel agents to prevent the widespread ticket price discounting that took place in other markets. With Japan's Civil Aeronautics Law granting MOT authority over all fares for flights originating in Japan, neither travel agents or airlines could legally sell tickets below the authorized price.[25] The activities of tour operators was also strictly limited in order to prevent low vacation fares from directly competing with the scheduled airlines. Unlike in the U.S., where laws governing tour operators and charter carriers were changed from the mid-1960's onward to allow charters to compete more effectively against scheduled

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airlines, Japanese tour operators were not allowed to sell to individuals and fare levels were dictated by the MOT. As a result of these extensive regulations, Japanese air fares tended to be substantially higher than in other OECD nations.[26]

While the MOT had regulatory authority over the allocation of route rights and thus awarded domestic and international routes to particular Japanese carriers, the MOT shares responsibility with the Ministry of Foreign Affairs (MOFA) for negotiating bilateral air services agreements. In most negotiations, MOT heads the Japanese delegation, although U.S.-Japan negotiations are often chaired by the MOFA due to the importance of the U.S. in Japanese foreign affairs.[27] Concerned with overall U.S.-Japan relations and viewing aviation as only one of many trade issues, the MOFA has taken a more conciliatory stance in U.S.-Japan negotiations. The MOT, on the other hand, represented the interests of JAL and resisted the influence of broader trade concerns on aviation negotiations.[28]

The regulatory arrangements described above governed U.S.-Japan aviation markets until 1985, when the 1985 U.S.-Japan MOU provided the catalyst for wide-ranging changes in Japan's domestic and international aviation policies.[29] Although the Japanese government had made small moves toward some liberalization in the early 1980's, the MOU allowed additional U.S. and Japanese carriers to enter the U.S.-Japan market and thus ended the strictly segmented market structure of the 1970-1972 "Aviation Constitution." In December 1985, the Japanese government issued a Cabinet Meeting Resolution officially abolishing the 1970-1972 Aviation Constitution.[30] In June 1986, the Japanese government announced the privatization of JAL and new entry on both domestic and international routes.[31] In practice, the new policy meant the MOT retained extensive control over both domestic and international markets. In domestic markets, both routes and fares continue to be allocated by the MOT and new

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entry on domestic routes has only been permitted if passenger volume necessitates new services.[32] Moreover, although the new aviation policy stressed the importance of entry for competition, the MOT continues to limit entry and exercise strict control over fares. Internationally, Japan continues to conclude extremely restrictive bilateral agreements with European partners and supports IATA fare-setting conferences in markets where IATA still functions. Very little liberalization has taken place in the U.S.-Japan bilateral market; and the Japanese government continues to resist U.S. pressures for a more liberal bilateral. The Japanese government also continues to intervene in international markets to limit competition and thus protect JAL. Thus, despite limited entry and more extensive discount fares beginning in 1994, Japanese aviation policy has not facilitated real competition nor has it benefited the Japanese consumer.[33]

Although the MOT continues to administer the market and liberalization has not produced the dramatic fare decreases which occurred under U.S. deregulation, it is important to note that dramatic changes have taken place in Japanese aviation markets since 1986.[34] In July 1986, the MOT announced a program of liberalization that included double- and triple-tracking (two or three carriers on a single route) on domestic routes, and JAL and TDA/JAS entered some domestic routes formerly served only by ANA. By 1993, about 70 percent of passengers flew on double- or triple-tracked routes.[35] Importantly, however, these routes only account for 19 percent of the total number of routes, which means that carriers on 81 percent of domestic routes continue to enjoy a monopoly. Constrained competition has thus come to major inter-city routes, while monopolies have been maintained on thin local routes.[36]

Accompanying double- and triple-tracking in the domestic market was the entry of ANA and TDA/JAS into international markets. ANA was gradually granted

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permission to serve long-haul international routes while TDA/JAS was given permission to serve local Asian markets on a limited basis. ANA secured international rights as part of the 1985 and 1989 U.S.-Japan MOUs, and the carrier expanded it's international route network in the early 1990's.[37] Concurrent with the slow erosion of JAL's international monopoly was a 1987 government initiative to double the number of Japanese international travelers to 10 million by 1992. The plan called for increased licensing of Japanese carriers to serve international routes, and noted that increased licensing increases demand for international air travel (via lower prices) and increases the international competitiveness of Japanese airlines.[38] Importantly, implementation of the proposal was calculated to help Japan reduce its trade surplus by $11 billion by 1991.

The Japanese government also changed the regulations governing the operations of ticket consolidators (i.e. group tour operators) in the late 1980's. Undertaken in response to the fact that large number of consumers were simply buying imported tickets from "bucket stop" travel agencies, these new regulations allowed travel agents and tour operators to market lower fares and, most importantly, allowed them to legally sell tickets to individuals rather than groups.[39] Analogous to the loosening of restrictions on charter flights in the U.S. and Europe in the late 1960's, the new regulations removed the threat of legal action against travel agents and consolidators for selling tickets to individuals and thus effectively increased the availability of discount fares to consumers. The laws, coupled with the entrance of the major Japanese travel agencies into the discount ticket markets, ultimately meant a much larger segment of consumers could purchase discounted tickets.[40]

The new laws governing charter tickets were important in pushing down fares.[41] Prior to the new rules, Japanese airlines could only sell high-price tickets

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directly to consumers and were reliant on travel agents to sell discount-priced tickets. Although the travel agents were also bound by the MOT price regulations, the MOT did not exercise its authority to stop the gray market in discount airline tickets from travel agents. Thus, ubiquitous fare discounting through travel agents often made MOT guidelines meaningless.[42] However, airline dissatisfaction with rising travel agent commissions and complaints of rural consumers who lacked access to the discount travel agencies led the MOT to issue new rules.[43] Under the new rules, individual fares fell by some 60 percent, and MOT officials claimed that prices were near market prices.[44] Domestically, new rules were issued in September 1995 which allowed carriers to set their own prices within an MOT-dictated range that ensured that the carriers can recover their costs plus a fair profit.[45] The MOT also lowered the passenger thresholds for double- and triple-track routes in April 1996, and has been encouraging local airports to begin to offer international services.[46]

Partial liberalization, however, has set forces in motion which has resulted in on-going battles between Japanese airlines and the MOT. This is particularly true in international markets, where Japanese airlines have been forced to compete in increasingly competitive markets but remain constrained by MOT administrative oversight. Unlike in the U.S., where deregulation entailed changing the legal underpinnings of regulation and ultimately led to the demise of the Civil Aeronautics Board (CAB), liberalization in Japan has been undertaken by administrative fiat and has left the legal basis for extensive MOT intervention in the marketplace intact. Thus, the MOT still retains extensive oversight of the market and regularly attempts to steer Japanese airlines' business decisions. Extremely loose or undefined MOT procedures and standards only exacerbate the potential for MOT "administrative guidance."[47] Japanese airlines chafe under MOT guidance, however, as they now face substantial

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competition and have attempted to radically alter their operations in order to meet the demands of the marketplace.

The result has been a series of on-going disputes between the MOT and Japanese carriers. In 1994, for example, Japanese Transport Minister Shizuka Kamei threatened to withhold route awards from JAL unless JAL canceled its plans to recruit stewardesses on short-term contracts rather than the traditional open-ended contracts. As one JAL official put it, "if the (MOT) does not approve....then there is no hope for the plan."[48] Although Kamei was eventually forced to publicly recant his threat after the two leading Japanese business associations, Nikkeiren (the Federation of Employers Associations) and Keidanren (the Federation of Economic Organizations), criticized the Transport Minister, the event typified the on-going battle between the MOT and Japanese airlines in the early 1990's over the scope of MOT regulation in Japanese aviation markets.[49]

Before proceeding, it is worth noting two aspects of Japanese aviation markets. First, as in most other nations, Japanese law limits foreign investment and the role of foreign interests in the Japanese aviation marketplace. Thus, aircraft registration is limited to Japanese nationals and foreign ownership in excess of one-third of the voting interest in a Japanese airline is prohibited.[50] Second, Japan's Civil Aviation Law provided that the Anti-Monopoly Law did not apply to the activities of airlines as long as airline activities are approved by the Minister of Transport and provided that fare and rate levels are not adversely affected by unfair trade practices.[51] With the MOT serving as the anti-trust regulator, airlines could essentially collude as long as MOT sanctioned the arrangements.

6.3 Historical Overview of the U.S.-Japan Bilateral

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The U.S.-Japan aviation marketplace is governed by the original 1952 bilateral, and the numerous, memorandums, consultations, minutes, and amendments that have been concluded since.[52] The 1952 agreement provides for extensive government control over entry and capacity, and delegates fare-setting authority to IATA fare conferences. Although similar in most respects to standard Bermuda I bilaterals, including double-approval provisions for fares, capacity, and entry, the U.S.-Japan bilateral is unusual due to the extensive fifth-freedom rights afforded U.S. airlines and the fact that U.S. airlines are technically not required to secure Japanese permission for expanding capacity or adding new routes.[53] The extensive rights enjoyed by U.S. airlines stem from two important historical facts: the limited range of aircraft in 1952, and the fact that JAL did not begin to offer international air services until later on in the 1950's. Combined, these two factors meant that U.S. airlines required extensive beyond rights from Japan to serve Asian destinations, and that unless U.S. airlines were granted these rights there would be no service to most Asian countries.

Although U.S. airlines were initially required for intra-Asian air services, JAL began international services in 1953, and Japanese dissatisfaction with the bilateral began shortly thereafter. Indeed, Japan has argued since the late 1950's that the agreement unfairly advantages U.S. carriers, and that Japan would not have accepted the agreement except for the dominant role of the U.S. in international aviation in 1952. Japan has consistently sought to impose additional constraints on U.S. airlines, and has attempted to link any new services by U.S. carriers, even if these rights appear to be granted in the 1952 bilateral, to new rights for Japanese airlines. Despite consistent Japanese criticism, the original 1952 bilateral was largely unchanged until the early 1980's. Although the rapid growth of the Japanese economy led to an

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explosion of transpacific air traffic in the 1950's and 1960's (U.S.-Tokyo flights quadrupled between 1958 and 1968[54]) and created political pressure in the U.S. for the liberalization of the bilateral, the introduction of wide-body jets in the early 1970's greatly expanded the supply of services and thus alleviated pressure for reform.[55] Paradoxically, however, the greater range of the new jet aircraft increased U.S. airline dependence on Tokyo and thus the importance of the fifth freedom rights included in the bilateral.

By the late 1970's, pressure for liberalizing the bilateral emerged in both the U.S. and Japan. In the U.S., the adoption of a pro-competition aviation policy under Carter led to a concerted effort to liberalize the 1952 bilateral. With the size of the Japanese economy and the location of Japan astride Asia making Japan the key to liberalizing Asian aviation markets, Japan was the primary target of U.S. efforts at liberalization in the Pacific.[56] Like the U.K. in the trans-Atlantic marketplace, Tokyo serves as the major gateway for U.S.-Asia traffic, and Japan was seen as the most important bilateral market for U.S. efforts at reforming the entire trans-Pacific aviation marketplace. However, the market structure in the Pacific presented a fairly difficult situation for U.S. negotiators: traffic flows were primarily U.S.-Japan, with other points, such as South Korea, Taiwan, Hong Kong, and the Philippines, served via Tokyo. With the Japanese favoring capacity controls and de facto maintaining unilateral capacity controls by limiting the capacity of their airports, U.S. negotiators were unsuccessful in liberalizing the bilateral. Faced with Japanese opposition to liberalization, U.S. efforts at liberalization concentrated on signing liberal bilaterals with neighboring Asian countries in order to pressure Japan to liberalize the 1952 bilateral.

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In Japan, pressures for liberalizing the bilateral came from domestic Japanese airlines, in particular ANA, domestic cargo operators eager to enter the lucrative international cargo market, and from Japanese firms worried about U.S. reactions to the growing Japanese trade deficit. ANA had sought to expand its operations to the international marketplace since the early 1970's. At each turn, however, JAL managed to block ANA efforts to secure international routes from the Japanese MOT. In response to JAL's successful blocking efforts, ANA joined four major Japanese shipping companies to form Nippon All Cargo (NCA) in 1978.[57] With trans-Pacific cargo growing rapidly and the Japanese economy becoming increasingly international, NCA provided ANA with domestic political allies--not only the shipping companies but also Japanese firms paying high international cargo prices--to break JAL's monopoly. Finally, the ballooning Japanese trade deficit with the U.S. ($8.6 billion in 1979 and a forecasted $10 billion in 1980) and the resultant discussion in the U.S. Congress about imposing import quotas on Japanese automobiles also created pressure in Japan to liberalize the bilateral as a signal of commitment to an open trading system.[58]

Following informal discussions and the development of bargaining positions, government-to-government talks to liberalize the bilateral began in January 1981.[59] At the initial round of negotiations, the U.S. offered Japan most of the new routes it was seeking in exchange for substantial liberalization in pricing, charters, and market entry, while Japan tabled a proposal which provided for new routes for Japanese carriers but nothing for U.S. carriers. The first round of negotiations thus quickly exposed the divergent preferences of the two states over any new bilateral, and the negotiations quickly collapsed. Political pressure in the U.S. for the liberalization of the 1952 bilateral only became more intense following the failure of the first round of

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negotiations, and petitions to the CAB by United Airlines and Air Micronesia-Continental substantially raised the political stakes surrounding the bilateral negotiations.[60] Although the CAB temporarily deferred action while negotiations continued, the threat of the legal deadline imposed by the United complaint hung over subsequent rounds. Following the failure of the second round of negotiations to produce any resolution to these outstanding disputes or any new agreement, the CAB found that Japan had "committed a serious violation" of the U.S.-Japan bilateral agreement by refusing to authorize United to service Japan and imposed minor sanctions on Japan. The CAB also informed Japan that JAL would be required to file its schedules with the CAB, a formality required for the CAB to reduce a carrier's service, and the CAB submitted a confidential order to President Reagan imposing severe sanctions against JAL, but included a recommendation that further sanctions be delayed to give negotiations a final chance. Japan responded by imposing a large number of prospective sanctions against U.S. carriers. Following the failure of the third and final round of negotiations in 1982, negotiations between the Japanese ambassador and the chairman of the U.S. delegation ultimately produced an agreement which provided for a limited expansion of rights for incumbent U.S. airlines and JAL.[61] However, the 1982 mini-agreement failed to provide rights for ANA or NCA, and did not resolve any of the major issues sought by the U.S.

U.S.-Japan negotiations throughout the 1980's and 1990's have produced similar outcomes: the U.S. has sought to conclude a bilateral which would lessen government control over fares and entry and thus provide the foundation for a competitive marketplace, while Japan has sought to maintain strict government control over all aspects of the marketplace and regulate the market to protect inefficient Japanese airlines. As one State Department official noted, "Japan sought additional

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route authority for JAL while attempting to constrain the entry of another U.S. carrier into the market. At the same time, it resisted our efforts to introduce fare flexibility into the market. Overall, its policy was oriented to a basic single goal-maintaining JAL's position in the market by limiting the entry of new airlines and by protecting JAL from price competition."[62] Although the two sides did sign MOU's (i.e. additions to the existing 1952 bilateral) in 1985 and 1989 which ended the JAL monopoly and added new rights for U.S. airlines, Japan has consistently rebuffed U.S. efforts to conclude Open Skies agreements, and has continued to protect Japanese airlines against the more efficient U.S. carriers. Today, the basic positions of the two sides remain unchanged.

The political logic driving aviation policies in both the U.S. and Japan in the 1980's and 1990's is quite clear. In Japan, the government has represented the interests of Japanese airlines, in particular JAL, and has thus sought to limit competition, keep fares high, limit U.S. fifth-freedom rights, and secure more rights for Japanese airlines in the U.S.[63] With the electoral system providing incentives for pro-producer policies at the expense of consumers, Japanese politicians have simply attempted to regulate the international aviation marketplace in a manner consistent with the interests of Japanese airlines. Although business and consumer complaints about high fares have produced some limited liberalization, the reality has been that the MOT has retained control over all elements of the international marketplace and has intervened in this market to protect the interests of Japanese airlines.

In the U.S., the political support for competition international aviation markets only increased in the 1980's. Although U.S. incumbent international airlines managed to stall the pro-competitive policies during the first Reagan presidency, growing demands from the former U.S. domestic airlines and the cities and regions they served

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grew intense by the mid-1980's. This was particularly true for airlines and cities based in the west and southwest of the U.S., where rapid economic growth and the explosion of trade with the Pacific Rim combined to dramatically increase demand for trans-Pacific aviation services. Political support for liberalization increasingly came not only from airlines but also from cities and Chambers of Commerce which sought to capture some of the economic benefits from the economic growth in the Pacific Rim. Indeed, increased traffic and economic activity in the Pacific Rim, combined with new aircraft technology which allowed greater flying distances, meant that there were growing numbers of potential international gateways and a consistent growth in the number of international travelers--both of which provided solid political support for low fares and a liberalization of the 1952 bilateral.[64] For U.S. airlines, the large size of the U.S.-Japan market and the dominant role of Tokyo in Asian aviation markets made the liberalization of the 1952 bilateral particularly valuable.

6.3.2 Summary

The previous two sections have provided background on the regulation of aviation markets in Japan and the history of U.S.-Japan aviation relations. Two important conclusions should be clear from these sections: (1) the Japanese government has regulated Japanese domestic and international aviation markets in ways favorable to Japanese airlines, and (2) the U.S. and Japan have opposite preferences vis-a-vis the organization of U.S.-Japan aviation markets. The Japanese MOT has regulated Japanese aviation markets with a strict hand since World War II, and shows little sign of relinquishing regulatory control. Importantly, even the limited liberalization which has taken place in the past ten years has been based on administrative action, and the legal basis for MOT intervention in all aspects of

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Japanese aviation markets remains intact. Internationally, the MOT has also sought to impose its vision on U.S.-Japan aviation markets. Since the U.S. adoption of a pro-competitive international aviation policy, U.S.-Japan aviation relations have been a study in frustration. The U.S. has sought liberalization while Japan has sought further regulation. With domestic interests in both states clamoring for a revision of the 1952 bilateral, the two governments have attempted to find a middle ground and sign an agreement acceptable to both sides. Fierce political action, particularly in the U.S., has made agreement difficult, however. Understanding how domestic politics and international bargaining dynamics have made squaring the circle difficult is the subject of the next two sections.

6.4 The 1985 Memorandum of Understanding: Introduction

In March 1984, the U.S. and Japan entered into negotiations to amend the 1952 bilateral. In Japan, political pressure for securing additional trans-Pacific rights came primarily from NCA's desire to enter the U.S.-Japan cargo market, and the Japanese government sought to expand the cargo marketplace while maintaining a highly restricted passenger marketplace. In the U.S., liberalizing the 1952 bilateral had been at the core of U.S. strategy in the Pacific since 1978, and the U.S. pressed for additional rights for both cargo and passenger carriers. The standard bargaining positions of the two sides thus repeated themselves: Japan sought to secure new rights for one additional cargo carrier, NCA, while keeping the rest of 1952 bilateral intact, while the U.S. sought a comprehensive liberalization of the bilateral.

Following more than a year of negotiations, the U.S. and Japan concluded a MOU in May 1985 which provided new rights for both cargo and passenger carriers in both states. In Japan, the MOU provided rights for NCA and ANA to provide

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international services to limited U.S. cities, while JAL obtained permission to fly Tokyo-Atlanta.[65] In the U.S., Delta received rights to serve Portland-Tokyo and American to serve Dallas-Tokyo, new services were added from Guam and Saipan to several points in Japan, and additional capacity was added to existing route awards. The 1985 MOU thus provided more liberalization than the Japanese government initially wanted, but less liberalization than preferred by the U.S. government.

6.4.1 Japan: On the Defensive

Domestic pressure from NCA and ANA for allowing new entry into international aviation markets and the political pressure generated in the U.S. by the large bilateral trade deficits were the primary features of the political landscape facing the Japanese government in the early 1980's. As early as 1974, ANA considered entering the international market its top priority.[66] Following the Lockheed scandal in the late 1970's and the subsequent failure of ANA to secure entry into international markets in the 1982 mini-deal, ANA renewed its efforts by forming NCA with the explicit purpose of recruiting domestic political allies to its cause.[67] Meanwhile, the ballooning U.S.-Japan bilateral trade deficit created serious U.S. Congressional unrest about the overall imbalance in the U.S.-Japan trading relationship, and rendered aviation relations a much more prominent issue in the U.S. than would have otherwise been the case.[68] Facing domestic political pressure at home and fearing worse outcomes abroad if no expansion of aviation rights was forthcoming, the Japanese government agreed to a "balanced expansion" of new rights in the 1985 MOU.

6.4.1.1 Japanese Firms: JAL vs. NCA and ANA

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Prior to the 1985 MOU, JAL maintained a monopoly on Japanese international routes. Despite JAL's monopoly on international routes, ANA had long sought to enter the international marketplace, an entrance which JAL had successfully blocked in the late 1970's and again in the early 1980's. The 1985 U.S.-Japan MOU negotiations thus coincided with a major domestic political battle between ANA and JAL over whether JAL should continue to serve as Japan's sole international airline.

For ANA, the 1985 MOU negotiations provided another opportunity to enter the international markets. Despite its long-standing interest in entering international markets, however, ANA did not directly press the Japanese government for new passenger services. Instead, ANA pressed for the expansion of the charter market and for the allocation of new rights to NCA in these cargo markets. In short, ANA put its political efforts on supporting NCA's petition in cargo markets. Why was NCA so central to ANA's strategy? As we shall see, ANA's strategy reflected calculations about both Japanese domestic politics and international bargaining dynamics led ANA to adopt this particular strategy rather than directly lobby for more passenger rights--its' ultimate policy goal.

One important feature of the 1972 Aviation Constitution was that it provided that additional cargo airlines could enter international markets if demand necessitated. Thus, while Aviation Constitution explicitly granted JAL a monopoly on international passenger routes, it provided ANA with a loophole to enter international markets as a cargo airline. With ANA realizing that JAL could block ANA efforts to enter international passenger markets simply by appealing to the Aviation Constitution, ANA launched the NCA strategy as a way to recruit political allies and as a way to overcome the problems associated with directly attacking the Aviation Constitution. In pushing NCA, however, ANA also hoped that cargo liberalization would pave the way

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to international passenger rights via wholesale unraveling the Aviation Constitution.[69] Thus, ANA's strategy endogenized calculations about the political basis of the Aviation Constitution, and launched strategies in light of this calculation. ANA's strategy also internalized international bargaining dynamics, as ANA calculated that the U.S. would be unwilling to conclude a cargo-only deal, and thus any new Japanese cargo rights would result in an agreement which provided new cargo and passengers rights for Japanese airlines.[70]

In 1978, ANA joined four major Japanese shipping companies, Kawasaki, NYK, Mitsui OSK, and YSS, and formed NCA. Although JAL was also the only Japanese international cargo airline and vigorously opposed the entrance of NCA into international cargo markets, ANA calculated that the support of the shipping companies would provide the necessary political support for more widespread liberalization. Thus, ANA's strategy focused on securing domestic political support for cargo liberalization and relied on international pressure to provide the necessary push toward passenger liberalization--which was ANA's goal in the first place. In effect, then, ANA adopted a bargaining strategy which endogenized the political constraints created by JAL in the domestic marketplace, and also endogenized U.S. pressure for passenger and cargo liberalization.

While ANA utilized a strategy which attempted to circumvent the domestic political barriers posed by JAL's political influence and relied on international pressure to secure liberalization of passenger markets, JAL adopted a position which reflected its realization that it could no longer oppose ANA's entry into international aviation markets.[71] As noted above, JAL had vigorously and openly opposed ANA's entry into international markets throughout the 1970's and early 1980's, and maintaining its international monopoly was also the preferred outcome in 1984-1985. In the

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negotiations in 1984-1985, however, JAL sought domestic aviation routes to complement its international operations rather than openly oppose ANA's entry into international markets. To be sure, JAL sought to block the designation of NCA and ANA to serve international markets, and even sought out political allies in the U.S., notably Federal Express, to oppose any expansion of bilateral rights.[72] JAL's did not simply oppose ANA's expansion as it had in earlier negotiations, however, and JAL pressed the Japanese government to award new international and domestic routes to JAL in exchange for ANA's entry into the international marketplace. In effect, JAL accepted the fact that ANA would secure international rights and merely sought to extract some quid pro quo in exchange for what it considered to the inevitable entry of ANA into the U.S.-Japan international marketplace.

Why did JAL adopt the particular bargaining strategy it did? Domestically, JAL calculated that the Japanese government was likely to allow ANA's entry into international markets. Although JAL had managed to block ANA's earlier efforts to recruit the major shipping companies as allies and had thus blocked ANA's early efforts at coalition-building, OSK and Nippon Yusen defected to ANA's camp in the early 1980's after they realized that JAL did not intend to ever launch a new all-cargo airline.[73] With JAL no longer proposing its own all-cargo airline, the political support of NCA's owners--a combination of steamship companies, Japanese banks, ANA, and insurance companies--ensured that NCA's petition to enter international service had considerable political support.[74] In addition to the support of commercially and politically important industries behind NCA's petition, the threat of import quotas and other trading sanctions by the U.S. also increased Japanese domestic political support for compromising with the U.S. on aviation issues. In short, JAL realized that broad U.S.-Japan trade issues made some compromise with the U.S. inevitable, and thus

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realized that new rights would be granted to both ANA and additional U.S. carriers. In effect, JAL reasoned that an expansion of ANA rights was a fait accompli, and sought to extract some concessions from the Japanese government rather than block the agreement. Needing new U.S.-Japan routes and more domestic routes to feed its' international operations, JAL sought these rights as the quid pro quo for ANA's entry into the U.S.-Japan marketplace. In effect, then, JAL adopted a second-best bargaining position simply because the political and economic landscape created by Japanese domestic political institutions and international bargaining dynamics made its preferred outcome--maintaining its international monopoly--politically impossible.

6.4.1.2 The Japanese Government: Reconciling Protecting JAL and Allowing New Entry

With an electoral system favoring producers over consumers and both Japanese airlines preferring a regulated international marketplace to a competitive bilateral aviation market, Japanese domestic politics dictated that the Japanese government refuse U.S. entreaties for an Open Skies agreement.[75] Consumers interests were not consulted before, during, or after the negotiations, nor were other non-aviation interests, with the exception of the owners of NCA, particularly active in the negotiations. Although the growing number of Japanese international travelers and the resultant public criticism of JAL were important political forces pushing the Japanese government to allow ANA to enter international markets, these political pressures had little impact on the particular negotiating positions adopted by the Japanese MOT.[76]

The extent of politicking surrounding the negotiations were the petitions the MOT requested and received from ANA, JAL, and NCA regarding their preferences

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for any U.S.-Japan agreement. ANA, JAL, and NCA did not publicly lobby the government, but relied on extensive consultation with MOT officials to press their case with the Japanese government. In short, private conversations between MOT officials and ANA, JAL, and NCA were the driving force of Japanese government policy. As one Japanese official noted, "relations between business and government are different in Japan (than in the U.S.). In Japan, the needs of the business world are most important....there is close communication with business interests....to accommodate the needs of the airlines."[77] Although JAL and ANA had divergent preferences regarding ANA's entry into the international marketplace, both carriers were opposed to any sort of liberalization that would have exposed them to more competition on U.S.-Japan routes. With accepting any of the U.S. entreaties for a competitive bilateral marketplace politically unacceptable at home, the only question facing the Japanese government was whether or not to allow NCA and ANA to enter the international marketplace. Thus, although a major political question still revolved around whether or not the Japanese government would secure new rights for ANA and NCA to enter the international marketplace, the clear mandate of Japanese domestic politics was to maintain extensive government control over all aspects of the marketplace in order to protect Japanese airlines.

International bargaining dynamics were ultimately important in pushing the Japanese government into resolving the difficult domestic political question posed by the potential entrance of ANA into Japanese international aviation markets. As noted above, U.S.-Japan negotiations in 1982 had produced limited new rights for incumbents airlines, but had not provided any rights for ANA or new U.S. airlines to enter the market. Likewise, it was also far from obvious at the beginning of negotiations in 1984 that the bilateral negotiations would end JAL's monopoly in

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international markets. Indeed, in the negotiations leading up to the MOU the Japanese government was only interested in securing new rights for NCA, and sought to maintain JAL's monopoly in international passenger markets.[78] However, with the U.S. Congress holding hearings on the overall U.S.-Japan trading relationship and threatening to impose quotas on Japanese auto imports, the overall U.S.-Japan trading relationship was important in convincing the Japanese government to acquiesce to U.S. demands for an expansion of aviation rights in the bilateral marketplace.[79] Following early rounds of disappointing negotiations, the MOT seemed to shift gears in the negotiations from a stance favoring the status quo to a stance which accepted the reality of increased trans-Pacific traffic and attempted to balance U.S.-Japan interests in light of the inevitable expansion.[80] Like JAL in regards to ANA and NC's entry into international markets,[81] the Japanese government thus accepted a solution--new entry for U.S. and Japanese carriers--due to international constraints. Thus, while Japanese domestic politics dictated that government control over the marketplace be maintained in order to protect Japanese airlines, international bargaining dynamics were important in forcing the Japanese government into accepting some liberalization and thus allowing both ANA and NCA to enter the U.S.-Japan aviation markets.

6.4.2 The U.S.: Route-by-Route Expansion?

Although the 1982 mini-deal provided new rights for incumbent airlines, the former U.S. domestic carriers were especially eager to enter the trans-Pacific market in light of growing trans-Pacific trade links and the large profit margins on trans-Pacific flights. With Japan unwilling to authorize new U.S. airlines to enter the market and the U.S. government facing significant political pressures to secure entry for U.S. airlines, the primary goal of the U.S. government was to conclude some agreement

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with Japan that provided new entry rights for those U.S. airlines excluded from the bilateral marketplace.

6.4.2.1 U.S. Firms: Seeking Entry

As discussed above, the 1952 U.S.-Japan bilateral provides incumbent U.S. airlines with extensive rights in both the bilateral (i.e. U.S.-Japan) marketplace and in markets beyond Japan (i.e. fifth-freedom rights).[82] Given the extensive rights enjoyed by these incumbent airlines and the limited number of competitors on U.S.-Japan routes, these carriers were less than enthusiastic about allowing additional U.S. airlines into U.S.-Japan markets. At the same time, however, the huge size of the market and the strategic position of Japan as the only viable hub in Asia made obtaining entry in the U.S.-Japan bilateral market a major goal of excluded U.S. airlines (American, Delta, Continental). The primary divide among U.S. airlines thus revolved around whether or not the airlines were incumbents or lacked rights in U.S.-Japan markets.

While the excluded airlines were eager to enter the U.S.-Japan marketplace, the incumbents were enjoying the rewards of operating in a strictly regulated marketplace and did not relish the prospect of increased competition.[83] However, with Congress investigating the overall U.S.-Japan trading relationship and threatening sanctions against Japanese products, the U.S. political environment frowned on maintaining the restrictive agreement. Put simply, Japan-bashing was good politics, and U.S. incumbent airlines had to be careful in pressing their positions. As a result of this situation, the incumbents did not actively oppose the efforts of the have-nots to expand their rights in U.S.-Japan markets. With the incumbents unable to actively oppose U.S. government efforts to create new competitors for them in the Pacific (by

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liberalizing the bilateral), the have-nots played up the role of Japan as an unfair trader, and found numerous political supporters in both Congress and the White House.

International bargaining dynamics were important in shaping U.S. airline strategies and U.S. domestic politics vis-a-vis the Pacific aviation markets in two key ways. First, the preferences of the incumbents and the have-nots were essentially determined by the rights allocated in the 1952 bilateral. In short, the 1952 bilateral dictated the property rights that determined the status quo market positions, and thus provided the framework within which any negotiations--and firm strategies--took place. Second, the lengthy and route-by-route expansion promised by government-to-government negotiations ultimately led some U.S. airlines, notably United, to conclude that relying on the U.S. government to expand their international networks was likely to be time-consuming and ultimately not very successful in light of Japanese unwillingness to liberalize the market. The most prominent example of the shift in airline strategy (away from relying on government negotiators to purchasing routes directly from other airlines) was United's purchase of Pan Am's route network.[84] Seeing the Atlantic as a crowded playing field with numerous U.S. and foreign carriers already serving the market, United had long been particularly interested in entering the Pacific.[85] Although United got its first route right in the U.S.-Japan market in 1978, it was not until 1983 that Japan finally authorized United to begin service. This episode, combined with the lack of new rights for excluded carriers in the 1982 mini-deal and the lack of serious progress in the 1984-1985 negotiations, led United to conclude that the route-by-route expansion produced by government-to-government negotiations was not going to work for United in expanding its Pacific route network.[86] In effect, United concluded that Japanese reluctance to liberalize the bilateral would ultimately mean years of frustration and a very small number of routes

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if United relied on the U.S. government to procure route rights. In light of this calculation, United purchased Pan Am's Pacific route network for $750 million in late 1985.[87] As the first major international route acquisition of the Big Three U.S. carriers, United's purchase marked the beginnings of the globalization of the aviation industry and ultimately resulted in a major change in the structure of competition in the Pacific. The decision to buy Pan Am's route network, however, resulted from United's calculation that international bargaining dynamics meant piecemeal expansion would never work, and that purchasing existing route networks was the only way to circumvent bilateral bargaining constraints and the constraints imposed by the existing bilateral agreement with Japan.

6.4.2.2 The U.S. Government: Pushing for Liberalization, Settling for Routes

For the Reagan administration, the 1985 MOU negotiations were primarily driven by the huge U.S. trade deficit with Japan and pressure from the have-not carriers to enter the U.S.-Japan marketplace. Throughout the early 1980's, U.S.-Japan aviation relations took place in an environment characterized by serious U.S. Congressional unrest about the overall imbalance in U.S.-Japan trading relationships.[88] The 1984-1985 aviation negotiations became a central issue in this broader debate, with the U.S. seeing aviation as an important issue given Japanese intransigence in a series of other trade disputes. As one DOT official put it, the trade imbalance "just got to the point where everyone in every sector had got a bellyful (of the imbalance problems) and the aviation negotiations fell into that crack."[89] Facing serious pressure from Congressional interests to "get tough" on Japan, the Reagan administration hammered Japan that the aviation negotiations were a test case for the

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Japanese commitment to an open international economy. Coupled with broad political support for getting tough on Japan was political pressure from the have-not airlines. Mobilizing their Congressional supporters and lobbying the administration directly, these carriers were eager to enter the U.S.-Japan market and provided the necessary political support for overwhelming the meek protests offered by the incumbent carriers.

While U.S. domestic politics created clear support for the pro-liberalization policy pursued by U.S. negotiators, international bargaining dynamics were important in shaping the timing and content of the bargaining positions taken by the U.S. government. As noted above, the U.S. had sought to liberalize the 1952 bilateral since 1978. Following failure in 1979 and a disappointing mini-deal in 1982, U.S. negotiators were not sanguine about accomplishing any liberalization. However, domestic political action in Japan, in particular the creation of NCA and its push for rights to service the U.S. market, led U.S. negotiators to re-evaluate their willingness to enter into negotiations with Japan. Ultimately, NCA's actions signaled to U.S. negotiators that Japan might be interested in increased rights to the U.S. market, and thus the time was ripe to re-enter negotiations with Japan. However, Japanese government concerns over the economic viability of JAL meant wholesale liberalization was not politically possible. Thus, although the U.S. preferred more comprehensive liberalization, the U.S. accepted a deal that was politically acceptable to the Japanese government. In short, the U.S. accepted a second-best deal in order to conclude an agreement that was politically acceptable to the Japanese government.

6.4.3 Discussion

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The preceding section has sought to demonstrate how international bargaining dynamics and domestic politics have shaped the preferences and strategies of firms, and how these strategies have in turn shaped the choices of national governments. Both U.S. and Japanese firms adopted bargaining positions which were shaped in important ways by both domestic politics and international bargaining dynamics. In the U.S., the basic political divide between the incumbents and the have-nots arouse as a result of the property rights afforded incumbents carriers in the 1952 bilateral. Thus, international property rights were the primary determinant of firm preferences vis-a-vis the U.S.-Japan international market. But domestic politics were also important, as incumbents carriers did not oppose new entry into the marketplace quite simply because this would have been politically foolish, and useless anyway. Meanwhile, frustration with the speed of government-to-government talks led United to step outside the bilateral process and seek remedies to its problems in economic markets. Indeed, United's strategy in purchasing Pan Am's route structure thus rested on a calculation that government-to-government talks would produce slow and very limited market liberalization. In Japan, Japanese domestic politics were crucial determinants of the strategies pursued by JAL and ANA. After failing to win entry into international markets by directly challenging the 1970-1972 Aviation Constitution, ANA joined major shipping companies in forming NCA and thereby attempted to exploit the loophole in the Aviation Constitution regarding international cargo operations. ANA also calculated that the U.S. would be unwilling to accept a cargo-only deal, and that thus NCA would provide the catalyst for ANA's own entry into international aviation markets. Thus, ANA's strategy was driven by calculations about both Japanese domestic politics and international bargaining dynamics. For JAL, ANA's coalition-building, coupled with calculations that the Japanese government would ultimately

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acquiesce to U.S. demand for fear of trade sanctions, meant JAL did not actively oppose NCA's or ANA's entry into international markets. Indeed, rather than oppose the deal, JAL accepted it as a fait accompli and sought instead to gain additional routes in Japanese domestic markets.

While U.S. and Japanese firms pursued their goals within the win-set defined by domestic political dynamics and international bargaining, national governments in Japan and the U.S. also were strategic. In Japan, U.S. Congressional unrest over the overall U.S.-Japan trade deficit lent support to using aviation as one policy area to demonstrate Japanese commitment to an open trading system, and Japanese concerns over the possibility of a worse outcome if no liberalization took place were ultimately important in driving Japan to conclude the MOU. In the U.S., meanwhile, the only reason U.S. negotiators were willing to enter into negotiations was that they thought some agreement could be achieved. In this regard, the activity of NCA and the situation in regards to international cargo operations under the Aviation Constitution were particularly important in shaping U.S. calculations about the likelihood of agreement. Meanwhile, the U.S. did not take the position that comprehensive liberalization was the only possible outcome, despite the fact that this was the preferred outcome for the U.S. U.S. positions were thus taken with an eye to Japanese domestic political considerations, and the U.S. did not pursue its most preferred outcome at all.

6.5 Open Skies in the Pacific? The 1995-1997 Negotiations: Introduction

Although the 1985 MOU provided new rights for both U.S. and Japanese airlines, the rapid growth of trans-Pacific aviation traffic in the late 1980's quickly overwhelmed the existing capacity and created demands for further liberalization. In

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response to demands for more services, the U.S. and Japan signed another MOU in 1989 which again provided new rights for both U.S. and Japanese carriers, but left the 1952 bilateral unchanged. As in the 1985 negotiations, the 1989 negotiations saw the U.S. pushing for comprehensive liberalization of the 1952 bilateral while Japan sought to protect JAL and ANA from meaningful competition in international markets. The 1989 MOU thus provided specific new routes for U.S. and Japanese carriers, but left the strict government control over the marketplace included in the 1952 bilateral intact.

Despite Japan's reluctance to liberalize the 1952 bilateral, the demand for aviation across the Pacific exploded during the 1990's, and the market is expected to continue to grow at a dramatic pace for the next few decades. According to IATA, the number of passengers on the North Pacific will jump from 12 million passengers in 1993 to 42 million in 2010. Likewise, Boeing expects growth in the Pacific to be 6.8 percent per annum (compared with 4.4 percent on the North Atlantic), and East Asia is expected to account for 50 percent of global air passenger traffic by 2010. These demands figures are underscored by U.S. Department of Commerce statistics showing that U.S. multinationals are boosting investment in Asia by 25 percent a year.[90] The huge stakes involved in Asian aviation markets has produced extraordinary levels of political action in both the U.S. and Japan. In the U.S., both the incumbents and the MOU carriers have been extremely active in lobbying for liberalization of the bilateral, while JAL and ANA have opposed any Open Skies agreement and have instead preferred a "balanced expansion" of rights.

Despite their divergent preferences over the rules governing the bilateral marketplace, on-going negotiations have taken place since 1993. Although the first round of talks quickly stalled in August 1993, talks were revived in September 1995 following the Japanese refusal to allow Federal Express to undertake additional cargo

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flights from Japan to other Asian destinations.[91] Despite these on-going negotiations, the two sides have not concluded any new major aviation agreement. Although a limited all-cargo deal was concluded in March 1996, even this agreement quickly disintegrated into mutual recriminations over the correct interpretation of the agreement, with Japan adopting a more restrictive interpretation and the U.S. pushing for a more liberal interpretation. Meanwhile, no new passenger agreement has been signed, and the level of frustration and political action has only increased in both the U.S. and Japan.

The major sticking points in the negotiations has revolved around the fifth-freedom rights enjoyed by U.S. incumbent airlines and Japan's unwillingness to extend further route awards to additional US carriers. The U.S. has taken the position that the fifth-freedom rights are part of the 1952 bilateral, and thus will not be bargained away, while Japan has argued that these rights should be curtailed in order to produce a more balanced distribution of benefits between U.S. and Japanese carriers. In the 1995 Federal Express dispute, for example, Federal Express and the U.S. government claimed these rights were authorized under the 1952 bilateral, while Japanese Transportation Minister Shizuka Kampei refused to allow the increased flights on the grounds that "it would widen the imbalance between Japan and the U.S. in the Asia-Pacific aviation market."[92] Although many observers thought the political momentum from the March 1996 cargo deal would carry over to passenger negotiations, the positions adopted by the two government in passenger negotiations have so far proved irreconcilable.

6.5.1 Japan: On the Defensive

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Since the late 1980's, when United replaced Pan Am and Northwest revitalized its Pacific operations, the basic reality has been the need for the Japanese government to protect the inefficient Japanese airlines from competition from the more efficient U.S. carriers.[93] Like most airlines, JAL and ANA had operations, including route structures, constructed in order to compete in the point-to-point marketplace produced by the Bermuda regime. Following the adoption of hub-and-spoke networks by U.S. airlines, these point-to-point route structures quickly became much less efficient than the U.S. hub-and-spoke systems.[94] Combined with the strict cost-cutting which took place in the aftermath of U.S. domestic deregulation, this fact ultimately made U.S. airlines much more competitive than JAL and ANA. With U.S. airlines growing increasingly competitive, the Japanese government was forced to protect JAL and ANA from direct competition from U.S. airlines.

Unable to force greater restrictions on U.S. airlines in the U.S.-Japan marketplace (because U.S. airlines were authorized these rights under the 1952 bilateral), the Japanese government sought to limit the operations of U.S. airlines on intra-Asian routes in order to at least protect JAL and ANA on these routes.[95] With intra-Asian markets extremely lucrative and JAL and ANA in deep financial trouble, avoiding competition on these intra-Asian routes become an important objective of the Japanese government in the early 1990's.[96] At the same time, however, the Japanese government faced political pressure for greater international aviation services, and ANA sought to expand its rights in the U.S.-Japan marketplace. The Japanese government was thus eager to expand the rights of Japanese carriers at the same time it sought to limit the rights enjoyed by U.S. airlines.

6.5.1.1 Japanese Firms: Moving Slowly Towards Globalization

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As in the 1985 negotiations, the two Japanese airlines involved in the on-going U.S.-Japan negotiations were JAL and ANA. As the incumbent Japanese airline, JAL enjoys greater marketplace rights than ANA, and has thus opposed any liberalization of the bilateral. As the Japanese MOU carrier, ANA has very few limited rights under the existing bilateral, and has thus been more supportive of liberalization. For JAL, as in earlier negotiations, the central problem in the current negotiations has been how to maintain the status quo in order to protect itself from direct competition from the more efficient U.S. carriers. Indeed, JAL depends on Japanese government intervention in the international marketplace for economic survival, and any liberalization of the bilateral would have a serious negative economic impact for JAL, particularly if U.S. carriers were allowed to continue to service a large number of intra-Asian routes.[97] Unfortunately for JAL, the Japanese government faces pressure from ANA to liberalize the bilateral, and widespread domestic pressure for deregulation and liberalization have lent additional support for liberalization.

Widespread pressure for liberalization from Japanese companies fearful of a protectionist-prone U.S. Congress, coupled with massive excess demand for air services, meant JAL was unable to simply oppose any liberalization of the bilateral. Given the constraints of Japanese domestic politics, JAL's strategy in the current negotiations has been to argue that Japan should "balance" the bilateral and end U.S. airline abuses of fifth-freedom rights before any further expansion occurs.[98] JAL has been the most prominent critic of the extensive fifth-freedom rights enjoyed by U.S. incumbent carriers, and has consistently pointed out that United, Northwest, and other American carriers have a total of 804 slots per week at Narita while Japanese airlines have 856.[99] In 1995, JAL openly announced that the bilateral should be renounced, with JAL vice-president for corporate planning Kori Nagata stating that "cancellation is

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a dramatic act, but when all else fails, it may be the right step to take." Nagata went on to note that "the U.S.-Japan bilateral agreement is not balanced, and before any further steps are taken towards establishing a completely new regime, it should be balanced."[100] In arguing that the current bilateral is favors U.S. airlines and thus must be balanced before any further liberalization can occur, JAL has de facto sought to stifle any and all liberalization. With U.S. incumbents, especially United and Federal Express, taking the position that no new rights can be negotiated for until the issue of existing fifth-freedom rights has been resolved in favor of the U.S. interpretation of the bilateral, JAL's insistence on balancing has effectively kept ANA and new U.S. carriers out of the marketplace. Thus, so far at least, JAL has successfully managed to block liberalization without ever directly opposing expansion of the bilateral.

JAL's strategy also reflects the importance of international bargaining dynamics. First, JAL has sought to separate aviation issues from the broader U.S.-Japan trading relationship; "Trade issues should not have anything to do with aviation problems," says JAL Chairman Susumu Yamaji.[101] Nonetheless, JAL accepts that there will be some agreement expanding the market due to the importance of the overall U.S.-Japan trading relationship--despite the fact that JAL would prefer to maintain the status quo. Thus, JAL has moved to secure allies in the U.S. in the hopes that its' U.S. allies can push the U.S. government to adopt a negotiating position favorable to JAL. In particular, JAL has taken the position in recent negotiations that JAL is willing to increase the number of carriers in the U.S.-Japan marketplace in exchange for limits on U.S. fifth freedom rights. This position is remarkable similar to the position taken by the ACCESS U.S.-JAPAN group, which has sought to trade away the fifth-freedom rights enjoyed by U.S. incumbents in exchange for increased bilateral rights for U.S. carriers.[102] Given that intra-Asian fares are much higher than elsewhere in

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the world, JAL effectively sought to trade away right in U.S.-Japan markets in exchange for U.S. carriers giving up their intra-Asian rights--a bargain which JAL hoped would have political support in the U.S. given the activities of ACCESS U.S.-Japan. In August 1995, JAL cemented this tacit alliance with ACCESS-U.S.-Japan when it linked its CRS with American Airlines' CRS and agreed to an alliance in frequent flyer programs and cargo sales.[103]

While JAL has sought to stifle any liberalization, ANA has pressed the Japanese government to liberalize the bilateral and allow ANA greater rights in international markets. With this clear strategic objective, ANA has adopted strategies which nicely reflect both Japanese domestic politics and international bargaining dynamics. The major impact of Japanese domestic political institutions on ANA's strategy has been on the lobbying strategy pursued by the airline and ANA's involvement in international alliances.[104] As in the 1985 MOU negotiations, the only politicking surrounding the beginning of negotiations in 1993 in Japan was the MOT's request for petitions from ANA and JAL. No public lobbying campaigns were launched by ANA or JAL, nor did other interested parties use public fora to establish their positions. Although this strategy might be more understandable for JAL, which stands to benefit from stalemate and merely seeks to maintain the status quo and thus delay liberalization, the almost non-existent effort in the domestic political arena is puzzling. With ANA severely disadvantaged under current rules, why hasn't ANA launched any lobbying campaigns comparable to the vigorous and extremely sophisticated effort launched by American and Delta via ACCESS-U.S.-Japan in the U.S.? The answer to this question lies in the structure of Japanese political institutions, which provide structural incentives for Japanese firms to rely on quiet, behind-the-scenes discussions with Japanese officials to press their points. With the

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Japanese government not too enthusiastic about U.S. Open Skies proposals given JAL's vehement opposition and the government still maintaining extensive control over all aspects of Japanese domestic and international aviation markets, ANA concluded that avoiding public pronouncements which opposed official Japanese government policy was the only prudent strategy. With extensive bureaucratic flexibility meaning that ANA could easily and quickly be punished for public opposition to government negotiating positions, ANA has thus avoided public confrontation and has instead quietly made its case with the Japanese government.

Domestic politics were also important in ANA's decisions regarding the benefits and feasibility of entering into international alliances with foreign airlines. Domestic politics have been important simply because the Japanese government placed so many restrictions on inter-airline agreements that both JAL and ANA were reluctant to enter into any international alliances. Indeed, throughout the early 1990's, the MOT used its extensive regulatory oversight to introduce strict guidelines over joint ventures with foreign airlines and thus limited the effectiveness of these agreements for Japanese firms. Thus, Japanese airlines, and the Pacific marketplace in general, has not until very recently witnessed the explosion of airline alliances that has characterized the trans-Atlantic marketplace since the late 1980's. In 1995, however, the Japanese government modified its position on joint ventures and began to encourage Japanese airlines to use these ventures to increase their international competitiveness.[105] Thus, JAL expanded its pre-existing limited alliance with American Airlines while ANA began to expand its links with Delta.[106]

International constraints were also important in ANA's decisions regarding international airline alliances. Once it was resolved that alliances would be permitted by the Japanese government, ANA began to consider the possibility of an international

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alliance to expand its international network. Facing bilateral constraints on expanding its operations, especially in the U.S.-Japan marketplace where JAL opposition to any significant liberalization promised to produce long delays in any new rights for ANA, ANA concluded that international alliances were the best solution in light of the international constraints facing the airline. ANA thus launched the first alliance between a U.S. and a Japanese airline by concluding an agreement with Delta in June 1995[107] and also began to search for Asian airline partners to expand its network in Asia.[108] Featuring joint flights on U.S.-Japan markets, cooperation in frequent flyer programs, coordination of schedules, and sharing of ground facilities and passenger handling, ANA and Delta also agreed to explore the possibilities for code-sharing and blocked-space arrangements in the Asia.[109] Thus, although ANA was initially reluctant to enter into these agreements, it did so when bilateral regulatory constraints and the government-to-government impasse left it no other option to expand its international presence.[110]

6.5.1.2 The Japanese Government: Protected Liberalization

The Japanese government position in the current negotiations reflects the interests of ANA and JAL: increase the rights of ANA in the Japan-U.S. market and decrease the beyond rights held by U.S. carriers in order to protect JAL from more competition on intra-Asian routes.[111] Although the interests of the two airlines were the primary domestic political interests involved in the negotiations, diffuse pressure from business interests for better services and the desire to avoid major trade disputes with the U.S. also provided domestic political support for at least some expansion of rights in the bilateral marketplace. In October 1996, for example, the largest Japanese daily newspaper, *Asahi Shimbun*, published an editorial calling on the government to

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stop protecting the interests of Japanese carriers and negotiate an Open Skies agreement with the U.S.[112] Despite these pressures, the Japanese government has sought to secure an agreement which simultaneously protects JAL yet provides new routes for ANA, and the Japanese government has argued that the bilateral must first be "balanced" before any expansion can take place.[113] In other words, the U.S., and U.S. airlines, must agree that Japan's interpretation of the 1952 bilateral--an interpretation which would require U.S. airlines to secure Japanese government permission to add new fifth freedom routes or capacity on existing routes--before any discussion about new rights can take place.[114]

The Japanese government bargaining position, as we shall see below in the discussion of the U.S., has produced a torrent of political action in the U.S. as the incumbents and the MOU carriers have attempted to shape the U.S. government's negotiating position. These U.S. domestic political debates, however, did not ultimately change the most important facet of U.S.-Japan aviation negotiations: the U.S. sought liberalization at a much faster pace and on a more radical scale than did Japan, which accepted the fact that some liberalization was inevitable but still sought to retain the ability of the Japanese government to intervene in the marketplace to protect the interests of Japanese airlines. Constant U.S. pressure for liberalization, including U.S. attempts to "encircle" Japan with a series of liberal bilaterals with neighboring Asian countries, has had two important impacts on the strategies of the Japanese government as it has attempted to secure a U.S.-Japan agreement which would satisfy ANA and JAL.

First, the Japanese government has sought to launch a multilateral aviation forum in Asia which would provide an alternative bargaining fora for international aviation agreements. Following the breakdown of U.S.-Japan aviation talks in

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August, 1993, the Japanese government launched a diplomatic effort at achieving a multilateral aviation forum in Asia designed at countering the effects of U.S. liberalization efforts. Hoping that the forum would lead to greater government-to-government cooperation on aviation issues in Asia, the effort was primarily addressed at securing Asian support for Japan's bilateral aviation dispute with the U.S., although this was denied by Japanese officials.[115] The inaugural meeting in 1996 took place under the auspices of the Japanese MOT, and U.S. requests to participate were refused.[116] U.S. support for using APEC to liberalize Asian aviation markets, coupled with the fact that the new group closely mirrored APEC membership but excluded the U.S. and other pro-liberalization states, suggested that the group intended to use itself as a multilateral forum to block U.S. liberalization efforts in the region. Although the effort has not been successful in securing the cooperation of all Asian countries, the group has expanded its activities and become much more vocal and pro-active in aviation affairs, and at one point vowed to use the multilateral group to block U.S. efforts to "pick off individual Asian countries one by one" in its liberalization efforts.[117]

The second way in which U.S. pressure has shaped Japanese government bargaining strategy revolves around the impact of U.S. Open Skies agreement with neighboring Asian countries. The U.S. launched an effort to sign Open Skies agreements in Asia in late 1996 with an explicit eye to forcing Japan to liberalize the U.S.-Japan bilateral or face increasing diversion of traffic from Japan (to liberal neighboring states). With long-range jet technology increasing the range of flights from the U.S. in the early 1990's and the dramatic growth of these markets providing the necessary demand for direct flights, Japanese decision-makers were forced to take the threat of diversion seriously for the first time.[118] Although the potential for

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diversion did not produce immediate changes in Japanese negotiating positions, the problems posed by Open Skies bilaterals with neighboring countries, combined with the failure of the Japanese effort to create a multilateral forum to block U.S. efforts at liberalization in the region, made Japanese policymakers much more willing to consider so-called "phased-in Open Skies" agreements that would have otherwise been the case.[119]

One final note on the Japanese government negotiating strategies: the Japanese government has also attempted to secure the support of major American airlines, notably United, American and Northwest, in order to secure U.S. domestic political support for maintaining the status quo agreement. In short, the Japanese government has offered concessions to particular U.S. airlines in the hopes that the carrier (s) will support the Japanese vision of the bilateral marketplace--a vision which will allow the Japanese government to continue to protect JAL and ANA in international markets. The most prominent example of these attempts is the Japanese government attempt to secure the support of ACCESS-U.S.-Japan for Japan's offer for limited entry into the U.S.-Japan market if the U.S. gives up the beyond rights held by United and Northwest.[120]

6.5.2 The U.S.: Seeking Open Skies in the Pacific

With clear and solid bipartisan support from Congress, the Clinton administration has made aviation a prominent issue on its trade agenda, and in particular on the U.S. economic agenda with Japan. The formal adoption of Open Skies as U.S. international aviation policy in 1994 marked the first policy announcement since the Carter policy statement, and the Clinton administration has elevated liberalizing international service markets to the forefront of U.S. international

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economic policy. However, while the U.S. has managed to secure Open Skies agreements with numerous European countries and thereby radically alter the structure and competitiveness of trans-Atlantic markets, trans-Pacific markets remain restrictive and continue to reflect the point-to-point route structures created by the Bermuda regime.[121] Japan's reluctance to liberalize the 1952 bilateral has been the key barrier to the liberalization of Asia's aviation markets. Despite massive U.S. pressure, including several letters between Clinton and Japanese Prime Minister Ryutaro Hashimoto following the breakdown of talks in 1996, no new bilateral agreement had been concluded as of this writing (September 1997).

While government-to-government talks have failed to produce any new agreement, the huge stakes involved in the trans-Pacific aviation market have produced unprecedented levels of political action by U.S. airlines and other societal interests. Frustrated by the government-to-government stalemate expected by U.S. efforts to negotiate an Open Skies agreement with Japan, the MOU carriers have organized a massive effort to change U.S. negotiating strategy and thereby increase the likelihood of a new, more liberal agreement. Headed by American and Delta, the MOU carriers have organized the ACCESS-U.S.-Japan group and recruited a wide range of societal groups, ranging from Walt Disney to the Boston Chamber of Commerce, in support of agreeing to liberalize the U.S.-Japan bilateral marketplace in exchange for limiting U.S. fifth freedom rights beyond Japan.[122] Although ACCESS-U.S.-Japan denies advocating giving up U.S. beyond rights, in practice this is the bargain they have proposed. In response, incumbent U.S. airlines have sought to convince the U.S. government to stay the current course and press for an Open Skies deal with Japan rather than settling for bilateral liberalization.[123] Like the MOU carriers, the incumbents have also recruited a variety of civic and economic interests to their side.

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6.5.2.1 U.S. Firms: Seeking Rights and Entry

U.S. incumbents and MOU carriers had different incentives and bargaining positions vis-a-vis the latest round of negotiations: incumbents enjoyed extensive rights and were unwilling to support liberalization unless an Open Skies agreement could be concluded, while MOU carriers had limited rights and were thus willing to support any and all agreements which provided additional rights in the bilateral marketplace. These basic preferences translated into distinct strategies in both the U.S. and in the international marketplace--strategies that nicely illuminate how domestic politics and international bargaining dynamics can usefully be thought of as constraints within which firms pursue their interests. I examine the MOU carriers and incumbents in turn.

In the early 1990's, the MOU carriers were the most vocal proponents of liberalizing the U.S.-Japan bilateral. As briefly noted above, the MOU carriers calculated that the basic trajectory of government negotiations in 1994-1995 promised no quick agreement and could perhaps even lead to Japanese renunciation of the 1952 bilateral. In short, the U.S. and Japan had adopted widely divergent negotiating positions, and there seemed no agreement in sight. Worse, public announcements that the primary goal of U.S. international aviation policy was Open Skies agreements suggested that the incumbent carriers might continue to enjoy the huge profits available in Pacific markets for the foreseeable future.

In response to this domestic and international impasse, two MOU carriers, American and Delta, formed ACCESS-U.S.-Japan, a coalition of interests committed to liberalizing the bilateral U.S.-Japan marketplace. The basic goal of ACCESS-U.S.-Japan has been to convince the U.S. government to trade away the beyond-rights held

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by U.S. incumbent airlines in exchange for increased entry for the MOU carriers in the U.S.-Japan marketplace. Although ACCESS-U.S.-Japan denied that it wanted to trade away fifth-freedom rights beyond Japan for increased U.S.-Japan rights, American's earlier push to offer Japanese airlines more rights in exchange for additional U.S.-Japan rights for U.S. MOU carriers and the fact that American was quite explicit in arguing that the U.S. should accept limits on fifths in exchange for a liberalized bilateral marketplace made ACCESS-U.S.-Japan claims that it did not wish to trade away fifth-freedom rights less than convincing.[124]

The basic argument of ACCESS-U.S.-Japan is that the U.S.-Japan aviation market is far less competitive than other markets, notably the North Atlantic, due to the stringent restrictions on entry and competition imposed by the existing bilateral. Pointing to higher fares, fewer carriers, and the fact that less cities offered service to Japan than in other international markets, the central point of ACCESS-U.S.-Japan was that market entry was the key to lowering fares for travelers, providing increased competitive opportunities for carriers, and securing a greater share of Asian tourists for U.S. cities and vacation interests. Service from new cities would be launched at entry barriers were reduced, while the increase in air travel resulting from new entry and lower fares would lead to increased revenues for airlines serving the Japanese market. New U.S. cities and tourist industries which would profit handsomely from new service and increased Asian tourists, and U.S. airlines would also benefit from increased revenues.[125]

ACCESS-U.S.-Japan efforts to alter U.S. negotiating strategy highlighted the local economic impact of increasing U.S.-Japan bilateral rights and thus sought to gain the support of Congressional interests. Drawing on the history of liberalization in North Atlantic markets, ACCESS-U.S.-Japan argued that improving the convenience

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of travel, notably by increasing flight frequency or adding direct service from new cities, would stimulate both new travel and the economies of the locations from which new service was introduced. ACCESS-U.S.-Japan also pointed to the 300,000 jobs which it claimed would be created by the liberalization of the bilateral U.S.-Japan marketplace.[126] Claiming to represent more than 2000 companies, business groups, elected officials, consumer groups, and assorted other groups, ACCESS U.S.-Japan argued that improved passenger service between the two countries "reasonably could be anticipated" to generate between $9.2 and $13.8 billion per annum.[127] ACCESS U.S.-Japan pointed to increased Japanese investment which would result from better air services and the exports this investment would generate for the U.S. economy. Moreover, the group also pointed to the fact that increased competition would also lower fares, and thus allow more U.S. consumers to be able to afford to fly to Asian destinations. Of course, lower prices also re-enforced the virtuous cycle begun by increased services in the first place, thus leading to even greater benefits for the U.S. domestic political economy. Finally, ACCESS-U.S.-Japan also argued that expanding US-Japan service would mean that both US and Japanese airlines would have to acquire additional long-range aircraft--which in turn would generate increased demand for jet aircraft which would benefit US commercial aircraft manufacturers.

While American and Delta pressed ACCESS-U.S.-Japan to stress the local economic benefits which would accrue from bilateral liberalization, the two MOU carriers also worked hard on assembling a diverse and geographically dispersed group of interests in the organization. Thus, for example, ACCESS-U.S.-Japan claimed to represent more than 2000 companies, business groups, elected officials, consumer groups, and assorted other groups, including the Walt Disney corporation. With more than 4 million Japanese tourists visiting the U.S. in 1994, Japan was the number one

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source for foreign visitors visiting the U.S. Moreover, the average Japanese visitor spends more than $4,000 per person on transportation, food, and entertainment while in the U.S., approximately 30 percent more than the typical foreign visitor. ACCESS-U.S.-Japan went on to stress that spending by Japanese visitors contribute $17 billion to the U.S. economy and accounts for 22 percent of the total receipts of the U.S. tourism industry.[128] Finally, in response to the claims of the incumbents about the value of U.S. fifth freedom rights in Japan, ACCESS U.S.-Japan argued that insisting on maintaining existing beyond rights made no sense because the beneficiaries of these rights are mainly not foreign passengers and because new long-range aircraft and economic growth in the region will eventually make Tokyo less valuable as an Asian hub.[129]

While the ACCESS-U.S.-Japan organization and the massive domestic political effort it led to alter the U.S. government negotiating position represented one facet of the MOU carriers efforts to circumvent the impasse presented by the on-going government-to-government talks, American and Delta concluded limited alliances with JAL and ANA, respectively, as a way to gain increased access to Pacific markets if U.S. government pressure did not produce any liberalization of the bilateral. ACCESS-U.S.-Japan and the JAL and ANA alliances were complementary strategies, in the sense that ACCESS-U.S.-Japan attempted to convince the U.S. government to give up the fifth freedom rights of United and Northwest in exchange for bilateral route awards, while American and Delta could use their new bilateral rights to channel customers to the Asian networks of their Japanese alliance partners. In August 1995, JAL and American Airlines linked their computer reservation systems and agreed to an alliance in frequent flyer programs and cargo sales. At the same time, American CEO and President Robert Crandall noted that one way to move forward on the U.S.-Japan

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bilateral might be to give JAL access to more U.S. cities via code-sharing opportunities. In other words, JAL would support more liberalization if JAL were allowed to expand its alliance with American.[130] Likewise, in July 1995, ANA and Delta Airlines entered into an alliance featuring joint flights on U.S.-Japan markets, cooperation in frequent flyer programs, coordination of schedules, and sharing of ground facilities and passenger handling. The two companies also agreed to explore the possibilities for code-sharing and blocked-space arrangements in the Asia. As Joseph Hale, Director of Marketing in Japan for Delta, stated "we want to maintain a presence in as many places as we can, but given the realities (of legal and structural limitations), there are places that we can't fly to ourselves but that we could do in conjunction with other carriers."[131]

While the MOU carriers expanded their Asian network through alliance partners and sought to alter the U.S. government negotiating strategy by shifting the political balance in favor of a more limited liberalization (i.e. rather than an Open Skies agreement or nothing), the incumbent carriers counter-attacked and argued that the U.S. should maintain its Open Skies negotiating strategy and that outstanding disputes over fifth-freedom rights should be resolved before any expansion of rights takes place. While ACCESS-U.S.-Japan commissioned Coopers & Lybrand to produce a series of reports on the economic benefits of bilateral liberalization, United commissioned Booz, Allen, Hamilton[132] and Northwest hired Roberts, Roach, and Associates[133] to bolster their case that giving away U.S. fifth-freedom rights threatened to cost more than the gains promised by the liberalization in exchange for fifth-freedom rights championed by ACCESS-U.S.-Japan. Like the reports and economic studies produced for ACCESS-U.S.-Japan, these studies sought to demonstrate the local impact in terms of jobs and local economic activity, particular in

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California and the rest of the West Coast, as a means to secure political support for the incumbents position.[134] In an electoral year in which California loomed large in Clinton's campaign and with the largest House delegation, the focus on California made clear political sense.[135]

Although the incumbents relied on economic studies just like ACCESS-U.S.-Japan, the major thrust of the incumbents strategy rested on linking their position with the overall U.S.-Japan trading relationship. Pointing out that aviation was one of the few industries in which U.S. firms were very successful vis-a-vis their Japanese counterparts, the incumbents portrayed the aviation dispute as yet another example of Japan using unfair trading tactics to wrestle concessions from the U.S. government. As Joseph Francht, Jr., Northwest's senior vice-president-finance, noted in a speech at the Pacific Economic Cooperation Conference, "Japanese companies have done very well here (in the U.S.) because of our open markets. We think we can legitimately ask: Why would Japan seek to handicap a U.S. economy that is doing so well there? It really comes down to basic fairness."[136] United and Federal Express both adopted similar strategies as they pressed Congress and the Clinton administration to hold out for an Open Skies agreement rather than conclude the more limited agreement proposed by ACCESS-U.S.-Japan.

One final note about U.S. airline strategy in the current U.S.-Japan negotiations is in order. U.S. incumbent carriers, despite enjoying a virtual franchise to make money as a result of their extensive rights in Japan, have been willing to support liberalization of the bilateral if an Open Skies agreement can be secured. As one unnamed United source noted, although United enjoyed widespread rights in Japanese marketplace, "everybody that does business here would like to do more business." Likewise, in June 1996, United Airlines Chairman Gerald Greenwald

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announced that United would be willing to accept a limitation on the number of Japanese-originating passengers on beyond-Tokyo flights if a broader U.S.-Japan aviation agreement could be worked out.[137] Northwest has adopted a similar position, with one Northwest official noting that "if we see market growth, we will seek further expansion."[138] U.S. incumbents have thus adopted a position which is contingent on the outcome of U.S.-Japan government-to-government negotiations--yet another example of how international bargaining dynamics shape the preferences and strategies of firms as they pursue their interests in international regulated markets. The contingent nature of firm strategies took another turn in early 1997, when United began to shift its position to be more accommodating with Japanese positions and to be less strident in their demands. This was part and parcel of the announcement of the Star Alliance--a move which effectively signaled that United would increasingly rely on its partnership with Thai Airways International to service intra-Asian points and would utilize its Narita slots for more profitable U.S.-Japan traffic.[139]

6.5.2.1 The U.S. Government: Open Skies or Bust

The Clinton administration, with strong bipartisan backing, formally adopted Open Skies policy as U.S. international aviation policy in 1994, and the Clinton administration has elevated liberalizing the international aviation marketplace to the forefront of U.S.-Japan international economic relations. Most importantly, the Clinton administration and Congress have been steadfast in their support of U.S. negotiating strategy in the Pacific (i.e. secure an Open Skies agreement rather than settle for piecemeal liberalization), and have remained committed to pressing the Japanese at every turn on international aviation issues.

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The central political force driving both Congressional and administration support for U.S. international aviation policy in the Pacific has been the strong link between the aviation dispute and the overall U.S.-Japan trading relationship. As noted above in the context of Japanese firms and bargaining strategies, the backdrop to the current negotiations has been deep Congressional concern over U.S.-Japan trade relationship and how Japan's unwillingness to liberalize the 1952 bilateral fits into this overall relationship. The House Subcommittee on Aviation has held hearings on U.S.-Japan aviation relations, and Congressional interests have followed the negotiations with a keen eye.[140] Following a Japanese threat to cancel seven beyond routes operated by Federal Express following the conclusion of the cargo deal in March 1996, for example, Senator Larry Pressler (Chairman of the Senate Committee on Commerce, Science, and Transportation) and 56 other Senators wrote a letter to President Clinton warning that "these actions raise serious doubt about Japan's willingness to allow free and fair trade in any sector in which the superior performance of U.S. firms and their employees results in a trade surplus for the United States."[141] The letter went on to note that "nothing short of full compliance with (the U.S.-Japan bilateral) agreement is acceptable." Senator David Pryor was even more blunt, stating that "this letter sends a bipartisan message to the Japanese that this threat or future actions against U.S. international aviation rights will not be tolerated by Congress or the White House."[142] In another letter to Clinton, Pressler also wrote that Japan had "routinely ignored" the U.S.-Japan bilateral and called on Clinton to "take whatever steps you deem necessary" to compel Japanese compliance with the bilateral.[143]

While Congress supported taking a hard line with Japan in the aviation dispute, the Clinton administration also placed serious political weight on achieving liberalized international aviation markets and expanding the number of U.S. airlines and cities

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which benefit from international aviation services. Clinton appointed a bipartisan committee to study the problems facing the U.S. aviation industry in 1994, and the recovery of the aviation industry after the disastrous 1990-1992 period received broad attention in the press. Likewise, the 1994 policy statement also included a provision that explicitly noted the importance of cities by noting that U.S. policy should "enhance the access of U.S. cities to the international transportation system."[144] As early as 1993, when DOT Secretary Pena attacked protectionism and vowed a vigorous pursuit of liberalized air agreements in a 1993 address to the annual IATA meeting, Pena made it clear that the U.S. would adopt a hard-line with the aviation dispute with Japan when he stated that "the U.S. is weary of running chronic, multi-billion-dollar trade deficits with nations whose governments lecture Americans on the need to produce more efficient, more desirable products."[145] Moreover, the U.S.-Japan aviation dispute in 1995-1996 took place against a backdrop of growing U.S. impatience over Japanese trade practices and the increasing use of strong-arm tactics by the Clinton administration in its trade dealings with Japan. With the administration claiming that hard bargaining tactics had produced success in car parts, aviation and photographic film were grouped as the two major trading issues that might be resolved through similar tactics.

With U.S. domestic politics dictating an Open Skies negotiating position, the question became how to negotiate such an agreement with Japan. As in early negotiations in both the Atlantic and the Pacific, the U.S. adopted a negotiating strategy explicitly designed to lessen Japanese resistance to an Open Skies agreement through an "encirclement" strategy. Thus, in late 1996, the U.S. began offering Open Skies agreements to Korea, Taiwan, Singapore, Taiwan, Malaysia, Brunei, and New Zealand.[146] The U.S. also signaled its willingness to offer Japan a phased-in Open

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Skies agreement in light of Japanese domestic political difficulties in concluding an Open Skies agreement. Designed to allow JAL and ANA time to restructure their operations and thus become competitive enough to face real competition from more efficient U.S. airlines, this negotiating offer was made solely because of Japanese domestic political considerations. Indeed, the decision to offer a phased-in Open Skies deal was made simply because "internal political dynamics prevent (Japan) from signing an Open Skies agreement."[147] In effect, the U.S. changed bargaining positions because it saw that Japanese domestic politics meant that simply pushing for an Open Skies agreement would produce no results, whereas allowing a phase-in time period would provide the necessary period for JAL and ANA to adjust to more competitive markets and thus provide the requisite domestic political support for the phased-in Open Skies agreement. In short, the U.S. government offered a second-best option only because the first best option was off the table, i.e. Japanese domestic politics prevented Japan from ever agreeing to an immediate Open Skies agreement.

6.5.3 Discussion

The previous section has outlined the domestic political action which has driven U.S. and Japanese government negotiating positions in the current round of government-to-government talks. In particular, I argued that the 1952 bilateral established property rights in the bilateral marketplace which have set the basic political debate in both the U.S. and Japan: incumbents have been less supportive of liberalization because rule changes threaten to leave them worse off than under the status quo, while MOU carriers have pressed for liberalization as they are sure to be better off under different rules. The 1952 has thus structured the strategies and preferences of firms in both the U.S. and Japan, and has in turn shaped the political

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calculus of national politicians vis-a-vis the rules governing the bilateral marketplace. National politicians, meanwhile, have also been strategic in their actions, and have sought to undertake policies designed to recruit political allies in the respective foreign countries in order to obtain their desired policy outcomes. It is worth reviewing the activities of firms and national governments in turn.

U.S. MOU carriers have adopted the most sophisticated and carefully calculated lobbying campaign in aviation history. Designed to convince the U.S. government that the U.S. should be willing to give up fifth-freedom rights from Japan in exchange for liberalization of U.S.-Japan markets (i.e. the U.S. should abandon Open Skies as the policy goal in U.S.-Japan aviation negotiations), the strategy has been carefully constructed in light of both U.S. domestic politics and international bargaining dynamics. Domestically, the coalition has sought to construct a geographically diverse set of interests in support of its' position in an effort to secure widespread Congressional support for the plan. With Congress most worried about the overall U.S.-Japan trading relationship, in particular the trade deficit, MOU carriers faced their most serious challenge in Congress and sought to overcome this problem by recruiting allies from a broad range of Congressional districts. The ACCESS-U.S.-Japan strategy also reflected international bargaining dynamics, as American and Delta quietly concluded alliances with JAL and ANA, respectively, in order to recruit political allies in Japan for the ACCESS-U.S.-Japan position. The MOU carriers thus launched a strategy designed to secure more access to Japanese aviation markets in a way that was self-consciously designed to succeed within the parameters defined by both U.S. domestic politics and international bargaining dynamics.

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In response to the efforts of the MOU carriers, U.S. incumbents launched a series of strategies designed to recruit political allies to their position on U.S.-Japan aviation markets. In particular, the incumbents sought to link their struggle with Japan to maintain their fifth-freedom rights with the broader issue of Japan's role as a free-trade in international markets. Put differently, the incumbents linked the aviation dispute with Japan to the broader trade problems with Japan--so that aviation became just one more issue where Japan was breaking the rules to the detriment of U.S. companies. Of course, the incumbents also launched their own research efforts to demonstrate the economic costs of giving away fifth-freedom rights, but the main thrust of incumbent efforts was to convince U.S. national politicians that aviation was just one more area where Japan was blatantly violating international rules and thereby hurting U.S. interests.

In Japan, ANA and JAL have launch similar strategies, despite the fact that the two carriers enjoy very different positions in the market. In short, neither carrier has launched any public lobbying campaigns in support of their view of the U.S.-Japan marketplace, and both carriers have sought alliances with U.S. airlines in order to (1) maintain the intra-Asian markets for Asian airlines, (2) defuse pressure in the U.S. for an Open Skies agreement, and (3) expand their access to U.S. domestic traffic. Alliances with U.S. airlines, even limited alliances which do not require U.S. government approval, have been the central aspect of Japanese airline efforts to prepare for more competitive U.S.-Japan bilateral markets. At the same time, however, these carriers are both inefficient and would prefer less competition, especially on heavily regulated intra-Asian routes. JAL and ANA thus see alliances as the means by which to secure their goals within the constraints of international bargaining dynamics.

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The strategies of national governments in both the U.S. and Japan also reflect calculations about international forces. In Japan, the government accepts that some liberalization will have to take place (due to intense U.S. pressure) but has attempted to deflect this pressure in ways that allow the government to continue to protect ANA and JAL. Thus, the Japanese government has launched a series of multilateral aviation efforts with Asian partners designed to thwart U.S. liberalization efforts in Asia, and has sought to recruit allies in the U.S. to support the Japanese position (i.e. expand the bilateral market on a route-by-route basis in exchange for the U.S. giving up fifth-freedom rights). All these efforts have been undertaken with a keen eye to U.S. domestic politics, where Japan fears a Congressional backlash. In the U.S., the government has pushed Japan to conclude an Open Skies agreement, but has signaled U.S. willingness to sign a phased-in Open Skies agreement that would provide time for JAL and ANA to become more competitive. Thus, U.S. negotiating positions explicitly recognize Japanese domestic political dynamics, and the need for Japanese politicians to ensure the economic viability of JAL and ANA.

6.6 Conclusion

As in previous chapters, this chapter has sought to demonstrate how domestic politics and international bargaining dynamics have dictated the shape and content of the U.S.-Japan bilateral international aviation marketplace. Since World War II, Japan has supported restrictive international aviation markets and sought to protect Japanese firms within these markets. Until the late 1970's, the U.S. was content to support this particular market structure, and U.S.-Japan aviation relations were relatively peaceful. Since the U.S. adoption of a pro-competitive international aviation policy in 1978, however, U.S.-Japan aviation relations have been extremely conflictual. On the one

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hand, Japan remains wedded to restrictive aviation markets, while on the other hand the U.S. has sought to pressure Japan into liberalizing the bilateral marketplace.

A domestic political analysis focusing largely on domestic political institutions can explain the broad trajectory of the rules governing the U.S.-Japan aviation markets. In Japan, electoral rules and a parliamentary system mean politicians have incentives to produce pro-producer policies, and rely on extensive delegations to opaque bureaucracies to achieve their policy goals. In aviation, this has meant that the MOT has sought to protect inefficient Japanese airlines by refusing to liberalize international aviation markets. Japanese aviation policy has thus favored Japanese airlines at the expense of other interests. In the U.S., on the other hand, electoral laws has provided incentives for parties to compete for the median voter, and the U.S. has thus espoused a pro-competitive international aviation policy since the late 1970's.

Although domestic political institutions can explain the broad organization of the bilateral market, domestic politics and the structure of international markets and existing international regulatory rules have also been important in shaping the strategies of firms in both states and thus in shaping the timing and design of national policies and subsequent international regulatory rules. In Japan, ANA has sought to enter international markets by recruiting business allies and exploiting regulatory loopholes in the 1970-1972 Aviation Constitution. This strategy, however, rested on calculations about U.S. domestic politics, which ANA hoped would produce passenger rights in addition to NCA cargo routes. In the U.S., frustration with the slow pace of government-to-government negotiations has led MOU carriers to adopt extremely sophisticated strategies designed to convince the U.S. government to switch negotiations strategies in the hopes that changing negotiating strategies will produce quicker bilateral liberalization. Incumbent carriers have fought back by linking their

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preferred aviation markets with broad U.S.-Japan trading disputes and the impact of these disputes on U.S. interests. Overall, of course, the basic political battle has been between the incumbents and the MOU carriers, a divide which has been artificially created by the existing bilateral agreement.

Ultimately, the impact of domestic politics and international bargaining dynamics on the strategies of economic actors are important because the strategies of domestic actors shape the timing and design of changes in the rules governing the marketplace. The impact of particular strategies on the positions adopted by national governments, and hence on the rules governing the marketplace, promises to be even more important once any comprehensive liberalization becomes a political possibility. Indeed, recent announcements by JAL and American Airlines that they were expanding the scope of their alliance and suggestions that the U.S. government was about to conclude a bilateral agreement along the lines suggested by ACCESS-U.S.-Japan and their Japanese alliance partners attest to how particular firm strategies can shape the positions taken by national politicians and in turn the rules governing international aviation markets.[148]

As quoted in "Doing the rights thing," *Air Transport World*, Vol. 32, No. 12 (December 1995), p. 57-61.

[1] Fifth-freedom passengers are passengers carried by U.S. carriers from Japan to Asian destinations on U.S.-originating flights. In other words, a Japanese passenger flying from Tokyo to Jakarta on United Airlines would be considered a fifth-freedom passenger, as United only flies from Tokyo-Jakarta as part of a flight which originates in the U.S.

[2] U.S. domestic institutions are not outlined here because they were discussed in some detail in chapter four. The reader is referred to section 4.1 for a discussion of U.S. domestic political institutions.

[3] Although the Japanese electoral system was reformed in 1993, most analysts believe that the political logic of these new electoral rules will take some time to play out. Moreover, while some of the elements cut against the incentives provided by the political institutions discussed here, particular elements of the reform also re-enforced these incentives. Thus, my analysis rests on the incentives provided by the basis institutional structure outlined here. The reform was in the electoral system, where single non-transferable vote districts were replaced with 300 single member districts and 200 proportional representation seats from 11 big districts. The idea of the reform is that electoral politics ought to become more party-centered (no more intra-party competition) insofar as a politician must

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win closer to half the votes to win in a single-seat constituency and therefore it makes sense that politicians might abandon any hope of buying off enough voters to win, and instead issue broad, mass appeals (i.e., pro-consumer appeals) in order to win the district. However, the conversion from 511 seats in 129 districts to 300 seats in 300 districts made for much smaller districts, such that candidates tended to respond by simply cranking up the money machine. Today, the party system is still in flux, and no one knows what any of the party platforms are any more. It looked like the policy division between the LDP and the biggest opposition party (the NFP) would be over regulation/deregulation, but other than rhetoric, nothing much has happened.

[4]For a discussion of how Japanese electoral rules produce incentives for Japanese political parties to "divide the vote" by running on particularistic policies, see Mathew McCubbins and Frances Rosenbluth, "Party provision for personal politics: dividing the vote in Japan," in Peter Cowhey and Mathew McCubbins, eds., Structure and Policy in Japan and the United States (Cambridge University Press, Cambridge. MA), 1995, p. 35-55.

[5]Daniel Okimoto, "Political Inclusivity: The Domestic Structure of Trade," in Takashi Inoguchi and Daniel Okimoto, eds., The Political Economy of Japan, Volume 2: The Changing International Context (Stanford University Press, Stanford, CA, 1988, p. 305-344.

[6]Numerous scholars of Japan have argued that bureaucrats wield power in Japan, and that politicians do not in fact delegate authority at all. In this light, the opaque and informal bureaucratic rules are just another way in which the bureaucracies control all aspects of the Japanese economy. For the locus classicus of this line of argument, see Chalmers Johnson, MITI and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975 (Stanford University Press, Stanford, CA), 1982.

[7]For a discussion of how U.S. and Japanese domestic political institutions shape government-firm coordination, see Ellis Krauss and Jon Pierre, "Targeting Resources for Industrial Change," in R. Kent Weaver and Bert Rockman, eds., Do Institutions Matter? Government Capabilities in the United States and Abroad, (The Brookings Institution, Washington D.C.), 1993, p. 151-186.

[8]See Gary Allison and Frank Upham, Bargaining, Not Dominance: How Politics Are Negotiated in Japan, Occasional paper, Woodrow Wilson International Center for Scholars, Asia Program, No. 39 (Washington. D.C.), 1990, and Frank Upham, Law and Social Change in Postwar Japan (Harvard University Press, Cambridge, MA.), 1987.

[9]Author's interview with Masashi Izumi, Director, International & Government Affairs, All Nippon Airways, Washington D.C., 10/ 21/96 and 10/29/96, and author's interview with Japan Airlines Officials, Washington D.C., 10/96. See also Okimoto, 1988.

[10]*Tokyo Business Today*, March 1994, p. 6.

[11]Civil Air Transport Agreement Between the United States of America and Japan, August 11, 1952, as reproduced in Civil Air Transport Agreement between the United States of American and Japan, 2nd Edition, documents collected and annotated by William Kutzke (Kutzke and Associates, Washington D.C.), March 1995.

[12]United replaced Pan Am in 1985.

[13]They are known as MOU carriers simply because the rights these carriers have were added in Memorandum of Understandings (MOUs) in 1985 and 1989.

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[14]In order for airlines to offer services to particular airports, time for landing and take-off must be secured. Known as slots, these take-off and landing times are extremely important as they determine the timing and type of services which airlines can provide. Because bilateral rights to enter a particular market mean nothing if new entrants cannot secure slots at desirable times, the issue of slots becomes part and parcel of the political process rather than merely an administrative issue.

[15]Civil Aviation Authority, Airline Competition on European Long Haul Routes (CAP 639) (Civil Aviation Authority, London), November, 1994, p. 17.

[16]The U.S. political system was explicitly designed to allow numerous "factions" to participate in and influence policy-making. As a result the conscious institutional tinkering by the founding fathers, the U.S. has numerous veto avenues for interested parties to influence policy outcomes. See Alexander Hamilton, James Madison, and John Jay, The Federalist Papers (Bantam Books, New York, N.Y.), 1982.

[17]Author's interview with U.S. and Japanese officials, Washington D.C., October and November, 1996.

[18]The regulatory framework in aviation in the U.S. is omitted here as it was discussed in some detail in chapter four.

[19]JAL was only partially government-owned. In 1953, JAL was restructured (from a private corporation) in order to establish the company as the national flag carrier. At that time, the government invested the same amount in JAL as the capital stock that the company originally sold in starting its business, thus making JAL effectively 50-percent government owned. See Hirotaka Yamauchi and Takatoshi Ito, "Air Transport Policy in Japan," in Gary Hufbauer and Christopher Findlay, eds., Flying High: Liberalizing Civil Aviation in the Asia Pacific (Institute for International Economics, Washington, D.C.), 1996, p. 33-61.

[20]Arthur Alexander, "Domestic Aviation in Japan: Responding to Market Forces Amid Regulatory Constraints," *JEI Report*, March 29, 1996, and Yamauchi and Ito, 1996, p. 36-37.

[21]Trunk routes were defined as routes connecting Tokyo, Osaka, Sapporo, and Fukuoka. See Alexander, 1996, p. 2. The "loophole" concerning the entry of an additional cargo carrier eventually led to the entrance of NCA and ANA into the international market in 1985.

[22]See Hirotaka Yamauchi and Hideki Murakami, "Air Transport in Japan: Policy Changes and its Evaluation," *The Economic Analysis*, No. 143 (December 1995), p. 85-126. Even after the liberalization of the late 1980's and early 1990's, the MOT stilled exercised extensive control over the airlines via administrative guidance. In 1994, for example, the MOT attempted to kill plans by the airlines to hire foreign flights attendants to lower costs. See Gordon Cramb, "Japanese Minister kills 'part-time' job prospects," *The Financial Times*, August 17, 1994, p. 3, and Kenichi Tsuruoka, "What's Gov't doing making airline management decisions?" *The Daily Yomiuri*, August 23, 1994. The MOT only backed down after extensive pressure from two leading Japanese business associations (the Nikkeiren and the Keidanren). See "Mickey Mouse Antics," *The Economist*, September 10, 1994, p. 82.

[23]Takahashi, 1992.

[24]See Yamauchi and Ito, 1996, p. 33-61, and Nozomu Takahashi, "Aviation Policy in Japan," *KSU*

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Economic and Business Review (Kyoto Sangyo University), No. 19 (May 1992), p. 13-35.

[25]The differential between fares purchased in Japan and those purchased abroad eventually produced a large market in imported tickets that could be sold at "bucket stop" travel agencies at far below the prices of authorized tickets. "MOT: Ministry of Tyranny: The Ministry of Transport is Guilty of Bureaucratic Megalomania and Rampant Regulatory Rampages," *Tokyo Business Today*, March 1994, p. 6.

[26]For a detailed description of the process of fare-setting in Japan, see Takahashi, 1992.

[27]Daniel Kasper, Holding Over Tokyo: U.S.-Japan Air Service Negotiations (Pew Case Studies in International Affairs, Case 104), 1989, p. 2.

[28]These positions reflect the dynamic in U.S.-Japan negotiations for the past twenty years: the U.S. has consistently been pressing Japan to grant more rights to U.S. carriers while Japanese carriers have been reluctant to allow more competition. Author's interview with Kenichi Uchinami, Senior Representative, Washington Office, International Transport Research Institute, Washington, D.C., 10/25/96., Washington D.C., 10/31/96.

[29]Yamauchi and Ito, 1996, and author's interviews with Kenichi Uchinami, Washington, D.C., 10/25/96.

[30]"Council Report will lead to freer skies," *Japan Economic Journal*, December 21, 1985, p. 1.

[31]Peter Bruce, "Tokyo Moves to Open Up the Skies," *The Financial Times*, June 12, 1987, p. 7, and "Gov't council advises more competition among airlines," *Japan Economic Journal*, June 7 1986, p. 21.

[32]Initially, routes with more than 1 million passengers were eligible for triple-tracking and routes with 700,000 or more passengers were potential double-tracked routes. These standards were lowered in 1992 to 700,00 for triple-track routes and 400,000 for double-track routes.

[33]Yamauchi and Ito, 1996, and Alexander, 1996.

[34]For a broad overview of aviation liberalization in Japan, see "Tokyo Moves to Open Up the Skies," *The Financial Times*, June 12, 1987, p. 7.

[35]Yamauchi and Ito, 1996, p. 40.

[36]Today, ANA holds 52 percent of the domestic market, while JAL and Japan Air System hold 26 and 22 percent, respectively. See Yuri Yamamoto, "Public clamor spurs air-fare skirmish: rate hikes after deregulation roil passenger ire; deep discounts offered for advanced purchases," *The Nikkei Weekly*, March 11, 1996, p. 10.

[37]Although ANA entered the international market cautiously, the high cost of establishing it's network and the constraints imposed by slot restrictions led ANA to slow its international expansion in 1992. See "Japan: All Nippon's Move Into International Services Has Not Proved as Profitable as Hoped," *Airline Business*, September 1, 1992.

[38]*Japan Economic Newswire*, December 18, 1987.

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[39]Although tour operators had been selling to individuals illegally, the new regulations significantly loosened the regulatory rules governing tour operators. Author's interview with Akihiko Tamura, First Secretary, Embassy of Japan, Washington D.C., 10/24/96, and *Tokyo Business Today*, March 1994, p. 6.

[40]Prior to 1992, discount tickets had only been sold by the small and medium sized Japanese travel agencies. See "Major Travel Agencies Start Selling Discount Tickets," *The Daily Yomiuri*, August 11 1992, p. 2.

[41]For a detailed discussion of the regulatory rules governing fares, see JEI Report: Domestic Aviation in Japan: Market Forces/Regulation, Part 2, *JEI Report*, No. 12 (March 29 1996).

[42]There is widespread debate about fare levels in Japanese aviation markets given rampage discounting and the acknowledged fact that official statistics are meaningless. For a discussion, see JEI Report: Domestic Aviation in Japan: Market Forces/Regulation, Part 3, *JEI Report*, No. 12 (March 29 1996), and Alexander, 1996, p. 7.

[43]For a detailed discussion of the new rules, see *JEI Report*, 1996.

[44]It is worth noting that international factors were important in generating pressure for the recent round of domestic fare liberalization. In particular, Japanese tourist interests complained that high domestic air fares meant that they were losing business to overseas vacation destinations, claims which re-enforced MOT recognition that further domestic and international liberalization were unstoppable. See JEI Report: Domestic Aviation in Japan: Market Forces/Regulation, Part 3, *JEI Report*, No. 12 (March 29 1996).

[45]See "Public clamor spurs air-fare skirmish: rate hikes after deregulation roil passenger ire; deep discounts offered for advanced purchases," *The Nikkei Weekly*, March 11, 1996, p. 10.

[46]"Internationalization taking off at airports; Flights abroad increasing at Sendai, other regional facilities also reach out," *The Japan Economic Journal*, March 23 1991, p. 5.

[47]See "Bureaucratic Power: MOT Dispenses Rights as it See Fit," *Tokyo Business Today*, January-February 1993, p. 18.

[48]Quoted in "What's govt doing making airline management decisions?" *The Daily Yomiuri*, August 23, 1994.

[49]"Mickey Mouse Antics," *The Economist*, September 10, 1994, p. 82.

[50]IATA, Air Transport in a Changing World: Facing the Challenges of Tomorrow (IATA, Montreal, Canada), 1993, p. 29.

[51]IATA, 1993, p. 29, and Takahashi, 1992, p. 15.

[52]The original 1952 bilateral and all the subsequent additions can be found in Kutzke, 1995.

[53]U.S. carriers were only required to inform the Japanese government of an changes in capacities or routes. This changed during the 1980's, however, as Japan became increasingly dissatisfied with the agreement and a tacit understanding emerged that U.S. carriers had to apply for Japanese permission to add new capacity or routes. See below for a more detailed discussion.

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[54]Mark Hansen and Adib Kanafani, "Airline Hubbing and Airport Economics in the Pacific Market," *Transportation Research*, Vol. 24, No. 3 (May 1990), p. 217-230.

[55]The expanded cargo capacity of the 747 was also important is dampening political pressure from U.S. companies for a more liberal bilateral. See Hansen and Kanafani, 1990.

[56]Daniel Kasper, Deregulation and Globalization: Liberalizing International Trade in Air Services (Ballinger Publishing Company, Cambridge, MA), 1988, p. 82-87.

[57]Author's interview with Masashi Izumi, Washington, D.C., 10/ 21/96, and 10/29/96.

[58]Kasper, 1988, p. 84.

[59]The following section draws on the extremely detailed discussion of the 1980-1982 talks and the final 1982 mini-deal provided in Daniel Kasper, Holding Over Tokyo: U.S.-Japan Air Service Negotiations (Pew Case Studies in International Affairs, Case 104) (The Pew Charitable Trusts, Washington, D.C.), 1989.

[60]Air Micronesia sought to increase its existing service to Tokyo from four to seven days a week, a move that the U.S.--and hence Air Micronesia--was authorized to do under the 1952 bilateral, but Japan denied Air Micronesia permission to offer any increased frequencies.

[61]In particular, United was authorized to operate daily service from Portland and Seattle to Tokyo, Continental/Air Micronesia was granted access to Nagoya, and JAL secured new access to Chicago and Seattle.

[62]Communication from Powell Moore, Assistant Secretary for Congressional Relations, U.S. State Department, to Rep. Elliot Levitas, December 22, 1982, in Committee on Public Works and Transportation, A Review of U.S. International Aviation Policy, Hearings Before the Subcommittee on Investigations and Oversight of the Committee on Public Works and Transportation, 97th Congress, First and Second Sessions, 1982 (U.S. Government Printing Office, Washington, D.C.), 1983, p. 859.

[63]"Snatching Defeat From Victory," *The Washington Post*, March 28, 1978.

[64]Author's interview with Jeffry Shane, Washington D.C., 10/29/96 and 5/23/97. Shane served in the U.S. government as Deputy Asst. Secretary of Transportation for Policy & International Affairs from 1983-1985, Deputy Assistant Secretary of State for Transportation Affairs from 1985-1989, and Assistant Secretary of Transportation for Policy & International Affairs from 1989-1993.

[65]NCA was authorized to serve Tokyo-San Francisco-New York while ANA was authorized to Tokyo-San Francisco and Tokyo-Washington D.C.

[66]James Woolsey, "All Nippon Airways: Faster Than a Speeding Bullet?" *Air Transport World*, Vol. 11, No. 6 (July 1974), p. 16-21.

[67]Author's interview with Masashi Izumi, Washington D.C., 10/ 21/96 and 10/29/96.

[68]"Japan-U.S. aviation talks are heading toward solution," *Japan Economic Journal*, March 2 1982, p.

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[69]Author's interview with Masashi Izumi, Washington D.C., 10/ 21/96 and 10/29/96.

[70]Author's interview with Masashi Izumi, Washington D.C., 10/ 21/96 and 10/29/96.

[71]The following discussion of JAL strategy draws on the author's interviews with senior JAL officials, Washington D.C., October 1996.

[72]Joan Feldman, "U.S.-Japan Bilateral Jousting Continues," *Air Transport World*, June 1985, p. 28-29. It is also worth noting that both JAL and ANA buy exclusively Boeing and McDonnell Douglas airplanes, and use their links to these aircraft manufacturers to bring pressure to bear on U.S. domestic political officials when government-to-government negotiations threaten to undermine these airlines interests. Author's interview with William Kutzke, Washington D.C., 10/24/96 and 10/30/96. From 1968 to 1979, Kutzke was employed at the CAB where he served as Assistant General Counsel for International Law and Assistant General Counsel for Litigation in the General Counsel's Office. From 1979 to 1985, Kutzke was Vice President-Airline Planning and Vice President-Washington of Northwest Airlines. Since 1985, Kutzke has worked as a consultant and an attorney for numerous airlines.

[73]When ANA formed NCA in 1978, JAL had countered by forming its own new all-cargo airline and recruited some shipping companies to the new venture. It became clear by 1982-1983, however, that JAL did not actually intend to launch the new carrier and had merely used the planned cargo airline to derail ANA's attempts to secure international rights for NCA. Author's interview with Masashi Izumi, Washington D.C., 10/ 21/96 and 10/29/96.

[74]Joan Feldman, "U.S.-Japan Bilateral Jousting Continues," *Air Transport World*, June 1985, p. 28-29.

[75]The following discussion of the politics surrounding the 1984-1985 negotiations and Japanese negotiating strategy draws from the author's interviews with Akihiko Tamura, Washington D.C., 10/24/96, Kenichi Uchinami, Washington D.C., 10/25/96 and 10/31/96, Masashi Izumi, Washington, D.C., 10/ 21/96 and 10/29/96, and senior JAL officials, Washington D.C., October 1996.

[76]It is worth noting that pressure for more Japanese international air services was not intended to reduce prices but merely to allow more entry so as to expand the range of available services.

[77]Author's interview with Akihiko Tamura, Washington, D.C., 10/24/96.

[78]Yamauchi and Ito, 1996, p. 50.

[79]Author's interview with various industry officials; see also Kasper, 1987.

[80]"Freer Skies Over Pacific," *Japan Economic Journal*, May 7, 1985, p. 6.

[81]Even JAL accepted that the end of its monopoly position on Japanese international routes was a fait accompli outcome of the negotiations. See the discussion of JAL strategy above.

[82]In 1985, the three U.S. airlines were Pan Am, Northwest, and Flying Tigers; United replaced Pan Am in 1986 and Federal Express bought Flying Tigers in 1989.

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[83] Although it is true that Pan Am, the major U.S. carrier in the Pacific, was nearly bankrupt in the mid-1980's, the Pacific operation was consistently profitable even as the airline disintegrated around this profitable route network.

[84] Although United's strategy in the Pacific did not play out in the context of the 1985 MOU, the episode is worth noting as it nicely demonstrates the role of international bargaining dynamics on firm strategy.

[85] Author's interview with George Aste, 10/31/96, Washington D.C. Aste served in the International Regulatory Affairs office at United from 1978 to 1992.

[86] Author's interview with George Aste, 10/31/96, Washington D.C.

[87] Japan also threatened to hold up the deal on legal grounds that the bilateral did not specify United as one of the incumbent carriers. Following serious U.S. pressure that the deal should be approved by Japan, Japan eventually allowed United to assume Pan Am's Pacific route network. See "Japanese May Force U.S. To Negotiate For United Rights," *The Traffic World*, December 16, 1985., p. 8.

[88] "Japan-U.S. aviation talks are heading toward solution," *Japan Economic Journal*, March 2 1982, p. 3.

[89] "U.S. Plans Effort on Airlines' Competitive Problems Abroad," *Aviation Week and Space Technology*, June 3, 1985, p. 263.

[90] "Asian Aviation Meet Sparks Washington Concern." *JEI Report*, No. 5 (February 9. 1996), and "North America: Zero Sum Game-North Pacific," *Airline Business*, February 1. 1996.

[91] Although the Federal Express case provided the proximate cause of a new round of negotiations, other issues had been simmering since 1992. In particular, a 1992 Northwest decision to apply for Osaka-Sydney rights as an extension of New York-Osaka rights led to a simmering conflict over the correct interpretation of the rights of incumbent U.S. airlines in the 1952 bilateral.

[92] As quoted in "Battles with Japan not over for Kodak, Federal Express," *Chicago Tribune*, July 2 1995, p. 1C.

[93] Most analysts argue that these inefficiencies result from labor costs and productivity, a fact which makes making quick changes in the efficiency of Japanese carriers very difficult. According to a 1993 Economic Strategy Institute Report, U.S. airlines have an average operating expense of 17 cents per mile, compared with 59 cents per mile for Japanese carriers. See Clyde Prestowitz, Don Hilty, Lawrence Chimerine and Laura Sweeney, Turbulence Over the Pacific (Economic Strategy Institute, Washington, D.C.), March 1996.

[94] Kasper, 1988.

[95] Although U.S. incumbents were in principle authorized to serve any and all intra-Asian markets, the U.S. government had de facto accepted Japan's interpretation of the 1952 bilateral--which limited the rights of U.S. incumbents to add new fifth-freedom services--in the late 1970's.

[96] "Foreign airlines in Japan: Flyaway," *The Economist*, November 28, 1992, p. 79. and "Australia: Cook Hopeful of Airline Peace," *Australian Financial Review*, June 15, 1993.

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[97]Twenty-nine percent of JAL's international passengers are in the U.S.-Japan marketplace, with the majority of the remaining passengers on intra-Asian routes. See "Building for the 'New Era.' " *Air Transport World*, Vol. 29, No. 6 (June 1992), p. 23-26.

[98]The following discussion of JAL strategies draws on the author's interviews with senior JAL officials, Washington, D.C., 10/96 and 11/96.

[99]*Aviation Week and Space Technology*, October 5, 1992, Vol. 137, No. 15, p. 32.

[100]As quoted in "Thailand: Thai Aviation Officials Closely Eye U.S.-Japan Dispute," *Bangkok Post*, June 7 1995. See also "Japan: JAL - Cancel U.S. Bilateral," *Airline Business*, June 1 1995.

[101]"Changing Course: Japan Airlines gets inventive," *Air Transport World*, Vol. 31, No. 6 (June 1994), p. 185-186.

[102]On ACCESS U.S.-Japan, see "Economic Scene: Freeing air routes to Japan will help travelers but won't be easy," *The New York Times*, March 7 1996, ACCESS U.S.-Japan, U.S.-Japan Aviation Options (ACCESS U.S.-Japan, 1996), and ACCESS U.S.-Japan, Expanding the U.S.-Japan Aviation Market: Economic Opportunity, Growth, and Jobs (ACCESS U.S.-Japan, Washington D.C.), 1996. Although membership in ACCESS-U.S.-Japan is closely guarded, American and Delta are widely believed to be the two primary supporters of the organization.

[103]See below for a discussion of how domestic political changes encouraged both JAL and ANA to enter alliances with foreign airlines.

[104]The following discussion of ANA's strategy and Japanese domestic politics draws on the author's interviews with Akihiko Tamura, Washington D.C., 10/24/96, Kenichi Uchinami, Washington D.C., 10/25/96 and 10/31/96, Masashi Izumi, Washington, D.C., 10/ 21/96 and 10/29/96, and senior JAL officials, Washington D.C., 10/96 and 11/96.

[105]See "Japan: All Nippon's Move Into International Services has not Proved as Profitable as Hoped," *Airline Business*, September 1992, and "Japan Moving to Strengthen Aviation Industry," *The Reuter Asia-Pacific Business Report*, August 3, 1995.

[106]"Japan Moving to Strengthen Aviation Industry," *The Reuter Asia-Pacific Business Report*, August 3, 1995.

[107]The agreement called for schedule coordination, sharing of facilities and passenger handling, and mutual participation in frequent flyer programs. See "All Nippon, Delta agree to co-operate," *The Financial Times*, June 17 1994, p. 8.

[108]"All Nippon Looks to Asia; Airline is Squeezed at Home and Over Pacific," *International Herald Tribune*, July 12, 1996.

[109]ANA also sought a modification in the bilateral to secure the gains promised by the Delta-ANA alliance which required bilateral changes to make effective.

[110]Author's interview with Masashi Izumi, Washington, D.C., 10/ 21/96 and 10/29/96. On the high cost of international expansion, see "Japan: All Nippon's Move Into International Services has not Proved as Profitable as Hoped," *Airline Business*, September 1992.

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[111]Author's interview with various industry sources, Washington D.C, 10/96 and 11/96.

[112]"Japan should embrace 'open sky' concept," *Asahi Shimbun*, 10/25/96.

[113]Ministry of Transport, "A Review of Aviation Relationship between Japan and the United States," (Ministry of Transport, Japan), July 1996.

[114]Since the mid-1970's, Japan has insisted that U.S. carriers limit their fifth-freedom traffic to no more than 50 percent local traffic. Although the U.S. tacitly accepted that Japan had a legitimate right to limit new services added by U.S. airlines in the late 1970's, the different interpretations offered by the U.S. and Japan over the fifth-freedom rights included in the 1952 bilateral are at the core of the current U.S.-Japan negotiations.

[115]"Asia: Japan Urges Asian Forum," *Airline Business*, July 1 1995.

[116]"Asian Aviation Meet Sparks Washington Concern," *JEI Report*, No. 5 (February 9, 1996).

[117]"Bloc Vows to Resist Inroads," *International Herald Tribune*, February 21 1994, and "Orient airline group prepares to face the U.S. bully-boy challenge," *South China Morning Post*, September 22 1993, p. 6.

[118]In the late 1970's, the U.S. had attempted a similar strategy in Asia, and Braniff and other U.S. airlines had attempted to build hubs in Asian destinations other than Tokyo. This attempt failed, however, as the demand for services and the limited range of existing jet aircraft rendered these alternative hubs economically unviable. Both these factors--local demand and the range of aircraft--had changed by the late 1990's.

[119]Author's interview with Akihiko Tamura, Washington D.C., 10/24/96, Kenichi Uchinami, Washington D.C., 10/25/96 and 10/31/96.

[120]Author's interview with Mike Whittaker, Director of International Affairs, United Airlines, 9/9/96.

[121]As discussed in chapter three and four, the Bermuda regime created protected domestic markets which were connected by coastal international gateways. This model has steadily eroded in the U.S. and Europe, however, as liberalization has facilitated the opening of new interior gateways and the development of immunized alliances has created new "networks" of carriers which provide a complete service to the customer. Although the historical gateways continue to dominate these networks in Europe, liberalization has changed the structure of the trans-Atlantic market to a market based on networks rather than point-to-point services.

[122]In effect, ACCESS-U.S.-Japan wants the U.S. to agree to limit U.S. airlines rights beyond Japan in exchange for increased U.S.-Japan routes. Since this deal would be more palatable for JAL and ANA, ACCESS-U.S.-Japan hoped altering U.S. negotiating strategy in this way would produce an agreement more quickly.

[123]Booz, Allen, Hamilton Shaping Pacific Aviation in the 21st Century: Risks for California (Booz, Allen, Hamilton), September 1996.

[124]See "Crandall Urges U.S. to Push Talks with Japan, Seeking Routes, Not Networks," *Asian Aviation News*, Vol. 3, No. 21 (October 20 1995), and "Doing the right thing," *Air Transport World*,

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Vol. 32, No. 12 (December 1995), p. 57-61.

[125]ACCESS U.S.-Japan, U.S.-Japan Aviation Options (ACCESS U.S.-Japan. 1996).

[126] The group argued that most of the jobs would come in aviation, tourism, aircraft manufacturing and related industries, although broad job growth in other sectors was included in the data. More specific data and calculations, see ACCESS U.S.-Japan, The Impact of Increased Passenger Flights to Japan on U.S. Employment (ACCESS U.S.-Japan, Washington D.C.), July 1996.

[127]ACCESS U.S.-Japan, Expanding the U.S.-Japan Aviation Market: Economic Opportunity, Growth, and Jobs (ACCESS U.S.-Japan, Washington D.C.), 1996. ACCESS U.S.-Japan figures are consistent with data from U.S. Airports for Better International Service (USA-BIAS), an association of civic groups interested in expanding international air services. USA-BIAS estimates that each seat of added capacity in the U.S.-Japan market generates more than $4,600 for the airline and the local community, and that the total U.S. economic impact of a daily 747 service between a U.S. city and Tokyo was $720 million in 1992, the figures cited by ACCESS-U.S.-Japan seemed to be on solid ground.

[128]ACCESS U.S.-Japan, Expanding the U.S.-Japan Aviation Market: Economic Opportunity, Growth, and Jobs (ACCESS U.S.-Japan, Washington D.C.), 1996.

[129]*The New York Times*, March 7 1996, p. D2.

[130]"Sky's the Limit in On-Going U.S.-Japan Air Battle," *Tokyo Business Today*, April 1995, p. 30.

[131]"Sky's the Limit in On-Going U.S.-Japan Air Battle," *Tokyo Business Today*, April 1995, p. 30.

[132]Booz, Allen, Hamilton, September 1996.

[133]Roberts, Roach, & Associates, Getting it right: A response to factual assertions in Expanding the U.S.-Japan Aviation Market (Roberts, Roach, & Associates, Hayward, CA), 1996.

[134]The Booz Allen Hamilton study, for example, calculated that existing fifth-freedom rights were worth as much as $100 billion over the next twenty years.

[135]Booz, Allen, Hamilton, September 1996.

[136]*Aviation Week and Space Technology*, October 5, 1992, Vol. 137, No. 15, p. 34.

[137]"United's Greenwald: We May Agree to Limit Beyond Pax." *World Airline News*, Vol. 6. No. 26 (July 1, 1996).

[138]"Sky's the Limit in On-Going U.S.-Japan Air Battle," *Tokyo Business Today*, April 1995, p. 30.

[139]"Five Airlines Announce a Partnership," *The New York Times*, May 15, 1997, and author's interview with David Mishkin, Vice President, International and Regulatory Affairs, Northwest Airlines, May 1997.

[140]Aviation Relations Between the United States and Japan, Hearings Before the House Committee on Transportation and Infrastructure, Subcommittee on Aviation, 104th Congress, 2nd Session, July 20

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1995 (U.S. Government Printing Office, Washington D.C.), 1995.

[141]Congressional Press Release, March 27, 1996.

[142]Congressional Press Release, March 27, 1996.

[143]As quoted in "Same old story: bilateral aviation dispute between Japan and the U.S.," *Aviation Business*, Vol. 11, No. 8 (August 1995), p. 42.

[144]Federal Register, Vol. 60, No. 85, Notices: Department of Transportation (DOT), Office of the Secretary, [Docket No. 49844], Statement of United States International Air Transportation Policy, Wednesday, May 3, 1995.

[145]*Aviation Week and Space Technology*, November 8, 1993, Vol. 139, No. 20, p. 31-32.

[146]Author's interview with Alec Wilczynski, Office of Aviation Negotiations, U.S. State Department, 10/23/96, Washington D.C.

[147]Author's interview with Alec Wilczynski, Office of Aviation Negotiations, U.S. State Department, 10/23/96, Washington D.C.

[148]"An Open Letter from Northwest Airlines to Access U.S.-Japan Members," *PR Newswire*, September 19, 1997, and "BTCC Urges Guaranteed Open Skies With Japan: Calls Current Japanese Offer a False Choice," *PR Newswire*, September 18, 1997.

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Chapter 7: Conclusion

"The open skies failed, and must always fail-they would be deadly."
William Hildred, IATA Director-General, 1945-1964

7.0 Introduction

In the immediate aftermath of World War II, states created a set of institutions and regulatory arrangements to govern international aviation markets. From 1945 to the late 1970's, the aviation regime provided a set of complicated multilateral and bilateral rules which created a de facto cartel in international aviation services. Supported by powerful domestic constituencies in major aviation states, the Bermuda regime successfully restricted supply and inflated prices to the benefit of particular market participants. In the late 1970's, dramatic changes in the economics and politics of aviation led key governments to question the political logic of the regime. With domestic political interests pressing governments to create more competitive aviation markets, key states attempted to restructure the international marketplace. Today, fiercely political inter-negotiations continue to dictate the rules governing international aviation markets.

This dissertation has explored the creation, maintenance, and change of the rules governing international aviation markets in the postwar era. Chapter two provided the theoretical argument for why the preferences of domestic interests, domestic political institutions, and international bargaining dynamics are both necessary and sufficient to explain the rules governing international aviation markets. The previous four chapters have empirically demonstrated how these variables explain the shape and content of the Bermuda regime, U.S. international aviation policy, and

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the organization of U.S.-U.K. and U.S.-Japan aviation markets. This conclusion reviews the findings of this dissertation, discusses the implications of these findings for the study of international relations, and briefly notes the ramifications of the argument for current efforts at re-structuring international service markets.

7.1 The Domestic Roots of International Rules

This dissertation has argued that the rules governing international aviation markets reflect domestic political bargains in states with significant market power. Powerful states seek to create international regulatory rules which are consistent with and re-enforce domestic regulatory bargains. Although powerful states cannot simply foist international rules on unwilling partners, international market power can often drive changes in the preferences of both firms and politicians in less powerful states, and thereby secure agreement for preferred rules. International regulatory rules are extensions of domestic regulatory arrangements, and the creation, maintenance, and change of international rules is thus likely to reflect domestic political bargains in states with significant market power.

Precisely how domestic politics translate into international regulatory policy, however, requires an understanding of how international bargaining dynamics shape the strategies and preferences of domestic political actors (both firms and national politicians). Explanations focusing on domestic politics have correctly noted the impact of domestic actors on the foreign policies of states. But these approaches, I argued, have neglected the impact of imperfect international markets on the preferences and strategies of these domestic actors. In short, these analysis rested on assumptions of perfectly competitive international markets that are undermined by highly imperfect international service markets. In other words, the insights of the literature on strategic

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trade theory and imperfect markets have not been integrated into our understanding of the domestic politics of international markets.

As I have demonstrated in the previous four chapters, the rules governing international aviation markets has varied across both time and space in the postwar era, variation which I argued reflected different domestic political bargains at different times and in different states. In the immediate postwar period, national governments colluded to create a cartel in aviation services, and international aviation markets were strictly regulated throughout the 1950's and 1960's. Over time, this arrangement came under political pressure as technological and economic changes created demands for more competitive international markets. But understanding the demands for reform was not enough for understanding policy change, as chapter four clearly demonstrated. Demands for reform have been important, to be sure, but the timing and design of liberalization, if any, has reflected how these demands have been refracted through domestic political institutions. International bargaining dynamics have also been important in both shaping the demands of societal actors, and in the strategies and bargaining positions adopted by national politicians. The timing and extent of international regulatory change has thus depended on the preferences of domestic actors, how these preferences are aggregated by domestic political institutions, and how international bargaining dynamics shape the strategies and preferences of domestic actors.

Chapter three provided an analysis of the postwar Bermuda regime. Although the U.S. pressed for the creation of a competitive international aviation marketplace, the British preference for strictly regulated markets and the strong U.K. bargaining position ultimately led to the compromise Bermuda regime. With concerns over the role of aviation in cementing the postwar peace and the preferences of domestic airlines

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driving the negotiating positions of both the U.S. and the U.K., the Bermuda compromise provided a complicated set of multilateral and bilateral rules which satisfied key domestic constituents in both states. The 1946 U.S.-U.K. Bermuda I agreement subsequently became the basis for other bilateral agreements, and the rules governing international aviation markets became known as the Bermuda regime.

The inability of the U.S. to dictate postwar marketplace rules cast doubt on realist approaches to international institutions. Indeed, the U.S. was unable to secure its' preferred international marketplace, despite the fact that the U.S. accounted for 72 percent of world air traffic and the dominant power in the postwar period. Likewise, concerns about the gains from coordination were not prominent in the negotiations leading to the creation of the Bermuda regime, casting doubts upon neo-liberal or functionalist explanations for international institutions. The failure of both realist and neo-liberal approaches led me to an analysis of the domestic political underpinnings of the Bermuda regime. Viewing international institutions as regulatory structures, the analysis highlighted how the particular institutional structure of the Bermuda regime produced marketplace outcomes that benefited dominant domestic coalitions. The organization of the international aviation markets in ways consistent with underlying domestic political regulatory bargains--and the coalitions which supported these bargains--lent support to the argument about international institutions advanced in chapter two. The analysis of Bermuda regime presented in chapter three thus demonstrated two central arguments advanced in chapter two: (1) international approaches to regimes are unable to explain the substantive content of international regimes, and (2) national governments create international institutions to structure international aviation markets in ways favorable to salient domestic political constituencies.

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No system of regulatory rules lasts forever, however, and technological developments, economic growth, and subsequent political changes ultimately undermined political support for the restrictive international aviation markets produced by the Bermuda institutions. As discussed in chapter three, the development of jumbo jets and the growth in disposable income ultimately set the stage for the end of the Bermuda regime. How technology and economics translated into concrete policy outcomes, however, depended on the domestic political landscape in individual states and the market power of particular countries, notably the U.S. As discussed in chapter four, particular features of U.S. international aviation markets meant pressure for policy change emerged first in the U.S. and that the U.S. was be the natural leader in efforts to liberalize international aviation markets.

Chapter four demonstrated how the preferences of domestic actors, domestic political institutions, and international bargaining dynamics explain the timing and content of U.S. policy reversal . Changes in the preferences of key domestic political actors, I argued, set the stage for the adoption of a more pro-competitive international aviation policy. But these demands were not successful in pushing policy change, however, until broad electoral dynamics supported a move toward deregulation of both domestic and international aviation markets. Put simply, U.S. national politicians were unwilling to ignore the opposition of the beneficiaries of the Bermuda regime and implement policy change until deregulation became a prominent political issue to the Democratic party. Once broad electoral dynamics dictated deregulation was a winning political issue, however, Carter launched his pro-competitive international aviation policy as a complement to the on-going process of domestic deregulation. Demands for reform were thus only part of the story, and how U.S. domestic political

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institutions shaped the incentives of national politicians vis-a-vis regulatory change were ultimately the deciding factor in the reversal of U.S. international aviation policy.

New U.S. domestic political bargains did not dictate any particular international bargaining strategy, however. Why did U.S. policy-makers chose one particular international bargaining strategy rather than some other in the pursuit of competitive international aviation markets? The answer, I argued, lay in how international bargaining dynamics, including international market forces, the preferences of other states, and the rules to the status quo, shaped the likelihood of success of different strategies--and thus conditioned the positions taken by the U.S. Specifically, I demonstrated how U.S. bargaining strategy was shaped by existing international institutions and the preferences of other states and was explicitly designed to produce more competitive international markets within the constraints defined by these international constraints.

Chapters five and six analyzed the U.S.-U.K. and U.S.-Japan bilateral aviation markets, respectively. In both chapters, U.S. pressure for more competitive international aviation markets has failed to produce the desired policy outcomes, outcomes which raise serious questions about the utility of realist analyses of international markets. The major empirical puzzle posed by the history of U.S.-U.K. was straightforward: if both national governments are committed to pro-competitive international aviation markets, why has comprehensive liberalization proved impossible? The answer to this question, I argued, lay in how international bargaining dynamics, particularly the set of existing rules and property rights inherited from the Bermuda regime, shaped the strategies and preferences of key economic actors and thus made liberalization politically problematic. Domestic political institutions were also important in shaping the outcomes of the negotiations, with the multiple veto

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points provided by U.S. domestic political institutions rendering piecemeal liberalization problematic and weak U.K. competition laws making U.K. proposal problematic for the U.S. government. The U.S.-U.K. marketplace thus demonstrated how international bargaining dynamics shaped the preferences and strategies of firms, and thus rendered international liberalization extremely difficult.

Chapter six takes up the question of why U.S.-Japan aviation market remain governed by the restrictive 1952 bilateral, despite massive pressure from the U.S. The answer to this question, I demonstrated, lay in how Japanese domestic political institutions provided incentives for Japanese national politicians to maintain strict control over international aviation markets in order to protect inefficient Japanese airlines from more competitive U.S. carriers. But international bargaining dynamics were also important for understanding why significant U.S. pressure and U.S. bargaining strategies explicitly designed to pressure Japan into more liberal aviation policies have failed. Indeed, the question posed by U.S.-Japan aviation markets was not so much why Japan has been opposed to further liberalization, but why Japan has been able to rebuff U.S. efforts at liberalization. I answered this puzzle by arguing that the structure of international markets meant that Japan could resist U.S. pressure for more competitive markets. Unlike in Europe, where U.K. airlines faced the threat of traffic diversion and thus felt competitive pressures to liberalize U.S.-U.K. markets, the threat of traffic diversion is unimportant to Japanese airlines simply because Japan is and will remain the most important aviation market in Asia. In other words, U.S. airlines have no choice but to base their Asian operations in Japan, and the Japanese government can thus continue to regulate both U.S.-Japan and intra-Asian markets in order to protect Japanese airlines. Japanese market power thus meant that Japanese

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national politicians have been able to continue to protect Japanese airlines from the more competitive U.S. airlines.

To summarize, understanding the rules governing international markets requires understanding what national politicians want from international regulatory rules. I have argued that firms endogenize both domestic politics and international market dynamics when launching strategies, while politicians endogenize international bargaining dynamics when launching strategies designed to secure policy outcomes favorable to domestic constituents. Although the postwar Bermuda regime provided a uniform set of rules for almost all aviation markets, technology and economic changes had led different states to adopt divergent international aviation policies in the past twenty years. Divergent firm preferences and domestic political institutions have thus produced a set of distinct rules in individual bilateral markets. Indeed, individual bilateral aviation markets are now governed by different regulatory rules: many governments have accepted significant competition in aviation markets while others have defended their national flag carriers by maintaining strict regulatory control over the marketplace. Significantly different regulatory environments thus govern different parts of the international aviation marketplace. The scope, timing and design of the changes in international rules, I demonstrated, reflected the impact of firm preferences, domestic political institutions, and international bargaining dynamics.

7.2 International vs. Domestic Explanations?

Explanations for international regulatory policy have come in two different guises: (1) analyses which find answers at the international level, and (2) analyses which seek to demonstrate how domestic politics shape the foreign policies of states and thus the structure and content of international markets. As I argued in the

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introduction, scholars at the international level often ignore domestic politics, while scholars of domestic politics often ignore the insights of the realist and neo-liberal literature on international regimes. That discussion will not be reiterated here, but it worth noting that I highlighted two distinct problems for existing explanations: (1) problems of omission, and (2) problems of mis-specification. As a remedy to these problems, I argued in this dissertation that it is necessary to understand both domestic level variables and international level variables to understand the domestic political roots of international regulatory policy. More specifically, I argued that we must understand the impact of international bargaining dynamics on domestic politics in order to fully understand the domestic political roots of international regulatory policy.

From a strategic choice perspective, I have argued that we must study the complete game faced by actors, from domestic institutions to international bargaining, in order to understand the strategies and preferences of domestic actors. In arguing that both firms and national politicians look down the game tree to the international game when adopting strategies, however, I have undermined the very notion of international vs. domestic level explanations. Since Waltz's publication of Man, the State, and War in 1959, the three analytic constructs defined in that book have dominated approaches and intellectual debates in international relations.[1] Debates about the relative merits of international vs. domestic level explanations have been particular important in the past twenty years, with proponents of domestic level explanations successfully attacking the orthodoxy of realism in the past twenty years. That debate has been won by neither side, and proponents of both approaches have had both their successes and failures. The debate is in fact un-winnable, as different questions require different theoretical apparatus to provide compelling explanations. The important thing to note, meanwhile, is that domestic and international level explanations are only analytic constructs created

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to help analysts organize the world and thereby render complicated empirical reality more amenable to scientific analysis and theory-building. The question facing scholars of international relations is thus not whether domestic or international explanations are better or worse, but rather whether or not these analytic constructs are useful for organizing the empirical world and thus rendering theoretical analysis possible.

The argument I have advanced in this dissertation suggests that the international vs. domestic debate has interfered with our understanding of the rules governing imperfect international markets. Rather than relying on domestic or international explanations, I have attempted to define the strategic setting facing domestic actors (both firms and politicians) and sought to understand their behavior within this strategic setting. Domestically, this setting included domestic political institutions. Internationally, this setting included international market forces, the preferences of other states, and the rules to the status quo. By carefully defining the entire strategic game faced by firms and politicians, I sought to understand how these actors pursued their goals within the parameters dictated by both domestic and international constraints. In defining the strategic setting in this way, and asserting that domestic actors look down the game tree to international bargaining dynamics when adopting strategies, I in fact undermined the artificial divide posed by domestic vs. international explanations.

I have thus adopted what is known as the strategic choice approach to international relations in this dissertation.[2] Rather than entering into debates on the merits of domestic or international explanations for policy outcomes, the strategic choice approach asserts that it might be more fruitful to approach the world as a series of strategic situations. By differing the preferences, the constraints, or the information available to actors, the approach seeks to understand international relations from a

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game theoretic perspective. The underlying premise of the strategic choice approach is straightforward: the division of approaches to international relations according to the level of analysis is only one way to organize empirical reality, and theory-building can be more fruitfully pursued by thinking about events as a series of strategic situations which vary according to the preferences of the actors, the constraints faced by actors, and the information available to these actors.

To date, most scholars of international political economy working in the strategic choice tradition have not self-consciously addressed the impact of international constraints on domestic actors. Indeed, although scholars of security have employed the strategic choice approach to understand a variety of important issues in international security, scholars of international political economy have remained focused on domestic politics.[3] This dissertation thus seeks to contribute to this research agenda by demonstrating how international constraints shape the strategies and preferences of domestic political actors. In other words, this dissertation seeks to demonstrate the impact of the international game on the domestic game, and how in turn the domestic game shape the international game in which actors pursue their goals. Looking down the game tree to how international bargaining dynamics shape the strategies and preferences of both firms and national politicians allows me to contribute to the strategic choice research agenda in this way.

7.3 Lessons for Present Efforts at Liberalizing Services

Behind the controversy over how international aviation markets should be organized lies the huge economic significance of the industry. Directly and indirectly accounting for as much as six percent of global GNP, airlines make the much ballyhooed process of globalization possible. Just-in-time sourcing, technical support,

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technology transfer, global economies of scale and scope and multinational management all depend on safe and effective international travel networks. Likewise, the international travel industry--the largest industry in the world and one in which significant areas of the developing world now depend for economic growth--depends on aviation services as one of the major inputs. In short, the rules governing international aviation markets have tremendous economic impacts. As I argued in the Introduction, aviation services are also important because they are representative of other services industries: governed by restrictive sector-specific institutions for most of the postwar era, these institutions are coming under increasing pressure from advocates of liberalization. Liberalizing international service markets thus represent both the major challenge facing the advanced industrialized states, and the most promising avenue for expanding the gains from an open international economy. Understanding the domestic political roots of international aviation markets, and how the strategies of domestic political actors are shaped by international bargaining dynamics, thus has important implications for scholars and policy-makers alike.

I have argued in this dissertation that international regulatory rules can be viewed as extensions of domestic political bargains. The post-war regulatory rules in services were thus created because they were supported by important domestic constituents. Changing these restrictive rules, in turn, thus requires the construction of domestic political coalitions in support of new international rules. This argument, however, suggests that international regulatory change is more complicated than both scholars and casual analysts suggest: the U.S. does not simply "force" other states to alter their bilateral service markets or delegate authority over particular service markets to the World Trade Organization (WTO). Delegating authority to international institutions or agreeing to new bilateral rules are political choices made by national

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politicians in foreign states, not simply reactions to U.S. pressure. But the U.S. can encourage liberalization by relying on international bargaining dynamics, in particular international market forces, to alter the strategies and preferences of domestic actors in foreign states. As I demonstrated in chapter four, for example, the U.S. was able to dramatically alter the incentives of foreign airlines by withdrawing anti-trust immunity from IATA and thereby unilaterally changing the reversion point of no new bilateral agreements. Similar tactics in international telecommunications markets have been successful in prodding substantial reform of international telecommunications markets.[4]

The point in the preceding discussion is to suggest that a careful understanding of how international bargaining dynamics shape the preferences of domestic actors can help policy-makers construct the proper policies to secure the desired policy goals. As I have suggested often in this dissertation, international regulatory policy requires the participation of many states--a fact which means national governments must seek the cooperation of foreign states to secure policy goals in international markets. Securing policy goals, then, requires an understanding of the domestic political bargain on which existing rules rest, and the coalition which must be constructed to support any new set of rules. Put differently, inter-state cooperation and the creation of international regulatory rules is a matter of constructing the domestic political support for particular cooperative arrangements. Ultimately, understanding the complete domestic political game, including how this game is shaped by international bargaining dynamics, is necessary for policy-makers to construct international bargaining strategies which will allow them to successfully achieve their international policy goals.

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