

WORLDWIDE AIR TRANSPORT CONFERENCE: CHALLENGES AND OPPORTUNITIES OF LIBERALIZATION

Montreal, 24 to 29 March 2003

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THE NEED FOR GREATER LIBERALIZATION OF INTERNATIONAL AIR TRANSPORT

(Presented by the International Chamber of Commerce)

INFORMATION PAPER

1. INTRODUCTION

1.1 The International Chamber of Commerce (ICC) has since its inception supported the freer flow of trade and investment across national borders. In this context, ICC supports a freer exchange of air services throughout the world, under competitive conditions transparent for all users of the air transport system. With the rapidly changing economic environment brought on by trade liberalization, globalization and e-commerce, it has become increasingly clear that bilateral air service agreements, while they have led to steady improvements, can no longer of themselves meet the rapidly changing needs of airlines, users or the global economy.

1.2 The efficiency of air transport would be enhanced by creating more open markets and more flexibility with regard to foreign ownership. Because air transport is so important a facilitator of economic activity, its further liberalization would also allow sectors that make use of its services to become more efficient.

1.3 Many national governments are actively seeking more open markets for their air carriers. Regional economic arrangements, such as the European Union (EU), have removed economic constraints on airline ownership and operations within their borders. International agencies such as the Organization for

Economic Co-operation and Development (OECD) have become active advocates of air transport liberalization. There is much merit in pooling ideas and seeking a common approach to the issues facing the future of the industry and its users.

1.4 This statement proposes options for accelerating the pace of liberalization and for addressing the obstacles that remain.

2. THE CURRENT SITUATION

2.1 As the primary mode of long distance transport within and between nations, air transport has become a crucial facilitator of economic activity. As such, it plays an essential role in the development of national economies and, by extension, in the health of the global economy.

2.2 The international air transport sector has grown under a complex regime of regulations since the conclusion of the Chicago Conference of 1944. Lack of agreement at that time on how the market for air services should be regulated led to the growth of bilateral agreements between countries. These were generally restrictive and they controlled market entry, fares, and service levels. Such a system probably did little to impede the growth of international air transport in the early years, but as technology has evolved and markets have developed, the limitations of such bilateral air service agreements have become apparent.

2.3 The rapid deregulation of the US air transport market from 1977 on gave an impetus for international reform of both cargo and passenger air services. Considerable progress has been made since that time in liberalizing international air transport. Some of the changes have come through renegotiation of bilateral agreements to remove many barriers to competition. The Open Skies policy of the US, although it took time to become effective, reflected a new approach to international markets. From the early 1990s, it allowed the US and many trading partners to sign a liberal template bilateral accord, which has led to a common framework of agreements. The US Open Skies policy is a conspicuous example of bilateral liberalization: by the end of the year 2000 some fifty such accords will have been signed.

2.4 The emergence of an internal EU air transport market represents a major achievement in creating a liberal regional market for air services. The three packages of reform introduced over a decade from the mid-1980s gradually removed impediments to the free provision of transport services within the EU. An airline substantially owned and effectively controlled by citizens of a country within the European Economic Area (EEA) can now establish itself anywhere within the EEA and can offer services, including cabotage, within the area. There are no tariff controls (except in very clearly defined and exceptional circumstances) and there is a gradual movement to liberalize and introduce effective competition in ancillary services.

2.5 There are other, more recent harbingers of freer trade areas in air services. The most recent example is that of five Asia Pacific Economic Cooperation (APEC) countries concluding a new, multilateral agreement in November 2000. Western Hemisphere nations have pledged to create the Free Trade Area of the Americas (FTAA) by 2005. These are developments less extensive than the EU Single Market in air services, but they represent movements forward. The Yamoussoukro Decision reached in July 2000 at the Organization of African Unity meeting in Togo is a similar move towards liberalizing intra-African air transport.

3. GATS AND AIR TRANSPORT

3.1 While other sectors of the economy have benefited from a multilateral trading regime initiated by the General Agreement on Tariffs and Trade (GATT) and continued within the World Trade Organization (WTO) framework, air transport services have, so far, not followed that pattern. There is difficulty in reconciling bilateral air service agreements with the GATT principles of Most Favoured Nation (MFN) and national treatment, because access to agreed routes is limited to national carriers of the bilateral parties. Consequently, only three areas of air transport are explicitly included in the transport annex of the General Agreement on Trade in Services (GATS) at the present time: aircraft repair and maintenance services, computer reservation system services, and the selling and marketing of air transport services. Leasing as a separate service activity is also covered in the GATS.

4. THE OUTSTANDING ISSUES

4.1 Bilateral agreements

4.1.1 The structure of bilateral air service agreements originated in the early days of air transport and has developed since adoption of the Chicago Convention of 1944. It allows countries to retain traditional controls over access to their air transport markets. In practical terms it is a system countries are familiar with, and one in which change is generally straightforward since it does not entail a large number of consenting parties.

4.1.2 However, since the system has tended to focus on individual routes or small sets of routes between pairs of countries, it has led to difficulties in arriving at a high level of efficiency over global networks of air services. Also, the bilateral system has not developed evenly and as a consequence there remain bottlenecks in the overall air transport network. Many bilateral agreements are still restrictive. These introduce impediments that among other things prevent carriers from planning their route networks purely on the basis of commercial considerations.

4.1.3 Although recent liberal bilateral agreements (e.g., US Open Skies agreements) have dramatically improved the situation in some markets, many important issues are still strictly controlled, e.g., ownership and control, cabotage, and the right of establishment. Thus, even the Open Skies model preserves many of the anachronisms that distinguish the international air transport sector from most other globalized industries. These restrictions prevent free trade in air transport services and optimal capital movement and as a consequence push up costs of production. National differences in the way these market impediments operate also make it difficult in the current bilateral system to bring about their removal.

4.2 Limits on foreign investment

4.2.1 Freer trade and movement of capital across borders require open investment policies. In practice, partly due to the need to have 'national' airlines under traditional bilateral agreements, governments restrict foreign investment in airlines. In 1994, ICC advocated the easing of limitations on foreign ownership to airlines, stating that "air transport development should be determined by economic and technical considerations and not by questions of national pride and national ownership." The US, for example, allows only a 25 per cent foreign voting right and, for investors from Open Skies signatories, a maximum 49 per cent

equity holding. In the EEA, for example, while there are no restrictions on the amount a member country citizen can invest in an airline registered in another EEA member State, there remain limits on non-EEA shareholdings. As a result, air carriers cannot generally establish themselves outside of their "national" State and cannot take a majority share in, or fully merge with, a foreign airline. There are examples of multi-national airlines such as SAS, Air Afrique and Gulf Air, but these are exceptions. Many airlines are still State-owned. There remains the need for an internationally accepted structure of airline registration to avoid flag of convenience problems, but efficiency in service provision would be significantly advanced by permitting a freer flow of capital in the airline sector.

4.3 Competence over aviation rights

4.3.1 The development of free trade areas, and the potential promise of agreements between trade blocs, have raised the issue of the competence to negotiate these agreements. This is the case within the EU where there is a need to achieve a common position, most notably with respect to a possible negotiation with the US. The issue is whether negotiations on aviation rights must be held at the Community level or whether they can still be conducted at the national level. Failure to resolve such questions impedes the prospects for wider international negotiations and the potential for further liberalization. ICC urges the prompt clarification of such situations.

4.4 Divergent competition policies

4.4.1 As set forth in its 1997 policy statement, "Convergence of competition law and policy in the field of air transport", ICC, in keeping with its support for a freer exchange of air services throughout the world, notes the growing number of cross-border alliances, notably in transatlantic markets, and notes the potential in this context for the unilateral application of competition policy. This creates a lack of coherence between air transport regimes and uncertainty for users and airlines. Accordingly, ICC reaffirms its conviction that efforts should be undertaken to reduce these differences and thus to enhance the stability and predictability of the legal framework within which the increasingly globalized airline industry operates.

4.5 Fiscal policies

4.5.1 Air transport is the subject of many taxes aimed at financing general government expenditure. These act to increase travel costs and to reduce mobility. ICC, in its 1997 statement "Taxes on International Aviation: A 1997 Update", urged the reduction of such taxes, making them transparent whenever imposed and limiting authority for their imposition to central governments.

4.5.2 There has been a long tradition of subsidizing certain aspects of air transport for political, social, economic, and strategic reasons. These subsidies are diminishing as air transport becomes more commercially oriented and ICC welcomes this change. Nevertheless, subsidies remain. In many cases they are explicit and direct but in others they come in the form of cross-subsidies applied through mechanisms such as route licensing and state monopolies regimes. Subsidies distort markets and ICC supports their removal. ICC notes that it has already expressed its strong disapproval of state aid in its 1995 statement "State Aid to Airlines" which concludes that "State assistance to airlines, whether direct or indirect, should be deemed to distort the market and to be detrimental to airlines and users." If subsidies are used, for instance for regional economic or social reasons, they should be transparent and phased-out as rapidly as possible.

4.6 **Customs impediments**

4.6.1 International transport by all modes normally involves the need for customs clearance. This can be time consuming and costly for the transport service supplier. It can be a particular cost on air transport where speed and reliability of delivery are important attributes. ICC, the OECD and other organizations have proposed ways of facilitating simplified customs clearance and ICC welcomes the benefits that adopting these measures would have for the air cargo sector in particular.

4.7 **Infrastructure access**

4.7.1 Infrastructure constraints can be a particular impediment to market entry in air transport. Many airports are now operating at their design capacity and the efficiency of the air traffic control (ATC) system is limited by major bottlenecks. Further liberalization of air transport would increase demand, which could lead to further constraints on the capacity of airports and ATC to meet this demand effectively. ICC urges governments to treat the need for improved ATC technology and expanded airport infrastructure as priority issues. Failure to address them effectively will seriously impede economic growth generally.

4.7.2 Ground handling monopolies can also be another barrier to the provision of air services on a commercial basis. Ground handling should be open to competition, with privatization and divestiture from national carriers.

5. **POTENTIAL PATHS TO FURTHER LIBERALIZATION**

5.1 The challenge in moving toward multilateral liberalization of air transport is one of choosing an appropriate path. With the inexorable trend toward globalization, there is a growing recognition of the limits of the current bilateral framework and the need to launch an initiative toward genuine liberalization of air services. ICAO supports the process of progressive liberalization, accompanied by safeguards to ensure the effective participation of all states in international air transport. The OECD and others are also examining possibilities for furthering reform. The Association of European Airlines (AEA) proposal for a Transatlantic Common Aviation Area (TCAA) is a comprehensive proposal to replace the current fragmented regulatory regime by a unified system that gives airlines commercial opportunities on an equal basis, and ensures that their activities be governed by a common body of aviation rules. Indeed, different paths could be pursued in parallel, and complementary to one another, toward further liberalization of air transport:

- a) **Liberalization within the bilateral framework** whereby, when bilateral agreements are renegotiated, specific provisions using defined standard terms may be incorporated. Such provisions might include open route exchanges, multiple designation, capacity freedom, pricing freedom, open third and fourth freedom rights, and so on. This type of approach enjoys the benefits of introducing a degree of uniformity into the existing, though disparate, system of agreements without disrupting their basic structure. A challenge would be that there may be few common concepts of practical importance which all or a significant number of countries would accept on a purely bilateral basis.

- b) **A lead sector approach**, whereby specific markets, such as cargo services, are liberalized first, with these providing a basis for subsequent liberalization of other services. In particular, with the strong growth in air-freight traffic, liberalization of cargo markets could have significant add-on effects. ICC was one of the first advocates, in 1998, of a separate agreement for the liberalization of air cargo. The OECD proposes two alternative paths for further liberalization of air cargo: a protocol to existing air service agreements, liberalizing a number of cargo specific barriers, or a multilateral agreement that would facilitate a more immediate liberalization of air cargo services. Possible advantages of that approach are improving efficiency in fields where there is some common ground for agreement, and demonstrating the benefits for a subsequent widening of the liberalization process.
- c) **Phased multilateralism (plurilateralism)**. This involves a gradual branching out from a single core of like-minded states which establish fully liberalized air transport markets among themselves. New members either need the agreement of existing participants or can join simply by agreeing to the terms in place. It would allow like-minded member states to come together fairly quickly and avoid forcing reluctant states into a rapid change in policy. The latter could join whenever they feel it is appropriate. Transitional arrangements, without burdensome preconditions other than some basic minimum requirements, would be envisaged to provide for the accession of new states to the multilateral agreement.
- d) **Full multilateralism**. Here, in every participating country it is possible for an airline to compete for passengers and cargo regardless of its nationality. This would in the long term entail the opening of cabotage to all carriers as well as freedom to supply services in international markets. This is the ultimate free market situation that would yield maximum economic efficiency. Such a situation could be achieved in a number of possible fora, including aviation-specific diplomatic conferences and the WTO. For example, the GATS rules provide clarity and legal certainty to all participants, non-discriminatory treatment and the advantages of the WTO dispute settlement procedure. However, certain issues would need to be addressed, including the application of most favoured nation treatment to air transport services, the availability of reservations, and reciprocity.

6. A PRAGMATIC APPROACH

6.1 ICC believes in the multilateral liberalization of all goods and services and also believes that, as a general matter, the WTO has proven to be the most effective mechanism for achieving such liberalization. ICC recognizes, however, that the air transport sector possesses particular characteristics that may be seen as complicating the inclusion of direct market access (traffic rights) in the GATS at this stage. Governments seeking the most rapid path to liberalization may feel that the prospects for achieving agreement on including air transport within an agreement as widely subscribed as GATS are too uncertain, and that other, more predictable avenues are preferable – at least in the near term.

6.2 Accordingly, ICC recommends that an initiative be launched for the negotiation of an agreement between like-minded countries to liberalize air transport between them. Some promising current

initiatives include the multilateral agreement just concluded by five like-minded APEC countries and the FTAA. These initiatives would establish a minimum threshold of liberalization beneath which a participating country could not go in the future.

6.3 Another useful model is the AEA's proposal for the creation of a Transatlantic Common Aviation Area. This is a liberalization initiative that comes from industry, offering a practical way forward toward truly genuine multilateral liberalization of air transport services.

6.4 The TCAA identifies four core areas as targets for initial action:

- a) liberalization of the freedom to provide services;
- b) liberalization of regulations over airline ownership, right of establishment, and control;
- c) convergence and harmonization of competition policy; and
- d) liberalization of regulations on leasing of aircraft.

6.5 The TCAA also contemplates a genuine grant of competence to the European Commission to negotiate traffic rights. ICC supports many of the proposals set forth by the AEA.

6.6 Both the TCAA and APEC initiatives advocate liberalization on an incremental and regional basis, beginning with the US-EU market in the case of the TCAA and with the Asia-Pacific market in the case of the APEC initiative, and then spreading elsewhere by offering the prospect to other like-minded states of joining. Over time, one or more of these initiatives could evolve into a more widespread multilateral arrangement.

6.7 ICC, the world business organization, commends the European airlines and the five APEC countries for developing their proposals for air transport liberalization. ICC already supported the creation of a "Common Aviation Area" between the US and the EU in its 1997 position "Convergence of competition law." The proposed TCAA is predicated on a constructive, evolving dialogue between the EU, the US and other governments, as a basis for developing the framework for a comprehensive agreement, which would then be open to participation from other countries. The APEC initiative is similarly premised on negotiating a comprehensive agreement among a small number of like-minded countries which would then be open for accession by other countries in the region and around the world.

7. SUMMARY AND RECOMMENDATIONS

7.1 ICC is in favour of a freer exchange of air services throughout the world. ICC believes that it is time to move beyond the bilateral system, toward a genuine multilateral liberalization of air transport. Such an environment will facilitate the globalization of air transport markets, to match the globalization of other sectors of the economy.

7.2 ICC also recommends that air transport developments be determined by economic and technical considerations and not by questions of national pride and national ownership. Change will be considerably accelerated if industry pushes for the necessary advances to be made.

7.3 Air transport can only fulfil its economic role if there is adequate and appropriate infrastructure. ICC therefore supports the improvement of ATC technology and the expansion of existing airport capacity as a priority.

7.4 There are many paths to liberalization. The various approaches can be combined with the goal of seamless liberalization. Regional approaches, for example, can be pursued in parallel with further bilateral reforms, or in conjunction with lead sectors such as cargo. These could indeed offer a series of test beds for the development of wider agreements, ultimately within a region-to-region framework. A combined approach also provides for at least some potential improvements in the supply of international air services, while issues holding up fuller liberalization are resolved. Any large scale reforms should be tailored so that they can be extended to countries or groupings of countries that are originally outside of the arrangement but pursuing their own liberalization strategy.

7.5 Ultimately, just as in the trade of other goods and services, there must be an underlying legal structure for international air transport. In the short-term, ICC recommends that discussions on existing and potential frameworks be expanded and accelerated, noting that related issues, such as competition policy, must be pursued as an integral part of these discussions. Once a more liberal environment is achieved, this would create a more favourable context for consideration of a new agreement within a new, aviation-specific diplomatic conference, or existing bodies such as ICAO, or of further GATS coverage of the air transport sector.

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