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A New Policy is Required for Air Transportation

By Mary-Jane Bennett

Executive Summary

> ***U.S. departure flights are cheaper... because of a dormant air transportation policy in Ottawa.***

When in 2004, American low-cost carrier, Allegiant first noticed that half of its passengers at the border airport in Bellingham were Canadian, it quickly strategized to lure even more Canadians with "cheaper fares, different choices and cheaper parking." Soon other U.S. low-cost carriers were chasing the same market at the dozen or so airports just south of the Canadian border. The strategy, to attract even more Canadian passengers, had an added bonus: the carriers didn't even have to come to Canada, Canada came to them—at the rate of about five million passengers a year. Since then, several U.S. cross-border airports have either expanded or are in the process of doing so.

Canadian carriers are not to blame. U.S. departure flights are cheaper —by an average $428 for a round-trip ticket—because of a dormant air transportation policy in Ottawa. In the U.S., a different view reigns. With commercial aviation generating nearly nine per cent of domestic jobs in the U.S., air transportation is seen as critical to economic growth, jobs and trade. They see improving and expanding the air sector as a national priority. Canada, by contrast, considers its air industry a source of tax revenue. The lack of competitive policy in Canada is resulting in job loss and reduced regional and GDP growth.

Two factors fuel higher ticket prices in Canada. First, Canadian air tickets are ratcheted up with federal taxes. As a result, this portion of the ticket is close to three times higher than a corresponding U.S. ticket. Second, base fares are substantially higher because of factors, such as higher Canadian airline labour wages, lower labour productivity, a less favourable tax regime and a narrower capital market.

A significant factor fuelling higher base fares is the anti-competitive stance taken by Ottawa on the entry of foreign carriers to the market. Although Canadian carriers deserve consideration, Canadian cities and consumers are surely worth equal weight in determining Open Skies issues. When dealing with the protection of international alliances, the alliances' interests should receive less weight than Canadian cities, their economies and travellers. Domestic competition could be enhanced by allowing a new foreign carrier to enter the market. Virgin's entry in Australia (now Virgin Australia Airlines) stimulated the domestic market and resulted in Australia experiencing some of the lowest domestic air fares in the world.

The five million Canadians who cross the border to fly U.S. carriers every year should signal to the federal government that new policy is required.

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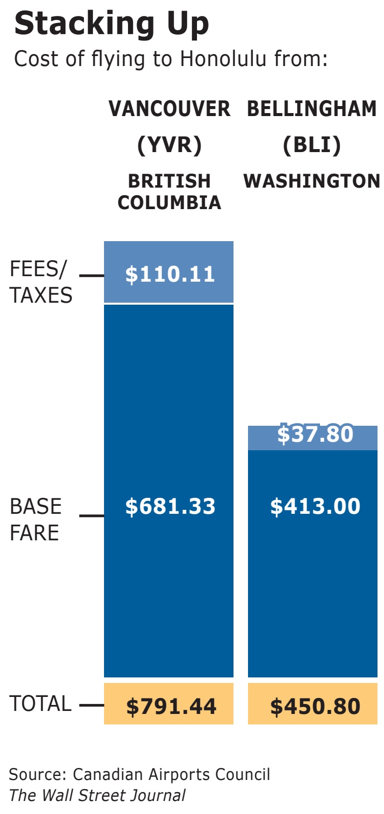
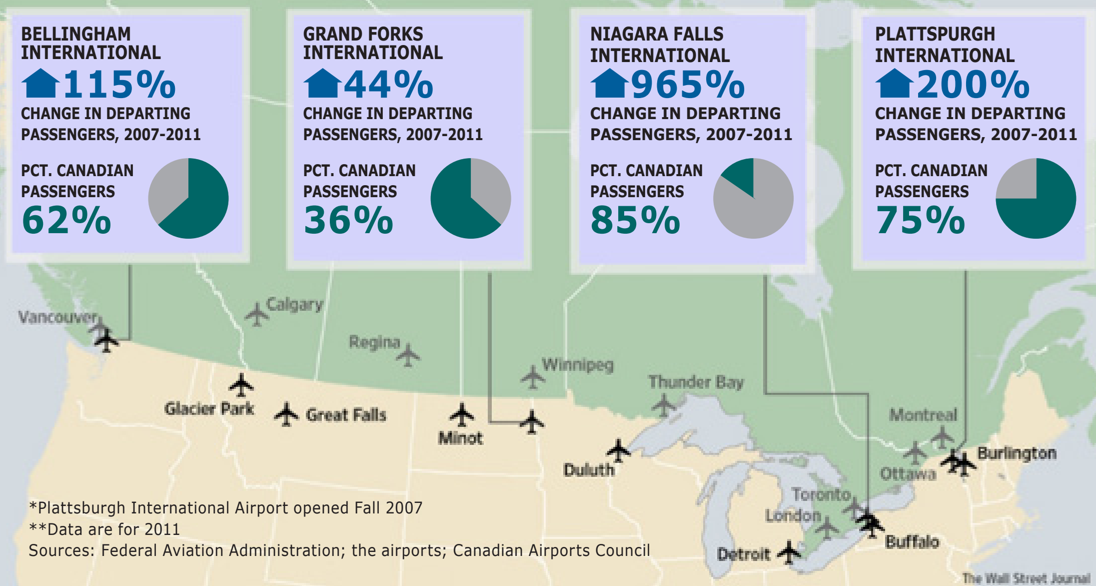
The problem: Canadian air tickets are too high

Simply choosing a U.S. over a Canadian departure airport saves travellers an average $428 round-trip per person according to the Canadian Airports Council. For a family of four, that means a saving of $1,712. With 75 per cent of the Canadian population living within 90 minutes of the U.S. border, it is not surprising that every year almost five million Canadians are travelling to U.S. airports to take advantage of reduced airfares and over one and a half million more weigh the option.

It's so bad that New York's Plattsburgh International Airport, located one hour south of Montreal, markets itself as 'Montreal's U.S. Airport.' Canadians make up 75 per cent of passengers at that airport, 85 per cent at New York's Niagara Falls International Airport and 62 per cent at Washington's Bellingham International Airport, one and a half hours from Vancouver.



> **Simply choosing a U.S. over a Canadian departure airport** *saves travellers an average $428 round-trip per person...*



> **At the dozen or so U.S. airports strung along the border, cheap flights have resulted in a Canadian passenger exodus.**

At the dozen or so U.S. airports strung along the border, cheap flights have resulted in a Canadian passenger exodus. Passenger numbers have tripled and airport expansions have been planned or undertaken.

Passenger drain is hurting Canada's airlines and airports and is stalling job growth: every 1000 passengers represent about three full-time jobs and a daily 747 flight translates to 400 airport jobs. Passenger drain to the U.S. results in an annual loss of about 11,000 jobs and a GDP loss of $1.3-billion according to the Canadian Airports Council. Higher fees and charges also affect tourism, cargo shipments and business connectivity to global markets.

Believe it or not, WestJet and Air Canada are not to blame. U.S. airline tickets are cheaper for two reasons. First, the Canadian ticket price is ratcheted up with federal taxes, fees and surcharges. By contrast, air transportation in the U.S. is subsidized. Second, the base fare, that is, the price before the taxes, fees and surcharge add-ons is cheaper—by about 30 per cent—because of the lack of airline competition and other factors, such as airline labour issues and aircraft tax and financing considerations.

Both reasons behind higher Canadian airline tickets require further analysis.

1. Taxes, fees and surcharges:

Washington, unlike Ottawa, fully subsidizes its air transportation sector resulting in cheaper flights. Subsidization of the U.S. industry is all-encompassing, covering airports, air navigation, airport security and financing. In Canada, by contrast, air transportation has become a cash cow for Ottawa which collects fees, taxes and surcharges from travellers totalling about a billion dollars annually.

Washington subsidizes its airports through a generous Airport Improvement Program. Not only are U.S. airports subsidized, they do not pay ground rents, are not subject to municipal property taxes and are able to fund capital projects through an attractive municipal tax-free bond issue. Washington fully covers air navigation and funds a hefty portion of the air transportation security costs. As a result, U.S. airports are actively spurring economic activity.

In Canada, fees are either paid for directly by passengers or indirectly paid by them through higher ticket prices. For example, the onerous ground rents which Ottawa charges the airports are paid by airports passing the fees on to airlines in terminal and landing fees and the airlines passing that fee on to passengers in higher ticket prices. Air transportation security charges, air navigation charges and Airport Improvement Fees (used to fund airport expansion) are directly reflected in the ticket. Taken together, the result is higher ticket prices charged to Canadian travellers,

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passenger drain to the U.S. and slowed economic activity.

Canadian economists conclude that policy change could level the competitive playing field and turn around the state of Canada's air transportation sector. The areas targeted for change are: fuel excise tax, airport ground rents, municipal taxes, air transport security charges and NAV CANADA fees.

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New policy in these areas would return two million passengers to Canada, estimates the Conference Board of Canada in its October, 2012 report. Although change would result in the loss of government revenues in the short term (via the charges, fees and surcharges attached to the airline ticket and airport), the Conference Board concludes that the loss would be recaptured through the direct and indirect tax revenue generated by the additional traffic.

In each of these areas—jet fuel tax, airport ground rents, municipal airport taxes, airport security taxes and NAV CANADA fees—change is both necessary and fair.

The federal jet fuel tax—a levy on domestic flights—originated as a means to finance airports. However, Ottawa no longer finances airports since the 1994 transfer, off-loading them and their operating and expansion costs to the current not-for-profit airport authorities. Fred Lazar of York University's Schulich School of Business argues that with the federal government no longer financing airports, fair policy requires the elimination of the tax. The federal portion of the tax amounts to four cents per litre in Canada—which disappears into the federal treasury—and about one and a quarter cents a litre in the U.S.—which gets re-invested in aviation.

Canada's eight busiest airports pay a combined $270-million dollars a year in airport ground rent to the federal government, representing about 11 per cent of airport revenues. U.S. airports, by contrast, operate rent-free. In its recent report, The future of Canadian air travel: toll booth or spark plug?, the Canadian Senate recommended that airport rents be phased-out, given they represent an airport's largest expense and are part of the reason behind passenger drain.

In Canada, the basis of municipal taxing of airports differs from city to city. Although some cities base their taxing structure on the value of the airport property and improvements, other cities base them on passenger volumes. Both taxing structures, however, ignore the airport's crucial contribution to the municipal economies. No major airport in the U.S makes municipal tax payments. The attempt in the 1990's to impose a municipal levy on Los Angeles International Airport (LAX) highlights the different attitudes to airports in Canada and the U.S.

After the massive rioting in Los Angeles in 1992, L.A. faced hefty rebuilding costs and attempted to boost city coffers with a tax on LAX. The Air Transportation Association of America (ATAA), now Airlines for America,

opposed the levy with its Vice-President warning that over-taxing airports ultimately causes passengers to flee airports. LAX, he added, was "the one thing in the city that works." Congress not only agreed with the ATAA position but responded with legislation to ensure the "prompt and effective enforcement" of any attempt to divert revenue from an airport through municipal taxing schemes.

The Canadian Air Traveller's Security Tax (ATST) is the highest security tax in the world with the federal government taking $380 million annually from Canadian air travellers. To better compete with U.S. airlines, the ATST should be reduced. Not only would a reduction help place U.S. and Canadian airports on a level playing field, but such a reduction would also recognize that air security has a national benefit, not one that should be borne by air travellers alone. Second, the effect of the tax is most pronounced at lower fares. This not only affects the short-haul industry but equally the markets and regional airports they serve.

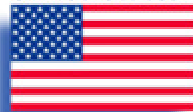
In its 2008 report, transportation expert InterVISTAS concluded that if the ATST in Canada were charged at U.S. levels, savings would amount to almost $200 million annually to the airports of Montreal, Toronto and Vancouver alone.

A final concern is the substantial over-recovery of security costs. InterVISTAS found that over the period of 2001-2007, revenue from the Air Traveller's Security Tax exceeded the cost of operations of the Canadian Air Transport Security Authority (CATSA) by $325 million or roughly 20 per cent. In 2010, however, the Canadian government increased the ATSC with fees ranging between 27 and 53 per cent of the existing charges.

Fairness requires an adjustment to the NAV CANADA fees. Not only do U.S. passengers not pay an equivalent, NAV CANADA has been structured to include reimbursement for assets already fully repaid before the 1996 Canadian government transfer of air navigation to the current authority.

Forty per cent of the price differential between a Canadian and a U.S. ticket originates with Ottawa's fees and taxes. Absent those ticket add-ons, two million Canadians would be back at Canadian airports claims the Conference Board of Canada.

United States



Transportation is seen as essential to trade competitiveness, therefore it is in the national interest to improve it.

Canada

Transportation is a source of tax revenues.

Source: The National Travel and Tourism Coalition.

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2. The base fare:

U.S. airline tickets show a wide price advantage, on average by 30 per cent, in the base fare. The Conference Board of Canada found some of the factors influencing a higher Canadian base fare to be airline labour issues, fuel costs and, aircraft taxing and financing. A significant factor influencing a higher base fare is the lack of competition in Canada driving higher fares on both international and domestic flights.

Each of these base fare irritants is now addressed.

Generally, labour compensation is lower with U.S. airlines. Compensation per employee ranged between $66,000 and $71,000 in the three U.S. air carriers, Allegiant, AirTran and Spirit assessed by the Conference Board. By contrast, Canadian carriers had a per employee wage at $81,000. Employee labour productivity was higher in the U.S.

With the exception of jet fuel tax, fuel prices between the two countries were found to be generally in line. The jet fuel tax drives the wide difference between the two countries.

Aircraft issues which could lead to reduced ticket price include tax depreciation rates and foreign ownership restrictions.

A significant factor influencing aircraft ownership costs is tax depreciation (the capital costs allowance) with U.S. treatment more favourable concluded the Conference Board. This contributes to the difference in aircraft ownership costs between the two countries.

There are compelling reasons for raising the foreign ownership limits from its current level of 25 per cent: It would give Canadian carriers access to a broader capital market, it would lead to greater stability in this sector, it would make it easier for new competition to enter the field and it would help smaller carriers expand. There is no compelling economic reason for continuing the restriction concluded Canada's Commissioner of Competition in 2008. Although foreign ownership restrictions of 25 per cent apply to both countries, they disadvantage Canadian carriers to a greater extent because of our smaller domestic capital market.

The lack of airline competition in Canada, domestically and internationally, is a crucial factor fuelling higher base fares.

Canada's air sector policy is inherently anti-competitive. By contrast, the U.S. realized early on that the economic interests of the country and those of passengers were best served through competition. A sea-change occurred with the 1990's pro-competition Cities Program launched by President George H.W. Bush's Transport Secretary Samuel Skinner. In order to increase competition, the Cities program allowed a liberal trading partner access to any U.S. city if there was no airline serving that city. In effect, routes were given away in exchange for competition.

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This greatly liberalized air transportation and led naturally to a liberal and reciprocated Open Skies policy between the U.S. and its current 94 partners. The liberalization of the skies in the U.S. has resulted in the creation of new hubs which have transformed secondary cities, like Charlotte, North Carolina.

Canada has never liberalized its skies to the same degree. Quite the opposite as Ottawa's policy is to closely regulate and prohibit service into many Canadian cities. Its 2006 Blue Skies agreement weighs whether it would be deemed to be in Canada's overall interest to allow competition into Canada. The destination and frequency restrictions which Canada imposes in its agreements have impaired the creation of hubs.

The 'overall interest of Canada' test has resulted in only eight true Open Sky agreements with most of those having been inked with low flight countries. Emirates Airline, which in 2010 sought daily service to Toronto, Calgary and Vancouver, was turned down with Canada claiming three flights per week sufficed—even though Canada didn't fly to Dubai. With a U.S. study (Kurth Report) linking the benefit of daily access to a city economy at between $265 and $720 million annually, depending on aircraft size and the wealth of the city market, the loss to these key Canadian cities was large.

Singapore Airlines' request for greater access to Vancouver and Air France's request for access to Vancouver were both denied by Canada a year earlier. Singapore Airlines moved operations to San Francisco and Los Angeles while Air France re-located to Seattle. Rob Howard, Provincial Lead for the Government of British Columbia on the air access file claims a large loss when an airline relocates. Lost as well and invested instead in the U.S. were the "capital, people, networks and dollars."

Canada is perceived as having the most restrictive and protectionist attitude towards reciprocated air agreements in the developed world. Not only restrictive, Canada's negotiations and agreements are so secretive "the public is not privy to them" says transportation economist, David Gillen of the University of British Columbia's Sauder School of Business.

The secrecy, lack of transparency and the weighting of "benefit" as opposed to "opportunity" in Canada's Blue Skies negotiations would simply not be tolerated in the U.S. claimed Andrew Steinburg, former U.S. Assistant Secretary of Aviation and International Affairs in 2009.

Competition greatly benefits consumers. InterVISTAS found that Open Skies in the U.S. had resulted in a significantly higher level of activity than would otherwise be the case. This creates lower costs and lower ticket price.

Competition from other carriers has "a major influence on airline fares" concluded the 2001 Canadian Transportation Act Review Panel Report. It pointed to the emergence of Southwest Airlines in the U.S. as having

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caused a sharply reduced ticket price capturing an estimated 40 per cent of the reduction in fares through de-regulation. A 2008 study by the Chartered Institute of Logistics and Transportation International reported that, although business fares had spiked, economy fares in the E.U. had been reduced by 30 per cent with competition under the European Union liberalized air agreements.

On domestic routes, Ottawa could facilitate competition and reduce ticket price by allowing a Right of Establishment airline ownership policy. A Right of Establishment policy would allow a wholly owned foreign carrier to serve only Canadian points. The foreign carrier would employ Canadians and would be subject to Canadian taxes and regulations. Right of Establishment in Australia through the creation of Virgin Blue (now Virgin Australia Airlines) stimulated the domestic market and resulted in Australia experiencing some of the lowest domestic air fares in the world.

In summary, a significant contributor to higher ticket prices in Canada is the lack of competition. Studies on the relationship between competition and air fares suggest that the current gap in the base ticket price between Canada and the U.S., at 30 per cent, could be reduced through competition.

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"**Ottawa** has abandoned its role as policy creator.

Passenger Leakage has a Profound Effect on the Canadian Economy

Economic Loss in Canada from U.S. Passenger Leakage (2011 - Estimated)

Catagory of Impacts	Output ($ Millions)	GDP ($ Millions)	Jobs	Employment Income ($ Millions)	Tax Revenue ($ Millions)
Direct	$1,758	$ 642	4,344	$ 232	$ 93
Indirect	$ 862	$ 530	4,469	$ 279	$ 95
Induced	$ 375	$ 225	2,333	$ 130	$ 50
Total	$2,995	$1,395.6	11,145.1	$ 640	$ 237.7

Source: CAC Leakage Report, 2011.

Conclusion

Economies require the good working of its four sectors of finance, telecommunications, energy and transportation, claims Lazar, the York University economist. Due to its ability to expand markets, increase employment and investment, spur competition and magnify the benefit of trade liberalization, Lazar finds air transportation is most critical to an economy with a dollar invested in this industry likely to produce a larger benefit than in other sectors.

Dependant on its taxes, fees and surcharges, Ottawa has abandoned its role as policy creator. In fact, Canada is ranked worldwide by the OECD as 125th out of 139 economies when it comes to competitive ticket taxes and airport charges.

There are two options ahead, claims Lazar: one is for Canada to develop an air policy that benefits consumers. The other is to continue its path of "confusion and lack of purpose" with continued drain on passenger growth and the economy. Without a change in policy, he says, no Canadian airport will rank among global hub airports and travel will take longer, be less convenient and more expensive.

Change requires a turn-about in our thinking and in the value we place on our air transportation sector and its ability to generate healthy economic activity.

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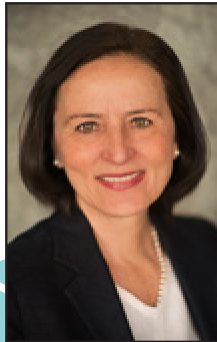
About the author

Mary-Jane Bennett, is a lawyer and transportation consultant, and a research associate at the Frontier Centre. She began her career with the Ontario Ministry of Justice and has since practised law in Manitoba and British Columbia. In 1997, she received an appointment by the Governor-in-Council to the newly formed Canadian Transportation Agency where



she was involved in a broad range of transportation issues, including grain freight issues. Mary-Jane Bennett served as a Board Member with the Canadian Transportation Agency from 1998 to 2007.

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Airport Policy in Canada

By Mary-Jane Bennett

http://www.fcpp.org/publication.php/4291