

Air Transport Policy in Japan

Hiroataka Yamauchi and Takatoshi Ito

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Hirotaaka Yamauchi
Professor of Commerce
Hitotsubashi University
Tokyo, Japan

Takatoshi Ito
Professor of Economics
Institute of Economic Research
Hitotsubashi University
and
Senior Advisor
Research Department
International Monetary Fund
Washington, D.C.

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Abstract

This paper reviews the development and status of the airline industry of Japan and the points of debate in the recent Japan-U.S. airline dispute. Until 1986, international routes were given only to Japan Air Lines, while domestic routes were dominated by All Nippon Airways, with minor shares given to JAL (major routes only) and Japan Air System (local, short-haul routes only). A policy change in 1986 allowed the three airlines to mutually expand into each other's routes. Major deregulation on airfares did not come until 1995-96. The original Japan-U.S. treaty of 1952 was "unfair" in the sense that the U.S. carriers were given more freedom than their Japanese counterparts, especially in "beyond rights." The amendments of 1982, 1985, and 1989 expanded the routes of Japanese airlines (JAL and new entries of ANA and JAS) as well as those of the new U.S. entrants (American and Delta). However, disputes remain between the two countries over routes, frequencies of flights, and beyond rights. Interestingly, these disputes are not always divided along national boundaries: Carriers with large market shares (JAL, United, Northwest and FEDEX) have an incentive to stall negotiations, while restricted carriers (ANA, Nippon Cargo Airlines, AA, DL, Continental, and UPS) are eager to open negotiations in order to expand their routes.

I. An Overview of Air Transport in Japan

The airline industry in Japan is dominated by the “big three”--Japan Airlines (JAL), All Nippon Airways (ANA), and Japan Air System (JAS). There are five other (scheduled service) carriers, of which one is specialized in cargo, that are mostly regional subsidiaries of these airlines.¹ The big three collectively account for about 95 percent of the passengers carried by scheduled Japanese airlines, but their areas of strength are different with respect to domestic and international markets. ANA dominates domestic markets, with a 47.8 percent share, while JAL controls about 77.5 percent of international markets served by Japanese airlines. (See Figures 1 and 2.)

The domestic air transport market, with about 78 million passengers and 52 billion revenue passenger kilometers annually, is one-sixth the size of the US market in terms of passengers, and one-tenth the size in terms of revenue passenger kilometers. Japanese airlines carry about 11 million international passengers per year, about one-quarter the figure for US carriers. Japanese national international passengers increased sharply in the second half of the 1980's, from 5 million in 1985 to over 10 million in 1990. The number of foreigners visiting Japan is less than one-third of Japanese going abroad.

Japanese airlines experienced a boom during the second half of the 1980's. From 1985 to 1991, passenger kilometers in domestic markets grew at the rate of 9.3 percent annually, and in international markets at the rate of 8.0 percent annually (see figure 3). These trends, however, have turned downward since 1990. Between 1991 and 1993, average growth rates dropped to 3.4 percent in domestic markets and 4.8 percent in international markets. The operating profits of Japanese carriers have followed the growth in traffic, soaring to record highs in 1989, and

¹They are Nippon Trans-Ocean Airlines; Japan Asia Airlines; Air Nippon; Japan Air Commuter, and Nippon Cargo Airlines. Trans-Ocean is a regional carrier based in Naha, Okinawa; Japan Asia Airlines, a subsidiary of JAL, mainly serves routes to and from Taiwan; Air Nippon, a subsidiary of ANA, is a regional carrier with routes both in Hokkaido and in southwestern parts of Japan. Japan Air Commuter, a subsidiary of JAS, was mostly a charter air service company, but has recently become a scheduled air service company.

declining since 1990 (see figure 4). JAL has been particularly hard hit, not only by slower growth, but also by price competition and yen appreciation which have adversely affected the international routes that account for more than half of its operations. In fact, the carrier has suffered huge losses since 1991.

Air transportation in Japan has developed in a strictly regulated environment. The Civil Aeronautics Law, which governs the industry, requires that airline companies obtain government licenses to establish operations. Airlines also need government approval for setting and changing their fares, and even for their annual business plans. Naturally, international routes also require government negotiated bilateral agreements with other countries. In this sphere, Japan has been a traditionalist. Its agreements are generally modeled after the old Bermuda Agreement concluded between the United States and United Kingdom in 1946.

A typical Bermuda-type bilateral agreement is the US-Japan agreement concluded in 1952. Its main features are the fixing of service points (cities), the double approval of fares by the two governments, and ex post facto control of capacity.² While the original US-Japan agreement has not been revised, several provisional agreements have altered its impact. The latest provisional agreement was concluded in 1989. As we shall see later, this provisional agreement affected recent air transport policy in Japan.

² Under this approach, the airlines set their own schedules for the forthcoming period, subject, however, to ex post facto review by the two governments on the basis of actual experience. See de Murias (1989), pp. 55-56.

II. Air Transport Policy to 1986

The Aviation Constitution

In 1952, Japan Airlines was established as a major private company and started service in domestic markets. The next year, Japan was allowed to commence international air transport services, and the government decided to restructure JAL as a half-owned public corporation. The purpose of this reform was to foster the company as a national flag carrier.³ Around the same time, several private airline companies were founded. These companies were small and their business conditions unstable, so some bankruptcies and consolidations occurred. In 1957, the two largest carriers merged to form All Nippon Airways, which became the second major national airline and a purely private carrier. After that, the remaining companies underwent various consolidations, and by the mid-1960's, there were four airline companies in Japan: JAL, ANA, Japan Domestic Airlines (JDA) and Toa Airways (TA). In the second half of the 1960's, TA developed cooperative arrangements with ANA, while JDA associated with JAL. As a result, it was assumed that they would be consolidated into the big two, JAL and ANA.

However, demand for airline services rapidly increased from 1968 to 1969. As profits surged, Toa Airways became reluctant in 1969 to be merged with ANA, while JDA refused to be acquired by JAL in 1970. Consequently TA and JDA merged with each other in 1971 to form Toa Domestic Airlines (the name was later changed to Japan Air System). The Cabinet Meeting Resolution "Concerning Airline Operations" was issued in November 1970 and the Notice from the Minister of Transport in July 1972. The Cabinet Meeting Resolution of 1970 approved the change from a two-company (JAL and ANA) regime to a three-company (JAL, ANA, JAS) regime a year later. Furthermore, the ministerial notification of 1972 laid out specific rules pertaining to the business fields of the three firms. These decisions and

³ The government invested in JAL the equivalent of the value of the capital stock that the company originally sold in starting its business. A new bill was passed to make JAL a special corporation.

notifications have another aspect, generally referred to as the "Aviation Constitution." Under the "Constitution," the Japanese airline industry was segmented into different markets: Japan Airlines would serve international routes and domestic trunk routes; ANA would serve domestic trunk routes, local routes and short-distance international charter flights; and Toa Domestic Airlines would serve local routes and a portion of domestic trunk routes. As for international air cargo, a new carrier could enter the market if demand would justify the existence. In this manner, the so-called 1970-1972 airline regulation system, referred to as the old regime, was established.⁴

The old regime was intended to secure and nurture the transport capacities of all members of the airline industry by establishing a segmented business base for each firm.⁵ In the subsequent years, trunk routes (Sapporo--Tokyo--Osaka--Fukuoka--Naha) markets grew much faster than other "local" markets. Japan Domestic Airlines was also allowed to continue to operate a limited amount of trunk routes, to partially help its profits. As the price was set proportional to distance, the trunk routes for ANA and JAS became a source of internal cross-subsidization for their deficit-ridden local routes. Some suggest that the segmented-market approach can be judged a success by pointing out that this internal cross-subsidization allowed each carrier to expand its route network without cut-throat competition, to protect profits for reinvestment, and to allow stable management and growth.⁶ In the 1970s, the average annual growth rate of revenue passenger kilometers in the domestic markets was 12.2 percent, while the international markets figure was an astounding 42.4 percent. Those high growth rates of traffic were accomplished due to the expansion of networks, although the main source of it was the high growth rate of the economy in this period.

⁴ In Japan, it is also known as the 45-47 regime, standing for Showa 45th year (1970) and 47th year (1972).

⁵ The segmentation of markets was a common feature of Japanese industrial policy in the 1950's, 1960's and the first half of the 1970s. The airline industry was a typical case.

⁶ See Masui and Yamauchi (1990; ch. 3).

During the period from the end of the 1970's to the mid-1980's, however, new regulatory trends emerged in international air transportation. The impact of the US deregulation of domestic air services was felt all over the world. In Europe, the Thatcher government started its privatization policy, a major component of which was the privatization of British Airways. Influenced by these policy shifts in foreign countries, opinion in Japan started to change towards more deregulation.⁷

The End of the "Aviation Constitution"

What happened next was an interesting political economic power play, involving both domestic and international air routes. Citing a rapid growth of international air cargo transportation, ANA decided to apply for an entry into international cargo by forming Nippon Cargo Airways (NCA) with some shipping and moving companies. The new international cargo carrier was, as mentioned above, a part of the "Aviation Constitution," so that the application to set up the company itself was not a challenge to the old regime. However, international cargo flights to cities in the United States required renegotiation of the Japan-US bilateral agreement. The Japanese government took a position that the NCA flights should be allowed to enter the market only to rectify the "unfair" aspect of the treaty. However, the United States seized an opportunity to demand expanding US-Japan passenger service. Note that by the mid-1980s, US domestic airlines had gone through revolutionary changes (the rise of United, American, and Delta, and the fall of PanAm and TWA) due to deregulation, and the effects were about to spillover to the international network. Holding the NCA approval as a "hostage," the US successfully negotiated an entry of Delta and AA into the US-Japan market. As more US carriers entered the market, the Japanese authorities allowed ANA to enter the trans-Pacific

⁷ In the field of transport, including aviation, the opinions of the Fair Trade Commission called for relaxation of regulations in all areas of transport administration, including aviation (1982), and administrative inspections of the Administrative Management Agency with respect to aviation administration (1984).

market. This effectively tore down one of the "Constitution" clauses. Now that ANA was in the international market, JAL wanted to rapidly expand non-trunk domestic routes. The abolishment of the "Aviation Constitution" in 1986 was only a belated recognition of reality, rather than a bold policy initiative. This kind of explanation of the chain of events, due partly to strategic decisions and partly to accidents at least for the Japanese policy maker, is not fully appreciated in the literature. It is sometimes mistakenly believed that the decision to end the "Aviation Constitution" came independently, or that the abolishment of the "Aviation Constitution" or the complete privatization came before the ANA entry into the international scheduled route.

In short, the provisional agreement of 1985 (described in detail in section 4) precipitated the end of the old regime which restricted international operations to only one company. More importantly, it also triggered a major change in domestic markets.

In September 1985, the Minister of Transport consulted the Council for Transport Policy (an official advisory committee to the minister) about the future of airline services in Japan. The Council submitted an interim report in December 1985, and a final report in June 1986. The reports emphasized the need for change in the old regime, and for greater competition in both domestic and international markets. They advocated a new aviation policy with the following features:

- (1) International routes would be served by multiple carriers;
- (2) Competition on domestic routes would be promoted by new entry into particular city pair markets; and
- (3) Japan Airlines would be completely privatized.

After receiving the interim report, the Japanese government immediately issued a Cabinet Meeting Resolution abolishing the old regime.

New Domestic Policy Since 1986

In this section, we examine in greater detail the main features of the new policy that has evolved since 1986. With respect to competition, the Council for Transport Policy Report argued that "an American style of deregulation does not suit circumstances in Japan" because of the capacity limitations of Tokyo International (Haneda) Airport and Osaka International (Itami) Airport and the different competitive strengths of the airlines. As such, the report went on, "for the time being, it is appropriate to proceed with policies which promote competition through the implementation of flexible administrative management." In the report, promotion of competition refers specifically to "the promotion of double tracking (i.e. two carriers serving the same route) and even triple tracking (i.e. three carriers serving the same route) not in accordance with the previous demarcation of trunk routes and local routes, but rather corresponding to the size of the demand of individual routes and status of progress at airport facilities and so on." In addition, because of slot restraints at major airports, the report seeks to "further expand air traffic capacity through improvements of air transport facilities and the air traffic control system."

Thus, with respect to the domestic side, the Ministry of Transport changed only to a policy which allegedly promotes competition through measures such as double tracking. Therefore, a new entrant to a particular route is considered only when passengers for that route exceed a certain threshold.⁸ Moreover, the designation of the second carrier and flight frequency between the two carriers of the route are strictly regulated by and are at the discretion of the Ministry of Transportation. Since the introduction of the new policy, the number of double- and triple-tracking routes has increased. In 1993, about 70 percent of air passengers flew on double or triple tracking routes, although the number of these routes

⁸ The double (or triple) tracking was allowed in routes in which more than 700,000 passengers (1 million passengers, respectively) in a year have flown. Based on this policy, Japan Air Lines entered Tokyo-Kagoshima (triple tracking) and Tokyo-Komatsu (double tracking) in 1986.

accounted for only 19 percent of the total number of routes in service. It should be emphasized that even if a particular route is served by multiple carriers, these carriers cannot compete on the basis of airfare. A normal fare for a particular route is set according to its distance, irrespective of any other supply and demand conditions: price elasticity of customer, season, days of the week, hours of the day, etc. Even discounted fares are regulated and until recently only a few types of discounts were approved.

In addition, a bill was passed in September 1987 which resulted in the complete privatization of JAL in November 1987. Just prior to complete privatization, the Japanese government still held a 34.7 percent equity share in JAL.

The new policy is often criticized by many economists for not creating a truly competitive system. Specifically, the licensing system for new entry and the approval system for setting fares have remained unchanged. Even though two or three carriers are serving the same route, the fares are the same. Some critics argue that the new policy of introducing double and triple tracking has created even more room for administrative discretion, since bureaucrats are now empowered to decide which routes will be double and triple tracked, and which carriers will be allowed to operate them. The report contends that the Japanese domestic market differs greatly from that of the United States where deregulation was implemented through legal reforms that practically abolished bureaucratic control.

From the consumers' viewpoint, the new policy has clearly failed to create the substantial welfare gains that would have resulted from the increased flight frequencies, and the diversified types of, and on average lower, fares associated with US deregulation.⁹ After domestic deregulation, US airlines introduced many discount fares based on price elasticity of the market

⁹ For example, see Morrison and Winston (1986). They estimated the annual improvement in the welfare of travelers by deregulation was at least \$6 billion (in 1977 dollars), of which the greatest net benefits accrued to business travelers from increased flight frequency. Additional benefits came from the emergence of diversified fare structures, in which many different fares are available, subject to varying conditions and restrictions.

which benefitted consumers who otherwise would have avoided air transportation. Over 90 percent of US domestic passengers now use some type of discount ticket.

A comparison of Japanese and US fares shows that US deregulation has resulted in lower fares, but has done so through price diversification rather than through across-the-board downward pressure on prices.¹⁰ For instance, Ito (1992) compared Japanese and US fares (see Tables 1 & 2, and Figure 6) per unit distance (yen per kilometer) and showed that regular fares in the US are higher than in Japan, but that US discount fares are much lower than their Japanese counterparts. However, since discount rates in the United States are much larger than in Japan, Japanese fares for all practical purposes are still higher than US fares. In addition, as noted above, most American passengers fly on discount fares; thus, the American fare structure benefits a greater share of the flying population.

The "new" air transport policy introduced in 1986 has not brought effective competition to the Japanese market. As a result, consumers have not gained significantly. Many feel that there is more room for deregulation. The Civil Aeronautics Law was revised at the end of 1994 to relax the conditions for introducing and setting discount fares in domestic markets.

In 1995, Japanese airlines introduced a new discount fare which was 25 to 35 percent lower than the regular fare, with restrictions similar to the US deep discount ticket. The newly introduced discount ticket must be reserved 1-2 months prior to departure and must be ticketed within 24 hours of reservation; once ticketed, flights cannot be changed; and the cancellation penalty is 50 percent of the ticket price. It should be noticed that in the United States, tickets with similar restrictions will typically qualify for discounts of up to 75 percent off the regular fare. The amount of discounts (25, 30, or 35 percent) change by routes and season, and this type of "deep" discount ticket is not available at all in most of August, the most heavily traveled month.

¹⁰ Since the early 1990's, however, discount fares have been greatly simplified.

IV. International Aviation Policy

Background

International air transport has mostly been carried out based on bilateral agreements. A bilateral agreement is typically called a Bermuda Agreement, named after an agreement that was concluded between the United States and the United Kingdom in 1946. The U.S.-U.K. agreement of 1946 was largely a creature of compromise, because of the conflicting interests of the two countries. The United States, the country with by far the strongest airlines at the time, insisted that skies should be open to any firm that wanted to enter. By contrast, the United Kingdom insisted that some intervention and protection was necessary for the steady development of air transport. The concluded US-UK Bermuda Agreement of 1946 left ambiguous details, but had an overall open skies flavor--no explicit capacity constraints--reflecting the dominant position of the United States. Thirty years later, the UK government argued for revision of the Bermuda Agreement and obtained the Bermuda II Agreement that was more conservative--in the sense that it restricted the growth of capacity if necessary--than the original Bermuda Agreement. However, many countries approved bilateral treaties among themselves in the 1950s in accordance with the seminal US-UK treaty. As Asian countries, including Japan and China, were either devastated by war or still at the low-income development stage in the early 1950s, bilateral agreements between an Asian country and the United States (or a European country) typically gave more freedom and market access to the US carriers.

Bilateral agreements define reciprocal rights and reflect the interests of each country. These agreements often restrict capacity (types of aircraft and frequency), traffic (setting gateway cities, setting routes, and designating firms) and service levels (beyond rights, etc). Countries with small and less competitive airlines try to protect these airlines and their monopoly profits by restricting supplies through bilateral treaty, and by the IATA airfare cartel (discussed below). Until very recently, having a "national flag carrier" for a newly independent

country was said to be as important and prestigious as joining the United Nations. For a small country, the nurturing of the national flag carrier was sometimes done without economic calculations of costs and benefits.

In the past, the International Air Transport Association (IATA) operated as a cartel that sought to "stabilize" international airfares and avoid serious competition. With explicit and implicit capacity controls by bilateral agreements, the IATA price cartels that set fares on a route-by-route basis had been effective until the 1970s. While the IATA still holds Traffic Conferences regularly to revise airfares, its ability to restrict competition and enforce the set airfares has been substantially eroded. A main role of the IATA has shifted to cooperative functions such as operating a clearing house for credit payments among airlines. As a result, the degree of competition in international markets is directly dependent on the content of bilateral agreements, especially their capacity control clauses.

Development of Japanese International Aviation

Geography and economic ties define Japanese international aviation. Three major fronts-- North America, Europe, and Asia and points beyond--have evolved over time. In the 1950s (DC-3 era), it took days for a propeller passenger aircraft to reach North America by hopping over various islands in the South Pacific and Hawaii. The air service to Europe was equally time-consuming, with layovers in the South Asian cities, typically Hong Kong, Singapore, and Delhi, India. After jet services was introduced, the (North Pacific) polar route became viable. Most popular routes such as Tokyo-New York and Tokyo-London started to fly through Anchorage in the late 1960s (Anchorage as technical landing). Bilateral agreements with the United States and European countries were the most important pillars for Japan's international aviation. The government of Japan and Japan Airlines were probably content with sharing the passengers for each major destination (say, the United States, the United Kingdom, France,

Germany) with counterparts (Pan Am and Northwest, British Air, Air France, Lufthansa). Tokyo was the only viable gateway in northeast Asia throughout the 1970s and 1980s, with a strong domestic economy and a strategic geographic location given aircraft technology at the time. After the tension between East and West eased a bit, the Soviet Union allowed European and Japanese airlines to fly over Siberia via Moscow in 1970. The Siberian route shortened travel time between Japan and European countries by several hours, even with a stop-over at Moscow. The Soviet Union had a unique leverage over the fly-over rights of the Siberian route and extracted rents from the route for a long time. At one point (early 1980s) there were three different routes available between Tokyo and Europe: via Anchorage, the Siberian route, and the southern route.

Tokyo was a natural hub, and the only hub for northeast Asia. Tokyo was not challenged as a major hub in Asia until very recently. Development of the Boeing 747 (B747) revolutionized air routes and opened the way for potential changes in the competitive positions of various cities. With newer models of the B747 (with improved engines), there was no need to stop at Anchorage en route from Tokyo to New York, or between Tokyo and northern Europe (over Siberia). The end of the Cold War and potential competition for the nonstop polar route (with the B747-400) led Russia to open further the Siberian route. By the early 1990s, nearly all Japan-European routes were flying over Siberia (without stopping at Moscow), and Japan-US major cities were connected by nonstop flights.

There is little conflict between Japan and European countries over air treaties. European airlines have little interest in flying beyond Tokyo (to east or southeast Asia or south Pacific), and Japanese airlines have little interest in building any significant connected flights within Europe or beyond Europe (to Africa or Eastern Europe). Both Japan and Europe are content with exercising implicit or explicit controls of total capacity. Rare bilateral conflicts between Japan and European countries involve the landing slots in congested Japanese airports (Narita

and Osaka before Kansai was built) and some European airports, and entry of a second national carrier (such as Virgin and ANA for the London-Tokyo route).

As Asian economies boomed, Japanese, US, and European airlines increased the number of flights to Asian cities. European airlines now have nonstop flights to other Asian cities (such as Seoul, Hong Kong, Singapore, Bangkok, and Kuala Lumpur), thanks to the B747-400 technology, and have little interest in "beyond rights" from Japan.

From the United States mainland, flights to southeast Asia still require a stopover in northeast Asia due to technological limits even with the B747-400 and too few passengers despite booming economies (with the notable exception of San Francisco-Hong Kong nonstop). Tokyo has been a natural and historical "hub" with spokes directed toward Southeast Asia and North America.¹¹ In addition to Japanese and Asian airlines, the US airlines (Northwest and Pan Am which was succeeded by United) have had strong networks in Asia. This is a legacy of the US airline's dominance in the world, combined with unlimited "beyond rights" for the United States contained in the bilateral agreement between Japan and the United States (and other Asian countries and the United States). As the Asian economies boom, "beyond rights" have become an important, controversial issue between Japan (and other Asian countries) and the United States.

Generally speaking, complaints from foreign countries, including the United States, concerning Japanese international aviation policy are focused on the difficulty of setting up the route for the first time and increasing the frequency to Tokyo from their countries. These complaints largely stem from airport congestion problems in Japan. The opening of the new Kansai airport partially alleviated the problem. Later we will discuss airport problems in Japan.

¹¹ Tokyo's status as the "hub" in the northeast Asia will be increasingly challenged in the near future. On the one hand, an expansion of Narita airport --and construction of a second airport -- has been blocked by farmers; on the other hand, cities such as Seoul, Taiwan, and Hong Kong are building new large-scale airports. Given these factors, as other economies become stronger, their chance of replacing Tokyo increase. The decline of Tokyo as a hub is already evident. From Japanese "local" cities (cities other than Tokyo and Osaka), it is often more convenient to go to North American cities via Seoul than via Narita.

Japan-US Bilateral Agreement: The Original Treaty

The most important country destination for Japan Airlines has been the United States. The share of trans-Pacific routes (including Hawaii) traveled by Japanese international passengers has been about 3 million a year in the 1980s. Curiously, the share of the Pacific routes held by Japanese airlines has been declining recently, from 40 percent in 1986 to about 32 percent in the 1990s. (See Figure 5.)

The Japan-US bilateral aviation treaty of 1952 remains in force with no major changes. Although memoranda have been attached to the treaty, the treaty is basically intact. Japan has long insisted that the treaty is unfair: Various rights granted to the US airlines far exceed those granted to Japanese airlines. The Japan-U.S. bilateral of 1952 has the following features:

- (1) [Imbalance in the number of carriers and beyond rights] The carriers originally designated by the United States--Pan American Airways, Northwest Orient, and Flying Tiger--have unlimited fifth freedom rights (beyond right) to carry traffic from the US beyond Japan and also local traffic between Japan and points beyond. The carrier originally designated by Japan--Japan Air Lines--has limited fifth freedom rights, routes have to be explicitly approved. The original carriers (and any carriers that took over those companies) of 1952 are called "incumbent," or "full-right" carriers in the business.¹²
- (2) [No capacity limit of incumbent carriers] Full right carriers (both US and Japanese) are able to increase or decrease capacity (flights per week, types of aircraft) without any limit, without the prior approval of either country.
- (3) [Gateway cities] The US (incumbent) carriers can fly from any city in the United States after filing these routes with the US Department of Transportation, but the Japanese carriers are limited to certain cities (Tokyo and Osaka) and new cities

¹² Pan American Airways changed its name to PanAm, Northwest Orient became Northwest. PanAm Pacific division was sold to United, and Flying Tiger was bought by Federal Express.

have to be negotiated. For Japan Air Lines, both Japanese cities of origin and US gateways must be filed with their respective governments.

There is no disputing that the legal framework of the agreement favors US carriers. Disputes lie in the economic impact of these discrepancies. The legal imbalance made no economic difference in 1952, since Japanese aviation then was then recovering from the devastation wrought by World War II. US and Japanese officials and business executives differ in their judgement of whether the legal disadvantages constrained Japan Air Lines' growth and prevented All Nippon Airways from entering the market. The degree to which US unlimited "beyond rights" contributed to the economic advantage of the US carriers is also a point of contention.

The Japanese government and Japan Air Lines for decades have complained that the unfair treaty resulted in the difference in performance in trans-Pacific markets: The US carriers increased the number of flights from many cities in the United States and acquired more passengers from both countries. Moreover, by using beyond rights, US carriers continue to compete effectively in the markets between Japan and Asian countries; that is, the US carriers not only capture Americans who travel to points in Asia via Japan, but also Japanese traveling between Japan and Asia. With the economies of scale created by carrying passengers beyond Japan, US carriers could increase the number of flights between the United States and Japan. This would result in increased economies of scale and increased frequency of service which is highly valued by business travelers.

US officials counter Japanese arguments as follows. The beyond rights (fifth freedom) exercised by the United States -- Asia-Tokyo-US -- can be replicated by Japan Air Lines by using its spokes from Tokyo. The beyond rights for Japan Air Lines from the United States to points beyond are not vigorously pursued by Japan, since its economic interest in such rights is

in doubt.¹³ In fact, the US side would argue that the Japanese side does not ask for an equalization of various "rights" by expanding Japanese rights, but for equalization of "rights" by limiting the scope of US beyond rights. Japan's way of achieving its goal conflicts with global aviation trends and consumer benefits. Although US incumbent carriers have unlimited access to Tokyo, the number of flights are effectively controlled by Japanese authorities because Narita airport landing slots are effectively rationed. The low percentage of trans-Pacific passengers carried by Japan Air Lines (and later JAL and ANA) reflects more of a lack of competitiveness by Japan Air Lines (and later JAL and ANA) rather than the unfair aspects of the treaty.

Japan-US Bilateral Agreements: The MOUs of 1982, 1985 and 1989

In the 1980s, there was a series of "Memorandum of Understanding" (MOUs) by which Japan-US bilateral agreements were significantly modified without renegotiating the treaty itself. The treaty with the United States has always been the main problem, because it is viewed as giving more freedom to the US carriers. The United Kingdom renegotiated the treaty itself; Germany renounced the treaty; while France has long complained. In the Japan-US bilateral agreement, Japan is more eager to renegotiate the treaty itself, while the United States avoids such talk. The essential part of the series of MOUs was to allow new entries to the trans-Pacific routes, and to put some restrictions on the rights of carriers that were already in the market. The new entries based on the MOUs (ANA, NCA, AA, Delta, United Parcel) are sometimes called "MOU carriers" as opposed to "incumbent carriers."

The MOU of 1982 resulted in expansion of services only with restrictions on the frequency: JAL got Tokyo-Seattle-Chicago (5 per week), and Tokyo-Los Angeles-San

¹³ In fact, Japan Air Lines at one point operated New York- London (a beyond right), but suspended the route due to a lack of customers. The only exercised beyond right by Japan is from Los Angeles to Brazil.

Paulo/Rio de Janeiro (2 per week); UA got Seattle/Portland (OR)-Tokyo (7 per week); and Continental Micronesia got Saipan-Nagoya (7 per week).

In 1985, the Japanese and US governments conducted negotiations on the entry of NCA into routes between their countries. On this negotiation, the Japanese government only desired to obtain the right for NCA to enter the Pacific air cargo markets in exchange for giving an equivalent right to the United States. On the other hand, the US government wanted to take this opportunity to increase its carriers of both passenger and cargo, because there were a lot of airlines that had strong competitiveness and an intention to expand their business into Japan-US markets. The negotiation ended in a victory for the United States. A "provisional agreement" (a Memorandum of Understanding) was reached which allowed each country to operate three new airline companies on trans-Pacific routes based on the "balanced expansion" of air transport services in both countries.

This provisional agreement did not give carriers much freedom of capacity and price setting; however, it did trigger a change in Japanese international aviation policy and was the starting point for liberalization of entry and restriction on capacity expansion with other countries. The MOU of 1985 opened the trans-Pacific market to All Nippon Airways (Tokyo-Los Angeles, Tokyo-Washington DC), Delta (Portland-Tokyo), and American (Dallas-Tokyo), in addition to the entry of NCA (Tokyo-San Francisco-New York). JAL also got Tokyo-Atlanta. (United Airlines purchased operating rights from Pan American and became a full right carrier in 1986.)¹⁴

The MOU of 1989 added additional routes, among others, to ANA, Delta, and AA, and new entries to JAS. The MOU of 1989 expanded routes of incumbent and MOU carriers, plus new entries of JAS (Tokyo-Honolulu) and United Parcel (Anchorage-Tokyo). Until the MOU of 1985, the full-right carriers (JAL, PanAm-- succeeded by UA in 1986, and Northwest) had

¹⁴ Full right carriers can increase or decrease capacity without advance notice. See Section 4.

rights to choose freely which cities to fly to and from in the United States. The MOU of 1985 restricted further routes, even for the full-right carriers (grand fathering all routes granted and filed at that point). The MOU of 1989 further expanded routes served by the full-right carriers, such as Northwest's and ANA's Honolulu--Nagoya, and United's Chicago--Tokyo.

With these MOUs, the Japanese government took the position that any expansion beyond those routes flown at the time of the MOUs is subject to further negotiation. The slight difference in interpretation was tested in 1992, when Northwest applied for "beyond rights" between Osaka and Sydney, as an extension of flights from New York to Osaka. The Ministry of Transport gave an approval with a restriction that local (Osaka--Sydney) passengers should not exceed 50 percent of total passengers for that route. The Japanese government argued that "beyond rights" should be exercised in the context of "primarily" carrying passengers from the United States. As Northwest Airlines reportedly carried more local passengers for the route, the Japanese Ministry of Transport threatened not to renew a temporary license to the route, and Northwest and the US government protested that the Japan side did not have a right to restrict Northwest's beyond right. Northwest eventually abandoned the route. It was probably due to lack of demand rather than being subjected to the Japanese government's demands. The United States "retaliated" when JAL applied for the Sendai-Honolulu route by holding up the decision long enough to make JAL manage the route by "charter" flights for several months.

In 1995, Federal Express (full-right carrier) applied for 7 routes from Tokyo to Asian cities (including the Philippines, where Federal Express is going to build its Asian hub). The Japanese government held up the application, demanding similar expansion for the Japanese carriers. The United States protested and threatened a sanction against Japanese carriers, arguing that Federal Express would not be subject to any restriction on its beyond right. The Japanese side demanded a revision of the "unfair" bilateral agreement before Japan gives permission to Federal Express expansions.

V. Toward Liberalization of International Air Transport

Difficulty in Liberalizing the Japan-US Bilateral Agreement

The current difficulty in negotiating a revision of the treaty (or significant amendment) between Japan and the United States indicates that it could take a long time to liberalize Japan-US international air transport. In order to negotiate a liberalized bilateral agreement, the commercial interests of airlines in the two countries have to match, or one country needs to offer substantial concessions. This can happen. For example, in the case of the US-Netherlands agreement signed in 1992, both countries had a strong interest in obtaining a liberalized agreement. The United States sought to create a precedent for open skies negotiations with other European countries, and the Netherlands wanted to use the negotiation to strengthen the global alliance of KLM and Northwest Airlines. However, there is no apparent motivation for Japan and the United States to liberalize the current bilateral agreement.

In the face of the "unfair" treaty, Japan tries to restore a "level playing field" by restricting the US interests, while the United States wants to pursue an open sky policy. The United States, while not disputing the existence of its advantage in the current treaty, seems to be reluctant to "equalize" the rights first, by unilaterally expanding rights to the Japanese, before pushing for further liberalization. Any delay in negotiation only serves the U.S interest at large.

What makes the prospect of renegotiation complicated is that "incumbent" airlines (Japan Airlines, United Airlines, Northwest, and Federal Express) only receive benefits by delaying the start of renegotiation, while newer entrants (All Nippon Airways, American Airlines, Delta Airlines, and Nippon Cargo Airlines) have to wait anxiously on the side line. Judging from the lack of renegotiation, it seems to be the case that the incumbent carriers have stronger political clout than new entrants in both countries.

Would A Multilateral Agreement be Possible?

Because of the difficulty of negotiating liberalized bilateral agreements, some observers suggest that a multilateral agreement would be a better scheme for creating a more liberal environment in international aviation.¹⁵ Others are more skeptical, arguing that if bilaterals are difficult, multilaterals are impossible. Proponents of multilateralism would argue as follows. In a multilateral setting, unified standards for various types of "freedom" would be introduced and regulation would become more transparent. The US government insists on the merits of the multilateral approach based on the "open sky" principle, and has proposed it in some international forums. For example, it was discussed at the latest meeting of the International Civil Aviation Organization (ICAO),¹⁶ but was not warmly received.

As this example illustrates, it is difficult to create a multilateral framework that satisfies all parties. Nevertheless, several multilateral agreements in international aviation have been concluded. The Chicago Convention of 1944, which created the post-war international aviation system, is a multilateral treaty, although it has no economic regulatory framework. In 1980, the United States and the European Civil Aviation Conference (ECAC) signed the Memorandum of Understanding (MOU) on rules for setting passenger fares. Since the ECAC is the representative organization of the aviation departments of European countries, this MOU was the first multilateral agreement relating to the economic regulation of airlines.

In 1992 the Council of Transport Ministers in the European Community (now the European Union) adopted the third package of common air transport policy, which substantially deregulated the European internal air transport market. The success of the European Union in achieving a multilateral regime was largely due to the overriding desire of European member states to forge a single market. In addition, the European Commission, the administrative body

¹⁵ For example, see Kasper (1988).

¹⁶ International Civil Aviation Organization, World-Wide Air Transport Conference on International Air Transport Regulation: Present and Future, Montreal 23 November - 6 December 1994.

of the European Union, could exercise strong leadership to persuade vested interests, sometimes overriding political "sovereignty," while appearing impartial.

For example, France was ordered to open up the domestic routes (such as France-Toulouse) to foreign carriers in return for allowing state subsidies to Air France. A subsidiary of British Air has a substantial presence in Germany. This kind of opening up seems to be improbable in Japan or in the United States.

To conclude, a multilateral approach may be best suited to the liberalization of international aviation, but this approach needs strong leadership, without the appearance of bias. A multilateral approach, however, must place primary emphasis on economic integration. In the absence of these factors, any multilateral push would not go far. As mentioned, the best example of multilateral success is a regional agreement pushed forward by the European Union. But, this may be more an exception rather than a model for the rest of the world, particularly to the Asian region. Another avenue is for three or more countries with similar interests to conclude an agreement, outside the context of a formal regional group. Proponents of "gradual multilateralism" would argue that even subregional agreements could create important spillover effects that would lead to a more liberalized international air transport environment.

VI. Building Airports in Japan

Congestion at Japanese airports leads to three distinct shortages: terminal facilities, airplane parking spots, and landing and departure slots. The best way to remove congestion is to expand airport capacity, but building new airports is costly, contentious, and time-consuming. Japanese policy makers often assert that the congestion of major airports in the Tokyo and Osaka areas is an obstacle to any workable competition. The report of the Council for Transport Policy pointed out that this is one of the main reasons for its decision not to adopt American-style deregulation in Japan.

The most important feature of the recent Five-Year-Plan for Airport Development formulated by the Japanese government is the expansion of airport capacity in the Tokyo and Osaka areas.¹⁷ For this purpose, the Kansai International Airport was opened in 1994, and Haneda Airport has been expanded. Issues related to the completion of the New Tokyo International Airport (Narita) are still being resolved in the political system (farmers still refuse to sell land). Other plans for constructing or expanding major airports include the third airport in the Tokyo metropolitan area, Chubu International Airport (near Nagoya city), and the second stage of construction at Kansai airport. In the Seventh Plan of Airport Policy, one or two more big airport construction plans will probably be adopted, though financing remains a serious problem.

In Japan, major airports (except for Narita and Kansai) are financed through the Airport Development Special Account, which is funded by airport charges such as landing fees, special landing fees and en-route navigation charges, aviation fuel tax, subsidies from the General Account of the national government, and borrowing from government investment and loan program (see figure 7). The main feature of this mechanism is that most of the financial resources for building airports is borne by passengers (rather than general taxpayers). The airports are not supported as public goods as much as fishery ports and highways are or the national railways once were. Passengers pay aviation fuel tax and airport charges which are included in airfares. Funds borrowed from the government will be also repaid by passengers in the future. Another characteristic of the mechanism is revenue pooling. The revenue received at each airport is brought together into the special account and spent out according to the central governments planning. In this process, the cost and benefit of each airport is not considered, so the mechanism may well lead to cross-subsidization among airports. It is true that such a mechanism maintains a steady source of income for the special account and supports

¹⁷ The Five-Year-Plans were started in 1967. The Sixth Five-Year-Plan is currently being implemented, and discussions on the Seventh have already started.

the long-term planning of airport building. However, the process of deciding which airports are to be supported by the program may be distorted by political pressure. In a sense, the Kansai International Airport is a victim of this revenue pooling system. The Airport Development Law of 1956 provides that the central government is responsible for building a large international airport (the so-called Category I airport). Of course the Kansai Airport is classified as category I, nevertheless it was built by a third sector company. A third sector company is an incorporated company with government (either central or local) equity capital as well as private sector equity capital. In the Kansai case, the central government invested two third of equity capital, and the local governments and private investors contributed one sixth each. The main reason why the third sector company, rather than the central government alone, was chosen to build an airport was a combination of the tight financial conditions of the Airport Development Special Account during the Kansai planning stages and a strong desire of local government and businesses.

Figure 1: Domestic Market Share of Japanese Airlines (in RPKs) 1994 (fiscal year)

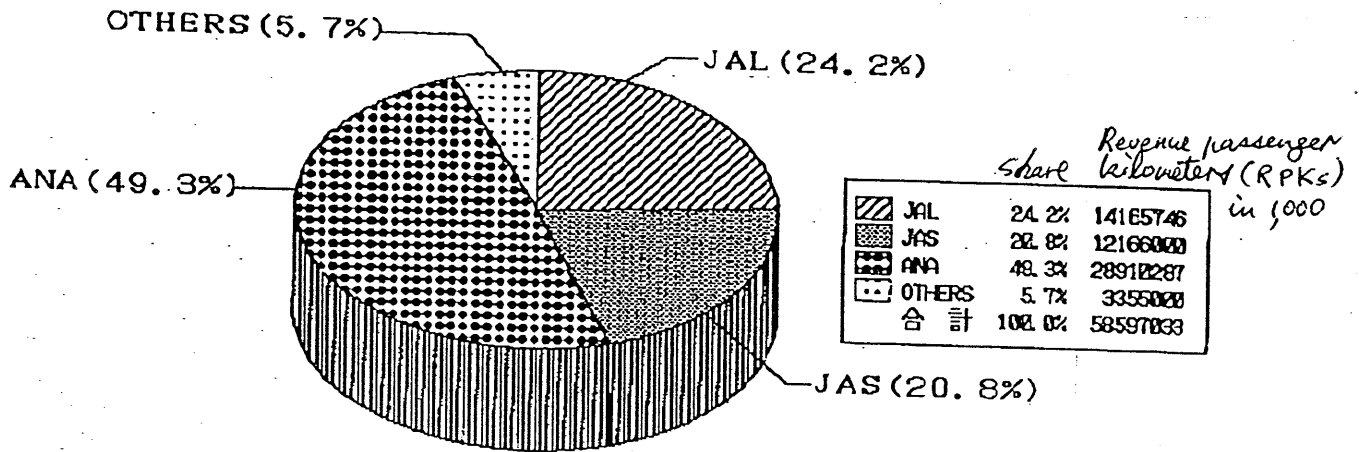


Figure 2: International Market Share of Japanese Airlines (in RPKs)

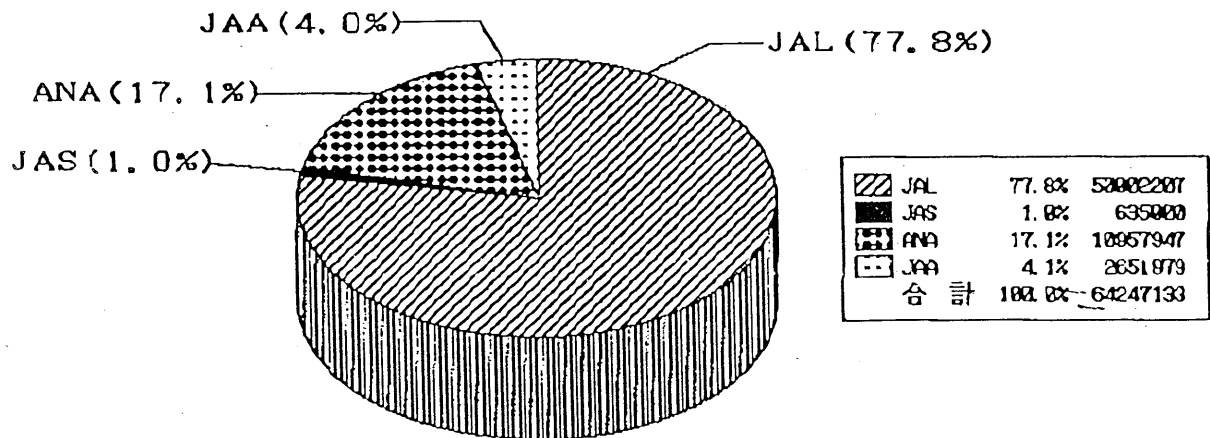


Figure 3. Traffic Carried by Japanese Airlines, 1980-93.

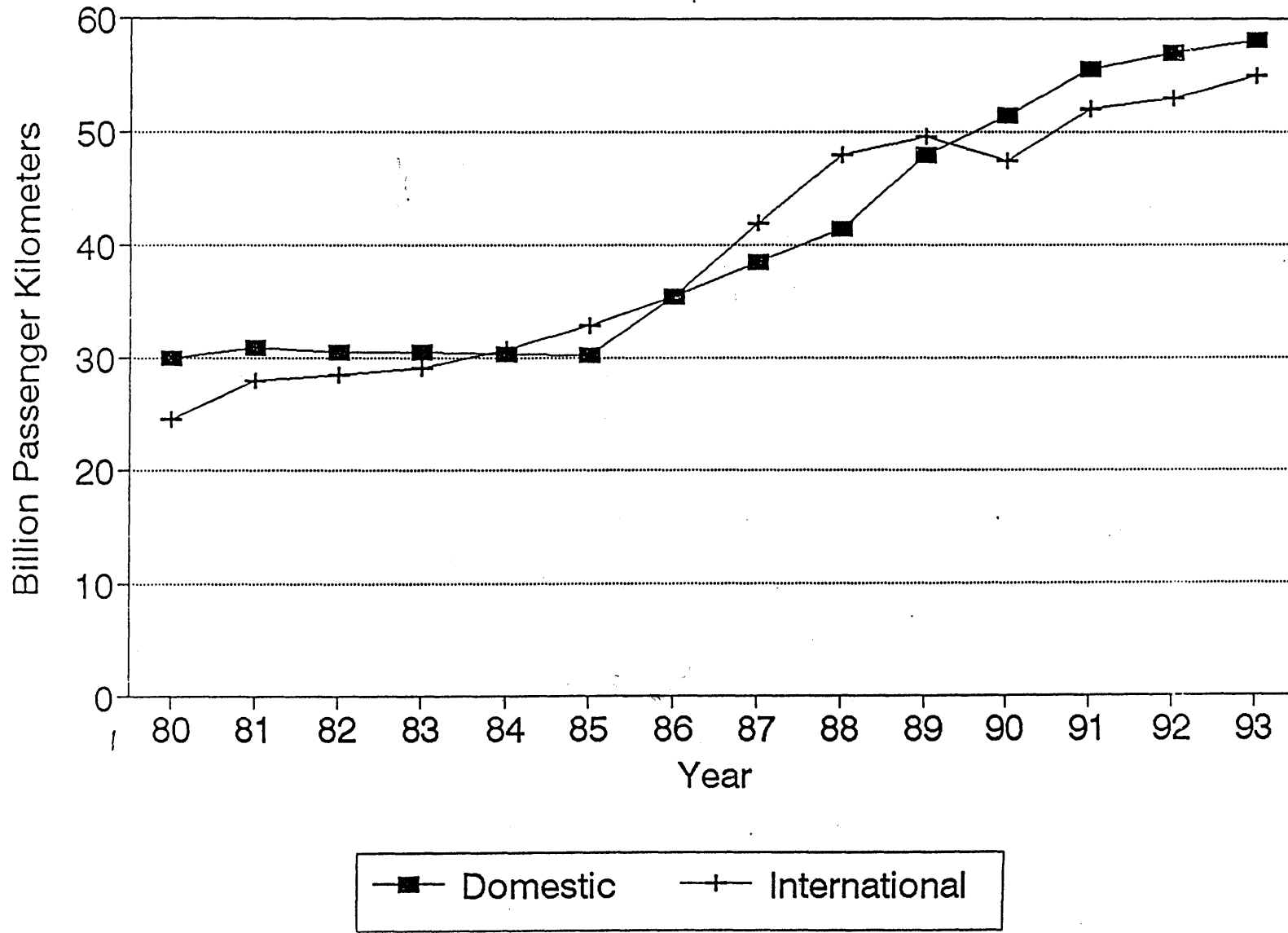


Figure 4. Operating Profits of Japanese Airlines, 1985-1992.

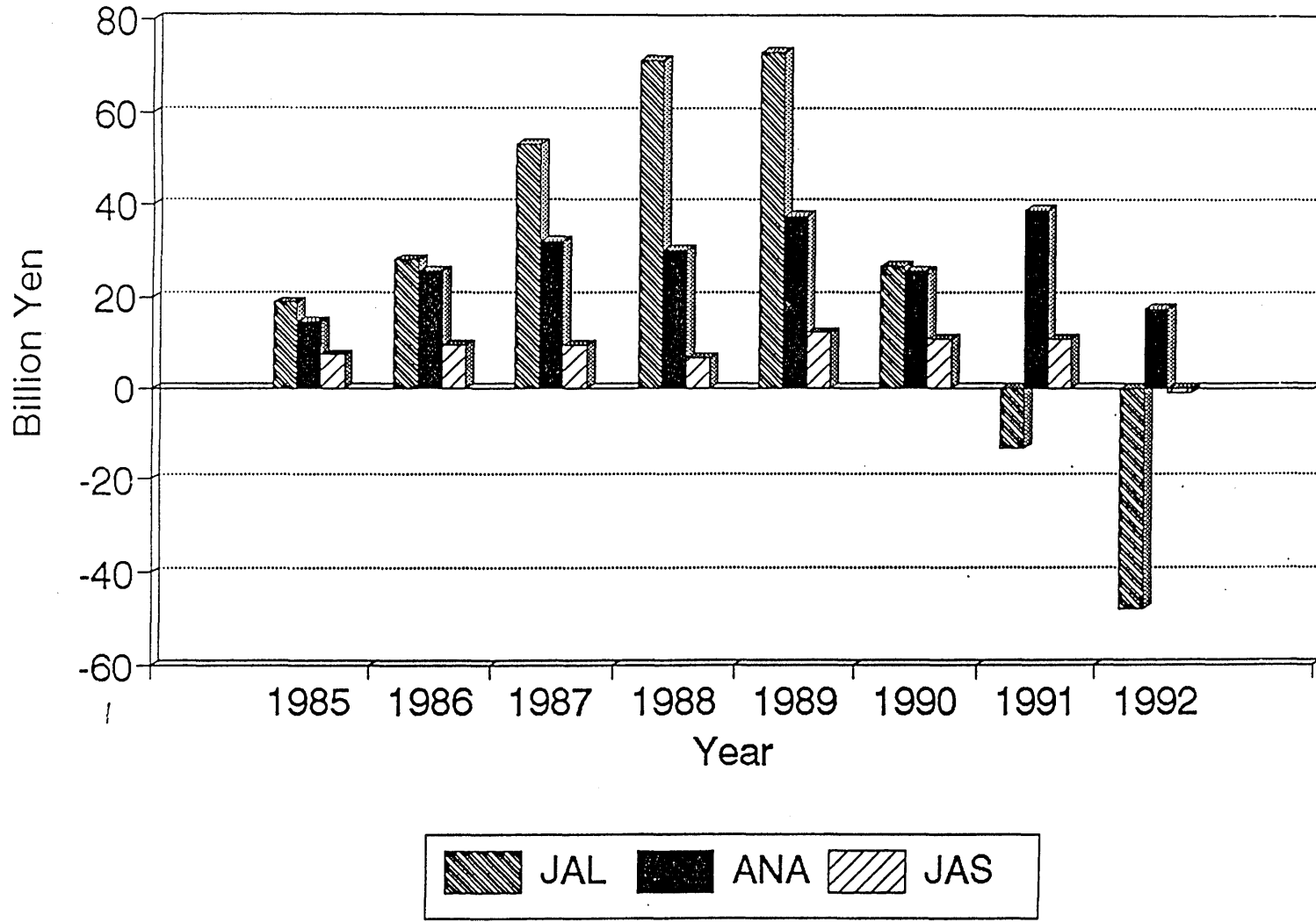


Figure 5. Share of Japanese Airlines in Trans-Pacific Markets.

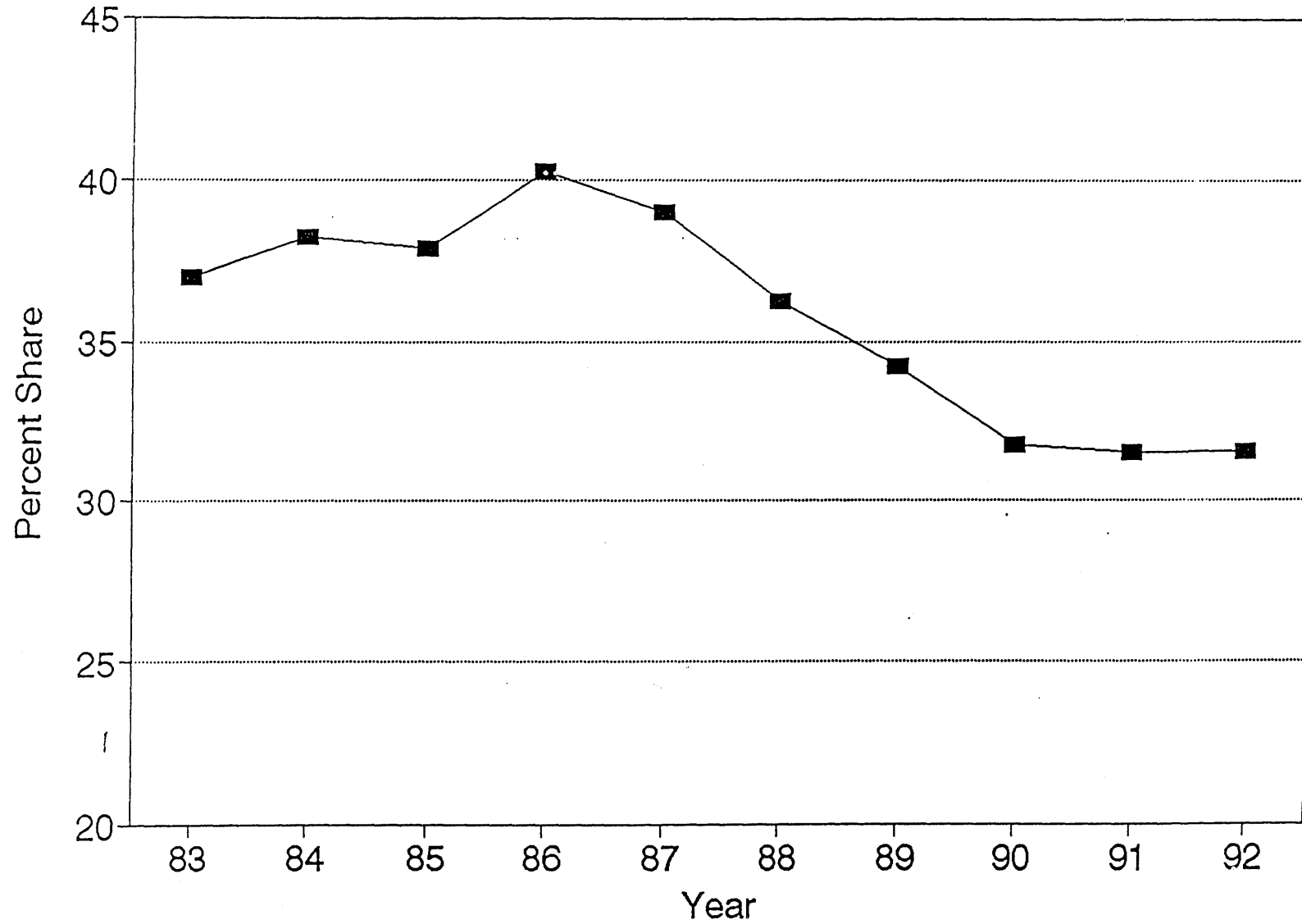
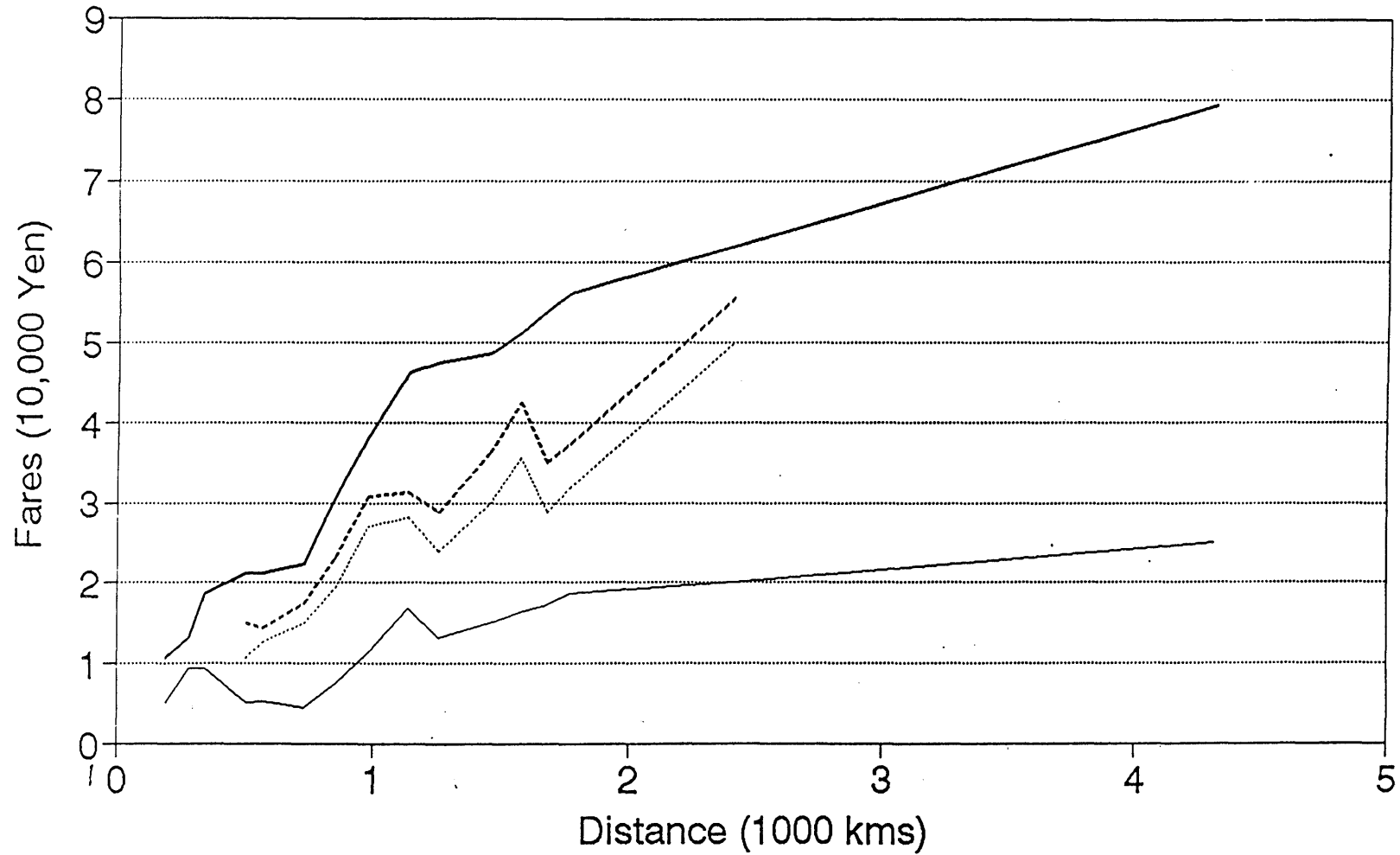
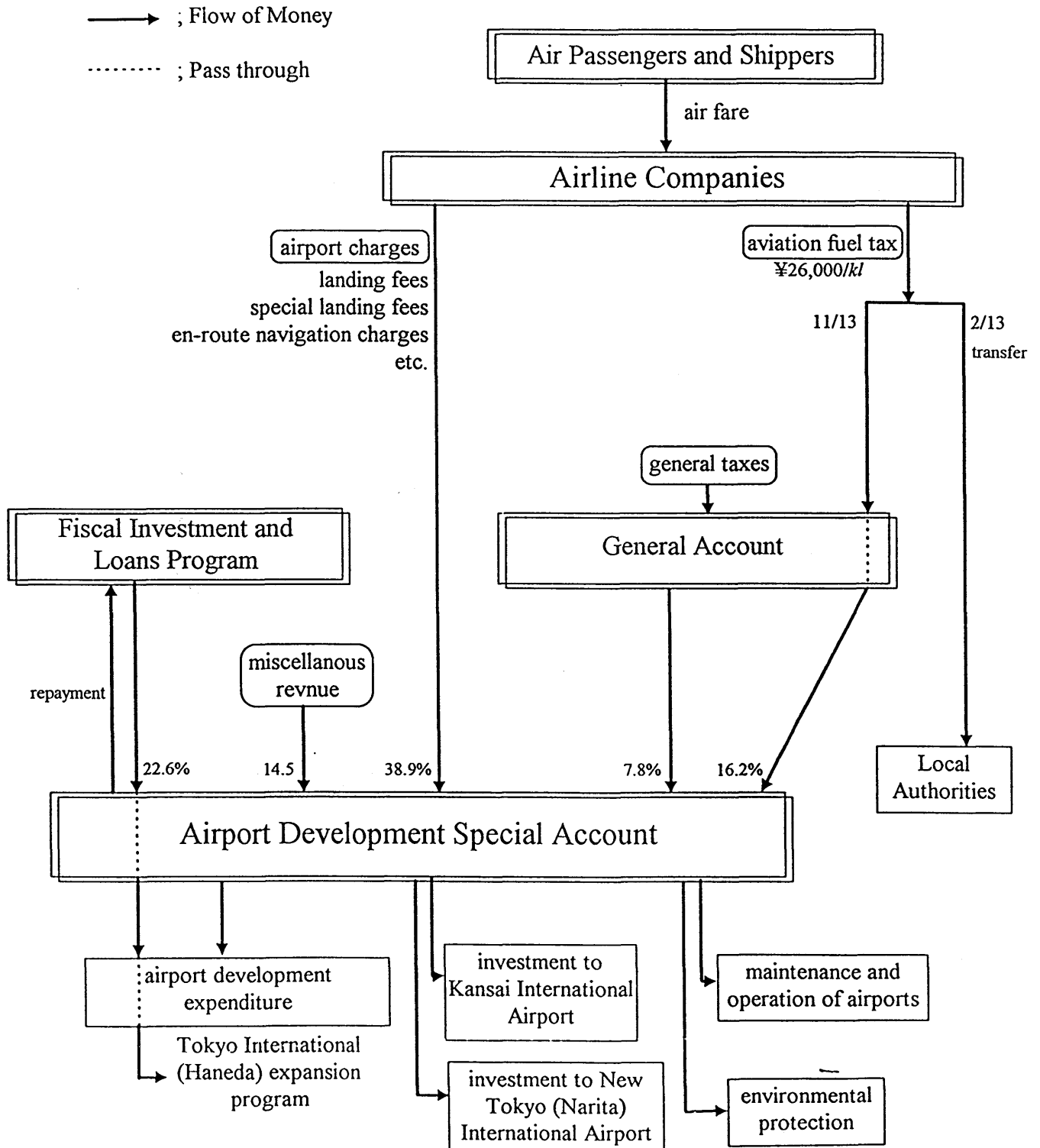


Figure 6. Comparison of US & Japanese Fare Structures., 1991.



— US Discount Fares — US Regular Fares Jap. Discount Fares Jap. Regular Fares

Figure 7. Structure of the Airport Development Special Account



Sources for figures:

Figures 1 - 5. Nihon Koku Kyokai (ed.). 1994.

Figure 6. Ito (1992a)

Figure 7. Authors' calculation from various sources.