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Chicago Regime Research Committee

Report

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Introduction

This report explores the problems with the framework for modern civil aviation activities defined by an international aviation system composed of the Chicago Convention and various bilateral aviation agreements based on that Convention (hereafter called the Chicago Regime), and presents directions for improvements as well as specific details.

In the 60 years since the agreement on the Chicago Convention was obtained in 1944, international aviation has developed remarkably, from the initial extremely limited scale to the present enormous scale. This kind of rapid development has only been equaled by the growth of international telecommunications. Furthermore, international aviation has come to fill an increasingly important role in the international transfer of people and goods and is certain to continue to develop in the same way as international telecommunications. In spite of the development achieved and the certainty of future growth, the international rules governing the field of aviation are the Chicago Regime, which was created based on the concepts, attitudes and circumstances from the middle and end of World War II. In addition, these basic concepts are essentially the same as those in the Paris Convention, created in 1919, shortly after the birth of air transport.

In the latter half of the 20th century in the field of international economics it has become axiomatic that free trade is preferable to protected trade, and that the free-market economy is preferable to the government-regulated economy. Globally consistent rules are being created for transactions involving products and services that have global markets. This approach is steadily taking hold in every economic field, through GATT-WTO, etc. In spite of this, international aviation continues to operate under concepts that are in stark contrast to those applied for other economic fields, which aim for “free, diversified” economic systems. The International Air Transport Agreement is essentially a dead letter, and reliance on bilateral agreements to devise the rules for international aviation have resulted in regulations that differ for each pair of countries instead of the necessary consistent set of rules that apply to the entire international aviation market

Consider the example of a Bermuda type bilateral agreement applied to the automotive trade between USA and Japan. The governments in both countries arbitrarily decide between themselves which participants will be permitted access to their domestic markets, as well as the sales areas, sales volumes and selling prices. This is an even more stringent trade restriction than any existing import quotas.

Everyone recognizes that these agreements are at odds with current thought in the field of international economics. Nevertheless, for the field of international aviation, it is common for there to be even more restrictive agreements than the one described above. As might be expected, since the 90’s, movements to correct this have appeared in the USA and EC. The conclusion of the Open Skies Agreements and regional liberalization, are examples

of such movements. However, as discussed in Chapter 2 (3) of this report, the efforts so far are woefully inadequate or allow for protectionist measures.

In other words, under the Chicago Regime the advantages of a market economy that rewards the more efficient enterprises are lost. Furthermore, the bilateral agreements have led to rampant protectionism in a variety of forms. Specifically, the reserving of certain markets (domestic markets) for domestic enterprises is approved in the basic agreement, the Chicago Convention. Consequently, businesses in a country with a high-powered domestic market have an overwhelming advantage over businesses from other countries.

In light of recent international situations, government restrictions on international aviation are claimed to be necessary for national security. The authors of this report understand that government intervention in the field of aviation from the viewpoint of national security is a given, and that national security should certainly have a higher priority than economic profits for civil international aviation. Nevertheless, the authors protest against the need to restrict ordinary economic dealings in effect when no situations affecting national security occur. In other words, there should be a separation in the handling of government measures for national security, and in dealing with ordinary economic activity. For the latter, there should basically be no government interference in market access or in the quality or quantity of service goods that are offered.

Based on the fundamental awareness, as described above, the authors of this report point out the problems of the Chicago Regime from the perspective of the incongruities with modern aviation services providers, and present some directions for resolving the incongruities. There is also a proposal for an approach of not just correcting the problems with the Chicago Regime, but also addressing new policy issues that have arisen in the latter half of the 20th century, such as limitation of government subsidies, consumer protection, and rectification of the conditions and infrastructure for competition.

The authors of this report propose significant changes to the Chicago Regime, while also recognizing the need for immediate, practical measures. The realities of the system of negotiation of bilateral aviation agreements, the discussions thus far at ICAO, the protectionism of each country's aviation industry, and the post 9.11 security enhancements suggest that it will be hard to make progress just because a reform of the current situation is rational or desirable. In order to make a move forward on reforming the current situation, it may be necessary to consider practicalities rather than ideals, and to compromise on what is realistically achievable rather than fighting for an unattainable standard. Therefore, chapter 4 of this report offers various proposals, including ideas that consider the current situation, and chapter 5 presents measures for Japan to use to handle the issues in the near future.

Please note that the content of this report reflects the personal opinions of the

authors and does not necessarily represent the view of the organization to which the authors belong.

The authors hope that this report will serve as a stimulus for much international discussion on the international aviation system, and help to direct the energy toward making improvements.

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Contents

Chapter 1 History of the Chicago Regime

This study was undertaken based on a recognition that the Chicago Regime (Chicago Convention and the bilateral agreement system that is based upon the convention) that is currently the basis of regulation of international civil aviation activities protects existing interests and hinders the economic activities of motivated aviation businesses, and that there is a need to reform the existing framework in order to promote the further development of aviation. Therefore, in this chapter, (1) the historical background of the development of the Chicago Regime, or the Chicago Convention (official name, Convention on International Civil Aviation, but throughout this report called the Chicago Convention) is summarized, as well as (2) a summary of the attempts to change this framework of bilateral agreements based on the Chicago Convention. (Since the issue of airspace sovereignty is not a subject of this study, the definition of "airspace" is not discussed in detail; nor is the organizational theory of ICAO discussed.)

Under current international law, a country has control over the areas of the sky that are above their territories and territorial waters. In other words, there is sovereignty of territorial airspace. This is a comprehensive right granting the highest level of exclusive control and enforcement[1].

Discussions about the status of territorial airspaces began in earnest at the start of the 20th century, and two theories were proposed. The first was a free airspace theory, which stated that portions of the sky did not inherently belong to the country occupying the territory below those portions. The other was the sovereignty theory, which stipulated that the sky did belong to the country occupying the territory below it. Based on the latter theory, Article 1 of the Chicago Convention states, "The contracting States recognize that every State has complete and exclusive sovereignty over the airspace above its territory." It is generally understood that the convention did not create anew "territorial airspace sovereignty," but merely declared, in a statutory form, the principle of international law that had widely been recognized after World War I[2].

The "complete and exclusive sovereignty" stipulated in Article 1 of the Chicago Convention means that for flights through any airspace, permission must be obtained from the country controlling that territorial airspace. Based on this provision on airspace sovereignty, the Chicago Regime denies the concept of "free skies," allowing flights over or landing within a State only if permission has been obtained in advance from the contracting State for scheduled flights. The lack of "free skies" in the Chicago Convention led to the

[1] Kisaburou Yokota, *Kokusaihō II (Shinban)* (International Law II, new edition) (Yuhikaku Horitsugaku Zenshu (Complete Works of Jurisprudence), 1976)
[2] Akio Sakamoto, *Kokusai kōkū hōron* (International aviation law) (Yushindo, 1992)

subsequent establishment of bilateral agreements, which permit "free skies" on an individual and limited basis, and the imposition of various economic restrictions; with all these factors, the Chicago Regime has become a severely restrictive economic regulation system.

This means that the basic provisions regulating the economic activity known as international commercial aviation come from Article 1 of the Chicago Convention on the sovereignty of territorial airspaces, so the outline of the history of the Chicago Convention will focus on this. Therefore, it is first necessary to describe the Paris Convention, which has a stipulation that is identical to Article 1 of the Chicago Convention.

1. Paris Convention (Convention Relating to the Regulation of Aerial Navigation)

The Paris Convention (Convention Relating to the Regulation of Aerial Navigation) was established in 1919 after World War I. This was the first multi-lateral agreement regulating international civil aviation activities, and is the treaty that forms the foundation of the Chicago Convention.

Article 1 states that "The High Contracting Parties recognize that the every Power has complete and exclusive sovereignty over the air space above its territory. For the purpose of the present Convention, the territory of a State shall be understood as including the national territory, both that of the mother country and of the colonies, and the territorial waters adjacent thereto," thereby defining territorial airspace sovereignty.

On the other hand, Article 2 states that "Each contracting State undertakes in time of peace to accord freedom of innocent passage above its territory to the aircraft of the other contracting States, provided that the conditions laid down in the present Convention are observed," thus recognizing the freedom of innocent passage through territorial airspaces.

Furthermore, in Article 15 there is the stipulation that "Every aircraft of a contracting State has the right to cross the airspace of another Space without landing". The third paragraph of this same Article states that "The establishment of international airways shall be subject to the consent of the States flown over." Subsequently, there were two interpretations of these provisions. One interpretation was that the contracting countries must give prior consent to all the flight routes through their own country, and must not put any restrictions on civil aircrafts using these flight routes. The other interpretation was that the countries flown over must have the authority to restrict the activities of the international aviation companies regularly using the international flight routes[3].

[3] Masahiko Kido *Kūiki shuken no kenkyū* (Study on airspace sovereignty) (Kazamashobo 1981). According to this report, the disparity between the interpretations led to a discussion of revisions in 1929. Four countries, the UK, USA, Netherlands, and Sweden, pushed for the liberal interpretation, but the other 27 countries insisted on the restrictive interpretation. As a result, the provision was revised to state that "every contracting State may make conditional on its prior authorization the establishment of international airways and the creation and operation of regular international air navigation lines, with or without landing, on its territory".

As this illustrates, the Paris Convention, as indicated by the provisions on the rights of innocent passage and Article 15 paragraph 3, was not as restrictive as the Chicago Convention, or had provisions that can be interpreted to be less restrictive. The Paris Convention recognized some leeway for economic freedom, even under a situation of "complete and exclusive" sovereignty of the territorial airspace.

2. Chicago Convention (Convention on International Civil Aviation)

(1) Formation process

As air transport developed rapidly, the USA was quick to recognize the need for an internationally-organized framework on international civil aviation following World War II. In 1944, the year before the end of WWII, the USA held a conference on international civil aviation in Chicago for the purpose of concluding a multi-national aviation treaty.

During the process of deliberations, based on recognition of the principle of territorial airspace sovereignty in Article 1 of the Paris Convention, the USA insisted that only the freedoms of transit and landing (first and second freedoms[4]) in the treaty be approved and the other three freedoms be left for separate agreements. In comparison, the UK feared that leaving the stipulations related to economic activities, especially the five freedoms, subject to separate agreements would lead to a system that was centered on the USA, which was the overwhelmingly preeminent force in aviation at that time. The UK insisted on an agreement specifying four freedoms, excluding the fifth freedom, presupposing that an international agency would be established with the authority to oversee international aviation. There were also complications such as the interests of South American countries, and the provisions on the five freedoms required for commercial aviation services could not be satisfactorily incorporated in the treaty[5]. As a result, four treaty proposals were created, including in addition to the Chicago Convention, the International Air Services Transit Agreement (hereafter called the Transit Agreement) stipulating the first and second freedoms, the International Air Transport Agreement (hereafter called the Transport Agreement) stipulating five freedoms, and an interim agreement (an agreement to fill the gap until the Chicago Convention entered into force). In 1944 these treaty proposals were adopted. The Chicago Convention was ratified by 26 countries and entered into force in 1947.

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[4] The five freedoms stipulated in the International Air Transport Agreement are as follows. (1) The privilege to fly across the territory of contracting States without landing. (first freedom) (2) The privilege to land for non-traffic purposes. (second freedom) (3) The privilege to put down passengers, mail and cargo taken on in a territory of the State whose nationality the aircraft possesses. (third freedom) (4) The privilege to take on passengers, mail and cargo destined for the territory of the State whose nationality the aircraft possesses. (fourth freedom) (5) The privilege to take on passengers, mail and cargo destined for the territory of any other contracting State and the privilege to put down passengers, mail and cargo coming from any such territory. (fifth freedom). A United States Accountability Office report classifies aviation freedoms as 9 freedoms, including cabotage, etc. (Transatlantic Aviation, July 2004).

[5] Refer to the previously mentioned reference by Kido for details on the history of the deliberations process.

(2) Territorial airspace sovereignty and the framework for commercial aviation under the Chicago Convention

(a) Article 1 stipulates that "The contracting States recognize that every State has complete and exclusive sovereignty over the airspace above its territory." This is a nearly verbatim statement of the principle of territorial airspace sovereignty codified in the Paris Convention. The big difference from the Paris Convention is that there is no stipulation similar to Article 2 of the Paris Convention about the freedom of innocent passage.

(b) Secondly, a distinction was made between scheduled international flights and non-scheduled international flights. Certain freedoms were recognized for the latter, while the former are subject to severe restrictions.

In other words, the first paragraph of Article 5 states that "Each contracting State agrees that all aircraft of the other contracting States, being aircraft not engaged in scheduled international air services shall have the right, subject to the observance of the terms of this Convention, to make flights into or in transit non-stop across its territory and to make stops for non-traffic purposes without the necessity of obtaining prior permission, and subject to the right of the State flown over to require landing. (qualifications omitted)". The second paragraph of Article 5 stipulates that non-scheduled flights carrying passengers, cargo or mail for remuneration or hire shall also have the privilege of taking on or discharging passengers, cargo or mail, subject to specific conditions. However, the subsequent qualifications do stipulate that "the State where such embarkation or discharge takes place has the right to impose such regulations, conditions or limitations as it may consider desirable." (Subsequently, the actual situation in each country has developed into being run in a way that is very similar to the prior permission system for scheduled flights.)

(c) Regarding scheduled international flights, Article 6 states that "No scheduled international air service may be operated over or into the territory of a contracting State, except with the special permission or other authorization of that State, and in accordance with the terms of such permission or authorization." The basic principle of the prior permission system is that freely-conducted air services are not allowed. This means that special permission or blanket permission is required to transit through the airspace over a country or into the country. In order to complement the Chicago Convention, the Transit Agreement with provisions only for the first and second freedoms, and the Transport Agreement with provisions for all five freedoms were established. The Transit Agreement entered into force in 1945[6], and remains in force, with 122 contracting States. The Transport Agreement had 28 contracting States in 1946, but some states, including the USA, later withdrew and there are currently only 11 member states, so it is virtually

[6] For both agreements, the member states of ICAO (International Civil Aviation Organization) may accept these agreements as an obligation binding on themselves by notification of such acceptance to the US government. On the date that the US government receives the notice of acceptance, the agreements become effective.

ineffective. As a result, the third through fifth freedoms that are indispensable for civil aviation services were left to bilateral aviation agreements, and this is the framework that remains today, basically unchanged.

(d) Article 7 grants contracting states the authority regarding cabotage, stating that "Each contracting State shall have the right to refuse permission to the aircraft of other contracting States to take on in its territory passengers, mail and cargo carried for remuneration or hire and destined for another point within its territory. (second and subsequent lines omitted)."

In this way the Chicago Convention just introduced a system of prior permissions for scheduled international aviation business, without specifying anything about the five freedoms, a situation that is completely inadequate for international air services. The parties to the Chicago conference, although desiring a multilateral agreement, adopted the immediately practical approach of blanket permissions through bilateral aviation agreements about the five freedoms, with the expectation that a multilateral agreement would be established in the future. Since it was felt that it would be desirable for later bilateral agreements to be as uniform as possible, a Standard Form of Agreement for Provisional Air Routes (called the Chicago Standard Form) was specified in the final protocol of the Chicago Convention, and it was recommended that the contracting States to the Chicago Convention utilize the Standard Form when concluding any bilateral agreements. (Since there was multinational agreement on the first and second freedoms, the Transit Agreement held promise, but there was no consensus reached on the third through fifth freedoms, so the prospects of multinational participation in the Transport Agreement are slim. For this reason the reliance on bilateral agreements was practical).

The Chicago Standard Form, in addition to specifying the granting of the privileges needed to establish operations and routes in the annexes, also specifies details of the rights to routes and commercial flights, designation of aviation businesses, control and ownership of aviation businesses, airport usage fees, etc.

3. Bilateral agreements

(1) Bermuda Agreement

In 1946 the USA and the UK concluded an aviation agreement (called the Bermuda Agreement because the negotiations took place in the Bermuda Islands. This came to be called Bermuda I to differentiate it from the agreement with the same name concluded in 1977). This Bermuda Agreement did conform to the Chicago Standard Form, but, since the Chicago Standard Form did not have provisions for fares and fundamentals related to transport capacities, the agreement itself covered these portions. This agreement has been called a product of negotiations between the USA pushing for liberal policies and the UK pushing for a more restrictive framework, but the result was a very restrictive agreement,

with comprehensive provisions made on the details of transport capacities and fares. Subsequently, this agreement became a model for other bilateral agreements throughout the world, and the basic framework endures even today.

This agreement is composed of three portions[7]. The first portion contains resolutions stipulating the principles related to the transport capacity offered by the designated aviation businesses in both countries. For this, four principles were adopted. (a) A close relationship to public demand must exist for aviation transport (balance with demand), (b) fair and equal opportunity, (c) consideration of the interests of the businesses of the partner nation on identical routes, (d) the primary objective is the provision of services between one's own country and the final destination in the partner nation. Beyond rights must be exercised in accordance with general principles on systematic development agreed upon by the governments of both countries. With regard to the transport capacities, it is requested that consideration be made of the demand for air transport between the originating region and final destination, as well as the demand for direct aviation routes. Second, there is a portion stipulating the principles related to aviation operations conducted by the designated aviation businesses in both countries. These stipulations focus on the matters specified in the Chicago Standard Form, such as the domestic handling, including airport fees and designation of aviation businesses. Third, there are annexes clarifying the principles related to fares and the routes serviced by the designated aviation businesses in both nations. With regard to fares, the fares applicable from both negotiations must be approved by both countries. However, as a result of a compromise by the USA, the fare determination mechanism of the International Aviation Transport Association (IATA) was approved. For routes, the USA and the UK divided up the routes, and assigned a region name for each, including origination points, intermediate stops, sites within the partner nation, and beyond points. There is also an annex with provisions on the conditions for a change of gauge.

In this way the Bermuda Agreement introduced detailed restrictions on fares and routes and the operation the aviation services between two countries by the designated aviation businesses. The USA aimed to build a competitive international aviation system with minimal regulation, and proposed the Chicago conference. However, this goal was not achieved. Instead, contrary to expectations, an extremely restrictive international aviation system was formed as a result of the Bermuda Agreement concluded by the USA and the UK. Later, variations appeared, such as the US Open Skies agreements, but even today the Bermuda Agreement based on the Chicago Convention is the basic model for bilateral agreements throughout the world. As of March 2002 there were approximately 4000 bilateral agreements in existence. (This situation represents a "cryptomultilateral regime for scheduled aviation operations.")

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[7] Refer to Akio Sakamoto, *Gendai kōkū hōron* (Modern aviation law) .

(2) After the Bermuda Agreement

The UK decided that the Bermuda Agreement was unfair and unsatisfactory, and notified the USA of their intent to abolish the agreement in 1976[8]. As a result of negotiations a new agreement (called Bermuda II) was established in 1977. In the new agreement new elements were introduced, including additional provisions on international aviation charter services because of a need to include the expanding and diversifying charter business into the regulatory framework, introduction of the concept of aviation businesses that only handle cargo, introduction of the concept of efficiency as the standard for transport capacity, and a system of notification of fare changes (however, current fares remain in effect if there is a formal objection to a change by the partner nation). Within the USA, however, this did not match the Carter administration's ideas on furthering aviation liberalization, and was even more restrictive of the five freedoms for US businesses than the existing agreement.. There was also strident criticism of the UK's demands for additional gateway cities in the USA as being a revision that was disadvantageous to American businesses.

Influenced perhaps by the criticism of Bermuda II concluded in 1977, President Carter signed a proclamation on International Aviation Transport Negotiations the following summer in 1978. This proclamation proposed the elimination of restrictions on transport capacities and routes, the creation of greater opportunities for reformed, competitive pricing, liberalization of charter regulations, and increasing the number of US cities serving as gateways as the targets for aviation negotiations in order to maximize benefits to consumers through the expansion and preservation of business competition in fair markets. Actually, in the spring of 1978 the USA and the Netherlands concluded an aviation agreement detailing reduced government intervention on transport capacities, fares and charters, as well as increasing the number of designated aviation businesses, providing a preview of the contents of the proclamation. This US-Dutch aviation agreement became the model for later bilateral agreements involving the USA. By 1980 similar agreements had been concluded with Israel, West Germany, Belgium, South Korea, Singapore and Thailand. However, within the USA there was a great deal of criticism from American businesses regarding the granting of gateway locations within the USA to the aviation businesses of other countries. Since there was a severely negative attitude about the granting of locations, the new agreements lost their appeal, and such agreements were never concluded with a large number of countries.

In the 1980s there was actual progress on the liberalization of fares on many international routes, and new participation in international aviation by many countries was expected. New participants in international routes at this time include All Nippon Airways

[8] According to Akio Sakamoto in *Kokusai kōkū hōron*" (International Aviation Law) the dissatisfaction of the UK can be summarized in the following 3 points. (a) Ambiguity about the number of designated aviation businesses (b) Doctrine of post facto examination of transport capacity, giving rise to excessive provision of service for beyond routes by US aviation businesses (c) Fare provisions were ineffective

(ANA) from Japan, Asiana Airlines from South Korea, and EVA Air from Taiwan. Major US carriers also expanded into international routes, including United Airlines, American Airlines and Delta Airlines.

By the beginning of the 1990s several countries, starting with the USA, had reached a strong conclusion about the need for further liberalization of the international aviation market. There were three main points raised[9]. The first was a growing recognition that there is nothing unique about the aviation industry in comparison to other industries, and that there is no reason for special regulation. The second was that it was determined that the bilateral agreements were inherently limited due to the repeated disputes over their application and interpretation, and that they were not a desirable framework from the perspective of creating or developing new opportunities. Third, as the airline businesses were privatized and government subsidies eliminated, there was a demand for an environment that allowed freer operation. Furthermore, there were movements calling for tie-ups with businesses in other countries. In the USA new participants like United Airlines found opportunities for business expansion in the international market based on the solid network in the domestic market, and recognized the need for market liberalization.

Under these circumstances the USA and the Netherlands concluded a new agreement in 1992 which liberalized routes and locations, recognized the fifth freedom without restrictions and eliminated the transport capacity and fare controls. This formed the foundation of the Open Skies Policy that was officially announced in 1995, and was the first Open Skies Agreement. Today it is the model of aviation agreements for the USA. The major feature of this policy was the recognition of code sharing for international aviation services. Moreover, the US government allows such global alliances to coordinate pricing without fear of antitrust prosecution. However, for an individual alliance to receive antitrust immunity, the foreign carrier's home country must have signed an Open Skies agreement with the United States. Since 1978 an effective negotiation tool for promoting the conclusion of an agreement had been the granting of gateway cities to the other nations. The USA adopted international code sharing and created a situation promoting business tie-ups, using the granting of an exemption from anti-monopoly laws as a negotiating tool to encourage participation in Open Skies agreements. (Refer to Chapter 2 for details about the Open Skies Policy.)

In May 2006 the USA concluded an Open Skies Agreement with Chad (albeit, a provisional agreement), bringing the total number of countries concluding such agreements since 1992 to 76. However, these 76 agreements are only a small portion in numbers among the 4000 aviation agreements that are currently in existence throughout the world. Attempts at multilateral Open Skies Agreements, starting with some of the APEC countries, have not led to great increases in the number of participating countries. The Open Skies

[9] Rigas Doganis, The Airline Business in the 21st Century (Routledge, Nov 2000)

Agreements are a large step toward liberalization in comparison to the existing framework. Nevertheless, there are various restrictions preserved in the annexes, depending on the signatory nation, indicating the limit of the attempt of liberalization through bilateral agreements.

(3) Liberalization in Europe

Since the middle of the 1980s there has been progress on liberalization in Europe parallel to that in the USA. In contrast to the pursuit of liberalization through bilateral agreements like the USA, the approach in Europe has been to form a framework of multi-national liberalization limited to the members of the European Community (EC).

In 1984 and '85, the UK and the Netherlands concluded bilateral agreements recognizing free entry by new businesses, liberalization of transit points and transport capacities, as well as a double disapproval system for fares. On the other hand, within Europe there was increasing demand from the European Parliament and users for deregulation of aviation services within the region. The Transport Directorate of the European Commission worked toward aviation liberalization policy within the European Community, and the Competition Directorate tried measures to protect the competitiveness of the markets. In 1986 a decision of the European Court stated that the Rome Convention on competition is applicable to air transport. Based on this decision, in 1987 the transportation cabinet assembly announced the first liberalization package as the first step toward multinational aviation liberalization. (Refer to Chapter 2 for details on the liberalization from the first package through the third package in 1993.)

In addition to the above, the ICAO has been working on liberalization, and the OECD has tried to create an international framework including efforts to liberalize shipping, but there are no practical results. At the Beyond Open Skies Conference held in Chicago on December 6, 1999 Chicago, sponsored by the US Department of Transportation, (then) EC Commissioner of Transport, Loyola de Palacio, noted that for the establishment of fair and equal-competition markets it was appropriate for the USA and EU to take the lead as the two largest aviation markets in the world, with many shared aviation policies and a great influence in the world, and suggested the formation of a Transatlantic Common Aviation Area (TCAA). The proposal called for the elimination of all the restrictions on the exercise of freedoms and investment in both of the markets, and the harmonization of non-commercial policies including competition policy. The USA agreed to initiate talks aimed at further liberalization of the US–EU market, and the USA and EU have continued discussions toward a new transatlantic framework.

Initially, the EU side expressed a desire to have a conference for an agreement before the summer of 2002, and the USA and EU subsequently conducted negotiations

several times. However, the discussions did not produce a new agreement before the summer of 2002.

In November 2002 the European Court of Justice ruled that bilateral agreements between the USA and eight EU member nations (Denmark, Sweden, Belgium, Luxemburg, Austria, Germany and the UK) were in conflict with European Community law. Following this judgment, the European Commission and the USA began aviation negotiations in October 2003.

In the provisional USA-EU Open Skies agreement in November 2005, it was agreed that there would be freedom on transport capacities, routes and the setting of fares based on market principles, and free participation in cooperative arrangements with other aviation companies, such as code-sharing and equipment leases, as well as freedom of entry points in each country for the aviation businesses of both sides.

Apart from the negotiations, the US proposed a change to the interpretation of the current US foreign control restrictions (to allow foreign investors to take part in business decisions that may affect their investment while not changing the current 25% cap on foreign investment). The EU, however, viewed this proposal as an implicit component of the US-EU Open Skies agreement.

Some US aviation companies and related labor unions have expressed opposition to the changes to the foreign control restrictions. In addition, Congress has also expressed strongopposision to the relaxation of foreign control restrictions. Thus, the rejection of the proposal by the US congress casts doubt on whether the EU will formally adopt the Open Skies agreement. Facing mounting criticism against the proposed rules, the US government announced its withdrawal on December 5, 2006. There is a danger that the likelihood of establishing a new aviation agreement between the USA and EU will vanish as a result of this new development.

4. Summary (from the perspective of airspace sovereignty and security)

Previously it was explained that the Chicago Regime denied the right of innocent passage that had been recognized in the Paris Convention. However, the Paris Convention was actually revised in 1929, completely denying the right of innocent passage. This is explained by the increase in the need for national security and the growing competition among aviation companies in the 1920s. Even at that time there was a strengthening tendency for the concept of airspace sovereignty to work as an economic restriction on international aviation in the name of national security.

The intent of the USA in taking the initiative in establishing the Chicago Convention was to create a free system for international aviation business. However, contrary to the intent of the USA, the Chicago Convention recognized airspace sovereignty,

denied the right of innocent passage and did not secure the necessary "freedom of the skies" for civil international aviation operations. Since Article 6 of the Chicago Convention requires approval to land in a member nation, the Chicago Regime has been built from bilateral agreements adopted to enable scheduled international aviation operations but including restrictive economic regulations on details such as transport capacities, routes and fares. To say it another way, Article 6 of the Chicago Convention reflects the principle of airspace sovereignty on commerce, while the formalization of bilateral agreements introduced a variety of economic restrictions and provided each country an opportunity to protect their own aviation businesses.

This kind of economic regulation does work as a preventive measure for assuring exclusive airspace sovereignty. As a ex-post measure, for foreign aircraft that accidentally or intentionally invade a nation's airspace without permission, each nation has adopted the necessary measures to ensure exclusive sovereignty of their airspace (Article 1 of the Chicago Convention) and prevent threats to the security of their territories.[10] (However, such measures must be in proportion to the damages to legal interests that arise from the encroachments on airspace.)

The following points can be made regarding an assessment of the Chicago Regime at the present time.

(1) The continued use of advance permissions in order to ensure exclusive sovereignty of airspace is based on an assumption of threats to security from airplanes during time of war. Therefore, this restriction should not be abandoned merely as being outdated. Rather, the increased awareness of the impact on aviation security brought about by the terrorist attacks on September 11, 2001 illustrates that the intent of the permission system has not lost justification.

(2) However, the problem is that the Chicago Convention does not ensure "freedom of the skies", and, in leaving the situation to bilateral agreements the principle of exclusive sovereignty of airspace has become linked to a variety of economic restrictions, such as capacity controls, routes and fares that are justified under the guise of national security. These restrictions have come to work as protection for domestic aviation businesses, and are excessive economic restrictions with no connection to national security. Certainly, permission to land or pass through a country is related to security issues; but, the blanket permissions granted in the bilateral agreements mean that the regulations on transport capacities and fares are essentially no different than import quotas and price controls for automobiles and steel. Such restrictions are severely limited by GAT, GATS. Theoretically, economic benefit increases by eliminating economic restrictions as much as possible.

[10] Security of the territory originally was related to wars and the use of weapons, but today it covers the concept of legally protected interests that are threatened by various encroachments, such as territorial incursions and environmental pollution (Kisaburou Yokota "International Law II (revised))

Accordingly, it is necessary to pare down regulations only to those needed from the viewpoint of security, and to investigate whether there are justifiable reasons for the other regulations. (3) There is a more fundamental question. Even if the justification for the system of prior permission is still meaningful today, there is a need to investigate whether a system of "Prohibited in principle, permission granted as an exception" is necessarily desirable in modern society.

The principle of exclusive sovereignty of airspace does not logically require a system of prior permission. If the system of prior permission is the necessary result of the manifestation of sovereignty, then it should apply not just to scheduled flights, but also to non-scheduled flights. However, the text of the Convention grants non-scheduled flights the rights to land. For security, prior permission should apply to both scheduled and non-scheduled flights. In fact, the reason prior permission was not required for non-scheduled flights is that such flights were not considered to be a significant factor in commercial aviation. In other words, the system of prior permissions was established mainly to protect international aviation businesses with scheduled flights. In this case, from the perspective of minimizing economic restrictions as much as possible, it is not necessary to blindly adhere to the current system of prior permission; there is plenty of leeway to construct a new system that strikes a balance between security and economics.

For example, there could be a system in which during times of peace the use of airspace sovereignty is limited, so that in principle there is freedom, with denial permitted in cases where there are likely threats to security. In any case, regardless of legal structure, it should be possible to allow free economic activity of foreign aircraft during peaceful times while adequately ensuring security through a system of multilateral agreement including a safety net, such as restricted permission or flight prohibitions in the event that a serious security situation becomes likely (for example, clear and present danger).

Chapter 2 Problems with the Chicago Regime

(1) Background of Issues (Changes in the circumstances of aviation)

As described in the previous chapter, the Chicago Convention does not provide the economic privileges related to free airspace. Since the convention was first established, it has been assumed that it would be revised in the future. On the other hand, it was also intended that a practical system of bilateral agreements would be adopted, so the Chicago Standard Form was proposed. Referring to the Chicago Standard Form, the USA and the UK concluded the Bermuda Agreement, which became the model for the system of bilateral agreements that was subsequently established. The fundamental concepts supporting the Chicago Regime can be summarized in the following two points. One was the idea that since the aviation industry at that time was in its infancy, with excellent future prospects, the aviation industries, particularly national flag carriers, needed to be protected from competition with carriers of other countries (specifically the USA). The second was the need for adequate consideration of national security; an awareness arising from the importance of aircraft as weapons during World War II. In the face of such attitudes, the Chicago Convention justified and allowed governments to enforce unrestricted market intervention and protectionism. The bilateral agreements resulted in a fragmentation of the global aviation market, with many different sets of restrictive and exclusionary rules in force.

In the 60 years since the Chicago Convention was signed, there have been enormous changes in both the world economy and the aviation industry.

To illustrate the changes in international aviation transport, consider the following. In 1947, the year that the Chicago Convention entered into force, the worldwide transport volume of scheduled international passenger flights was 19 billion person-kilos, while in 2003 it was 2,991.621 billion person-kilos, an increase by a factor of 157. During this time, in 1954 Japan Airlines started service on Japan's first international route between Tokyo and San Francisco. The fare was equivalent to more than the average annual salary in Japan. In comparison, the current fare between the same cities is less than 3% of the average annual salary[11]. In the past, international aviation was regarded as a luxury service. Today, it can be claimed that international air services have become a mass-consumption good. According to a recent IATA survey[12], the users of civil aviation have become mainly middle

[11] One-way fare between Tokyo – San Francisco in 1954 was $650 ($1 = 360 yen, so this was equivalent to 234,000 yen). There was no first class at that time. The average annual salary was about 180,000 yen.
Currently, if a discounted ticket is used to fly the same segment, the fare is less than 100,000 yen. In 2003, the average annual salary was 3.75 million yen. (Salary data is not available for 2004 and thereafter; the figures shown above are calculated based on the assumption that salaries have not risen much since 2003 and that current airfares are not very different from those in 2003.) The average salaries were calculated using data from Report on the Survey of Wages and Salaries at Private Firms (National Tax Agency).

[12] IATA Economics Briefing: Air Travel for the Rich or Mass Transport (June 30, 2005)

class, and this trend has become more pronounced in recent years.

UK passengers at London Area airports by socio-economic group (TABLE)

Socio-economic group	1978	1991	2003	2003 leisure only
A/B	52.9%	50.9%	41.8%	35.4%
C	39%	43.5%	52.7%	57.4%
D/E	8.1%	5.6%	5.5%	7.2%

Source: UK Civil Aviation Authority Annual Passenger Survey.

Groups based on occupation of head of household:

A/B – Higher or intermediate management professional

C – Supervisory clerical, junior management professional, skilled manual worker

D/E – Semi-skilled, unskilled manual worker, pensioners, widows, casual workers

The transport volume of scheduled cargo flights has also grown, from 270 million metric tonnes in 1947 to 125.241 billion metric tonnes in 2003, an increase by a factor of 464 in a little more than half a century. During the same period the volume of freight carried by ships increased by 15 times[13], highlighting just how remarkable the growth of air freight has been. This makes it clear that international air services have become mass-consumption goods, and form a mature industry. In spite of the fact that the rules for this situation should naturally be different from the rules during the period immediately after the world wars, which were established with the aim to protect and develop the aviation industry, there has been no overhaul of the Chicago Convention that forms the basic framework supporting international air transport, except for bilateral agreements and an accumulation of partial modifications. The current situation does not require severely restrictive rules to control economic activity; instead, there is a need to create an environment that allows more freedom for business activities, and for rules that protect the consumer.

The business model and methods in the aviation industry have changed significantly to exceed the confines of nationality. One of the biggest changes is the shift from each country having only a single national flag carrier as a state-owned business, to having many international aviation businesses, along with privatization and new market entry that has been progressing since the 1980s. Furthermore, in the 90s there began to be global business alliances formed. At present, in addition to the formation of three large groups, called Star Alliance, SkyTeam and One World[14], there have also been alliances such

[13] This is based on a comparison of 360 million metric tons in 1946 to the 5549 million metric tons in 2002. Numerical data was obtained from the Review (Funraise) and the UN Monthly Bulletin of Statistics cited by the Marine Shipping Statistics Handbook (Japanese Shipowners' Association).

[14] The 3 alliances of companies are as follows

Star Alliance: United, US Airways, Lufthansa, ANA, Air Canada, Air New Zealand, Asiana, Austrian, British Midland, South African Airways, LOT Polish Airlines, Scandanavian Airlines, Singapore Airlines, Spanair, Swiss,

as code-sharing between individual companies. These alliances, such as the Star Alliance anchored by United and Lufthansa and SkyTeam anchored by Northwest and Air France/KLM, have been granted anti-trust immunities, providing a framework where corporate decisions have priority over domestic law. These alliances have had an effect on the direction of the negotiations of the bilateral agreements. In the past, the conflicts and balancing of the interests of country B versus the interests of country A formed the basis of the discussions. In the 90s aviation businesses began competing to acquire customers beyond their home nation borders, forming mutually complementary global networks through business alliances. As a result, company b in country B in an alliance with company a in country A may have interests that conflict with those of company y in country B in an alliance with company x in country A. Such conflicts of interests between corporate groups can be a more important factor than the conflicts of interests between countries. This means that the old concepts of national interest and exchanges of privileges between governments that are assumed in the bilateral agreements have become extremely vague and abstract, losing significance.

Passenger transport volume for scheduled international flights from 1958 to 2003 – Top 10 companies

	1958		2003	
	Company	Revenue passenger-kilos (Thousands)	Company	Revenue passenger-kilos (Millions)
1	KLM	64,345	British Airways	96,661
2	British Overseas Airways Corp.	64,170	Lufthansa	90,896
3	SAS	55,912	Air France	88,965
4	Air France	48,797	Singapore Airlines	63,816
5	British European Airways	39,699	American Airlines	59,733
6	Sabena	36,151	United Airlines	59,451
7	TWA	34,188	Japan Airlines	56,549
8	Swiss Air	32,162	KLM	56,540
9	Qantas	20,835	Northwest Airlines	47,690
10	Alitalia-Lai	20,636	Qantas	46,543

(Note) The shaded portions are aviation businesses that are directly or indirectly owned by a

Thai, Varig, TAP Portugal.
SkyTeam: Aeroflot, AeroMexico, Air France, KLM, Alitalia, Continental Airlines, Delta, Northwest, Korean Air, Czech Airlines
One World: American Airlines, British Airways, Cathay Pacific, Finnair, Iberia, Qantas, Aer Lingus, LAN. JAL is expected to join in 2006.

country.

Another large change in the situation surrounding international aviation is that the terrorist attacks on September 11, 2001 have increased awareness of the importance of aviation security for national security more than ever before. Unlike previous hijacking incidents, the airplanes commandeered on 9/11 were used as terrorist weapons, and an enormous amount of damage was caused. Since then a variety of measures have been taken, including more stringent security checks at airports, cockpit door reinforcement, and the placement of air marshals on flights. The airline industry has spent $5 billion annually on enhancing security[15]. In World War II aviation became an important part of military operations[16], and air raids and rocket attacks from the air became a reality, wreaking large-scale damage on the ground. The introduction of prior permissions in the Chicago Convention was based on recognition of the threat to security from airplanes, as seen during the war. In the same way, since 9/11 it has become generally accepted that this is a justifiable restriction from the perspective of ensuring national security.[17] Of course, these concerns cannot be subordinated to economic profits. However, this does not mean there should be obstruction of economic activities through excessive regulation in the name of national security. For example, we should reexamine whether or not strict regulations currently enforced in the modern international aviation industry, like the prior permission, restrictions on capital transactions, and nationality requirements, are truly necessary for national security.

The problems with the current system will be discussed separately below.

(2) Systemic problems and their negative effects

(a) Segmentation of international aviation operations

A problem with the Chicago Regime is the segmentation of international aviation service, with separate regulations for each area. Specifically, the so-called "freedoms of the sky" are defined and each is handled differently, and scheduled flights are differentiated from non- scheduled flights (charters) and subjected to different regulations. International aviation service is the provision of air transport corresponding to the demands of a market, from boarding cargo and passengers, going to the destination, unloading and loading, then flying on to the next destination. To achieve this, aviation companies seek to build networks to optimally meet the demand. Therefore, there should also be a regulatory framework for international aviation designed to help optimize the networking of aviation services for the market. The artificial differentiation by government regulation and segmentation through the different handling are unrelated to the choices of actual aviation users and are very

[15] Speech by IATA Director-General Bisignani (September 27, 2004).
[16] The USA alone produced more than 300,000 military aircraft between 1939 and 1945.
[17] In a speech, FAA administrator Garvey mentioned that 9/11 was a watershed for security countermeasures (Jan. 22, 2002)

likely to be detrimental to the market. It is difficult to find an economic rationale for segmentation of the transport operations.

(i) Freedoms of the Sky

One can point out as one example of segmentation of the international aviation industry due to government regulation the formation of different frameworks for each of the freedoms defined in the so-called "freedoms of the skies". Specifically, five freedoms are defined as the freedoms of the sky, and they are granted to aviation businesses in the form of privileges in operating international aviation under bilateral agreements or other frameworks. The first (right to fly through airspace) and second (right to land in a partner State for refueling or repair (technical landings)) freedoms shall be mutually and multilaterally recognized under the International Air Services Transit Agreement. The third freedom, fourth freedom (rights on transport between two States) and fifth freedom (right of transport to a point beyond a partner State) are handled in the bilateral agreements. In particular, since the Bermuda Agreement provides for capacity controls, stipulating that the primary objective is to provide transport capacity that corresponds to the supply and demand between the country to which an aviation business belongs and the final transport destination, many bilateral aviation agreements primarily pursue transportation relating to the third and fourth freedoms, while treating the fifth freedom as a secondary element.

However, the essence of international aviation service is providing the services from boarding cargo and passengers, going to the destination, unloading and loading, then flying on to the next destination in response to the demand in a market. To achieve this, aviation companies have been working to form optimized networks. The designation of certain portions of these networks as essential, and the others as secondary as a result of government regulation is far removed from the actual circumstances of transport as well as the choices of aviation users. The main concern of users is whether the aviation company provides transport from the origin to the destination safely and at a reasonable cost. There is no differentiation between an essential and secondary element of the transport. What if an aviation company refuses to meet the needs of users in a particular field of air transport, by reason that this transport is categorized as a secondary transport under government regulation?

Practically speaking, the freedoms of the sky can be enumerated beyond five, up to a ninth freedom, though in bilateral agreements the exercise of these freedoms are restricted. The sixth freedom, defined as transport originating from a foreign country, transiting through the home country, and landing in another foreign country, in many cases is typically denied in bilateral aviation relations. The seventh freedom concerns transport between a

partner country and a third party country with no connection to the home country, while the eighth and ninth freedoms concern cabotage[18]. Basically, these are not recognized in bilateral aviation agreements. This segmentation of the international aviation operations creates markets to which aviation businesses have limited or no access.

As a result, the range of services of aviation companies is limited with a focus on their home country, and it is only possible to provide these services under the fixed terms and conditions in the bilateral agreements. Because of this the profitability of the operations of each company is greatly influenced by the economic cycles in the home country. Furthermore, in the event of an external shock to the home nation economy, such as terrorism, epidemic or natural disaster, there is risk that such a shock will have a profound impact on operations, since it is not permitted for such shocks to be absorbed by other markets. In other industries that have internationally developed portfolios of several markets, the good or bad fortunes of a specific country's economy do not affect the operation of the business, and it is possible for slumps in one market to be off-set by performance in other markets. However, in the field of international aviation this kind of business activity is blocked by the bilateral agreements.

(ii) Handling of scheduled and non-scheduled flights

This same kind of segmentation can be seen in the differentiation and separate handling of scheduled and non- scheduled flights. Even in the Chicago Convention there was a distinction made between scheduled and non-scheduled flights. For scheduled flights Article 6 of the Chicago Convention does not allow flight through the airspace nor landing within the territory of a contracting State without the permission of that contracting State. In comparison, for non-scheduled flights paragraph 1 of Article 5 the aircraft of contracting States may fly to a territory, pass through without landing, and land for purposes other than transport without obtaining prior permission. Paragraph 2 of Article 5 ensures that even for flights of passenger or cargo transport for remuneration, the loading and unloading rights are available, though each country reserves the right to regulate, restrict or impose requirements. During the 1940s the percentage of non-scheduled flights in international aviation was extremely low, and unlike the schedule flights that were the focus of the deliberations of the Chicago Conference, for the non-scheduled flights contracting States seem to have exchanged transit rights and commercial operation rights with one another[19].

Is it really necessary and appropriate to have this kind of differentiation and separate regulation (Articles 5 and 6 of the Chicago Convention) for scheduled and

[18] The eighth freedom is domestic transport linked to international transport, and the ninth freedom is domestic transport that is not linked to international transport.
[19] Bin Cheng, The laws of international air transport P25

non-scheduled flights? (The pros and cons of the necessity of regulation of international aviation business is discussed in the following chapter, so only the differentiation between these two types is the issue here.) Today non-scheduled flights (charter flights) account for a huge volume of traffic. Looking at non-scheduled flights on international routes, the transport volume in 1958 was less than 62 million passenger-kilos, but grew to 232.5 billion passenger-kilos by 2003. Looking at the share as well, non-scheduled flights accounted for 7.1% of the international routes in 1958, rising to 11.8% in 2003[20]. Today non-scheduled flights account for a large volume of traffic today, but there is a differentiation made between scheduled and non-scheduled flights. If scheduled and non-scheduled flights are operated on the same routes, in principle the scheduled flights should have priority. However, from the perspective of the aviation user, the issue is whether the aviation company provides safe transport from the origin to the destination for a reasonable price. The question of whether the flight is scheduled or not is a secondary consideration at best. In addition, the distinction between scheduled and non-scheduled flights is extremely arbitrary. For example, there are "scheduled" flights that are only operated for certain periods during the summer, and "non-scheduled" flights that operate regularly every week during busy periods. In addition, there are special scheduled flights during busy periods. It is artificial to make any distinction between services that are so extremely similar, and one must wonder what the rationale could be for such a regulatory system.

Transport comparison of Non-Scheduled Flights (IATA member states)

	1958		2003	
	International	Domestic	International	Domestic
Paying passenger-kilo	62	35	232,524	12,194
Effective cargo tones	400	141	48,542	5,477

Unit : Millions

Furthermore, there is the problem of unclear and excessive intervention by governments in non-scheduled aviation operations. In spite of the fact that the Chicago Convention grants non-scheduled flights privileges like lading of passengers and cargo, many countries impose a variety of restrictions based on the qualifications in Article 5 Paragraph 2, resulting in intervention at the unbridled whim of the local government. The provisions of Article 5 paragraph 2 stipulate "…subject to the right of any State where such embarkation or discharge takes place to impose such regulations, conditions and limitations as it may consider desirable." Governments make full use of this clause and impose a variety of restrictions on charter flights. For example, when obtaining permission for a

[20] IATA data. Since it was only possible to extract back to 1958 from the available data, the numbers for 1958 were used.

non-scheduled flight, there are typically restrictions on transport capacity, fares, as well as limits on the route (off-line, etc.), and on the type of charter (ITC, one-use, etc.). These regulations go beyond the bounds of reasonable regulations based on the difference in operational form, i.e. scheduled or non-scheduled, resulting in protection of scheduled flights and vested businesses that engage in this field of air transport. This hampers the efficient operation of the international aviation market, including the non-scheduled flights.

(b) Determination of aviation service details by governments

Many people will probably be surprised to hear that there are modern commercial transactions for which governments define the scope of the market, as well as specifying the details of the services transacted in the market. This is precisely what is occurring in international aviation.

Article 6 of the Chicago Convention states that scheduled flights may not be operated into or over the territory of a contracting State without the special permission or other authorization of that State, so the bilateral agreements provide for blanket permissions to enable operations. The details of these permissions specify the permissible form of the air services between the two countries. This means that the details of the international aviation operations conducted in or over the territory of a country are subject to a process of permissions and approvals by the government of each country. Furthermore, the conditions specified in the bilateral agreements are extremely detailed, including which aviation companies can fly, where they can fly, how many weekly flights they can fly, what kind of aircraft they can fly, whether they can make a stopover, and whether code-sharing with other companies will be allowed. There are even instances of regulations on the annual flights from one point to another for non-scheduled flights. Thus, in the field of international aviation it is governments, through the bilateral agreements, that determine the details of the services provided by the aviation companies. Aviation businesses are not permitted to make their own decisions about the services that they provide to the consumers.

What is the explanation of the necessity for such far-reaching government intervention? There are two main reasons government intervention in markets might be appropriate: to achieve social objectives, and correct market failure due to inefficient allocations of resources. The major factors for market failure in the transport industry are (1) monopoly, oligopoly, (2) excessive competition, (3) asymmetry of information, and (4) externalities[21]. Based on the idea that it was necessary to ensure the appropriate transport capacity to meet the increasing demand and the quality of the new businesses to provide

[21] Yoshitsugu Kanemoto and Hirotaka Yamauchi (ed.), "Kōza: Kōteki kisei to sangyō 4, Kōtsu "(Lecture: Public regulations and industry – Transportation

such capacity during a period of rapid growth, official regulation was enforced all across the transportation industry. However, in recent years, it has been pointed out that the intended objectives might be better achieved through market mechanisms, and that the existence of regulations might actually impede efficient business operations[22]. Market competition has been encouraged in transportation modes other than international aviation, and deregulation has been underway to reduce regulation to a minimum level. International aviation has been subject to government intervention in the form of economic restrictions (restrictions on entry, number of flights and fares) from the very beginning. Even today the deregulation trend has bypassed international aviation, and there are still far-reaching, stringent restrictions. Is there a reason that only international aviation is subject to special treatment and subjected to such strong government regulation? It is not a case of governments seeking to achieve lofty social aims, such as raising the income of the poor by intervening in international aviation. In fact, government intervention probably is maintained to redistribute income from travelers to the suppliers of international aviation services. In other words, the reason the restrictions continue is nothing more than politics. This section examines the need for government intervention mainly with respect to scheduled flights. There is no justification for government involvement when there is no market failure to be corrected. Looking at the current situation in international aviation, one can find many cases of efficient operations being obstructed by "government failure". To re-phrase it, the competition in the international aviation market is eminently workable. The items considered below will be (i) market access, (ii) capacity controls, and (iii) fare controls.

(i) Market access

The designation of airlines, routes, traffic rights and the degree of access the businesses have to the markets of a given foreign country are determined through bilateral negotiations. With respect to the designation of airlines, the governments designate the airlines that will be permitted to participate in the market and limit the number of such designated businesses. Furthermore, points and routes are also regulated, including the number of flights, transit points, intermediate points and beyond points. Even the traffic rights are determined for each route. In bilateral agreements, transportation relating to the third and fourth freedoms is considered as core services, while transportation relating to the fifth freedom is treated as a secondary service, and therefore, subject to stricter regulations than the preceding two freedoms; as a result, transit through a third party country and cabotage are typically not recognized. Recently, business alliances and code-sharing have become the norm. From the perspective of market access, a company in an alliance is subject to the restrictions of the country of their alliance partner, their own country, and other

[22] Report no. 16, Council for Transport Policy

third-party countries.

Is it necessary to restrict market access in this way for international aviation, specifically the entry? Let us consider the basis for such an argument.

First is the argument of protection for an infant industry which was asserted at the time the Chicago Regime was established. In other words, the aviation industry was still in the development stages and was an industry with great future promise, so it was felt that for the time being it was necessary to protect the fledgling aviation businesses in each country from competition from foreign countries. However, considering that there are presently more than 2 billion passengers transported each year[23], the international aviation industry is now clearly not an infant industry, and it will keep growing in the future[24]. It is inappropriate to apply restrictions based on an argument of protection for an infant industry.

A second argument is the public-interest business theory. This is the idea that there should be protection in the form of access restrictions in order to stably provide the appropriate transport capacity to meet the demand for transport services that offer great public services and are indispensable to the public and industries. This public-interest argument has been the justification for government intervention in all transportation modes. Today, however, for other transportation services, there is liberalization of market entry restrictions because when there is an established network, restrictions actually create problems. International aviation is no different than these other transportation modes. There is an established network in place, and it is no longer necessary for governments to impose entry restrictions in order to ensure that the transport capacity matches the demand. In addition, regulation for the purpose of "public good" is prone to be arbitrary unless there is a clear concept of "public good", but it is not easy to clarify public interests. When defining the public good, it can be said to be something indispensable or important to the daily lives of the people; but, the determination of what is "indispensable" or "important" is extremely subjective. If this determination is left up to the side that implements the regulations, the scope can expand without limits. Furthermore, if the restrictions continue in the name of protecting a business that "has a great public interest," it means that the consumers continue to bear the cost of maintaining the high level of services. Since current international aviation routes can support several aviation companies, and the demand is sufficiently strong, it is possible for participating businesses to use economies of scale and offer the appropriate capacity. It is clear that competition in the international aviation

[23] The number of domestic and international passengers on scheduled flights reached 2 billion in 2005(ICAO Press Release, 12/15/2005)

[24] The long-term forecast by Boeing calls for growth over the next 20 years of 4.8% for passengers and 6.2% for cargo (both annual averages). (Boeing, Current Market Outlook 2005)

markets is working, and that it is not meaningful to continue government regulation to protect specific businesses.

The orderly competition theory, which says that excessive competition should be avoided, is loudly supported by those with vested interests to protect whenever there is deregulation, but this is the same logic as protection of an infant industry. The idea is that strong competition between aviation companies will cause both companies to fail, but there have been no actual cases of this occurring. The example of the recent competition in domestic aviation in the USA is a case in point. Since 2001 the domestic aviation market in the USA has been subject to the full application of market mechanisms with the entry into the market by low-cost carriers. Large, inefficient carriers were forced to cut costs by restructuring, and a heavy burden on consumers was avoided. Such competition, that appears to be excessive to those with vested interest, actually led to vitalization of the industry and benefits to consumers.

As described above, there is little need for governments to restrict participation in modern international aviation markets by determining service details and the providers of aviation services. In spite of this there are still restrictions on market access for international aviation businesses, which end up causing more harm than benefits. In the field of international aviation, since it is not possible to provide certain services without negotiations between governments reaching an agreement, this hinders the timely development of business operations in response to market demands. For example, even if it is always difficult to obtain a seat because flights are always full, it is not possible to add flights, or for new companies to enter the market until negotiations between governments are concluded. In bilateral markets the businesses of the host countries have a virtual monopoly, so there is only limited competition, which is a big disadvantage to the consumer compared to cases where there are no regulations on fares. If the transport volumes by one country's carriers are relatively larger than the transport volumes by the partner country's carriers, in many cases, the first country tends to be unwilling to grant market access to the partner country through bilateral negotiations. Furthermore, arbitrary regulations are often enforced with regard to the extent of market access, with the intention of minimizing the impact of future negotiations or competition or giving preferential treatment to a particular market segment. There were also cases where restrictions were enforced to intentionally diminish the usability of the routes of the business from the other country, so as to maintain a competitive advantage for businesses of one's own country. Recently, from the viewpoint of achieving a balance in traffic rights exchanged between the parties to bilateral negotiations, there is restrictive handling of code-sharing, which is supposed to be done to improve the efficiency of service and operations. As this reveals there are major problems with the

regulations on market access, leading to reduced equilibrium of the market for aviation services, as a result of protectionist attitudes between countries.

(ii) Capacity controls

The transport capacities provided by the aviation businesses in both countries are specified in the bilateral agreements according to the demand estimated by the governments and the aviation businesses. Specifically, there is typically a mechanism for determining the capacities to be provided, including consideration of the transport capacities of the aircraft to be used and frequency of flights. For the actual specification of the transportation capacity, during bilateral negotiations, many countries feel that cargo and passengers originating from within their country belong to them, and often insist that domestic-origin cargo and passengers should be transported by domestic businesses, and that the ratio of provided transport capacity should match the ratio of the cargo and passenger volumes originating in each of the two countries[25].

Today, there are still many bilateral agreements specifying capacity controls based on the basic model of capacity controls in the Bermuda Agreement. These are specified as follows.

a) The offer of aviation services must closely relate to the supply & demand relationship
b) There must be fair and equal opportunity for operation of routes
c) There must be no unreasonable effect on other aviation businesses
d) The primary objective is to provide transport capacity to meet the transportation demand between the country of affiliation of the aviation business and the final destination of the transport.

With regard to the supply & demand relationship in a), a government determination is not appropriate. Even if the government makes the determination, since it should be based on market data and the needs of the aviation businesses, the market itself can make a more accurate determination more rapidly than the government. Market insiders are better-versed in the supply and demand situation of travelers and cargo than the government, and there is no rationale for asserting that a government judgment is more accurate than the judgment of the market insiders. This is a restriction that does not exist for other services, and there is poor rationale for leaving such a restriction only for international aviation.

If a “fair and equal opportunity” mentioned in b) is pursued without regard for the efficiency of the businesses, it would restrict competition and keep inefficient businesses alive, thereby forcing higher fares on consumers.

[25] ICAO Manual on the regulation of international air transport DOC9626 4.3-1

The “unreasonable effect on other aviation businesses” in c) is ambiguous, and contributes to a ground for further obstructions to competition.

Finally the “primary objective of transport” in d) mentions the compatibility of the transportation demand between the country to which the aviation business belongs and the final destination of the transport, so the fifth freedom is treated as being a secondary objective in comparison to the third and fourth freedoms. The original meaning of international aviation is the entire sequence of air transport depending on market needs, from boarding cargo and passengers at the place of departure, going to the destination, unloading and loading, then flying on to the next destination. The differentiation between parts of the trip, and the designation of certain parts as primary, and the others as secondary is artificial in light of the actual circumstances of transport. Furthermore, it is completely separate from the selections of aviation users, and it is difficult to find an economic rationale for differentiation of the transport operations.

As a result of these capacity controls the businesses in both countries enjoy a monopolistic advantage in the market between the two countries. The segmentation of the applicable markets leads to the negative effect of minimizing the extent of competition in the markets. This is a mechanism that provides no incentive to operate efficiently through competition throughout the aviation industry, resulting in a loss of consumer surplus that would have been generated if the market had functioned properly.

(iii) Fare controls

Fares are generally controlled by the governments in order to eliminate inappropriately high or low prices from the perspective of consumer protection and competition. Although there are a variety of regulations, such as a double-permission system that requires fare approvals by both countries involved, or a double-refusal system in which a fare is valid unless both countries reject it.

The gist of fare controls is to regulate price setting by those in a market-controlling position when there is restricted competition in a market due to entry restrictions. As mentioned in item (i), currently, international aviation routes can support several aviation companies, and the demand is sufficiently strong, it is possible for participating businesses to use economies of scale and offer the appropriate capacity. It is clear that competition in the international aviation markets is working and there should not be any access restrictions for international aviation, and the fare controls that accompany the access restrictions are also completely inappropriate.

There are big problems with the way the current international aviation fare controls are implemented. For international aviation, there is a mechanism of agreement on fares between designated businesses under the bilateral agreements and the IATA fare determination mechanism. This is not necessarily a system that can reliably produce reasonable fares. Instead, the fares set by a business having a certain level of predominance in a market are basically adopted as is; or, there is a system of granting the right of refusal for fares set by the aviation competitors, which is nothing more than international collusion, and therefore, inappropriate. This system was only formed because, during the bargaining between the USA and the UK at the time the Chicago Convention was established, the USA compromised on the UK's concept for orderly development of international aviation, that is, a system of fare and capacity controls through the consent of aviation businesses via the IATA. In light of this, it is difficult to see how it is reasonable under the present circumstances[26]. This peculiar fare system for international aviation avoids competition through division and monopolies of the markets in two countries, and results in highly inappropriate airline fares because aviation businesses with no incentive to improve efficiency determine the fares, and as long as there is unanimous agreement, the governments respect the fares that are set, leading to inappropriately high airline fares. This is supported by comparing the IATA fare levels with the international aviation fares set independently by various aviation companies as fare competition has progressed since the 90s.

(c) Reservation of the domestic market for domestic businesses (cabotage)

Article 7 of the Chicago Convention allows each country to prohibit the aircraft from foreign countries from transporting cargo or passengers between points within its territory (cabotage). As a result, the domestic laws in many countries have these prohibitions. Article 7 of the Chicago Convention is a confirmation of the sovereignty of territorial airspace, but various countries insist that the reasons for such prohibitions in the domestic law are related to national security.

However, consider the illegal activity by a foreign aircraft in the territorial airspace of a country. The national security argument is not convincing because if the same foreign aircraft flies in the territorial airspace as an international flight, it is permitted, but if it is a domestic flight, it is not permitted. This is not logical. It is only natural to think that if the international flights are allowed, the same activity should also be allowed for domestic flights.

[26] Akio Sakamoto, International Aviation Law

The protection of the domestic aviation industry provided by prohibiting cabotage can be considered from the perspective of national security in the sense that it makes it possible to call upon the domestic carriers in the event of an emergency. However, there are other industries besides aviation that have military importance and are subject to requisition during an emergency, which are not specially protected for national defense purposes. Since there are also other means available for enabling requisition at the time of an emergency, there does not seem to be any reason to protect domestic aviation industry specifically for national defense purposes. This is discussed in detail in section (d) Restrictions on Capital and Labor, item (i) Nationality requirements. In addition, if there is liberalization of the flow of capital, and foreign capital is allowed to establish wholly-owned subsidiaries that operate domestic flights, other forms of domestic transport, such as extensions of international transport within the destination country (in the case of international transport that transits through two or more points within a partner State, permission to board and off-load passengers traveling only between these points within the partner State in empty seats) would be comparatively limited. Therefore, there is no reason to exclude liberalization of other forms of domestic transport.

Furthermore, cabotage is also allowed within the EU, limited to the aviation businesses within the region, so the argument that prohibition of cabotage is crucial for national security is no longer an absolute idea. Considering the factors above, the purpose of prohibiting cabotage is nothing more than the reservation of the economic benefits of providing transport within the country for domestic businesses, and the protection of the domestic aviation industry.

There are two points that present obstructions to economic efficiency caused by the prohibition of cabotage. The first is the hindrance to efficiency improvements in the domestic market. Deregulation, increasing competition and new market entry can be seen in the domestic markets in various countries, but it is all between domestic businesses, and there is no competition from the participation of competitive foreign businesses. Also, the situation of limiting domestic market entry to domestic businesses alone is unconditionally depriving consumers of available options. Recently, the various countries in the EU region have granted the right of cabotage to EU aviation businesses. As a result, aviation within the region has become more efficient, and fares have decreased.

The second problem is that prohibiting cabotage distorts the conditions of competition in the international aviation market. Specifically, if the domestic market is restrictive and has large demand, the domestic market becomes a place of making profits. In such a case, the scale of an aviation business' economic interests in the domestic market

becomes the basis for competing in the international aviation market. When an aviation business that has access to such domestic market advances into the international aviation market, foreign businesses that do not have access to the domestic market are compelled to compete under different conditions from the beginning. Thus, an aviation business of a country with a large domestic market has an overwhelming competitive advantage from the start of the competition. As mentioned earlier, since the prohibition of cabotage is a protective measure for the domestic market and domestic aviation businesses, liberalization while prohibiting cabotage makes it possible to internally subsidize the international aviation market from the domestic market. In this way prohibiting cabotage could become a factor obstructing the realization of truly fair competition in the international aviation market. Therefore, there is a major problem in liberalizing the international aviation market while continuing reservation of cabotage.

With respect to cabotage, there was a following opinion: Restrictions on stand-alone[27] cabotage will be politically much harder to remove than restrictions on foreign ownership and control including the restrictions on right of establishment. In almost every country, labor unions will be aggressively opposed to any proposal to allow stand-alone cabotage, because, it would threaten domestic jobs. If foreign capital restrictions are removed and the freedom to set up a business is granted, cabotage will no longer be a fundamental problem. In this sense, stand-alone cabotage is nothing more than a red herring..

(d) Restrictions on Capital and Labor

The nationality requirements and wet lease restrictions impose significant restrictions on the operating resources of aviation businesses, specifically capital and labor.

(i) Nationality Requirements

The nationality requirements for aviation businesses are specified in the bilateral agreements, and the specific standards for the nationality of the aviation business are specified in the domestic law. The system of nationalities of aviation businesses serves as the basis for achieving the effective functioning of an international aviation arrangement that has developed through an exchange of rights and interests between two countries based on bilateral agreements. To change this will require major changes to the existing arrangements between each pair of countries. In fact, introduction of the concept of a regional aviation business in the EU served as an essential basis for modifying the existing nationality requirements, and thereby, changing the bilateral arrangements into a unified arrangement for the EU. In this way the nationality requirements, from the perspective of

[27] Cabotage with no local base that is implemented as an extension of international aviation is found to have a certain level of significance, but small commercial value.

linking the aviation businesses to the corresponding countries, have played such role as clarifying the responsibilities for safety and security, eliminating free-riding, and serving as the basis for an exchange of rights and interests

On the other hand, in the midst of economic globalization, it is becoming common to move capital across national boundaries. In industries other than aviation, there are many multi-national companies, and mergers that cross national boundaries are not unusual. In the aviation industry as well, traditionally government-run airlines have been privatized, and alliances and code-sharing agreements have made progress, often involving movements of capital. In this manner, capital alliances and mergers across national borders have become a reality in the aviation industry. The merger of the operations of Air France and KLM was a precursor of such a development. New airlines are growing rapidly in Southeast Asia, with many of these new airlines set up under the partnerships between domestic investors and foreign airlines, and becoming part of the network of the group of the foreign airlines. Air Asia and Qantas' subsidiary, JetStar Asia, are examples of this. Under such circumstances, it has been indicated that the existence of nationality requirements for the aviation industry may be hindering aviation businesses in their efforts to ensure flexible operations and efforts to strengthen their business bases involving international movement of capital.

In such a case, what are the reasons necessitating the existence of nationality requirements for modern international aviation? The first reason given is the idea that it is related to national security. Historically, the first time the nationality of aviation businesses became an issue was in 1940 at the Pan-America Conference where the nationality requirements were used as logic for barring a German-controlled aviation business that was registered in South America from the Panama Canal area[27]. Precisely, the nationality requirements were asserted for a security purpose. This holds true for many countries including the U.S. which generally takes market-oriented approaches. For example, in the USA there is a Department of Defense program called the Civil Reserve Air Fleet (CRAF). Under this program commercial air carriers voluntarily pledge to provide military airlift and crew members in a military emergency in exchange for exclusive access to U.S. government peacetime transport business. This program is a critical component of US military readiness, and there is a fear that allowing foreign ownership of the U.S. air carriers would jeopardize the military's dependable access to this emergency capability.

From the view point of preventing illegal activities by foreign aircraft in a country's

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[27] Yutaka Osada, "Airspace System and Civil air transportation agreement" in International Law Society ed., A century of Japan and International Law, Vol.2

own airspace or mobilizing commercial aircraft for use as a military reserve fleet, it is certainly possible to understand the importance of knowing the nationality of the aircraft, as well as the nationality of the aviation business that makes business decisions concerning the operation of the aircraft. In other industries besides aviation, there are certainly many countries that impose foreign capital restrictions. Often the reason given for these restrictions is to ensure national security. However, the question is whether there is a special need for the international aviation domain to have a regulation to categorically ban any investments that meet certain conditions, such as the nationality requirements in aviation law, rather than a system to only restrict investments when they are likely to particularly damage national security. One possible answer to the question is that strict nationality requirements are needed from the perspective of national security because the aircraft may be commandeered as a means of transport in the event of a national emergency.

If there is an emergency, it is difficult to imagine that a foreign air carrier would be participating in military activities that were strongly opposed by its home government, and it can be argued that the domestic companies will rather volunteer to participate in such activities out of patriotism. However, in fact it may be out of economic considerations rather than patriotism that air carriers participate in programs like CRAF. For example, if a company reneges on its CRAF commitment in the U.S., the US Department of Transportation could suspend or revoke its operating certificate, and could seize its aircraft as well as potentially call up its reservist pilots to fly them. In other words, the US government could make non-compliance very costly to a U.S. carrier. Accordingly, this is a program that relies more on economic considerations than a sense of patriotism.

There are those who also insist that if a foreign entity were to buy a domestic air carrier, there will be a danger that the country will no longer have the same level of influences on the domestic aviation business. However, in the same way as for other industries, foreign buyers of domestic carriers typically have to operate it as a domestically-incorporated subsidiary. In this case the country would maintain the same level of legal and economic influences on the purchased company as on domestically owned air carriers. For example, if it failed to comply with its CRAF commitment, the Department of Transportation could revoke its operating certificate, and a foreign owner would be extremely unlikely to renege on its commitment to DOD if it would amount to committing financial suicide..

Besides, marine transport is just as important as air as a means of transportation in the event of an emergency; but, there is almost never a problem over the nationality of a ship in marine transport, and it is common for ships under flags of convenience. When the

US company Sealand entered under the financial umbrella of the Danish company Maersk, no action was taken to stop the transaction in the USA. There is a program for marine transportation that is similar to the CRAF program, but the American subsidiary of Maersk is a foreign-owned US business, and by obtaining appropriate clearances from the Department of Defense, the company transport about half of the Department of Defense peacetime maritime cargo.

There is the argument in the U.S. that even if DOT had the authority to revoke the operating certificate of a foreign-owned subsidiary, there would be legal challenges. Since it would take a very long time to resolve the case, such a mechanism would not work during an emergency. It can also be theorized that for the maritime transport case the program has not been tested during an emergency either. In addition, it has been suggested that eliminating nationality requirements would make it possible for terrorists or their sympathizers to buy airlines. With regard to the lawsuits, it would be possible to have the companies waive such lawsuits in advance. In addition rather than uniformly regulating investments based on investment ratio under the nationality requirements, purchases by terrorists or their sympathizers could be prevented by establishing a review mechanism, such as that for the US Exon-Florio provision, in which foreign investment is reviewed to determine whether it would harm national security.

Weighing the advantages against the disadvantages of the current nationality requirements reveals that the abstract advantages are far outweighed by the disadvantages arising from the restriction on investment in aviation businesses, obstruction of broad access to capital markets, as well as the obstruction to expansion and strengthening of operations through international mergers and acquisitions. The restrictions on mergers and acquisitions also prevent the formation of global networks, which is an enormous disadvantage. With regard to the foreign capital restrictions from the viewpoint of national security, instead of the current nationality requirements, it would seem sufficient to have a mechanism like that in the Exon-Florio provision whereby it is possible to stop specific transactions only in cases in which there is actually a clear national security issue.

There may be strong opposition to the elimination of nationality restrictions from labor unions. If nationality restrictions are eliminated it is possible that there will be mergers between companies in different countries, and labor unions have claimed that this would lead to shrinking domestic employment, or that particularly on international routes, the crews from countries where salaries are high would be replaced by foreign crews from countries where salaries are lower.

However, sweeping liberalization, including the elimination of nationality requirements, makes efficient operation possible, and lower fares greatly increase passenger demand, which will increase employment overall. Furthermore, the training of crew members is time-consuming and costly to achieve the highest degree of safety, so the salary levels of international flight crews may not differ greatly. In addition, flight crew unions are extremely organized, and in many cases it would be quite difficult to replace highly-paid native crews with lower-paid foreign crews due to the existing contracts. As pilots are starting to organize across borders, to a considerable degree, pilot wages will converge in a competitive market. Accordingly, there will be only a limited impact since even if native crews are replaced with foreign crews, the scale of replacement may be limited.

When thinking about how nationality requirements should be treated, it is necessary to consider the relationship between the nationality requirements and safety/security as well. On the question of nationality there are two issues: the question of the nationality of the aircraft, and the question of the nationality of the aviation business operating the aircraft. From the viewpoint of territorial airspace sovereignty, since the flight of foreign aircraft over territorial airspace is restricted, generally the nationality of the aircraft matches the nationality of the air carriers. When nationality is granted by registration of an aircraft in a country, that country bears the responsibility for and jurisdiction over the air-worthiness and environmental compliance of the aircraft, as well as the qualifications of the crew on the aircraft. In addition, when fly-in permission is granted, the certificates issued by the country granting nationality are regarded as equivalent to the same kind of certificates in the country where the aircraft lands. The flight operation control is also the responsibility of the country granting nationality to the aviation business. The nationality of an aircraft and aviation business is quite important from the perspective of ensuring the safety systems.

From the viewpoint of clarifying the system of responsibility for safety and security, the nationality of aircraft and aviation businesses does fill an important role. However, if it is only about clarifying the system responsible for safety, every aviation business has nationality in some country, so it should be sufficient to know that there is effective administrative oversight. Is it really necessary to also require a fixed level of capital from the citizens of the same country? Certainly, it would be a problem if aircraft flew under flags of convenience like ships, registering in countries with lenient safety and security standards to allow reductions in the costs of complying with the applicable safety and security standards. In order to resolve the safety problems, it will be necessary to guarantee uniform, international criteria for safety standards, and secure a system of oversight rather than relying on varying standards in each country with jurisdiction. Although achieving this is

not simple, it is feasible.

(ii) Wet Lease Restrictions

A wet lease, in which aircraft is leased together with the crew to operate it, is a method of procuring aircraft and crews in a flexible and effective fashion. Since the 90s, the use of wet leasing has increased. In many countries restrictions are imposed on wet-leasing due to nationality requirements and safety concerns. For example, wet leases can only be made with domestic aviation businesses. Wet leasing from a foreign air carrier is restricted because traffic rights of the domestic air carriers operating wet leased aircraft are effectively being used by the foreign leasing carrier, and a carrier of the partner country or a third country could free-ride on the traffic rights granted to domestic air carrier under the bilateral agreement. Many countries only allow wet leasing from other domestic air carriers. The free-riding concerns arise from the current international aviation system where the operation of international routes is defined as privileges and such privileges are exchanged under state control. If the international aviation system were changed, however, this argument would not hold water. Besides, given the current international aviation system, if there is any profit by resorting to a wet-lease, those profits go to the domestic company (while a part of the profits is also allocated to the lessor providing aircraft and crew, according to the contract). If the wet lease brings larger profits than before or even some profits which cannot be gained without use of the wet lease it would also be advantageous for the domestic economy. An example of effective redistribution of bilateral interests by the partner country or a third party is code-sharing. In code-sharing the aviation services operated with the aircraft and crew of the partner country are utilized, but some of the seats are assigned your company's code and sold to travelers. If 100% of the seats are sold by your company, this seems no different from a wet lease. The use of wet leases, particularly the lending of each other's aircraft and crews through wet leases as part of a development of partnership amid the progress in alliances between aviation businesses, contributes to the efficient operation of aviation businesses, and is expected to enhance economic welfare through the market.

The restrictions on wet leases are another manifestation of the nationality requirements, and are a measure to protect the domestic aviation industry. Besides, in essence, it all ends up being a labor union problem for the aviation companies in each country. The problem with wet leases is the fact that the flight crews are included in leasing. This is apparent because there are no restrictions on dry leases. Flight crews are generally strongly organized, and the lifting of the ban on wet leases is opposed on the grounds that this will take jobs from the domestic flight crews. As noted in the discussion on nationality

requirements, it is expected that there will be limited impact on domestic flight crews even if the ban on wet leases is removed.

On the other hand, there are valid concerns about safety issues with regard to wet leases. To ensure the safe operation of the aircraft it is necessary to ensure the safety of the tangible aircraft as well as the intangible crew standards, the aircraft maintenance system, and the flight administration system that guarantees the safety of aircraft. These are all the responsibility and jurisdiction of the country of the nationality. Recently, wet lease companies with no routes of their own have appeared. There are also groups operating wet leased aircraft and claiming to be airlines, even though they do not actually own any aircraft, flight crews or an appropriate flight administration system. As these groups are questionable in terms of safety and security, it seems better to exclude them. It would be sufficient to deal with these problems by establishing regulation and oversight methods to exclude such groups that have safety and security problems, so the presence of these problems does not explain why it is appropriate to generally restrict wet leases.

(e) Lack of multinational agreements on economic operations

As discussed thus far, the rules for commercial operation of international aviation are determined through bilateral agreements, and there are no multilateral rules. Basically, the international aviation market is expected to develop on a global scale, but operating under different rules of bilateral frameworks tends to segment the international aviation market into bilateral markets with each having different rules, hindering the development of the global network that should exist. It is said that there are about 4,000 bilateral agreements. With all these segmented rules, the international aviation market has become extremely opaque and complicated, making it nearly impossible to make any forecasts. Since the 1990s the international aviation market has become more global as an overall economic globalization has progressed[28]. As it has become more common for businesses to cooperate through partnerships across national borders, such as alliances, the inefficiencies due to the large number of rules have become more apparent. For example, for a route that links country A – country B – country C, if the airlines in country A and country B want to conduct code-sharing, even if it is approved through negotiations between country A and country B, it can only be implemented on the routes between country A – country B. To implement code-sharing on the entire route there also must be negotiations between country A and country C, and between country B and country C. Even if companies want to form alliances, it is necessary to obtain the approvals of all the relevant countries, which takes some time to achieve. If they are opposed by one of the countries during the negotiations, the plan can only be partially implemented, or must be dropped as a whole. As business alliances that

[28] For instance, the trade value has roughly doubled from 1990 to 2000 and roughly quadrupled from 1990 to 2005. (WTO)

transcend national borders become common, there is even greater need to devise uniform multinational rules. The inconsistencies between each set of bilateral rules were already recognized by 1946 and 1947, right after the Chicago Convention resolution session. International conferences were held in those years to create a new draft of the key points for multilateral application, but no consensus could be reached during the political and economic circumstances at that time. The operation of the international aviation market under the current bilateral arrangements is nothing more than the product of compromise because multinational rules could not be formulated. Furthermore, the details of bilateral arrangements tend to give considerations to the situations of the aviation industries in the countries involved, and protectionism has become prevalent. In extreme cases there can be retaliatory behaviors brought about between the two countries, resulting in exchanges of retaliation exchanges that lead to a contraction of the market. Of course, this also carries the risk of harming the convenience and benefits to users.

(3) Assessment of recent efforts toward liberalization

The recent efforts in the USA and EU to liberalize the international aviation industry in order to address the problems with the international aviation systems and improve market efficiency are discussed below. Both of these efforts can only be considered partial improvements and incomplete, because neither includes reforms of the basic essence of the Chicago Regime.

(a) USA Open Skies

The USA Open Skies policy is summarized below.

- Ordinary bilateral agreements basically only regulate scheduled aviation operations. There are sometimes provisions on charter flights, but charters are generally outside the scope of the bilateral agreements. In contrast, Open Skies agreements apply to both scheduled aviation operations and charter operations, dealing with international aviation transport collectively.
- With regard to the market access of scheduled flights, the routes are defined as "from points behind the USA via the USA and intermediate points to a point or points in (*the agreement partner country*) and beyond". This means that there is no limitation or restriction on points within their own country and the partner country, and behind, intermediate or beyond points.
- There is no limitation on the number of designated airlines but the usual requirements of substantial ownership and effective control of the designated airlines by nationals of the designating country are applied.
- Rights are guaranteed, such as freedom of commercial agreements, including code-sharing. (Also includes agreements with aviation businesses of third party nations.)
- Broad flexibility is ensured in the operations of scheduled flights, but does not recognize

cabotage rights of partner country to domestic flights or transport to a third-party country with a stop in their own country.

- Free determination of fares based on the business assessments of the airline, and a notification system is allowed. Government intervention is allowed in the cases such as unreasonably discriminatory fares, unusually high fares through abuse of a dominant market position, or unreasonably low fares as a result of government subsidy.
- For charter flights, the service format, fare determination and permissions generally have to be compliant with the charter rules in both the originating and destination countries, and the permission of both countries is required. However, under Open Skies Agreements, airlines operating international charters have the option of complying with the charter laws, regulations and rules of either the originating or destination country. In addition, if the criteria in the two countries differ, the least restrictive may be used.

Of the problems with the Chicago Regime described above, in comparison to the typical bilateral air service agreements the Open Skies Agreements mitigate some of the government restrictions related to market access, and determination of transport capacities and fares. Furthermore, with regard to non-scheduled (charter) flights, which were subject to permission of countries concerned, bilateral rules are defined and restrictions are relaxed.

However, as a liberalization mechanism the Open Skies policy is only a partial solution and incomplete, and cannot be considered an essential reform of the Chicago Regime, mainly for the following three reasons.

The first reason is that since it recognizes reservation of cabotage for domestic businesses, it is overwhelmingly advantageous to profit-earning US aviation businesses that have access to a huge domestic market. The aviation businesses that have the earning capacity from a robust domestic market can use those earnings to cross-subsidize the international market. This gives American businesses an unfairly strong competitive advantage. This is not the same as low fares supported by government subsidies, and any cross-subsidization occurs within each company; but, from the viewpoint of achieving unreasonably low fares through cross-subsidy using a government-approved framework, the effect is the same as unreasonably low fares supported by government subsidies, so it is a large problem.

The second reason is that the nationality restrictions and wet lease restrictions on aviation businesses remain as strict as ever. In the USA, only a 25% foreign voting interest (with up to 49% equity interest) is permitted, and wet leases are limited to those from American aviation businesses. Since this means that free international movement of capital

and labor is not recognized, the functioning of the international aviation market is incomplete. In recent years there seems to be a movement toward relaxation of actual control requirements in the USA, but true deregulation is far in the future[29].

The third reason is that because Open Skies Agreements are essentially bilateral air service agreements, the details differ depending on the partner country, and they lack in consistency. In November 2000 the USA concluded a multinational agreement with Brunei, Chile, New Zealand, and Singapore, and is seeking to conclude an Open Skies agreement with the EU; so the USA seems to have a long range goal of switching to multilateral agreements. Although Open Skies Agreements can be applicable in multilateral settings, it is not happening since US air carriers hold their own demand for traffic rights, and the U.S. government takes into consideration the reality that their voices is not one, and gives priority to pursuing bilateral agreements instead. Furthermore, the inefficiencies of market segmentation also still remain as a result of the economic operation rules between a pair of nations.

(b) Liberalization policies within the EU

From the 1980s through the 1990s the EU implemented three liberalization packages[30]. As far as the effects within the region is concerned, it is considered to be more advanced than the US Open Skies Policy. The results of the complete implementation of the final stage in 1997, the 3rd package, were complete liberalization of all "freedoms of the sky", including cabotage, and the elimination of government interference in route designation, and the setting of capacity controls. The bilateral aviation agreements between EU members were abolished, and common rules throughout the EU were applied for aviation within the region. Fundamentally, fares can now be determined freely, and within the region, there are no more restrictions on the movements of capital. In 2002 the European Court of Justice (ECJ) ruled that the nationality requirements in the Open Skies Agreements between EU

[29] The US Department of Transportation proposed to allow decision-making authority to foreign investors on business operations other than organizational composition, safety, security and defense, within the 25% upper limit on foreign capital, but the Department withdrew the proposal, facing mounting opposition from the Congress, labor unions and some airlines..

[30] In the EU the first package was implemented in 1987, the second in 1990 and the third in 1993 (complete enforcement in 1997), to liberalize aviation in stages. The first package partially relaxed regulations on fares and transport capacity allocations. The second package recognized the third and fourth freedoms for EU members on almost all routes within the community, and implemented further deregulation. The third package granted complete operating rights within the EU region to the aviation businesses of the EU members, with fares basically left to the discretion of the aviation businesses (although, restrictions can be placed on excessively high or low fares with the consent of the EU members). The third package also introduced "EU Community Licensing". In order for an aviation business to obtain a license to operate within the Community, more than half of the stock in the business has to be owned or controlled by EU members or their nationals. (Since this does not require that the aviation company be owned or controlled by the country in which it is registered, or by the nationals of that country, this liberalizes investments and mergers within the region.) (From Rigas Doganis, *The airline industry in the 21st century* (Routledge, Nov. 2000)).

members and the US were in violation of European Community Law[31], and earnest discussion on the liberalization of capital movements outside the region began. It seemed that this would resolve the "Systemic problems and their negative effects" pointed out in part (2) of this chapter. The EU has concluded 16 such agreements so far.

However, the relationships between the EU and countries outside the region are still governed by the restrictive framework of the Chicago Regime. In each of the EU members there is government intervention in the international aviation market, basically in the same way as always, based on the various bilateral air service agreements with countries outside the region. In other words, the EU liberalization is not open to countries outside the region. Ultimately, it is an exclusionary mechanism that only applies to the EU members.

The question for the future is whether the EU liberalization will be actively expanded to countries outside the region, in an attempt to apply it on a global scale. If this occurs, the EU liberalization will be an effective means of reforming the Chicago Regime. If this does not occur, it probably will not contribute much to Chicago Regime reform. In order to determine this aspect, the negotiations between the USA and EU should be watched closely. The "historic" aviation negotiations that started between the USA and EU in October 2003, motivated in part by the ECJ decision, led to a provisional agreement in November 2005. When starting the negotiations with the USA, the EU mentioned the objective of the negotiations to be to build a system that allows unrestricted establishment of aviation businesses and their free operations in the "Open Aviation Area" covering the Atlantic Ocean, in other words, not only in the international market between the EU and USA, but also including their respective internal markets. Looking at the details of the provisional agreement between the EU and USA at this time, it seems to be essentially the same as an Open Skies agreement, except for the recognition of an EU enterprise for the nationality requirements and the liberalization of capital within the EU. During the negotiations broad relaxation of cabotage restrictions and foreign capital restrictions was carried over, and the discussions focused only on the framework of a conventional bilateral aviation agreement. With regard to cabotage, the EU demanded the opening of cabotage rights for EU carriers in the US domestic market, but did not discuss domestic transport within each of the EU members. The main objective of EU capital liberalization was to merge the aviation market

[31] In 1998 the European Commission (EC) filed a suit in the ECJ regarding the 8 member countries (Denmark, Sweden, Finland, Belgium, Luxembourg, Austria, Germany, UK) which had entered into Open Skies Agreements with the USA. In this decision the ECJ found that the member nations involved in Open Skies Agreements were in conflict with European Community Law because (1) the nationality requirements were in violation of the Community law stipulating equal opportunity in the establishment of rights and privileges, and (2) the regulations on CRS and fare determination within the EU region fall under the exclusive authority of the EU to deal with foreign policy.

within the EU region and then strengthen and ensure the competitive edge of the EU aviation businesses against those in countries outside the region. There is little prospect for the international aviation market on a global scale. Thus, the EU attempts at liberalization will not be leading to any immediate changes in the essential nature of the Chicago Regime.

Chapter 3 Reform Directions

(1) Basic Concepts

As mentioned in Chapter 2, the government protection of the domestic businesses and market intervention in the international aviation markets has given serious effects to the sound developments of aviation industries. Looking at the historical examples, the recent experience with liberalization of the domestic aviation markets in various developed nations, particularly the experience in the US market over the last 20 years with the start of liberalization, through oligopolies, to the state of competition, teaches that it is possible to achieve efficient air services only by maintaining the market functions that enable competition. Accordingly, the first concept for a new international aviation order is that the international aviation market should be a competitive market in which market functions operate properly.

It is a given that transactions of commodity services when there are global markets will be regulated according to global rules, such as GATT and GATTS. In the case of international aviation where the rules differ between each pair of countries, significant inefficiencies are introduced. In fact, the inadequacies of such a situation were recognized almost immediately after the meeting on the resolution of the Chicago Convention. To address this, international meetings were held in 1946 and 47 to draft a new multinational air services agreement, but the political and economic situations at that time made it impossible for an agreement to be reached. The new international aviation system should be uniform, international rules instead of a collection of bilateral agreements. The recent development of international aviation is illustrated by the existence of international hub airports and alliances between multinational businesses. The demand for aviation transport is diverse and far-reaching, going beyond the repeated moving back and forth between specific points. In light of this, it is clear that a new international aviation system should have uniform international rules.

This does not mean that we should reject efforts to create liberal bilateral agreements that fulfill the above requirements, followed by efforts to extend such agreements to other countries. There is no doubt about the logic that the system for international civil aviation should have uniform international rules, as described above, but there is no reason to oppose efforts to make the market function properly using other methods. If the best course of action, for whatever reason, is determined to be difficult to implement, or to require an excessive amount of time to achieve, it is understandable that the second best plan be adopted. Moreover, it is also effective to start liberalization in innovative fields wherein progress is easily made, and reach agreement, for example, in cargo freighting, or to leave fields where it is hard to reach agreement, such as cabotage, on

the back burner.

There is government intervention that is related to national security concerns. This is discussed in detail in the following section.

(2) Relationship between sovereignty of territorial airspace and liberalization

(a) Article 1 of the Chicago Convention stipulates the complete and exclusive sovereignty of each country over their territorial airspace, confirming a basic principle of international law. The basic meaning of sovereignty of territorial airspace with regard to international aviation is that aviation operations from another country will be subject to the regulations of the country they fly into or over. Of course, the permissions may be case-by-case, blanket, for single flights, or mutually granted based on agreements. From the perspective of national security, a system in which governments may exercise sovereign rights over territorial airspace in order to apply restrictions on foreign aircraft is entirely appropriate. Accordingly, there is no need to discuss changes to the gist of Article 1 of the Chicago Convention. However, the exercise of territorial airspace sovereignty in the name of national security does not mean that it is acceptable to impose restrictions on transport capacity, routes and fares of foreign civil aircraft at times when there is absolutely no hint of a situation affecting national security. For example, there is no fare level on a foreign civil aircraft that would have an impact on national security.

In short, under ordinary circumstances the conditions of commercial transactions have absolutely no connection to national security. In other words, it is reasonable and expected that governments have the right to regulate foreign aircraft to protect national security, but it is not acceptable to continuously restrict ordinary commercial transactions. A new international aviation system should recognize the existence of safe territorial airspace sovereignty; otherwise, it is necessary to devise consistent multinational rules in which it is agreed that restrictions based on territorial airspace sovereignty will not be applied to the ordinary economic activities of foreign aircraft when there is no expectation of a situation affecting national security.

(b) There is also the view that national security policy is not about preventing the aircraft from other countries from entering the home airspace and behaving illegally; but instead about the need to restrict and protect the domestic aviation industry so that civil aircraft can fill a logistics role for the military in the event of military action. The military has unique air transportation requirements, and some portions of the civil aviation industry can fill these requirements. If these are necessary for national defense, and thus, are subject to protections, the above view is understandable. However, if the view that the civil aviation industry is protected because it is necessary from national security reasons is approvable, it will be necessary to protect almost all fields of industry, including energy, steel, automotive,

food, and marine transport, because they are crucial for the aviation industry. It is hard to prove that the aviation industry is more crucial to a nation's defense than these other industries. Therefore, this view does not seem to be adequately justified.

Another similar idea that is essentially the same with a slight variation is the idea that capital cannot be liberalized because of the danger that foreign capital participation in the domestic aviation market could lead to domestic aviation companies being controlled by foreign interests, who could then refuse to cooperate even when it was necessary for national defense. However, there is already historical evidence in the U.S. that disproves this view and can be applied to any other nations restricting foreign capital transactions in the name of national security and sovereignty. In the marine transport industry, based on the same reasoning discussed above for the aviation industry, the US government had a Ship America policy and provided assistance to the marine transport industry. However, the US marine transport industry was not internationally competitive, and disappeared by the end of the 1990s. US international marine transport of goods has come to be handled entirely by foreign ships, but this has not led to any national security issues for the USA since the 90s. This is also made clear by the fact that the US government has not subsequently decided that leaving the logistics to foreign ships is a problem, and has not taken any action, such as establishing their own marine shipping company. This situation demonstrates the error of the belief that a transportation industry must be domestically fostered and protected because it may be needed for military transport.

(3) Details of new rules

As described in (1) and (2) above, the new international civil aviation system should aim to form consistent, worldwide rules for the purpose of (1) forming competitive aviation markets in which market functions operate properly, and (2) restricting the exercise of territorial airspace sovereignty to impede the economic activities of international civil aviation at normal times when there is no expectation of a situation affecting national security. An outline of new rules based on these ideas is given below.

(a) Member States promise to eliminate the restrictions that are currently imposed on the economic activities of foreign aircraft within their own territory under the Chicago Regime.

(b) International civil aviation businesses will be the subject of these rules, with no distinction between scheduled and non-scheduled flights.

International civil aviation businesses refer to the overall sequence of aviation transportation from boarding freight and passengers, going to a destination, unloading, and flying to the next destination.

(c) The specific problems for the restriction measures promised to be eliminated in (a) above

were pointed out in the previous chapter. For the international civil aviation business, this means restrictions on routes, transport capacities, fares, and cabotage, as well as restrictions on the freedom of capital movements, including the establishment, merger and purchase of aviation companies, and restrictions on the employment of flight personnel like pilots.

As might be expected, Member States may make an agreement with each other that they may take necessary actions against foreign civil aircrafts within territorial airspace if it is considered necessary from the perspective of national security.

The main content of the corrections to the Chicago Regime itself are as outlined above. These changes alone do not mean that purpose (1) (competitive markets) will be achieved. In order to form competitive markets there must be more than liberalization of aviation interests; there must also be new regulations on the utilization of aviation infrastructure, like slot allocations, in order to promote competitive behavior. It is also necessary to abolish government subsidies and assistance, which are a major disruption to the proper operation of market functions. Furthermore, a new policy issue is the need to address the protection of consumers who have the least power in the market. These would be safeguards to ensure the proper operation of the market functions that lead to benefits of liberalization for both consumers and producers, while completely liberalizing the aviation interests. The simultaneous implementation with the liberalization of interests is an important issue.

(4) Effects of liberalization

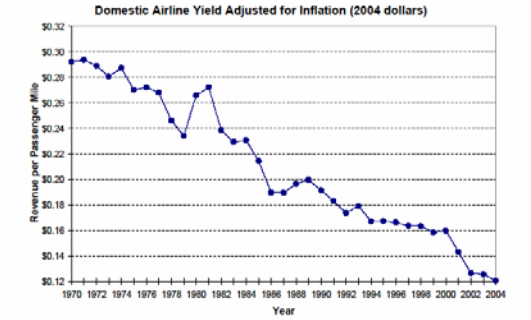
In economics, it is not easy to perform experiments and derive universal results from them. Although it is not easy to conduct experiments regarding the effects of liberalization of international aviation, it is not impossible to presume the effects, as similar case examples are available. In this section, the effects of liberalization of international aviation are forecasted based on the effects of U.S. airline deregulation. As described below in details, the effects of international airline deregulation will be similar to those of U.S. deregulation in several respects, but there also remain unclear points. However, the liberalization of international aviation will not affect security, though it will bring significant fare declines and increase in flight frequency. There is also the possibility that aviation companies can increase their own profits, depending on how they respond to competition and the operating freedoms. The elimination of these regulations will bring numerous benefits to air travelers and will also give aviation companies an opportunity to improve their profits.

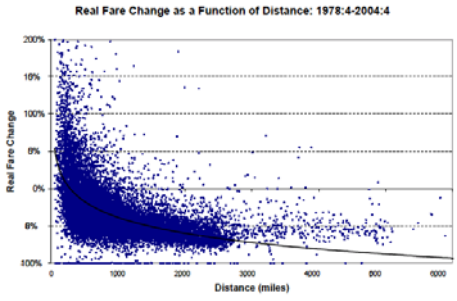
(i) Experience of the USA

Airline deregulation instituted in 1978 has significantly improved traveler' welfare, as predicted.

a) Fare

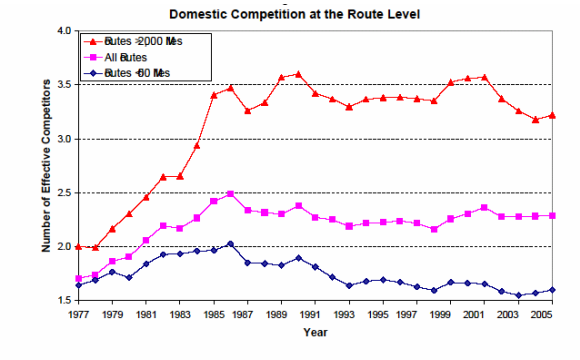
Instituted in 1978, airline deregulation has led to a decline in real fares as competition from established carriers and new entrants increased, carriers were freed from operating restrictions that raised costs, and carriers had the incentive to become innovative and respond to economic and technological shocks. To be sure, fares were declining before deregulation, but much of that decline was due to technological change such as the introduction of jet aircraft. Technological "shocks" of that magnitude have not occurred since deregulation. Thus, deregulation has actually reduced fares some 20-30 percent compared with what fares would have been under regulation. The change in fares by distance is particularly relevant for our assessment of the effects of deregulation of international travel. Improvements in fares increased with flight distance. Part of the reason is that the regulated fare structure elevated fares above costs in long-haul markets to subsidize fares in short-haul markets, which were kept below costs. In addition, long-haul markets greater than 2,000 miles had sufficient traffic to support several competitors. Such markets are also less costly to serve on a per-mile basis because of economies of distance that spread the fixed costs of takeoffs and landings over longer trip distances.

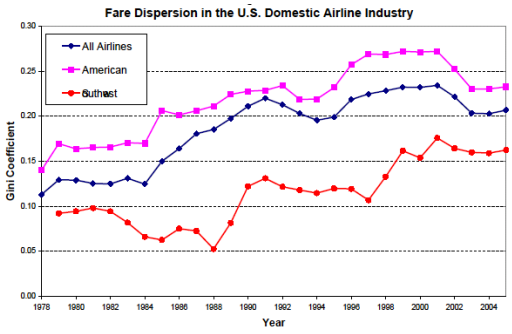




Deregulation of fares allowed airlines to charge travelers different fares according to the costs of service and travelers' willingness to pay. Costs significantly vary between travelers who book capacity far in advance and travelers who decide to fly at the last minute and seek to book a seat, because the former reduce carrier risk that seats would be empty when a flight departs. Carriers also try to devise ways to find out the highest fare that distinct groups of travelers are willing to pay for a flight. This can be difficult in practice, but some strategies that appeared to be successful were travel restrictions such as a required Saturday night stay to obtain a discounted fare. Those who are not inconvenienced by the requirement (e.g., vacation travelers) tend to fly at discounted fares while business travelers tend to pay higher fares for unrestricted tickets to avoid the inconvenience. In any case, the dispersion of fares has increased since deregulation. It is

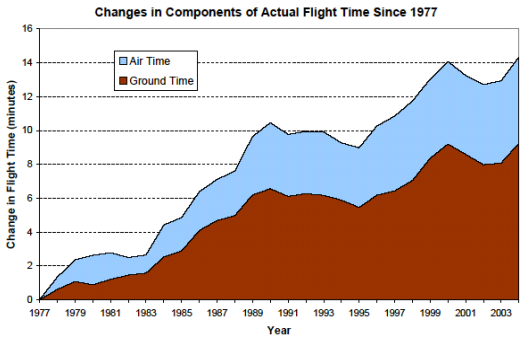
interesting that the difference in fares is smaller for travelers who fly on low-cost Southwest Airlines than for travelers who fly on American Airlines.

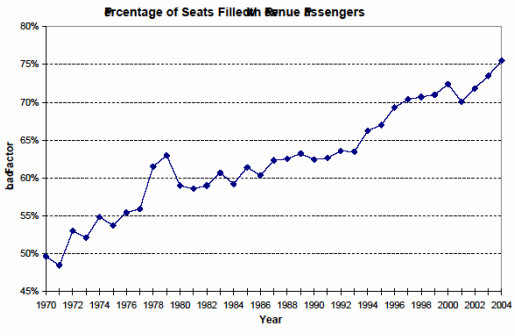




b) Service

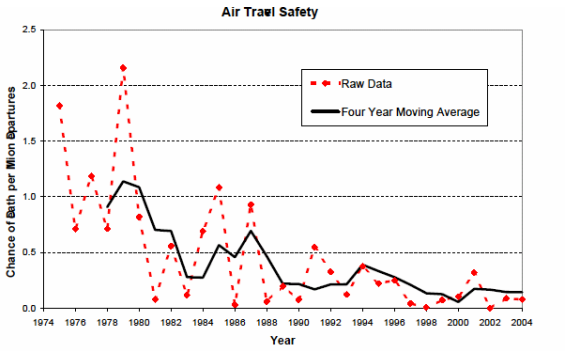
Service is somewhat of an amorphous concept and can be difficult to measure. In air transportation, the most important components of service capture the time costs of travel. These include flight frequency. The higher the flight frequency, the shorter the waiting time required and the smaller time costs required. A major benefit of deregulation, especially for business travelers, was the increase in flight frequency. Flight frequency increases for two reasons. First, lower fares stimulate greater demand and airlines add more flights to meet the demand. Second, carriers change their networks to accelerate the development of hub-and-spoke operations, which increases feasible flight departure alternatives. However, the increase in flight frequency has a dark side: greater delays for carriers waiting to takeoff and land and greater delays in the air. Actual flight times have increased since deregulation. However, part of the problem is due to the failure of airport authorities to adopt efficient takeoff and landing congestion tolls at airports and for the federal government to allow more efficient routings en route. Thus, it is not clear that deregulation per se should receive the blame for this cost. The high fares under regulation caused a large share of airline seats to be unfilled. Thus, load factors (the share of seats filled with paying passengers) have increased since the deregulation of fares. Higher load factors reduce airlines' average costs and contribute to lower fares. But higher load factors can also make the passenger cabin a more stressful place in which to be and increase the chance that a traveler cannot get a seat on his or her preferred flight.





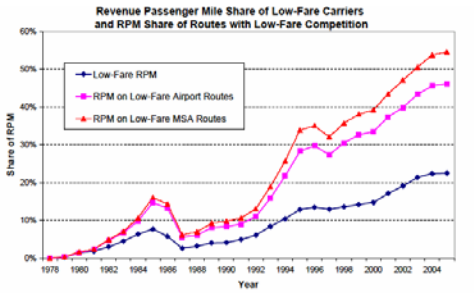
c) Safety

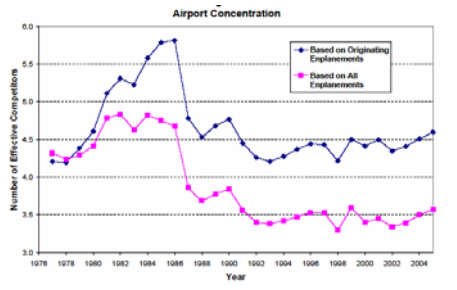
Safety is the most important consideration for airline travelers. When U.S. airlines were deregulated, there were some concerns that the intensified competition would cause carriers to jeopardize safety by cost reduction measures, such as reducing maintenance costs, hiring less experienced flight crews, and so on. However, airline safety has continued to improve since deregulation. The major force behind this improvement is learning—that is, airlines continue to adopt new technologies and draw from experience to find the best way to anticipate and respond to potential causes of accidents (poor weather, pilot error, air traffic control error and so on). Therefore, it is impossible to find any evidence to prove that deregulation brings a deterioration of safety.



d) Competition

The beneficial effects of airline deregulation, especially lower fares, could be eviscerated if the airline industry became less competitive. Carriers' adjustment to deregulation has taken a longer time than economists expected, but competition has become more intense. Low fare carriers such as Southwest, Jet Blue, and Air Tran have continued to increase their share of traffic and their presence on domestic routes. To be sure, individual airports have become more concentrated—that is, fewer carriers account for a larger share of operations. But these two trends in combination with the continued decline in real fares reveal that the identity of carriers in the market, not their number, has a great effect on airline competition.





e) Profits

Airlines have had to adjust to several shocks since deregulation including changes in the business cycle and in oil prices, U.S. involvement in the Middle and Near East conflicts, and the expansion of terrorism. Deregulation has made it possible for airlines to adjust to these shocks and limit their impact on industry profitability. In fact, a comparison of profitability under deregulation with what profitability would have been had airlines still been regulated shows that airlines are better off under deregulation. Still, the shocks have been hard on the industry. Airline profitability has been quite volatile, with losses occurring at the beginning of each decade since deregulation in association with foreign conflicts and slowdown of the macroeconomy. Following the September 11 terrorist attacks, the industry has had difficulty turning a profit. On the other hand, low-cost carriers have been making a profit.

(ii) Consideration from the perspective of international aviation

What can be learned from these effects of U.S. airline deregulation in regard to the expected effects of liberalization of international aviation?

a) Fares

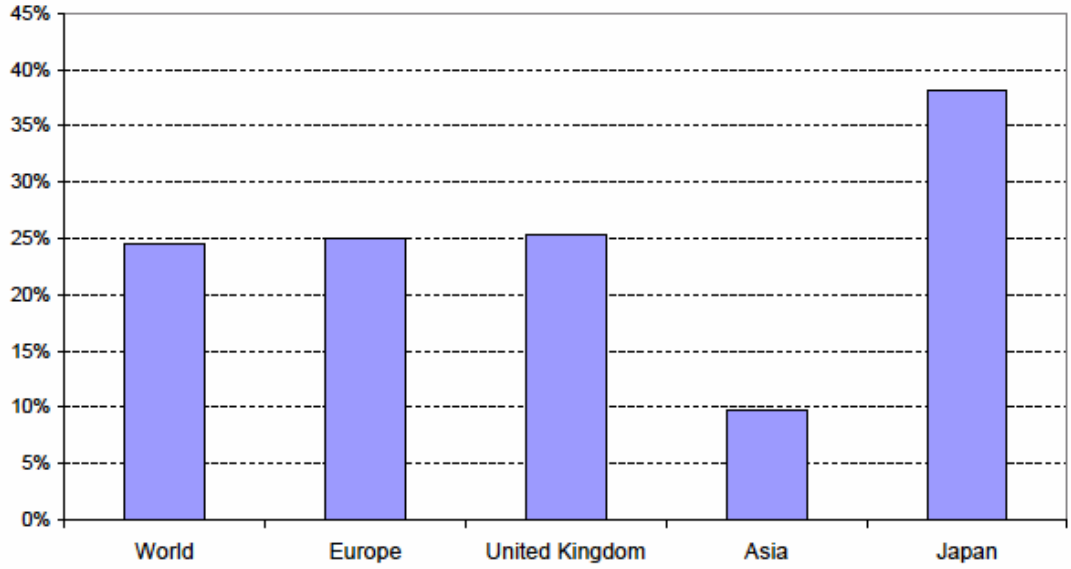
Currently, fares in international markets are placed under the regulation set by negotiations between countries. In addition, carriers are not free to enter any routes they choose. Therefore, fair competition is restricted and there is no possibility of either actual or potential competition. Hence, fares are highly likely to be higher than fares in a deregulated market.

In order to estimate the extent to which fares are currently elevated in international markets, we predicted the effects of international airline deregulation on fares for routes between the USA and foreign countries (Europe and Asia). We chose an appropriate distance block for the U.S. domestic market that is substantially deregulated, and then compared the U.S. domestic fare for that distance with fares in the international markets under the same conditions. By this means, the effects of international airline deregulation can be predicted to a certain degree.

In fact, fares under the regulation in the international aviation market hover at a high level. As of 2004, fares were, on average, 25 percent higher than what deregulated fares would have been. The premium is basically at that level in Europe and in the UK, but surprisingly, it is lower in Asia. We suspect several forces may be at work here that contribute to the lower premiums in Asia including lower incomes, higher price elasticities of demand, subsidized fares for the continent's flag carriers, and so on. However, the

premium is quite high for flights between the U.S. and Japan. This may be expected for routes that tend to have a high share of business travel emanating from wealthy countries. Fare dispersion is also likely to increase under deregulation as competition generates some low discount fares, but still maintains relatively higher walk-up fares.

Percentage Difference in 2004 between International Fares (U.S.-Foreign) and U.S. Domestic Fares (adjusted for distance)



Source: Steven A. Morrison, "Airline Service: The Evolution of Competition Since Deregulation," in C.Tremblay and V.Tremblay, eds., *Industry Studies*, Armonk, NY: M.E. Sharpe, 2006.

Of course, these estimates are only suggestive, but they are generally consistent with a priori expectations. In practice, the magnitude of the fare declines from deregulation will depend to a great extent on the identity of the carriers that serve international markets. If airlines like low-cost carriers in the USA start serving international markets, it will have significant influence on fare declines.

b) Service quality

Lower fares and the elimination of restrictions on flight frequency should lead to a marked increase in flight frequency in international airline markets. The marginal value of greater frequencies should be quite high given the incomes of people who fly in these markets and the relatively low level of the current frequency. On the other hand, deregulation should not lead to a significant increase in load factors. In contrast with the case of U.S. domestic routes, carriers in international markets are not by necessity compelled to compete with flight frequency. Demand should increase with lower fares, but frequency should expand to accommodate demand so that load factors do not change very much. Additional flights in international markets will increase congestion at the airports

that serve these markets and en route. Hopefully, policymakers will adopt policies that can help reduce delays because airports will be more congested.

c) Safety

The U.S. experience with airline deregulation has no effects on the long-run decline in the probability of a fatality from an airline accident. No reason exists for deregulation to have any effect on safety in international markets. Indeed, the greater competition from free entry will increase the cost to a carrier from tarnishing its reputation by having an accident. Hence, if anything, carriers that compete in international markets will have greater incentives to operate safely.

d) Profitability

It can be said that carriers have benefited from regulatory restrictions in international markets as fare premiums occurred on these routes. Deregulation will significantly reduce fare premiums, but given greater operating freedoms, it would be easier for carriers to find ways to lower costs and increase revenues. Depending on how carriers respond to their operating freedoms, they could fare well under international deregulation.

(5) Other issues for discussion

(a) Access to infrastructure

The main elements of aviation infrastructure (land and facilities needed to conduct transportation by air) are the airports and the flight control facilities. For the airports, the typical aviation infrastructure includes the available take-off and landing times (slots), terminals, parking, etc. Currently, at crowded airports the biggest issue is the allocation of slots.

Even assuming that a company has the right to conduct aviation transport, if it is not possible to obtain take-off and landing times (slots) at the airports on the route, that right cannot be exercised. Even assuming that slots can be obtained, if the times of the slots have no economic value for the operation of a flight, it is meaningless. The current slot allocation rules are not determined between nations. Except for the USA, which has many crowded airports, most international airports use IATA rules. Under the IATA rules the slots are basically awarded on a first-come first-served basis. After being allocated the slots remain assigned to the same aviation company as long as the rate of use by the company is more than a fixed level for each season every year.

This kind of vested rights system is called a system of grandfathered rights. Since there are physical limits to the number of take-offs and landings that can occur at an airport, maintaining such a slot allocation system makes new entry quite difficult, especially at the crowded airports that need it most. Most aviation authorities recognize that this is a

problem. As a result of intervention by aviation authorities, new entrants are now given a certain degree of priority, and if the authorities with jurisdiction over competition policies approve, it is possible for slots to be transferred between aviation businesses from the same country.

If aviation interests are completely liberalized, but the current slot allocation rules remain in effect, this will seriously impede the proper operation of market functions, particularly for international aviation markets associated with crowded airports, like Heathrow. The reason for this is that for new participants, even if the current priority rules are applied, can still only obtain a few slots per day when they enter a given airport, so it is impossible to compete with companies having strong vested interests. Furthermore, even if a limited number of slots are obtained in the future, in many cases they are not the high-value slots already owned by existing companies, placing the new companies at a large competitive disadvantage. Some countries, like the USA, have a wealth of aviation infrastructure, with usable, smaller-scale airfields near crowded airports; but, in most countries it is difficult to adopt a policy of having new participants use an alternate airport.

In light of the above, in order to create competitive markets it is necessary to change the slot allocation rules that currently grant too much consideration to vested interests. However, if the current rules are completely abolished, and for airports that exceed a certain level of traffic if slot allocation is made using a lottery or a bidding process by participating businesses each season, this could significantly impede route planning and the stability of the flight services currently offered by airlines.

Since it is impossible to satisfy both these concerns simultaneously, some sort of compromise must be devised. The following two methods can be considered.

The first method is to establish a free competition framework in addition to the current system of priority for new participants. In the competitive framework 10% ~ 20% of all the slots would be allocated using a lottery system or an auction process in which all companies that want to operate at a given airport will participate. The remaining 80% ~ 90% of the slots would be allocated using the grandfathered rights system.

The second method would be to expand the definition of a new participant. For example, an airline that has fewer than 10 slots per day for an international route would be considered a new participant and be given priority in the next slot allocation.

Both of these require more detailed and specific consideration before they can be considered for implementation. In addition, since the circumstances differ at each airport, it is open to debate whether it is best to set uniform, specific rules. Further consideration is also required in this respect. However, for the handling for the problem of slot allocation, it is possible that the liberalization will be achieved only nominally or only with respect to aviation interests; therefore, this should be resolved simultaneously with the problem of liberalization of aviation interests.

(b) Application of laws on competition

There is expected to be a steady increase in mergers and alliances between aviation businesses from different nations as the liberalization of capital proceeds and situations in the aviation transport business develop. Under such circumstances, a big issue is how the competition rules, such as anti-monopoly laws, will be applied internationally. Presently, there is a de facto requirement for international mergers and alliances between aviation businesses to be approved by the US government and the European Commission. Even if approval can be obtained from these authorities, it is also a de facto requirement to return slots at crowded airports (such as Heathrow Airport, London). Although this is not necessarily required under international law (there are pros and cons as to whether or not the effect doctrine is applicable as a prima facie basis for the jurisdiction established under general international law), there is a "fact" that the competition laws of the two most influential powers in the international community, the USA and Europe, are applied exterritorially.

The exterritorial application of domestic laws of certain countries (especially the USA) is often seen for anti-monopoly laws and transportation administration laws, for example. However, this is generally not the best approach as it leads to conflicts with jurisdiction under the territorial rights of the sovereign nation, and is a source of diplomatic friction. At least in the field of aviation transport in particular, it would be best to create international coordination rules to be applied autonomously in order to avoid international disputes, and eliminate the compulsory use of the domestic laws of certain countries. If an agreement on this kind of rule can be reached in the field of international aviation transport, it could become a general model for anti-monopoly rules and be an epoch-making contribution to international law.

With respect to international competition rules, it would be reasonable to consider, as a basic judgment standard, whether or not fair competition might be impeded when a particular aviation business's share in the global or regional aviation market as a whole exceeds a certain limit, irrespective of its share for a particular airline route, for such method would be helpful for avoiding excessively cumbersome examination. However, there is room for further discussion on this idea.

Disputes regarding the mergers or alliances between aviation businesses from different countries should be resolved using the dispute handling mechanism described in (d) below. For instance, the authority to make a final decision on a merger or alliance between Asian airlines should not be vested in a national court of the USA or European Court of Justice, but in an international forum in the true sense as described in (d) below. A decision by a national court of any member State might not be entirely impartial, and there may be difficulties of recognition and enforcement in another country, so this makes it

hard to achieve an appropriate resolution.

(c) Consumer protection

When an aviation market is liberalized, first there is a large amount of new entry, and the competition weeds out the inefficient companies, followed by a progression to oligopoly, as shown by the experiences in America. Accordingly, if the liberalization of international aviation contemplated here is implemented on a worldwide scale, it is expected that there will be even further advance of the oligopolies. One important countermeasure to prevent negative effects from the formation of oligopolies is the development of slot allocation rules (NOTE) that promote competition in order to facilitate new entry to markets, as described previously. Another is to protect consumers from excessively high prices, since consumers have a weak position when there is an oligopoly. The companies that form an oligopoly have the power to control prices, so it is well known that prices are set flexibly to correspond to demand, placing the consumer at a disadvantage.

The recent experiences in the American market have shown that after the formation of oligopolies this kind of complicated fare setting occurs, especially at hub airports, proving that the theory of oligopoly pricing is correct. In order to prevent the consumers from being placed at a disadvantage, for an aviation market that has become an oligopoly, the member nation governments involved in that market must have the authority to impose restrictions, such as stipulating that the prices set by oligopolies must be within a specified range. However, since there is a risk of arbitrary government judgments on the criteria for deciding that an oligopoly has been formed, and on the price setting range, it is better to resolve the problem by improving competition in the market in question, rather than imposing direct regulation. On the other hand, if it is not possible or is time-consuming to increase market competition, leaving consumers at a disadvantage in the meantime, this concept will not be valid.

In light of the above, this report does not present any conclusion about which approach is better. However, it will be necessary to introduce measures to deal with the expected formation of oligopolies, in addition to the existing anti-monopoly laws, in order to promote competition and protect consumers.

It will also be necessary to define a certain obligation of aviation businesses to disclose information in order to ensure fair transactions, and not only when the oligopolies are formed. Reporting will be required because individual consumers are not on an equal footing regarding the amount of information regarding the dealings with an aviation business. The EU has already begun to establish regulations, and the USA began similar efforts at the start of 2000. In this way, the standing of the consumer will not vary widely between regions. If aviation businesses can begin providing services anywhere as a result of liberalization, it is appropriate to apply uniform international rules on consumer protection.

Specific details to consider for such rules are as follows.

a. Ensure transparency of information: Make the rules on how and when discount tickets and other services can be used very clear. Make restrictions on excessive advertising, etc.

b. Responsibilities of aviation businesses: Compensation for flight delays and cancellations that are the company's responsibility. Compensation for lost or damaged luggage, etc.

(Note) Other important countermeasures to monopoly and oligopoly must be investigated, including the prevention of exploitative pricing toward competitors by monopolistic / oligopolistic companies

(d) Dispute handling mechanism

The majority of bilateral air services agreements contain provisions on dispute resolution. These provisions generally stipulate that disputes will be resolved by international arbitration. Thus far there have been five cases on the interpretation and application of air service agreements that have been submitted to international arbitration (1963 USA vs. France, 1965 USA vs. Italy, 1978 USA vs. France, 1981 Belgium vs. Ireland, 1992 USA vs. UK). Cases involving disputes about the legal situations for airspace (national security issues) are referred to the International Court of Justice (ICJ), but disputes concerning aviation transportation (economic issues) are not heard by the ICJ. Until the 1960s it was rather common for bilateral air services agreements to include provisions stating that disputes would be referred to the ICJ, but in the bilateral agreements concluded since then the provisions about the referrals to the ICJ have been replaced with provisions stating that disputes will be submitted to international arbitration.

Article 84 of the Chicago Convention specifies that differences of opinion between member States on the interpretation or application of the Convention (or the Annexes) will be decided by the Council at the request of the countries involved in the dispute. The Article also states that member States may petition an ad hoc arbitration tribunal or the International Court of Justice regarding a decision by the Council.

The rules for decisions by the Council on disputes (composed of 33 articles) were approved by the Council in 1957 (partially revised in 1975). An example of a referral of a dispute to the Council is the attack on US civil aircraft by Cuba in 1996, following which, the USA prohibited Cuban aircraft from passing through US airspace, and Cuba referred the dispute to the Council, alleging that such prohibition was in violation of the Chicago Convention.

As liberalization of aviation transport proceeds, it is reasonable to expect that the

number of disputes over the interpretation and application of air service agreements will increase. Any new system must consider the fact that as liberalization progresses (government participation decreases) there will not only be disputes between states, there are likely to be more disputes involving non-state entities (such as aviation businesses and airport operators). In such circumstances, it will be necessary to introduce some new mechanisms in addition to the dispute handling mechanisms described above.

Specifically, one possible method would be to employ two different approaches, i.e. an arbitration system for disputes between states, and a panel system for disputes involving non-state entities (such as aviation businesses and airport operators). If resolutions to disputes between states were left to a national court of either state, the court's decisions might be alleged as impartial; to avoid this, an international forum-based dispute resolution mechanism should be developed in the following form. When a dispute occurs between states, an arbitral tribunal shall be established upon request of either state. Arbitration procedure shall be carried out in accordance with the arbitration rules prescribed by the existing aviation agreement (the tribunal shall generally consist of three judges). A decision by the arbitral tribunal shall be binding under international law. However, an advisory report that is not legally binding may be required if both parties agree.

The panel system is based on a list of panelists who are experts on aviation law. In the case of a dispute between states, a panel may be established upon request of either state. Where either or both parties to a dispute are non-state entities (such as aviation businesses and airport operators), panel examination shall be conducted based on an agreement between the parties. Each panel shall consist of three panelists. A decision by the panel shall be given only as an advisory decision; however, a legally binding decision may be required if both parties agree. The state to which the defeated business belongs shall assume the best efforts obligation to recognize and enforce the panel's decision, even if it is given only as an advisory decision.

(e) Abolition of government subsidies

Even where government regulations on international aviation are eliminated, if some aviation businesses continue to receive government subsidies, as in the case of slot allocations at crowded airports, it cannot be said that businesses with access to subsidies and those without such access participate in competition under the same conditions of competition. In this context, government subsidies to aviation businesses, like government regulatory intervention, hinder effective functioning of the market, and therefore, government subsidies should, in principle, be abolished under the new regime.

In reality, various types of government subsidies are granted to aviation businesses, including direct subsidies granted in cash as well as indirect subsidies granted in the form of

tax benefits, low-interest loans, and debt guarantee. Where the government grants subsidies to rescue an aviation business in financial difficulty[32], it would enable such business that should be excluded from the market to remain in the market despite its inefficient management, thereby distorting the conditions of market competition. This treatment must be prohibited under the new regime. Competition would also be affected where the government lowers the landing fee at the airport affiliated to it for the purpose of inviting particular aviation businesses to use the airport.[33] Government subsidies harmful to competitive conditions should be prohibited.

On the other hand, government subsidies are required to be granted to aviation businesses so as to help them maintain their local lines for community travel as part of social policy. In such case where a particular aviation business receives subsidies from the government, if the business is unable to maintain its local lines without subsidies, and the subsidies would only make up its deficits in the operation of the local lines and would not affect its income and expenditure as a whole, such subsidies cannot be deemed to be distorting conditions of competition with other aviation businesses. However, there is sufficient possibility that in the name of social policy, government subsidies are granted to a particular aviation business for the purpose of increasing its competitiveness. Therefore, it is necessary to establish a system to fully oversee and check whether government subsidies granted in each country are distorting competitive conditions. To achieve this, let alone prohibiting the grant of government subsidies in principle, we should develop a clear list of subsidies that do not distort competitive conditions, which would be a helpful reference for a neutral organization to enforce supervision and check.

In the case where the government directly or indirectly owns the whole or part of an aviation business, it is possible for the government to rescue the business in the event of

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[32] Under Article 87 of the EC Treaty, paragraph 1 generally prohibits aids granted by a member State, and paragraphs 2 and 3 list aids that are exceptionally allowable or considered to be exceptionally allowable, respectively. Regarding whether or not an aid for rescuing or restructuring a particular aviation business falls within the scope of "aid not adversely affecting trading conditions" as prescribed in Article 87, paragraph 3 of the treaty, the following guidelines were provided in 1994.

- The aid must be linked to a viable restructuring/recovery program and should be granted only once.
- The aid must not shift an unfair share of burden onto other member States.
- The aid must be transparent and provable.

Since 1991, restructuring aids granted to the following air carriers were found to be falling within the scope of government aids: Sabena Airlines (1991); Iberia Airlines (1992); Aer Lingus (1993); TAP (1994); Air France (1994); Olympic Airways (1994); Alitalia Airlines (1997). All of these aids were granted from national expenditure on the condition that restructuring be implemented, with the aim to improve financial conditions of state-owned aviation businesses. However, these aids can also be regarded as an attempt to prolong the life of state-owned aviation businesses, which should be ordered to exit the market, at government expense. Furthermore, aids granted jointly with private banks are not always found to be included in the scope of government aids. For these reasons, it is very questionable to employ the guidelines that are applicable in Europe as they are under a new framework.

[33] In 2004, part of the preferential treatment for Ryanair by the Brussels South Charleroi Airport was found to be a prohibited government aid, and Ryanair was ordered to return part of the aid money.

financial crisis, by increasing its capital or arranging loans from government-affiliated financial institutions. The government can also participate in the management of the business. These measures by the government would distort competition in the international aviation market, while allowing inefficient management to be maintained. For this reason, in the future, the government should promote privatization by offering its shares in the business for sale. Until then, such an aviation business in which the government is deeply involved should be subject to strict supervision and check, so that the government's involvement would not distort competition in the international aviation market.

Chapter 4 Action Plan for Reform

(1) Basic Concepts

As seen in Chapter 2, the current Chicago Regime is an inappropriate framework with many restrictions on businesses pursuing free economic activities, as well as on the convenience and benefits for consumers and shippers. The need for reform and the directions for such reforms are presented in Chapter 3. Therefore, the question here is how to proceed to achieve the reform in the current framework.

As described in Chapter 3, a new international aviation system should not consist of bilateral agreements, but should be a consistent set of rules agreed upon among many nations. The system should fit both the theory and practical necessity of this principle, and the first need is to investigate action plans that are in accordance with the principles. However, being realistic about the ways of the world, it is understood that the theoretically appropriate and desirable reforms will not be immediately accepted by many countries. As history has shown, the Chicago Convention, Bermuda Agreement, and the bilateral air service agreements, such as the US Open Skies Agreements, are not the products of logical consistency, instead, they have been established through compromise. Accordingly, even assuming the principles presented in Chapter 3, it is still necessary to investigate the effectiveness and feasibility of various methods to advance liberalization as practical action plans. In the following section, several approaches for action plans to reform the current system are presented, from the ideal to the practical. Each of the patterns is compared and the basic points of discussion are presented below.

The first point is the impact of the liberalization. If there are more countries with relationships through treaties and multilateral agreements, the effects of liberalization will also be greater. In contrast, the benefits from liberalization through bilateral agreements or frameworks that only involve a few nations will only have a limited range. The second point is the feasibility of liberalization. The formation of a multinational framework is expected to require a great deal of time and effort. In particular, revision of the Chicago Convention requires the approval of at least 2/3 of the member States, so that will not be easy to accomplish. On the other hand, bilateral agreements and frameworks involving a small number of countries are likely to have a higher probability of being achieved. In addition to the feasibility of the frameworks themselves, there is also the practical potential of the content to consider. In other words, for the revision of the Convention, agreement on the entire package is required, which means selective liberalization is difficult to enforce. In contrast, the frameworks that involve only a few countries can be selectively achieved by tailoring the content to points for which agreement is possible. A third point is about the issues extraneous to the liberalization. Specifically, to what degree safety and security are

addressed. For this point, a treaty or multinational agreement is likely to enable a more comprehensive solution than the frameworks that involve only a few countries.

In any case, it is the development of the aviation industry through competition and the enhancement of benefits for users that is important, not the abstract interests of a single country or the protection of businesses. A framework to achieve the necessary liberalization is proposed in this report, but there is no intent to imply that there is only one path to achieve the goal.

(2) Action Plan Options

Here, five options for specific proposals to achieve the reforms indicated in Chapter 3 are presented and discussed in detail. These five options are (a) Revising the Chicago Convention, (b) Creating a new multilateral treaty ("International Civil Aviation Agreement"; tentative name), (c) Making small-scale multilateral agreements between countries desiring liberalization, (d) Deepening and expanding liberalization through bilateral agreements, (e) Making international aviation transport subject to GATS

(a) Revising the Chicago Convention

The plan of action to reform the present system which is most idealistic and difficult to achieve is to first revise the Chicago Convention. Articles 5 through 7 of the Chicago Convention impose direct regulations on the economic activities of civil aviation, so these are the sections that must be the focus of the revisions. The principle of sovereignty of territorial airspaces stipulated in Article 1 is the basis for these economic restrictions, but, as mentioned in Chapter 3, a partial revision of Article 1, without any sweeping changes to the territorial airspace sovereignty principle itself, will be sufficient. Other articles will also need some changes, but the main focus here is to present the key concepts, not to map out a concrete draft of the revised text.

(i) Revisions to the preamble of the Chicago Convention

- The preamble to the Chicago Convention states the fundamental concepts of the Convention, so it will be necessary to discuss changes to the preamble. Specifically, the concept of "equality of opportunity" is an out of date notion impeding economic efficiency, so it should be deleted. Instead, the basic principle mentioned in Chapter 3, i.e. the establishment of "a competitive aviation market in which the market functions operate properly," should be clearly stated as the goal.

(ii) Revisions to the economic restrictions in the Chicago Convention

- First, it is necessary to consider revising Article 5 and Article 6, which define the restrictions on non-scheduled and scheduled flights, so as to abolish such categorization

of flights and eliminate restrictions on the economic activities of all international civil aviation operations (meaning the entire sequence of air transport, from boarding cargo and passengers, going to the target destination, unloading and loading, then flying on to the next destination). Specifically, Article 6 should be deleted, and Article 5 revised to enable the civil aviation businesses of any member State to land in or pass through the airspace of other member States, or freely fly on any international route, of course, subject to any restrictions related to safety and security. The deletion of Article 6 will abolish the "special permission or authorization of that State," which probably eliminates the direct foundation of the bilateral air service agreements between member States.

- Article 7 defines the reservation of cabotage. This should be deleted to remove cabotage restrictions.

(iii) Sovereignty of territorial airspace and measures related to safety and security

- Article 1 of the Chicago Convention recognizes the sovereignty of territorial airspace of all nations, not just of the member States, so it is mainly a statement of common international law and the existing text does not require any revision.
- If the government of a member State determines that there is a need for national security reasons, it will be possible to enact the necessary measures to regulate foreign civil aircraft within the territorial airspaces. Therefore, the portions of Article 3 defining the authority to demand landings by civil aircraft of member States, and the stipulations in the Chicago Convention on safety and national security will remain in force, basically unchanged.
- When Article 5 is revised, it will be necessary to maintain the authority of member States to designate airline routes, which is retained by member States under the said Article, from the perspective of national security.

(iv) Other revisions to the Chicago Convention

- If the Chicago Convention is revised, it would be a good opportunity to also modify portions that are not directly related to the liberalization of economic restrictions. For example, revision of terminology that is outdated, such as the "sovereignty, suzerainty, protection or mandate" in Article 2, and revision of the amendment procedure can be considered.
- The issues pointed out in Chapter 3 (4) "Other issues for discussion," after being discussed can be incorporated into the Chicago Convention or a supplemental agreement as needed.

(v) Abolition of bilateral agreements

Following the revisions to the Chicago Convention outlined above, each contracting State shall abolish all of its bilateral agreements regulating civil air transportation.

(b) Creating a new multilateral treaty (International Civil Aviation Agreement)

Even if the Chicago Convention is not revised, it is still possible to strengthen the limitations on sovereignty of territorial airspace and advance the liberalization of economic restrictions through agreements among contracting States. Article 6 of the Chicago Convention states that scheduled international air services may not be operated without the "special permission or other authorization of that State". However, the "special permission" is a limitation on the sovereignty of territorial airspace executed by the nation itself. Theoretically, isn't it impossible for a contracting State to grant "permission" that completely liberalizes scheduled international air services? With regard to cabotage, Article 7 of the Chicago Convention only states that each contracting State "has the right to refuse permission" for cabotage, it does not exclude member States from allowing cabotage. Accordingly, as mentioned in the previous chapter, it is not necessary to revise the Chicago Convention itself to achieve liberalization, there is room for a variety of alternative measures.

One alternative is to conclude and enforce multinational treaties that recognize free aviation, separate from the Chicago Convention. The problem is the degree of liberalization, but the International Air Transport Agreement mentioned in Chapter 1 is similar. Suppose that a limited liberalization under a framework that assumes the "five freedoms" is organized. This would probably be, essentially, a way to get the International Air Transport Agreement put into force. (In this case, it is necessary to be careful about the fact that there are reservations about the "five freedoms" in Article 4, Paragraph 1 of that agreement). Nevertheless, as indicated in the previous chapter, this would be inadequate. In order to achieve our objective, an agreement with much more liberalization than the International Air Transport Agreement must be made. We will call such a treaty the "new International Civil Aviation Agreement".

Ideally, the specific details incorporated into the new International Civil Aviation Agreement would be as follows:

- Contracting States agree to allow all civil international aviation service operations among themselves (boarding of cargo and passengers, going to the target destination, unloading and loading, then flying on to the next destination). Each contracting State promises to allow all aviation businesses from other contracting States to take off and land within their territory, and to pass through the airspace for access to any international aviation route. Each contracting State further promises not to impose restrictions on the economic activities of aviation businesses from other contracting

States, including capacity controls or fare controls.

Since the Chicago Convention has not been revised, there is still a distinction made between scheduled and non-scheduled international flights. For the new agreement, there will be no differentiation between scheduled and non-scheduled flights among the contracting States.

- Contracting States also agree to mutually remove restrictions on cabotage. Each contracting State will recognize free access to any domestic route for all civil aviation businesses from other contracting States. There will also be no nationality requirements restricting the free movement of capital.
- Since it will be permitted for the governments of each contracting State to take the necessary measures against foreign civil aircraft within their territorial airspace in the event that there is determined to be a need for national security, it will be necessary to have provisions on safety and security. The new International Civil Aviation Agreement will include provisions that do not hinder the free operation of aviation businesses. (In addition to the provisions that already exist in bilateral agreements, new provisions will be added as needed.)
- With regard to the issues indicated in Chapter 3 (4) "Other issues for discussion," provisions will be incorporated in the new International Civil Aviation Agreement as necessary based on the results of discussions.
- Following the creation of the new International Civil Aviation Agreement, each contracting State shall abolish all of its bilateral agreements with other contracting States, which regulate civil air transportation.

As the process for creating the new International Civil Aviation Agreement, one method is to make major revisions to the existing International Air Transport Agreement, and another method is to start over from the beginning to make a new agreement. The former method is not possible. There is too much distance between the International Air Transport Agreement and the content needed for this new agreement. This means the latter method is appropriate. In either case, however, it will be necessary to hold deliberations at ICAO and to draw up a plan, encourage ratification by as many countries as possible, and work to ensure that the agreement is entered into force.

(c) Small-scale multilateral agreements between countries desiring liberalization

The second alternative can be implemented outside of ICAO, with a specific multilateral agreement stipulating the liberalization proposals of the previous chapter ratified among nations working toward liberalization. The model should not be a regional agreement like the liberalization treaties within the EU region, but instead, an agreement that is less focused on a specific geographic region, more like the small-scale multilateral

Open Skies agreement (Multilateral Agreement on the Liberalization of International Air Transportation: MALIAT) concluded among the USA, New Zealand and some of the APEC member economies. As discussed in Chapter 2, however, the details of liberalization in both of these existing agreements is insufficient, so an agreement in accordance with the directions outlined in Chapter 3 is required. In this section, the term "small-scale multilateral agreement" is used to refer to an agreement concluded between a small number of countries so as to clearly distinguish it from an agreement concluded between a large number of countries, a "(large-scale) multilateral agreement"; a small-scale multilateral agreement may become a (large-scale) multilateral agreement as more countries join it.

Specific details of the content are essentially the same as described in (b) above. That is, the aviation businesses of any contracting State have free access to operate on the international routes between contracting States as well as the domestic routes of any other contracting State. There will also be no nationality requirements restricting the free movement of capital. In addition, in the same way as in (b) above, the details will include provisions on safety and security, the necessary provisions from existing bilateral agreements, as well as the results of discussions on "other issues". Accordingly, existing bilateral aviation agreements between contracting States shall be abolished.

Unlike the situation in (b), there is no need for deliberations through ICAO. This would be a proposal for like-minded nations that approve of the liberalization outlined in the previous chapter. It may be possible to modify existing small-scale multilateral agreements, but it seems more appropriate to try to create a new proposal, since the existing agreements are inadequate with regard to the details of liberalization.

There are cases of regional agreements, but the agreements should not have a regional bias, and there should be no creation of blocs. Accordingly, a new small-scale multilateral agreement must be a framework that can allow participation by non-contracting States. Even if there are only a few ratifying nations initially, by later increasing the number of contracting States, it should be possible to ultimately approach a global-scale agreement like the one described in (b).

(d) Deepening and expanding liberalization through bilateral agreements

Another alternative method that is practical, although somewhat limited, is to promote liberalization within the framework of the bilateral agreements. At present, there is some degree of bilateral liberalization being advanced, but the content that has been seen thus far, such as the Open Skies agreements, is inadequate. In order to work toward the goals in the previous chapter, it is assumed that the contents will at least satisfy the following requirements:

- Free access to all international routes between both countries, with no capacity controls
- Release of restrictions on cabotage

- No nationality requirements restricting the free movement of capital

First, the bilateral agreements between countries willing to accept this content can be revised. As the action becomes more widespread, eventually, this could lead to more multilateral efforts like the ones described in (c), and even (b).

(e) Making international aviation transport subject to GATS

A fourth alternative method is to proceed with liberalization of international air services within the WTO framework. Under the current WTO system, aviation transport services are basically outside the scope of GATS (General Agreement on Trade in Services) based on the annexes. Excluding certain peripheral services (aircraft maintenance services, sales & marketing, computer reservation system (CRS) services), air transportation is handled separately, outside the WTO framework. In order to proceed with liberalization under the WTO framework in the same way as most other service fields, it will be necessary to abolish or revise the annexes on the aviation transportation service field in GATS, and make aviation transport subject to GATS, including all the hard rights of international aviation transportation.

Even if international aviation transportation services were made subject to GATS, this in itself would not liberalize international air services. The details of liberalization would be left to later WTO service negotiations. In other words, liberalization negotiations between WTO member nations are conducted on a bilateral basis. If there is an agreement on liberalization, under the main principle of GATS, Most-Favored Nation (MFN), the results of the agreement (National Treatment (NT) Market Access (MA)) would be extended to other member nations. However, even if international aviation services did become subject to GATS, since it would not be practical to immediately invalidate the existing bilateral agreements, it is likely that these will have an MFN exemption. On the other hand, it is not clear whether the MFN exemption would apply to any future measures related to existing bilateral air service agreements (addition of sites through modifications of appended tables, etc.) Assuming that it did apply, this is likely to lead to bilateral air service negotiations simultaneously serving as the above service negotiations.

(3) Comparison of each proposal

The advantages and disadvantages of the five options presented in section (2) are discussed, with a focus on the basic issues indicated in section (1), the effects of liberalization, the feasibility and the handling of safety and security concerns.

(a) Revising the Chicago Convention

In order to truly reform the existing system, the ideal solution is to revise the Chicago Convention. The Chicago Convention is the foundation of the current international

aviation system, and the origins of all economic restrictions on international civil aviation spring from this convention. If it is possible to revise the Chicago Convention as described above, it will be possible to establish truly globally consistent rules, and make it possible to expand free, competitive aviation markets on a worldwide scale. As the name indicates, the market for international aviation is international. As liberalization occurs, the effects become larger as the size of the international network increases. Among the various options presented above, there is no doubt that the maximum liberalization effect would result from a revision of the Chicago Convention. In addition, since the Chicago Convention includes provisions on safety and security, it is likely that it would be possible to achieve a proper balance between liberalization of economic restrictions and preservation of safety and national security. It is also possible to revise and enhance the provisions on safety and security in the convention as needed.

However, among the options mentioned above, the revision of the Chicago Convention is also the approach that is least likely to be achieved. Not only is a 2/3 approval of the Assembly required for a revision of the agreement, but revisions must also be ratified by the number of contracting States specified by the Assembly (a number which must be at least 2/3 of the total number of contracting States) (Chicago Convention Article 94), and this requirement places a very high hurdle against revision. Since this revision is connected with fundamental issues, it is likely that the discussions will take a very long time. Countries that do not agree to the revisions would not be bound by the revised agreement, but since it is possible that non-ratifying countries would be separated from the contracting States by an Assembly decision, it is very important to conduct thorough deliberations on revision proposals. For the ICAO, like other UN agencies, each nation has one vote, regardless of size, so the decision-making rights are evenly distributed. Since more than half of the voting rights are held by developing countries, it is probably going to be very difficult to implement the revisions outlined above, which are very likely to be opposed by developing countries. If the priority is placed on the implementation of revisions to the Convention rather than on the revision details, it is likely that there will be compromise upon compromise, leading to inadequate liberalization.

(b) Creating a new multilateral treaty (International Civil Aviation Agreement)

If a completely new agreement is devised, even if the Chicago Convention is not revised, it is expected that a result similar to that of a Chicago Convention revision can be obtained. The greater the number of countries ratifying the agreement, the greater the effect is likely to be. If the number of ratifying nations can be increased to the level of the existing International Air Services Transit Agreement, it will be possible to say that “globally consistent rules” have been established. Regarding the balance with safety and national security, from the use of the ICAO, it is thought to be possible to make appropriate

consideration.

As a general rule for an agreement at an international conference, it is necessary to have a 2/3 vote of the countries attending and voting in order to adopt a proposal (Vienna Convention on the Law of Treaties, Article 9 Paragraph 2). Therefore, it is likely to be difficult to obtain this through the ICAO. However, since the requirements for the enforcement of an agreement are determined through an ordinary agreement, it will not necessarily require approval by at least 2/3 of the member states in order to have an agreement enter into force. Since the hurdle can be lowered, this is probably more likely to be achieved than a revision of the Chicago Convention.

If there is a revision of the International Air Transport Agreement, although there is the worry of limitations on the development from the perspective of the content, it is procedurally simple, and has a high probability of success.

(c) Small-scale multilateral agreements between countries desiring liberalization

Since deliberations would be held only with the participation of countries that desire liberalization, it is comparatively easy to reach agreement, so the feasibility seems to be higher than for (a) and (b). As the number of ratifying countries becomes larger or major countries ratifies, it will be possible to obtain an effect similar to that of (a) or (b).

On the other hand, compared to (a) and (b), there is a fairly high probability that the effect will be limited if the number of ratifying countries is small. For example, even if the differentiation of the “freedoms of the skies” is abolished and all patterns of service are liberalized between a limited number of countries, there will still be an effective limitation of the “fifth freedom” or the “seventh freedom” when a non-contracting State is a third party. Furthermore, with regard to nationality requirements, since the nationality requirements will remain in effect with non-contracting States, it will be necessary to maintain the ownership and control of the aviation businesses in a country by nationals of the home country in order to retain the right to operate in those non-contracting States. Therefore, even if the ratifying countries agree to abolish nationality requirements among themselves, it will still be difficult to actually achieve liberalization of capital.

In addition, if the details of liberalization conflict between different regions or groups of countries, this is expected to create further difficulties for later unification and formation of a global system. In particular, liberalization like that in the EU, as described in Chapter 2 section (4) (b), is a closed geographic framework which seems to be difficult to blend with other frameworks to create globally consistent rules.

With regard to the safety and security issues, it may be difficult to take globally consistent measures compared to (a) and (b) because the ICAO will not be used. However, if a sufficient number of contracting States are secured and the situation becomes practically close to the multilateral treaty of (b), it would be possible to take consistent measures in this

respect as well.

(d) Deepening and expanding liberalization through bilateral agreements

This is an extension of the typical process under the current system. Among the options presented above, this has the highest probability of being achieved, so the feasibility is high. There is little necessity for progressing with packages, unlike the treaties or multilateral agreements, so it is a method that can be easy to adopt by starting with content for which it is relatively easy to obtain consent. For this reason, it can also be said that the feasibility with respect to the content is high.

However, since it is a continuation of the bilateral framework, the effects are likely to be extremely limited. Specifically, the problems such as inefficiency arising from market segmentation and rampant protectionism mentioned in Chapter 2 will be extremely hard to solve without reforming the bilateral nature of the system itself. Furthermore, the problems with "freedoms of the skies" and the nationality requirements pointed out in (c) above are likely to be even bigger problems under a bilateral framework. Accordingly, in comparison to the other three options already discussed, this one has the highest probability of having very little effect. In particular, if the content that is easy to achieve is selectively implemented, there is a fear that the liberalization will be stunted.

Since there is also a strong possibility that the arrangements between each pair of countries will have different liberalization details, it is likely to be difficult to attain the "establishment of globally-consistent rules" stated as the basic principle in the previous chapter. Nevertheless, there is the theory that if the countries involved have large markets, even a bilateral agreement could achieve significant liberalization, which could hasten the penetration of more liberal frameworks to other more restrictive countries through market strength.

Finally, with regard to safety and national security, since the handling differs in the bilateral framework, it is likely to be relatively difficult to make the appropriate considerations.

(e) Making international aviation transport subject to GATS

Placing international aviation transport into the WTO framework simply means that aviation would be handled in the same way as other service industries. From the viewpoint that "it is inappropriate to have special treatment for certain industries" this option may appear to be ideal.

However, as mentioned above, even if international aviation services are made subject to GATS, this will not immediately bring about any liberalization, and there is no guarantee of any liberalization later on. With regard to NT and MA, liberalization is advanced through a "positive list" approach, but since the liberalization is only to the extent

promised by each country, the details are entirely at the whim of each country. Since there is the MFN principle, it would seem that once there is any progress on liberalization it will immediately spread. In fact, since MFN can lead to "free-riding" in which countries that do not implement liberalization reap the benefits from the countries that do implement liberalization without offering anything in return, countries are likely to be very cautious about liberalization. As a result, the effects of liberalization have a strong likelihood of being worse than from the other options.

Besides, in order to make international aviation subject to GATS, it is necessary to obtain a consensus from the Aviation Services Review Committee of the WTO Service Trade Commission to abolish or amend the Annexes. Since these committees have members from many countries that oppose making international aviation subject to GATS, there is probably only a low probability that this can be achieved.

Furthermore, it is not possible to include consideration for safety and national security under the WTO framework. In fact, since there is a tendency to regard safety restrictions, etc. as non-tariff barriers that obstruct liberalization, it is probably not the appropriate tool for liberalization of international aviation services, which must develop while maintaining safety and national security.

(Summary of comparisons)

As described above, each of the five options has advantages and disadvantages, but Option (e), "Making international aviation transport subject to GATS," offers no advantages, neither from the perspective of the liberalization effects nor in terms of feasibility, and has many problem points, so that it cannot be reasonably adopted. Option (d), "Deepening and expanding liberalization through bilateral agreements," probably has the highest probability of being achieved, but there are many problems with the effects of the liberalization, and it is likely to be relatively difficult to address safety and security issues. For this reason, this should probably only be used as a last resort, only if improvement is still needed after trying other options. Among the remaining three options, Option (a), "Revising the Chicago Convention," is the best in terms of having the greatest liberalization effect, and with regard to handling for safety and national security. Since it is also the least likely to be achieved, however, it is not practical to place a high priority on this option. This means that the methods to advance liberalization that offer a reasonably strong effect, enable measures to deal with safety and national security, as well as having a certain probability of being attained are (b), "Creating a new multilateral treaty (International Civil Aviation Agreement)," and (c), "Small-scale multilateral agreements between countries desiring liberalization." Especially at this time, it is worthwhile to focus on (b), which is more effective.

(4) Practical Approaches

The content of the liberalization discussed above is not new; economic restrictions have existed and do exist in other industries besides international aviation. Looking at the history and present circumstances of international aviation, it is also clear that proceeding with reform will not be simple. The system based on bilateral negotiation is unique, and is deeply entrenched in the international aviation world. There are strong ties between the aviation businesses and the governments in each country, and protective behaviors have developed. In the midst of this, it is likely that some of the liberalization content described above, such as the liberalization of the international transfers of capital and labor and the elimination of cabotage restrictions, will not be immediately accepted, even among developed countries. Among developing nations, there are probably still many that want to maintain and support their domestic aviation industry in order to preserve national prestige, so it is expected that convincing developing countries to support uniform rules like the ones described above will be even more difficult than convincing developed nations.

In view of this reality, it is necessary to adopt a practical approach in order to make a start on a new system. In section (2) and (3) above there was discussion of types of practical approaches, not only the ideal options, but also options with a higher probability of being attained. It is felt that it should be possible to start with a practical option (for example, (d)) as a first step, and then later make a transition to a more ideal option (for example, (b)).

Here in this document, for the adoption of each option, a practical approach is proposed to enable a phased introduction of the specific details. For example, if the option ranked highest above (option (2)) is adopted, even if there is general agreement overall, there is likely to be some reluctance by some countries regarding certain details, such as the elimination of cabotage restrictions. In such a case, the countries participating in the new system could temporarily hold off on the proposed liberalization contents that were not acceptable (although, if an item is temporarily set aside, it would be necessary to introduce alternative measures or to clarify a schedule for future implementation with the consent of the other members). If there were many countries opposing certain portions, it should be possible to propose that all countries set aside the items in question, to be reexamined at a later time.

The approaches presented here must ultimately be a compromise between the ideal and the practical, not the originally intended goal. If only practicality is pursued, this will probably only result in make-shift measures that ultimately change nothing. However, if there is an insistence on lofty ideals, there will only be impractical proposals that cannot lead to any change of the current situation. The aim should be to make the maximum change possible within the feasible range, while maintaining a clear understanding of reality and keeping the ideal system in mind.

Chapter 5 Japan's Options

As mentioned in the previous chapters, the Chicago Regime is not an appropriate international legal system to govern current international civil aviation activities, or such activities in the future. It is necessary to change the system into one in which market functions operate properly. Regarding specific action, the United States and the EU have been holding negotiations on a framework beyond the Chicago Regime though it is not clear at the present moment (December 2006) whether or not negotiations will succeed and the content of the negotiations is limited. Based on such reality, what direction will Japan indicate in the near future though it has taken traditional and conservative responses in the field of international aviation?

Japan along with other developed countries does not have special circumstances in the field of aviation. Therefore, needless to say, it is beneficial, in the long run, to both users and the aviation industry to get away from the Chicago Regime and work toward liberalization. However, the reality in Japan is that the aviation industry is still more likely to approve the current order while there are no organized movements to seek liberalization among users. The government has not shown any willingness to take the initiative in further liberalization in the field of aviation, taking into account the frequency of security-related cases and accidents in the field in which regulations have been eased.

In examining the possibility that Japan will move toward limited liberalization in the future, based on this recognition of the current situation, the following two directions are possible for the short term.

(1) Liberalization negotiations among Japan, the United States and the EU (Jiro Hanyu, Committee chairman is responsible for the contents of this section.)

Japan will head in this direction on the basis that (1) negotiations between the United States and the EU have achieved results and (2) the United States and the EU have put strong pressure on Japan to join the negotiations.

The 98MOU exists between Japan and the United States, and both countries have agreed to enter negotiations toward complete liberalization in the near future. Though there has finally been recovery in demand in recent years, U.S. companies have not been sufficiently using their interests due to an extreme decline of the U.S. aviation industry from 2001 onward. Thus, there is no pressure to resume the negotiations. Therefore, the U.S. government has been unable to seriously request the resumption of the negotiations up to the present date. However, as the start of use of a new runway at Haneda Airport in December 2009 comes closer, the U.S. side will by necessity strengthen pressure to start the negotiations. It is expected that around that time (2007-2008), U.S. companies, which will

have been pulling themselves from recession, will have cut costs through severe competition in the country and will have strong international competitiveness and strong enthusiasm to participate in high-yield international routes (in particular, non-incumbents).

Therefore, the negotiations will inevitably go into full swing around 2007. However, the key issue is the direction of the negotiations, that is, whether the negotiations, on this occasion, will head over to full-fledged liberalization negotiations or remain within negotiations on compromising measures for U.S. companies (partial amendment to the perimeter rules, or compensatory measures) taken along with the start of the use of the runway.

The fate of the negotiations largely depends on the management strategy of U.S. companies and the intent of U.S. policy makers after the Bush administration. However, the possibility that the negotiations will head in the latter direction is slightly higher, taking into account the expected disarray among U.S. companies and the intent of Japanese companies. Despite this, the negotiations will lean to the former direction on the basis that there is strong pressure from the U.S. side. Although Japanese companies will also have to gain some sort of specific advantage, there is almost nothing that Japanese companies can gain from the U.S. side through aviation negotiations in the short term, under existing circumstances. If there is anything advantageous to Japanese companies, it will be the freedom to establish aviation companies, such as subsidiaries, in the United States, in order to eliminate cost overruns of Japanese companies. Needless to say, complete freedom is hard to achieve, and freedom will be confined to the relaxation of the current restriction on the shareholding level (up to 25%). For this purpose, the revision of U.S. domestic law is necessary, and the United States seems to be unlikely to accept such revision. Even if the negotiations succeed, the result is highly likely to be as the United States is now proposing to the EU. However, some progress may be made because the negotiations will not be those for complete liberalization unless the United States at least responds to this.

In addition, some U.S. cargo companies are expected to make strong requests for a freer activity environment than exists at present. In response to such a request, Japanese companies may develop small-scale services, and a certain degree of progress in liberalization can be expected in this field if it becomes possible for Japanese companies to tie up with U.S. companies. Therefore, it is possible to expect that the next aviation negotiations between Japan and the United States will bring some progress toward liberalization, depending on the United States' attitude. Even in that case, full liberalization is unlikely.

(2) Common East Asian aviation market among Japan, China and South Korea (Jiro Hanyu, committee chairman is responsible for the contents of this section.)

The EU has an internal market on a par with the United States due to liberalization

of internal aviation. In addition, market integration has produced results, including stronger international competitiveness achieved through promotion of competition in the internal market. Moreover, the EU has come to enjoy more advantage than ever before in negotiations with the United States or other countries. At the same time, in Asia, there is a move to seek for a common aviation market among ASEAN countries although the progress on this is sluggish. On the other hand, China has been rapidly making apparent its vast potential aviation market. (Japan lags behind the United States, which succeeded in opening the door to the Chinese market by a considerable degree through negotiations with China.) Japan has an aviation market of the level reasonable for one country. However, the Japanese market is very small compared to the markets of the United States, China, the EU and the ASEAN. Falling behind in cross-border regionalization and formulation of a common market is definitely disadvantageous to the Japanese aviation industry. This recognition is shared among persons engaged in the field of aviation.

On the other hand, a common East Asian Market and the plan of a free trade zone have been proposed in Japan as political slogans. The aim of these proposals is to incorporate the Chinese market, which has become huge. However, fields in which these proposals can be immediately put into practice in a specific manner are probably limited to the fields of aviation and tourism.

Whether or not a freer market can be realized in the field of aviation, irrespective of whether it is in East Asia or between Japan and China, obviously relies on China's response, i.e., whether or not China sees any advantages. In the field of aviation, Japan has a plan to start the use of a new runway at Haneda Airport in 2009, which is very valuable and attracts high interest from China. Japan has already announced that there would be a policy of giving priority to neighboring countries (China, South Korea and Taiwan?). Therefore, it seems possible for Japan to use this as a lever to realize a certain degree of liberalization between Japan and China or to create an aviation market designed on regional internal liberalization with the participation of South Korea. In addition, even if sufficient success cannot be achieved in the field of passenger flights, Japan may request relaxation of restrictions on entry or lifting of restrictions on the fifth, sixth and seventh freedoms in the field of cargo flights as the United States has succeeded in negotiations with China.

At any rate, if Japan aspires to liberalization in international aviation, it is likely to choose this direction, which is more advantageous to the Japanese aviation industry, rather than liberalization through immediate aviation negotiations with the United States.

(3) Accelerated liberalization of international aviation and Japan's response (Shigenori Hiraoka, committee member is responsible for the contents of this section.)

From the medium- and long-term perspective, the worst scenario is that Japan misses the right occasion for liberalization and falls behind its rivals in developing networks

in the growing markets, resulting in losing an opportunity for further advancement. Global attention is focused on China, India and other countries which have been achieving rapid economic growth. Leading aviation companies around the world are quick to establish a foothold in these markets and are determined to incorporate these markets and to share in the benefits from economic growth. The United States also gives priority to an Open Skies Agreement with China, leaving full liberalization with Japan on a back burner. If the U.S.-China Open Skies Agreement is concluded even with a set transitional period, U.S. aviation companies will become able to develop business more freely in China's growing market. In order that Japanese companies increase their capacity, separate negotiations with China are required. However, a certain period of time is required before the conclusion of the negotiations, and there is the risk that the negotiations will be influenced by the political environment between Japan and China. Even if Japan should acquire rights as needed through negotiations with China, and Japanese companies could reinforce their capacity, the expansion of their services would be at least half a year behind the U.S. companies. In addition, passengers in Southeast Asia will travel to the United States via China without going through Japan if the United States starts fully utilizing China as a hub of passenger flights in Asia and the Chinese government is supportive of such move. This will have a considerable influence on the sixth freedom flights of Japanese companies. Is Japan able to refuse liberalization where such a situation is expected to arise? However, if Japan liberalizes aviation after such a situation has arisen, the liberalization will be completely mistimed. Therefore, Japan should avoid falling behind other countries by promoting liberalization at least in the strategic markets without missing the right occasion.

Looking at Southeast Asia, liberalization has actually made progress beyond the level of Open Skies Agreements. In Southeast Asian countries, many low-cost airlines modeled after low-cost airlines in Europe are now springing up. Air Asia and other companies have achieved success at a furious speed and have been expanding their business. To counter the onslaught by these companies, existing airlines are pressed to take action. For example, Qantas Airways launched low-cost Jetstar Airways. Air Asia was launched as a Malaysian aviation company. However, it now has its subsidiaries, in which it has a minority stake, in Thailand and Indonesia, and forms a network that transcends borders and foreign ownership restrictions. Qantas Airways' subsidiary, Jetstar Airways, also has a subsidiary, with a minority share, in Singapore.

Moreover, Virgin Atlantic Airways in Great Britain is promoting the worldwide development of its brand. Aviation companies bearing the name of "Virgin" exist in Great Britain, Belgium, Australia and Nigeria, and a license application has also been filed in the United States. These are aviation companies' movements to develop networks and brands that overcome foreign ownership restrictions, which prove that foreign ownership restrictions and restrictions on cabotage have already become obsolete. These low-cost

airlines are expected to go beyond Southeast Asia and seek to develop routes to China and Japan. In such cases, Japanese companies will be no match for these companies in terms of cost, and the restrictions under existing bilateral agreements and foreign ownership restrictions may become stumbling blocks. From the perspective of cost competition, it should be considered as one of the options to establish subsidiaries in countries where operations can be conducted at a lower cost and develop networks based on such subsidiaries. Dream-like stories such as establishment of ANA Asia and JAL Asia in Thailand or Malaysia have become reality in other countries. There is sufficient possibility that new developments in reality progress at a higher speed than regulatory authorities' actions; meanwhile Japan is locking itself in a fort of bilateral agreements. While keeping watch on latest developments in the world, Japan should also develop the business environment and rules so as to prevent the existing order from becoming a shackle to Japanese airlines.

The fundamental reform of the Chicago Convention that we propose in this report may be regarded as unrealistic, seen from the mind-set so used to the world of traditional bilateral agreements and negotiations. However, in fact, liberalization of capacity, routes and points have been steadily carried forward through negotiations on Open Skies Agreements, and foreign ownership restrictions and restrictions on cabotage have been gradually becoming a mere formality, as mentioned above. Therefore, our proposal is pointing to the final destination of these waves of liberalization. We have no doubt that the fundamental reform of the Chicago Convention will spur the waves of liberalization and will be a right path to bring benefits to air carriers and consumers sooner in a more reliable manner.

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