

Taxing the US Airline Industry – A Time for Change?



Airlines make use of an extensive array of infrastructure facilities – airports, global distribution systems, air traffic control and navigation, and so forth. This infrastructure has to be paid for. In some cases, there are direct user fees that are, at least very crudely, related to economic costs. In other cases, there are subsidies with transfers from non-air transports users to support the system. The situation in the United States embodies a variety of charges and taxes that have been cobbled together over the years to finance infrastructure. In particular, here we are concerned with the ties between the taxes paid by United States airlines and the facilities provided, largely through the Federal Aviation Administration, by the federal government. In a recent report, “The Taxation of Air Transportation”, I examined the structure of the current regime of taxes, and in particular the distortions they impose on the United States’ market, and at the lack of incentive the system has to ensure that those responsible for infrastructure provision use resources efficiently. The issue is of long term importance for the development of the airline sector in the United States and of more immediate concern as the existing remit governing some taxes end in 2007.

By *Kenneth Button*

I INTRODUCTION

Air transport is a crucial enabler of economic activity. The nature of air transport, however, superficially makes it a convenient subject of taxation. As a high-revenue (though not generally high-profit) sector with relatively few suppliers, aviation tax collection is inexpensive and convenient for the Treasury. And as an industry, air transport is in many countries politically vulnerable, lacking any large voting bloc to protect its interests. There is also an ingrained common perception, largely misplaced in the 21st century (after years of economic deregulation and with the widespread availability of the services of low-cost air carriers), that taxation of air transportation constitutes a tax on a luxury good.

All this is true of the United States as elsewhere but, nevertheless, over the years a plethora of taxes has been imposed on America’s airlines in addition to generic corporate taxes. These taxes have risen substantially over time. These special aviation taxes impose burdens on airlines and, ultimately, can adversely affect not only the commercial viability of many carriers, but also the vitality of the nation’s economy and the social welfare of its citizens.

This is not to say that the airlines should be exempt from contributing to an efficient taxation regime; rather, it is a matter of equity and structure.

The aim here is to highlight the problems that the current regime of taxes imposes on American carriers, and in turn their customers. The discussion would be topical at any time, but perhaps more so now as the United States authorities must consider in 2007 how the air traffic control and other functions of the Federal Aviation Administration are to be financed when existing taxation legislation expires. There is also the associated question of the appropriate structure for the air traffic management body. The United Kingdom has privatized NATS, and Germany is following with its DFS. Other systems, including those in Canada, New Zealand, and Switzerland are corporatized – non-profit entities administratively separated from government. There are now continual debates in the United States about whether the Federal Aviation Administration should remain within a government department; any change would inevitably also mean taxation reforms.

II. AIRLINE TAXATION IN THE UNITED STATES

By way of background, the structure of aviation taxation in the United States dates back to the Airport and Airway Development Act and the Airport and Airway Revenue Act of 1970 that aimed to provide a solid basis for the financing of the nation’s air transportation infrastructure. Federal funds for airport development were authorized for acquiring, establishing, and improving air-navigation facilities. The Airport and Airway Trust Fund was established and financed by the collection of aviation-related excise taxes, including the existing tax on aviation fuel. New taxes were introduced on international passenger tickets, cargo waybills, and annual aircraft registration. The 1982 Airport Improvement Act re-established the Fund allowing expenditures for operating and maintaining air-navigation facilities. In 1990 excise taxes were increased on the movement of passengers and cargo, and for non-commercial jet fuel and in 1997 legislation extended aviation-related excise taxes for 10 years to provide a stable source of funding for the Trust Fund. Taxes were added on sales of frequent flyer miles by airlines to credit card and other companies.

There are thus currently several major sets of taxes and fees levied on domestic travel in the United States.

The Federal Ticket Tax and the Federal Flight-segment Tax are paid into the Airport and Airway Trust Fund that finances congressional appropriations to cover obligations attributable to planning, research and development, construction, or operation and maintenance of air traffic control, air navigation, communications, or supporting services for the airway system. The federal ticket tax is equal to 7.5 percent of the base fare. The federal segment tax is \$3.20 per flight segment in 2005.

The Passenger Facility Charge was instituted as a means for assisting airports finance eligible airport-related projects, including making payments for debt service. It is imposed by individual airports to supplement funds available from Airport Improvement Program grants to assist in airport development, and for expansion. Over time, more airports have imposed these charges and there has been a general drift upward in the fee that they elect to charge.

The Federal Security Service Fee was created under the 2001 Aviation and Transportation Security Act as a direct reaction to the events of September 11, 2001. The legislation authorized a \$2.50 tax per enplanement, limited to a maximum of two segments per one-way trip. Consequently, the highest possible security fee paid by a passenger on a domestic round-trip ticket is \$10.

Numerous other taxes support the Airport and Airway Trust Fund, including the international arrival tax, the international departure tax, and federal aviation fuel taxes. At the more local level, individual states levy taxes, often considerable, on such things as fuel. Florida, for example, levies a \$0.069 per gallon tax, Hawaii a \$0.01 per gallon tax, and Colorado a \$0.04 per gallon tax, on jet fuel. There may also be taxes levied on airport facilities themselves (e.g., car parks). Additionally, foreign nations impose taxes and fees on United States carriers engaged in international operations.

Because many of the taxes paid by airlines are neither related to flight lengths, nor directly to other convenient physical parameters, it is difficult to identify the “average tax burden” that confronts any airline and, ultimately, any passenger – not an ideal situation for public debate on the topic. The effective tax rates vary according to the nature of the passenger’s itinerary and base fare. The burden is heaviest on those making shorter trips involving multiple connections. The result of the current structure of aviation-related taxes is that a flow of funds from a diversity of taxes goes into the Airport and Airway Trust Fund and is then spent on a variety of airport and airway items.

III. THE NATURE OF TAXATION

Taxation is inevitably a contentious issue. No one likes paying taxes. They involve the compulsory transfers of money from the general public to the government – subsidies, strictly “negative taxes”, are far more popular! But taxes are important as a means of financing government activities, providing public goods, and as a mechanism for bringing about social transfers to protect the less well-off in society. It is important, therefore, that the forms of taxes imposed serve the public interest rather than being arbitrary or capricious.

Aviation taxation involves indirect taxes paid by the provider of airline services, but the incidence of the taxation is borne more widely as part of the burden is passed on to travelers and shippers. The amount passed on depends on the conditions of supply and demand in the relevant transport markets. During times of intense competition for budget-minded, Internet-empowered customers, such as the present, the economic incidence of the tax shifts principally to the airline, rather than to the consumer. Taxes are normally assessed in terms of their administrative convenience, and their implications for economic efficiency and equity.

Administrative issues

In itself, the assessment, administrative, policing, and collection activities associated with taxation can be costly. For administrative reasons, taxing

agencies therefore seek sectors where these transactions costs are low. Politicians also like sectors where they are likely to encounter only limited opposition from those directly paying the tax. Airlines meet both these transactions cost and political criteria. There are relatively few airlines in the United States and hence, the administrative and political costs of tax imposition are small. Taxes on aviation services place much of the cost of collection and administration on the airlines, which have no votes in the determination of a tax. It is easy to see why fiscal authorities find airlines an attractive tax base.

But administrative considerations also entail having a good idea of the amount of revenue any tax will raise, and a continuity of income from taxes. This generally favors stable markets where demand does not fluctuate significantly over time. But recent demand for air transportation has been volatile with systematic uneven business-cycle effects, and is regularly subjected to “system shocks” such as September 11, SARS, oil price variations, and the war in Iraq. The airlines themselves have difficulties in cost recovery and there has been a regular flow of bankruptcies in the industry. There is thus the issue of the “golden goose.” The short-term revenue situation is not the only important consideration; a sound tax base should also exhibit long-term vitality. A cursory review of United States airline industries profitability illustrates its unsuitability as a major source of stable tax income.

Efficiency in taxation

Efficiency in taxation policy is concerned with the implications for those who bear the final burden of the tax – i.e., the downstream effect. Technically, an efficient tax minimizes “excess burden” – essentially minimizing the overall economic distortions associated with taxation. This is most easily done when the tax system is simple, and its various implications on different groups are transparent – which is manifestly not so to anyone looking at the printing on a United States ticket. One means of minimizing the excess burden of indirect taxation is to follow the “Ramsey Principle,” whereby the tax rate for any good or service is set according to its elasticity of demand. If

the quantity of the product demanded is highly price-sensitive, then it should be taxed less than a product for which demand is much less elastic. It is clear from recent changes in consumption patterns and, in particular, the relative amount of income now spent on air travel as fares have fallen, that the demand for air service is, in the aggregate, quite sensitive to price levels.

While aggregate estimates of the distortions caused by airline taxes are difficult to compute, particular examples abound. Reducing the tax burden on those wishing to fly to Florida, for instance, would act as a stimulus to local travel-based industries, as well as having expenditure-multiplier implications. Scenario analysis indicates that removing the federal ticket tax could, depending on how travelers choose their services and routings, reduce the cost of air travel to the extent that some 77,000 additional jobs would be created in the state from enhanced tourism. Reducing or eliminating the passenger facility charge or federal security surcharge could also yield powerful economic benefits. Removing the former could generate over 35,000 jobs.

Taxation also affects the relative prices of services and thus the competitive position of industries supplying similar services – automobile and railway transport in the case of American airlines. Taxes on car travel have generally not risen post-9/11 and, hence, while airlines now pay Federal Security Service and the Aviation Security Infrastructure Fees, drivers crossing into Canada or Mexico are not subjected to any such fees. Nor are they subjected to international departure or arrival taxes, immigration fees, customs fees, or agricultural inspection fees. And rather than being taxed, Amtrak received \$40 billion (2003 prices) in federal subsidies between 1971 and 2002 and currently loses well over a billion dollars a year. The United States General Accounting Office estimated that passengers in 2003 on such routes as Orlando-Los Angeles receive nearly \$350 in subsidies per trip, while those traveling by train between Pontiac and Chicago are effectively subsidized on the order of \$66.

Fairness and social considerations

Equity considerations affect taxation policies, but notions of equity are inevitably subjective. This does not mean, though, that broad, socially accepted principles are not applied when looking at who pays a tax. Normally, progressive taxes are favored, with higher-income groups absorbing the proportional greatest burden. While air transport was once a luxury, technology changes, such as wide-bodied planes and jet engines, along with managerial reforms that followed deregulation, have reduced costs and fares considerably. In 2003, over 70 percent of domestic United States passengers had access to low-cost carrier service, up from 30 percent a decade ago. In recent years, the long-standing link between national income and spending on air travel has also fallen from 1.1 percent of gross domestic product to 0.7 percent. This pattern is not one consistent with air travel being a luxury good where consumption rises faster than or at the same pace as income.

Within the broad realm of social equity, there is also a general tendency to favor taxing items that are anti-social (e.g., tobacco, alcohol). In this context, former presidential advisor Lawrence Lindsey raised the following interesting question in a “Wall Street Journal” article, “Federal taxes and fees now consume 25 percent of the cost of a low-priced [airline] ticket. That does not include the further tax burden on profits and wages that most businesses face. This tax compares with an 18 percent federal excise tax on cigarettes and an 11 percent federal excise tax on whiskey. Is air travel more a sin than alcohol or tobacco?” If airlines provide a public bad akin to alcohol or tobacco, then such a rate of tax is justified, but few subscribe to this position.

IV AVIATION TAXATION AS A USERCHARGE

The air traffic management structure in the United States, and overseen by the Federal Aviation Administration, is by far the largest and most complex in the world. Efficient management of such a safe system is difficult, not least because of the challenges posed by the collection and interpretation of information on needs and stresses in the

system. Enhanced information systems are continually being developed and deployed, but they remain far from perfect. In many areas of activity common to developed countries prices and charges are used, if not as the primary information source, at least as a supplement to other channels. User charges, in particular, even when profits are not the motivating force, can help in the coordination and prioritization within complex systems.

There are some that argue that airline taxes in the United States are akin to a user fee and act as payments for a government service, that is used so widely that payments at the immediate point of consumption are not practical. A genuine user fee, however, directly relates the costs of an activity to the fees that are collected, irrespective of who does the collection. The existing system of taxing American aviation fails most of the criteria applying to an appropriate user fee, namely: influence the user in such a way that the facility is used efficiently, provide guidance as to where capacity changes are needed, and generate revenue to finance additional capacity.

Assessing the efficiency of any air traffic management system is pockmarked with problems, and tying it to those that fund it is even more difficult. Eurocontrol’s “ATM Cost-Effectiveness (ACE) 2002 Benchmarking Report”, offers some guidance to the European efficiency situation, but significant national and intranational variations in the nature of services offered and the demands placed on them make the findings indicative, albeit useful, management tools rather than real indicators of whether resources are being used optimally. Equally, examination of the payments made by carriers in Europe, which vary considerably from a national unit rate as low as €4.80 for Portugal to as high as €2.58 for Switzerland, probably real more about system variations than efficiency. The underlying pragmatic issues are thus rather more whether value for money is being obtained, and whether the implications of charges on users, and potential users, of air traffic management on their decisions produces an efficient use of resources.

Influence on the use of the air traffic management system

Taxes on United States' aviation are numerous and diverse, but they do not even approximate the opportunity costs of the resources used by airlines either in magnitude or in the specifics of individual services. General aviation constitutes about 70 percent of the operations handled by the Federal Aviation Administration's control towers, and 40 percent of flights handled by centers, but contributes only two percent of Airport and Airway Trust Fund revenues. Overall, the revenues collected from general aviation fall far short of attributable costs imposed on the air traffic control system.

The ticket and segment taxes were initially designed to pay for capital needs (e.g., runways, air traffic control equipment), but have evolved into a source of funding to cover the bulk of the Federal Aviation Administration's operating budget. The ticket tax is also driven by the state of supply and demand on any route rather than by factors such as distance, time or duration of travel, or phase of operation. The segment tax bears a closer relationship to the number of takeoffs and landings, the more resource-intensive phases of flight.

Investment guidance

The system offers no guidance as to where capacity is under pressure, and where additional investment is needed. There is no mechanism to ensure they are funneled into appropriate capacity. There is a danger that, with the lack of an immediate link between those paying the taxes and those spending them, expenditures have little connection with the tax preferences of the taxpayers. There is, for example, the prospect of "gold plating," with those spending the tax revenues providing facilities in scale and quality that are well beyond those sought by the taxes payers. The problem is that those spending the tax revenues have no commercial incentive to provide low-cost capacity or to minimize cost. Indeed, scale and complexity may be an attraction for them.

This problem is compounded in the United States where the Federal Aviation Administration has no recourse to the private finance market

for resources to fund its investment program. Some other countries, for example France, retain state ownership and control of their air traffic management systems, but have user charges allow and access to private finance, albeit with some state oversight, for capital developments. Others, such as Canada and Australia have corporatized, not-for-profit suppliers that again have the ability to tap financial markets with the disciplines that entail. The link between user and financier is still not direct in these cases, but greater insight can be gained as to the investment needs of a system.

Overall, the notion that aviation taxes represent user charges in the United States is thus a rather opaque one. As a recent Steve Morrison and Cliff Winston study (*Fares and Taxes Paid By Business Travelers*, National Business Travel Association, Washington) summarizes, "...the efficiency and quality of air travel has been compromised by the government's failure to provide efficient airport and ATC services and to set appropriate charges for them."

V. WHERE DO WE GO FROM HERE?

Aviation taxation has clear merit from an administrative perspective – it is relatively easy for the authorities to collect and, because it is collected from a few companies, is largely hidden from voting public. In that sense, it is a soft target for fiscal policy. Beyond that simplistic criterion, however, policymakers must consider equity and downstream efficiency. In general terms, there seems no reason to treat aviation taxes as a source of sumptuary taxation revenues. Air travel is now widespread and used by all strata of American society. It is important in the facilitation of social cohesion as families become more geographically dispersed and as globalization brings large numbers of permanent migrants and short-term workers into the country.

Nevertheless, over the years a veritable kitchen sink of taxes has been imposed on America's airlines, in addition to the generic corporate taxes levied in the United States. These taxes have risen substantially over time, creating a burden that has not been more broadly

shared by other industries. By 2000, the airline contribution to United States excise tax revenues had climbed to 14 percent, up from just four percent in 1971. Truly efficient taxation minimizes distortion to the relative levels of consumption of different goods and services. Aviation taxation fails this test, wherein multiple forms and rates apply. Further, efficient taxes are levied on final output, rather than on intermediate inputs such as transportation. Taxing an input yields unpredictable outcomes (i.e., "downstream effects") on final consumption and often creates perverse disincentives for the intermediate supplying industries.

Reforming taxation is never easy; the Treasury is inherently conservative and there are vested interests in maintaining the status quo. Nevertheless, the forthcoming revue of the United States airline tax structure legislation effectively requires does provide an opportunity, as does the ongoing concern in the United States about the future of the Federal Aviation Administration. Taxes are a public issue and are determined outside of the market. User fees reflect an immediate tie between the consumption of, in this case air traffic management services, and their costs. Logic indicates that there should be separation between the two. Explicit user fees, even where those charging them are state entities and outside of the market, offer transparency to those paying them and some degree of accountability for those running the air traffic management system. One could argue that privatization with a regulator to limit monopoly exploitation is preferable on a number of grounds, but that is a somewhat different debate. Taxes, on the other hand, are explicitly political. It is really up to the electorate to decide what public services (policing, social, services, defense, etc) are to be provided and how they should be financed. Airlines may well be a legitimate source of such revenues, but the forms and the scale of the contributions should be explicitly debated and not confused with payments for infrastructure services that carriers make use of.

A copy of, "The Taxation of Air Transportation", is available on the George Mason University, Center for Transportation Policy, Operations, and Logistics web site – www.gmupolicy.net/transport2003/draft.htm