Airline goals From 1975 - 1985

Richard A. Kosiec

Follow this and additional works at: https://huskiecommons.lib.niu.edu/studentengagement-honorscapstones

Recommended Citation
https://huskiecommons.lib.niu.edu/studentengagement-honorscapstones/116
AIRLINE GOALS FROM 1975 - 1985

Richard A. Kosiec
ECON 498
9 December 1985
# TABLE OF CONTENTS

List of Figures and Tables ........................................ iii  
Preface ................................................................ iv  
Goal Seeking ............................................................. 1  
  Survival ................................................................ 1  
  Profit Maximization .................................................. 2  
Other Goals ................................................................. 4  
  Revenue Maximization .................................................. 4  
  Social Responsibility ..................................................... 5  
Personal Goals .............................................................. 6  
Factors Effecting a Firm’s Goal Seeking Capability ......... 9  
  Imperfect Knowledge .................................................... 9  
  Conflicts with Personal Goals ....................................... 9  
  Governmental Influence .............................................. 10  
Economic Factors ........................................................ 11  
  Changes in Cost .......................................................... 11  
  Changes in Demand ...................................................... 12  
Influences on the Airline Industry’s Goals Between 1975-1985 ........................................ 14  
  1975-1978 ................................................................ 14  
  1979-1985 ................................................................ 17  
Graphs ........................................................................ 22
Notes ........................................... 24
Bibliography ................................... 25
LIST OF FIGURES AND TABLES

Break-Even Load Factor (Trunk and Local-Service Carriers) ........................................... 20

Dividends and Revenue ........................................... 22

Return on Equity ........................................... 22

Economic Factors ........................................... 23

Passenger Load Factor ........................................... 23
PREFACE

The airline industry has gone through a number of changes over the last ten years. These changes have occurred as a result of the recent deregulation of the industry, the fluctuations in the price of oil, and the changes in the overall economy. These changes have meant that the airlines have been faced with re-evaluating the goals of their firms. No longer are they free from competition through government deregulation. Operating costs can not be easily covered by merely increasing the air fares. And an increase in the demand for their service can no longer be acquired through increased customer service alone. These type of changes have meant changes in the airlines' goals.

Before there can be a full understanding of the effects on the firms' goals in the airline industry, an explanation of the goal seeking process by any firm must be understood. Therefore a description of the sequence of goal seeking by a firm and the factors affecting these goals will be discussed first.
GOAL SEEKING

When a firm comes into existence there are certain goals that it must try to satisfy first. The common assumption that firms will always try to maximize their profit does not hold true in all instances. There are times where the firm is unable to pursue profit as its main objective. There are also times that the firm will try to obtain goals that are not directly in line with obtaining the maximum profit. It appears that the firm goes through a series of stages as it attempts to reach certain goals. Satisfaction of the survival goal is necessary before any further goal can be sought. The profit goal must then be satisfied before any nonprofit goal can be pursued. While the "other" goals are the goals which are unique to a particular company, which may be outwardly on top of their list of priorities, but are the least important in fulfilling their goal requirements.

SURVIVAL

The first and fundamental stage that a firm will pass through is the survival stage. It is here that the firm's only goal is that of staying in existence. This stage does not include the long-run survival goal since this is a goal.
that all firms attempt to ensure at all times; and so it is never a goal which will develop at any particular time in a firm's existence, but will always be a continuous concern.

Short-run survival on the other hand is an immediate concern of the firm and will become the main objective when it becomes critical. Short-run survival is of such importance to the firm that it is unable to pursue any other goal until it is able to assure this objective is satisfied.

PROFIT MAXIMIZATION

During this stage of the firm's goal seeking, the firm is assured of short-run survival and so can pursue profit as a goal. The firm will continue to produce in such a way that marginal revenue will increase, while marginal costs decrease until they are equal to each other, where profits are maximized. Stated another way, "a firm faced with several alternatives having different expected profit outcomes can usually be counted upon to select the alternative with the greatest expected profit." 1 Maximized profit is the ideal situation and the achievement of this position may not be obtainable.
What a firm will do is to increase profits to a point where they at least equal the profit that could have been earned by their money on the next best alternative investment. This profit can be defined as the excess of total revenue over total cost for the firm. For the purposes of this paper, the return on the next best alternative investment is equivalent to the T-Bill rate (which will be assumed to be an investment with zero risk) plus a percentage equivalent to what is believed to be the risk associated with the firm by investors.

The assumption of Profit-Maximizing behavior is especially suitable in those situations where

1) large groups of firms are involved and nothing has to be predicted about the behavior of individual firms;

2) competitive forces are relatively intense;

3) the effects of a specified change in conditions upon prices, outputs, and resource inputs are to be explained and predicted rather than the values of these magnitudes before and after the change; and

4) only the directions of change are sought
rather than precise numerical results.

Like the survival stage, the profit maximization stage must be assured before any other stage or goal can be sought. Unlike the survival stage, a firm does not have to leave this stage at any particular time. Profit maximization is a legitimate long-term goal for many firms. It is only the ability to pursue any higher level goal that is dependent on the acquisition of adequate profits.

OTHER GOALS

The other goal stage of a firm's goal seeking progression is the highest level of achievement. It is here that the firm is relatively assured that it will stay in existence and will be bringing in sufficient profits to allow it to pursue other goals. This stage can be broken up into three main categories.

Revenue Maximization Revenue maximization may appear to be equivalent to profit maximization, but the two are not always compatible. If sales are designated as the goal for the firm, there will be a heavy emphasis in bringing in the greatest dollar amount possible. This type of philosophy can lead to producing
beyond the optimum level, where marginal costs are greater than marginal revenues. Having market share as the goal of the firm can lead to similar uneconomical decisions. But according to Stephen Shaw, "maximization of market share must be the first of the alternative objectives...without it, it will allow new airlines to enter to make up for unfulfilled demand."³

Social Responsibility "The earning of adequate profit is a prerequisite for giving a firm the organizational ability and the financial wherewithal to respond to social objectives."⁴ But not all social objectives are goals which the firm had chosen for itself to pursue. When the social goal is imposed on the firm, the most economical decisions are not always made and can lead to the firm having to pursue lower level goals in order to comply with the regulation. These social goals that are imposed upon the firm are normally administered by the government in an attempt to ensure the public's well being. Since the firm does not legally have the option to ignore the regulation, it may try to achieve this goal before the basic goals of survival and profit maximization are met. This can lead to the conclusion that these imposed social goals are not actually goals or that they should actually be
reclassified as survival goals because noncompliance could mean the end of the firm.

Social goals that are sought by the firm itself are more appropriately part of this third level of goal seeking. The pursuance of this goal usually will result in the spending of funds on non-revenue seeking expenditures and is meant to boost the firm's public image. This of course could indirectly increase revenue or at least keep revenue from falling, so a profit motive may still be there. The satisfaction of customer needs is also related to increasing their market share. If the current airlines are not able to fulfill all of the customers' needs new airlines will enter to meet the demand. This goal seeking may also lead to a satisfying behavior by the firm. This is where the firm is no longer concerned with increasing profits, but rather maintaining them at least at the current level because trying to maximize profits is viewed as being too complicated, time-consuming and futile.

Personal Goals There are two groups of people that will attempt to have their personal goals fulfilled by the firm. The first of these groups are the owner/stockholders. These individuals are concerned with all phases of the firm's goal seeking. Their personal goals
are the firms goals. When the firm is owned by only a few people there may be a tendency for individual goals to be sought over the firms other goals. When there are many owners of a firm, such as with stockholders, individual personal goals can not normally be sought over the firm's other goals. In this circumstance the stockholders are assuming the risk associated with the firm, and therefor expect to be "compensated for having skill and foresight to give buyers the kind of value they wanted."

The second of these two groups are the top level managers. These individuals will usually have enough control over the operation of the firm that they are able to influence some of the decision making processes. The personal goals that these individuals will seek will depend on the individual. Job security is a common goal that can either lead to following the firm's goals exactly or can lead to deviating from them to reduce the chance of making a mistake by not taking any risks. Prestige as a goal for these individuals will usually lead to inflating financial statement accounts that will be the most impressive to the owners. This however may not be the best choice for the company or may not be compatible with the goals the firm is seeking.
The main objective of the manager when they choose to seek their personal goals is to obtain autonomy from the stockholders/owners. This is necessary in order to pursue goals that are not in line with company objectives. In order to do this, they must ensure that the owners are satisfied with the profits that they are receiving. A steady growth rate and increases in annual dividends are the usual means the managers have to show the owners that they are better off by not interfering with the operations of the firm.
FACTORs EFFECTING A FIRM’S GOAL SEEKING CAPABILITY

IMPERFECT KNOWLEDGE

The lack of perfect knowledge in the business environment is usually due more to the lack of time or money needed to obtain the additional knowledge than the inability to obtain it. This is not to say that the system is inadequate, since there is a point where the cost of the additional information will exceed the benefits received from it. What this does indicate though is that the firm may not be making the optimum decision when trying to reach a specific goal because of the imperfect knowledge it has. Therefore the firm must rely on a trial and error method to reach its best decision.

CONFLICTS WITH PERSONAL GOALS

Stockholders and owners are primarily concerned with receiving the greatest possible return on their investment. They also expect a higher return the greater the risk involved with the investment. These attitudes may lead to stressing short-run profits which may cause the firm to suffer in the long-run through incorrect decisions aimed at increasing immediate profits.
Manager's personal goals will usually not interfere with the firm's goals directly. What will usually occur though is that the managers will seek less risky ventures with lower returns in order to ensure that they will meet the required minimum return expected by the owners. This again could reduce the success of the firm as it attempts to seek specific goals because of the managers unwillingness to take any risks.

GOVERNMENTAL INFLUENCE

Regulation is an "attempt by governments or their agents to ensure certain objectives are met which might not be met under the operation of free market forces."

This will usually affect the firms in that industry by decreasing the uncertainties associated with the industry, there by decreasing the risks involved and lowering the required return on investment. It however may place restrictions on growth which will limit the firms ability to pursue a revenue maximization type goal.

Social goals can be part of a government regulation. They too are usually implemented to protect the public. Regulations on such items as noise, pollution, and congestion are items that will usually cause firms to
increase costs without an increase in revenue. This reduces the profit earned making it harder to reach any desired goal.

Deregulation only becomes a factor when the industry had been previously regulated. In this situation the opposite occurs. The uncertainties associated with the industry increase along with the risks, so that the required return is also higher. If restrictions to entry are eliminated, the increased competition will not only increase the risks to the industry but will also reduce the total revenue received per firm making the profit goal difficult to obtain. "Firms faced with severe and sustained competitive pressures are prone to exemplify short-run profit-maximizing behavior."^7

ECONOMIC FACTORS

Changes in cost Uncontrolled changes in the costs of inputs may cause the firm to alter its goal. Labor is usually considered a major cost of a firm's product, so when a wage increase is implemented the cost factor will increase significantly, which will reduce profits. A strike will normally mean that the workers are not satisfied with some aspect of their employment and will
usually lead to some increase of the cost of labor to the firm. On the other hand we have witnessed in recent years wage and benefit reductions being accepted by the unions as a trade off to job security, which has had an opposite influence on the firm’s costs.

Other input costs of the firm can also be significant. The large increases in oil prices have not only reduced the profits received by many firms but also has played a part in reducing the demand for their product as the general economy has declined as the price of oil rose. Another indirect cost associated with the rise in oil was the accelerated obsolescence of equipment that was dependent on oil. Replacement of the equipment is an expected occurrence, but with the increase in oil it became necessary to replace old inefficient equipment earlier than was originally expected. This however has only played a factor in the short-term fall in profits and not the long-run, since the replacement would have occurred regardless of the price of oil.

Changes in Demand As explained in the previous paragraph, demand for the product or service of a firm will change as the price of the good changes. It will sometimes also fluctuate as the economy changes. The other factor affecting the amount of goods and services demanded
is the amount of the good supplied. Actually what occurs is that as the supply begins to increase the price of the product will fall so that the demand for the product will rise due to the fall in prices and not the increase in supply.

Both the changes in cost and changes in demand will influence the firm's ability to pursue a certain goal. It will usually not alter the goal that they are pursuing, but rather make it either easier or more difficult for them to obtain the goal they are trying to reach.
The airline industry was still being regulated during these four years. For the airlines that were part of the industry at this time, it was a period of limited risks. There were restrictions on entry into the market, which meant that the airlines did not have to worry too much about competition. There were even restrictions on the flight schedules and service routes that the airlines had to fly. These types of regulation reduced most of the uncertainties as to the continued existence of any particular airline. Even price could not be used as a means of competition since there were both minimum and maximum levels that fares had to be maintained between. The only form of competition came in offering noneconomical benefits to the customers such as inflight music and movies, or increased service during high demand periods. Survival was not a main concern during this period.

During this period of regulation the Civil Aeronautics Board (CAB) was placed in charge of the U.S. airlines. The responsibilities that were given to the CAB were as follows:
1. Awards of operating authority through certificates of public convenience and necessity.
2. Regulation of rates and fares.
3. Regulations of agreements among air carriers.
4. Support of air services through subsidy payments.
5. Regulation of air carrier accounting and reporting.

The economy in general was very beneficial to the airline industry during this period also. Demand for travel is very highly correlated with the mood of the economy. The recession was ending in 1975, which was one of the worst years the industry had experienced in its history. For the following three years the economy would experience a mild recovery and along with the recovery a resurgence in demand for travel.

The airline industry is also dependent on the price of oil. There had been large increases in the price of oil from 1970-1974. During the years between 1975 and 1978 oil prices remained relatively constant and actually fell when inflation is taken into consideration. Since the fares were regulated by the government, the airlines were not able to
immediately raise their fares in order to compensate for the increase in oil prices. Once the fares began to rise there was a decrease in demand for travel caused by both the higher fares and a faltering economy. As the economy improved and the consumers began to accept the higher fares the demand for travel increased.

This was a period that allowed the airlines the opportunity to pursue other goals beside survival and profit maximization. Regulation was a major factor in reducing the risk level which meant lower returns were sufficient to satisfy owners demands. Increased revenues were made through increased growth. Even though routes were regulated the airlines were able to offer more flights and so would use this method to increase total revenue brought in. This however was not done with the idea of efficiency and so passenger load factors were low.
1979-1985

In October of 1978 the airline industry began its process of deregulation. The security that the airlines had had under regulation was removed. There was free entrance into the market and no restrictions on service routes. This meant greater competition in the market as a whole and in competing for passengers along the most profitable routes. It also meant that unprofitable routes were abandoned by the larger airlines and picked up by smaller regional carriers that could efficiently handle the routes.

This new competition had major effects on the industry. The competition itself raised doubts in the minds of investors of the risks involved in the airline industry. This was seen in a large drop in airline industry stock prices immediately following deregulation. It also meant a new way of operations that the older airlines were unfamiliar with and sometimes did not know how to handle. As is the case of Braniff which expanded too fast and was unable to fill their planes to the breakeven point. Deregulation also meant no minimum fare. With the new competition, fares were being reduced so that minimum profitability became difficult to achieve.
The economy was not favorable for an industry in transition. During 1980 the economy began to take a downturn which put further pressures on the airline industry. During 1982 the economy began to move upward again.

Oil prices also played a significant factor during these years. Starting in 1979 oil prices once again increased significantly. This time the airlines were able to adjust their fares to compensate for the increase in oil prices. But because of the increased competition which was putting a downward pressure on fares and the decrease in demand that began in 1980 because of the recession, fares were not able to increase as much as was needed to cover the increases in cost.

The increased oil prices once again made the airlines evaluate their fleets and determine whether to replace the old gas-guzzlers. In many cases there was a need to replace the planes with new fuel efficient jets, but this meant that large costs had to be incurred earlier than originally planned, which further reduced profits. This was only a short-term concern since replacement would have occurred regardless of the cost of oil.
Flight load factors became another major concern with increased efficiency. The more people they were able to carry on a flight the more profits they could make. Airlines have large fixed costs per flight so that once the breakeven point is reached, any additional passengers mean almost all profit. "While an improvement in the average load factor during the last decade has improved efficiency and reduced cost per passenger, the declining fares combined with the increasing costs, have raised the break-even load factor."

The increases in oil prices only lasted until 1983, when the price of oil began to fall. This had pretty much the opposite effect as the increase in oil did, except that now that the airlines had trimmed down their operations of inefficient planes, profits increased even more than would have been expected.

After seven years of deregulation the General Accounting Office (GAO) announced in December of 1985 that increases in air fares "were lower, on average, than what might have been expected under continued regulation." The reason cited by the GAO was the increased use of discount fares. This is another indication of the increased competition among the airlines that resulted in lower revenues.\(^9\)
### Break-Even Load Factor (Trunk and Local-Service Carriers)

**Quarterly**

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual Break-Even Spread</th>
<th>Twelve Months Ended</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td></td>
<td></td>
</tr>
<tr>
<td>50.5</td>
<td>53.9</td>
<td>54.4 53.1 1.3</td>
</tr>
<tr>
<td>53.7</td>
<td>53.2</td>
<td>53.3 53.0 0.3</td>
</tr>
<tr>
<td>56.2</td>
<td>56.0</td>
<td>53.4 53.9 -0.5</td>
</tr>
<tr>
<td>56.1</td>
<td>57.7</td>
<td>54.7 55.2 -0.5</td>
</tr>
<tr>
<td>1976</td>
<td></td>
<td></td>
</tr>
<tr>
<td>54.0</td>
<td>56.7</td>
<td>55.5 55.9 -0.4</td>
</tr>
<tr>
<td>57.8</td>
<td>54.0</td>
<td>56.6 56.1 0.5</td>
</tr>
<tr>
<td>59.8</td>
<td>54.1</td>
<td>57.0 55.5 1.5</td>
</tr>
<tr>
<td>54.3</td>
<td>53.4</td>
<td>56.6 54.5 2.0</td>
</tr>
<tr>
<td>1977</td>
<td></td>
<td></td>
</tr>
<tr>
<td>54.2</td>
<td>54.5</td>
<td>56.6 54.1 2.5</td>
</tr>
<tr>
<td>56.8</td>
<td>53.3</td>
<td>56.3 53.9 2.5</td>
</tr>
<tr>
<td>59.9</td>
<td>54.1</td>
<td>56.4 53.9 2.6</td>
</tr>
<tr>
<td>56.5</td>
<td>54.4</td>
<td>56.9 54.1 2.8</td>
</tr>
<tr>
<td>1978</td>
<td></td>
<td></td>
</tr>
<tr>
<td>58.4</td>
<td>57.1</td>
<td>57.9 54.8 3.2</td>
</tr>
<tr>
<td>63.8</td>
<td>57.8</td>
<td>59.7 55.9 3.8</td>
</tr>
<tr>
<td>67.3</td>
<td>58.7</td>
<td>61.7 57.1 4.5</td>
</tr>
<tr>
<td>52.5</td>
<td>57.2</td>
<td>62.1 57.8 4.3</td>
</tr>
<tr>
<td>1979</td>
<td></td>
<td></td>
</tr>
<tr>
<td>60.5</td>
<td>60.6</td>
<td>62.5 58.6 3.9</td>
</tr>
<tr>
<td>69.0</td>
<td>65.9</td>
<td>63.8 60.6 3.2</td>
</tr>
<tr>
<td>66.1</td>
<td>64.8</td>
<td>63.5 62.1 1.4</td>
</tr>
<tr>
<td>57.8</td>
<td>59.7</td>
<td>63.3 62.8 0.5</td>
</tr>
<tr>
<td>1980</td>
<td></td>
<td></td>
</tr>
<tr>
<td>57.2</td>
<td>60.4</td>
<td>62.4 62.9 -0.4</td>
</tr>
<tr>
<td>60.0</td>
<td>61.6</td>
<td>60.4 61.8 -1.4</td>
</tr>
</tbody>
</table>

**Twelve Months Ended**

Source: Meyer/Oster/Morgan/Berman/Strassman. 

This period of time had meant a departure for the airlines from seeking there other goals. It was a time that they had to at first concentrate on the basic necessities of survival and minimum profits. From what has been observed of the airline industry the changes that have occurred because of deregulation, oil prices, and the economy have...
caused changes in the goals of the firms by necessity rather than choice. For many of the firms existence under regulation would have been just fine, but once deregulation occurred only those firms willing to drop their old ways and adopt new goals were going to survive.

What we can conclude from this study is that firms do not have control over their goals to the extent that the public feels they may have or what they feel they may have over themselves. Outside factors will control the ultimate decisions, so only when the basic necessities are met can the firm attempt to seek the goals it has set for itself.

The airline industry was presented with three major obstacles to overcome in order to seek their desired goals.
NOTES


2 Thompson Jr., p.301


4 Thompson Jr., p.306

5 Thompson Jr., p.289

6 Shaw, p.90

7 Thompson Jr., p.300


9 "Fares didn’t fly so high". The Chicago Tribune, 30 November 1985.
BIBLIOGRAPHY

"Fares didn't fly so high". The Chicago Tribune, 30 November 1985.


