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Philippine Air Transportation: Impact and Challenges

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With the Philippines' archipelagic geography, air transport is the most efficient way to connect its islands and boost economic activities. Using the latest Philippine input-output tables (National Statistical Coordination Board, 2006; Philippine Statistics Authority, 2014, 2017), the air transport sector proves to be the leading driver of economic activities. Ranking first relative to all other sectors in the economy, in terms of backward linkages, indicates its general dependence on the rest of the economy for inputs to the services that it provides.

Significant links of the air transportation sector have been traced to various economic sectors going as far as three steps in the production chain, although its forward linkages are not as strong. To be more specific on its backward linkages, an increase in demand for air transportation sector's output will have a direct and positive effect on the construction sector, land transportation sector, other transportation sector, communication and storage sector, finance sector, and other private services sector. In addition, an increase in demand for the sector's output will have a positive but an indirect effect (two-step demand-pull effect) on the manufacturing sector and trade sector. A three-step demand-pull effect has been tracked on the agriculture, fishery, and forestry sector; mining and quarrying sector; electricity gas and water sector; and tourist buses and cars sector. These sectors benefit from demand-pull indirect effects that pass through the primary sectors that are directly linked with the air transportation sector. Meanwhile, a price increase in the output of air transportation sector will have a direct cost-push effect on the land transportation sector, other private services sector, and government services sector; but a two-step cost-push effects will be experienced in the manufacturing sector and the finance sector.

In addition, it is the top contributor of economic output resulting from the same level of investment made in other sectors as evidenced by its output multiplier of 2.4621 which accounts for the direct and indirect effects to the Philippine economy. Furthermore, its activities generate the highest amount of net indirect tax revenue for the government with an indirect tax multiplier of 0.0842. In terms of job creation, there are two jobs created for every million pesos invested in the air transportation industry. The capital-intensive nature of the industry ensures that billions will pour into the country once it is liberalized, thereby promising thousands of jobs for the Filipino people.

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Challenges

Air transportation is the backbone of the Philippine tourism sector with 98.59% inbound tourist arriving by air (Department of Tourism, 2017). Policy reforms to increase competitiveness in this sector should be prioritized. Initial reforms through Executive Order 219 issued in 1995 during the Ramos administration facilitated the entry of new airlines in the domestic air transport sector, increased number of flights and domestic scheduled passenger traffic, established niche markets in the major, secondary and tertiary domestic routes, and reduced airfares primarily in the major domestic routes (Austria, 2000). Further reforms were introduced through Executive Order 500-A (2006) granting unlimited third and fourth freedom rights to foreign carriers operating in the Diosdado Macapagal International Airport (DMIA) and the Subic Bay International Airport (SBIA), subject to evaluation by the Civil Aeronautics Board (CAB). The most recent policy introduced was Executive Order 29 (2011) which gives CAB the authority—within the boundaries of existing laws, rules, and regulations—to: 1) grant any foreign air carrier increases in frequencies and/or capacities in the country's airports other than NAIA; 2) impose a period or other conditions on the utilization by foreign carriers of such additional frequencies or capacities; and 3) revoke the increases in frequencies or capacities if conditions are not met. Despite these reforms, there are numerous issues that hamper growth and expansion in the aviation sector, in particular:

- *Ownership cap and effective control*. The privilege to fly international routes requires an official designation, indicated in the air services agreement, from the home country. Non-designated airlines are, thus, denied access rights in bilaterally-negotiated routes. In the Philippines, with a 60% minimum domestic equity requirement, designated carriers are essentially owned and controlled by the government or Filipino corporations;
- *Taxes and airfares*. While airlines have the liberty to set airfares, they cannot be offered to the flying public if disapproved by aviation authorities of the bilateral partners (Austria, 2000). Similarly, other airline charges are subject to CAB approval. With the implementation of TRAIN in 2018 (The Tax Reform Acceleration and Inclusion Act, 2017), higher fuel costs have prompted Philippine Airlines and Cebu Pacific, the Philippines' designated carriers, to file their requests with CAB in May 2018 to collect fuel surcharges. If CAB permission is granted, the surcharge will raise the cost of flying. In addition, the second package of the TRAIN law will impose taxes on the importation of air transport equipment and spare parts which will drive the price of air transport up. Furthermore, the Philippines imposes a PhP1,620 travel tax for Filipino citizens traveling abroad, creating a natural barrier for Filipinos to expose themselves to global trends. These policies will yield adverse effects for the Philippine air transportation industry;
- *Cabotage*. Executive Order 29 (2011, § 5), the latest mandate on aviation deregulation, specifically states that "In no case shall the CAB grant to any foreign air carrier Cabotage traffic rights of any kind, i.e., the right to transport passengers and goods between two or more points within the Philippines";
- *Freedom of rights*. The first four freedoms are granted. Fifth freedom is granted subject to conditions set by CAB under Executive Order 29 (2011). Granting the sixth and seventh freedoms have not been addressed in any of the previous nor the recent liberalization efforts.

The Way Forward

Liberalization of the air transportation sector is vital to achieve welfare gains not only for consumers but also for airlines, thereby spilling over to the economy. Shreds of evidence of the benefits derived from liberalizing the aviation sector have been visible in the European Union (EU) and Latin America. EU member countries are regulated as a region and negotiated external agreements that resulted in an average of 20% decrease in fares with other countries which signed agreements with them (Abate & Christidis, 2017). The Latin American Civil Aviation Commission (LACAC) coordinates the air transport policies of its 22 member countries through active discussion, which led to bilateral and multilateral negotiations among its members. The LACAC member countries have varying degrees of openness, which highlights the benefits of adopting more open policies (Abate & Christidis, 2017).

The Philippines is slowly opening up to the idea of relaxing its 40% foreign ownership cap on firms. President Rodrigo Duterte issued a directive to the National Economic and Development Authority Board and its member agencies "to exert utmost efforts to lift or ease restrictions on certain investment areas with limited foreign participation" (Memorandum Order No. 16, 2017). Senate Bill No. 1754 proposes to lift foreign ownership restrictions on public services that are not considered as public utilities (Senate

Committee Report No. 301, 2018). These restrictions are in place based on the principles of regulatory control and national security. Regulatory control is traditionally dependent on the nationality of the owners and officers of an airline, but recent developments replace such with a carrier adopting the nationality of its principal place of business and be subject to regulatory oversight. Further concerns on the risk of nationals from an unfriendly country gaining ownership and control of an airline of another country remains one of the arguments for such restrictions. This can be avoided through proper vetting and imposing restrictions on selected countries (Lumbroso, 2019). Investments in the air transportation sector accounted for 7.16% of gross capital formation in 2017. By adjusting the cap on foreign ownership from 40% to a higher percentage, this can boost economic activities, generate income and taxes, and create employment opportunities.

The Ninoy Aquino International Airport (NAIA) serves as the main gateway to the Philippines from the rest of the world. It can accommodate a total of 35 million passengers on an annual basis. However, in 2016, according to the Civil Aviation Authority of the Philippines (2018), it accommodated 39.6 million passengers. This number continues to grow annually. Under the Philippine Development Plan 2017–2022, one of the main agenda is to expand and develop regional airports to accommodate more flights (National Economic and Development Authority, 2017). The development plan calls for systematically linking airside, landside and access to roads facilities to ease congestion.

- *Development of a low-cost carrier terminal*. While there are new plans for the airport in Manila (such as the consortium of seven of the largest conglomerates in the country for expanding NAIA and an unsolicited bid from San Miguel Corporation to construct a new airport north of Metro Manila), planning for low-cost terminals should also be considered. De Neufville (2008) emphasized the differences in needs and costs of operating a low-cost terminal, wherein constructing a low-cost terminal is only 10% to 20% of the cost of a full-service terminal. In addition, operation and maintenance expenses of low-cost terminals are significantly lower, leading to lower terminal fees. The emergence of low-cost airlines has affected the market share of legacy airlines in the domestic market such that 80% of domestic passengers are cornered by the low-cost carriers. Aside from an increase in market share, an increase in the volume of passengers is expected with the reduction in prices that will result from lower terminal fees. These strategies will contribute in achieving the Department of Tourism's goal of reaching 10 million tourist arrivals to the Philippines, which it has missed for several years.
- *Introduce reforms to airport slot allocation policies*. NAIA currently adapts International Air Transport Association (IATA) guidelines on slot allocation which is based on historical operations and airport capacity. This grants "grandfather rights" to existing airlines as long as they operate at least 80% of the time during the previous season. This system creates a barrier to new entrants such that airport slots are scarce resources and incumbents have an advantage over acquiring slots. Market-driven mechanisms such as secondary slot trading, higher slot prices, and slot auction may be introduced to increase efficiency in airport slot allocation (NERA Economic Consulting, 2004). Congestion pricing can also promote efficient use of slots through price differentiation between peak and off-peak hours (Butcher, 2017). Applications to heavily congested airports in the EU proved improvements in both consumer welfare and airline profits as well as carbon emission levels (Mott MacDonald, 2006).
- *Promote the development of the ASEAN single aviation market*. The ASEAN accounted for 9.2% of total world tourist arrivals in 2015 (Yong, Song, Artispong, Khor, & Singapore Research Team, 2016). As one of the fastest growing regions in terms of tourist arrivals, the ASEAN stands to reap benefits from negotiating as a whole. Furthermore, this can also reduce the cost of entry for carriers within the ASEAN by applying uniform standards through a common certification body rather than individual certification from each member country. By granting fifth freedom rights, countries such as the Philippines, Vietnam, Lao PDR, and Myanmar stand to enjoy increases in GDP by 9% to 51% (Laplace & Latge-Roucolle, 2016).

Protectionism in the air transportation sector deters the flow of tourists into the economy (Zhang & Findlay, 2014). Pursuing liberalization of the air transportation sector will yield an increase in competition among airlines, improvement in services, and reduce fare prices which will guarantee societal welfare gains. Hence, the government should consider eliminating the cap on foreign investments and introduction of policy reforms in the air transportation industry to achieve economic growth.

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