THE ECONOMICS OF AIRPORT DEVELOPMENT

Anybody who has followed the debate on the UK's new runway over the last few years will be all too aware that there is no free market when it comes to the development of airport capacity. The space considerations and the potential environmental and social impact are so significant as to ensure that decisions of this kind will always be the prerogative of government. But despite their central decision-making role, governments should not neglect the importance of the private investor test in deciding when airport investment is really justified.

The UK's situation is special, because of a number of factors, including the sheer scale of the aviation market and the density of surrounding development. But it is not unique: in the next twenty years Eurocontrol predicts that more than 20 European airports will be full to capacity. However, this statistic reflects more on the problems of expanding already very large airports than it does on the general issue of airport development. At the other end of the spectrum, a significant proportion of small airports fail to make money, or at least to earn an adequate return on the capital invested in them. This suggests there may be a problem of too much capacity, not too little.

Overall, it does seem the decision making process has a problem in ensuring we get the right amount of the right type of capacity in the right places. It is essential we have a balanced and proportionate approach to development in this area.

The obstacles to getting the development decision right are manifold, but here I want to focus briefly the economic contribution that an airport makes and the role this plays in development decisions.

This contribution, as it figures in most airport planning decisions, falls broadly into one of two categories. In almost all cases the airport's "footprint" is considered, that is the airport itself as a generator of local jobs. In addition, we increasingly see consideration of the wider economic activity facilitated by the increased transport opportunities that the airport provides. Both approaches have their issues.

Starting with the issue of "footprint", it very much depends on one's perspective whether or not there is much sense in treating this as a positive attribute of airport development. Government and development agencies with a parochial focus understandably value local job-creation. But looked at from another perspective, is an airport that employs more people more valuable than one that employs fewer? If we were talking about building a new highway we would not think that the highway gets more valuable the more people it takes to build it. That would just make it more expensive. The same argument applies with airports: from a local perspective more employment here rather than there looks great. But at a macro level this is no justification for airport expansion.

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Recently the wider economic contribution from airport development has started to figure more prominently, but here too we should approach the issue with caution. Thinking about the contribution that the use of air services makes to the economy is definitely the right way to value the economic value of air transport in the same way as it is the right way of thinking about the contribution of a highway. There is also a persuasive argument that says that air travel supports trade and FDI by assisting interactions between businesses and by facilitating the management of international supply chains, while higher levels of trade and FDI are associated with increased productivity and so greater wealth creation. But that is not the same thing as saying airport investment can be justified in any circumstances on the basis of the projected impact of aviation on national or regional output.

The key economic concept policy makers should bear in mind when considering wider justifications for infrastructure development is whether there is a market failure in this case? Much transport infrastructure, including many highways are public goods and the users do not pay for them directly (toll roads aside). So government needs to estimate the value the users are getting from the new infrastructure to see if it's worth having in the first place. Aviation is not like that: the users of aviation pay for the benefits it gives them, whether that is the enjoyment of a foreign holiday, being able to reconnect with friends and relatives or making connections that increase their business opportunities. Companies using passenger or freight services as a key input into their businesses can already factor-in the forward-looking value that that travel brings to them.

If those businesses are willing to pay at least as much for air services as they cost to provide then the airport development will pass a private investor test. If it does not, then government should be cautious about pinning the decision to proceed with development on value that the users themselves perceive.

This is where we see much of the issue with the development of smaller airports – the numbers do not add up under the private investor test, but governments supporting job creation or convincing themselves of the wider benefits for tourism or business push ahead anyway when the market is telling them to beware.

Of course there are market failures associated with airport development which require public intervention, especially around ensuring that the local and wider environmental impact of aviation development are properly valued and respected. And on the other side of the equation imperfectly functioning markets mean that issues such as agglomeration may be worth considering. But once those factors are accounted for, and provided business and individuals value the service to themselves correctly (and we have no reason to suppose they don't), then development should primarily hinge on the private investor test, as it would with any other commercial venture.

In following instalments of this regular bulletin I will return to the topic of market failure, considering the possible mismatch between political and economic valuations of aviation's environmental impact and whether the network effects around airports justify policy intervention to favour one sort of traffic over another.

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