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Competition and Market Process in the U.S. Airline Industry

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INTRODUCTION

Since Airline Deregulation there have been a plethora of studies demonstrating that consumers have generally been well-served by deregulation in that more open competition has resulted in lower prices. Huge losses by most of the carriers in the early 1990's apparently confirm the impression that vigorous price competition is the industry rule. Paradoxically, there are also numerous studies purporting to demonstrate that airlines achieve significant monopoly power through devices such as travel agent commission over-rides, computer reservation systems, and frequent flyer programs. The government exhibits the same schizophrenic tendency-- as some bureaucrats press price-fixing charges against the airlines while others participate in commissions desperately searching for some way to promote airline profitability.

This paper will attempt to reconcile this cognitive dissonance by demonstrating that the alleged anti-competitive effects mentioned above are either non-existent or relatively minor. Since the issues discussed involve travel agents there is also a survey of their attitudes included in the conclusion.

TRAVEL AGENT COMMISSION OVERRIDES (TACOs)

A number of researchers (See, for example, Levine, 1987; Borenstein, 1992) maintain that airlines achieve substantial market power by essentially bribing travel agents to steer consumers their way through the payment of TACOs. Borenstein (1992, p.63) asserts that "Most consumers are not aware of TACOs and do not realize that the agent has a reason to prefer one airline over another ... even if customers were aware, it is extremely difficult for any customer to monitor travel agent performance due to the complexity and constant flux of prices and seat availability." While it is probably true that most people are unaware of TACOs it is doubtful that consumers are generally unaware of the fact that agent compensation is based on commissions related to the purchase price. Even for those consumers who are so unaware, it seems that only the most naive of them would assume that all agents will always diligently and exhaustively search for the lowest price. It is unlikely that such universally perfect consumer service exists anywhere else on the planet and could not reasonably be expected of travel agents either. There is no reason to assume airline travelers are particularly ignorant consumers; if anything, air travel customers seem likely to be better educated and more savvy than the average consumer.

Furthermore, as discussed in the survey results below, travel agents strongly believe that the more naive and infrequent air traveler is more likely to call airlines directly. Inexperienced travelers seem to assume that travel agents must somehow end up charging customers; so, they "cut out the middle man" and call airlines directly.

Turning to the issue of complexity and variability in airline pricing, this point may be correct but is greatly overstated and of dubious relevancy. It will be argued below that airline

pricing may not be substantially more variable than other industries but, for the moment, let us assume that airline pricing actually is unusually unstable. This does not automatically imply consumers will be more readily fooled by unscrupulous travel agents. Although the fluctuation of prices may make discovering the lowest theoretically possible price more difficult, the volatility of airline prices has become so famous that the very possibility of price changes serves to alert consumers and increase their expected return from time invested in bargain hunting. This encourages price sensitive travelers to "double check" in order to ascertain that the agent has not made a mistake, honest or otherwise, in declaring a price to be the "lowest available."

In simplest terms there are two opposite effects of "price complexity:" On the one hand, it is more difficult to know the minimum available price and gauge agent performance against that standard. But, on the other hand, this same complexity increases the expected return from gathering more information and postponing purchase when the price seems too high. Thus, it is not at all certain that price fluctuations make it easier for agents to pursue TACOs at the expense of consumers.

Now, let us turn to the more fundamental question-- are airline prices truly more volatile and complex than most industries? It is difficult to answer the question conclusively but it is safe to say that complex pricing, as exhibited by the airlines, is less unique than it seems. Consider pricing strategies common in other industries. Prices are changed for seasonal sales, day of the week sales (such as double coupon day), time of day sales (sometimes "midnight madness"), rebate sales, coupon specials, "loss leader" specials (to create more floor traffic), discounts for teachers, discounts for students, discounts for senior citizens, professional discounts, discounts for people who mention they heard an ad over the radio, over-stocked sales, clearance sales, going out of business sales and unadvertised in store specials.

If the consumer raises the issue, many stores will match any other store's advertised prices; if you have already bought their product they will refund the difference between their price and the competitor's and often throw in an extra ten percent. Additionally, the savvy consumer can often bargain with sales people on middle and large ticket items to obtain lower prices, interest free credit or extra features at no extra cost. In fact, finding the lowest possible air fare may be child's play compared with the objective of minimizing the family's grocery bill. Personally, I have obtained some pretty good air fares but, unlike those amazing shoppers I read about in the paper, I have never come close to buying \$200 worth of groceries with three dollars and two reams of coupons!

The main difference between the variability of grocery prices and the variability of airline prices is not the degree of variance but rather the unusual degree of media and consumer attention focused on air fares. Air travel is a fairly "big ticket" purchase and is still somewhat of an exotic product so it naturally captures attention readily. Air travel, compared with most consumer purchases, is a more homogeneous product so it is often easier to notice and compare prices. Perhaps most significantly, information about air fares actually is more systematically organized and conveniently available to consumers! Suppose, for instance, that we would and could call apple juice agents to obtain apple juice prices offered by various stores and details about coupons, rebates, and special restrictions ("limit 4 with a ten dollar purchase" or "today only"). We might, then, all be talking about how variable and complicated apple juice prices are. Quite possibly, some economists would be as worried about AJACOs as they are TACOs!

Still, some might argue that TACOs must somehow effectively bribe travel agents to abandon their integrity and sweep unsuspecting consumers away from competitors' lower fares. After all, if this were not the case then why do airlines pay TACOs? One probable answer is that TACOs are used simply to promote salesmanship, to get agents to legitimately but persuasively sell the airline. Persuasive selling techniques are often difficult to incorporate in many conventional economic models because there is often an underlying assumption that consumers have fairly complete information and fairly rigid preferences. So, the common assumption is that the consumer who asks a travel agent for the lowest fare really does want the lowest fare regardless of any other consideration; therefore TACOs can not be effective unless the agent lies.

However, actual consumers are often preoccupied with life's various complications to such an extent that they have not fully processed available information, have not thought out their plans clearly enough to always know exactly what they really want (See, for example, Kirzner [1973]). In reality, some of the callers who ask for the lowest fare would be willing to pay a somewhat higher fare to obtain more convenient departure times, a nicer aircraft, more useful frequent flyer miles, better in-flight meals, etc. TACOs provide significant motivation for the agent to take the time and trouble to bring these other features to the customer's attention. Clearly, when a better informed consumer decides it is worth paying more for superior service, economic efficiency is enhanced.

The pattern of TACOs supports the theory that they are rewards for successful salesmanship. Existing evidence (U.S. DOT 1988; Borenstein, 1992) indicates that TACOs have their biggest impact on the area's preeminent airline. In other words, the airline with the most flights and most frequent service (the key service component for business travelers) is most able to influence ticket sales through TACOs. Persuasive selling works best when you have the best product to sell.

Of course, to refocus on our main point, it is still probably true that TACOs will encourage at least some travel agents to attempt to deceptively steer consumers toward higher prices. To at least partially offset this tendency, some have suggested (Borenstein, 1992) that travel agents should be required to prominently post the commission rates paid by airlines and also mail this commission list along with the tickets. Although, in theory, it seems that such a requirement might significantly alert consumers to possible bias at only a small cost to the travel agencies, there is reason to doubt the usefulness of this proposal. Most consumers, as already discussed, are probably aware of travel agents' biases and imperfections. Considering those few consumers that might significantly benefit from discovering that agents are paid various commission rates, a goodly portion of these people probably would not comprehend or competently act on the implications of these commission rates.

Still, there would certainly be some benefit, however small, from such a regulation. The problem is that it would probably not be worth the cost. These rules would have to be promulgated and enforced by a government bureaucracy not known for its own efficiency and unbiased sensibility. It is easy to envision the likely emergence of costly and complex government instructions and subsequent litigation concerning whether travel agents properly worded, posted and updated these consumer warnings.

Since the government "cure" would likely cause more problems than the "disease" it seems best to simply tolerate this travel agent bias. However, this would not appear to be

calamitous. Consumers do generally expect sales persons to have some tendency to push pricier options in order to enhance their commissions. This possible bias on the part of the travel agent can be readily off-set by asking probing questions, shopping around to other agents (and airlines themselves) or establishing longterm relationships or specific contracts that alter the incentives of agents.

These solutions, like all human endeavors, will undoubtedly be imperfect-- intentionally or not some agents will falsely claim to have found the lowest price and some consumers will believe them and ending up paying prices above the theoretical minimum. The same thing, as mentioned above, happens routinely in most consumer realms. However, "errors" of this sort are unlikely to be very persistent or systematic because of the interests of both the consumer and the low price supplier. One way or another, the low cost supplier has incentive to speak to consumers and they have incentive to listen. This is most dramatically illustrated in the airline industry by Southwest Airlines. Despite being somewhat unloved by travel agents because of its low prices (and commissions) and not being fully integrated in the computer reservation systems, the airline has become the most successful and emulated company in the industry.

FREQUENT FLYER PROGRAMS FFPs

FFP criticisms center on the notion that they spring from a principal-agent problem between business travelers and their employers and that FFPs constitute a barrier to entry. The principal-agent problem is based on the theory that FFPs are essentially kickbacks that motivate employees to sacrifice their employer's interest in minimizing travel costs in order to obtain the preferred FFPs. Although this theory of FFPs seems to be widely accepted it is readily refuted. It is actually fairly simple for employers to require that FFP miles be turned over to the company (Hirsch 1994). Since employee business travel payments are ultimately made by the company it is extremely difficult for the employees to secret away their FFP miles! The fact is that companies are aware that employees enjoy and are influenced by FFPs; they simply allow FFPs to be part of the employee benefit package and to particularly compensate those who must travel on company business.

One main reason airlines favor FFPs may simply be that FFPs are an extremely efficient quantity discount. Airlines control FFP redemptions so that these travelers generally do not crowd out other paying customers. In other words FFP customers enjoying their free flight are typically sitting in a seat that would otherwise have been empty. (The airline must also factor in the possibility that, if not for the FFP, the customer enjoying the free flight might himself have been a paying customer but that problem need not concern us here.) Thus, the marginal cost of providing that service to the FFP customer is quite low relative to the benefit that this consumer enjoys from the flight. (The airlines do incur substantial accounting costs to monitor FFPs although such costs are probably somewhat off-set by benefits that the data provides in terms of market research.) FFPs allow a fuller, more efficient use of the airlines' capacity. This fact also explains why airlines increasingly have established agreements with other businesses to award FFP miles for customers of restaurants, phone companies, and various other enterprises.

On the other hand, there is a potential inefficiency associated with FFPs caused by the income tax. Since FFP awards are not taxed as income this biases compensation away from cash toward FFPs. This would cause, in some marginal cases, employees to travel on more expensive flights than required or even to make unnecessary trips. In a taxless world a profit maximizing employer would eliminate this problem by, say, confiscating all FFP awards as long as the cost reductions from this activity exceeded the benefits to the employees of keeping their FFP awards. Suppose, for instance, an employer could confiscate all FFP awards and thereby reduce costs by 100 and that employees valued the lost awards at 60. By confiscating the awards and increasing cash compensation by 60 the employer enjoys a net savings of 40 while employees are no worse off. However, with, say, a 50% marginal income tax rate the employer would be better off to simply leave workers to enjoy FFPs as compensation rather than claiming such awards but having to increase cash compensation by \$120.

Naturally, it would be optimal to eliminate this problem by abolishing all income taxes. Failing that, the bias could be eliminated by taxing business travelers' FFP awards as income. However, this may not be optimal and also poses some practical implementation problems. Borenstein (1992, p.69) points out that it would be difficult to distinguish awards earned from leisure travel from business travel. The appropriate taxable value is also not easily determined.

More fundamentally, canceling FFPs' tax exemption may not be efficient even if it could be done with no transaction costs. The otherwise unused flight capacity that is awarded under FFPs is a sort of quasi-public good that may well warrant the "tax subsidy" received by FFPs. That is, occupying otherwise unused seats represents approximately non-rival consumption. It is not completely non-rival because the average traveler prefers a less crowded flight; thus, the FFP awardee is, from the viewpoint of most travelers, somewhat of a negative externality. It is probably safe to conclude that this external cost is fairly slight-- based on the fact that leisure travelers seem to view price, not quality, as the paramount consideration and the busiest business travelers most likely to be bothered by crowding are often sitting in business or first class sections anyway.

Therefore, the relevant question is: are the gains experienced by FFP awardees, all be it partially offset by slight costs to the airlines and even slighter costs to paying customers, greater than the inefficiency costs resulting from the tax subsidy? It may be impossible to conclusively answer that question but even if the answer is "no" it would be difficult to improve efficiency by taxing FFP awards given the practical problems mentioned above. There is also some suggestive evidence that indicates business travelers may not be greatly influenced by FFPs. It is well established that business travelers strongly favor the airline that offers the most flights since that allows them to fit departures and arrivals more readily into their work schedule. Business travelers also exhibit relatively less price elasticity of demand and greater concern for fuller service and comfort. All of this indicates that, in the absence of FFP considerations, business customers would tend to mainly fly on the area's preeminent full service airline. This is exactly the type of airline that business travelers choose to build up their FFP miles. It appears that any change in airline choice motivated by business travelers' FFPs is not huge. This makes it less likely that taxing FFP awards would promote efficiency.

Of course, FFPs are also frequently criticized on the grounds that they constitute barriers to entry. Borenstein (1992) argues that this effect exists and stems from the facts that the marginal value of FFP miles increase as total miles accumulated increase and that the value of

awards to consumers is greater if many destinations are served. While it is true that both of these features make life tougher for smaller and start-up airlines it is doubtful that they cause any anti-competitive problems at all. The fact that FFPs from larger airlines are more appealing is simply a reflection that, in this aspect of airline service, there are real economies of scale. As explained above, there are efficiency gains when otherwise empty seats are filled and, in this regard, larger airlines are better at filling them. Thus, on this score, we are better off with more larger airlines and fewer smaller ones. Of course, smaller airlines may overcome this deficiency by excelling in other areas as they often apparently have. The point is that sanctions against FFPs on the grounds that they favor large over small airlines would, in principle, be equivalent to banning mass production techniques in automobile manufacturing because such techniques favor large companies over "mom and pop" car producers.

The criticism that FFPs create artificial loyalty since the marginal value of FFP miles increase as total miles accumulated increase seems similarly weak. Any airline is free to match a competitor's terms in this regard. They might, for instance, simply have the customer fax in their FFP scorecards and then match the competitor's marginal terms. Other airlines might compete better by excelling in some other area of service or offering lower prices. In a real sense, FFPs are simply a way of selling a bundle of goods where the customer pays before the full bundle is delivered. A new entrant that encounters a consumer in "mid-bundling" must simply offer incentive for the consumer to switch.

COMPUTER RESERVATION SYSTEM (CRS)

Since CRSs are owned and operated by a particular airline-- for example, American's Sabre and United's Apollo systems, it is not surprising that there would be some "bias" against competing airlines that are carried in the system (Borenstein, 1992; U.S.DOT, 1988). Although the Civil Aeronautics Board 1984 ruling forbids "screen bias" it seems to be widely agreed, as well as consistent with common sense, that more subtle forms of bias still persist. However, it is, once again, doubtful that this "bias" in CRSs constitutes any alarming barrier to entry. In fact, it is not even clear that the government's regulation against screen bias is necessary or appropriate.

CRSs are, in essence, an important but not vital complimentary good to air travel that any airline or anyone else is free to create. Critics point out that the earliest entrants, United and American, quickly signed up large numbers of travel agents and that latecomer entrants, with a few regional exceptions, have found it virtually impossible to shift many travel agents to their competing CRSs. Isn't this just another way of saying that the firms who were innovative and efficient have performed at such a high level that later "copy cat" competitors could not persuade customers to switch? This is the sort of creative behavior that, in other instances, government policy encourages by granting monopoly power to creators through the establishment of patents and copyrights.

In the CRS case there is no government barrier stopping other firms from copying the service offered by Apollo or Sabre. Those firms mainly remain dominant because of their current efficiency which stems, in part, from the legitimate inheritance of advantages from their previous "first mover" status. It might well be appropriate to allow these innovators to reap the

rewards from an unregulated, "biased" CRS as a sort of private alternative to a patent. After all, such an arrangement is much less restrictive than a patent would be and CRS bias is inherently limited by the fact that too much bias would render the CRS essentially worthless. Competing airlines are unlikely to be willing to pay CRS charges if their flight information is displayed in secret code and such a display system would be equally unlikely to attract travel agents. Indeed, a number of airlines, most prominently Southwest, successfully refuse to fully participate in the current CRSs.

Furthermore, the regulatory requirement to be "unbiased," even if not completely obeyed, slows innovation and imposes its own inefficiencies on the system. For at least some types of innovation the constraint to remain unbiased means that one must immediately share any breakthroughs with one's competitors-- not a good inducement for a large R & D budget. It is not even certain that the non-bias rule helps the intended airlines since the CRS owner is free to raise booking fees in response; the CRS airline customers largely end up paying higher fees that capture the gains from having nicer displays. In some cases, both CRS owner and client might have achieved a more efficient outcome by having a "biased" but cheaper display.

TRAVEL AGENT SURVEY RESULTS

The survey shown below was conducted by telephone on June 15-16, 1994. All 32 travel agencies in the Daytona Beach area were contacted with 24, 75%, responding. Obviously, there are some limitations to this sort of "quick and dirty" survey. Perhaps the most serious being that Daytona Beach is not likely to be representative of the U.S. as a whole. Nor can it be claimed that survey results settle all of these issues. Nevertheless, the exercise appears to provide some insight. For example, the strongest implication of the survey is that it does appear to be true, according to 91% of agents surveyed (question number 5 on the survey), that the less experienced traveler typically calls airlines directly (and is therefore not subject to any agent bias from TACOs).

The most surprising result was that 59% agreed that "customers [are] unaware that travel agents earn commissions from airlines." This may be explained by the wording of the question; comments volunteered from the agents indicated that they felt clients were unaware of the details of agent compensation, such as the exact payment rate. So, survey respondents may have been commenting more on patrons' understanding than general awareness. Another problem is that agents seemed to base their answer on recollections of particular customers inquiring as to "how do you guys make money if you don't charge me?" It stands to reason that those clients who did generally understand agent compensation would probably not bother to bring the subject up. Thus, the agents' responses may be based on their own biased sampling.

CONCLUSION

It is interesting to note, in these days when we hear so much about future information super highways, that airline passengers have enjoyed the benefits of such a super highway for many years. Although the CRSs which deliver and the travel agents who interpret this

information do not operate perfectly and totally bias free, we should not lose track of how relatively well this system does operate. How many other industries can conveniently supply so much information to a consumer who makes a single phone call? The air traveler's "information glass" may be 1/3 empty but its 2/3 fullness is a remarkable achievement.

Similarly, as we fret over the "tax subsidy" to business travelers FFP awards we should not forget the efficiency gains from this rather clever method of utilizing mostly excess seat capacity. Furthermore, any regulatory attempt to erase inefficiency and bias may very well make things worse. Indeed, as mentioned above, this may have already happened in the case of CRS regulation.

The bottom line is that the airline industry is inherently competitive and that consumers do generally find their way to lower priced airlines. Again, Southwest Airlines is a particularly outstanding example of this process (Value Jet, Kiwi, Reno Airlines and others also fit this mold). The airline does not fully participate in the CRSs, pays skimpy commissions, and does not have a spectacular FFP. It is, however, the low price leader of the industry, the most profitable airline and the model that other airlines are striving to emulate. It is clear that CRSs, TACOs, complex pricing and FFPs do not effectively impede competition or stop consumers from finding the low cost carriers. In conclusion, there is a timeless motto particularly appropriate for those considering government regulation in these areas: "If it ain't broke, don't fix it."

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ENDNOTE

- * The author is a professor at Embry Riddle Aeronautical University.

Travel Agent Survey Form

696

(STRONGLY AGREE) (1) (2) (3) (4) (5) (STRONGLY DISAGREE)

1. **Are CRS's seriously biased in favor of the carrier who operates the system?**
2. **Is there a noticeable difference in the CRS screen from before 1984, now that bias is prohibited?**
3. **Are most customers unaware that travel agents earn commissions from airlines?**
4. **Are airline customers better educated than the average consumer?**
5. **Do you think that inexperienced travelers, as opposed to experienced ones, are more likely to call an airline directly rather than use the services of a travel agent to purchase tickets?**
6. **Do you believe that some travel agents misguide customers in order to benefit from better commissions?**

Daytona Beach Travel Agent Survey Results

697

Questions

Responses

# 1	# 2	# 3	# 4	# 5	# 6	
(strongly agree)	1	2	3	4	5	(strongly disagree)
5	3	1	5	1	5	
5	4	1	3	1	1	
4	1	1	1	3	2	
3	3	1	4	1	4	
5	5	1	2	1	5	
5	3	4	5	2	2	
1	3	4	2	1	5	
5	3	3	1	1	5	
3	1	3	2	1	5	
2	1	1	5	1	3	
3	1	3	4	1	1	
4	3	3	3	1	5	
5	3	1	5	1	1	
1	5	2	5	4	5	
4	5	1	3	1	3	
4	3	2	1	1	5	
3	2	2	2	1	1	
5	3	1	4	1	4	
4	1	4	1	1	4	
5	5	1	5	1	1	
5	3	1	1	1	1	
4	3	4	1	2	2	
5	3	3	2	1	5	
4	3	5	3	1	1	
3.92	2.92	2.21	2.92	1.29	3.17	

Average

Frequency

(1)Strongly agree	8%	21%	46%	25%	83%	29%
(2)Moderately agree	4%	4%	13%	21%	8%	13%
(3)Neutral	17%	54%	21%	17%	4%	8%
(4)Moderately disagree	29%	4%	17%	13%	4%	13%
(5)Strongly disagree	42%	17%	4%	25%	0%	38%

*Population: 32, Responded: 24, 75% of Population Surveyed