Up for Debate: Deregulation

STEPHEN BREYER

Associate Justice of the U.S. Supreme Court

Why regulation rarely achieves the goals it is designed to serve

STEPHEN BREYER: Two things I think turned out to be wrong [with regulation]. The first is that if you take a group of people, set them up in a commission and try to insulate them from congressional control or from presidential control, other political forces will develop in an effort to take control. And what you will find is that the agency itself develops its own politics. Where industry had a major role in trying to influence the commission, and then later consumer groups or public-interest firms, or those who felt they represented the public interest would also try to influence the commissioners. And politics develop around the commission; and soon it's learned that there is no science that dictates the proper level of a railroad rate; and pretty soon it turns out -- and it takes people a while to understand it -- but someone sitting in a room with a pencil and piece of paper is not going to be able to figure out the proper airline rate any better than allowing the consumers and producers in a competitive marketplace to experiment with rates and service, and permit those that provide the lowest rates or the best service or the proper combination to survive, while the others fall by the wayside. In other words, efforts, both here and abroad, to have people guess what the market would produce if it were free to create a price are so very different in their result from what the market does produce when it is free that it becomes a kind of parody of a free market situation. And people found that it often would hurt the consumers and the producers as well, compared to what would happen if you allowed the market to function on its own.

What deregulation has the potential to achieve

STEPHEN BREYER: No-one envisaged that what would happen would be a tremendous ground swell, a political support for so radical a solution as deregulation. But we did think it would be possible to interject more competition into the industry and thereby begin to get prices down. The political approach would be, let's do what works. What works for whom? What works for the ordinary citizen...? We felt that if [airline deregulation] worked, there would be other areas where the same approach would work as well, and most particularly in trucking. Because if one estimated the savings to the public through deregulation, by lowering prices and by allowing more competition, if one estimated it in several billion dollars, which I think were [the] estimates among the economists at that time in the airline industry, it would be up to 10 or 15 or 20 times that in respect to trucking. There were huge savings to be made by introducing competition [and] by lowering prices. And then there were other industries where the same might be true.

Working with competition, not against it

STEPHEN BREYER: There was agreement: [the airline industry] is a competitively structured industry. Competition ought to work. Now, if you take a group of competitors and make an artificial rule that prohibits them from competing in price, then they'll still compete. They will compete in service. And that's just what was happening. What we discovered at that time, which is long gone, is that there was the "Aloha Pub" in the back of a Continental airplane. The great sandwich war [occurred] when the regulatory agency, in an effort to stamp out competition [in order] to raise profits, told them they couldn't compete by having better and better sandwiches. But the most important form of competition was simply putting on more flights and having ever more seats and having them ever emptier. It's nice to have a seat next to you that's empty. And our first witness, Lou Engman, the Chairman of the Federal Trade Commission, pointed out that when the business traveler flies, he's delighted under regulation to have an empty seat next to him where he puts his briefcase. But would he be so happy if he understood that he's paying full fare for the briefcase? Then [Harvard University economist] Dick Caves had written a book where he said that there are industries where there is a lot of service, and you make a lot of money, for example, flying from New York to Los Angeles. And then, he said, there's other service, let's say, from New York City to Buffalo where airlines wouldn't make less money. And he said what they're doing... is they're taking the profits from the profitable route and using them to subsidize the short, unprofitable route. But, he asked, why should a grandmother flying to see her grandchildren in Los Angeles pay more so that the businessman flying up to Buffalo could pay less? That was a good argument.

Flying with the chickens

STEPHEN BREYER: When Lamar Mews, the President of Southwest, came in to our hearing, he said, I'm not regulated and therefore I can cut my price within Texas. And he cut his price. I think it was something like ten dollars or fifteen dollars on weekends, across Texas. And, he said, the people who put those chicken coops on the tops of their car and drive across Texas don't do that any more. They and their chicken coops can come right on my airplane. And they did. And airline deregulation was designed to do that across the country. No one says it's fun, flying in an airplane filled with chicken coops. But nonetheless, if people want to pay the low prices for that kind of service, they should have the opportunity to do it. That's what had to happen in Texas, and now the object of the hearings was to ask why shouldn't that be true everywhere?

How the regulatory system really operated for the airlines

STEPHEN BREYER: We knew that the [airline] industry and the [regulatory] agency felt that the profits [of the airlines] were too low. And therefore, since the cause was competition, the agency would try to stop competition every way possible. Well, I'd gotten a little taste of that in the fall, because I remember President Ford at that time was trying to fight inflation. And he had a meeting at the White House about how to fight inflation. And I had heard that that was going to be followed by a meeting at the Department of Transportation with the airline industry, which seemed to have as its possible subject matter how to raise prices. So I just simply went over there and went to the meeting. And I sat in on a meeting, and the Secretary of Transportation was encouraging all the industry to raise its prices in order to make more money and to stop competition. And the only people who were objecting were some tour operators. One of them was a British tour operator called Freddie Laker, and he wanted to charge low prices to fly to England. I thought, well, maybe we could have a hearing on this very meeting. Why is the President on the one hand saying, "Keep prices down," and the Secretary of Transportation, on the other hand, is trying to raise the price? And we did have that hearing. And the Transportation Department was not very happy, and they said that this may hurt Pan Am, and Freddie Laker testified and said, "The cause of this whole thing is Panamania." So we said, "What is that"? And he said, "Well, everybody should do everything for Pan Am." And we said, "Well, what price do you want to fly at?" And he'd say some very low number, I don't remember, $120, $130 to bring people to England. "And what's the price now?" And the price is about twice that. "And can you make money at this low price?" "Yes." "Well, why don't you do it?" "Well, the regulatory authorities won't let me." "Why not?" And he'd say, "Well, Panamania." That's the gist of what it was.

It turned out that 3 or 4 or 5 percent of the time [of the Enforcement Division of the Transportation Board] went to stop prices that were too high, and 95 percent of their time went to stop prices that were too low. And then we'd go into the hearings of the routes. And we'd say, "When was the last time you granted a new route?" They hadn't for a few years.

"When was the last time a new firm entered the industry?" Which turned out, never, you see. There had been carriers that had entered in a different capacity, regional carriers, soon after the war, but you discovered that basically the same firms that had been there in 1938 were still there. We began to get the answer as to how their system worked, and when you really understood it you saw that it worked alright, but always the effort was to put the price high and not low. And then we're back to our original question. Don't you think competition would do a better job at keeping the price down? [Consumer advocate] Ralph Nader had testified. He'd said, "They say they have these low fares, but every time we phone up, they sell us a high fare. You never can find the [low fares]." And then I [consulted] the manual, and the manual said your job is to sell the customer the highest price ticket he will buy for the service he desires. So there was the odd sort of comedy, but the underlying theme was quite serious, very much an effort to find out why the agency charged with protecting the consumer was subject to such biting criticism for having fares that were higher than competition would likely bring about.

The outcome of deregulating the airlines

STEPHEN BREYER: [The main effect of deregulation] has been lower prices. I think the prices went way down quite quickly. The cheapest cross-country flight in 1975, I think, was $173 one way, $350 return and so if you multiply that by three point five you get something like $1200-1300 [in today's prices], somewhere in there. And [today] you can fly across the country for a lot less than $1200-$1300. I just went out to California, I bought my ticket on the Internet last minute, and I think it was around $450 return. So we're way down in some areas. And what's happened is that as the prices went down, demand went up dramatically.

ALFRED KAHN

Former Chairman of the Civil Aeronautics Board

Why regulation seemed like a good idea

ALFRED KAHN: [Behind the idea of regulating the airline industry was] the notion that unrestricted competition, particularly in the presence of heavy fixed investment costs, had a tendency to be destructive, that is to say, to drive prices below levels that would cover average total cost. That would prevent continued maintenance of facilities and renewal of facilities and innovation by forcing down to bare bones operating costs, thereby threatening the progress of the industry and indeed safety. That was the conception. In trucking, the conception was that small competitors who were regarded as chiselers and irresponsible would drive unsafe trucks and not maintain them, and so there would be increased accidents on the highways.

Ideology aside, airline deregulation accomplished its goal

ALFRED KAHN: I don't know what weight to place on government regulation as a contributor to the stagflation problem as we saw it in the 70s in particular, any more than I know how to weigh the beneficial effect of deregulation. In a macroeconomic sense, it's fashionable to say today that the great success of the American economy in the last 20 years has been in an important measure attributed to deregulation. It's not in my interest to minimize the small role that I played in that. But I rather suspect that there is (just as in the 30s) a clear erroneous tendency to attribute to micro-organization and micro-intervention the blame for what proved to be a massive macroeconomic cataclysm. Partly on ideological grounds, there's a tendency now to parade the virtues of a deregulative economy. Having offered all those qualifications, I don't think there's any question that deregulation has contributed, in these particular sectors of the economy, to revitalization, to increased entrepreneurial effort, to increased pressure for increase of productivity.

Pros and cons of regulating the telephone industry

ALFRED KAHN: In many ways, the total monopoly of AT&T permitted AT&T to run one of the best research laboratories in the world. And when I regulated the utilities in New York State, we required them to set aside one percent of their revenues to do research that would not otherwise be done, particularly in conservation, in environmental protection. And we could do that because it was a regulated industry. At the same time, having said that, I think that the explosion of technology that is occurring in telecommunications clearly owes a great deal to the break-up of the AT&T monopoly.

INTERVIEWER: Bell Labs was a great lab, but they kept inventing things they never marketed. Like mobile phones...

ALFRED KAHN: That's right. I remember that I was a member of the National Economic Advisory Committee to AT&T for 6 years. And all they were pushing was the picture phone, which for whatever reason proved to be a total failure. So in the exploitation of innovation, in developing alternative sources of ideas, there's nothing as effective as an open market.

My first recognition of the importance of deregulation had no relationship whatever with the stagflation phenomenon. I was born and grew up a strong advocate of competition. It was… somewhere in the 60s that I became intensely aware of how many cases [there were] in which regulation was being used as a form of cartelization.... I began to press for deregulation in the telecommunication industry, which was widely regarded as a natural monopoly, even before I became a member of the National Advisory Committee to AT&T. And one of the major pieces that I produced for AT&T was called a Grand Competitive Strategy for the Bell System. And the general argument (this was the late 60s) was [that] competition is coming; it's technologically necessary; why don't you prepare for it and, instead of fighting it, accept it, but demand alterations in the regulation that will enable you to compete effectively in that new environment? It appeared that the leadership of AT&T at that time was receptive to that kind of argument. But then there was a change in the leadership, and AT&T proceeded to do the very opposite to what I was recommending. They brought upon themselves the anti-trust suit. And the rest, as they say, is history.

The real beneficiaries of regulation

ALFRED KAHN: There are two ways of demonstrating [what harm the regulation was doing]. Look at who politically was pushing for the motor-vehicle regulation act restricting price competition. The railroads were the prime exponents, because the truckers, free to compete, were wreaking havoc on the railroad rate structure. They were pointing [out] that freight rates were very, very high, and offering them better service [for] things that were small, of great value, and [required] door-to-door service. So the truckers by their competition with the railroads were taking business away -- and undermining the complicated rate structure of the railroads. The other major advocates were the teamsters, because they wanted the protection of competition for their wages. Which were indeed by various estimates 35 to 50 percent above the level of people with comparable skills in the competitive industry. And the American Trucking Association who didn't want competition. In precisely the same way, when I was pushing for deregulation [of the airline industry] the prime proponents of retaining regulation were the airlines and the airline unions. And [there] was the growing recognition that this competition [in favor of regulation] was at the expense of the consumer....

So in general, the political line-up tells you that the essential component [of regulation] was protecting people from competition -- and cartelization had at its core restricting competitive entry, restricting competitive pricing. The best estimate that I can find is that there may have been 15 percent of air travel that was subject to discount fares in 1976. [In the year 2001], 96 percent of all mileage was at discount price. That took competition. United Airlines came to us and said we would like to offer [ski insurance to people travelling to Denver and Colorado's] ski resorts. Buy your tickets in advance we'll give you discounts [on insurance], and in addition we'll make it attractive; if there's no snow we'll refund your money. The [Civil Aeronautics Board], my lawyers, said to me, you can't permit them to do that. Because that's a departure from a tariff. Eastern Airlines was very cash poor; they were badly run; they had poor labor relations. They needed advertising [and] they couldn't pay for it, so they wanted to pay for it by giving free tickets. The [Civil Aeronautics Board] lawyers said, you can't permit them to do that; that's a no no. That's a departure from a tariff; it's a discount; discounts are not permitted.

Freddie Laker's "Skytrain" vs. the major carriers

Freddie Laker was a very enterprising tour operator, who got the idea of introducing a very different kind of service. The one thing to be said about air service was that it was quite good. Planes were only 50 percent full. The lines were short; there was very little congestion. Service was good [and] you paid a high fare. Freddie Laker said, "I'm going to introduce a different kind of service: no reservations; I'll run a sky bus. People will come; they'll get in line; I'll charge instead of $1,000 or $1,500 across the Atlantic," I think at that time, "$250." "And I'll schedule enough flights so that we'll fill the flights." Well, the carriers got together, and they introduced new special low fares that exactly matched Freddie Laker's fares. I remember being visited by Freddie Laker. And I said (he wasn't yet Sir Freddie), "Mr. Laker, I think you're a public benefactor; I love what you've done, but I'm terribly worried that [the major carriers are] going to get together and drive you out of business." He said, "Don't worry about me, Dr. Kahn; I'm a survivor." The fact is, they drove him out of business. I persuaded the board that that response was a predatory response.

The long term effects of deregulation

ALFRED KAHN: [With deregulation] the situation changed dramatically. Within a few years we had a flood of new entrants. Instead of some 15 incumbent dominant airlines we had hundreds now. Most of them disappeared. In fact, in the first wave every one of them ultimately disappeared except for America West. Of the second wave in the 90s, many of them have disappeared, but we still have several [that] continue to operate… That was dramatic. There hadn't been a single new airline formed in the 40s, 50s and 60s and early 70s. And then, of course, what was equally dramatic was the explosion of discounting. Facilitated by the happily advantageous circumstance that the airlines had engaged in an orgy of buying new capacity in the later 60s and early 70s. They had all these Jumbo Jets with empty seats. And once they were free to compete, you began to get super-saver fares, and super-apex fares, and potato fares, and peanuts fares. An explosion of discounting and competition [occurred].

There's no question that with competition has come real problems. The first thing to say is, by the most definitive estimates consumers are saving $17 to $20 billion a year as a result of the price competition and the explosion of discounting that has occurred. It is perfectly true, second, that that has been accompanied by increased congestion, crowding of planes, longer lines, and poorer service. That is what we wanted. The trouble with the regulated market was that it offered consumers only one option: good service -- high price. A competitive price market offers options. And the option that we ended up giving people, without fully appreciating it, was low quality, cheap service. And I mean, there is no free lunch. So I regard it a success that 96 percent of all mileage last year was at very deeply discounted fares. Average discounts of more than 70 percent. On the other hand, there's no question either that while average fares have gone down, inflation adjusted, more than 40 percent. Full fares have gone up dramatically: fivefold in monetary terms, and something like 70 percent in inflation-adjusted terms. In part, that is inevitable: [you do have to pay more] for better service, for more origins, for more destinations, for ability to get service at the last moment, to get on insurance lines, to get upgraded to first class. And in order to fill the planes and make possible those bigger planes and the more convenient service you have to offer discount to fill the seats. But it does raise a threat of monopoly exploitation. The same kind of evidence is clearly visible in trucking and in telecommunications. In the case of trucking, average rates have gone down. In the case of telecommunications, you've had an enormous improvement in rates. The most obvious and important case of that is long-distance services. I can remember when I watched my watch whenever I called long distance. And whenever I visited anybody, I would insist that I would pay. Well now [I use] long distance service like tap water. I mean 10 cents, 9 cents, 8 cents a minute, that's still well above even the average total cost. And what also has been dramatic is the explosion of all kinds of services. I mean, just think about cellular wireless services, as a major example. And now the development of high-speed data service and internet access. There's just an explosion of services.

JUDITH HAMILL

Administrator, Chicago O'Hare Airport

The effects of deregulation for workers in the airline industry

JUDITH HAMILL: In 1982 Braniff International Airlines was going out of business, and my father had worked for Braniff, and I happened to be in this government regulation course with Stephen Brayer, who was responsible for the airline deregulation act, and so I took upon myself to do research on what the airline deregulation acts said about displacement of people within the industry. And it said that people were supposed to get special benefits, and get government subsidies, none of which to my mind was really happening. So I wrote [a paper about airline deregulation and how it impacted labor] in order to say to Professor Breyer, look, there are all these jobs in this industry, and really how has the airline deregulation act addressed that?

In 1992 when Braniff went into bankruptcy they had 10,652 employees; all of those employees were out of work. Then you had Eastern, which subsequently went under at 37,277 employees; Pan American had 29,639 employees; and Western had 9,362 employees. All of those people were displaced and most probably left the industry for other jobs.

One of them was my dad. My dad was out of work for a couple of years, and then went back with Braniff. My father had been a jet mechanic from 1949 until 1982, and he was an incredible mechanic, but when he came back the second time around with Braniff, his wages were half of what he had earned before -- and he was an experienced worker with incredible skills, and it was very difficult to see that [happen] to him.

To ordinary people like my dad it was just incomprehensible. He'd given his life to an industry, and they changed the rules in the middle of the game, and they didn't even provide for the appropriate compensation at the end that would [help] them to come back in.