Deregulation: The Political Environment

MARVIN COHEN[1]

I have to credit my good friend Harvey Wexler that his paper doesn't say that airline travel is less safe because of deregulation. We used to deal with that ten to twelve years ago. I would call to your attention a study that was done by Morrison & Winston published in Science Magazine in which they compared the causes of accidents. All of you know, if you are interested in the subject, that fatal accidents are down by about a half while airline traffic has almost doubled. Yet the question of safety persists.

Winston & Clifford compared the causes of accidents in the ten years before deregulation to the causes of accidents in the ten years after deregulation. They were looking to see the degree to which maintenance caused accidents, and the degree to which younger and less experienced pilots were involved in accidents, because one might logically connect poor maintenance and younger pilots with deregulation. What they found was that maintenance was actually less of a cause of accidents after deregulation than it had been in the ten years before deregulation. They found that pilots were older and more experienced in the accidents that occurred after deregulation than in the accidents before deregulation. It's impossible to say with exactitude that there has been no effect, but whatever effect there has been, there seems to be no evidence at all that flying is less safe because of deregulation.

As all of you know, between 1938 and 1978, the U.S. government closely regulated fares and routes of domestic airlines. For the past twelve years, airlines have been free to structure their own route systems and set their own prices, disciplined by competition in the marketplace rather than by the government. All of the factual studies and results of this change show that to date the benefits have far outweighed the costs. Deregulation has succeeded in allowing this nation's air transport resource to be used efficiently to deliver convenient service at low cost to the great majority of American passengers.

1. Mr. Cohen is a partner of Sacks, Tierney in Phoenix, Arizona. He is also Chairman of the Arizona Commission on the Arts and of the Governor's Regional Airport Advisory Committee. He is well known as Chairman of the CAB between 1978 and 1981. His educational background came from the University of Arizona. He got his BA in 1953, an LLB in 1957. He was Phi Beta Kappa and Phi Kappa Phi. He's authored numerous papers.

Prior to deregulation, entry was closely regulated. No new major carrier was allowed to enter the industry during the entire forty years. And in most cities, air service was limited to one or two airlines. In 1979, just before the airlines were allowed to rationalize their route structures, nearly seventy percent of the nation's passengers traveled in city pair markets served by fewer than three airlines. It was believed that allowing more than two airlines to offer service in most city pair markets would be duplicative and wasteful. Sort of like in Europe where they thought it would be more efficient to allow European airlines to pool. If you examine it, you'll find that load factors in this country under deregulation, every year have been higher than load factors in intra-European air travel where they were pooling. High load factors mean greater efficiency.

Air transportation is an important national resource - utilizing high technology aircraft, precious fuel and well trained, highly skilled personnel. Planes should not fly around half empty. And that is exactly what happened under regulation. Despite the limitation to under two carriers on most routes, the airline load factors in the years prior to 1978 were generally under fifty five percent. Since 1978, load factors have run generally an amazing ten points higher in the range between sixty and sixty five percent.

Why this difference? When the CAB regulated fares, it generally established them on a basis which allowed the least efficient carrier to recover its costs. With high fares, efficient carriers would have earned high profits, but they didn't. Since airlines could not compete on prices, they competed on service. Efficient carriers competed away their high profit opportunities by offering more service than the markets could sustain. Businessmen and the wealthier portion of the American public that could afford to fly at the high, CAB regulated fare levels, became accustomed to traveling on half empty airplanes with a vacant seat next to them and lots of attention from flight attendants.

Since 1980, airlines have been permitted to establish their own route networks. As a result, the city pair markets in which a majority of passengers travel are now served by three or more airlines. The majority of markets have three or more carriers for the majority of travelers. This increase in competition has not led to wasteful duplication. Since airlines are now allowed to compete on price as well as on service, the increased competition has led to lower fares and increased travel. This has meant greater efficiency in the utilization of our valuable transportation resource.

The recent comprehensive multi-volume DOT study on competition in the U.S. domestic airline industry established that airfares have declined significantly under deregulation. There was an increase from 1979 to 1981 because the price of jet fuel skyrocketed from about thirty five cents to seventy cents a gallon. As you can see, fares went up during that early period because of fuel but then the fares declined in real terms considering inflation, twenty six percent after 1981. Between 1977 and 1987, according to Bailey's recent article, average fares from 1977 to 1987 dropped in real terms over twenty five percent from about four point six cents to three point three cents.

Morrison & Winston have done a careful and updated study of the cost and benefits of deregulation. They concluded, in their most recent publication, that fare changes have saved the American public about $6 billion a year in 1988 dollars. Another key dimension of benefits is service. While many passengers complain because airplanes are crowded and they often must connect to a hub, air travel is actually more convenient today than it was when CAB regulated routes and fares.

The key to this increased convenience is the significant increase in departure frequencies throughout the country. According to the DOT study, the number of flights available from the twenty eight largest cities has increased more than sixty percent since 1978, with twenty nine medium cities offering nearly seventy percent more flights, small cities thirty three point two percent and rural small communities fourty three point nine percent. This increase in flight frequency has meant an increase in non-stop service. In March 1979, the average hub city offered non-stop service to fifty eight destinations. By 1989, service was available to seventy destinations. In other words, non-stop frequency has not decreased, it has increased. Frequency is particularly important to time sensitive travelers such as businessmen.

While hub and spoke systems have proliferated, the number of passengers who change planes on their trip is around fourty percent compared to thirty five percent in 1978, a small increase. The big difference is that in 1978, nearly half of those who changed planes also changed airlines. In 1988, only five percent of those passengers had to change airlines. Morrison & Winston estimate the net benefits from this are $7 billion a year. That's taking into account about a half a million dollars in cost.

There is a great concern notwithstanding all this about fortress hubs. And the fact that rates are higher in monopoly hubs than in competitive markets. These single carrier markets represent only ten percent or so of the total domestic RPM's travelled. For businessmen traveling to or from a fortress hub, the higher fares are in some degree compensated for by frequency. Charlotte is a good example of this, going from thirty two cities non-stop service in 1979 to seventy three non-stop cities ten years later.

The thing that I think hasn't been taken into account by the opponents in evaluating deregulation is the dynamics of the system. Southwest in the past few months has been entering new markets. Its new service from St. Louis to Detroit had a dramatic effect. Average fares dropped by two-thirds, traffic trebled and Southwest captured a fourty percent market share. Southwest has moved to Detroit, Nashville, Birmingham, New Orleans and is offering low fares capturing significant portions of market share. In this dynamic marketplace, even fortress hubs are vulnerable from other hubs on the spokes that go back and forth. Winston and Morrison have pointed that airlines with strength at one hub can attack another carrier in another hub.

Another benefit that has not been talked about is the benefit of putting former automobile travelers into airplanes. A study by Richard McKenzie indicates 1,700 lives a year have been saved because air travel is more available to the traveling public and people have moved from their cars to airplanes.

Most importantly, deregulation has allowed air transportation in this country to grow from a conservative focus on businessmen and the wealthy to mass transit serving the great majority of Americans. Air travel is now affordable by families, retired people and students. The nation has shrunk and we're much closer to each other. Of course, just as the regulated air transport system was flawed, the development of our domestic air transport system after the government stopped regulating fares and routes has been less than perfect. Fares are high in the short haul in concentrated markets where competition is minimal. Airline profitability on average has not improved compared to the pre-deregulation period. Airports are becoming crowded and constrained. Control of CRS systems has threatened competition in many instances.

In 1983, I urged action to deal with all of these issues and I'm pleased to see serious attention is finally being paid. The Persian Gulf War and attendant fuel cost increases are causing major industry losses. Eastern is gone and we've heard about the others that are in trouble, but enough healthy air carriers remain to offer continued competition in city pair markets throughout the country. After all, we're not talking about a national market concentration. The market we deal with is the market for travel from one city to another. That's the relevant market here. The question is whether there is competition in those markets, and you can see in the DOT study, there are more carriers serving city pair markets for more travelers than there were ten years ago.

International liberalization was a partner in domestic deregulation back in the late seventies. As new international markets have opened, all the major U.S. carriers have developed international service. And in fact, lower international fares and ease of entry into gateways throughout the United States have built international operations to twenty four percent of the total RPM's recorded by U.S. carriers in 1988, and accounted for twenty nine percent of the profit of the carriers.

I'm pleased that Secretary Skinner is moving to open up globalization of air transport by allowing more investment by foreign carriers in U.S. airlines. I am pleased to see the potential open skies with Canada. I would call to your attention to the fact that other countries around the world are starting to emulate the American experience. Canada, Chile, New Zealand, and Australia have already deregulated. Some forty airlines around the world are moving to privatize and, of course, the great movement is in Europe in connection with 1992 economic integration. At this historic watershed, when millions of people in Eastern Europe and Russia have rejected close government control of their economies and are struggling to develop free markets, can there be any credible reason to reject market principles in the air transport system? The American experience over the past twelve years establishes that however imperfect, competition in air transport has provided substantial benefits to the American public. If we constructively address the remaining infrastructure and competition problems, these benefits should continue and with globalization should expand. A free dynamic air transport system able to respond quickly to changes and demands will be a crucial element of the next century's world economy. Thank you.

HARVEY WEXLER[2]

Economics is as old as man himself for man's survival has depended in no small measure upon his material well being. The Babylonians were concerned about interest, the Phoenicians about trade and mediums of exchange, and the Greeks about division of labor, etc. Economic thought found its way into the writings of the early philosophers including Plato and Aristotle. With the emergence of Christianity, consideration was given to a "just price", a term which is an anathema to proponents of deregulation.

For good or for evil, there have only been five economists that have had an everlasting impact upon the world. One of these five was Alfred Marshall. His mammoth treatise was published just over a century ago, and reflected a synthesis of what he perceived the English economy to be in the mid and late nineteenth century. His work represents both the New and Old Testament to the theology of deregulation. It was, in fact, Professor Marshall who conceived the theory of contestable markets although he termed it the theory of equilibrium. More recent writers have merely relabeled his thought.

Professor Marshall's perception of the English economy, which may have been reasonably valid at the time of his writing, bears little resemblance to what is now almost twenty first century air transportation. His theory and philosophy were applicable to an economy that was described by one of Britain's most famous Prime Ministers as a "nation of shopkeepers". Shopkeeping is neither a capital intensive industry, nor one where the natural barriers of entry are severe. If the economics of contemporary air transportation were even vaguely similar to the mid nineteenth century English economy, deregulation would have proven to be a success, but such is not the case.

It is significant to note that none of the deregulation advocates ever refer to "The Economics of Imperfect Competition" or "The Theory of Monopolistic Competition." For academic economists to ignore these monumental advances in economic thought and perception is tantamount to a theologian ignoring the Reformation, or an historian ignoring the American and French Revolutions.

Mr. Tipton, the air transport executive who testified more times before Congress than any other, had a standard second paragraph in his

2. Harvey Wexler received his B.S. in Economics from New York University, where he also taught Economics when taking his first Masters Degree. He was subsequently a Fulbright scholar at Oxford University, and then took his MBA from Harvard Business School. After a distinguished military career, Mr. Wexler was Director for International Services for the Air Transport Association, after which he joined Continental Airlines. He was a Senior Vice President and Continental until his retirement in August 1981, and he has had 38 years of experience in aviation encompassing, at one time or another, almost all phases and aspects of the industry.

testimony. He stated that the U.S. scheduled airline industry is the most efficient, most technologically advanced, most competitive and most economic in the world. He was absolutely correct when he described the U.S. scheduled air transport system. No one can make that same statement now — at least not under oath without the risk of perjury.

1. Efficiency is a measure of how effectively a given factor of production is utilized, and in this case, it is the airplane. The utility of the plane is speed. Under regulation, the plane's natural advantage was maximized by providing the public with a maximum of non-stop and single plane service. Such service, unlike change of plane service, minimizes the elapsed travel time. Under deregulation, the advantage of the plane is inhibited since change of plane service is regarded as "the norm". Thus, the efficiency of the plane is reduced under deregulation.

For distances of less than 1,000 miles, today's change of plane service (a standard adopted by the DOT) results in elapsed travel time approximating the non-stop travel time in the piston era. For a very substantial portion of air travel, deregulation has resulted in reducing efficiency back to the state of the art of thirty years ago!

It should, of course, be pointed out that there is a considerable amount of efficient non-stop service today to and from hub cities, but such service is now regarded as a premium service and priced accordingly.

The hub and spoke system with its attendant change of plane is substantially less efficient than non-stop and single plane service (the standards under regulation). Why then is change of plane now a norm? Simply because this lower quality service is more economic from the point of view of the producer of air transportation. The greater costs of the hub and spoke system (substituting more frequent flights with smaller aircraft for fewer flights of larger aircraft and incurring the additional costs of circuity or added flying time) is more than offset by the market domination and consequent pricing that the hub and spoke system accords the producer — to the disadvantage of the buyer. In a word, deregulation has reduced the efficiency of the plane, but in so doing, has made for a more economic operation for the airline by enabling it to effectively field monopolistic power and all the advantages which flow therefrom. The most convincing evidence to confirm this is the fact that today, probably no airline would willingly trade its hub and spoke system for an equivalent linear route system because a trade would dissolve its monopolistic advantages.

2. Technology. The U.S. aircraft fleet today is not the most modern in the world. Nothing more needs to be said in this regard. Deregulation has sacrificed American technological leadership insofar as our airline fleet is concerned. The most advanced aircraft are now first purchased and introduced into service by heretofore competitive foreign carriers.

For example, the B747-400 was first ordered by a European and an Oriental carrier.

3. Competition. Here we get to the crux of the debate. Much has been written on this element, and unfortunately there has been considerable misinformation published.

To view this all important element properly, one has to return to elementary economics. Competition exists when no one buyer or seller of a good or service can determine its price. It is as simple as that. Competition exists when price is determined by factors well beyond the unilateral control of individual buyers or sellers. Price is determined by the impersonal forces of the marketplace. That is the classical competitive model, and it is applicable in certain industries — deregulated air transportation is not one of those industries. Much of agriculture is.

The largest wheat farmer in the nation cannot influence the price of wheat on the commodity exchange nor can General Mills, Kellogg, or any other individual buyer of wheat.

When a seller (or buyer) can influence or determine price, such ability represents monopoly power. The Federal Reserve and the Bank of England, working in collusion, cannot fix the price of the dollar or the pound with any precision. However, a director or manager of pricing in a sophisticated airline can and does set prices of fares each day. I submit to the reader's judgment as to whether or not monopoly power exists under deregulation when the power over pricing is greater by an airline than that of a central banker.

Under regulation, pricing was akin to that of competition; no individual airline or buyer of air transportation could unilaterally determine its price. Price was determined beyond the control of seller or buyer as in the case of competition. It was determined by an agency of the Federal government which was accountable to the duly elected representatives of the people. In a word, under regulation pricing was determined far more like that of competition than currently exists.

Under deregulation the monopoly power of the seller is to a significant extent offset by the monopoly power of the large buyer (monopsony power). No one knows the extent and exact magnitude of the price concessions extracted by monopsony power. Recently, the U.S. Government announced that it was able to obtain a twenty five percent discount for unrestricted travel on one route. Stated otherwise, the taxpayer who funds such travel pays one third more than his or her government for the identical service — even though there is no difference in the cost to the airline for such carriage. This type of monopsony power is being widely exercised by federal and state governments as well as by travel management companies and others. It is quite pervasive. What is ironic is that this type of discounting and rebating, which was illegal under regulation, is applied to the most inelastic traffic; namely, business and government travel. I cannot prove the following, but likewise no one can disprove it; namely, if the Robinson Patman Act were applicable to passenger air transportation, the airline industry within the U.S. would be profitable today! (The Robinson Patman Act permits price concessions that are cost justified; it curbs the effects of monopsony power.)

The pervasive exercise of monopoly power on the part of the seller and monopsony power on the part of a relatively few large buyers leaves the public at large at a tremendous disadvantage. Whether a system which benefits the few and disadvantages the many, is fair, reasonable and in the overall public interest I leave to the reader to decide. Proponents of deregulation, by definition, believe it is.

4. Economic. Does a system characterized by monopoly power with some offset by virtue of monopsony power produce a more economic price than a system where price is determined in a manner akin to competition? Again, deregulation proponents believe it does.

Every study I have seen that concludes that monopoly power with some offsetting monopsony power produces lower prices than a regulated system based its conclusion not on comparative prices but on yields. This is grossly misleading. Does anyone believe that a comparison of yields in food stores (revenue per square foot of store space) would represent a fair and accurate measure of the food component of the CPI index? The airline studies based upon yields would urge you to accept that as a measure of comparative prices.

I have yet to see a study which supports deregulation that bases its conclusions on specific comparative prices. They cannot as such a comparison contravenes the conclusions reached in these studies.

The reliance on yield data ought to be obvious as to its shortcomings. Have you ever seen an airline ticket expressed in yield? I have not nor has anyone else. It is expressed in terms of a specific price, but specific prices are not compared for they would reveal that deregulation has disadvantaged the public at large.

Let me cite two illustrations to reveal how grossly misleading these yield studies are. If all prices and fares throughout the U.S. had been held absolutely static for the past decade and a half, yields would have declined. Some would conclude that this means that consumers have saved vast sums by virtue of deregulation as evidenced by the decline in yields. What, in fact, happened is that the increased circuity (a lower quality of service) caused by deregulation resulted in a decrease in yield even though what the consumer paid remained static.

One trade association sponsored study concluded that even where an airline has a monopolistic position, monopoly prices have not occurred under deregulation. This is absurd as it means its members are either overly philanthropic or economically irrational.

One should be extremely skeptical of any study based upon yield data which attempts to measure comparative prices. Prices and yields are not interchangeable data. Passengers pay prices. Yields are an important micro management tool, but not a measure of the prices paid by consumers.

The occasional "fire sales" in airline pricing that have occurred under deregulation have been cited as a public benefit derived from deregulation. When fires occur, one or two things happen: either the fire is forcibly extinguished by one means or another or the property burns up and disappears. In air transport, fire sales occur when a carrier is strapped for cash and is in extreme financial ill health. History has indicated that such carriers usually disappear, and the stability of monopolistic pricing restored.

5. Growth. The faithful defenders of deregulation often make the point that "more people are flying today than ever before", and attribute it to the public benefits of deregulation. The reader should be aware that "more people are flying than ever before" is a statement that could be made for virtually every year since 1937! In fact, the rate of growth of air travel has been slightly less under deregulation than under regulation. The singularly largest percentage increase in air travel took place the year the original Civil Aeronautics Act was legislated.

The reader may properly ask that given the economic advantages that the hub and spoke system produces for the respective carriers, and their ability to yield a measure of monopolistic pricing, why is the airline industry in such a dismal financial state at the present time? Fuel prices have increased, but the 1990 fuel shock was proportionately less severe than in 1973. In 1973 under regulation, there were no bankruptcies, no forced liquidations, and no change in the structure or competitive balance of the industry. Is it recession? Recessions occurred since 1938 under regulation, and again, no bankruptcies, no forced liquidations, etc. Deregulation has in some important aspects, prevented the industry from adjusting to an unpleasant environment.

Under regulation, a carrier would reduce its plane miles flown in order to tailor its output to demand. Reducing plane miles flown under a hub and spoke system becomes extremely difficult, if not impossible, because a reduction in plane miles flown causes a more than proportional decrease in traffic carried. It is ironic that under deregulation the system is less flexible in adjusting to the business cycle than was the case under regulated linear routings.

The dire financial consequences of deregulation are becoming increasingly evident. Individual carrier balance sheets are deteriorating with cash outflows so extreme that foreign capital is being invited to provide operating subsidies for our domestic air transport network. The term "foreign investment" as used today is a misnomer — such capital is not intended for the purchase of new equipment or facilities but rather to cover current losses, and that can more aptly be termed "foreign operating subsidies". The financial picture of the airlines is such that the Department of Transportation, which is mandated by law to establish financial fitness standards, has not even promulgated such standards for major carriers.

If the current deregulatory trends continue, it will most unfortunately produce a Marxist result. It was Karl Marx who stated that, "It always ends in the ruin of many small capitalists, whose capitals partly pass into the hands of their conquerors (through route sales and acquisitions), partly vanish (through bankruptcies and liquidations)."[3] Over a sustained period, the issue facing the nation as CBS-TV might term it, is not regulation versus deregulation but rather regulated private enterprise versus a form of socialism. The author fervently urges the former; faithful adherence to a century old concept that is not applicable to a public utility will eventually produce the latter.

As a wise CEO of a major carrier aptly observed, "deregulation was not premised on economics — it was a political movement." As a political movement, it was a short term feat. As a matter of economic public policy, it is proving to be a long term disaster.

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3. Parentheses added.