

MANAGING THE TRANSITION TO DEREGULATION*

DARIUS W. GASKINS, JR.†
JAMES M. VOYTKO‡

INTRODUCTION

This country is now engaged in what is undeniably an historic reconstruction of many of the federal government's most important interventions in the private economy. One by one, regulatory programs, which have had an enormous influence on key sectors of the nation's economy, are being removed or substantially reduced: airlines, railroads, crude oil, banking, natural gas, trucking, communications, and so on. In every instance, the practical problem of managing the transition from economic regulation to reliance on the marketplace is a major issue in the decision to deregulate.

These historic shifts in regulatory policy have substantial effects on the fortunes of many of the nation's most powerful interest groups. This adds more than a mere hint of politics to these attempts to markedly reduce government intervention in the economy. Table I illustrates one consultant's analysis of the effects of trucking deregulation. We present it here not to argue the merits of trucking deregulation, nor the accuracy of this particular forecast (although we think it is reasonably on target), but merely to illustrate the effects of reform on various sectors. In essence, the Table is a balance sheet for trucking deregulation. Even a cursory review shows winners (shippers and consumers receive dramatically lower transportation costs), losers (regulated trucking companies experience diminished earnings), and those who draw (growth in wage rates declines, but total employment rises sharply).

The point is that the transition from regulation to competition affects many people's fortunes in dramatic ways. Those who would manage this transition successfully must devise policies which, among other things, reflect these effects. Our direct experience in the case of airline deregulation, crude oil decontrol, rail, truck, and bus deregulation, and other regulatory programs, has led us to believe that the transition problems involved in moving from regulation to competition often are poorly understood both from an economic and a political viewpoint. Thus, we have two objectives in this article. The first is to describe, in a generic but practical fashion, the problems which arise in moving from strict economic regulation to reliance on the market forces of competition. The second is to suggest some practical ways to address these problems by devising transition mechanisms which

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† Chairman, Interstate Commerce Commission.

‡ Director of the Office of the Chairman, Interstate Commerce Commission.

TABLE I
 PROJECTIONS OF THE GENERAL FREIGHT TRUCKING INDUSTRY'S NET INCOME
 UNDER VARYING CONDITIONS

	1978 Actual	CASE I		CASE II	
		Regulation continues in its present form 1985	Growth rate	Cost-based pricing 1985	Growth rate
Ton miles	113,474	140	3.0%	196	8.1%
Revenue per ton mile	.167	.296	8.5%	.212	3.4%
Operating revenues	18,964	41.5	11.8%	41.5	11.8%
Employees	470,000	540,000	2.0%	648,000	4.7%
Wages per employee	23,846	45,600	9.0%	35,900	6.0%
Labor	11,216	24,600	11.9%	23,300	10.9%
Pretax income	.900	1.8	10.4%	1.3	5.4%
Ordinary income after tax	.541	1.1	10.7%	.8	5.7%
Total net income	.588	1.2	10.7%	.9	6.3%
Return on equity	16.2%	16.4%		13.2%	
Return on equity excluding intangibles	18.8%	19.4%		15.5%	

Dollar amounts and ton-miles in billions except for wages per employee.

SOURCE: *An Analysis of Rates and Costs in the Motor Carrier Industry*, Office of Policy and Analysis, Interstate Commerce Commission (April 1980).

are relatively economically efficient, encourage the appropriate amount of innovation, speed the private sector's move toward competitive behavior, and dodge the political pitfalls which can endanger these regulatory reforms.

One final introductory point is in order. Many of the problems we discuss here are associated with substantial changes in regulatory policy, including increased regulation, decreased regulation, or simple vacillation. We intend to focus only on problems arising in the move from regulation toward increased competition.

I

TRANSITION PROBLEMS

A. BALANCING PRICING AND ENTRY FREEDOM

One of the most visible problems in managing the transition from regulation to competition is to ensure that pricing freedom is kept commensurate with the degree of competition in the regulated industry. Most frequently, this requires striking a balance between increased pricing freedom and eased entry into the industry during the transition. Obviously, if an industry which government has shielded from competition for several decades were suddenly given complete pricing freedom, simultaneous with the removal of regulatory barriers to entry, a potential for sudden dramatic price increases would exist during the transition period to *effective* competitive entry.¹ To a limited degree, this was true in the case of airline deregulation. In cases where other factors exist such as legally-sanctioned collective price setting, the existence of anti-competitive operating restrictions, or the existence of truly "captive" buyers, pricing freedom may have to be balanced against, or made commensurate with, the rate at which a series of anti-competitive regulatory requirements are removed and effective competition is introduced.

Although this is one of the most commonly recognized transition problems, there are instances where it has gone unrecognized. For example, at one point the Interstate Commerce Commission (ICC) considered allowing interstate bus companies upward rate flexibility without explicitly tying this freedom to any changes in the anti-competitive elements of bus regulation.²

Solution 1: Proper Sequencing

Obviously, one solution to this particular transition problem is to devise a proper sequencing for reforms. A "proper" sequence is one which reduces the opportunity for any market power resulting from years of anti-competitive regulation to be exploited in a transition period during which substantial pricing flexibility is permitted. The trucking reform bill recently passed by Congress provides an excellent example of deliberate and balanced timing of both pricing freedom and elimination of anti-competitive regulatory protection.³ In the first year, the bill

1. However, we should point out that such short-term exploitation of market power could only accelerate entry. In this sense, this particular problem is self-limiting.

2. Ex Parte No. MC-125, *Fare Flexibility for the Bus Industry*.

3. References to trucking legislation are to Pub. L. No. 96-296, 94 Stat. 793, Motor Carrier Act of 1980, unless otherwise noted.

allows individual trucking companies to raise their rates at least 10 percent without regulatory interference. At the same time, the bill instructs the ICC to dismantle rapidly a host of anti-competitive operating restrictions and substantially lower the regulatory barriers which impede new entry into the industry and the expansion of existing firms into new markets. In the second year, the bill permits the Commission to increase the upward rate freedom from 10 to 15 percent if competition is deemed adequate. Finally, in the third year, the amount of upward rate freedom is enlarged still further. But, this additional pricing flexibility is followed in the succeeding year by the elimination of antitrust immunity for collectively setting the majority of trucking rates and comes two full years after the effective date of the liberalized entry policies.

The trucking legislation provides an example of a particularly good scheme for balancing of pricing and entry freedom. The experience with air freight, however, provides an example of the problems which arise during the transition period when there is a poor sequencing of pricing and entry freedoms coupled with the existence of price levels at the beginning of the transition which are artificially depressed through regulation. In the case of air freight, the Civil Aeronautics Board (CAB) had held rates as much as 30 to 40 percent below costs. This, combined with a transition mechanism which simultaneously lifted regulatory restraints on pricing and entry, led to a rapid escalation in air cargo rates which, in retrospect, was not surprising.⁴ Similarly unsurprising was the way in which opponents of a return to competition used the example of air freight in an attempt to discredit regulatory reform in the airline and trucking industries.

The air cargo lesson suggests that developing a "proper" sequence for introducing pricing freedom requires a clear understanding of the situation immediately *prior* to the start of the transition period. If it had been widely recognized that air cargo rates were far below costs, that this was a result of existing regulation, and that this virtually ensured rates would rise to compensatory levels as the regulatory lid was lifted, one of two possible changes might have been made. First, pricing freedom might have been lagged or phased in gradually preceded by eased entry. But, in this case, this would have only ensured that there was ample competitive restraint on rates *once* they had risen to compensatory levels. For surely, no one believes that additional entry can keep rates 30 to 40 percent below the cost of providing service. In our view, the only sensible approach was not to lag pricing freedom behind entry (though that could have been done), but rather to bite the bullet by admitting that regulatory policy called for compensatory rates and acting on that admission by granting substantial rate increases prior to deregulation. This would have avoided lending any credence to the bogus argument that deregulation *caused* higher air cargo rates when, in truth, the regulatory agency had failed to allow compensatory rates.⁵

4. *Domestic Air Freight Investigation (DAFRI)* (1975), see also U.S. DEP'T OF TRANSPORTATION, DOMESTIC AIR CARGO DEREGULATION (June 1979).

5. This approach was adopted in an early version of the legislation to deregulate the household goods movers industry—S. 1798, 96th Cong., 1st Sess. (1980), The Household Goods Transportation Act of 1979. The bill would require the ICC to set compensatory rate levels before pricing freedom becomes effective.

Solution 2: Market Segmentation

An alternative or, in some cases, a complementary solution to proper sequencing is market segmentation. This is most appropriate when the transition problems associated with substantial pricing are clearly limited to specific market segments or operations. In the case of rail regulation, for example, existing reform legislation—the 4R Act—divides the rail transportation market into four distinct segments.⁶ First, the railroads are permitted total pricing freedom for any transportation which is deregulated by the ICC under its general exemption authority. At the same time, however, they do not enjoy the right to set these rates collectively with immunity from the antitrust laws. Second, railroads are also permitted complete pricing freedom for transportation services performed under a long-term contract freely negotiated between the railroad and a shipper. Third, railroads enjoy substantially unrestricted pricing freedom where there is no evidence that a particular railroad holds a “market dominant” position⁷ with respect to the traffic in question. The fourth market segment—where a railroad is market dominant—is the only case where the regulatory agency (in this case, the ICC) places limits on pricing freedom. By segmenting rail transportation in this manner, substantial pricing freedom is permitted in those areas where there is no market power to exploit, or where a railroad’s ability to exploit it is curtailed or eliminated.

The 4R Act is not the only example of a solution based on market segmentation. The ICC had proposed a tentative scheme allowing pricing freedom for the trucking industry which would permit individual segments of the trucking industry greater pricing flexibility based on the intensity of competition.⁸ The CAB, in implementing the Airline Deregulation Act, also adopted a policy of targeting increased pricing freedom to routes where they found competition to be sufficiently vigorous.⁹

We should point out that the market segmentation solution can present special problems in cases where regulatory limitations on rate increases allow for returns above competitive levels and are applied through some type of overall rate of return standard. In such a case, the regulatory agency would have to: (1) separate the segments for regulatory purposes, (2) abandon rate-of-return style regulation, or (3) risk having excellent (or poor) earnings on the portion of business conducted under flexible pricing (presumably because it is competitive) automatically depress (or inflate) the rate levels in the more stringently regulated segment.

One possible example where a regulatory agency could face this choice is the bus industry. Here, the ICC, on the basis of the level of actual or potential competition, might allow substantial pricing freedom for one of the services in the

6. Railroad Revitalization and Regulatory Reform Act, Pub. L. No. 94-210, 90 Stat. 31 (1976) (codified in sections of 15, 45, 49 U.S.C.).

7. *I.e.*, holds substantial market power over particular shippers.

8. Ex Parte No. MC-135, *Master Certificates for Motor Carriers of Freight*, see also INTERSTATE COMMERCE COMM’N, THE INITIAL REPORT OF THE MOTOR CARRIER TASK FORCE (May 1979).

9. Even before the passage of the Airline Deregulation Act, Pub. L. No. 95-504, 92 Stat. 1705 (1978), the CAB placed routes into three categories—workably competitive, intermediate, and monopoly—and allowed different degrees of pricing flexibility in each. See 14 C.F.R. Sec. 399.31(h), 43 Fed. Reg. 39522 (1978). The CAB preserved this approach in implementing the act.

following pairs: (a) regular route passenger operations and package express service, or (b) all aspects of regular route service including package express and charter service. The Commission could allocate costs between the individual services in each pair. In the case of pair (b) this would be easily feasible. But, for pair (a), the joint costs (or non-allocable costs) represent an extremely high percentage of the total cost of providing these services, thus making the two rate-making regimes—one flexible and one more stringent—difficult to operate. If costs are not kept separate and the rate of return regulation is maintained, a seesawing effect, with returns on the flexibly-priced services determining in part the rate levels for more strictly regulated services, is likely.¹⁰

We should note that our discussion of the importance of timing in introducing rate flexibility does *not* reduce to the simple maxim, "the slower the better." First, we should not forget that flexible pricing provides benefits to both buyers and sellers, benefits which are at least temporarily denied by unnecessary delay in dismantling restrictive pricing regulation. Moreover, our experience with numerous federal regulatory programs suggests that there is often more competition in regulated markets than some buyers seeking additional leverage through the government and those who are simply committed to economic regulation are willing to admit. The bus industry, mentioned above, is an excellent example. That industry may be characterized by restricted intra-modal competition—as a result of federal and state regulation. However, it clearly faces fierce competition from the private automobile, the airlines, and AMTRAK (the latter being subsidized by all taxpayers including bus riders). Additionally, if partial regulatory reform, such as eased entry, stimulates inter-firm competition which cannot be manifested through vigorous price competition, it will almost certainly make itself felt through wasteful service competition.¹¹ Finally, in a case where an industry like the railroads has been crippled by years of stringent rate regulation, its very ability to deliver services to buyers may depend on relatively rapid movement to greater pricing freedom.

B. Production Inefficiencies

In every case of which we are aware, a critical element in attempts to move an industry from regulation to competition is the elimination of crippling inefficiencies which result from these regulatory programs. Just as increased efficiency is an ultimate objective of deregulation, it is also an important concern during the transition period. Yet, there are many examples of reform programs which maintain or even exacerbate inefficiencies during the transition.

The crude oil decontrol program, for example, contained pricing provisions which provided incentives to target investment on particular types of oil production

10. A structurally similar problem arises when a firm provides both interstate and intrastate service and is simultaneously subject to both state and federal regulation. In some cases, state regulatory agencies have been reluctant to allow higher rates on intrastate operations, thus placing financial pressures on the industry to seek higher rates on interstate operations than would otherwise be the case.

11. This is widely recognized to have been the case in the airline industry prior to deregulation.

during the two and one-half year transition period. The program announced in April 1979, allowed production from newly discovered wells and tertiary recovery projects to rise from a controlled price of approximately \$13.00 to the then current world price of approximately \$18.00 per barrel. However, production from secondary recovery techniques and marginal well reworking will not reach the world price until September 30, 1981. Thus, during this two and one-half year period, there is an incentive to focus incremental investment on those fields and wells where returns, as determined by the artificial price differential, are greatest and not where returns reflect the true market value of the production. In short, the transition period preserves the inefficient allocation of investment between types of production.

A similar problem is evident in the transition mechanism for natural gas deregulation. The Natural Gas Policy Act¹² allowed the price of "deep field"¹³ gas to rise immediately to the market price. In contrast, the price of most other types of natural gas production was placed on a modest upward trajectory. This incentive structure has had a predictable result. In 1977, the oil and gas industry drilled 414 deep wells. But in 1979, well into the transition period, they increased the number of deep wells drilled by 30 percent to 614. Drilling wells below 15,000 feet costs approximately five times as much as those sunk to only 5,000 feet.¹⁴ Thus, the price differential could be substantially distorting investment away from low cost drilling opportunities in price controlled gas fields and toward more costly deep field drilling.¹⁵

Solution 1: Refuse to Segment Production as to Price

Obviously, in the examples given above, the inefficiency springs from product price differentials artificially induced by regulation. An equally obvious solution is to employ transition mechanisms which do not allow for artificial pricing differentials. In the case of crude oil decontrol, for example, this could have been accomplished by setting a single new oil price for all production and then gradually raising this price to the world level. This alone would have solved the inefficiency in allocating investment *among* fields, but unless this hypothetical uniform starting price had been at least as high as the average domestic crude oil price, this solution would come at the cost of two other crucial objectives in the decontrol decision: getting the U.S. crude oil price to world levels as soon as possible and eliminating the overall disincentive against investment in maintaining or increasing U.S. production.

We believe this offers a more general lesson on the question of dealing with inefficiencies induced by particular transition mechanisms. In beginning this article, we stated that one of our objectives was to suggest transition mechanisms which

12. Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 15 U.S.C. § 3301 (Supp. II 1978).

13. "Deep field" gas is recovered below 15,000 feet.

14. These statistics were reported in the Wall Street Journal, March 27, 1980 at 46, col. 1.

15. Given the long-term nature of some of these investments, it is not clear how serious (*i.e.*, costly) these distortions actually are. If the transition period is short enough, as perhaps is the case with the crude oil decontrol schedule, the distortions may be minimal.

were *relatively* economically efficient. By definition, a transition scheme which maintains elements of the regulatory program being dismantled cannot be efficient except when compared to alternative transition mechanisms, not the free market. If regulators, economists and economists/regulators pay too much attention to short-term inefficiencies during the transition, they risk losing sight of the ultimate objectives of deregulation and how fast they are being achieved.

Solution 2: Limit the Duration and Size of Price Differentials

Having warned against overemphasizing the problems of transition inefficiencies, we will note that all other things being equal, there is merit, of course, in limiting the duration and size of artificial price differentials whenever possible. In this regard, the crude oil decontrol program withstands review better since, in the first year, the two-tiered pricing system for "old" oil production is collapsed into a single higher-priced tier which is then gradually raised to the world oil price.

Solution 3: Pick Market Segmentation to Minimize Inefficiency

A final method, for at least partially addressing transition inefficiencies, is to segment the market on the basis of likely efficiency losses. For example, if in the case of deep drilling for gas, we know in advance that roughly similar unit production costs occur in fields down to the 15,000 foot level, we might demarcate the production-based price differential at 10,000 feet to ensure that, during the transition, higher product prices, and hence investment, do not target on the markedly more costly pockets.

Unfortunately, this example illustrates the serious flaw in this approach. It is unlikely that managers of the transition would have the information necessary to reduce significantly the transition inefficiencies in this manner. Moreover, there is a certain incongruity in an approach which assumes exceptional competence and knowledge of the regulatory process as part of the scheme to eliminate regulatory programs, which are often seen as impossible to run competently.

Along these same lines, it is interesting to note that an enormous amount of attention was devoted during the crude oil decontrol debate to the issue of production inefficiencies during the transition period. Some participants argued at length about the serious nature of these distortions. The most important of these was the "withholding" argument.¹⁶ Proponents argued that rapid decontrol of crude oil prices would induce producers to suppress production in anticipation of dramatic rapid price increases.

Though this concern was understandable, it illustrates the problem of focusing too much on the interim distortions and too little on the ultimate objective of returning to the market. For example, the concern over withholding turned out to be unwarranted in retrospect. The decontrol scheme ultimately adopted does

16. This issue was first raised in the debate by William Nordhaus, a member of the Council of Economic Advisers. Though he concluded that withholding was unlikely, the spectre was continually revisited by lower level staffers in the Administration and Congress. W. Nordaus, *Withholding Incentives Under a Decline Rate Proposal* (Nov. 22, 1978) (Council of Economic Advisors internal memorandum).

provide for fairly rapid price increases, but a closer inspection reveals no obvious incentive to withhold.¹⁷ The gravity of the withholding argument lay in its potential effect on the decontrol program itself, since, if taken seriously, it would have supported a decision to decontrol immediately or to drag the decontrol schedule out. Either one would have solved the withholding problem had there been one, but the first called for price increases so dramatic as to threaten the policy itself, while the second required the Administration to seek an *extension* of controls beyond October 1981.¹⁸ Thus, a concern for a potential interim distortion could have led to *continuation* of oil price controls in either instance.

C. Winners and Losers

The “balance sheet” approach for trucking deregulation noted earlier could be repeated for each instance where government regulation is eliminated or substantially reduced. Our economy is extremely dynamic, and under restrictive regulation rents quickly flow to those advantaged by regulatory policy. Thus, there are winners and losers when those policies are changed or eliminated. One of the most difficult problems in managing transitions toward competition is to deal with these gains and losses and the inevitable political forces they generate.

Crude oil decontrol and the deregulation of natural gas involves the most massive transfers of any regulatory change we have seen. Over the course of several decades, hundreds of billions of dollars, formerly held by oil users as a result of crude oil and natural gas price controls, will be returned to producers allowed to charge the market price. But there will be other shifts as well. The domestic petrochemical industry whose advantage in world markets is principally derived from the artificially depressed prices of its basic inputs—natural gas and liquids—will see that advantage disappear. Small refineries whose federal subsidies, derived from the crude oil price control program, are the source of substantial profits will find those subsidies disappearing. On the other hand, producers of competing energy sources—coal, nuclear, and solar—will find their products fare much better in fair market competition with increasingly more costly supplies of oil and natural gas.

Policy changes supporting pro-competitive rail mergers have similar effects. Some railroads face much stiffer competition from merged rail carriers which gain new advantages such as longer average line hauls, less need to perform costly switching and interline service, and shorter routings between origins and destinations. On the other hand, shippers on the merged lines and consumers of their products benefit from rate reductions or improved rail services. Changes in regulatory policy governing rail revenue divisions between interlining carriers offer an even more stark example. Since 1953, the ICC has mandated the revenue split between railroads offering joint north-south service in the eastern half of the

17. Blankenship, *Production Withholding Incentives Under Proposed Domestic Oil Decontrol*, Off. of Pol'y Evaluation/Dep't of Energy, Memorandum (June 8, 1979).

18. The Energy Policy and Conservation Act, the statute authorizing crude oil price controls, will expire September 30, 1981.

country.¹⁹ In the absence of freely negotiated revenue divisions, we cannot be absolutely sure that those mandated are incorrect, but the fact that the northern railroads have been demanding changes for over a decade, while the southern railroads have been resisting, suggests that removing the regulated divisions would alter the revenue split between the connecting lines.

Solution 1: Side Payments

One method for easing the pain of transfers attendant to deregulation is to provide for side payments. There is a persuasive argument, of course, that eliminating the regulatory policies which caused the original transfers is the correct course to take, and any such "righting" of the original wrong need not be accompanied by bribes to gain the cooperation or acquiescence of those who would lose if the market were to operate freely once again.

In many cases, we are inclined to agree with this view. There are, however, two potentially persuasive arguments for requiring side payments of some sort though not necessarily ones which fully compensate losers in the transition. First, as a matter of equity, it might be proper to compensate individuals who have made substantial investments, relying in large part on implicit guarantees from the government that the economic environment created by regulation would prevail. The second, and more important, argument offers a strictly pragmatic reason for considering side payments. Simply put, there are cases where a side payment scheme may be necessary as a political matter to complete the transition from regulation to the marketplace. We will offer examples which illustrate these two arguments and their ultimate effect on the transition.

On April 17, 1980, the ICC approved the largest railroad merger in history.²⁰ This merger, linking the Burlington Northern with the St. Louis and San Francisco Railroad, will result in heightened competition between the merged railroad and its chief competitors. The Commission had a decades old policy of attaching operating restrictions on a merged line to prevent it from using the lower costs resulting from the merger to divert traffic from competing roads.²¹ The Commission, realizing that such restrictions would leave competitors whole, but prevent any economic gains from the merger, considered three options. First, they could simply refuse to attach the operating restrictions and expose these railroads to the additional competition. Second, they could attach the restrictions for a limited period of time to allow the competing lines to prepare. And third, they could give the competing lines a choice between imposition of the restrictions on the merged line and a mutually negotiated cash settlement in lieu of the restrictions.

In this case, however, the Commission chose to attach the restrictions for no more than two years and to not allow the alternative of negotiating a cash

19. See 287 I.C.C. 497 (1953); 289 I.C.C. 4 (1953); 325 I.C.C. 1 (1965); 377 I.C.C. 74 (1970).

20. Finance Docket No. 28583 (Sub-No. 1F), *Burlington Northern, Inc.—Control and Merger—St. Louis-San Francisco Railway Company*, ICC (April 17, 1980).

21. These conditions are commonly referred to as the DT&I conditions after a case involving the Detroit, Toledo, and Ironton Railroad.

settlement. The equity argument for a longer period of protection from competition was less persuasive since the merger had been discussed for many years, more than enough time to prepare for the adjustment. Moreover, it was clear that this pro-competitive change could not be blocked by opponents, thus removing another possible reason to consider side-payments. Yet, this was only the second time the ICC had ever failed to attach these restrictions. The ICC's reluctant acquiescence in applying the restrictions one last time was itself a transition mechanism, for, in the same decision, the Commission announced that not only would they expire in two years, but that the Commission was proposing neither to apply them at all in future cases nor to preserve those imposed in the past decisions.

Another example of a side payment, albeit on a far grander scale, is the Carter Administration's windfall profits tax on crude oil. The course of the Congressional debate on the windfall profits tax and, more importantly, the unexpectedly weak opposition to the President's decision to decontrol oil prices demonstrated the effectiveness of the tax as a side payment. Congressmen clearly indicated that they felt justified in accepting the decontrol of crude oil prices in part because of the merits of the action and in part because the windfall tax returned a sizeable portion of the increase in oil revenues to the public.

In our view the equity argument has some legitimacy in this case, particularly with regard to investment choices made in energy and home heating facilities. Nevertheless, the chief difference between crude oil decontrol and the BN-Frisco merger is that the opponents of decontrol had a realistic chance to block the return to the market, and failure to propose a side payment in the form of a tax would have strengthened their position.²²

Solution 2: Parallel Deregulation

Some cases allow for a different solution to the problem of transfers. They arise when two regulated industries reach a competitive equilibrium with one another. Eliminating regulatory restrictions on one industry gives it a competitive advantage over its regulated rival profoundly disturbing the previous equilibrium. The solution is simply to allow equal opportunities by responding to deregulation in one industry by taking parallel action in the other.

An example of this approach is the ICC's recent exemption of rail movement of fresh fruits and vegetables.²³ Truck transportation of these commodities has been deregulated for the last several decades while rail carriage has remained strictly regulated. Predictably, the railroads share of this traffic has declined dramatically over the last two decades. The Commission was aware of this unequal regulatory treatment when it freed railroad movement of fresh fruits and vegetables from

22. In retrospect, the side payment took on even greater political importance since soon thereafter the world oil price leaped from the \$18.00 per barrel level when decontrol was announced to nearly \$30.00 per barrel and visibly swelled the inventory profits of the major oil companies. But, the windfall profits tax will extract much of this increase in the coming years.

23. Ex Parte No. 346 (Sub. No. 1), *Rail General Exemption Authority—Fresh Fruits and Vegetables*, 361 I.C.C. 74 (1979).

regulation. The railroads responded in a spectacular manner, increasing their market share by 24 to 40 percent in only seven months.²⁴

The attempt to introduce coal slurry pipelines offers an interesting and important example as well. The regulation of rail rates for coal movements is one of the most difficult problems blocking comprehensive rail deregulation. The problem stems from the relatively strong market power of the railroads once a major coal-using facility has been sited. Yet, by blocking new competition from slurry pipelines, the railroads have also blocked development of the circumstances which would permit substantial, if not total, deregulation of coal rates. The need for strict regulation of rail coal rates (or for that matter, pipeline rates) would be significantly diminished if these pipelines could be developed. Thus, the railroads' stance blocks the preconditions necessary for consideration of the parallel deregulation approach for rail coal rates.

The parallel deregulation approach in practice, however, has one flaw. There is a great temptation for regulators, even those managing the transition to the market place, to adopt the parallel part of the approach by looking to parallel restrictions rather than parallel opportunities. Complicated regulatory policies designed to "balance" competition during the transition period become undesirable when they begin to draw attention away from the primary objective of returning to the market.

Solution 3: Gradualism

The familiar saying, "time heals all wounds" is often true in the case of "pains" resulting from transfers during the transition from regulation to competition. Providing an adjustment period by deliberately lengthening the transition period is probably the approach adopted most frequently to deal with significant changes in government policy including regulatory policy. The Motor Carrier Act of 1980²⁵ and the Airline Deregulation Act, among others, provide for a phased approach in introducing some of the major changes in regulatory policy.

The trucking legislation, for example, allows the industry a four year "grace" period before their antitrust immunity for collectively fixing rates is substantially reduced. The ICC has proposed a similarly gradual approach to the elimination of antitrust immunity in the rail industry.²⁶ In both cases, the industry's historic dependence on collective pricing meant that a shift to individual competitive pricing would require a substantial change in their business behavior. Similarly, the two and one-half year period for bringing domestic crude oil prices to the world level also reflects the need for all consumers in this case to adjust to significantly higher prices. Allowing the affected parties time to react in this manner makes these changes easier to accept and so enhances the possibility of realizing a return to the marketplace.

24. *Exempt Rail Transportation of Fresh Fruits and Vegetables: Initial Impacts*, Manalytics, Inc., ICC-80-M-1159 (April 1980).

25. Pub. L. No. 96-296, 94 Stat. 793 (1980).

26. Interstate Commerce Comm'n Special Conference on Rail Rate Bureaus, Discussion Paper and Transcript (April 8, 1980).

Solution 4: Direct Subsidies

A final method for addressing the transfers inherent in the transition is the provision of direct subsidies. The airline deregulation legislation, for example, authorizes a program of limited subsidies to communities left without commercial air service after deregulation.²⁷ In a broad sense, subsidies act in much the same manner as the side payments discussed earlier. However, the fact that subsidy payments are borne by the taxpayer (in contrast to side payments between the affected parties) engages an entirely different set of political forces, the upshot being that the subsidy mechanism is less likely to be employed. Moreover, visible subsidy programs, which are subject to periodic review in the budget process, are less likely to become a permanent source of industry revenues than the implicit subsidies hidden within regulatory programs.

D. Unequal Competitive Opportunities

The design of some transition mechanisms can unintentionally work to the advantage of particular firms or industry segments by allowing them greater opportunities to exploit the new, competitive environment than would normally be the case. There may be ways to remove or mute these distorting elements unless they are required to meet some more compelling objective.

For example, one early version of the trucking deregulation legislation allowed trucking companies to rid themselves of the myriad of operating restrictions placed on them *if* they could prove—presumably through analytical studies of some sort—that this would increase fuel efficiency.²⁸ The majority of the nation's 17,000 to 18,000 regulated trucking companies already find the legal costs associated with ICC regulation burdensome. Thus, it is likely that this provision would permit larger trucking firms with a greater capacity to perform or pay for these studies to free themselves from these restrictions more quickly than most. They would then gain an early competitive advantage in the move toward the market not because of aggressive management or greater efficiency, but because of the construction of the transition mechanism.

A more difficult example arises in the case of deregulation of the intercity bus industry. The two largest bus companies—Greyhound and Trailways—dominate the intercity regular route segment of the industry. In large part, their dominance may be the result of route awards and regulatory protection from competition. An early ICC staff report recommended substantial changes to reduce regulation of intercity passenger bus services.²⁹ However, the staff report also recommended that eased entry into new markets and routes apply only to carriers with less than 15 percent of the total intercity passenger market.³⁰

The staff's objective was clear: restrict those carriers which became dominant under regulation to give smaller firms and new entrants a chance to establish

27. The Airline Deregulation Act of 1978, § 33(a), 49 U.S.C. § 1389 (Supp. II 1978).

28. H.R. 6418, The Motor Carrier Act of 1980, 96th Cong., 2d Sess. (1980).

29. *Report of the Bus Industry Study Group*, Interstate Commerce Comm'n (October 1979).

30. This number just happens to separate Greyhound and Trailways from the remainder of the industry. INTERSTATE COMMERCE COMMISSION, REPORT OF THE BUS INDUSTRY STUDY GROUP (Oct. 1979).

themselves as effective competitors. Otherwise, those carriers which were most successful in manipulating the route award system under regulation would be advantageously positioned as the industry moved to more or less unrestricted competition. Furthermore, a temporary withholding of the benefits of deregulation from the largest firms often makes the move toward competition more palatable to the remainder of the industry.

These are not frivolous arguments. But, if Greyhound and Trailway's dominance is due more to their efficiency than to regulatory policy, restrictions like the "15 percent rule" will deny some passengers the benefits of unrestricted competition between all carriers during the transition period. Moreover, the entire exercise and the costs entailed will prove fruitless if the large system economies ensure that a few, large, efficient firms will ultimately dominate the intercity bus passenger market. Finally, we suspect there will always be a temptation to make these restrictions (and their costs) permanent and that this temptation is strongest when these scale economies are most evident.³¹

A final example is the case of direct intermodal competition with only one mode burdened by regulatory restrictions. An early version of the trucking deregulation bill, for example, would have totally exempted the transportation of processed food from regulation.³² However, transportation by rail of these same commodities remain regulated. The history of transportation of fresh fruits and vegetables referred to earlier suggests that a similar reform on the rail side would prevent the railroads from losing out to trucks in this area simply because of a change in regulatory policy as opposed to a shift in the inherent competitive advantage of one mode versus the other.

Solution 1: Parallel Deregulation

Here again, a policy of parallel deregulation can sometimes solve the problem of unequal competitive opportunities during transition. In the case of deregulation of processed food moving by truck, it would make sense to allow the railroads similar freedom. Similarly, in the case of trucking deregulation, a deliberate policy of parallel deregulation in both the specialized truckload only (TL) and less-than-truckload (LTL) segments of the industry would allow both types of carriers to compete on an equal footing for traffic which could be routed through either operation. Parallel deregulation may be one of the more attractive and effective solutions to certain transition problems since it does not involve the design of complicated regulation instruments and offers opportunities rather than restrictions to the parties affected.

Solution 2: Limited Burdens in Transition

Another approach is to design a transition mechanism whose individual elements do not, unnecessarily or inadvertently, grant significant competitive advantages

31. An incredible example of this problem is the case of the subsidy to small oil refiners provided under the pretext of perfecting competition. These payments of up to \$1.96 per barrel of oil "refined" were provided by F.E.A. regulations in 1976. This subsidy has led to the substantial investment in inefficient small refineries and a *deadweight loss* to the economy of approximately \$150 million per year by 1979. U.S. Dep't. of Energy, Office of Oil Policy.

32. S. 2245, 96th Cong., 2d Sess. (1980). Motor Carrier Reform Act of 1980.

to particular firms or industry segments. In the example noted earlier, involving operating restrictions on trucking companies, a relatively simple solution is to eliminate or substantially reduce, the evidentiary and procedural burdens carriers must bear in order to remove their restrictions.

Solution 3: Handicapping

Yet another potential solution to the problem of unequal competition opportunities is the use of “handicaps” or special regulatory restrictions on advantageously positioned firms or industry segments. One example is the 15 percent rule, mentioned earlier, which would maintain regulatory restrictions on entry for large intercity bus carriers. Another example, is the recently-ended ICC policy of attaching operating restrictions on merged railroads to prevent them from realizing the competitive advantages resulting from the efficiency gains made possible by the merger.

While arguments, sometimes fairly persuasive arguments, can be made for relying on transition “handicapping” in bus deregulation, rail nationalization, and so on, in general, we believe that this is a poor approach. It re-emphasizes regulatory solutions at a time when policy changes are meant to move closer to reliance on the market. If poorly designed and applied—an unfortunately and often inevitably common occurrence in regulatory policy-making and administration—handicaps can be ineffective at best and quite costly at worst. Finally, even the brightest regulators cannot always tell which firms or industry segments are well positioned, whether this is due to regulatory policy or efficiency, and whether any identifiable advantages we actually detect are significant enough to be decisive over the length of the transition period.³³

E. Uncertainty

Uncertainty is one of the many problems industry, investors, and buyers face under regulation. It can also be a problem in managing the transition from regulation to competition. Uncertainty presents different problems to different groups. For industry, it may complicate major long-term investment decisions. During the Carter Administration’s deliberations on the crude oil decontrol issue, one official proposed that decontrol be made contingent on Congressional approval of a windfall profits tax. As it was, Congress took a full year to pass the tax even with decontrol virtually assured.³⁴ Adopting the approach of conditioning decontrol on the passage of a tax would almost certainly have resulted in a stand-off lasting much longer, and ultimately might have doomed the attempt to decontrol crude oil prices. In the interim, the question of when and how the oil price controls might be lifted would have imposed additional uncertainty on important exploration and investment decisions.

33. In this regard, we echo the sentiments expressed by Kahn on the question whether or not the CAB should have managed the transition in airline deregulation with an eye toward handicapping or promoting one airline versus another based on their pre-transition market position. Kahn, *Application of Economics to an Imperfect World*, Am. Econ. Rev. (June 1979).

34. President Carter proposed the tax on April 5, 1979. It was finally approved by Congress on March 27, 1980. Pub. L. No. 96-223, 94 Stat. 229.

In the case of crude oil price controls, the transition scheme was relatively (remarkably in our view) free of elements introducing additional uncertainty. This was not true of the current bill to deregulate the trucking industry. The bill states, in unambiguous terms, that a substantial portion of the immunity from the antitrust laws now enjoyed by the trucking industry will end in 1984. However, the bill also contains a provision requiring a study on this same issue by 1982, thus intimating that the issue is not entirely settled. Worse still is the view expressed in parts of the legislative history that the ICC should preserve, in some limited form, the industry's ability to seek general rate increases. This has been the industry's preferred pricing method and has been exercised collectively under the shield of antitrust immunity.³⁵ Thus, though the legislation appears unambiguous on the antitrust issue, in fact, the water has been muddied and both truckers and shippers are left with some uncertainty about the pricing regime in which they will operate.

Solution 1: Cite a Date Certain in the Statute

One solution to the problem of uncertainty in transition periods is to set forth specific dates on which major regulatory reforms become effective. We deliberately refer to statutory dates here because, in many cases, the legislature can reasonably be expected to set specific dates marking major steps in the transition rather than defer to investigations and decisions by the regulatory agency. Moreover, a statutory timetable is more difficult to revise than those which are set administratively and so provides greater certainty.

Solution 2: Linkage

Another approach which tends to reduce uncertainty in transitions is to link major changes with other reforms or events. For example, the greatest increase in pricing freedom for trucking firms linked to changes in the industry's immunity from antitrust laws. Similarly, an automatic cost recovery scheme for the railroad industry proposed by the ICC is linked to major changes in their antitrust immunity. The ICC has also proposed a plan for terminating the fuel surcharge program which requires trucking companies using independent owner/operators to assess surcharges on freight bills and pass these revenues directly through to the driver. The proposal, however, links changes in the surcharge program to trucking reforms which benefit independent owner/operators.³⁶ In each of these examples, linking changes (and thus their otherwise separate supporters) together tends to increase the likelihood that they will actually occur.

Solution 3: Limit Opportunities For Policy Reversals

Finally, uncertainty during the transition period can be reduced by avoiding explicit opportunities for reversing the new policy direction in midstream. This may involve omitting provisions which require that the change in direction be

35. S. Rep. No. 641, 96th Cong., 2d Sess. 14 (1980).

36. Discussion Paper and Transcript, Interstate Commerce Comm'n Special Conference on Ex Parte No. 311 Fuel Surcharge Program (March 25, 1980).

reconsidered before it has been fully implemented. The trucking legislation which requires a study on the antitrust immunity issue before the effective date of the changes illustrates a failure to follow this approach. There may be other circumstances where opportunities for reconsideration will occur in the normal course of events. The solution here is to design a transition which accomplishes, in large part, the shift to the market before the point for reconsideration is reached. This allows a test of the entire policy, not merely the transition to it. For example, some of the proposals for the decontrol of crude oil prices would have employed transition periods stretching from 1979 to 1985. One of the many reasons a somewhat shorter transition period was chosen was that the statute authorizing the price control program expired in October 1981, providing an inevitable decision point.

The reduced uncertainty brought about by limiting the opportunities for policy reversals explains in part why legislatively-determined transition schemes are preferable to those developed by the regulatory agency itself. Regulators, the industry, and consumers correctly view legislation as a more permanent expression of public policy and much less likely to be reversed. The administrative processes of regulatory agencies, by their very nature, provide frequent opportunities to reverse or substantially revise policies as they are implemented.

We should make clear here that we are not advocating that all transition mechanisms avoid opportunities for rehearing. This approach is recommended in cases where there is a consensus to return to the market and the uncertainty generated by obvious opportunities for reconsideration is seen as undesirable. These may be instances where the anticipated outcome of a move toward the market (or the elements of a transition scheme) is less certain to be beneficial. In these cases, opportunities for reconsideration may be in order despite the increased uncertainty.

F. Lumpiness

Many of us find it easier to accept and adjust to major changes if we can break them down and take them a step at a time. For example, independent truckers, who own and operate their own equipment under lease to certificated trucking firms, face the possibility that the ICC will remove the mandatory surcharge pass-through and leave their division of revenues to be determined by private negotiation. There is no reason this must be done all at once. The mandated portion of the division could be gradually reduced to allow the independents an opportunity to renegotiate. Moreover, a more gradual approach to changes vital to the independent's livelihood is less likely to result in a debilitating strike. Most importantly, the gradual approach, by avoiding sudden wrenching changes during the transition, makes it more likely that the process will be completed.

The problem of "lumpiness" in transitions is encountered frequently where the return to the market effects sudden transfers, such as in the fuel surcharge noted above or sudden changes in prices. Examples of the latter are crude oil decontrol, deregulation of natural gas, and in certain instances, the institution of flexible pricing in the airline industry.

Solution 1: Gradualism and Floating Targets

Several recently initiated deregulation programs have relied heavily on gradualism to avoid sudden shifts during the transition: the crude oil decontrol schedule takes twenty-one monthly steps from January 1980 to October 1981 to bring the price of domestic crude oil to the world level. Controlled natural gas prices rise incrementally based on the consumer price index during a transition period which stretches from 1978 to 1985. Airline deregulation and the proposed reform of regulations governing household goods movers provide limited pricing freedom for some services.

Gradualism alone, however, will not solve the problem of lumpiness in transition in cases where regulated price levels must chase a moving target. Contrasting crude oil decontrol with the deregulation of natural gas makes this point clear. In the case of natural gas, it is becoming clear that the price escalator designed to accomplish the transition from artificially low gas prices to the market price will not be able to close the gap. The market price of unregulated gas, so far, has outpaced the upward trajectory of controlled gas prices. Thus, it is likely that in 1985 a sizeable gap may remain between the regulated and market prices for gas. This would necessitate either a sudden leap in prices to close this gap or another extension of the price controls on natural gas to complete the transition. And there is always the unfortunate possibility that the circumstances in 1985 will lend themselves to a reversal of the only partially completed move to market pricing.³⁷

In contrast, the transition scheme for crude oil decontrol employs a price trajectory that guarantees the gap will be closed by the time the price control program expires. Rather than raising domestic crude oil prices by a fixed monthly increment, each monthly increment is adjusted to ensure that the controlled price will reach the current world price by October 1981.

Solution 2: Flexible Zones

The use of flexible pricing zones for regulated industries during the transition period is another means for avoiding wrenching change. It is useful to compare the zone used in airline deregulation with that contained in the trucking legislation. The Airline Deregulation Act provided a relatively narrow pricing zone for carriers. In just two years, fares for many medium-to-high cost services had reached the top of the zone. Given that competition in most air markets has become quite vigorous, it is likely that, unless the zone is widened, fares will leap upward when rate regulation ceases entirely in 1985.³⁸

37. Under the Natural Gas Policy Act, the so-called "new gas," as defined by Section 102, is the highest priced category. Still, in 1980, the Section 102 gas price is expected to be only 57 percent of the alternative fuel price. While this price will escalate in real terms 3.7 percent per year through April 1981 and 4.2 percent per year from 1981 to 1984, it is expected to rise to only 61 percent of the alternate fuel price. The entire domestic natural price, gas price control program is expected to result in a \$36.1 billion "gap" between revenues under controlled prices versus revenues under decontrol in 1984. *A Preliminary Analysis of the "Gas Cushion,"* ICF, Inc., FERC (November 1979).

38. The CAB recently did act to broaden the zone by a substantial margin. See, Civil Aeronautics Board, Policy Statement No. 94 (June 11, 1980).

The trucking legislation, however, contains provisions which automatically expand the zone over a three year period. In addition, there is a specific provision authorizing the ICC to increase the size of the pricing zone by as much as five percentage points each year if competition is deemed adequate. Thus, if Congress decides to remove regulation of trucking rates altogether at some future date, there is less chance that rate controls during the transition period will have driven a new wedge between regulated and market-determined rates.

G. Slow Industry Response

A key element of any transition from regulation to competition is an aggressive response to the new operating freedoms by the industry itself. For example, although the passage of the 4R Act in 1976 gave the railroad industry dramatically increased pricing freedom, the railroads have made little use of these new opportunities despite their precarious financial position. As this example suggests, to a large extent, the rate at which firms exploit new opportunities which unfold during the transition is beyond the direct control of regulatory policymaking. Yet, there are means for encouraging sluggish industries to respond more quickly.

Solution 1: Reward Competitive Behavior

The regulatory agency almost always has the ability to adopt policies sought by the industries it regulates. During transition periods, these changes can be targeted to those firms which voluntarily relinquish traditional regulatory protections and adopt normal competitive modes of business behavior. An example is the zone of reasonableness of rate-making freedom for the trucking industry. In both the new legislation and earlier administrative proposals, pricing freedom is granted *only* when the firms proposing price changes are not in collusion.

Solution 2: Protection for Aggressive Competitors

Another means of stimulating voluntary change toward competition is the use of regulatory devices which give the initiators of competitive challenges a period of time to benefit from their action before their rivals can respond. One example is the ICC's ability to require motor carriers responding to rate reductions filed on short notice by their competitors to file their new rate thirty days before the effective date. This gives their competitors a thirty-day period during which they enjoy a price advantage in soliciting traffic.

In general, we are skeptical of the need and the wisdom of designing transition schemes specifically to increase the rate at which firms adopt competitive behavior typical of the market. Sometimes, elements of a transition scheme which contribute to this end are fully justified on other grounds. This is true in the case of the motor carrier rate-making zone, where pricing freedom is contingent upon individual noncollusive action. Here, public policy should not require buyers to face a group of sellers who have both pricing freedom *and* immunity to fix prices collectively.

But more often, regulatory "gimmicks" which deliberately reward particular firms during the transition are likely to cause more harm than good. First,

regulators may be rewarding conduct that is aggressive, although foolish by market standards. Where other people's fortunes are at stake, regulators would do well to let them test the market in their own way during the transition. And secondly, a transition mechanism, which treats firms inequitably *solely* on the basis of the enthusiasm they exhibit in exploiting these new opportunities, may arouse forces which endanger the entire policy of moving toward the market.

Solution 3: Reduce Uncertainty

While special regulatory incentives to stimulate the competitive spirit of newly deregulated firms may be counter-productive, there is little doubt that minimizing uncertainty can serve to encourage industries to make the transition to competitive behavior. As long as the industry believes that the transition may be stalled or reversed, they may fail to take the initial and sometimes expensive steps, such as new exploration and drilling plans, the adoption of individual rather than collective pricing plans, or the purchase of new aircraft, which are necessary to adapt to the new market-oriented regime.³⁹

H. Going All the Way

Throughout the discussion to this point, we have made scattered references to problems which could prevent a policy of returning to competition from being carried out. This problem deserves more direct attention even at the expense of repeating some of the points made earlier.

The issue of whether or not proposed transition schemes lend themselves to fully accomplishing the return to competition is important for two reasons. First, deregulation in many cases is vigorously contested by the defenders of government regulation. If only partial reforms are adopted, the regulation of economic activity through competition will not really be tested. Second, we have found that many influential parties involved in the various deregulation debates have strong incentives to support policies which remove only some aspects of regulation while preserving or strengthening others.

The debate over deregulation of the trucking industry provides some classic examples of this tendency for individual interests to propose policies which never result in completing the transition to the market. Some shipping groups, for example, strongly supported less restrictive policies governing entry and expansion in the trucking industry. At the same time, however, they opposed policies which would allow the industry substantial freedom to raise rates. The trucking industry, on the other hand, was anxious to gain pricing freedom but resisted freer entry. neither position would have produced a transition mechanism which would actually achieve an effective return to the market.

39. Interestingly enough, a recent study of the initial experience with airline deregulation suggests that the subsidy program to encourage service to small communities has been ineffective in influencing business decisions primarily because of doubts that the subsidy program will continue. Meyer, Oster, Gomez-Abanex, *Early Experiences with Airline Deregulation: Some Implications for Motor Carrier Regulatory Reform*, Interstate Commerce Comm'n. at IV-5 (April 1980).

Solution 1: Linkage

The most powerful approach in designing transition mechanisms which result in an effective return to the market is to link key elements together. There is no clearer example of this than the railroad-coal slurry pipe controversy. In this instance, these two industries have been locked in political combat for over a decade with the two key objectives pursued by each industry—eminent domain for the pipelines and deregulation for the railroads—considered *separately*. To date, the result has been a stand-off with little benefit to the railroads and none at all for the pipelines. While it is not certain that explicitly linking rail deregulation with eminent domain for the pipelines will break the logjam, there is certainly reason to hope for better progress if each one can come away from the debate with something of value.

Developing the right linkages in a transition mechanism is often difficult. One important step is to identify first those parties which have the power to block a move toward the market generally judged to be in the public interest. The linkages, then, can be arranged to recognize their interests and influence. For example, in the case of trucking deregulation, the trucking industry seemed unable to block the drive for substantial reforms. Shippers, however, might have been able to do so in this case because their interests in the outcome were perceived as substantial, as they (along with consumers) were viewed as the chief beneficiaries of reform. On the other hand, the trucking industry was not seen as suffering any long-term financial hardship under regulation and in any case has failed to push for deregulation on its own behalf. Thus, the entry provisions of the bill—the central reform objective of most shipper groups—more than meet their demands. At the same time, however, the legislation provides substantial pricing freedom for carriers, especially in the later stages of the transition period, despite shipper concern over the removal of regulatory controls on rates.

The trucking legislation also illustrates that linkage can prove difficult where the interest groups are not sufficiently divided in their objectives. Despite the positions taken by the Administration, the ICC, and influential legislators, the legislation does not eliminate the trucking industry's immunity from the antitrust laws. This is one privilege that the industry fought hard to retain. A major reason for the inability to make more sweeping changes in this area is that some major shipper groups, in particular the National Industrial Traffic League, supported the industry in their efforts to retain this protection. With the industry and elements of what were perceived to be the beneficiaries of this reform joined on this issue, no linkage was possible.

Another powerful example of linkage during transition, the windfall profits tax, was mentioned earlier. Here, it was clear that only one powerful group, consumers and their representatives, possessed the power to block the move toward the market. The windfall profits tax forged a link between crude oil decontrol and a substantial increase in tax revenues from the oil industry. This particular linkage was so clear that even a substantial portion of the oil industry, which faced a significant increase in their tax burden, accepted the tax for the most part and limited their arguments to its size and design.

Solution 2: Avoid Faulty Transitions

A second means for ensuring that transitions once begun are actually completed is to avoid flaws which make the transition unnecessarily painful or difficult. Sudden price increases brought on either by an imbalance between effective competition and pricing freedom or a failure to begin the transition with compensatory prices is likely to cause distress. The rapid jump in air cargo rates did not seem to greatly distress the shipping community largely because compensatory rates brought about dramatic improvements in service. The trucking industry, however, sought in every way possible to use the example of air cargo rates to block deregulation of their own industry.

II

FAST TRANSITIONS VERSUS GRADUALISM

In a recent address, Alfred Kahn stated his conviction that in making the transition from regulation to the market, it is best not to move continuously through each step adjusting to disruptions and distortions in the transition, but to move as rapidly as possible.⁴⁰ We agree with Kahn that an approach which relies on cautious, isolated steps followed by policies which patch up the new, albeit often less serious, distortions encountered in transition is undesirable. It leads to greater uncertainty about the ultimate resolution of regulatory policies and focuses too much attention on regulatory "fixes" for short-term distortions that quite often in the end can only be eliminated by successfully completing the transition.

However, we do not agree with the general conclusion that rapid transitions are generally preferable to more gradual approaches which allow the affected interest groups time to adjust to changes, particularly changes that would be distressing were they to occur in a short period of time. Rapid transitions, in our view, may be desirable in three instances.

First, speed is acceptable when a rapid movement to the market will not violently distress parties, particularly those interests whose support or acquiescence is a necessary element in the change. The decontrol of crude oil prices is a case where sudden change could have had disastrous consequences for reform. On the other hand, there was no reason why rules barring entry into the trucking industry could not be removed immediately since effective entry occurs over time and the change has been preceded by several years of gradual liberalization in entry policy.

Second, rapid transitions are preferable when a satisfactory side payment is available. In the case of rail mergers, for instance, a cash settlement in lieu of placing operating restrictions on the merged lines can allow the rationalization process, however sweeping its competitive effects, to take place immediately. On the other hand, Congress has shown no visible interest in compensating regulated trucking companies for the value of their operating certificates. Nevertheless, the mere fact that this potential side payment was available argued for a fast transition.

40. Kahn, *supra* note 27, at 5.

Third, rapid movement to the market is desirable when the inefficiencies from regulation become intolerable. One of the reasons the Administration rejected proposals to decontrol crude oil very gradually over a six year period was the critical need to restrain consumption and stimulate production during a period of world-wide crude shortages and political unrest in some of the major oil producing countries. Similarly, there is a growing sentiment in the Congress and certainly at the ICC to reduce the time involved in abandoning and restructuring rail lines to reduce excess capacity despite the effect of these changes on particular shippers. There is little doubt that this change is due largely to the disastrous influence regulation has had on the financial health of the railroads.

III

DEREGULATION AS A PROBLEM IN POLITICAL ECONOMY

The issue whether to go fast or slow in the transition from regulation to competition reveals much about the nature of deregulation and the role economists have played in it. Speed may seem desirable when one focuses on economic distortions during the transition. But if one focuses on the ultimate objective of completing the transition period, there is much to be said for a policy of gradualism. At times, it can present problems, as in the case of airline deregulation, where the zone appears to be too small to maintain significant pricing freedom through the transition to complete deregulation. On the other hand, we are impressed by the fact that nearly every successful or pending deregulation proposal employs some type of gradual approach to change. This is not an accident, but instead reveals that the policymaking process resolves issues in favor of ultimate objectives to a greater extent than is commonly realized.

Focusing on successful completion of the transition period does involve an examination of the *economic* consequences of the transition scheme. But, the virtue of focusing on the entire landscape rather than just the path beneath our feet is that it directs attention to those transition problems, the economic and political effects of which present a threat to the policy change itself. Economists have done an excellent job in revealing the power of the marketplace as the most efficient regulator of economic activity. By doing so, they have provided advocates of regulatory reform with an alternative regime superior to regulation in most instances. However, economists as a whole have neglected the problems of managing the transition from regulation to the market.

It is heartening to note, however, that the political process has been remarkably sensitive to transition problems. Some transition schemes are clearly superior, sometimes vastly superior, in our view, to others. But though there are numerous examples of failures to fully address economic distortions and avoid political pitfalls in the transition, the 4R Act, the Airline Deregulation Act, the pending trucking and rail deregulation legislation, and the Natural Gas Policy Act, exhibit at least a deliberate attempt to treat difficult transition problems.

Finally, it is even more heartening to note that, to our knowledge, no major transition from regulation to competition initiated recently has ever been halted or

reversed because of significant problems, explicitly addressed or otherwise, during the transition. Admittedly, this may be due as much to a political climate which is growing increasingly favorable to regulatory reform as to careful transition planning. Nevertheless, if we believe that a particular policy proposal which calls for a return to the market is sound public policy, it is worth the time and effort to develop a well-designed transition plan.