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## AND NOW "THE DEREGULATORS": WHEN WILL THEY LEARN?

FREDERICK C. THAYER\*

THIS JOURNAL published a symposium in 1975<sup>1</sup> on the contemporary effort to deregulate the airline industry. This article might be labeled an answer to the question one author posed, "Airline Regulation—A Hoax?" My response is that "hoax" is a mild word for what the advocates of deregulation are about, and this article is an attempt to be both comprehensive and brief in explaining why. Because many who deal with air transport policy ignore important aspects of airline history, misrepresent that history when they look at it, and completely disregard such important problems as the aircraft manufacturing industry, it is a tall order to be comprehensive without producing a giant volume. The attempt is needed, however, because the drive for deregulation is stronger now than it has been for some time; indeed, legislation may have been passed by the time this appears in print.

I shall first attempt to outline the airline system the advocates of deregulation seem to have in mind. In doing so, I shall argue that we are presently the victim of abstract and illogical theories attributable to classical economics, especially those of the most fundamental subfield of that discipline—microeconomics, or the economics of the marketplace. Drawing in part upon the work of John Kenneth Galbraith I will outline why the intellectual separation of microeconomics and macroeconomics (capital flow, aggre-

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<sup>1</sup> 41 J. AIR L. & COM. 573 (1975). Contributors were Roy Pulsifer, CAB Special Staff, Senator Edward M. Kennedy, John W. Snow, David Heymsfeld, James C. Miller III, Michael E. Levine, Lucile Sheppard Keyes, James W. Callison, Melvin A. Brenner, Donald J. Lloyd-Jones, Raymond J. Rasenberger, and Willard L. Demory.

gate societal data) is disastrous when we deal with particular industries. With one exception, the behavior pattern of the airline industry, one widely criticized, is no different than the behavior pattern in any market system dominated by a few producers, regardless of whether the industry is regulated or unregulated. Because prices are regulated, they are lower than prices in unregulated industries, and lower than they would be under deregulation. I then deal with the deregulators' insistence that the more closely any market approaches "perfect" or "free" competition, the better for consumers, arguing instead that price competition (as opposed to service competition) is logically impossible and leads only to social chaos when it occurs.

The second section takes up a peculiar variant of price competition, one widely favored when government agencies issue contracts for specified services. Based upon my experience with the awarding of contracts by the Department of Defense for airlift services by civil carriers, I outline why competitive bidding systems are as logically impossible as other designs involving price competition. In making the argument, I retrace some widely misunderstood aspects of airline history and competitive bidding. The insistence upon competitive bidding, whether for route awards or specific airlift requirements, can lead only to dangerous compromises in safety and training. Further, those advocating widespread competitive bidding do not seem to realize that such an approach requires the constant availability of a pool of unemployed aircraft and crews.

Thirdly, I take up a problem usually overlooked when regulatory policy is discussed. The history of the supplemental airlines is often misrepresented, principally because analysts seldom study it in detail. The supplementals are as much wards of the government as any other carriers, if in slightly different ways. The government used military contracts as incentives for the supplementals to buy modern aircraft and, even if government reneged on its commitments, it retains an implied responsibility for the carriers' success. A closely related long-term policy has encouraged the sale of as many U.S. air transports as possible (especially to foreign carriers via loans guaranteed by the Export-Import Bank), on grounds that the aircraft manufacturing industry is a necessary mobilization base for national preparedness. The result is that

many more aircraft are available than are needed (at least in peacetime), and this is the underlying cause of the demand for deregulation.

I conclude with the argument that nothing short of a "public utility" system can possibly work, one which treats each city-pair market as a monopoly operation. While this always has been the case, the need for city-pair monopolies is now a social imperative and, regardless of its advantages or disadvantages, is inevitable because of the energy crisis already with us. Beyond that, however, the record shows that public regulation of public utilities has been more beneficial to consumers than any other type of market system. This is admittedly a minority view, but I have no doubt the argument ultimately will prevail. It will prevail, that is to say, if anyone ever seriously looks at it, instead of assiduously ignoring it, as policy analysts have done for so many years.

#### TWO MYTHS: THE "INEFFICIENCY" OF OLIGOPOLY AND THE "EFFICIENCY" OF PRICE COMPETITION.

A logical place to begin is with an analysis of the premises of those who favor deregulation, particularly those who contributed to this journal's symposium. The statement, by James C. Miller, III in the *Journal of Air Law & Commerce* Symposium can be used to set the stage:

The theoretical argument for the efficiency of deregulated airline markets is extremely powerful. The airline industry appears to conform closely to the necessary conditions for price competition: no significant scale economies, fairly elastic (firm) demand, relative difficulty of co-ordinating pricing and output policies (that is, collusion), and, in the absence of controls, relative ease of entry and exit.<sup>2</sup>

This coincides with the assertion of the CAB Special Staff on Regulatory Reform that "the industry is naturally competitive, not monopolistic. In the absence of economic regulation, it is clear that monopoly abuses would not occur."<sup>3</sup> The CAB seeks to "en-

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<sup>2</sup> Miller, *A Perspective on Airline Regulatory Reform*, 41 J. AIR L. & COM. 679, 690 (1975) (footnote omitted).

<sup>3</sup> *Report of the CAB Special Staff on Regulatory Reform: General Conclusion and Principal Recommendations*, 41 J. AIR L. & COM. 601 (1975).

courage greater efficiency through price competition."<sup>4</sup> Miller's statement is also in line with John W. Snow's assertion that "since there are not any significant economies of scale in the industry, one would not expect any natural tendencies toward monopoly. The entry restrictions have reduced the number of firms below the number that would otherwise be effective competitors."<sup>5</sup> The report of the Senate Subcommittee on Administrative Practice and Procedure acknowledges that "in industries with only a few firms, fear of immediate retaliation makes general price-cutting rare; price floors are eroded only as firms each begin to make a few selective price cuts in limited areas."<sup>6</sup> Snow admits that, "given the oligopoly character of most airline markets and the monopoly characteristics of many local service markets, relaxation of entry is essential to police the pricing flexibility provisions of the proposed Aviation Act."

If we take these together, we see also a perfect representation of the conventional wisdom of micro (market) economics. The only forms of "competition" accepted as legitimate is all-out price competition in a "free" market, one not dominated by a few producers, but having so many producers that no single producer can influence the market price. It follows, as the conventional wisdom would have it, that competition can occur not only if we prevent airline monopoly, but only if we prevent oligopoly, that is, a market with few producers, as well. It follows, also, that the producers in an oligopoly do not really compete with each other at all. To refute the argument, then, I must deal with two questions which, I think, fairly represent the issues at stake: (1) Do members of an oligopoly compete with each other? and, (2) Is the all-out price competition of a "free" market possible to attain, especially for the airlines? I shall argue that (1) members of oligopolies, regulated or unregulated, do indeed compete fiercely against each other, but in very expensive and wasteful ways; and that (2) all-out price competition is logically impossible in any industry, never has worked, and never can work.

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<sup>4</sup> *Id.* at 603.

<sup>5</sup> Snow, *Aviation Regulation: A Time for Change*, 41 J. AIR L. & COM. 637, 664 (1975) [hereinafter cited as Snow].

<sup>6</sup> Kennedy, *Airline Regulation by the Civil Aeronautics Board*, 41 J. AIR L. & COM. 607, 621 (1975).

<sup>7</sup> Snow, *supra* note 5, at 648.

In making my argument, I ask the reader to keep in mind one important aspect of airline operations, often obscured by air transport policy analysts. The airline travel market is not one complex market of sellers (airlines) and buyers (travelers), but it is a very large number of individual markets, represented by the standard phrase "city-pair." Whether national or international, passenger or cargo, we deal with many individual markets, and when we speak of the total number of companies in operation we should do so with respect to specific city-pairs; it is not significant whether we have ten, or twenty, or fifty carriers, but only how many carriers are providing service for a single market.

To deal with the question of oligopoly competition, I begin with the overall phenomenon of oligopoly. One author defines oligopoly as a market in which no more than four producers have an aggregate market share of seventy per cent.<sup>8</sup> John Kenneth Galbraith uses a standard of sixty per cent, noting that four firms dominate aluminum, copper, rubber, cigarettes, soap and detergents, liquor, glass, refrigerators, cellulose fibers, photographic equipment, cans, computers, sugar, and many other items; three firms dominate automobiles, with occasional challenges from a fourth.<sup>9</sup> With little change from administration to administration, government agencies routinely accuse oligopolies of setting "artificially inflated prices." To cite just one example, the Federal Trade Commission proposed in 1972 to divest Kellogg, General Mills, General Foods, and Quaker Oats Company of some or all their cereal-making facilities, on grounds that a "competitively structured market" would lead to a twenty to twenty-five per cent decrease in prices. Consumer advocate Ralph Nader, long an advocate of more competition among airlines, praised the FTC action as "one of the most important developments in the last decade."<sup>10</sup>

There is little doubt that members of an oligopoly set higher prices and achieve larger profits than do the many producers in

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<sup>8</sup> J. MCGEE, IN DEFENSE OF INDUSTRIAL CONCENTRATION 126, ch. 8 (1971).

<sup>9</sup> J. GALBRAITH, THE NEW INDUSTRIAL STATE (2d ed. 1971).

<sup>10</sup> N.Y. Times, Jan. 25, 1972, 1, at 1, col. 4. In early 1977, supermarkets were a target. One Congressional study concluded that because four chains controlled 76% of the grocery business in one city, monopoly overcharges amounted at \$83 million per year. Pittsburgh Press, May 21, 1977, B, at 1. The new attorney general was announcing a drive against "shared monopoly," the pejorative phrase for oligopoly. TIME, May 23, 1977, at 71.

a "free" market. Indeed, one airline analyst, Richard Caves, concludes that profit rates are higher than normal any time eight or fewer sellers control seventy per cent of a market" (I shall return to this conclusion because of its significance to arguments about airline deregulation). Oligopolies lead to higher prices for at least three reasons, none of them ever mentioned by advocates of more competition.

The first is best outlined in Galbraith's analysis of modern industry; he has for years pointed out the inherent contradictions of our economic theories. Modern society and its associated technology are impossible without the planning and resources of large organizational systems. Conventional microeconomists study the market and conclude that problems of efficiency and performance are aggravated by the dominance of a few producers who set high prices. Macroeconomists study the economy as a whole, ignore the workings of industry, and conclude that great strides have been made. Prices are high, in part, because of the need to accumulate "retained earnings" for investment in technology and expansion. The minimum profits favored by advocates of free competition would make this impossible, hence the subject never is mentioned. Microeconomists, in other words, assume or imply that large organizational systems are not necessary.<sup>11</sup>

A second reason is a tacit agreement among producers that all-out price competition must be avoided because it would drive some producers out of business.<sup>12</sup> Government, despite its abstract support of price competition and its concrete support of airline deregulation, actually is a party to this tacit agreement. Government emphatically opposes the inevitable result of price competition when that result threatens to materialize. If a large company is on the verge of bankruptcy, government will intervene to keep it in business, often on anti-trust grounds. I need not remind readers of this journal of the eyebrows that are raised whenever two airlines announce they are considering merger.

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<sup>11</sup> R. CAVES, *AMERICAN INDUSTRY: STRUCTURE, CONDUCT, PERFORMANCE* 107 (2d ed. 1967), quoted in Rasenberger, *Deregulation and Local Airline Service—An Assessment of Risks*, 41 J. AIR L. & COM. 843, 863 (1975).

<sup>12</sup> GALBRAITH, *supra* note 9, at ch. 16.

<sup>13</sup> J. GALBRAITH, *AMERICAN CAPITALISM: THE CONCEPT OF COUNTERVAILING POWER* 45-49 (1952).

Third, any large organization must stabilize costs and prices if all such organizations are to plan their output over any period of time. This is a mutual requirement among all industries which buy and sell from each other, and it is as much a need for employees (salaried and wage earners) as it is for employers; unless things are organized on the basis of a "flow principle," there can be no yearly salaries and no labor contracts.<sup>14</sup>

Because prices are stabilized over long periods, the conventional argument is that large companies do not compete against each other, but they do indeed compete, and fiercely, for percentage shares of the total market. While they set "administrative" prices to yield "target" profits (sufficient for purposes outlined above), they allocate substantial portions of their operating budgets to advertising and promotion, excessive capacity, gimmicks or attractive services to consumers, and meaningless product differentiation, each dedicated to bettering the percentage market share of the individual producer. Examples are all around us; we have many more branch banks than we need, many more gasoline stations than required, all sorts of "green stamp" and "premium" offers, and such "product differentiation" approaches as that of one cereal manufacturer who charged eighteen cents more for a twelve-ounce box of one cereal than for another—the only difference being 0.6 cents worth of vitamins.<sup>15</sup> The large producers, of course, are those who dominate the advertising on prime time television, itself an indication of the resources devoted to competition itself; each manager must do all he can to insure his company's share of the market does not decline. Even with all this expenditure, however, members of an oligopoly usually achieve their "target" profits, and these seem high to casual observers; historically, profits have ranged between twenty and thirty-five per cent.<sup>16</sup>

If the reader retraces the above steps, it is clear how much the scheduled airline industry conforms to the behavior of typical oligopolies. The large city-pair markets (*e.g.*, New York-Los

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<sup>14</sup> In classical economic theory, each producer would operate at economic capacity (where unit cost of production equals price in the market). Large industries regulate production according to trends in sales, prices remaining substantially unchanged. G. MEANS, *PRICING POWER AND THE PUBLIC INTEREST* 199-205 (1962).

<sup>15</sup> N.Y. Times, Mar. 3, 1972, 1, at 12, col. 4.

<sup>16</sup> MEANS, *supra* note 14, at 236-44.



Angeles) seldom have more than three or four carriers serving them. They compete vigorously with each other, spending lavishly on prime time television commercials. We all are familiar with carriers advertising that the "seat in the middle is usually empty," thus luring passengers with an offer of extra elbow room. While they are widely criticized for much of the competition, as by the contributor to the symposium who ridiculed "more flights, more planes, more frills, . . . gourmet meals, and Polynesian pubs,"<sup>17</sup> the behavior is typical of any oligopoly, regulated or unregulated.

The regulated route structure, however, has two characteristics which distinguish it from most unregulated industries. One is uniquely a function of the product offered for sale. Unfilled seats do not become part of an inventory which can be stored in the hope customers will come along later; the inventory is destroyed as an inherent part of the competition itself. This situation also affects farmers producing perishable goods, hospital administrators worrying about empty beds, warehouse proprietors concerned about the next buyer of storage space, and truckers apprehensive about "deadheading." The second characteristic is that scheduled airline profits are usually meager or nonexistent, because fare regulation prevents carriers from achieving the profits of unregulated oligopolies. Keeping profits low is not the same as reducing the costs of competition, however, and the struggle for market shares goes on and on at enormous cost. This characteristic has an important corollary effect; airlines seldom have capital available for research and new investment. This has an effect on safety and training, but it also creates a crisis when it is time to replace equipment. We approach such a crisis now, as the original jet fleet nears the end of its life expectancy.

I find it difficult to imagine many city-pair markets which require the services of say, eight carriers. Yet, economists such as Caves never compare the precise characteristics of unregulated oligopolies with what might occur if airlines were deregulated. If, as he notes, profits are high when fewer than eight sellers dominate a market, it would seem logical to conclude that unregulated city-pair markets eventually must be dominated by a few companies

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<sup>17</sup> Kennedy, *supra* note 6, at 610. Elsewhere, Senator Kennedy's phrasing is "Mozart over Missouri . . . Lasagna over Los Angeles, . . . piano bars and polka-dotted planes." 122 CONG. REC. S6839 (1976).

which would then charge the high prices typical of unregulated oligopolies. I think there can be little doubt that the present scheduled airlines would charge higher fares than they do now if they were not prevented from doing so by the regulatory process itself. To be as fair as I can with respect to the advocates of deregulation and more competition, however, I must deal with the argument they make concerning this problem.

Deregulation proponents often begin by articulating a version of a point I made earlier in this section, that it is indeed necessary to look at individual city-pair markets. Any speech about the merits of deregulation contains some reference to intrastate carriers in California and Texas. Academic careers have been built on the study of a few small airlines, and Senator Edward Kennedy has often pointed out that "airlines in California and Texas that are not regulated by the CAB offer fares that are thirty to fifty percent less than those charged by CAB carriers over comparable routes."<sup>18</sup> Deregulators emphasize that airlines have "no significant scale economies . . . and, in the absence of controls, relative ease of entry and exit."<sup>19</sup>

This approach implies that airlines need not be large organizations at all, but can and should be small organizations that do not have routes extending beyond a single city-pair market. I have little doubt deregulators would attempt to deny this implication, but I suggest it is a major unarticulated premise of their position. After all, their prime examples are small airlines which rely largely upon individual city-pair markets (*e.g.*, Los Angeles-San Francisco) where passengers are not seeking to travel beyond that first destination. The arguments are usually accompanied by attacks on the major airlines for arguing that higher prices are necessary in high-density city-pairs in order to cross-subsidize travelers in low density markets (*e.g.*, Harrisburg-Peoria). The deregulators insist that because "dense routes . . . provide very little excess profit to pay for small-town service,"<sup>20</sup> the cross-subsidy argument can be ignored.

I take the arguments of the deregulators to be logical absurdities for several reasons. First, the deregulators ignore the need for

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<sup>18</sup> See, *e.g.*, 122 CONG. REC. S6840 (1976).

<sup>19</sup> Miller, *supra* note 2.

<sup>20</sup> 122 CONG. REC. S6842 (1976).

connecting city-pair markets together for the sake of efficiently moving passengers whose city-pairs overlap each other. Deregulators would admit the absurdity of requiring passengers to change both aircraft and airline at every intermediate stop but, once the connection between markets is accepted as necessary, the city-pair examples of California and Texas lose their validity. If any one carrier is to operate in many city-pair markets, it becomes something other than a small operation in which "ease of entry and exit" is possible. The airline systems we now have, complete with computer facilities second only in magnitude to those of the U.S. government,<sup>21</sup> are not "small" uncomplicated systems containing only a few pilots and mechanics.

Second, it is misleading to argue that dense routes do not provide "excess profits" for small-city subsidization; where there are no profits at all, none can be used for subsidy, but this obscures the fact that the costs of small-community service are absorbed in the costs of overall operations. In this connection, there can be no satisfactory way of separating costs, even when we know there is some separation.

Third, one of the professed objectives of the deregulators is to achieve fares low enough to attract those "millions of Americans who have never traveled by air because they cannot afford to."<sup>22</sup> If these millions were attracted by substantially lower fares everywhere, every small carrier would be suddenly transformed into a large one, and "ease of entry and exit" would no longer be possible. My own imagination leads me to wonder what it would be like to set up interline baggage handling systems at major airports if each airport were suddenly to have twice as many companies operating there as it has now.

The CAB contributes little to the discussion by its repeated insistence that "wasteful service competition is an inherent feature of the basic regulatory system."<sup>23</sup> As I have argued above, "wasteful service competition" is inherent to any oligopoly, regulated or unregulated. The deregulators would have us believe that more competition would lead to the classical design of a large number

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<sup>21</sup> Lloyd-Jones, *Deregulation and Its Potential Effect on Airline Operations*, 41 J. AIR L. & COM. 815, 826 (1975).

<sup>22</sup> Senator Kennedy's statement in 122 CONG. REC. S6841 (1976).

<sup>23</sup> CAB, *quoted in* 122 CONG. REC. S6841 (1976).

of producers. This seems to assume that many U.S. industries typically have "free" competition. As Galbraith correctly notes, most major industries are dominated by a few firms, and the overall economy rises or falls according to the fortunes of these "bell-weather" industries. Thus, deregulators actually argue that deregulation would bring about a condition that does not now exist in unregulated industries. Students of microeconomics press upon us the abstract models of classical economics which cannot be found in unregulated sectors. Suppose for a moment, however, that we had a classical "free" market in the airline industry, one in which say, 100 separate airlines were engaged in all-out price competition for the Los Angeles-New York traveling public. What might happen?

In a perfectly competitive industry, each firm is so small that it can ignore the effect of its output on the market price. Each firm finds it to its advantage to increase output to the point where marginal cost equals price and to ignore the effects of its extra output on the overall position of the industry. This tends to vastly increase the total output, each firm assuming (or hoping) that other firms will pay the cost by reducing output to obtain a higher price. Scores, perhaps hundreds, of producers vie for consumers, each keeps lowering his price to the point where it falls below production costs, and business failures mount. Downward price spirals and social chaos are absolutely inevitable in the absence of outside intervention, and no such industry survives without government price supports, tariffs, approved cartel agreements, subsidies for nonproduction, government purchases of surpluses, and similar actions. In those industries that most nearly approach perfect competition (agriculture, textiles), this cycle is a historic way of life. More to the point here, it cannot be avoided.<sup>24</sup> Once we get into such things as tariffs and quotas, we really adopt forms of regulation which are disguised to the point where producers, government, and economists can pretend we have unregulated industry. It is ironic that as the demands for deregulation reach a crescendo (1977), our most competitive industry (agriculture) languishes in a new depression brought about by the production

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<sup>24</sup> This argument is paraphrased from M. OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* ch. 1 (1969).

of more food than can be sold at viable prices. Farmers march on Washington, and the government plans to reintroduce regulation in the form of production cutbacks.

Classical microeconomics leaves us with a peculiar intellectual and operational contradiction. A free market is presumed to lead to improved efficiency, but this is a definition based upon the doctrine that planning cannot and should not be accomplished by anyone except individual producers and consumers. A market, this is to say, is an unplanned system because nobody plans for the market, only for his own situation. This amounts to saying that the less planning we do, the greater efficiency we achieve. This is the essence of the classical "invisible hand," but it contradicts every operational definition of efficiency known to man. Yet we remain hesitant to embrace any concept which links efficiency with planning, because it seems to imply the emergence of a "collective," "socialist," or "corporate" state.

In the 1930's, for example, President Roosevelt's recovery program initially permitted producer groups to plan a gradual increase in output and to regulate prices, it being understood that if production were not restrained to what the market would bear, and if prices did not enable producers to stay in business, the downward spiral into social chaos would resume.<sup>25</sup> The Supreme Court rejection of this delegation of authority to trade associations was, in effect, a declaration that production cannot be planned, a concept that epitomizes classical economic theory. Yet the sequence of overproduction and collapse is inevitable, except in the unlikely situation of absolutely infinite demand, but that would only produce runaway inflation. So long as overproduction is possible, it will occur.

The major aspects of the argument can be summarized and expanded. Contrary to the conventional wisdom, the members of any oligopoly do indeed compete with each other, and fiercely, for percentage shares of the total market, and this goes on (as it must) whether the industry is regulated or unregulated. It follows that shifts back and forth between regulation and deregulation cannot substantially affect this pattern of behavior. The prices and profits of unregulated oligopolies seem high, but they can be

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<sup>25</sup> A. SCHLESINGER, *THE COMING OF THE NEW DEAL* pts. I-II (1959).

lowered only if those industries are denied the opportunity to assemble capital for research and expansion.

While the usual approach to public regulation is monopoly, as in the case of power companies, there are a few regulated oligopolies. Radio and television are regulated by public agency, but there is no regulation of the prices for which the industry sells its air time, hence these escalate to unbelievable heights. The industry is financed by advertising expenditures, and these are tax-deductible, so there is every encouragement to spend wildly in the attempt to improve individual market shares. In essence, the broadcast media collectively form a giant quasi-taxing agency, taxes being passed along to consumers as part of the market prices they pay. Meanwhile the media themselves reap good profits while the airlines, whose prices the CAB restrains, often lose money.

Airline prices are higher than they need be, of course, because the airlines engage in the inherently wasteful competitive practices of all oligopolies. Once again, contrary to the arguments of both the CAB and its critics, these practices do not change as industries shift back and forth between regulation and deregulation. As to price competition and perfectly free markets, they remain the impossible and illogical myth of classical economics; they always have been impossible, and they always will be. The continued attempt to define efficiency as an absence of planning is mind-boggling, but such are the logical contradictions we pursue.

#### AN AMUSING VARIATION: COMPETITIVE BIDDING

In his "introduction" to the symposium on deregulation, Roy Pulsifer refers to the "scandals" Congressional investigations "exposed" in the 1930's with respect to the actions of Hoover's Postmaster General W. F. Brown in "circumventing competitive bidding."<sup>26</sup> The CAB Special Staff on Regulatory Reform emphasizes the need for a "low-bid contract system for the provision of small community subsidized air service,"<sup>27</sup> and, to use contemporary jargon, many seek to have the CAB decide whether given bidders are "fit, willing, and able" to perform specified services. The continued attack on the Hoover Administration and the enshrinement

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<sup>26</sup> 41 J. AIR L. & COM. 573, 574 (1975).

<sup>27</sup> Kennedy, *supra* note 6, at 604.

of competitive bidding systems are part of the conventional wisdom of air transport policy analysis, but neither can withstand scrutiny.

If there was a "scandal" in the 1930's, it lay in the wild accusations and disastrous policy decisions made by the Roosevelt Administration in early 1934. Postmaster General Farley suddenly issued an order canceling all domestic air mail contracts (the major source of revenue in the industry's early years), charging his predecessor with abetting wild stock promotions, illegally extending both air mail contracts and routes, destroying incriminating evidence, and acting in collusion with favored companies. The Army took on the task of flying the mail and wrote a tragic chapter in American aviation. Unprepared for the job and for severe weather, hampered by inexperienced pilots and planes with inadequate instrumentation, the Army suffered a series of accidents. The Roosevelt Administration was forced to reverse itself and advertise for new bids from the airlines. The charges levied at Postmaster General Brown and the airlines never stood up, but this has not persuaded the custodians of the conventional wisdom to take another look, and a careful one, at their fundamental premises.<sup>28</sup>

I use a personal experience to outline the fallacies of competitive bidding systems. Prior to the establishment of a "rate floor" by the CAB in 1960, the Military Air Transport Service (MATs) awarded overseas contracts by competitive bid. I was then a member of the MATs staff for operations in the Pacific, a substantial percentage of it handled by civil carriers (the MATs military fleet was oriented toward NATO). One operation put up for bids each year was substantial enough to keep twelve to fifteen DC-7 type aircraft fully occupied on routes from California to Tokyo, Okinawa, and Manila. Our task in MATs was to determine how "fit, willing, and able" were the prospective bidders (usually eight to ten supplemental carriers). We began with the assumption that we were to inspect eight to ten complete airline systems, staffed with pilots, navigators, flight attendants, mechanics, en route station personnel, and maintenance facilities. What we discovered, of course, was that these airline systems did not exist at all, except to

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<sup>28</sup> This history is summarized in detail and extensively documented in my *AIR TRANSPORT POLICY AND NATIONAL SECURITY: A POLITICAL, ECONOMIC, AND MILITARY ANALYSIS* ch. 1 (1965) [hereinafter cited as *AIR TRANSPORT POLICY AND NATIONAL SECURITY*].

the extent one of them might already be engaged on the current year's contract and rebidding for the following year. Each bidding company presented for our inspection a series of "contingency agreements" showing that if that company were selected, it would immediately assemble crews, mechanics, and aircraft. Each bidding company had contingency leasing or contract agreements covering for the most part the same set of crews, mechanics, and aircraft, and the company's financial ability was, in turn, dependent upon the award of the contract. On this basis, our "inspection" was a sham; there was no basis for declaring any company incompetent to perform.

The award of a contract, however, led to a form of confusion typical of old Laurel and Hardy motion pictures. Immediately upon receiving an award, always made very close to the specified date for beginning operation, the successful bidder would quickly create the airline he had promised to operate. This required hurriedly painting over the name of the last company operating the aircraft, hiring and refitting the crews in different uniforms, and negotiating subcontracts with operators having ground facilities at the various island stops. Invariably, the new operation would be sporadic for a few weeks, and it was amusing to note that hasty repainting did not always obscure the title of the previous operator of the aircraft. While I did not immediately realize it, this confusion exemplified the foolishness of competitive bidding.

We in MATS could hardly have been expected to find eight to ten completely staffed airlines "fit, willing, and able" to begin operations but, in the meantime, having nothing at all to do. What small company, after all, could afford to pay eighty to one hundred pilots, and all other necessary personnel, the going wage rate, on the chance the company might be awarded a contract? Yet the theory of competitive bidding led us to expect to find just that, and we were temporarily confused when we did not. Competition, in other words, requires and compels a terrible waste of resources if it is to function at all. This is one reason why competition, as in the example outlined here, is sham; with each competitor planning to operate the same airline system, we were all engaged in a hoax.

Proponents of competitive bidding seek to use it to implement the "classical" economic principle of "efficient allocation of re-



sources," arguing that the "lack of price competition" leads to "misallocation."<sup>29</sup> While never stated with precision, "price competition" means competition in the lowering of prices, not the raising of prices. If prices are to be constantly lowered as the result of competition, however, this can mean only that labor costs also must be constantly lowered. These constitute about one-half of airline operating costs, and, if Roy Pulsifer is correct, the proponents of deregulation assume that at least some of the economies must be achieved through lower wages.<sup>30</sup> This, in turn, would rule out long-term contracts with unions of highly skilled professionals (*e.g.*, pilots and mechanics), and would require day-to-day negotiations with individual employees to determine which of them would accept lower salaries. Logically, such a system is compatible only with high unemployment, a situation in which a pool of unemployed professionals makes it possible for operators to constantly drive down prices. While I do not argue that the deregulators knowingly favor "union busting," their proposals would have the same effect. This aspect of the problem, which Rasenberger gently but persuasively outlines in his essay, is ignored by those favoring price competition.<sup>31</sup>

Competitive bidding, always advocated as the prime method for installing price competition in connection with government contracts, has at least two other implications usually overlooked by the deregulators. The first of these is the long-term connection between airlines and military preparedness, directly related to the personal experience outlined above; the CAB's 1960 decision to abandon competitive bidding was connected with the complex history of the Civil Reserve Air Fleet (CRAF). Often described as an "air merchant marine," the underlying premise of CRAF is that many long-haul transports should be immediately available for military operations in the event of emergency. The government's role is to provide peacetime airlift contracts of sufficient magnitude, and at high enough rates, to permit the carriers to outfit the aircraft in accordance with military needs (reinforced floors, communications equipment), and also to allow for continuing modernization

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<sup>29</sup> See Snow, *supra* note 5, at 643.

<sup>30</sup> Pulsifer, *supra* note 26, at 577 n.7.

<sup>31</sup> Rasenberger, *supra* note 11, at 865-68.

of at least the portion of the total fleet designated for CRAF use.<sup>32</sup> In the late 1950's, when Cold War considerations seemed significant, the government's interest was to promote the conversion of the CRAF from piston to jet transports. This interest, of course, runs directly counter to the objectives of the deregulators; as John Snow put it, anything which discourages all-out price competition leads to "visible and extreme" distortions, as when older piston aircraft were "phased out of service after only a few years" use.<sup>33</sup> All-out price competition leads to the cheapest possible operation, one which simply does not permit the amassing of funds for modernization.

Before the CAB acted in 1960, small businesses (principally supplemental carriers) had captured about ninety per cent of the military contract market.<sup>34</sup> They operated the depreciated aircraft then being abandoned by the larger carriers, and the latter could not afford to underbid these small competitors. The effect of a "rate floor" was to establish a one-price situation high enough to attract the large carriers (with their jets) and to encourage the purchase of still more jets equipped for military uses. With all carriers bidding the same price, contracts were allocated on the basis of airline commitments to further modernization and CRAF expansion. While this is a defense-related example, the larger problem is not at all unique to defense issues. This is not to argue that continuous modernization is always a blessing, but only to suggest that these relationships can be ignored only at the peril of making nonsensical policy recommendations. It is a continuing feature of air transport policy debates that microeconomics dominates the discussion, thus insuring that issues of technology and modernization are always ignored.

The second implication of price competition and competitive bidding is the effect on safety, a subject that never gets enough attention. The symposium on deregulation had little or nothing to say, a significant omission in view of the attention given the subject in the CAB's own special staff report. Beginning with the judgment that "safety is most likely to suffer in such areas as

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<sup>32</sup> AIR TRANSPORT POLICY AND NATIONAL SECURITY, *supra* note 28, at 122-128.

<sup>33</sup> SNOW, *supra* note 5, at 643.

<sup>34</sup> *Hearings Before the Special Subcomm. on Military Airlift of the House Comm. on Armed Services*, 86th Cong., 2d Sess. 4828-29 (1960).

maintenance and training programs," the report cites evidence of the relationships among size of carriers, marginal profits, and accidents. We know, for example, that the irregular operators in business after World War II, and the air taxis and computer carriers in more recent years, had accident rates sufficient to justify considerable apprehension.<sup>35</sup> The special staff concluded, however, that any tendency toward deterioration in safety standards could be offset by "intensified preventive inspection" and "high passenger and third-party liability insurance and performance bonds."<sup>36</sup> To put it mildly, this seems to contradict a major thrust of the deregulatory effort, because an increase in inspection and insurance requirements would make it likely that costs, and prices, would go up instead of down.

Competitive bidding, then, is simply an attempt to institutionalize all-out price competition, and it cannot possibly work. Indeed, if we ever set about calculating the ultimate costs of competitive bidding, we will discover them to be enormous. When any contractor cuts corners so as to offer the lowest possible price, he sets in motion a train of events which we constantly see around us. New buildings collapse, roads give way after minimal use, and millions are spent in seeking legal determinations as to who must pay for costly repairs and reconstruction. As in the case of the airline manager who must waste resources to compete, each bidder must cut as many corners as he can if he is to secure the contract. We are not dealing with "evil" or "greedy" managers, but with individuals trapped in an illogical system.

#### RELATED PROBLEMS: SUPPLEMENTAL AIRLINES AND AIRCRAFT MANUFACTURERS

When discussions of air transport policy occupy the public stage, important and related problems are given little attention or none at all; yet, a long view suggests that these problems are at the root of the public debates. I take up the problems here, that of the supplemental carriers (and other "nonscheduled" operators) and that of the aircraft manufacturers. Lucile Sheppard Keyes, for

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<sup>35</sup> CAB, REPORT OF THE CAB SPECIAL STAFF ON REGULATORY REFORM 206-22 (1975) [hereinafter cited as CAB SPECIAL STAFF REPORT].

<sup>36</sup> *Id.* at 280.

example, is approvingly identified by Roy Pulsifer as one of the analysts who have advanced sound arguments for "more than twenty years";<sup>37</sup> indeed, she was a consultant to the CAB's Special Staff for Regulatory Reform. Keyes argues it is "a fact of the highest significance that both of the major marketing innovations in the history of the industry—air coach and charters—received their impetus from outside the protected group."<sup>38</sup> I suggest this is not a fact at all, and we are overdue in identifying it for the fantasy it is. To outline why this is so requires a recapitulation of the history of supplemental carriers, not to mention the relationship between their operations and those of the certificated carriers. It is not coincidental that crises in regulatory policy have been closely related to the fortunes of the supplemental carriers.

Immediately following World War II, travel demands were at a peak, and observers predicted growth would continue unabated. Passenger load factors on the major carriers reached eighty-nine per cent in 1945 and seventy-one per cent in 1948.<sup>39</sup> Convinced that demand would continue to escalate, the CAB quickly lowered both passenger and mail payments, and everyone seemed to believe there was room in the market for both scheduled and non-scheduled carriers.<sup>40</sup> Predictions did not stand up, however, travel demand suddenly leveling off in 1947 just as the scheduled airlines were introducing the new aircraft ordered at the end of the war (DC-6 and Constellation). These aircraft provided both expanded capacity and a need for load factors sufficient to cover new costs. Financial reverses began immediately; by 1949, scheduled carriers were losing money at the rate of twenty-two million dollars per year.<sup>41</sup> There were numerous strikes, some accidents involving the new aircraft, and corollary temporary grounds, all confronting the CAB with a policy crisis. It raised both passenger fares and mail payments, the latter to higher levels than before the reductions. The CAB, moreover, paid retroactive subsidies to spread the high

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<sup>37</sup> See Pulsifer, *supra* note 26, at 575.

<sup>38</sup> Keyes, *A Comparison of Two Proposals for Regulatory Change*, 41 J. AIR L. & COM. 727, 744 (1975).

<sup>39</sup> J. FREDERICK, *COMMERCIAL AIR TRANSPORTATION* 383-84 (1955).

<sup>40</sup> 1945 CAB ANN. REP. 7-8.

<sup>41</sup> U.S. PRESIDENT'S AIR POLICY COMMISSION, *SURVIVAL IN THE AIR AGE* 99 (1948) [hereinafter cited as FINLETTER REPORT].

airline losses over a three-year period.<sup>42</sup> In some cases the CAB forced the major carriers to raise passenger fares when they did not wish to do so, and, more to the point of this argument, denied the scheduled carriers permission to experiment with air coach operation.<sup>43</sup> The overall situation led to confrontations between the scheduled carriers and CAB Chairman James M. Landis, and President Truman dropped him in 1948. Landis admitted later he had been over-optimistic and that arguments with the major companies had led to his demise.<sup>44</sup>

Once the major carriers had new aircraft and travel demand had leveled off, there was no market for the nonscheduled carriers. By 1947, they were trying only to survive until something yet unforeseen would enable them to prosper.<sup>45</sup> The nonscheduled industry's strongest supporters later admitted that survival would have been impossible without the Berlin Airlift and the Korean War.<sup>46</sup> Even during the immediate post-World War II period, however, the record of the nonscheduled carriers was less praiseworthy than analysts later made it out to be. During the early peak, we do not know whether these carriers actually offered lower fares; there was little in the way of records, the CAB had no control over them, and passengers were desperate. When the Celler Subcommittee of the House of Representatives investigated the entire industry in the later 1950's, it collected considerable evidence of shabby operations, particularly through complaints filed by the Better Business Bureaus of such cities as Chicago, Los Angeles, San Francisco, and New York. There were reports that two-engine aircraft had been used instead of advertised four-engine craft, that return tickets had not been honored, that refunds had been refused, and that advertised meals had not been provided.<sup>47</sup>

Space prohibits the spelling out of similar documentation for

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<sup>42</sup> 1948 CAB ANN. REP. 1-2. CAB records indicate the payments amounted to about \$30 million.

<sup>43</sup> *Monopoly Problems in Regulated Industries: Hearings Before the Subcomm. of the House Comm. on the Judiciary*, 84th Cong., 2d Sess. 2191-93, 2212-16 (1956) [hereinafter cited as *CELLER SUBCOMM. HEARINGS*].

<sup>44</sup> *Air-Line Industry Investigation: Hearings Before the Senate Comm. on Commerce*, 81st Cong., 1st & 2d Sess. 213 (1949-50).

<sup>45</sup> Frederick, *American Air Cargo Development*, 2 AIR AFFAIRS 93 (1947).

<sup>46</sup> *House Comm. on the Judiciary, Report of the Antitrust Subcomm. Pursuant to H. Res. 107 on Airlines*, 85th Cong., 1st Sess. 107 (1957).

<sup>47</sup> *CELLER SUBCOMM. HEARING*, *supra* note 43, at 583.

the entire period from World War II to the present. Those familiar with the recurrent controversies since that time may recall that when the Korean War ended, the nonscheduled carriers again fell on hard times, their situation leading to attempts to help them by the Hoover Commission, the aforementioned Celler Subcommittee and the Senate Small Business Committee, many of the arguments centering on the issue of whether operations of the Military Air Transport Service should be curtailed so as to provide contract work for the nonscheduled carriers, the certificated carriers, or both. The supplementals, as they were known by that time, reached another low ebb in the early 1960's, by which time it was evident that they depended largely upon military contracts for their sustenance.<sup>48</sup> Based in part upon a prominent accident or two, new and more stringent regulatory legislation was enacted, including a provision that they could not exceed average levels of operation between 1959 and 1961. Once again, a military crisis intervened, this time the Vietnam War, an operation which brought many of the supplementals fully into the CRAF. This was a most significant step, because it enabled the companies to use tacit guarantees of unbroken Defense Department business as collateral for the purchase of CRAF-equipped aircraft.

The government's support for aircraft purchases took the form of tacit guarantees that substantial defense-related airlift contracts would be made available for many years. One Air Force official explained in 1962, for example, that his office was using long-term contracts as an "incentive" to air carriers to purchase new transports, that this gave the carriers a "firmer basis for financial plans," and that the quantity of ongoing military business would doubtless influence future aircraft purchases.<sup>49</sup> He noted also that eighty per cent of the contracts went to small businesses, an indication that even if the policy applied to all carriers associated with the CRAF, it most directly helped the supplementals. The supplementals found in the policy the first explicit long-term government encouragement ever offered them, even if it side-stepped the question of what to

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<sup>48</sup> See tables in AIR TRANSPORT POLICY AND NATIONAL SECURITY, *supra* note 28, at 106-107.

<sup>49</sup> *Aircraft Guarantee Loan Program: Hearings Before the Subcomm. of the Senate Comm. on Commerce*, 87th Cong., 2d Sess. 152 (1962) (Testimony of Edward J. Driscoll, then Deputy Assistant Secretary of the Air Force).

do with all such aircraft in time of peace. This encouragement led to the involvement of large companies not usually associated with airline operations. They bought new jet transports, then leased them to companies having military contracts; Greyhound Corporation was one such example.<sup>50</sup> The airline industry correctly perceived the policy as a government commitment, but discovered by 1965 that it was a commitment easily withdrawn. From that time forward, the Defense Department has awarded contracts only to the extent that military aircraft are not available to perform the airlift, while both scheduled and supplemental carriers have asked for new and much firmer guarantees.<sup>51</sup> Since the end of the Vietnam War, of course, it has been impossible to employ all CRAF-designated aircraft on military contracts. But this is not the only problem which involves what might logically be called a surplus of available aircraft.

While seldom noticed by those who confine their analysis to the airlines as such, the government has had a long-term interest in assuring the economic well being of aircraft manufacturers, and for several reasons. The Export-Import Bank, created during the Great Depression to stimulate exports, has for years guaranteed loans to foreign airlines for the purchase of transports built in the United States, and our aircraft have dominated international civil aviation since World War II. Between 1955 and 1960, fifteen countries used twenty-five such loans to buy \$173 million in aircraft; in 1961 alone, the U.S. guaranteed loans of \$94 million to Brazil, Columbia, Ethiopia, France, India, and Japan.<sup>52</sup> Having acquired a vested interest in the operational success of foreign airlines, the United States had little choice but to be generous in awarding routes into the country. Stung by criticism that this damaged United States flag carriers, the Eisenhower administration defended one such sale on grounds that the Dutch were the largest

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<sup>50</sup> TIME, Apr. 26, 1963, at 82-83.

<sup>51</sup> *The Posture of Military Airlift: Hearings Before the Research and Development Subcomm. of the House Comm. on Armed Services*, 94th Cong., 1st Sess. 112-118 (1975). (Testimony of Edward J. Driscoll, then president of the National Air Carrier Association, the trade group representing supplemental carriers).

<sup>52</sup> Compiled from FEDERAL AVIATION ADMINISTRATION, REPORT OF THE TASK FORCE ON NATIONAL AVIATION GOALS: PROJECT HORIZON 30 (1961); Aviation Daily, Aug. 11, 1961; AGENCY FOR INT'L DEV., U.S. DEP'T OF STATE, THE UNITED STATES PROGRAM OF AVIATION ASSISTANCE TO LESS-DEVELOPED COUNTRIES, REPORT OF THE ADMINISTRATOR, Appendices A-1 to A-14 (1964).

single purchaser of United States transports and that the route awards were necessary to protect the interests of American manufacturers.<sup>53</sup>

A second and stronger reason was the presumed necessity to maintain a healthy aircraft industry as a mobilization base for any future emergency. This was the central thrust of the major policy groups which set the United States course after World War II, the Congressional Aviation Policy Board (Brewster Board) and the President's Air Policy Commission (Finletter Commission).<sup>54</sup> The long-term impact of this approach has been so far-reaching as to almost defy comprehension. When other countries buy United States aircraft, the condition for securing a United States loan guarantee is that funds be not otherwise obtainable, a direct encouragement to grant loans that banks in those countries refuse to make. With countries such as France, Japan, and the Netherlands involved, the outcome could only be a sales program geared to the needs of manufacturers to keep producing rather than the needs of air travelers. Add to this the desire of developing countries to operate their own international airlines as a badge of national prestige, and the problem worsens. Add still further the expansion of the Military Air Transport Service through the purchase of standard air transport aircraft (e.g., DC-6 or Constellation), and add also the social unrest that might follow if a large aircraft manufacturer went out of business (e.g., McDonnell-Douglas or Lockheed). The result is that the United States created not only a large network of scheduled foreign airlines which threatened the livelihood of United States flag carriers, but an international and military network of nonscheduled airlines as well.

The U.S. government can be said to have a more direct interest in the financial viability of foreign and supplemental carriers than it has in the health of the certificated carriers. This is because government involvement is tied directly to particular aircraft financed through Export-Import Bank guaranteed loans or Defense Department "commitments" to specific amounts of contract airlift. The granting of a route certification to a scheduled carrier, conversely, is much more generalized, because the route award

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<sup>53</sup> DEPARTMENT OF STATE BULLETIN 1012-13 (1957).

<sup>54</sup> S. REP. NO. 949, 80th Cong., 2d Sess. 39-40 (1951); FINLETTER REPORT, *supra* note 41, at 69.



implies very little about the precise number of aircraft that should be bought and used. If a foreign or supplemental carrier defaults, government agencies can, at least in part, be blamed; if a scheduled carrier defaults, only the carrier is at fault. I remain amazed that the issue of government promotion of aircraft sales, so obviously significant to any comprehensive analysis of air transport policy, is seldom mentioned by those who debate and make that policy. The CAB Special Staff Report had nothing to say on the subject, nor did the symposium published in this Journal. Yet it remains reasonable to suggest that an underlying reason for Presidential and congressional advocacy of deregulation is, once again, the necessity of finding markets for the many transports purchased through government incentives, perhaps many more than should have been built. Once again, we face the old question; where do we go from here?

#### A NEW RATIONALE FOR A "PUBLIC UTILITY" APPROACH

Beginning with my 1965 book and, later in several articles,<sup>55</sup> I have argued consistently for something of a "public utility," or "natural monopoly" approach to airline regulation, and on a global scale at that.<sup>56</sup> These arguments, I think, were valid then, but they now take on an urgency greater than most of us could have foreseen until recent years. Because an emphasis on more competition and lower prices must always mean an increase in total output, as Senator Kennedy reminds us in his pleas that airline travel be made available to those who cannot afford it now, it becomes logically absurd to advocate both a substantial increase in airline operation and the conservation of very limited fuel supplies. From my perspective, it is no longer important whether readers agree with this concluding argument, because some kind of global public utility system is inevitable within a few years, solely because of the need to reduce airline operations to conserve fuel. Whatever the shape of that system, it will be a planned system, hence will not resemble the jumbled system we have now. It must become less competitive, not more competitive, and the initial effort will resemble a

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<sup>55</sup> See, e.g., *Air Transport Policy: A Crisis in Theory and Practice*, 36 J. AIR L. & COM. 661-72 (1970).

<sup>56</sup> *International Air Transport: A Microsystem in Need of New Approaches*, 25 INT'L ORGANIZATION 875-98 (1971).

cartel. Individual carriers, domestic and international, may retain their identities, but the system as a whole doubtless will be a pooling arrangement.

Much of the evidence for this revised argument is accepted to some extent by those involved in the contemporary deregulatory effort; while they present the evidence, they ignore it when they turn to making recommendations. The CAB Special Staff Report, for example, acknowledges that recent increases in the fare level are traceable to general inflation, an extraordinary rise in the cost of fuel, and a drop in the average real wage, the latter making it more and more difficult for individuals to fly.<sup>57</sup> There is no reason to assume these factors would have any less effect on an unregulated industry.

I do not pursue here a traditional argument for "natural monopoly." One aspect of the traditional argument, that costs of entry are so high in some industries as to make competition inefficient (as in the image of three power companies offering complete services on the same city block), seems applicable to the airlines. If one looks at the experience, global commuter systems, multiple route structures, and various maintenance facilities necessary to some of the large airline operations that must remain necessary in any overall airline system, it seems illogical to suggest that such entities as Pan American, Trans World, and even Allegheny can be created and recreated overnight. It is possible, however, to imagine a one-aircraft airline operating in a single city-pair market, and, as I have suggested, a part of the deregulatory argument is linked to that image. I argue instead for a "natural monopoly" approach which follows from the inherent logic of any competitive system. Even if only two airlines compete for the same city-pair travelers, the production of empty seats must inevitably escalate. One of the ironies of our time is that Ralph Nader, a long-time advocate of more competition among airlines, simultaneously argues for more regulation of hospital construction because non-regulation has led to massive overproduction of beds and unjustifiable price increases.<sup>58</sup> I agree with the Ralph Nader who analyzes hospitals, not the Ralph Nader who analyzes airlines.

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<sup>57</sup> CAB SPECIAL STAFF REPORT, *supra* note 35, at 6.

<sup>58</sup> B. ENSMINGER, *THE \$8 BILLION HOSPITAL BED OVERRUN: A CONSUMER'S GUIDE TO STOPPING WASTEFUL CONSTRUCTION* (1975).

The subject of public regulation has, I think, been subject to extraordinarily distorted arguments over the years. Regulatory agencies, including the CAB, usually are attacked as being captives of the industries they regulate, headed by incompetents, and deserving only of abolition.<sup>59</sup> This argument consistently overlooks abundant evidence that the record of regulated industries is far superior to that of the unregulated sector. Where recognized "natural monopolies" are concerned, costs have steadily declined for years despite generally upward cost trends in all other sectors.<sup>60</sup> Even the CAB Special Staff Report acknowledges as much, pointing out that before recent increases due to inflation and fuel, both electric power companies and the airlines had experienced "*decreasing real prices over a span of many years.*"<sup>61</sup> This can only mean that regulation has been more effective in holding down prices than the unregulated economy at large. The only exception cited by deregulators is the mythical "free market" which does not really exist anywhere; is it not significant that deregulators never cite a single industry as an example of what they seek for air transportation? The record of regulated industries, then, totally refutes the criticism of regulatory agencies. This does not mean we have a perfect relationship between such agencies and the industries they regulate, only that the results are better than in unregulated industries.

Our fear of monopoly, in this case by city-pair market, also is based on a central misunderstanding of the fundamental problem. Traditional opposition to the monopoly is based less on the planning aspects of monopoly than on the fear of the monopolist's unilateral authority to restrict output, set prices so as to maximize profits, then sell his output to whomever he chooses. We have sought to

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<sup>59</sup> The literature on this subject is enormous. See, e.g., *Can Regulatory Agencies Protect Consumers?*, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH ch. 1 (1971), in which George J. Stigler outlines the deficiencies in regulation in contrast to the "known" benefits of consumer sovereignty and competition. See also R. NOLL, *REGULATION: AN EVALUATION OF THE ASH COUNCIL PROPOSALS* ch. 11 (1971), in which regulation is condemned as "expensive, ineffective, and even anticompetitive."

<sup>60</sup> Posner, "Natural Monopoly and its Regulation," *quoted in* THE CRISIS OF THE REGULATORY COMMISSIONS 34-38 (P. MacAvoy ed. 1970). This trend doubtless has been reversed due to recently rising fuel costs, but the relative relationship remains unchanged.

<sup>61</sup> CAB SPECIAL STAFF REPORT, *supra* note 35, at 6-7 (emphasis added).

transfer this authority to the consumer, so as to make sure producers must respond to his "demands." If the consumer is to have a choice, however, there must be available to him at the time of each and every purchase more versions of a given product than he wants, needs, or can possibly use. Thus, the drive for deregulation and stringent antitrust enforcement always emphasizes a vast increase in supply over demand, as in Senator Kennedy's pleas for substantial expansion of passenger travel. It would be far better to rely on other methods of diffusing monopoly authority, public regulation being the only design currently available. Galbraith, hardly a staunch conservative, but one who understands organizations better than do other economists, compares the positive results we have attained through the planning of communications systems via A.T. & T. and public regulation and the terrible results in transportation of all sorts via insufficient or no regulation and planning.<sup>62</sup> There is little doubt that CAB regulation has been less effective than it might be, but for reasons beyond CAB control. Faced from the beginning with contradictory objectives traceable to the political turmoil of the 1930's and the refusal to give the Hoover Administration credit for anything, the regulatory process has been extraordinarily expensive because of the necessity to consider competing applications for new routes. When two or more carriers apply for a route award, there can be no sensible way to decide among them, yet the attempt must be made. Volumes of testimony emerge, everyone spends millions, but no sensible decision is possible except the one that cannot be made—a city-pair monopoly. Nor do the airlines have a choice, either; contrary to Senator Kennedy's claim that airlines are not compelled to seek new certifications and waste funds seeking them, managers know they will be fired if they do not stay even with competitors. The CAB, because it must install competition on many routes, has been unable to control the costs of competition and hence has been prevented from setting the lowest efficient price. Further, even though airline managers often recognize the need for some sort of "public utility" approach,<sup>63</sup> they cannot advocate an end to direct competition because they might be accused of damaging the in-

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<sup>62</sup> GALBRAITH, *THE NEW INDUSTRIAL STATE* 360-63 (2d ed. 1971).

<sup>63</sup> Donald J. Lloyd-Jones uses this argument, *supra* note 21, at 815-42.

terests of their shareholders. Even the consumer interest would be better advanced in a revised regulatory system. Relieved of the necessity to decide among competing applicants, the CAB would focus on better service to customers primarily by comparing the operations of airlines operating on different routes. The overall record of monopoly utility regulation is fairly encouraging in this regard.

A revised system of regulation, then, must not only begin with acceptance of a monopoly city-pair principle, but also with an understanding of what we have created. The ultimate regulatory system, domestic and international, will have no choice but to retire many aircraft from service, despite the unwillingness of government agencies to admit that sales promotion has been overdone. While this was done with good intentions (recovery from depression, helping allies, expanding air travel, supporting war efforts), the present drive for deregulation is clearly an attempt to find contemporary markets for more aircraft than can be used. Given the current situation, supplemental carriers are correct when they accuse the scheduled carriers of "predatory competition," and the scheduled carriers are just as correct when they mention "cream skimming." With the imperatives that face us, however, some larger settlement of the dispute cannot be avoided.<sup>64</sup>

It is time to recognize that the overall record of airline regulation is much better than is usually pictured by its critics. Aside from the CAB's fare record, better than that of unregulated industries, but damaged because of an inability to prevent competition, the airline system remains a vast improvement over its predecessor—the railroads. Some readers may recall the assertion of one president of the New York Central Railroad that "a pig can travel from coast-to-coast in the same railroad car, but the passenger cannot!" Without the initial intervention of the Hoover Administration, it is possible that transcontinental passengers might still be changing airlines in Kansas City or Chicago. While we are prone to believe that advances in technology determine such outcomes, regulatory

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<sup>64</sup> Interestingly, the wider settlement will resemble the actions of Hoover's Postmaster General. Because the present global system is based substantially upon U. S. government actions (route certifications, points of entry for foreign carriers, guaranteed loans, long-term military contracts), an equitable settlement will be difficult to achieve, but it must be done because of the government's responsibility. General Brown will be vindicated yet.

policy is more important. At any rate, the only question before us is what form the planning system takes; deregulation, or the absence of planning, simply is impossible to sustain. There is no fuel.<sup>65</sup>

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<sup>65</sup> The fuel problem "solves," if that is the appropriate word, the long-term problem of the supplemental carriers. They really have been (in disguise) the "air merchant marine" that has seemed so necessary for meeting military emergencies. Some of those who study the international aspects of air transport policy acknowledge that "redundancy" is built into airline policy on occasion just to meet such needs. R. THORNTON, *INTERNATIONAL AIRLINES AND POLITICS* 80-87 (1970). Redundancy, of course, means that some aircraft are not needed when there are no emergencies. Given the fuel crisis, however, a larger conclusion suggests itself. For practical purposes, the U. S. can no longer fight a sustained conventional war, because the fuel for tanks, planes, and ships is not available. Had, we not withdrawn from Vietnam when we did, the oil crisis of 1973-74 would have compelled us to withdraw anyway. We now face a future in which the only type of war available to us (except for insignificant skirmishes) is strategic nuclear war. This is argued at greater length in my *Proliferation and the Future: Destruction or Transformation?*, 430 *THE ANNALS OF THE AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE* 133-46 (1977). This leaves no requirement for the CRAF and none for the supplementals, but again, the future system must incorporate all present members and then allocate the cutbacks.

A small example of what must occur is the CAB's approval for Trans World Airline to reduce its coach fare between Chicago and Los Angeles by 37% while reducing the number of daily flights from five to two, as of Sept., 1977. This was not explicitly connected with any attempt to conserve fuel, but to reduce overcapacity in a city-pair market experiencing ragged growth. The action makes sense from the perspectives argued herein. Chicago-Los Angeles Super Coach Proposal by TWA, CAB Order No. 77-7-29 (July 11, 1977).

By early 1978, unfortunately, more liberal CAB charter rules (including CAB promotion of widespread international price wars), together with a belief on the part of the certificated carriers that drastic reductions in fares might encourage Congress not to pass deregulation legislation, was leading to the equivalent of old-fashioned gasoline price wars (always disastrous to gasoline dealers). There was little doubt that some surge in airline travel would result, but there also could be little doubt that airlines could not uniformly stay with such low fares and remain financially healthy. It seemed likely that when fares were once again raised (either by a CAB seeking to avoid the need for subsidy payments, or by the remaining dominant carriers in an unregulated oligopoly), the pattern would be similar to that following World War II; the revised fares ultimately would be considerably higher than before the 1978 price war.

