Journal of Air Law and Commerce

Volume 30

1964

Air Transport and Its Regulations, by Richard E. Caves

Samuel B. Richmond

BOOK REVIEW

AIR TRANSPORT AND ITS REGULATORS, by Richard E. Caves. Harvard University Press, Cambridge, 1962, pp. 479. $10.00.

Since its earliest days, the air transportation industry in the United States has been subject to regulation by the federal government. In the economic area the regulatory agency, since 1938, has been the Civil Aeronautics Board. Under the Civil Aeronautics Act of 1938 and its successor legislation, the Civil Aeronautics Board is directed to consider as in the public interest, among other things, . . . "competition to the extent necessary to assure the sound development of an air-transportation system properly adapted to the needs of the foreign and domestic commerce of the United States, of the Postal Service, and of the national defense. . . ."

Under this governmental regulation, the air transportation industry has grown to comprise eleven trunk lines, thirteen local lines, and three helicopter lines as well as six all-cargo lines, twenty-nine supplemental lines and other companies operating in Alaska, Hawaii and still others operating between the United States and foreign destinations. The total United States scheduled airline industry, in 1961, carried 58.4 million passengers and produced almost forty billion passenger miles, yielding a total operating revenue of three billion dollars. In 1951, the airlines ranked behind the railroads and the buses in the inter-city carriage of passengers, and they carried seventeen per cent of the traffic. By 1957, the airlines were first, and, in 1961, the airlines' share passed fifty per cent of the total common carrier market.

The congressional directive to foster competition has been carried out by the Civil Aeronautics Board. The individual airlines are independent enterprises, financed by private capital, and competing with one another in all of the markets which the Board feels can sustain competitive service. There has emerged within the industry a pattern of economic behavior which represents a compromise between that of the monopolistic regulated industries on the one hand and the competitive unregulated industries on the other. Decisions and events in the airline industry are influenced by both the force of regulation and the forces of the market.

The Caves book is an "industry study." It deals with the United States domestic passenger airlines in the post World War II period, and it seeks to analyze the market structure of the industry and relate it to the conduct and performance of the airlines. A stated purpose of the book is to evaluate the performance of the airlines and the regulatory authority in terms of various general economic criteria and also in terms of the special goals set by the Congress or the regulatory authority. It seeks also to point to ways in which the industry's performance might be improved.

The volume is organized into four parts: the market structure of the industry, historical analysis of the policies of the Civil Aeronautics Board, the airlines' patterns of market performance, and the assessment of market performance.

The author attempts, in the first part, to describe the industry in terms of: market concentration, demand, costs, freedom of entry, and the markets for labor, capital and equipment. In the second part, the history, development, and evaluation of regulatory policies are presented quite briefly but, nevertheless intelligently and perceptively.

In Part II and throughout Parts III and IV, the author tries to relate his observations to his framework of theoretical economic analysis. For example, he tries to speculate about what the industry's performance would be like with varying amounts and kinds of regulation, what might be expected to happen under differing methods of subsidy rate determination, under different policies with respect to entry of firms into the industry and into specific city-pair markets.

At the outset, the author describes his work as seeking ". . . to analyze the market structure, conduct, and performance of the United States domestic passenger airlines, and to point out the degree of consistency and the apparent causal relations among these elements." However, much later in the volume (p. 378), he limits this objective, saying that: "The general evidence on industrial organization in the American economy does not lend much hope to any attempt to summarize the relation of an industry's conduct to its structure." Nevertheless, in spite of this last comment, we find the conclusion near the end of the book (p. 447) that ". . . the air transport industry has characteristics of market structure that would bring market performance of reasonable quality without any economic regulation."

The book is a useful introduction to air transportation for economists and others who desire a quick introduction to the economics and economic history of the industry. Caves has done a workmanlike job of pulling together the output of many scholars, exhibit writers, and regulatory personnel, and of trying to view and analyze this mass of material in the framework of economic analysis. In observing the author's treatment of his sources, one cannot help but be amused at the spirit of local loyalty which inspires the consistent approbation with which the author views the works of his Cambridge colleagues; Cherington's study is "very competent," United Research's report is "excellent," and Gill and Bates' work is "an excellent source" of information. His bibliography is seventeen pages long, but these are singled out for praise. One can only surmise about the criteria for qualification for such adjectival commendation when, for example, the superb (adjective mine) works of Westwood and Wheatcroft, both of which are also cited as sources and quoted in the text, do not qualify for equivalent treatment.

The author has been persistent in his attempt to describe and analyze the industry in terms of his economic models, but his efforts were not uniformly successful. One reason for this is the sheer difficulty of the task and the uniqueness of the air transportation industry. However, there were other obstacles to success. One difficulty is the economic jargon itself. It should not be necessary to say something in a complicated way, if it can be said simply and clearly, for then the only purpose served by the complex formulation is linguistic. There seems to be throughout the book a commitment to use, wherever possible, economic jargon, and its effect is often to obscure rather than to clarify. For example, on page 359, "If the industry were atomistic, and firms did not possess significant indivisibilities, then the relations among city-pair fares would be like those existing in any set of competitive markets."

On page 369, reference is made to the fact that some airline routes "are unprofitable at the monopoly optimum fare." One may well wonder how the author knows this, unless he has somehow determined that the routes at issue are unprofitable at *any* fare, in which case, a statement to that effect would be simpler and clearer.

After discussing the fact that, when the price-product package has many dimensions, as is the case in air transportation, desirable changes in one dimension may be followed by adjustments in other dimensions with the final result being a net loss in welfare (p. 424), the author sums it up with, "To put it very crudely, it is logically possible that, though many sellers are preferable to one seller, one may be preferable to several."

Again on page 360, speaking of carrier petitions for fare increases, "Since the pleas for general increases normally assume a fare increase for the industry as a whole whether or not the carriers are of one mind on the *amount* of the increase, this price-calculation principle must be described as one of joint profit maximization subject to severe constraints." One cannot help but feel that here as well as elsewhere there is a self-conscious attempt to find situations to which the familiar models of economics can be applied, and that these models are referenced, as here, with no gain other than semantics. The author sees himself as an economist and feels free to speak for "economists," but the "economists" for whom he speaks are vastly overdrawn. They live with and make decisions from charts and curves and intersections involving purely economic variables. While there are doubtless still some economists of this type, most economists today, including the author himself, when looking at matters of public policy, think in terms that are broader than suggested by the following quotations about "economists": ". . . an economist would normally . . . prefer to see scarce resources used to provide air transportation in various city-pair markets up to the point where they earn merely a normal return in each market" (p. 403; ". . . the major standing policies of the Civil Aeronautics Board do not coincide with the economist's usual criteria of efficiency" (p. 433); and the concluding thought of the book (p. 479), "There are certain goals that can be achieved by airline regulation, but some sacrifices are necessary to achieve them. An economist may feel that the sacrifices are hardly worth the gains, but the decision is ultimately a political one and his role is only to inform."

In addition, the eagerness to formulate in terms of familiar economic models can lead to hasty judgments and to such formulation in situations which superficially might seem to fit neatly into the framework, but which actually are not quite what they seem. A case in point is the reference on page 443 that the adequacy-of-service case involving Fort Worth seems ". . . to reflect tacit understandings by the airlines to force travelers at the smaller of the two nearby cities to use the airport of the other." Actually, the history of the Dallas-Fort Worth litigation on this matter goes back to the origins of Amon Carter Field and of its substitution for Meacham Field at which time the intention of the major airline was quite the opposite of that which Caves speculates. In the same category is the author's comment that mergers (p. 442) eliminate competitors from markets where the surviving carrier enjoys an "enormous reward" from elimination of a competitor. Here there is failure to recognize the Board's historical position in such matters and the additional fact that the response of other carriers seeking entry and of various civic intervenors would, if the Board did not act spontaneously, be immediate and forceful. Also, on page 319, "Some carriers favor high utilization (as much as twelve hours a day) with the resulting higher maintenance costs; others seem to minimize maintenance costs at the expense of lower utilization per day." The implication that some carriers favor low utilization is novel, to say the least.

He notes on page 303 that the ". . . market conduct of the domestic airlines must be outlined in rather an odd way because of a technological difference in conduct between airlines and most other industries. A toothpaste buyer is utterly unconcerned with the nature and appearance of the capital goods which produce his dentifrice. The air traveler bases his choice among airlines on the nature of the capital goods producing the service more than on anything else." The distinction here is not nearly so sharp as this suggests. The toothpaste buyer may not care about the factory in which the dentifrice is made, but he cares much about the store in which he buys it. Indeed for all retail stores and services, for banks, hairdressers, dentists and any businesses in which the customer visits the premises or comes in contact with the equipment of the seller, the nature and condition of the capital goods of the seller are a factor in the customer's decision. In this sense, the airlines are hardly unique!

On page 427, it is noted that the advertising expenditures of the airlines, as a percentage of revenues tend to be relatively uniform among carriers with the exception that airlines with resort traffic seem to spend relatively more on promotion. However, the author fails to explain that there is good reason for this in that these resort serving airlines are trying to create travel by attracting tourists to these resorts and that they are not merely seeking to be the carrier selected for travel which would otherwise be provided by other airlines or by other modes of transportation. The expenditure is bigger because the job to be done is bigger and because the stakes are bigger.

One of the most discussed aspects of airline regulation is that of entry of new firms into the industry and of entry of firms, either new or existing, into routes which they have not been serving. This volume does not neglect this area. However, the uninitiated reader may be somewhat confused about the tightness of the control over entry. On pages 428-9, entry is easy: "On the other hand, cost conditions facilitate exit from a particular city-pair. This plus the ease of entry by an established carrier, makes competition workable in these markets despite the necessarily high seller concentration . . . over the history of the Board, entrenched carriers have seldom been free from the fear that a route case would unleash new competition. . . ." But, on page 430, "The control of entry and exit, both in the national market and in city-pair markets, has raised the cost of air transportation through protecting inefficient firms. . . ." And on page 442, ". . . with blockaded entry a carrier enjoys an enormous reward from seizing any opportunity to eliminate a carrier." Thus, we have it both ways.

On page 213, it is emphasized that the Board has been dominated, in its route awards, by its desire to strengthen the weaker carriers and ". . . to equalize the relative profitability and absolute size of the trunks." On this and the following page, the author emphasized the dogged determination with which the Board has pursued this objective. Yet, on page 322, in discussing the capital markets, he concludes that, "In sum, the structural traits of the capital market, combined with the Civil Aeronautics Board failure to come very close to equalizing the relative profitability of the large and small carriers, appear as critical elements in determining an increase in seller concentration in the airlines and possibly a decrease in the workability of competition."

It is indeed the case that the Board has tried very hard to strengthen the weaker carriers, and it is also true that there is still great variation among the carriers with respect to size and profitability. However, it is less than fair to the Board and its history to speak of the "failure" of the Board to equalize and to assign that as a cause of the "decrease" in the workability of competition; decrease from what? It makes a big difference whether reference is to decrease from what it was, from what it realistically might have been, or from the economist's ideal. The Board is fairly subject to much criticism, and Caves in this volume has added his share, but this is not an area in which the Board has been remiss.

Another attack on the Board's procedures was that they ". . . are generally aimed at giving a fair hearing to all carrier parties, and the Board has not faced the fact that this often makes impossible any firm or consistent pursuit of the public interest" (p. 442). The author does not explain why this follows, and, although one cannot disagree that the requirements of due process may limit the *efficiency* of the regulatory process, the argument that *pursuit of the public interest* is thereby made impossible is not convincing.

He concludes, on page 431, that ". . . the Board's policies, on the whole, have probably had little effect on the rate of profit earned by the industry." This presumably means, that it is not different from what it would be without regulation. If so, this comment is at variance with the statement on the same page that mergers ". . . would result in an increase in profit rates earned by the carriers." Certainly, if that is the case, the Board's policies will affect profit rates. Indeed, the previous reference to his statement that a carrier can reap huge rewards as a consequence of the "blockaded entry" suggests again that the Board's policies are not without effect on carriers' profit rates.

On page 441, Caves takes the Air Coordinating Committee to task for saying that "the greater strength resulting from merged operations would actually increase the keenness of competition within the industry."[1] Caves argues that this is refuted by all sorts of evidence which he does not present, and, he caps his argument with, "And if this were not enough, the logic of the quotation implies that reducing the number of firms in an industry renders it more and more competitive until, with only two left, competition reaches its maximum effectiveness; no comment seems necessary." Actually, I am afraid that some comment is necessary. The author, at the end of his long study of the air transportation industry has lost sight of the critical characteristic of that industry that the market for air transportation and the locus of competition in air transportation is the individual city-pair. The Air Coordination Committee's statement merely suggests that, for example, Northeast could have offered keener competition to Eastern and National on the New York-Florida route if Northeast had merged with, say, TWA or Delta; an idea which hardly merits such ridicule.

[1] Civil Air Policy, 1954, p. 12.

The volume is written primarily for the economist, and it assumes that the reader is familiar with economic models and with many economic and political aspects of public regulation. Chapter XII on the political environment is a sophisticated and well written analysis of the history and influence of political pressures on Civil Aeronautics Board policies and decisions. In it and elsewhere the author shows himself to be courageous in taking strong positions on controversial matters. While one might not agree with all of his conclusions, one cannot help but be impressed with his forthrightness.

He recommends, following United Research, that the trunks be shifted out of marginally profitable points, that direct subsidy be continued for the local service carriers, and that the Board drop all policies toward the trunks that are used solely to protect internal subsidy. However, his basic position is that "... the air transport industry has characteristics of market structure that would bring market performance of reasonable quality without any economic regulation." Further, he feels that now is the time and opportunity to phase out economic regulation of the airlines, and he presents a step-by-step procedure for this phasing-out process, at the end of which, the "... remaining role of the Civil Aeronautics Board would be strictly promotional" (p. 448).

*Samuel B. Richmond**

* Professor of Economics and Statistics, School of Business, Columbia University. Author of Regulation and Competition in Air Transportation (1961).