FACULTY COMMENT

Transportation Deregulation (1976-1984): Turning the Tide

ROBERT M. HARDAWAY*

TABLE OF CONTENTS

* Associate Professor, University of Denver College of Law. B.A. 1968, Amherst College; J.D. 1971, New York University.

I. INTRODUCTION

President John F. Kennedy, in his Transportation Message of 1962, called for "greater reliance on the forces of competition and less reliance on the restraints of regulation."[1] The "Great Deregulation Debate"[2] has

---

1. A. FRIEDLAENDER, THE DILEMMA OF FREIGHT TRANSPORT REGULATION vii (1969).
In particular, the following inefficiencies and inequities [of regulation] were singled out [by President Kennedy]: the dulling of managerial initiative; the inability of carriers to divest themselves of traffic that fails to cover costs; . . . the substitution of cost-increasing service competition for cost-reducing rate competition; . . . and, finally, the decline of the common carrier relative to private and exempt carriage.

Id.

Arguably, the seeds for the "deregulation movement" were first planted in the Transportation Act of 1958, Pub. L. No. 85-625, 72 Stat. 568, implementing several recommendations of the Presidential Advisory Committee, the chief objective of which was to "increase reliance on competitive forces of transportation in rate making." Harris, *Introduction*, 31 GEO. WASH. L. REV. 1, 20 (1962) (prepared prior to President's Message to Congress Discussing an Efficient Transportation System, U.S. CODE CONG. & AD. NEWS 4148 (Apr. 5, 1962), which made substantive recommendations for amending the Interstate Commerce Act.) However, what little deregulation philosophy was expressed in that Act was not translated into substantial air fare carrier relief. The year 1976 is perhaps a more appropriate year to begin the "age of deregulation," as this year marked only the beginning of a reversal of Civil Aeronautics Board (CAB) policy in initiating administrative de facto deregulation, but it was also the year of passage of the Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (codified as amended in scattered sections of 45, 49 U.S.C.) (4R Act), which with the later Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 (codified as amended in scattered sections of 45, 49 U.S.C.), began the legislative process of deregulation in the railroad industry. The passage of these acts, along with the airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (codified as amended in scattered sections of 45, 49 U.S.C.), led Professor P.S. Dempsey to observe that "the five year period from 1976 to 1981 will be remembered as perhaps the most active in the almost one hundred year history of governmental regulation of transportation." Dempsey, *Congressional Interest and Agency Discretion—Never the Twain Shall meet: The Motor Carrier Act of 1980*, 58 CHI.[-]KENT L. REV. 1, 11 (1981).

The de facto administrative deregulation of the ICC/CAB effectively extends the deregulation period up to the present. *See, e.g.*, Lawfulness of Volume Discount Rates by Motor Common Carrier of Property, 365 I.C.C. 711 (1982); Conrail Abandonment in Jeannette, Pa, 366 I.C.C. 384 (1982); Chicago & N.W. Transp. Co.—Abandonment—Between Marion City and Kesley IA, 366 I.C.C. 373 (1982). Staff standards of administrative review, if not a rederegulatory philosophy, have resulted in a large number of judicial opinions upholding the deregulatory decisions of the ICC and CAB. *See, e.g.*, National Small Shipments Traffic Conference, Inc. v. CAB, 618 F.2d 819 (D.C. Cir. 1980) (CAB within its authority in exempting domestic air cargo carriers from duty to file tariffs); Central Vermont Ry. v. ICC, 711 F.2d 331 (D.C. Cir. 1983) (competitor of merging railroad not entitled to protection); Brotherhood of Maintenance of Way Employees v. ICC, 711 F.2d 331 (7th Cir. 1983) (ICC has authority to reject conditions for protection of tariff routing for benefit of competing carriers). *But see* American Trucking Ass'n v. ICC, 659 F.2d 452 (5th Cir.

been raging ever since. The battle lines have now been drawn, while each side waits for the latest data that might confirm its position or discredit the opposition. In the long run, only the final results will count. During the present transitional phase, the returns have often been conflicting and confusing,[3] and it has been difficult to distinguish the effects of dereg-

---

1981); C&H Transp. Co. v. ICC, 704 F.2d 850 (5th Cir. 1983); Steere Tank Lines, Inc. v. ICC, 687 F.2d 104 (5th Cir. 1982) (ICC exceeded its authority); Ritter Transp., Inc. v. ICC, 684 F.2d 86 (D.C. Cir. 1982); Aero Mayflower Transit Co. v. ICC, 535 F.2d 938 (7th Cir. 1976); Modification of the Motor Carrier Fuel Surcharge Program, 365 I.C.C. 311 (1981); Central Forwarding, Inc. v. ICC, 698 F.2d 1266 (5th Cir. 1983); American Trucking Ass'n v. ICC, 672 F.2d 850 (11th Cir. 1982) (ICC extension of intercorporate handling exemption to nonincorporated entities deemed ultra vires); Wheaton Van Lines, Inc. v. ICC, 671 F.2d 520 (D.C. Cir. 1982) (ICC authorization of sale of dormant authority and gateway elimination not supported by the evidence).

2. In the broader historical context, the debate has been going on for a much longer period. For a description of the debate over railroad regulation from 1877-1976, *see infra* text accompanying notes 42-78. There was a flurry of debate over the philosophy of regulation just prior to the passage of the Motor Carrier Act, ch. 498, 49 Stat. 543 (1935) (codified as amended in scattered sections of 49 U.S.C.). Congressman George Huddleston probably spoke for the majority of those who opposed the Act when he observed that "the proponents of the bill admitted candidly that its main purpose was to give a monopoly to eliminate competition." H.R. REP. NO. 783, 71st Cong., 2d Sess. 16-17 (1930), *cited in* Webb, *Legislative and Regulatory History of Entry Controls on Motor Carriers of Passengers*, 8 TRANSP. L.J. 91, 96 (1976). Senator Wheeler, at the time, also argued in a minority report that "[t]his . . . bill will establish one more bureaucratic department of the government to interfere with the natural development of the peoples' business. It will mean more red tape on the part of both operators and government officials. Worst of all, it will prevent that competition that brings lower rates and better service to the people." S. REP. NO. 396, pt. 2, 71st Cong., 2d Sess. 3 (1930). Webb, however, points out that most of the congressional debates about federal regulation prior to passage of the Motor Carrier Act of 1935 gave little consideration to economic regulation which did not include control of entry, and that in fact the greatest concerns were with safety, and the unfairness of a system which regulated the railroads but not many of the motor carriers. Webb, *supra*, at 97-98. It was presumably the view at the time that the best way to help the railroads was to burden the motor carriers with the same type of regulations as the railroads. Now, after several years experience with deregulation, lively debates still spark interest at conventions. *See, e.g.*, Barry, *Speakers in 'Great Debate' in Detroit Differ in Appraisals of Deregulation*, 30 TRAFFIC WORLD 188 (1981).

3. Air fare data, for example, has been interpreted in a variety of ways. Senator Andrews, in a recent televised appearance on *Face the Nation* announced that his data revealed that air fares had increased 110% since deregulation while the general inflation rate was 48%. *See* Dempsey, *Deregulation: The Great American Aviation Catastrophe*, AIR CARGO WORLD, Mar. 1984, at 44, 46. While his source was unclear, this figure was apparently based on a comparison of regular coach fares. Thus, the figure does not take into consideration the increase in discount fares from approximately 40% to 80%. *Deregulation Oversight: Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation*, 98th Cong., 1st Sess. 10 (1983) (statement of Paul R. Ignatios, President of the Air Transport Association); *see also* AIR TRANSPORTATION ANNUAL REPORT OF THE U.S. AIRLINE INDUSTRY (1983). According to the *Air Transportation Annual Report*, airfares in the first year of deregulation decreased from 8.4¢ per passenger mile to 8.3¢ per passenger mile, rising slightly to 8.7¢ in 1979, and then rising with fuel prices in 1980 to 11.0¢, and to 12.3¢ in 1982 and staying the same through 1982. The Harvard Faculty Project on Regulation reported in 1981 that real average fares decreased by seventeen percent during the first few years of deregulation. J. MEYER, C. OSTER, I. MORGAN, B. BERMAN & D. STRASSMANN, AIRLINE DEREGULATION: THE EARLY EXPERIENCE 71 (1981) [hereinaf-

ulation from the effects of such independent economic forces as recession, fuel prices[4] and inflation. Nevertheless, it is argued here that the transition phase of deregulation, led by the airline industry, is drawing to a close and that the tide has now turned in favor of deregulation. Airline industry losses[5] were sustained during the worst recession since the Great Depression, which coincided with pioneering deregulation. These losses are now yielding to record industry traffic, revenues and profits.[6] Concerns about service to rural communities[7] are proving unfounded[8]

---

ter cited as HARVARD PROJECT]. The latter figures lend credence to the earlier estimates of the General Accounting Office in 1977 which reported that regulation of fares and cost the American consumer nearly $2 billion in excess fares between 1969 and 1974. *Id.* at 48.

4. During the first four months of 1979, fuel prices increased 86%. Between March 1979 and March 1980, prices increased by 105%. HARVARD PROJECT, *supra* note 3, at 163. It is interesting to note that during deregulation these staggering fuel price increases resulted in only very modest fare increases. *See supra* note 3. It is understandable then, that critics of deregulation often choose the 1979-80 time period to compare fares. Charles Murphy notes with concern that average fares from 1979 to 1980 increased by 26%. Murphy, *Airline Deregulation and Antitrust*, 50 ANTITRUST L.J. 381, 383 (1981). The 105% increase in fuel prices during that period is not noted, of course, nor is there any opinion expressed as to how such fuel price increases might have affected fares had there been regulation during that period. Professor Dempsey also chooses the year 1979 to note a "26 percent increase in passenger fares." Dempsey, *Rise and Fall of the Civil Aeronautics Board—Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 182 (1979).

5. Airline industry losses reached $280 million in 1980, and $641 million in 1981. As recently as the first quarter of 1983, industry losses exceeded half a billion. Dempsey, *Transportation Deregulation—On a Collision Course?*, 13 TRANSP. L.J. 329, 324 (1984).

6. American Airline's profits alone exceeded $15.6 million in the fourth quarter of 1983. Wall St. J., Jan. 19, 1984, at 62, col. 4. Air traffic increased in 1983, with only Continental among all major carriers showing a decrease. US Air showed a 19% increase in traffic, followed by United with 11.8%, Delta 9.6%, Eastern 8.4%, TWA 6.8%, Pan American 6.2% and Western 6.0%. Hamel, *Airline Traffic Up as We Go to the Sky*, USA Today, Jan. 9, 1984, at B-1, col. 3.

7. *See, e.g.*, Havens & Heymsfeld, *Small Community Air Service Under the Deregulation Act of 1978*, 46 J. AIR L. & COM. 641 (1981); Meyer, *Section 419 of the Airline Deregulation Act: What Has Been the Effect on Air Service to Small Communities*, 47 *J. Air L. & Com.* 151 (1981); Dempsey, *supra* note 4, at 183; Klaus, *The Dark Side of Deregulation*, WASH. MONTHLY, May 1979, at 33.

8. Even in the early years of deregulation, the effects of deregulation on small community service were often exaggerated. The Harvard Foundation Report, for example, investigated a Kysor Industrial Corp. advertisement in the March 7, 1980 issue of the *Wall Street Journal* which screeched: "Deregulation has shot down more planes than the Red Baron," and asserting that 25 small communities had lost their service due to deregulation. The report's investigation of the ad revealed that 7 of the 25 communities listed had lost their service *before* deregulation, and that the remaining communities were receiving replacement service, some at a higher level than before deregulation. HARVARD PROJECT, *supra* note 3, at 120. Recent CAB statistics reveal an overall increase in service to small communities, especially to small community or sequitur hubs. *See generally* CIVIL AERONAUTICS BOARD, CAB DRAFT REPORT (1984); Richard Ferris reports that, "In the ten years prior to the Deregulation Act, 173 communities lost air service. In the four and a half years since deregulation, no community has lost air service." *Deregulation Oversight: Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation*, 98th Cong., 1st Sess. 420 (1983) (statement of Richard Ferris, Chairman and Chief Executive Officer, United Airlines, Inc.). Partly because the Airline Deregulation Act made smaller

and misdirected.[9] Safety records have actually improved considerably since deregulation;[10] airfares are continuing a downward trend;[11] the necessity for subsidies has been reduced;[12] and, contrary to many predictions,[13] the number of carriers has increased rather than decreased.[14] In light of all these benefits wrought by deregulation, it is no wonder that at least twenty-nine of the thirty air carriers represented by the Air Transport Association would not oppose any attempt to re-regulate their industry.[15]

Professor Paul Stephen Dempsey in his recent article, *Transportation Deregulation—On a Collision Course?*, argues that deregulation of transportation has been a failure and there should be a return to "responsible" regulation. Looking at the history of railroad, motor carrier and airline de-

---

commuter turboprop aircraft eligible for subsidy under Section 419, and partly because of the increase in traffic coinciding with the end of the recession, the increase at some hubs has been substantial. "Although some individual communities have experienced losses since deregulation, a larger number—despite the terminations—have had gains in service." HARVARD PROJECT, supra note 3, at 156.

9. It is interesting to note that it was during the regulatory climate created by the CAB between 1960 and 1977 that service to over 179 communities was terminated. Havens & Heymsfeld, *supra* note 7, at 643. Indeed, it was not until deregulation in 1978 that replacement service was being provided at about sixty of those communities. H.R. REP. NO. 1211, 95th Cong., 2d Sess. 11 (1978). Those expressing concern about loss of service to small communities might do well to look at the economic disincentives created by regulation which resulted in the devastating loss of service prior to deregulation. *See generally* HARVARD PROJECT, *supra* note 3, at 13.

10. National Transportation Safety Board statistics reveal a decrease in fatal crashes per 100,000 take-offs from .10 in 1978 to .08 in 1982. The FAA reports that safety "performance indicators"—accidents, FAA violations, etc.—have improved by 30% in the last few years. Wall St. J., Oct. 18, 1983, at 35, col. 4. Even the most vigorous opponents of economic deregulation concede that safety has improved under deregulation. Murphy, *supra* note 4, at 383. Professor Dempsey concludes that "[s]erious questions arise as to whether an unhealthy industry can be a safe industry." He cites several commentators who opine that deregulation ought to result in decreased safety, but cites no studies or statistics to support this view, other than to recite several highly publicized crashes that have occurred since deregulation. Dempsey, *supra* note 5, at 352.

11. *See supra* note 3.

12. The Airline Deregulation Act "encouraged the use of appropriate size aircraft and made commuter carriers eligible for subsidy. The net impact of deregulation on small community subsidy levels in the first year of deregulation has been to substantially reduce the subsidies paid." HARVARD PROJECT, *supra* note 3, at 156-57. Indeed, in the first few years alone of deregulation, there was a "net reduction in annual subsidy payments of $5,297,326" under Section 419. *Id.* at 146.

13. Dempsey, *supra* note 4, at 183; *see also* Dempsey, *supra* note 5, at 344 (Professor Dempsey cites commentators who have expressed the opinion that deregulation would result in greater concentration in the airline industry).

14. Dempsey notes that Braniff and 17 smaller carriers have gone bankrupt, but did not mention 30 new entrants which have taken their place; and even Braniff has come back. Dempsey, *supra* note 5, at 343. In fact, it seems that for every inefficient or lumbering carrier that goes under, several lean and efficient carriers rise to take its place.

15. Telephone Interview with William E. Jackson, Vice-President for Public Information of the Air Transport Association, in Denver (Jan. 20, 1984). Only Republic would favor re-regulation. Notably, however, even Republic did not express this view at the ATA Directors meeting.

regulation, Professor Dempsey has compiled an impressive array of opinions hostile to deregulation and argues that deregulation has led to: 1) economic decline in the industry, 2) diminution of safety, 3) discrimination in pricing, 4) deterioration of service, and 5) erosion of carrier liability for loss and damage.[16] This article will critically examine these arguments through application of economic and legal principles, and reference to empirical data compiled from industry, labor and government sources.

Discussion and application of economic principles is often lacking in legal analyses of deregulation. This lack of cross-fertilization of ideas between the economic and legal spheres is illustrated by the observation that articles in the economic journals tend to favor deregulation,[17] while those in the legal journals tend to favor regulation.[18] One suggested reason for this difference in opinion is that lawyers themselves have an interest in regulation[19] because they play a significant role in its administration.[20] As a former associate general counsel of the CAB has observed, "it is understandably painful for one involved in economic regulation over a professional lifetime to consider his life's work outdated, or

16. Dempsey, *supra* note 5.

17. *See, e.g.*, Trapani & Olson, *An Analysis of the Impact of Open Entry on Price and the Quality of Service in the Airline Industry*, 64 REV. ECON. & STATISTICS 67 (1982); Carlton & Lanches, *Benefits and Costs of Airline Mergers: A Case Study*, 11 Bell J. Econ. & Mgmt. Sci. 65 (1980); Schmatensee, *Comparative Stotic Properties of Regulated Airline Oligopolitics*, 2 BELL J. ECON. & MGMT. SCI. 565 (1971); Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Levin, *Railroad Rates, Profitability and Welfare Under Deregulation*, 12 BELL J. ECON. & MGMT. SCI. 1 (1981); Anderson & Kraus, *Quality of Service and the Demand for Air Travel*, 63 REV. ECON. & STATISTICS 533 (1981); Spann & Erickson, *The Economics of Railroading: the Beginning of Cartelization and Regulation*, 1 BELL J. ECON. & MGMT. SCI. 227 (1970). Articles in the *Journal of Law and Economics* have a decidedly economic bias, with very few cross-references to the legal periodicals. *See, e.g.*, Stigler & Friedland, *What Can Regulators Regulate? The Case of Electricity*, 5 J.L. & ECON. 1 (1962); Jordan, *Producer Protection, Prior Market Structure and the Effects of Government Regulation*, 15 J.L. & ECON. 151 (1972); Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976). It is interesting to note that the articles on regulation in the legal periodicals place greater reliance on secondary sources for data, while the economic articles are generally more empirical, and less reliant on the opinions of others.

18. Most articles on deregulation in the legal literature do not even cite to articles in the economic journals. *E.g.*, Dempsey, *supra* note 4, at 91-185; Brewer, *Regulation—The Balance Point*, 1 PEPPERDINE L. REV. 355 (1974); Note, *Staggers Rail Act of 1980: Authority to Compete with Ability to Compete*, 12 TRANSP. L.J. 301 (1981). A unique and admirable exception is Jones, *Government Price Controls and Inflation: A Prognosis Based on the Impact of Controls in the Regulated Industries*, 65 CORNELL L. REV. 303 (1980).

19. The literature reflects a distinct bias in favor of regulation by lawyers practicing in the field. *See, e.g.*, Forest, *Is Open Competition Preferable to Regulation?*, 6 AIRLAW 7 (1981) (Head of Legal Dep't of International Air Transport Association); Anderson, *The Motor Carrier Authorities Game*, 47 I.C.C. PRAC. J. 22 (1979).

20. *See, e.g.*, Hirshleifer, *Comment*, 19 J.L. & ECON. 241 (1976). "[T]he regulators themselves constitute an interest group." *Id.*

even worse, misdirected."[21]

It is the purpose of this article to explore the social, economic and legal consequences of deregulation during its phase of transition, with emphasis on the application of economic principles to hard data obtained from industry, labor and government sources.

II. THEORIES OF REGULATION

The history of economic regulation[22] reveals a now familiar pattern: a failure to learn from previous mistakes and a constant hope that basic economic laws can be made to disappear if they are only ordered to do so. It has been thousands of years since the first attempts by a civilized society to regulate economic activity by fiat.[23] Still, there are those who believe that wealth can be increased by simply printing more money,[24] that real prices can be lowered (or raised) by the waving of a regulatory wand,[25] and that an efficient industry can be mandated.[26] The result of these failures to learn from previous mistakes has caused human tragedies of unparalleled proportions. For example, stringent rent controls in France from 1914 to 1948 resulted in an almost complete cessation of residential building during that period.[27] (It was only after the lifting of rent control after World War II that there was a vigorous boom in French residential building.) New York City, which failed to learn from that experience,[28] later instituted rent controls which resulted in the tragic abandonment of thousands of apartments at a time when shelter was desperately needed. Federal ceilings on natural gas have caused severe gas shortages and curtailment of vitally needed operations and explora-

21. Edles, *The Strategy of Regulatory Change*, 49 I.C.C. PRAC. J. 626, 628 (1982).

22. It is important not to confuse economic with social regulation. For example, child labor laws, food and drug laws, and FAA safety regulations are remedial and social in purpose, and have only an indirect effect on resource allocations.

23. By 301 A.D., economic regulation was well established as an instrument of state power. In that year the Emperor Diolectian issued his famous edict threatening death for violations of laws setting a "just price." H. SPIEGEL, THE GROWTH OF ECONOMIC THOUGHT 63 (1983). By 1359, private companies had obtained monopoly powers by charter from their respective governments. In that year, the society of Merchant Adventurers obtained a charter, and benefits of regulation; in 1600, the East India Company received its charter. Both attempted to suppress the competition, whom they called "free-traders" and "interlopers." *Id.* at 99.

24. *Id.* at 27. The simplistic notion that printing more money increases wealth should be distinguished from the more complicated, but now generally accepted liquidity preference theories of John Maynard Keynes. *See generally* J. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY (1936). For a discussion of the "acceleration" and "multiplier" effects of money and investment, see P. SAMUELSON, *Economics* 51-52 (8th ed. 1972).

25. P. SAMUELSON, *supra* note 24, at 51-52.

26. *See generally* Jones, *supra* note 18, at 315-16; Jordan, *supra* note 17; A. FRIEDLAENDER, *supra* note 1, at 99.

27. P. SAMUELSON, *supra* note 24, at 372.

28. *Id.* at 372-73.

tions.[29] So called wage-price controls still result in black markets, and renewed inflation.[30] The list goes on and on. These controls are always justified on grounds of "public interest." Yet, the government often has a difficult time in deciding whether to order prices *down* to "protect the consumer" or order them *up* to "protect an industry."[31] This ambivalence has often led to conflicting, inconsistent and ultimately counter-productive regulatory practices. It is not surprising to learn that regulation, while often eliminating one short-run consequence of market failure, more often that not results in more resource misallocation than it cures.[32]

This does not mean that economic regulation should not play an important role in a mixed economy. The laws of supply and demand result in equilibrium and maximum efficiency only in an idealized, perfectly competitive market.[33] Since such markets rarely occur,[34] it follows that equi-

---

29. Jones, *supra* note 18.

> The natural gas story also is well known. Federal ceilings on natural gas producer prices resulted in an imbalance between supply and demand. For years, natural gas was consumed more rapidly than new supplies could be obtained. The result was a reduction of supply to the point where neither peak nor annual demands for gas could be met. Industries dependent on gas supplies were curtailed in their operations and were shut down completely for limited periods. Residential consumers of gas were not far removed from interruptions in supply that could work major hardships. Natural gas users, deprived of supplies, imposed additional demands on their energy sources, aggravating energy problems elsewhere. Again public and industry dissatisfaction led to a legislative program of deregulation.

Id. at 318 (footnotes omitted).

30. S. BREYER, REGULATION AND ITS REFORM 60-63 (1982).

31. Peltzman, *supra* note 17. *See generally* Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

32. Peltzman, *supra* note 17; Stigler, *supra* note 31. *See also* Spann & Erickson, *supra* note 17.

> Regulation with effects which cut across boundaries between competitive and non-competitive sectors, even if it is successful in achieving its objective in the non-competitive sector, can impose costs in the competitive sector which far outweigh the benefits in the non-competitive sector.

Id. at 243.

33. *See* J. HIRSHLEIFER, PRICE THEORY AND APPLICATION (1976). Hirshleifer defines a competitive trader as a "price taker. The terms of control facing him in the market are, in his view, outside his sphere of control; he regards himself as able to buy or sell price." *Id.* at 198. There are three additional characteristics of a perfect market: 1) Perfect communication, 2) instantaneous equilibrium, and 3) costless transactions. *Id.* at 200-01. Obviously such characteristics occur in theory only. Another important characteristic of perfect competition is that entry into the market be "absolutely free in the long run." P. SAMUELSON, *supra* note 24, at 448. Samuelson shows that the long-run break-even condition:

> comes at a critical P[rice] where the identical firms just cover their full competitive costs. At lower long-run P[rice], firms would leave the industry, until P[rice] had returned to the critical equilibrium level; at higher long-run P[rice], new firms would enter the industry replicating what existing firms are doing and thereby forcing market price back down to the long-run equilibrium P[rice] where all competitive costs are just covered. . . . P[rice] = MC (Marginal cost) — minimum competitive costs.

Id.

34. In the pure sense, of course, they almost *never* occur. Samuelson notes that a few

librium in imperfectly competitive markets can result in economically and socially harmful resource misallocation.[35] The textbook definition of an imperfectly competitive industry is an industry where an individual seller controls such a large percentage of the total market that it can affect the price of a product by restricting or expanding its own production. In such an oligopoly (or monopoly) the equilibrium point of supply and demand does not result in maximum production or efficiency because it is always to the imperfect competitor's advantage to keep prices above marginal cost by restricting production. With no need to cut price in order to increase quantity, the incremental marginal revenue of each additional unit produced is "precisely the price received for that last unit, with no loss on previous units being subtracted."[36] Therefore an oligopolistic producer "maximizes profits by equating marginal *revenue* to marginal *costs*, which leads to a price that is *above* marginal cost. . . . The canny seller contrives an artificial scarcity of his product so as not to spoil the price he can get on the earlier premarginal units."[37]

The regulators have failed to distinguish *degrees* of oligopoly power in the industries they seek to regulate. Such distinctions are necessary to ensure that the extent of regulation is proportionate to the degree of oligopoly power in the industry. Judicious use of regulatory powers may indeed serve to counteract the misallocative effects of oligopoly power on resource distribution; indiscriminate regulation, however, results in far greater resource misallocation than the oligopoly it is designed to neutralize.[38] Since the administrative costs of regulation are high, and the polit-

---

agricultural industries come closest. Examples of imperfect competition are toothpaste, retail trade (many differentiated sellers), autos, steel, aluminum (oligopoly); a few utilities meet the definition of monopoly (single producer; unique product without close substitutes). P. SAMUELSON, *supra* note 24, at 467.

35. As Samuelson explains: "Under free pricing, when firms face a sloping demand curve, their marginal Revenue is below their price. Then, to the degree that such imperfect competitors intelligently pursue their self-interest, they will *not* be led by Adam Smith's Invisible Hand to perform the acts needed to promote the general interest." *Id.* at 475.

36. *Id.* at 474.

37. *Id.* at 479-80.

38. H. SPIEGEL, *supra* note 23, at 641. Misallocation of resources in the transportation industry may be traced directly to indiscriminate regulation. One such example in railroad regulation has been explained by Professor Friedlaender:

> Railroads are best suited to carrying high-density traffic with a minimum number of distribution points. The costs of service to relatively small, isolated communities with low traffic densities and inefficient means of distribution are substantially higher than the costs of service to communities with high traffic densities and efficient means of distribution. However, rates cannot generally reflect these cost differences.
>
> The problem is compounded by the Commissions's use of average costs in intermodal rate cases. Although efficient railroad operations may have a substantial cost advantage over trucks, the average cost data used by the Commission may not reflect it if the railroads perform a large amount of low-density service. Similarly, although trucking operations may have a substantial cost advantage over low-density rail service, the average cost data used by the Commission may not reflect it if the railroad performs a

ical incentives are great,[39] it is important to critically examine not only the economic effects of regulation on a particular industry, but also to look at the motives, political or otherwise, that brought it about. The transportation industry is an excellent case study in this regard, for perhaps no other industry has been subjected to such indiscriminate and self-defeating reg-

---

substantial amount of high-density, efficient service. By considering only average costs, the Commission effectively prevents each mode from adopting rates that would reflect their true cost advantage.

An efficient traffic allocation would permit the railroads to perform a wholesaling service and specialize in handling high-density traffic between major centers. It would permit trucks to perform a retail or distribution service and specialize in handling relatively low-density traffic. Such specialization would lead to a diversion of large-volume trucking traffic to rails, a diversion of low-volume rail traffic to trucks, and lower transport costs. By refusing to let rates reflect relative costs, the Commission ensures a continued traffic misallocation and excessively high transport costs.

A. FRIEDLAENDER, *supra* note 1, at 68-69. Friedlaender estimates the social costs of this misallocation by "calculating the deadweight loss associated with noncompetitive pricing," using a method outlined in Hotelling, *The General Welfare in Relation to Problems of Taxation and of Railway and Utility Rates*, in READINGS IN THE ECONOMICS OF TAXATION 139-67 (1959).

39. Regulatory legislation is the end product of a political process, which is sensitive to large power blocs and groups. *See* Olson & Trapani, *Who Has Benefited From Regulation of the Airline Industry*, 24 J.L. & ECON. 75 (1981). Jordan's study of both the regulated and unregulated airline industry in California revealed that regulations resulted in excess capacity and thus benefited airplane manufacturers, employees and suppliers. W. JORDAN, AIRLINE REGULATION IN AMERICA 226-38 (1970), *noted in* Olson & Trapani, *supra*, at 75. For a discussion of union political incentives, and the effects of union power on regulation, *see* Hendricks, Fehille & Szerszen, *Regulation, Deregulation, and Collective Bargaining in Airlines*, 34 INDUS. & LAB. REL. REV. 67 (1980).

Stigler analyzes political power and regulation as follows:

When an industry receives a grant of power from the state, the benefit to the industry will fall short of the damage to the rest of the community. Even if there were no deadweight losses from acquired regulation, however, one might expect a democratic society to reject such industry requests unless the industry controlled a majority of the votes . . . .

Because the political decision is coercive, the decision process is fundamentally different from that of the market. If the public is asked to make a decision between two transportation means comparably to the individual's decision on how to travel—say, whether airlines or railroads should receive a federal subsidy—the decision must be abided by everyone, travellers and non-travellers, travellers this year and travellers next year . . . .

The industry which seeks political power must go to the appropriate seller, the political party. The political party has costs of operation, costs of maintaining an organization and competing in elections. These costs of the political process are viewed excessively narrowly in the literature on the financing of elections: elections are to the political process what merchandising is to the process of producing a commodity, only an essential final step. The party maintains its organization and electoral appeal by the performance of costly services to the voter at all times, not just before elections. All of the costs of services and organization are borne by putting a party of the party's workers on the public payroll. An opposition party however, is usually essential insurance for the voters to discipline a party in power, and the opposition party's costs are not fully met by public funds.

The industry which seeks regulation must be prepared to do so with the two things a party needs: votes and resources.

Stigler, *The Theory of Economic Regulation, 2* BELL. J. ECON. & MGMT. SCI. 3, 10-12 (1971) (emphasis added).

ulation. The heavy-handed regulation of the railroads during the last three quarters of a century virtually brought that industry to its knees before recent legislation gave it one last chance, short of nationalization, to survive.

George Stigler, in his landmark article, *The Theory of Economic Regulation*, looks at two alternative views of regulation—regulation for the "benefit of the public" and regulation as the result of the political use of power by vested interest groups. In examining the second view, Stigler proposes the following general hypothesis: "[E]very industry or occupation that has enough political power to utilize the state will seek to control entry."[40] Thus, other state powers sought by an industry will include those which affect substitutes and complements (thus butter producers will try to suppress margarine and encourage bread production; airlines will urge subsidies for airports).[40a] Finally, an industry, through coercive use of government power, will seek to fix prices above the level which would be determined by supply and demand. Oligopoly profits can thus be achieved either by market concentration, or by use of political power. Ironically, regulation can actually serve as a substitute for naturally created oligopoly power. Stigler examines the nature of the political process in which an industry or interest group can employ political machinery which is beneficial to that industry but harmful to the public at large.

Once the political process of regulation is understood, its dangers can be appreciated. When evaluating regulation of an industry, five questions must be asked: first, does oligopoly power exist in the industry; second, what is the source of the oligopoly power (i.e., is the industry a "natural" monopoly);[41] third, what is the *extent* of the oligopoly power, and to what *degree* does it result in distortion of market prices and the

40. Stigler, *supra* note 39, at 6.

40a. *Id.*

41. Economists generally define "natural monopoly" as one where economies of scale are so great that only a single producer is viable in the industry." J. HIRSHLEIFER, *supra* note 33, at 300. By the same reasoning, a "natural oligopoly" is where economies of scale are so great that only a limited number of producers are viable in the industry. The capital requirements of economies of scale are usually high, creating a "natural" barrier to entry. Thus, it is important to determine the barriers of entry to a particular industry before choosing a regulatory model. In theory, where barriers to entry are sufficiently high to result in the creation of a natural monopoly or oligopoly, some regulation may be necessary to neutralize the oligopoly power. Likewise, where barriers to entry are not so high and where many producers may therefore enter a industry, regulation becomes self-defeating, especially if regulation takes the form of limiting entry. In fact, regulation under these circumstances actually creates barriers where none existed before, taking the place of "natural" barriers. This is exactly what happened with airline regulation: artificial barriers to entry were created, thus actually creating an "artificial oligopoly." The airline industry is a classic example of such an artificially created oligopoly. When airline regulation began in 1938, there were 16 carriers, which gradually evolved into 10 domestic trunk lines. No new trunk lines were permitted entry prior to 1978. HARVARD PROJECT, *supra* note 3, at 5. The tragedy of this heavy-handed regulation was that such an oligopoly was totally unnecessary because of the relatively low economies of scale and barriers to entry in the industry.

misallocation of resources; fourth, will the benefits of regulation outweigh the administrative and social costs; and finally, are there independent political motives and incentives that may explain the nature of the regulation ultimately enforced?

With regard to the transportation industry, these questions must be asked in relation to each of its primary modes: railroad, motor carrier and airline. The answers for each are different and will be considered separately in evaluating the effects of deregulation.

III. Surface Transportation Regulation (1887-1976): Producer Protection and the Rise of the Artificial Oligopoly

Critics of the recent revolution in deregulation point to the past few years experience in airline deregulation to prove their point that deregulation is a "dismal failure."[42] (The fact that deregulation coincided with a severe recession and skyrocketing fuel costs[43] does not cloud these critics' vision, nor does the evidence of declining fares,[44] better community service,[45] or even recent record industry profits.[46]) An evaluation of the effects of regulation compared to the effects of deregulation is not possible. The evaluation of deregulation is based on the experience of a few short years, while an evaluation of regulation is based on the experience of forty years of regulation in the airline industry,[47] forty five in the motor carrier industry,[48] and ninety three years in the railroad industry.[49] Studies of that experience reveal what is now obvious to all but the die-hard regulators: "There is a growing consensus that all of these regulatory programs have been monumental failures, in some cases bordering on disaster."[50]

Histories of the regulatory experience in transportation are numerous and readily available,[51] and no attempt will be made to repeat them in

42. Dempsey, *supra* note 5, at 386; W. Augello, The Deregulation Disaster 10 (1982) (unpublished monograph).

43. *See supra* note 4.

44. *See supra* note 3.

45. *See supra* note 7.

46. USA Today, *supra* note 6.

47. The period from 1938-1978. Although the Civil Aeronautics Act of 1938, ch. 601, 52 Stat. 973, marks the beginning of rigid entry control, previous acts actually began the regulatory process: Contract Air Mail Act of 1925 (Kelley Act); Waters Act of 1930; Black-McKellar Act of 1934. For an excellent history of these early years of regulation, *see* Harvard Project, *supra* note 3, at 13-37; Dempsey, *supra* note 7, at 95-107.

48. The period from 1935 to 1980. For a history of these years, *see infra* text accompanying notes 79-126; Dempsey, *supra* note 1; Sloss, *Regulation of Motor Freight Transportation: A Quantitative Evaluation of Policy*, 1 Bell J. Econ. & Mgmt. Sci. 327 (1970).

49. The period from 1887 to 1976.

50. Jones, *supra* note 18, at 316.

51. *See supra* notes 47-48.

detail here. Nevertheless, highlights of the regulatory experience are useful for purposes of comparison with, and evaluation of, the deregulatory experience.

A. The Politics of Railroad Regulation: The Great Train Robbery

Railroads perhaps epitomize an illustration of Stigler's hypothesis: "[E]very industry or occupation that has enough political power to utilize the state will seek to control entry."[52] Railroad regulation has its roots in the failure of early railroad robber barons to form their own cartels and "pools." The incentive to form such cartels and pools was high because of the fierce competition, which resulted in lower profits for the railroad magnates. In 1880, for example, shippers in Atlanta and St. Louis had twenty competitive routes between the cities to choose from. By 1900, there were 1224 operating railroads, and by 1907, there were 1564. By 1980, after ninety three years of regulation, the number of operating railroads had been reduced to but seven major carriers accounting for eighty five percent of traffic.[53] Because of this drastic reduction, it is now fashionable to refer to the railroad industry as a "natural" monopoly. There was nothing very "natural" about the regulation from 1887 to 1980. It virtually created a transportation oligopoly.

In the competitive atmosphere of the 1870's and '80's many railroads offered substantial rebates to shippers. In hopes of increasing profits, many railroad barons began calling for "anti-rebate" laws, i.e., a legalization of price-fixing and "pooling," and other anti-trust exemptions. By 1887, the barons had succeeded in characterizing any discounts or rebates to shippers as "discriminatory." Facing the same problems as today's oil cartels, the barons' attempts to raise rates by pooling and price-fixing repeatedly failed because of the large number of competitors.[54] In 1879, the head of the first government railroad statistics department recognized that pooling agreements would never work unless made enforceable by law.[55] When national freight rates declined by twenty percent, men such as Henry Seligman noted that "[t]he merchants are securing the benefits of very low rates, to which I suppose they do not object.[56] By 1884, such rail magnates as John P. Green were testifying to the House Committee on Commerce that "a large majority of the railroads in the United States would be delighted if a railroad commission or any other power could make rates upon their traffic which would insure

52. Stigler, *supra* note 39, at 5.
53. G. Kolko, Railroads and Regulation 7 (1970).
54. *See id.* at 10-11.
55. *See id.* at 26 (citing Apr. 15, 1899 memo by Joseph Nimmo, Jr.).
56. *See id.* at 30 (citing letter from Henry Seligman to Philip N. Lilienthal (Mar. 16, 1885)).

them six percent dividends."[57] (Friedlaender has observed that the railroads during this period supported regulation in part to formalize a rate structure.)[58] But perhaps the barons' greatest accomplishment was their

57. *See id.* at 35 (citing *Hearings Before the House Comm. on Commerce*, 48th Cong., 1st Sess. 1-2 (1884) (testimony by John P. Green)).

58. A. FRIEDLAENDER, *supra* note 1, at 2 (citing the following works supporting the view of railroad support of regulation: S. BUCK, THE GRANGER MOVEMENT, 1870-1880 (1913); L. BENSON, MERCHANTS, FARMERS AND RAILROADS: RAILROAD REGULATION AND NEW YORK POLITICS 1850-1887 (1955); I. TARBELL, THE HISTORY OF THE STANDARD OIL COMPANY (1904)).

There were a few Railroad men who did not welcome the 1887 Act: John Murray Forbes and William Bliss. *See* Letter from John Murray Forbes to John M. Endicott (Jan. 29, 1887); Letter from William Bliss to Chauncey Depew (Jan. 20, 1887), *quoted in* G. KULKO, *supra* note 53, at 45. For the most part, however, the Railroads openly welcomed regulation, as Kulko has observed:

> It is not my contention, of course, that railroad leaders were the only group favoring the federal regulation of transportation. The mere fact that they did not always get their specific legislative demands indicates that not only were the railroads divided among themselves as to precisely what legislative measures they wanted passed, but that they faced opposition on many points from shipping groups who had their own goals and demands. Railroad interests differed from line to line, and the disagreements among the railroads were frequently as strong as the disagreements between the bulk of the railroads and many shippers. The crucial point is that the railroads, for the most part, consistently accepted the basic premises of federal regulation since only through the positive intervention of the national political structure could the destabilizing, costly effects of cutthroat competition, predatory speculators, and greedy shippers be overcome. Moreover, the railroads were a much more constant force for federal regulation than the shippers, and the deeper divisions within the ranks of shippers often meant that their agitation for regulation contributed to the interests of the railroads. Legislative proposals, to be successful, usually needed the support of both the railroads and important shipping groups, and throughout the period from 1877 to 1916 neither could obtain legislation without the support of the other for some general form of legislation.
>
> Virtually all histories of railroad regulation have focused on the views and actions of politicians, farmers, or shippers. And while these groups played a crucial part, . . . the role of the railroads and the railroad men in the movement for federal regulation has largely been ignored, beyond the automatic assumption that they naturally opposed regulation. Such a perspective, . . . is like ignoring the role of the Confederates in the Battle of Gettysburg . . . .

G. KOLKO, *supra* note 53, at 5-6.

> Only the railroads were consistently interested in increasing federal regulation of the railroads throughout the 1890's. Neither merchants nor farmers offered significant opposition to their plans. Some merchants, especially in the East, actually aligned themselves with the railroads. It was clear to these merchants that rates were declining, and this alone took the impetus out of their earlier anti-railroad sentiment.

Id. at 78.

While the Railroads generally supported federal regulation, they had however, found state regulation difficult to control. When the states first began regulating the railroads in the late 1860's and early 1870's, the railroads challenged the state regulations, alleging that regulation of interstate commerce was within the exclusive power of the United States under Art. I, § 8 of the U.S. Constitution. Although state regulation was generally upheld, *see* Munn v. Illinois, 94 U.S. 113 (1876); Winona & St. P. Ry. v. Blake, 94 U.S. 180 (1876), it began to wane by the early 1880's, leaving the way open for federal regulation, culminating with the passage of the Interstate Commerce Act of 1887. For an excellent history of this early period, see Harris, *supra* note 1, at 4.

The Railroad's resistance to state regulation but support of federal regulation is consistent with Professor Thoms' observation: "The railroads have been the most intensely regulated of the

political success in characterizing any competition as "chaotic."[59] Big oil producers even organized a letter writing campaign, which flooded Congress with petitions calling for "the passage of a law to regulate commerce."[60]

There is no question that there were abuses in the railroad industry. The secrecy of many transactions, for example, resulted in widespread corruption and injustice.[61] But such abuses, created by the railroads themselves, were then used by them to justify not just remedial social legislation, but legislation to enforce higher rates across the board—something that attempts at illegal price-fixing had been unable to accomplish. But even the passage of the ICC Act[62] was not sufficient to satisfy the railroads' thirst for government-imposed oligopoly profits. Discounts and rebates persisted in reducing railroad profits. In 1899, Alexander Cassatt, president of the Pennsylvania Railroad, led the fight against rebating,[63] which finally resulted in the adoption by Congress of the Elkins Act[64] in 1903. The Hepburn Act of 1906 gave the railroads even more power to take the initiative in maintaining rates, prompting George Perkins to write to his superior, J.P. Morgan: "[T]he Hepburn bill is going to work out for the ultimate and great good of the railroads. There is no question but that rebating has been dealt a death blow."[65] The railroads had been

---

major transportation modes in the United States. The first major industrial corporation to wield great power, they alternately sought and avoided regulation." Thoms, *Clear Track for Deregulation—American Railroads, 1970-1980*, 12 TRANSP. L.J. 183, 184 (1982).

59. Harris, *supra* note 1, at 5.

60. *See* G. KOLKO, *supra* note 53, at 23.

61. Oren Harris described conditions:

> There was the sale of worthless securities and the granting of public land and credit by public officials to railroad corporations for worthless schemes.
> In regard to the frenzied speculation and manipulation that occurred, the Cullom report had this to say:
>
> > Railroad corporations have been organized and manipulated by *speculators*; rings within rings have controlled their operations and fattened on their revenues; "railroad wrecking" has become a fine art; values have been made to fluctuate wildly, without due cause; panics have been occasioned by the magnitude of these operations, and the whole railroad system, as well as the commerce of the country, will suffer for years from the effects of those eras of mad speculation which are yet fresh in the memory of all.

Harris, *supra* note 1, at 4 (emphasis added).

62. Act of Feb. 4, 1887, ch. 104, 24 Stat. 379 (codified as amended in scattered sections of 49 U.S.C.).

63. *See generally* Creelman, *All is Not Damned*, 15 PEARSON'S MAG. 543-54 (1906); Carnegie, *My Experience with Railway Rates and Rebates*, 75 CENTURY MAG. 722-28 (1908), *cited in* G. KOLKO, *supra* note 53, at 96.

64. Ch. 708, 32 Stat. 847 (1903) (codified at 49 U.S.C. §§ 41-43 (1982)). In short, the Elkins Act prohibited "unreasonable" rates, "unjust" discrimination, undue preference, and required adherence to published tariffs. *See* M. FAIR & J. GUANDOLO, TRANSPORTATION REGULATION 327-28 (1979).

65. Hepburn Act, ch. 3591, 34 Stat. 584 (codified as amended in scattered sections of 45 U.S.C.). This Act extended the provisions of the Elkins Amendment to cover express, sleeping

very careful not to voice their support of the Hepburn Act for fear of creating political liability for the bill's congressional proponents; but by the time its passage was assured the railroads were openly expressing support. The New York press even declared that the railroads had written the whole bill and "[t]his explains why the railroad lobbies did not raise a note of public or private protest against the Hepburn bill in the house."[66]

The Hepburn Act's solution to "discriminatory" pricing seemed to suit almost everyone, especially the railroads: simply make *all* pay the highest rate. Once again the railroads had managed to translate the obvious need for securities law and anti-trust reform[67] into railroad protection legislation.

Regulation left the railroads unprepared to compete with an unregulated motor carrier industry.[68] Indeed, the competitive advantage of an unregulated motor carrier industry was an important rationale for regulating motor carriers in 1935.[69] Motor carrier competition and subsidies,

---

car and private car lines. Notice of rate charges was extended to 30 days from 10 days; it provided specific fines for rebating; and provided for a two year prison term for violations. Most important was Section 15, which provided that, upon complaint of a shipper or railroad, the ICC could determine "just and reasonable rates." *See* G. KOLKO, *supra* note 53, at 144-45. The Progressives in the 1912 campaign portrayed the act as victory over the Railroads. Frank Dixon wrote in 1922: "It was in 1906 that the railroads fought their fight to the finish against federal regulation." F. DIXON, RAILROADS AND GOVERNMENT 1910-1921, at 3 (1922). Such a portrayal was, of course, entirely satisfactory to the Railroads, since they realized that such a portrayal was politically necessary for passage. *See supra* note 58.

66. *See* G. KOLKO, *supra* note 53, at 139 (quoting N.Y. Press, Mar. 16, 1906). Rail Magnate Cassatt stated in 1906: "Let the Government regulate us. For my part and for my associates in the Pennsylvania Railroad Company, I am generally heartily in accord with the position taken by President Roosevelt, and we have been all along." Creelman, *supra* note 63, at 551-52. The *Railway World* stated in 1906: "[N]ot withstanding the fears of many that railroads would be hurt by the operation of the law, no complaint has been heard from railroad men against its general provisions. On the contrary, the complaints are coming from the shippers, who were supposed to be the chief beneficiaries of the law." G. KOLKO, supra note 53, at 150 (quoting RAILWAY WORLD, Aug. 24, 1906, at 729).

67. See Harris, *supra* note 1.

68. A study by Clifford Winston reveals that despite rail's cost advantage over motor freight, it has been prevented from pursuing this advantage by regulation. Winston, *The Welfare Effects of ICC Rate Regulation Revisited*, 12 BELL J. ECON. & MGMT. SCI. 232, 233 (1981). Rail rate regulation affected the railroads in competing with exempt motor carriers. Since truckers could vary their rates to accommodate swiftly changing market conditions but railroads could not, the result was devastating for the railroads. *See* Thoms, *supra* note 58, at 194.

69. Nelson and Greiner, while acknowledging the pressures for motor carrier regulation brought by certain shippers, have observed that: "Control of truck competition through regulation may have held out the prospect of helping the railroads . . . ." A. FRIEDLAENDER, *supra* note 1, at 22. E. Anderson has summarized the logic of the legislative history of the Motor Carrier Act of 1935 as follows:

(1) railroads are regulated by the Interstate Commerce Commission;
(2) motor carriers are competing with railroads; therefore,
(3) motor carriers should be regulated by the Interstate Commerce Commission.

Anderson, *supra* note 19, at 28.

and the iron hand of the ICC, finished the job begun by the early regulators. By the 1970's, the railroads were in a state of virtual collapse. A 1974 White House Paper on Regulatory Reform concluded: "Railroading is a troubled industry. Virtually every American suffers some consequence of the industry's afflictions."[70] The study also found that half of all rail track was unfit for high speed operations, and that train speed limits of ten to twenty miles an hour were not uncommon. Accidents and derailments doubled from 1967-1974. A typical freight car moved only twenty three days a month.[71] The report also found that "cumbersome regulatory procedures impede responses to competition and changes in market conditions and at times result in traffic being handled at noncompensatory rates. Those procedures also have created a serious impediment to needed restructuring."[72]

Professor Thoms has mused that Washingtonians like to boast about their three great museums: the Smithsonian, the National Archives and the ICC.[73] According to Professor Thoms, by 1970 the effect of the latter's "utility-type regulation upon the railroads had been amply documented. The industry everywhere was in decline, with higher fixed costs leading to a rate of return much lower than the cost of capital. Some railroads had disappeared, others were seeking salvation through merger with parallel lines . . . ."[74] To make matters worse, although "[t]here had been some savings in labor costs through dieselization and consolidation of trains, . . . increased labor costs were still passed on to the public in general rate increases,"[75] further eroding the railroads' competitive position.

But by the mid-1970's, the American public had had their fill of railroad regulation. The critics, who had for so long warned against the ICC's capture by the industry it was supposed to regulate, were finally being believed.[76] An article in *Trains* echoed the popular sentiment: "The ICC must go!"[77] The stage was set for the nearest thing to a popular uprising since 1776: the first steps toward freeing the railroads (as well as other transportation industry modes) from the stranglehold of regulation.[78] It was perhaps fitting that it occurred during the 200th anniver-

70. Task Force on Railroad Productivity, *Introduction to the Problem*, in RAILROAD REVITALIZATION AND REGULATORY REFORM 3 (P. MacAvoy & J. Snow eds. 1977) [hereinafter cited as RAILROAD REVITALIZATION].

71. *Id.* at 64-65.

72. *Id.* at 65.

73. Thoms, *supra* note 58, at 190.

74. *Id.* at 195 (footnote omitted).

75. *Id.*

76. *See generally Winston, supra* note 68, at 232-33.

77. Hilton, *What Went Wrong and What to Do About It*, TRAINS, Jan. 1967, at 37.

78. Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat.

sary of that earlier revolution.

B. *Economics of Railroad Regulation: The Cry for Reform*

The speedy political origins of regulation might be irrelevant were it not for the tragic economic results. The irony of course is that, in the long run, the regulation which resulted from the railroad's quest for oligopoly profits inured to the detriment not only of the public, but of the railroads. It has been noted that after ninety three years of regulation, the number of railroads declined from 1564 in 1907 to seven major carriers (carrying eighty five percent of the traffic) in 1980. Service deteriorated, profits slumped, and bankruptcies were endemic. Regulation had reduced a proud, robust industry on the forefront of the industrial revolution to a lumbering, whimpering giant: a sad legacy from the regulators and a mockery indeed of the "public interest." But perhaps most sad is the fact that the results may be irreversible. High barriers[79] to entry prevent a quick return to the days of competition; the nation is now saddled with what may be a permanent oligopoly. Thus, unlike the airline industry, steps towards railroad deregulation have been more tentative[80] to allow a more gradual rise of the phoenix. Even those on the forefront of deregulation recognize that going "cold turkey" may not have the desired effect on a ninety three year old regulation addict.

The rationale for early regulation was "discriminatory pricing."[81] It is true that the Interstate Commerce Act initially caused a reduction in price discrimination—"in large part to facilitate increases in the general rate level and to make cheating on the cartel agreement more costly."[82] Arguments in favor of reducing price discrimination were seductive.[83] In the long-run, however, they put the railroads at a competitive disadvantage from which they have not yet recovered.[84]

---

31 (codified in scattered sections of 45, 49 U.S.C.). De facto deregulation of airlines is generally considered to have begun in 1976. *See supra* note 2.

79. Stephen Breyer has noted that "[v]irtually every form of classical regulation tends to *raise barriers to entry* into the regulated industry. Cost-of-service ratemaking is almost always accompanied by rules or laws that require a commission to allow new firms to enter the industry only if it serves the 'public convenience and necessity.' " S. BREYER, *supra* note 30, at 194 (emphasis in original).

80. *See* Thoms, *supra* note 58, at 212: "What emerged, of course, was compromise. Reregulation rather than deregulation was the order of the day. It was hardly a consumer bill—it was addressed to the real problem of flagging rail revenues." *Id.* (footnote omitted). *See also* Birkholz, *The Staggers Act of 1980, Deregulation and Regulation: A Railroad Perspective*, 17 FORUM 850 (1982); Abrams, *Railroads and Deregulation*, 17 FORUM 844, 844 (1982) ("Let's begin by remembering that the ICC still regulates some rates . . . .")

81. Harris, *supra* note 1, at 4.

82. Jordan, *supra* note 17, at 168.

83. See S. REP. NO. 46, 49th Cong., 1st Sess. (1886); *see also supra* note 61.

84. A. FRIEDLAENDER, *supra* note 1, at 63. As Friedlaender has pointed out:

A 1968 Presidential Task Force On Anti-Trust Policy stated that "price discrimination has an adverse effect on competition only in exceptional cases"[85] and that in some cases "price discrimination improves the functioning of the competitive system."[86] A 1969 Presidential Task Force on Productivity and Competition found that price-cutting, even in oligopolistic industries, led to general price reductions and thus benefited competition.[87] It is now apparent that the price-discrimination provisions in the railroad regulatory legislation were primarily protectionist in scope and not for promotion of the general welfare.[88]

But if the intent of regulation was really to prevent rate discrimination, it sorely missed the mark. While eliminating price discrimination that would have increased efficiency, the "enactment of the 1903, 1906, and 1910 laws . . . combined with the ICC's frequent suspension of the provisions of Section 4 [of the Interstate Commerce Act of 1887] resulted in a resurgence of locational discrimination."[89] It has been observed that "over 100 years of development have resulted in a marvel of complicated discriminatory pricing."[90] In fact, in 1970, it was reported that there were

---

> Price discrimination is probably a necessary aspect of the transportation industry. Different shippers have different elasticities of demand and are faced with different marginal costs for their shipments. Railroads have large fixed costs relative to their variable and marginal costs. As long as substantial excess capacity prevails, the optimal use of capacity requires price discrimination.
>
> The marginal shipper with a high elasticity of demand can be accommodated at close to marginal cost, while captive shippers with a low elasticity of demand can be used to cover the overhead and charged rates considerably above costs. Without price discrimination all shippers would be charged the same rate and less traffic would move. Thus price discrimination enables the railroads (or other modes) to capture the consumers' surplus of the low-elasticity shipper to enable them to carry the goods of the high-elasticity shipper. So long as the railroads are operating in the falling or constant portions of their cost curves, this leads to the maximum use of resources and thus is socially desirable . . . .

Id. at 63-64.

85. WHITE HOUSE TASK FORCE ON ANTITRUST POLICY, ANTITRUST & TRADE REGULATION REPORT [NEAL REPORT] 3 (1968).

86. *Id.* at 10.

87. TASK FORCE ON PRODUCTIVITY AND COMPETITION, REPORT OF STIGLER TASK FORCE TO PRESIDENT NIXON (1969), *reprinted in Price Discrimination Legislation, 1969: Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Comm. on the Judiciary*, 91st Cong., 1st Sess. 5 (1970).

88. Weston, *Rail-Barge Competition and Predatory Pricing: A Legal Prespective*, in RAILROAD REVITALIZATION, *supra* note 70, at 147.

89. Jordan, *supra* note 17, at 168.

90. *Id.* The pricing is no less discriminatory and nightmarish in the trucking industry. Discrimination by class is incredibly complex. As Breyer explains:

> The "class rate" lies at the heart of the system. The National Motor Freight Classification assigns approximately 25,000 commodities to 23 classes. The standards used for classifying include both cost- and demand-related factors. Each class is given an index number from 35 to 500, with 100 as the reference point. This number gives the class a constant relationship to all other classes. A tariff also develops a series of "rate-basis numbers"—basically a mileage scale occasionally modified to reflect spe-

over 43 *trillion* railroad rates on file with the ICC.[91]

The complaints of a mounting chorus of economists[92] and public leaders[93] went largely unheeded until the mid-70's, when many railroad firms made it clear that the likely alternative to regulatory reform was massive government subsidy.[94] Levine has observed:

> As scholars examined the record of regulated industries, they found prices which were too high or too low, distorted allocations, mercantile protection, suppression of innovation, extension of regulation beyond the bounds of any known market failure, and protection of entrenched interests, corporate or geographic, from any change at all costs.[95]

Economists have long argued against the ICC's use of "Value of Service" pricing.[96] The basic economic rationale of regulation is to keep price at marginal cost or at least average cost.[97] On the whole, however,

---

cial transportation characteristics such as mountainous terrain. A Shipper looks up a rate on a tariff table. He determines the class-rating number from the commodity classification table and the rate-basis number from a list of origin and destination points. He then refers to a table, or "class tariff," which has class ratings on one axis and rate-basis numbers on the others. The cell that he locates will have the rate in cents per hundredweight (it may have several rates, for different weight categories).

S. BREYER, supra note 30, at 231.

91. 2 I. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 26 (1970).

92. *See generally* Levine, *Revisionism Revised? Airline Deregulation and the Public Interest*, LAW & CONTEMP. PROBS. Winter 1981, at 179, 179 n.2.

93. *See, e.g.*, A. FRIEDLANDER, *supra* note 1; RAILROAD REVITALIZATION, *supra* note 70.

94. *See* Levin, *supra* note 17.

95. Levine, *supra* note 91, at 179.

96. *See* RAILROAD REVITALIZATION, *supra* note 70, at 14. *See also* 1 I. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS (1970):

> The basic defeat of full cost distributions as the basis for pricing is, then, that they ignore the pervasive discrepancies between marginal and average cost. Those discrepancies may require prices that take into account not just the cost but also the elasticities of demand of the various categories of service if the company is to recover its total costs. Whenever there is some separable portion of the demand sufficiently elastic that a rate below fully-distributed costs for it would add more to total revenue than to total costs, any insistence that each service or group of patrons pay their fully allocated costs would be self-defeating. It would force the firm to charge a price that would result in its turning away business that would have covered its marginal costs—in other words, would prevent it from obtaining from customers with an elastic demand the maximum possible contribution to overheads. Thus, under the guise of ensuring a fair distribution of common costs and preventing undue discrimination, it would be serving the interests neither of the patrons who would be prepared to take additional quantities if prices were closer to marginal costs, nor of the customers with the more inelastic demands.

Id. at 155.

97. Samuelson explains that if an industry is to be regulated in order to wipe out its "excess profits," regulators should force the price to where it equals average cost [AC], "and price covers only normal costs." P. SAMUELSON, *supra* note 24, at 479. However, Samuelson advocates that: "Ideally, P[rice] should be forced all the way down to MC [marginal cost] . . . ." *Id.* The latter solution, however, usually requires a government subsidy since "with a decreasing cost situation . . . setting P=MC while AC is still falling will involve [t]he firm in a chronic loss." *Id.* In summary:

> Monopolistic deviation from P = MC means "exploitation" of labor (and other transfer-

regulated railroad rates have been kept artificially pegged above marginal costs[98]—precisely the effect regulation was supposed to avoid. Thus, economists have long advocated the use of "variable cost" pricing.[99] When federal regulation was first enforced in 1887, it rested on the assumption of decreasing costs.[100] Economists have recognized, however, that "costs were in fact not decreasing."[101] Unfortunately, what was obvious to the economists was not so to the regulators who experienced political and interest group pressures. Economists had long realized that "[v]alue of service pricing leads to misallocation of transport resources, misplaced locational decisions, and distortion of the entire structure of production and of consumption. The regulatory process itself tends to encourage excess capacity and stifle initiative."[102] The literature is rich with economic analyses critical of regulation. The economic case against regulation may be summarized as follows:

1. *Traffic Misallocation*: Under regulation, many shipments did not go by the low-cost carrier. In the absence of rate competition, trucking attracted much traffic that could go

---

able resources), in the sense that society's labor is misapplied as between goods and leisure or as between too-scarce monopolized goods in relation to too-plentiful competitive goods.

Id. at 480.

The problem, of course, is that economics is at best an inexact science, and even the best-intentioned regulators can not hope to fathom the various costs, marginal costs, and average costs of an industry, and even if they could, estimates of "a 'proper' rate of return carried out to one or two decimal places are unlikely to be worth the effort expended." S. BREYER, *supra* note 30, at 59. As Breyer explains:

> The standard to which such efforts implicitly appeal is that of overcoming "distortions" produced by competitive market failure—the standard of trying to replicate what would occur without such a failure. Yet in trying to overcome such failures the regulatory process introduces so many distortions of its own, that one should be satisfied with gross estimates and not insist upon refined economic calculations. Second, insofar as cost-of-service ratemaking is advocated as a "cure" for market failure, one must believe that the unregulated market is functioning quite badly to warrant the introduction of classical regulation. That is to say, the regulatory process—even when it functions perfectly—cannot reproduce the price signals that a workably competitive marketplace would provide. Thus, only serious market failure will, even arguably, warrant the adoption of cost-of-service ratemaking as a cure.

Id. The irony, of course, is that so much expense and energy is expended by regulators to accomplish so imperfectly what is achieved virtually automatically by a free economy.

98. Sobotka & Domenrich, *Cost Standards for Rail Pricing*, in RAILROAD REVITALIZATION, *supra* note 70, at 105.

99. *Id.* While "variable cost" pricing may be better than value of service pricing, the fact remains that any external and coercive price mechanism related to costs will result in stifling incentives for cost reduction. As long as obtaining regulated rate hikes provides the path of least resistance, there will be no incentive for fighting intrinsic lost battles, since they are not necessary for survival. *Id.* at 108.

100. Spann & Erickson, *The Economics of Railroading: The Beginning of Cartelization and Regulation*, 1 BELL J. ECON. & MGMT. SCI. 227, 230 (1970).

101. *Id.*

102. A. FRIEDLAENDER, *supra* note 1, at 99.

cheaper by rail. By 1969, the cost to society of such resource misallocation resulted in an annual cost of a half billion dollars.[103]

2. *Excess Capacity*: The ICC refusal to permit rates that reflected higher costs of irregular route and peak demand service, combined with the regular emphasis on "fair return on fair value," encouraged wasteful and destructive overcapacity.[104]
3. *Reduced Incentives for Technological Change and Innova-*

---

103. A. FRIEDLAENDER, *supra* note 1, at 98. As Friedlaender explains:

> What then are the costs of the present regulatory policies? First is the misallocation of traffic resulting from the continuance of value-of-service pricing. Since railroads and trucks cannot compete for high-density traffic by cutting rates, an area in which railroads have the advantage, competition is concentrated on the service sphere, an area in which trucks have the advantage. Thus a considerable amount of high-density traffic goes by truck that could in fact go more cheaply by rail. Moreover, the use of uniform rate schedules prevents trucks from capturing a good deal of the low-density traffic that currently goes by rail. Because of this lack of rate competition, rates are higher than they would be in a competitive situation. The direct social losses resulting from this misallocation may run about $500 million per year.

Id. Professor Breyer puts the case somewhat differently:

> In a competitive industry, firms are motivated to produce efficiently—to find ways to cut production costs—by the hope of increased profits and by the fear that failure to keep costs low will cause more efficient firms to capture their customers by lowering price. In a regulated industry, the stick is usually unavailable. The carrot has diminished influence, for, if ratemaking is based upon actual costs and is performed accurately and promptly, firms do not benefit by adopting cost-saving devices; the total saving produced by increased efficiency flows to the consumer.

S. BREYER, *supra* note 30, at 47.

104. In an unregulated industry, a firm's insistence on costly excess capacity could be ruinous, and that firm would fail in the face of a competitor able to cut costs by reducing excess capacity. In a regulated industry, however, where firms do not have the option of open price competition, competition must be for service, i.e., providing transport even during peak periods (which of course means substantial over capacity in off-peak periods). Thus, whether a shipper wants to pay extra for the slightly greater convenience or not, he has to pay for it. Since a regulated firm can always get a rate hike based on costs (even costs of excess capacity), there is no incentive to cut down on excess capacity. Nor need a regulated firm fear a price reduction by a competing firm since: a) the competing firm's price can be challenged in a long expensive hearing, and b) the competitor has the same incentives for passing on the costs of excess capacity in the form of rate hikes. The MacAvoy Study found in 1974:

> In some parts of the country, there now is capacity to provide more rail service than is demanded at current rates. In this case, the elements that constitute variable costs are less inclusive than when additional capacity is demanded, because only those cost elements which are dependent on the volume of service are included. The reason for this is that variable costs must include only those elements which are required to provide, on a continuing basis, the demanded services. Since the level of service demanded falls short of the available capacity, no funds are required to expand or even, in the long run, to maintain the existing facilities. Indeed, it is desirable that the capacity shrink so that the resources can be redeployed. If monies are not provided for the replacement of fixed assets, there will be a gradual shrinkage of capacity to the level demanded.

Snow, *The Ford Administration's Proposal for Rail Regulatory Reform*, in RAILROAD REVITALIZATION, *supra* note 70, at 78.

tion: "Since legalism rather than competition has been used to protect the public interest with regard to the railroads, little premium is placed on entrepreneurial aggressiveness and competitiveness."[105]

4. *Reduced Incentives for Effective Management*: Railroad management is usually made up of lawyers or bankers rather than engineers or scientists. An executive who can write a good tariff or get along better with regulatory authorities will rise faster than a good manager or innovator.[106]

The large amount of excess capacity existing in the transport industries is due to regulation. The concept of the common carrier has doubtless encouraged capacity expansion in the transport industry. Common carriers have a responsibility to the public to provide adequate transportation services; they must be available to carry goods to and from isolated locations; they must have sufficient capacity to meet the peak demands. These requirements would not necessarily lead to excessive capacity expansion if the carriers were permitted to charge rates that reflected the higher costs associated with irregular route or peak demand service. However, rate differentials of this type have traditionally been forbidden by the Commission. Since rationing the facilities through the price mechanism has been precluded, the carriers have found it profitable to maintain sufficient capacity to handle all irregular demands without prohibitive increases in costs.

A. FRIEDLAENDER, *supra* note 1, at 78-79.

105. A. FRIEDLAENDER, *supra* note 1, at 92.

That the railroads spend relatively little on R&D and thus on potential innovations is clear . . . . All the available evidence suggests that the railroads have been particularly slow in adopting available innovations. For example, it took about 15 years for the diesel locomotive, 25 years for the mikado locomotive, 20 years for the four-wheel trucking locomotive, 25 years for centralized traffic control, and 30 years for retarders to be generally accepted.

. . . .

[T]he rate of innovation in the railroad industry has been stifled by the regulatory process.

. . . .

Moreover, even when railroad management wanted to exercise entrepreneurial initiative with regard to innovations, the Commission has often blocked the way. The experience of the Southern Railway System with its Big John cars provides a good case in point.

During the latter half of the 1950s, grain shipments to the southeastern portions of the United States rose from 3.6 million tons to 10 million tons . . . . The railroads did not share in this growing market, which was largely captured by barges . . . or by truck . . . . Because the ICC does not generally permit major rate reductions without proof of concomitant cost reductions, the Southern Railway developed the large, lightweight, aluminum Big John cars in an effort to regain its share of this market. Each car is divided into four compartments and is easy to load and unload and to clean and maintain; its capacity of 110 tons is twice that of a traditional boxcar, while its weight is 13 tons less. Confident of the success of the cars, the Southern invested $14 million in them.

On August 10, 1961, the Southern announced that it was cutting rates up to 60 percent for minimum five-car shipments of 450 tons, with 90 tons to a car . . . . The economies that permitted these reductions were due to heavier loads per car, multiple-car shipments, and greater utilization, in which each Big John car was expected to travel up to 60,000 miles a year compared to the annual mileage of 16,425 miles for a typical boxcar. These rates were immediately challenged and suspended.

Id. at 91-93 (footnote omitted).

106. *Id.* at 92.

5. *Reduced Incentive for Cutting Costs*: Since costs were considered in general rate increases, there was little incentive to cut costs or resist labor demands. It was far easier to request a rate increase. As Professor Thoms has noted: "[I]ncreased labor costs were . . . passed on to the public in general rate increases."[107] In addition, regulation impedes the divestiture of wasteful, inefficient operations.[108]
6. *Uncompetitive Rates Due to Imposed Tariffs*: The requirements of long cumbersome hearings for rate changes and reductions, the inability to adjust to market conditions, and the ease with which inefficiency is translated into high rates, account for rates which are up to nine to fifty percent higher than without regulation.[109]
7. *Reduced Incentives for Increasing Revenues*: Regulations impede any revenue raising innovations which might adversely affect other carriers (such as soliciting business or adjusting rates on short notice to accommodate seasonal or cyclical demands).[110] Railroads were also prohibited from diversifying into other forms of transportation.[111]
8. *Lack of Capital Investment Incentives*: With regulation dooming the railroads to low return on investment there was little incentive to invest funds necessary to modernize the industry.[112]
9. *Deterioration of Passenger Service*: Encumbered by regulation, passenger service deteriorated. Thoms noted that "[w]ith the exception of the heavily travelled Boston-Washington Corridor, service levels on American passenger

---

107. Thoms, *supra* note 58, at 195.

108. RAILROAD REVITALIZATION, *supra* note 70, at 86-91.

109. *Id.* at 92.

110. In President Kennedy's 1962 Transportation Message, he emphasized "the inability of carriers to make full use of their capacity by soliciting business or adjusting rates if such action would adversely affect other carriers." A. FRIEDLAENDER, *supra* note 1, at vii.

111. Thoms, *supra* note 58, at 196.

112. The ICC determined in 1978 that a return of 10.6% was needed just to cover capital costs. Adequacy of Railroad Revenue (1978 Determination), 361 I.C.C. 79 (1978). This figure was later increased to 11.22%. Adequacy of Railroad Revenue (1980 Determination), 364 I.C.C. 311 (1980). In 1978 the average rate of return was about 1%! *Hearings on H.R. 4570 Before the Subcomm. on Transportation and Commerce of the House Comm. on Interstate and Foreign Commerce*, 96th Cong. 1st Sess. 5 (1979) (statement of William H. Dempsey, President of the Association of American Railroads).

Obviously no astute investor will invest money at 1% when he can get 10% at the local savings & loan. Since one of the original rationales of railroad regulation was to prevent "monopoly profits," one wonders about a regulatory system that resulted in a return of 1%. If the road to Hell is paved with good intentions, the regulations should have a lot of pavement.

> trains are the worst in the world."[113] Often the deterioration was the result of purposely downgrading service in order to obtain regulatory concessions.[114]

If the above list is incomplete, it is only because the inefficiencies of regulation have so thoroughly pervaded the economic fabric of society.

The earliest efforts at reform,[115] such as the Rail Passenger Service Act of 1970,[116] have been characterized as railroad "euthanasia scheme[s]."[117] It was not until the Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act)[118] that any significant regulatory relief was given to the railroads. This Act, while not changing the basic regulating scheme, nevertheless allowed the railroads some flexibility to raise and reduce rates, imposed restrictions on the ICC's power to suspend rate changes, relaxed time limits for ICC action, and adopted an intrastate rate-making provision.[119] Finally, it introduced the concepts of "market dominance"[120] and "demand sensitive pricing."[121]

---

113. Thoms, *supra* note 58, at 196.

114. *Id.* at 197.

115. *See generally* Thoms, *supra* note 58, at 198 n.70.

116. Pub. L. No. 91-518, 84 Stat. 1327 (codified as amended in scattered sections of 45, 49 U.S.C.).

117. Thoms, *supra* note 58, at 198.

118. Pub. L. No. 94-210, § 205, 90 Stat. 31, 41 (current version at 49 U.S.C. § 15a (1982)).

119. *See* Note, *The Staggers Rail Act of 1980: Authority to Compete with Ability to Compete*, 12 TRANSP. L.J. 302, 305-07 (1982).

120. The Act purports to restrain rate flexibility where the railroad has "market dominance." In light of the severe financial plight of the railroads, one wonders why even this restriction should apply. If the railroads can improve on their one parent return as capital in a market in which they are dominant, more power to them. As it turns out, however, "market dominance" for the railroads is almost totally illusory. As Jones noted:

> The railroad's erstwhile dominant position in most transportation markets has been severely eroded. There is virtually no remaining market in which a railroad does not now face intermodal competition or in which such competition would not be promptly forthcoming in response to a railroad rate increase. Some of this competition comes from wholly unregulated carriers able to enter and leave markets at will and able to raise and lower prices in a matter of minutes in response to a competitor's action. The data also show that a wide range of options are open to shippers and consignees faced with railroad rate increases and that these options (seeking new markets or plant locations, changing inventory practices, and so forth) have been taken in the past in response to railroad rate increases.

Jones, *The Meaning of Market Dominance*, in RAILROAD REVITALIZATION, *supra* note 70, at 209. Jones concludes:

> Rail carriers no longer enjoy the dominant role they once played in the national transportation system . . . intermodal competition pervades the transportation markets in which railroads participate. It is clear that exceptions to the competitive norm are less a consequence of technological or cost considerations than they are the result of past regulatory decisions by the ICC regarding the entry of new firms into transportation markets. . . . Even in those instances where railroads enjoy a large share of a transportation market, they can no longer be complacent in the assurance that competition will not appear and erode their position. Potential competition from common carriers in other modes and from unregulated carriage faces the railroads in all markets. . . . As

The Staggers Rail Act of 1980[122] further relaxed the regulatory reins. Among other provisions, the Act reduced certificate requirements for new line construction and eased exit and entry requirements.[123] Also important were provisions allowing greater rate flexibility. Rate increases can become effective upon twenty days notice, with ten days notice required of decreases.[124] Perhaps the most significant development was that railroads were relieved from the burden of subsidizing some freight with revenue from other traffic.[125] Equally important, the railroads were finally permitted to enter into contracts with shippers,[126] enabling them to obtain long-term commitments and revenues.

Neither the 4R Act nor the Staggers Act deregulated the railroad industry. Railroad lawyers must still battle the ICC and each other in lengthy, cumbersome battles over what is a "fair" rate. But the reins have been loosened and the railroads now have some freedom to regain financial stability. The railroads will have to wait several more years for results, unlike the airline industry where the tangible benefits of a more complete process of deregulation are now being felt. While deregulation initiatives have been predictably modest, so have the results. But even now the outlook is more promising. As one scholar has recently observed since passage of the Staggers Act: "[F]or the time being railroads are doing relatively well financially. And the railroads probably couldn't do any worse under the Staggers Act and partial deregulation than they

---

a consequence, rail market dominance can be considered the exception rather than the rule in virtually every market.

Id. at 223.

121. 49 U.S.C. § 10727 (1982). One student scholar has opined:

> Demand sensitive pricing was premised on the assumption that transportation costs would be a primary factor in determining when grain would be shipped. However, that assumption was incorrect. Had Congress examined motor carrier price fluctuations, it would have realized the ineffectiveness of demand sensitive pricing. More importantly, the remedy did not address the underlying problem of competition with exempt motor carriers. During slack demand, grain transportation was provided by exempt motor carriers who effectively priced against the rail rate.

Note, *supra* note 119, at 306.

122. Pub. L. No. 96-448, 94 Stat. 1895 (current version at 49 U.S.C. § 10101a (1982)).

123. *Id.* § 10901(a). *See generally* discussion in Note, *supra* note 119, at 308-10.

124. 49 U.S.C. § 10762(c)(3).

125. The notion that railroads should be forced to subsidize some freight with revenue from other traffic was a favorite of the regulators. Although always based on a myopic view of the "public interest," it was based on a common fallacy. The results, of course, were predictable: railroad rates were uncompetitive where the rates were too high, thus causing a loss of business and revenues. Where the rates were subsidized and too low, the railroads had a tremendous incentive to abandon the route. For a study of the tragedy of these abandonments, *see* RAILROAD REVITALIZATION, *supra* note 70, at 86. As always, a policy by regulators to promote the "public interest" instead makes a mockery of it.

126. 49 U.S.C. § 10713. Even before enactment of this provision, the ICC had reviewed its administrative policy against contract rates. *See* Change of Policy, R.R. Contract Rates, 361 I.C.C. 205 (1979).

did when every rate and schedule was subject to ICC scrutiny."[127]

IV. Motor Carrier Regulation: The Wrong War at the Wrong Time

The motor carrier industry superbly illustrates how regulation accomplishes the political transfer of wealth.[128] The experience of trucking regulation also provides a striking example of the economic and social harm which results when classical regulation is imposed on a competitive industry.[129] Unlike the railroad industry, where relatively high barriers to entry and industry concentration could be used to rationalize regulation, the trucking industry was an industry closely approaching true competition.[130] At the time of the passage of the Motor Carrier Act of 1935,[131] only 18,000[132] out of 90,000[133] motor carrier "grandfather" applications were granted. Entry control was further tightened, until by 1977 the number had been reduced to but 15,000.[134] Regulation had done its work well. Even this latter figure is misleading, for under regulation, there had been tremendous concentration in the industry. In 1972 the top eight firms had seventeen percent of the trucking business, and a quarter of all income.[135]

The railroads, of course, wholeheartedly supported regulation of the

127. Thoms, *supra* note 58, at 218.

128. Peltzman, *supra* note 17, at 215.

129. See Allen & Hymson, *The Costs and Benefits of Surface Transport Regulation: Another View*, in Regulation of Entry and Pricing in Truck Transportation 93 (P. MacAvoy & J. Snow eds. 1977) [hereinafter cited as Ford Papers]. The study concludes that "the vast majority of economists who have looked at this issue have concluded that the net social cost of ICC regulation is truly substantial." *Id.* at 115. Professor Thomas G. Moore's estimates of ICC regulation, which showed an economic loss of between $6.5 billion and $15.2 billion, were critically examined by the ICC Bureau of Economics. The Bureau also estimated the social costs at no more than $1.7 billion. Bureau of Economics, ICC, *A Cost and Benefit Evaluation of Surface Transport Regulation*, in Ford Papers, *supra*, at 47. *See also* Winston, *The Welfare Effects of ICC Rate Regulation Revisited*, 12 Bell. J. Econ. & Mgmt. Sci. 232 (1981); Davis, *Surface Transportation Regulation—A Succinct Analysis*, I.C.C. Prac. J. 55, 62 (1979) (estimating costs of regulation in terms of resource misallocation as three billion dollars annually).

130. *See* Report of the Federal Coordinator of Transportation, app. I (1933); Report of the Federal Coordinator of Transportation, H.R. Doc. No. 89, 74th Cong., 1st Sess. 113-17, 119-20, 122-28 (1934), *reprinted in* Pierce, Economic Regulation: Energy, Transportation and Utilities 892 (1980) [hereinafter cited as Report].

131. 49 U.S.C. §§ 301-327 (1982).

132. Snow, *The Problem of Motor Carrier Regulation and the Ford Administration's Proposal for Reform*, in Ford Papers, *supra* note 129, at 19. *But see Intercity Domestic Transportation System for Passengers & Freight, 1977: Hearing before Senate Comm. on Commerce*, 95th Cong., 1st Sess. 73 (1977) (28,000 carriers received grandfather authority in 1935).

133. A. Friedlaender, *supra* note 1, at 112.

134. *Snow*, supra note 132, at 19.

135. *Id.* at 20.

motor carriers.[136] The ICC welcomed this support, finding that intermodal competition between the rail and motor carrier industries was being "conducted under conditions of inequality, particularly in regard to regulation."[137] It apparently did not occur to the railroads and the ICC to simply loosen the regulatory stranglehold on rail. Rather, it was assumed that if the railroads had to suffer the incubus of regulation, the imposition of equal burdens on motor carriers would make intermodal competition more "fair."

Before regulation could begin, a rationale had to be found. Although the "natural monopoly" rationale obviously didn't apply in an industry where 90,000 carriers were clamoring for admittance, an early attempt was made to put forward this argument. Even the ICC had trouble swallowing this.[138]

One 1934 study made the following observation:

> There are thousands of little operators, with a very few trucks or even a single truck . . . . As yet there are comparatively few well-organized, large scale operations, and these are small when judged by rail standards . . . . It has been and is easy to enter the business, especially on a contract or private business, and may require little expenditure elsewhere.[139]

Hardly a description from an Adam Smith handbook for a theoretical industry. This was the description of the actual state of trucking in 1934 by the same federal report which advocated regulation.

Obviously a rationale other than "monopoly regulation" had to be found in order to justify protectionism and entry control in the trucking industry. A rationale was finally found in what was euphemistically called "excess capacity."[140] A 1928 ICC report expressed concern over carri-

---

136. *See* Webb, *Legislative History of Entry Controls on Motor Carriers of Passengers*, 8 TRANSP. L.J. 91 (1976).

> In 1935 the railroads were fully regulated and were recognized to be a sick industry. Many argued it was unfair to burden the railroads with comprehensive regulation while turning the trucks loose to take the cream of their commerce and then expect them to offer comparable service. . . . It was obviously unfair to continue to regulate rail carriers without enacting a similar system of regulation for motor carriers of passengers.

Id. at 97.

137. Coordination of Motor Transp., 182 I.C.C. 263, 379 (1932).

138. Commissioner Woodlock's concurring opinion in Motor Bus and Motor Truck Operation, 140 I.C.C. 685 (1928) stated:

> Transportation by motor bus and motor truck does not necessarily depend upon monopolistic or semimonopolitic organization or performance. It is manifest that at the present time these services are much more largely of a competitive than of a monopolistic nature. For that reason the need for regulation, except in so far as concerns the public safety, is not wholly clear.

Id. at 750.

139. REPORT, *supra* note 130, at 893.

140. *Hearings on S. 1629, S. 1632, and S. 1635 before the Senate Comm. on Interstate Commerce*, 74th Cong., 1st Sess. 78 (1935). Commissioner Eastman stated: "The most important thing . . . is the prevention of an oversupply of transportation." *Id.*

ers which were cutting fares below compensatory levels and otherwise engaging in "reprehensible"[141] practices. (After all, what could be more "reprehensible" than *reducing* rates to consumers and shippers? The report never explained, however, how all these undercapitalized carriers managed to survive so long while charging fares "below compensatory levels.) What they meant, of course, as did all advocates of the "excess capacity" theory, was that the rates of these "reprehensible" firms were lower than that of many of their *competitors*. The regulators' solution was as predictable as it was simple: exclude by law all those whose rates were, in the ICC's opinion, "noncompensatory." Thus, what the market inexplicably failed to do through business failures, regulation could accomplish by fiat—or so theory went. The shippers were even condemned for "contributing" to the carriers' reprehensible acts. The 1937 *Report of the Federal Coordinator of Transportation* noted with obvious disgust that some shippers had "done little to discourage, and much to encourage, the cutting of rates," and, with apparent horror, noted that some had even "shopped around."[142] (Fortunately, consumers who "shopped around" were spared the immediate wrath of the report.)

Like the emperor's new clothes, most of the interest groups could not bring themselves to acknowledge the true motivation for deregulation: to control entry, and to eliminate competition for the benefit of those who, by political means, became one of the "elite"—those who would be permitted to enter the industry. Thus, those who had failed to successfully compete by economic efficiency were able to accomplish the same result by political means and the use of effective advocates before the ICC. There were a few, however, who saw the real purpose behind regulation of trucking. Congressman George Huddleston spoke for 115 members who voted against the Carrier Act: "The proponents of the bill admitted candidly that its main purpose was to give a monopoly, to eliminate competition."[143] Senator Wheeling stated: [I]t will prevent that competition that brings lower rates and better service to the people."[144]

These protests, and those of consumer advocates' were ignored, despite the numerous economic studies which revealed the inequities and inefficiencies wrought by regulation.[145] Meanwhile, those given entry privileges soon realized that their oligopoly rights had a tremendous windfall value. Indeed, the total value of operating "certificates" has been es-

141. *See* Motor Bus and Motor Truck Operation, *supra* note 137, at 702.

142. REPORT, *supra* note 130, at 893.

143. H.R. REP. NO. 783, 71st Cong., 2nd Sess. 16-17 (1930).

144. *Id.* at 96.

145. *See, e.g.*, Harper, *Entry Control and the Federal Motor Carrier Act of 1980*, 12 TRANSP. L.J. 51, 53 n.4 (1980) (listing various studies).

timated to be on the order of three to four billion dollars.[146] The windfall in certificate value reaped by those lucky enough to obtain oligopoly rights was at the expense of potential competitors who were denied entry, as well as at the expense of shippers and consumers.[147]

The American Trucking Association has noted that "virtually the only way for (a relatively small carrier) to obtain additional operating authorities is to buy them from other motor carriers."[148] Even more indicative of regulatory distortions of the market is the fact that amounts paid for operating authorities in 1972 were approximately fifteen to twenty percent of the annual revenues produced by those authorities, according to the ATA.[149] Predictably, however, those who reaped such windfalls used other arguments to support regulation. Exhaustive studies have now revealed the inaccuracy and the hypocrisy of the myths perpetuated to oppose regulatory reform: that it would (a) cause "market chaos"; (b) lead to "monopoly"; (c) cause price discrimination and "predatory pricing"; (d) decrease service to small communities; and (e) adversely impact railroads.[150]

It is often difficult to determine empirically what differences there would have been had there been no trucking regulation from 1935-1980. Fortunately, several controlled studies are available. During the 1950's, for example, fresh and frozen poultry were declared exempt under the Interstate Commerce Act. As a result, rates declined significantly more for fresh and frozen poultry than for frozen fruits and vegetables.[151]

A study of trucking rates in countries with little or no regulation showed rates there to be 43% lower than in regulated countries such as

---

146. Snow & Sobotka, *Certificate Values*, in FORD PAPERS, *supra* note 129, at 153.

147. As a 1976 study found:

> The best evidence of the widespread existence of market power caused by the ICC's restrictive entry policy is that operating rights have market value. They only have value because they have been artificially restricted. The value of rights consists of the capitalized value of the excess over normal competitive returns. . . Thus the policy operates to the detriment of the public and to the benefit of the original holders of these rights.

Snow, in FORD PAPERS, *supra* note 129, at 20.

148. *Id.* at 23. A good example of the injustice of the certificate system was seen in Shaffer Transp. Co. v. United States, 355 U.S. 83 (1957), discussed in C. FULDA, COMPETITION IN THE REGILATED INDUSTRIES: TRANSPORTATION 73-79 (1961). The W.A. Shaffer Co. sought a certificate, offering to provide faster and cheaper service between South Dakota and points east. The ICC refused to grant the certificate on grounds that even though present service was slow and expensive, it was "adequate." Six years later, the courts reversed the ICC, but by that time Shaffer had gone out of business.

149. American Trucking Ass'n, Brief and Petition, "Accounting for Motor Carrier Operating Rights," before the Financial Accounting Standards Board of the Financial Accounting Foundation, at 6 (July 14, 1972).

150. *Snow*, in FORD PAPERS, *supra* note 129, at 35-43.

151. *See* J. SNIZLER & R. BYRNES, INTERSTATE TRUCKING OF FRESH AND FROZEN POULTRY UNDER AGRICULTURAL EXEMPTION (1958).

the U.S. and West Germany.[152] A study by James Sloss showed that trucking rates in Canada were 9 to 12% lower in provinces without regulation than in provinces with regulation.[153] A recent study of Motor Carrier Deregulation in Florida, by Richard Beilock and James Freeman, revealed that most shippers felt that rates had been lowered due to deregulation of trucking in that state. As a result, only 10% of the shippers and private carriers preferred regulation. This finding was expected since both shippers and consumers had benefited from the rate reductions. The startling finding of the study, however, was that only 47% of the *carriers* preferred regulation. A large percentage of carriers felt they could operate just as well under deregulation as under regulation. Apparently for these shippers, the benefits of deregulation even outweighed the advantages of oligopoly rights.[154]

The explanation for the higher rates under regulation is now clear: "Because of restrictions on entry and other regulatory controls, they regulate as a cartel, exacting monopoly profits from shippers."[155] This is perhaps the supreme irony of regulation: a competitive industry has been transformed into a monopoly by the very regulation that was originally rationalized as a means of preventing monopoly. How can this be the case with thousands of carriers still operating? Even aside from the industry concentration in a few firms, the answer is simple: regulation permits all carriers to act in concert, to benefit and obtain oligopoly profits from a rate structure applicable to the industry as a whole rather than to a particular firm. The economic result is the same as if there were but one firm in the industry. It is not surprising, therefore, that operating oligopoly rights fetch such a high price, nor, as one scholar notes, that "the irrational nature of the regulatory scheme has spawned a vigorous illegal truck industry, able to maintain profitable operations against an inefficient and cartelized regulated truck industry."[156]

In short, regulation has been the means for a political transfer of wealth from consumers, shippers and non-union workers to a cartel and to certain privileged workers. Cartel gains went to the Teamsters; the rate structure of the ICC reinforces this result.[157] Professor Thoms has ob-

152. T. MOORE, TRUCKING REGULATION: LESSONS FROM EUROPE 141 (1976).

153. Sloss, *Regulation of Motor Freight Transportation: A Quantitative Evaluation of Policy*, 1 BELL J. ECON. & MGMT. SCI. 32 (1970). For an unbiased study, see Chow, *Economic Regulation of Motor Freight in Foreign Countries*, 47 I.C.C. PRAC. J. 44 (1979).

154. Beilock & Freeman, *Motor Carrier Regulation in Florida*, 14 GROWTH & CHANGE 30 (1983).

155. Jones, *supra* note 18, at 317.

156. *Id.*

157. As Moore explains:

> Management will be less unwilling to agree to higher wages knowing that the ICC will not only permit higher rates but enforce them on any nonunionized competition. More-

served that "unions . . . prefer an oligopolistic industry with excess profits which [can] be recaptured through collective bargaining."[158]

The fault, however, does not lie with the unions, which seek legitimate social redress for their workers and serve to counterbalance the power of the artificially created trucking cartel. The fault is with the *system* of regulation that, by granting rate increases, actually *rewards* a firm for its failure to hold down costs. A firm which *can* cut costs is punished by being forbidden from reaping a competitive advantage by lowering rates. This perversion of normal market incentives explains the staggering differences in efficiency in regulated and unregulated trucking industries. Since costs of individual firms differ, even the seductive notion of "equal pricing" has perversely caused true discriminatory pricing, since some shippers are charged more than the actual cost of the traffic, and some are charged less.

It is beyond the scope of this article to set forth all the harm and inefficiencies caused by trucking regulation; they may be summarized, however, as follows:

1. Rates which are too high,[159] irrational,[160] and discriminatory.[161]

---

over, regulation prevents new nonunionized firms from entering the industry and competing for the traffic carried by the unionized firms. Regulation therefore lowers the cost of agreeing to higher wages and *ceteris paribus*, thus should increase the wages earned by Teamsters. In particular, the ICC bases its rate regulation on the average operating ratio for a region of the country defined as the ratio of operating costs to total revenue. Rate increases for a region of the country can and must be justified by showing that, on average, operating ratios are above a given level. Thus an increase in Teamster wages usually triggers ICC approval of a rate increase.

Moore, *The Beneficiaries of Trucking Regulation*, 21 J.L. & ECON. 327, 331 (1978).

158. Thoms, *Rollin' On . . . To a Free Market: Motor Carrier Regulation 1935-1980*, 13 TRANSP. L.J. 43, 84 (1983).

159. *Snow*, in FORD PAPERS, *supra* note 129, at 8. "Rates are too high partly because unnecessary regulatory restrictions cause carriers to operate less efficiently than they would without the restrictions. Regulation causes carriers to use circuitous routes . . . ." *Id. See also* S. BREYER, *supra* note 30, at 234 ("certificates may limit the commodities that a carrier can transport between two points. This means that a truck must remain idle, rather than carry commodities for which it is not certificated.") (footnote omitted).

160. *Snow*, in FORD PAPERS, *supra* note 129, at 14.

> Because rates, especially class rates, are not tied to the actual costs of the service provided, rates are frequently irrational. . . . A study of rates in the Rocky Mountain region found that rates for a given commodity class are often higher for shorter distances than they are for longer distances in the same direction or even traveling over the same route. . . . [R]egulated rates are frequently irrational, capricious, and inconsistent because they are determined by regulation, not by competition. . . . [C]ompetitive discipline would force rates into a more consistent and rational pattern.

Id. at 14-15.

161. *Id.* at 15-18. "[I]n many cases the costs are not the same. When costs differ, the principle of equal rates results in actual discrimination. Some shippers are charged more than the cost of their traffic and some are charged less. The discrimination is irrequitable and it leads to economic inefficiencies". *Id.* at 15.

2. Social and economic inequitites.[162]
3. Inferior service to small communities.[163]
4. Waste and inefficiency.[164]

Reform, however, is being vigorously resisted by carriers, who see in deregulation the diminution in value of their inherited or purchased oligopoly rights. The result has been a compromise between those who favored deregulation as a means of improving efficiency and lowering rates for the consumer, and those opposed, fearful of losing protection and oligoply rights. Thus the Motor Carrier Act, while correcting many of the grossest regulatory abuses, nevertheless extended the basic regulatory scheme.

On the one hand, the Act shifted the burden of proof of "useful public purpose" from the applicant to a protestant,[165] allowed the issuance of new "master's certificates" in certain narrowly designated markets,[166] expanded the number of commodities exempt from regulation,[167] allowed carriers to give shippers credit for their own pickup without fear of being accused of "discriminatory pricing,"[168] created a ten percent "zone of reasonableness" in setting rates,[169] and curtailed "rate bureaus."[170] On

---

> Where rate distortions of this sort occur, shippers make adjustments which are often uneconomic . . . . For high valued, high rated items, it may in fact be cheaper to switch to the traditionally more expensive alternatives such as air freight . . . . Where these decisions are made simply because rates are distorted, and not for service reasons, shippers, motor common carriers, and ultimately consumers are needlessly harmed.

Id. at 18.

162. "The restrictions on entry into the regulated motor carrier industry inevitably result in gross inequities . . . . Persons who happened to be in the motor carrier business in the mid-1930s have been awarded, free of charge, valuable property rights . . . ." Id. at 23. Other individuals, no less capable, have been prevented from engaging in the business or occupation of their choice.

163. *Id.* at 27.

> The DOT has analyzed the rural service issue and has concluded that, far from providing a justification for the current restrictive regulatory policy, the present system has impaired rural motor carrier service. Rural towns would be much better served by a regulatory program which placed greater reliance on competitive market forces and which eliminated unnecessary and wasteful operating restrictions.

Id.

164. *See* A. FRIEDLAENDER, *supra* note 1, at 74-75. ("[T]he total welfare loss arising from value of service pricing can be estimated at approximately $300 to $400 million annually."). *See also* Jones, supra note 26:

> The nature of both the exemptions and the regulatory requirements has created a level of inefficiency condemned by numerous observers. The motor vehicle—which has as its major virtue an intrinsic capacity for flexibility—is locked into narrowly defined routes, carrying restricted commodities, and often operating empty or at less than full capacity.

Id. at 317 (footnotes omitted).

165. 49 U.S.C. § 10922(b)(1) (1982); Thoms, *supra* note 158, at 76.

166. Thoms, *supra* note 158, at 76.

167. *Id.* at 77; 49 U.S.C. § 10526(a) (1982).

168. Thoms, *supra* note 158, at 77; 49 U.S.C. § 10732 (1982).

169. Thoms, *supra* note 158, at 77; 49 U.S.C. § 10708(d) (1982).

the other hand, new applicants must still submit to a cumbersome hearing process before being allowed entry or the right to charge rates outside the ten percent "zone of reasonableness." Nevertheless, the Act is a step in the right direction, and it is probably only a matter of time before the interests of consumers and the public force a further loosening of the regulatory grip on what is potentially the most competitive mode of transportation.

V. AIRLINE DEREGULATION: CASE STUDY IN REFORM

A. UNFRIENDLY SKIES—"YE SHALL NOT ENTER HERE": HISTORICAL PERSPECTIVES ON AIRLINE REGULATION (1938-1976)

Under legal precedents established since the early days of railroad regulation, regulations became applicable in industries affecting the "public interests."[171] As long as airplanes were rickety, unreliable, gas-wheezing flying machines, they were not thought of in the context of the "public interest." As early as 1916, however, funds were appropriated for airmail service.[172] U.S. Mail Service came under Post Office control in 1918.[173] The Contract Air Mail Act of 1925 was the first major legislation affecting airlines.[174] Other legislation followed, further refining the air service system. An amendment to the Black-McKellan Act of 1934 removed responsibility for airmail contract rate setting to the ICC.[175]

The age of airline regulation began in earnest in 1938 with the Civil Aeronautics Act.[176] From the beginning, regulation was rigid. The Act gave the Civil Aeronautics Board (CAB) the power to control entry by allowing it to issue certificates of "public convenience or necessity," and suspending or establishing "just and reasonable" rates.[177] For the next forty years, the CAB wielded its power with a heavy hand: its chief accomplishment seems to have been preventing a single major trunk carrier into the industry during its reign. Professor Dempsey has observed: "[t]he excessively rigid regulatory scheme established by the Civil Aeronautics Board . . . between 1938 and 1975, allowed the creation of an effective oligopoly composed of the five largest trunk line carriers."[178]

---

170. Thoms, *supra* note 158, at 78; 49 U.S.C. § 10706 (1982).

171. P. BIEDERMAN, THE U.S. AIRLINE INDUSTRY 77 (1982).

172. *See* Morgan, *Government and the Industry's Early Development*, in HARVARD PROJECT, *supra* note 3, at 13.

173. *See id.*

174. *See id.* at 14.

175. Note, *Is Regulation Necessary? California Air Transportation and National Regulatory Policy*, 74 YALE L.J. 1416, 1417 (1965).

176. Ch. 601, 52 Stat. 973 (1938); *see generally* Dempsey, *supra* note 4, at 91.

177. *See* Dempsey, *supra* note 4, at 93.

178. Dempsey, *supra* note 2, at 2 n.1.

Between 1950 and 1974, seventy nine firms sought entry. Not *one* received it.[179] As Dempsey has noted: "As a result of these policies, the big four in 1938—United, American, Eastern, and Trans World Airlines—are the big four today."[180] This fact is even more startling when one realizes that the industry itself has expanded by 23,800 percentage points during the same period.[181]

The political and economic motives for an industry seeking regulation have been documented in the railroad and motor carrier industries. The advantages of artificial barriers to entry were no less for the original trunk carriers in 1938. It was not until the late 1950's that the "public interest" mythology began to be critically reexamined. Between 1960 and 1975, "[t]he scholarly view of the regulatory process changed from one of control of private behavior for the public benefit to one of use of governmental powers for private or sectional gain."[182]

In 1976, Roger Noll described public interest theories as "traditional," and "no longer widely shared."[183] Jean Luc Migué in 1977 postulated: "It seems fair to say that among economists the most widely accepted theory of government regulation is that, as a rule, regulation is acquired by the industry regulated and is designed and operated primarily for its benefit."[184] A. Downs had revealed, as early as 1957, a government run by individuals trying to maximize a *private*, rather than public, utility function.[185]

The "public interest" mythology fell hard, however. By the time of the first attempts at reform, the special interest groups, which had bene-

---

179. Dempsey, *supra* note 4, at 115.

180. *Id.*

181. S. BREYER, *supra* note 30, at 206.

182. Levine, *supra* note 92, at 180. Levine continues:

> This pattern emerges frequently enough to inspire speculation about the "true" sources of regulation and about the "true" motives of regulators. While no single explanation gained unanimous acceptance, a kind of "cluster consensus" appeared. This consensus characterized regulation as a device used by relatively small subgroups of the general population, either private corporations or geographic or occupational groups, to produce results favorable to them which would not be produced by the market. The regulatory services provided were variously described as organization of a cartel, wealth transfers as a form of "taxation," enshrinement of capitalistic class interests, or preservation of congressional and bureaucratic power. Of course, all gains, whether from regulation or the market, are in a sense realized by private human beings. The operational significance of this view of regulation is that government processes are used by organized subgroups of the population to enforce inefficient arrangements which transfer wealth or power to them.

Id.

183. R. NOLL, GOVERNMENT ADMINISTRATIVE BEHAVIOR AND PRIVATE SECTOR RESPONSE: A MULTIDISCIPLINARY SURVEY 12 (1976).

184. Migué, *Controls Versus Subsidies in the Economic Theory of Regulation*, 20 J.L. & ECON. 213, 213 (1977).

185. *See generally* A. DOWNS, AN ECONOMIC THEORY OF DEMOCRACY (1975).

fited from the airlines' oligopoly power created by regulation, posited every reason to resist reform, predicting that deregulation would bring industry ill-health, deterioration of service to small communities, reduction of safety, and even, without shame, the danger of industry concentration.[186] So far these prognosticators are batting .000: not one prediction has come true.[187] Fortunately, scholarly criticism was soon translated into political reform. Thirteen years after President Kennedy called for "greater reliance on the forces of competition,"[188] the U.S. Senate Judiciary Subcommittee on the CAB (The Kennedy Hearings) began oversight hearings. At the hearings, the tragedy of thirty five years of regulation was exposed to public view: studies revealed that fares were 40-100% higher than would have been the case under deregulation.[189] It was revealed that airfares in intrastate areas not regulated by the CAB were 50-70% of the CAB regulated fares for the same distances.[190] In response to a 1975 Presidential call for regulatory reform in the airline industry, an exhaustive study of the history of airline regulation summed up the fiasco of airline regulation.[191]

To its credit, the CAB in 1976-77 took the initiative in airline deregulation, easing entry and rate requirements. Breaking a tradition of bureau-

---

186. *See, e.g.*, TRANSPORTATION LAWYERS ASSOCIATION, STATE REGULATORY COMMITTEE REPORT (1983); Forest, *supra* note 19; Duffy (President of Airline Pilots Association), *Airline Deregulation: More Harm Than Good*, Denver Post, Dec. 31, 1983, at B2, col. 2.

187. *See supra* notes 3 and 4.

188. *See supra* note 1.

189. *Oversight of the CAB Practices and Procedures: Hearings Before the Subcomm. on Administrative Practice and Procedure of the Senate Comm. on the Judiciary*, 94th Cong., 1st Sess. 454 (1975) (statement of William A. Jordan) [hereinafter cited as *Kennedy Hearings*].

190. STAFF OF SENATE SUBCOMM. ON ADMINISTRATIVE PRACTICE AND PROCEDURE OF THE SENATE COMM. ON THE JUDICIARY, 94TH CONG., 1ST SESS., REPORT ON CAB PRACTICES AND PROCEDURES 41 (Comm. Print 1975).

191. The present system of airline regulation is seriously deficient. Its most serious deficiency is that it causes air fares to be considerably higher than they would be otherwise. It also results in a serious misallocation of resources, discourages innovations in service, denies consumers the range of price and service options which they would prefer, and creates a chronic tendency towards excess capacity in the industry.

The Civil Aeronautics Board (CAB) has historically used its broad powers to forbid competitive pricing and lower fares. Unable to compete on the basis of price, carriers have been forced into costly service competition, and the costs of these services have been passed on to the consumer. On review of the evidence, one is forced to conclude that the present regulatory system is hindering, not advancing, the original statutory objectives of "adequate, economical and efficient service by air carriers at reasonable charges." The present regulatory system has become a major obstacle to the provision of air service at the lowest cost consistent with the furnishing of such service. Ironically, airline profit levels are not increased by this regulatory system, and they may indeed be made more volatile than otherwise.

Snow, *The Problem of Airline Regulation and the Ford Administration Proposal for Reform*, in REGULATION OF PASSENGER FARES AND COMPETITION AMONG AIRLINES 3 (P. MacAvoy & J. Snow eds. 1977).

cratic inflexibility and inertia,[192] the Board paved the way for the Airline Deregulation Act of 1978.[193] This new Act, which placed "maximum reliance on competitive market forces,"[194] further eased entry restrictions, even allowing for some automatic entry, and established a means for unregulated price adjustments.[195] For the first time in forty years, the success or failure of an airline would depend upon its ability to provide the best service at the best price to consumers—not on its political influence or legal expertise before CAB.

B. Industry Health—Turning the Tide

In the years after regulation, the airline industry proved to be less profitable than firms in the unregulated economy.[196] On the eve of deregulation, former CAB Chairman John Bobson observed that "[o]nly three times in the past 26 years, and never in the past decade, has the industry earned the . . . allowable return on investment."[197] Although there were brief periods of profitability immediately after the introduction of new technologies,[198] the long periods of low profitability came despite the fact that regulation had given the airlines virtually everything they had asked for.[199]

Under CAB policy, a few carriers who were awarded lucrative routes, prospered, while inefficient carriers were kept afloat by enforcement of rates based on the average costs of the industry.[200] With absolute security, the privileged trunks had no incentive to be efficient and were content with their oligopoly profits. With no incentive to reduce costs the airlines engaged in wasteful and extravagant service competition, offering such frills as gourmet meals and Polynesian pubs,[201] and culminating in the

192. *See, e.g.*, Dempsey, *supra* note 4, at 123 nn.135-39, 123-24.

193. Pub. L. No. 95-504, 92 Stat. 1705 (codified as amended in scattered sections of 49 U.S.C.).

194. P. Biederman, *supra* note 172, at 80.

195. *Id.* at 81.

196. Office of Economic Analysis, Civil Aeronautics Board, Competition and the Airlines: An Evaluation of Deregulation 8 (1982) [hereinafter cited as CAB Report].

197. Traffic World, July 18, 1977, at 14.

198. CAB Report, *supra* note 196, at 8.

199. *See* C. Kelly, The Sky's the Limit: The History of the Airlines (1963).

> The Civil Aeronautics Act of 1938 gave the airlines almost all that they desired. The routes of the then existing . . . airlines were protected, and the outside competition was practically eliminated. Furthermore, a generous subsidy was provided, in effect a blank check . . . . Unless a carrier could be shown to be willfully fraudulent or inefficient in his management, he no longer had to fear losses. The government stood ready not only to make up any deficit, but also to insure a return on his investment. All in all, the . . . Act seemed to be a bonanza for the airlines, and the major figures in the industry greeted its passage enthusiastically.

Id. at 102.

200. *See* M. Lazarus, Airline Pricing Deregulation and United's Fare Policies (1983).

201. S. Breyer, *supra* note 30, at 200.

so-called "liquor wars" in which airlines competed by offering free liquor to customers. Deprived of the right to compete by price, some airlines were reduced to competing by offering more flights than were actually dictated by market demand, resulting in costly excess capacity.[202] Since the costs of such extravagances as liquor wars and Polynesian pubs were nevertheless considered in determining "average costs," and thus a factor in fixing industry-wide fares, there was every incentive to be extravagant rather than efficient. With nothing to fear from a competitor who might compete by reducing price, the airlines grew fat in their protected environment. Thus, despite studies showing that whenever passengers had the choice of fuller planes at lower prices, or better schedules but more expensive flights, they chose the former, the passenger was not given this choice.[203]

Nevertheless, the airlines had ample opportunity to bring their profits up to manufacturing industry standards. In 1938, passenger fares were set at approximately the rates for pullman travel on the trains.[204] After World War II, however, the industry introduced the DC-6 and Lockheed Constellation, which had drastically greater load capacity and cruising speeds. In a competitive environment such opportunities to cut costs would have resulted in drastically lower fares. With no price competition to fear, however, average fares declined far less than the reduction in costs.[205]

An even more dramatic opportunity to reduce costs per passenger mile came in the late 1950's and 1960's with the introduction of jets, which were far more efficient than the older propeller driven planes. Again, the CAB refused to allow a proportionate realignment of fares to reflect the lower costs, although a few discount fares were finally permitted.[206] Between 1960 and 1969, the trunks' cost per seat mile was reduced by 21%; average fares, however, declined only 7%.[207] Such a result would have been impossible in a competitive market, since any carrier reducing the fares by over 7% would have taken business from the other carriers, consequently forcing all fares down.

Since technological breakthroughs were so drastically reducing costs, while prices were kept artificially high by CAB price fixing policies, the question arises as to why the airlines did not reap a bonanza of prof-

202. *Id.*

203. S. BREYER, *supra* note 30, at 205. One economist has calculated that fare/service combination was suitable only for travelers whose time was worth over $60,000 per year. Travelers therefore paid half a billion dollars more than necessary in 1969 alone. Prior to 1975, overcharges ranged up to $3.5 billion *annually*. *Id.*

204. CAB REPORT, *supra* note 196, at 65.

205. *Id.*

206. *Id.* at 66.

207. *Id.* at 67.

its. There are several answers: 1) CAB policy encouraged the dissipation of revenue by service competition (e.g., "liquor wars");[208] 2) the airlines had no incentive to take advantage of their opportunities to reduce costs, since increased efficiency would only make their case more difficult when seeking fare increases from the CAB; 3) the CAB did not allow airlines to take advantage of their greater load capacity by use of peak load fares;[209] 4) CAB policy created an environment in which submission to union pay demands was a path of less resistance than fighting for lower consumer fares.[210]

The latter-most factor became a dominant one during regulation. Pilots' pay was originally based on a formula incorporating an hourly rate and a mileage rate.[211] When the Strato-liner increased productivity substantially, however, the hourly rate was increased. This change "established a precedent: as faster aircraft were introduced, pilots' hourly rates [were] increased."[212] When jets were introduced, productivity gains were again translated into higher hourly rates and reduced flying time. Average flying hours per month declined 8 hours during the 1950's, from 65 in 1955 to 50 hours in 1975. Since there were no competitive pressures on airlines to resist such pay increases and flight hour reductions, the net result was that airline employees were paid substantially more than their counterparts in deregulated industries. For example, typists were paid 41% more than their counterparts in deregulated industries, computer operators 38%, air freight agents 58%, and even janitors received 82% more than their deregulated counterparts.[213]

The fault for this injustice lies not with the unions, of course, which only seek to protect the interests of its workers, but with the system which provides the wrong incentives. Under deregulation, airlines with strong unions find they must compete with airlines which pay competitive wages. Workers previously excluded from airline employment can finally find work at market wages in a deregulated industry. The previous power structure is being drastically altered as airlines such as Continental are forced to reduce labor costs in order to compete with airlines paying fair market wages.[214]

While these developments under deregulation obviously affect the power of unions to reap the benefits of productivity increases, it also has

208. *See* M. LAZARUS, *supra* note 200.

209. CAB REPORT, *supra* note 196, at 69.

210. *See* Hendricks, *Regulation, Deregulation, and Collective Bargaining in Airlines*, 34 INDUS. & LAB. REL. REV. 67 (1980).

211. CAB REPORT, *supra* note 196, at 114.

212. *Id.* at 114.

213. *Id.* at 117-23.

214. *See* NLRB v. Bildisco & Bildisco, 104 S. Ct. 1188 (1984).

advantages for the unions. Far from creating an environment for "union-busting," deregulation creates unique opportunities for unions to obtain a voice in management and in their own future. In the deregulatory scheme of things, union and worker ownership and responsibility is a healthy trend. In such an environment, the interests of the firm and the workers coincide rather than clash, inuring to the benefit of both the public and the industry.

In light of the mediocre airline profit history under regulation, it was not surprising that in the very first year of deregulation, operating profits of the airline industry increased fifty percent over the previous year. Air fares declined for the first time in twelve years and air traffic in revenue passenger miles expanded faster than it had in ten years. Load factors in 1978 jumped five points and exceeded sixty percent for the first time since 1959.[215]

The recession which began in 1979 affected the airline industry in the same manner it affected all industries. Fuel prices increased by 105% in one twelve month period alone (1979).[216] The PATCO strike further curtailed operations and slowed the progress of deregulation.[217] While airline profits slumped during the recession, as did other industries in the economy, fares increased at a rate lower than the inflation rate.[218] Fuel cost increases, rather than being automatically passed on in fare increases, were absorbed by a newly emerging competitive industry. By 1983, as the recession ended, the airlines began to show record profits.

In early 1984, the Air Transport Association's chief economist estimated a half billion dollar operating industry profit for 1983, including a fourth quarter profit of between $300 and 400 million.[219] Passenger traffic in 1983 came close to the record of 317 million passengers set in 1979.[220]

Although few had doubted the consumer benefits of deregulation, 1983 industry profits showed that the industry also benefited. Even during the depth of the recession, when unemployment increased in other sectors of the economy, employment increased dramatically in the airline industry. From 1977 to 1979, the number of employees increased from 265,777 to 294,930, with a 7.7% increase in employment in 1979 alone. The most dramatic increase in employment occurred in the local service industry, where employment increased 11.7% in 1978 and 16.3% in

215. CAB REPORT, *supra* note 196, at 19-24.
216. HARVARD PROJECT, *supra* note 3, at 163.
217. CAB REPORT, *supra* note 196, at 30.
218. *Id.* at 73.
219. USA Today, Jan. 9, 1984, at B-1. America Airlines alone posted a record profit of $115.6 million for the fourth quarter of 1983. Wall St. J., Jan. 19, 1984, at 6, col. 3.
220. USA Today, Jan. 9, 1984, at B-1.

1979. From 1977 to 1982, local service employment increased from 31,402 to 44,559.[221] Thus, the explosion in passenger miles stimulated by deregulation was also serving the interests of the working person. What the economists and theoreticians had predicted for so long was now happening.

C. INDUSTRY CONCENTRATION

It has been argued that airline deregulation will result in industry concentration. In 1982, one commentator predicted that "within five to seven years you will have no more than five . . . trunk airlines."[222] The theory behind such predictions is usually simplistic: in a competitive industry, the more efficient airlines will take advantage of their efficiency and economies of scale, and engage in "predatory" pricing in the manner of a Standard Oil under John D. Rockefeller. The inefficient airlines will then cease to exist, and a substantial monopoly will result which can then reap oligopoly profits. These predictions, however, originate not from economists but from those who have an axe to grind,[223] and are clearly misdirected. Exhaustive studies have revealed that it was regulation which provided the only hope for creation of an oligopolistic industry.[224]

These predictions reveal how quickly memories fade. (The feared scenario of five major trunk carriers was one which actually existed under regulation.) However, the predictions also rest on two false assumptions: 1) barriers to entry are relatively high, and 2) there are significant economies of scale and decreasing costs. Economic barriers to entry are relatively low in the airline industry.[225] The most important barriers have been legal barriers enforced by the CAB. Economic barriers pale by comparison. Even such upstarts as People's Express have no trouble leasing jumbo 747's to start up operations.[226] The explosion in the number of new airlines since deregulation reveals the economic ease of entry. By September of 1981, eleven newly formed airlines providing jet service had entered the industry.[227] In addition, former intrastate and regional airlines such as Pacific Southwest Airline (PSA), Air California, and South-

221. CAB REPORT, *supra* note 196, at 35 (Table 1.4).

222. Gibney, *Continuing Airline Losses Predicted*, Denver Post, June 21, 1982, at 3C, col. 1.

223. One notable doomsayer was Howard Putnam, Braniff's Chief Executive Officer, who probably qualified for a sour-grapes award in predicting a drastic reduction in the number of carriers in the industry. *See* Dempsey, *supra* note 5, at 345 n.52.

224. Snow, in FORD PAPERS, *supra* note 129, at 28.

225. *See* Bailey & Panzar, *The Contestability of Airline Markets During the Transition to De-Regulation*, LAW & CONTEMP. PROBS., Winter 1981, at 125, 129.

226. For a comprehensive review of the lower costs of such up and coming airlines as Muse, Southwest, People's Express, Capital and World, *see* CAB REPORT, *supra* note 196, at 103.

227. *Id.* at 125.

west Airlines have greatly expanded their operations.[228]

Without high barriers to entry, "predatory pricing" does not become a factor. Such pricing is used when a large firm attempts to use its economies of scale to lower prices which it can absorb, but which bankrupts competitors. After the competitors go bankrupt, the large firm exercises monopoly power. Predatory pricing is irrational in an industry where exit and entry is easy. A firm hoping to practice predatory pricing must be prepared to absorb huge losses in the speculative hope of future high profits. Where firms can enter or exit the industry quickly there is little incentive to absorb huge losses. Even if a competitor or two is driven from the industry, the same or another competitor can reappear at a later time. In fact, in the present competitive environment, it is usually the predator rather than the prey that fails (e.g., Braniff Airlines). Breyer has observed that unless a predator firm is both insured of its own ability to absorb ruinous losses *and* protected by substantial barriers to reentry by competitors, "it is irrational for it to attempt predatory pricing."[229]

Economies of scale are relatively low in the airline industry;[230] in fact, there are significant diseconomies of scale. Small, lean airlines can often reap cost advantages unobtainable for the larger airlines.[231] Economies of scale are more related to the efficiency of particular aircraft in a particular market than on total number of aircraft. In addition, small lines like People's Express can cut costs by having ticket sellers perform baggage handling chores. And, of course, small airlines are less likely to be saddled with oppressive labor contracts. For example, Southwest's pilots fly

---

228. *Id.* at 124.

229. S. BREYER, *supra* note 30, at 61.

> In fact, *regulation can make predatory pricing easier*, since it often provides the barriers to entry necessary for a potential predatory pricer to succeed. Furthermore, the antitrust laws make predatory pricing unlawful. Those firms suffering its consequences can bring antitrust suits and appeal to enforcement agencies.
>
> Unfortunately, ordinary price competition is easily confused with predatory pricing. The former generally involves low-cost firms charging lower prices that take business from higher-cost firms; the latter involves short-term prices well below costs, set with the object of destroying competition and later recouping losses through prices well above cost. Those advocating regulation on these grounds in the transportation field may well have confused the two.

Id. at 61 (emphasis added) (footnotes omitted).

230. "[E]conomists have come to accept the conclusion that there are no significant economics of scale in air transport." Bailey & Panzar, *supra* note 225, at 126.

231. CAB REPORT, *supra* note 196, at 101.

> [The new airline's] lower costs are partly explained by the simplicity of their operations, partly by their lower input costs, especially wages; and partly by their no-frills service policies. In most cases, they set fares lower than the prevailing fares prior to their entry, and as a consequence, their share of industry traffic has grown to more than 8.5%. Because of their rapid growth, the influence on industry behavior goes well beyond what their market share would suggest.

Id.

73 hours per month compared to 43 hours for United.[232] Such factors explain why in 1983, a smaller, leaner airline like US AIR could increase its revenue passenger miles by 19.2%, while an older trunk airline like United was only able to increase by 11.8%; Delta increased by 9.6%, Eastern by 8.4%, Western by 6.0%.[233] These factors also explain an unmistakable trend since deregulation—the market share of the four largest trunk airlines has steadily declined, from 58.7% in 1978 to 55.8% in 1983.[234] Moreover, the trend is accelerating as new competitors enter the industry. Deregulation has also resulted in the market share of all the trunk airlines declining from 97.3% in 1978 to 92% in 1983, while that of new entrants and locals more than tripled, from a total market share of 2.7% in 1978 to 8% in 1983.[235] A recent study summarized the effects of deregulation on industry concentration as a replacement of the old route network by a new one arising from competitive market forces.[236] It is hard to imagine industry concentration being any worse than that suffered by the industry during the days of regulation.

D. Deregulation and Fares

A comparative analysis of pricing in the airline industry is difficult because of the number of independent economic factors that must be taken into account. A few such factors are the general inflation rate, particular rates of inflation (such as fuel), recessionary pressures, and technological advances. Most studies examining all these factors have concluded that regulation caused artificially high fares. Keeler's 1972 study of coach fares revealed that fares were 45 to 84 percent higher than what the unregulated competitive fares would be.[237] The 1975 Kennedy Hearings revealed that regulated fares were 40 to 100% too high, and that excess fares amounted to up to $3.5 billion.[238]

Comparisons of fares before and after deregulation do not tell the whole story; they are, however, a starting point. A May 1983 Air Trans-

232. *Id.* at 10 n.9.

233. USA Today, Jan. 9, 1984, at B-1, col. 1.

234. Staff of the Civil Aeronautics Board, CAB Draft Report 13 (Table 1.2) (1984) [hereinafter cited as 1984 CAB Draft Report].

235. *Id.*

236. The market share of the trunk airlines—the group most favored by CAB regulation—has fallen rapidly since 1978. What has happened is that the air service network has become better integrated, as the airlines have moved rapidly to develop route networks that match traffic patterns. The old route network created by the CAB is unraveling, and a new network structured by competitive market forces is coming into being. Graham and Kaplan, *Airline Deregulation is Working*, AEI J. Gov't & Soc., May-June 1982, at 26, 27.

237. Keeler, *Airline Regulation and Market Performance*, 3 Bell. J. Econ. & Mgmt. Sci. 399, 421 (1972).

238. *See Kennedy Hearings*, *supra* note 189.

port Association report revealed that the CAB Standard Industry Fare allowed for fare increases of 67% between 1978 and 1982.[239] In light of staggering fuel price increases of 105% between March 1979 and March 1980 alone,[240] fares would doubtless have increased dramatically during this period under regulation. Actually, fares decreased in real terms on an overall basis.[241] In 1982, 80% of all coach travel was on discount fares compared with 48% in 1978.[242] A 1984 CAB Draft Report states that fare increases between 1976 and June 1983 were less than both increases in the CPI and increases in carrier costs.[243] Thus, while average seat costs increased by 71%, fares during this seven year period increased by only 45%.[244] The decline in real average fares came about despite staggering fuel cost increases. (One shudders to think what fares would have been under a CAB "cost of service" policy of setting fares.) Moreover, the downward trend in prices is accelerating.

The cause of decline in real fares is attributable not only to economic incentives engendered by free entry and competition, but also to a relaxation of route and fare regulations. Thus, the airlines have been able to take advantage of higher load factors by offering special discounts, filling seats which would otherwise go empty. A wide variety of pricing strategies enabled the airline industry in 1983 to achieve record load factors.[245] Planes which went empty in off-peak hours during regulation now go packed with customers on special discount fares,[246] thus increasing maximum utilization of aircraft. Cheaper fares for "no frills" flights allow the consumer a choice not available under regulation, taking advantage of the high elasticity of demand for air travel.[247] No longer must a consumer pay for the wasteful "liquor wars" so prevalent during the "service

239. *Review of Airline Deregulation and Sunset of the Civil Aeronautics Board (The State of the Airline Industry Under Deregulation): Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation*, 98th Cong., 1st Sess. 10 (1983) (statement of Paul R. Ignatius, President and Chief Executive Officer, Air Transport Association of America) [hereinafter cited as *Hearings*].

240. HARVARD PROJECT, *supra* note 3, at 103.

241. *Hearings*, *supra* note 239 at 10.

242. *Id.*

243. 1984 CAB Draft Report, *supra* note 234, at 20.

244. *Id.*

245. *Id.* at 21, fig. 2.2 (average load factors). Load factors increased from 55% in 1977 to 64% in 1979. Even during the depths of the recession in 1982, load factors were at 60%, substantially higher than under regulation.

246. *Id.* at 20.

247. *Id.*

> The use of peak-load pricing promotes a more efficient use of the airline industry's resources. If airlines were to use their stock of aircraft intensively, and all passengers were charged the same fare regardless of when they traveled, load factors on different flights would vary considerably; they would be quite high at peak travel times and quite low on less popular flights. This is the type of pattern that regulation encouraged. The use of peak-load pricing encourages travel at less popular times, and therefore enables

competition" era of regulation. An investigation of intrastate airline fares in California in 1975 revealed that passengers, when given a choice, chose lower fares, even at the risk of fuller planes and inconvenient schedules. The high elasticity of demand for air travel was revealed by a study which looked at the experience of Southwest Airlines. Even if demand had been less elastic, however, it was noted that travelers' choices were not reflected by the price/service tradeoff.[248]

Under deregulation, the market was permitted to accomplish what all the "capacity reduction" fiats of the regulators had been unable to do: reduce excess capacity. Decreases in real fares since deregulation are obviously due to both competitive pressures and to relaxation of regulations which prevented market determination of fare equilibrium so as to maximize use of airline capacity.

E. Subsidies and Service to Small Communities

It is true, as some critics have charged, that fare reductions have been greater in some markets than in others under deregulation. These critics cannot understand why it should be cheaper per passenger mile to transport 400 persons on a Boeing 747 jumbo jet between New York and Los Angeles than to transport twenty people on a Boeing 737 between two small communities in Nevada. In a free economy, prices reflect costs. If inefficiency and the distortion of market forces is to be justified by reference to such "social benefits" as providing cheap service to high cost markets, the cost of providing such benefits should be borne fairly by society at large, and not by an unfortunate group of consumers in high density markets who otherwise are forced to "cross-subsidize" fares in high cost markets. The unfairness of forcing one group of consumers to subsidize another becomes apparent when one realizes that the cross-subsidies come from higher fares on the non-subsidized routes, thereby

---

carriers to serve more passengers with a smaller stock of aircraft. *It thereby reduces the average cost of air service.*

Id. at 18 (emphasis added).

248. Southwest Airlines, an intrastate carrier unregulated by the CAB, entered the market with fares about 50 percent below those of its competitors; total air traffic on those routes increased 100-150 percent between 1971 and 1975 . . . .

. . . .

The price/service tradeoff did not reflect what most travelers wanted. One economist calculated that in 1969 the fare/service combination suited only those whose waiting time was particularly valuable—such as business travelers whose time was worth $60,000 per year or more. Assuming that waiting time was worth $10 per hour (an assumption used by the industry trade association) travelers paid about half a billion dollars more than necessary in 1969. Moreover, whenever passengers had the choice of lower fares and fuller planes or better schedules but more expensive flights, they tended to choose the former. In California, PSA (which offered low-fare, full-place service) prospered, while its competitors went bankrupt.

S. Breyer, *supra* note 30, at 205.

precluding many consumers from flying the nonsubsidized routes who would otherwise do so.[249] The regulators prefer this hidden "cross-subsidization" over open subsidy since it is less visible and creates fewer obstacles to the political transfer of wealth. Unfortunately, it results in severe misallocation of resources.[250]

For example, the cost of transporting food to Hawaii no doubt increases the cost of food to Hawaiian residents, but so far no one has advocated that food consumers in Nebraska pay the difference in transportation costs to the residents of Hawaii. Only a "regulator" would say that it is unfair that Hawaiians pay a higher price for food. (Apparently, however, food is less of a "social benefit" than air travel.)

Hidden cross-subsidization, despite its wasteful misallocation of resources, might be tolerable if it only *worked*. Unfortunately, the CAB's policy of cross-subsidization resulted in the abandonment of service to 173 communities in the eighteen years before deregulation, devastating those small communities.[251] In addition, departures at cities served were cut back substantially. Between 1970 and 1975, airlines cut small community flights by twenty five percent.[252] The reason, of course, was simple: the CAB used routes as favors, handing them out to selected carriers, using them as bargaining chips to achieve cross subsidization, and even giving them out to reward airlines who had demonstrated a high level of mismanagement and inefficiency. In such an environment, the energies and resources of the airlines were directed not towards cutting costs but towards convincing the CAB to allow them to abandon routes which did not cover their costs. The results made a mockery of even the "social benefit" rationale used to justify the resource misallocation caused by cross-subsidization. A simple example illustrates the point. In

---

249. Note, *supra* note 175, at 1417, 1428.

250. Levine has described the misallocation of resources resulting from cross subsidization as follows:

> Non-economic justifications of subsidy are, *ex hypothesis*, beyond economic argument. But a subsidy provided on non-economic grounds ought to be designed to do as little economic harm as possible. By this standard public subsidy from general revenue is preferable to private transfer payments. It makes little economic sense to charge one group of consumers a higher-than-competitive price in order to provide similar but economically unrelated services to another group of consumers. Artificially high prices for main-line transportation decrease demand for such services, injuring those who could have profitably used the service at its true cost. Subsidizing in this way creates an allocation of resources which does not maximize output of goods and services in the economy as a whole. An efficient allocation is achieved only by employing resources where they can be most profitably used.

Id. at 1428.

251. CAB REPORT, *supra* note 196, at 135. A Director of the Aviation Consumer Action Project, founded by Ralph Nader, recently observed: "Between 1960 and 1977, the CAB allowed certificated airlines to abandon 179 communities across America—hardly a model of good, public-utility-style regulation." Wall St. J., Oct. 25, 1983, at 27, col. 2.

252. CAB REPORT, *supra* note 196, at 135.

1978, before deregulation, Hot Springs, Arkansas was served by 26 DC-9 and 14 Convair flights a week, consuming 2.5 million gallons of fuel. In 1980, after deregulation, service tripled, using 96 metro flights, but consuming only 600,000 gallons and saving consumers 1.9 million dollars.[253]

In 1983, after five years of deregulation, there were more city-pair markets receiving non-stop service than in 1978. Small communities received more service to cargo hubs in 1983 than in 1978. Non-hub small communities which lost trunk service after deregulation experienced a dramatic gain in departures, from an average of 17 a week in 1978 to 20 a week in 1983.[254] Communities eligible for local service subsidy experienced a 27% increase, and even unsubsidized communities had a 26% increase. Points retaining trunk or local service after deregulation experienced a gain from 11,146 to 11,172 departures.[255] Service also increased. In 1978, 40% of those passengers that had to change airplanes made interline connections. By 1983 this had declined to less than 15%.[256] Looking at small communities as a whole, an exhaustive independent study concluded that "as a group, small communities (both small hubs and nonhubs) were receiving more scheduled airline service after deregulation than before."[257]

More important to the taxpayer, however, was the fact that the better service to small communities was accomplished at lower subsidy levels. The number of subsidized communities declined from 392 in 1978 to 145 in 1984.[258] The average subsidy per point in 1978 was $355,000 compared to $292,000 in 1984.[259] While Section 419 subsidies (promulgated under the Deregulation Act to ensure service to small communities) increased from $380,000 in 1979 to $18 million in 1982, Section 406 subsidies declined from $79 million in 1977 to $45 million in 1982, for a net savings to the American taxpayer of approximately 16 million dollars.[260] Such results were accomplished in the deregulatory climate by encouragement of efficient carriers and a policy of preference for airlines requiring low subsidies. A recent study summarized the effect of deregulation on service to small communities, noting that some communities had gained service, while others had lost it; it concluded that "on balance, every class of city is benefiting from the better-integrated service network,

253. Comment, *Section 419 of the Airline Deregulation Act: What Has Been the Effect of Air Service to Small Communities*, 47 J. AIR L. & COM. 151, 168 n.112 (1981).
254. 1984 CAB Draft Report, *supra* note 234, at 36 (Table 3.6).
255. CAB REPORT, *supra* note 196, at 148 (Table 5.3).
256. 1984 CAB Draft Report, *supra* note 234, at 34.
257. HARVARD PROJECT, *supra* note 3, at 156.
258. 1984 CAB Draft Report, *supra* note 234, at 50.
259. *Id.*
260. CAB REPORT, *supra* note 196, at 146 (Table 5.2).

either through increased flights or more direct service to major cities, and the beneficiaries include the smaller communities (which were considered vulnerable to service losses from deregulation)."[261] Overall, deregulation has resulted in more "social benefits" to small communities than all the hordes of CAB bureaucrats did in all their years of trying to create an oligopoly for the privileged trunk carriers.

F. SAFETY

Safety standards have improved considerably during deregulation. Air Transport Association[262] and National Transportation Safety Board Statistics reveal that fatal crashes per 100,000 takeoffs declined from .10 in 1978 to .08 in 1982.[263] Even more important, the FAA reports that "performance indicators" (accidents, injuries, FAA violation) have improved by thirty percent in the past few years.[264] Airlines have found that maintaning high safety standards can cut maintenance costs. Seth Oberg, a senior vice-president for Western Airlines, has explained that "[w]e have found by maintaining a margin above what the FAA requires, we save money in the long run"—such as maintenance costs on older aircraft.[265]

Unlike the days under regulation, when an airline's security was always ensured by benevolent bureaucrats, airlines must now take extra care to ensure safety. As Jim Ashlock, a spokesman for Eastern Airlines, has explained, now "you've got to be awfully careful when you start taking those shortcuts," because if you lose "public trust" in an airline's safety, "you're out of business."[266]

Nevertheless, interest groups desperate to regain economic power lost by deregulation often confuse economic regulation with safety regulation.[267] Responsibility for regulation of safety lies with the FAA,[268] which is empowered to withhold air carrier operating certificates from airlines lacking sufficient resources to maintain FAA standards.[269] Even during

261. Graham and Kaplan, *supra* note 236, at 27-28.

262. AIR TRANSPORT ASSOCIATION, ANNUAL REPORT OF THE U.S. SCHEDULED AIRLINE INDUSTRY 6 (1983).

263. *See* Wall St. J., Oct. 18, 1983, at 7, col. 1.

264. *See id.*

265. *See id.*

266. *See id.*

267. The attempt to link safety to economic deregulation is often deliberate, but rarely supported by facts. Despite clear government statistics showing that safety has improved under deregulation, interest groups persist in trying to link safety and economic deregulation. *See, e.g.*, Henry A. Duffy (President of ALPA), Speech Before the Transportation Research Board (Jan. 17, 1984) ("That margin of safety is being steadily eroded by deregulation, and by Continental's brand of union-busting.")

268. See S. BREYER, *supra* note 30, at 199.

269. 14 C.F.R. pt. 43 (1984).

the days of regulation it was understood that the CAB was responsible for economic regulation and the FAA was responsible for safety regulation. The success of economic deregulation, however, has reduced critics of deregulation to blaming the CAB for what they perceive to be a decline in safety standards.[270]

Critics look to the expansion of commuter airlines servicing small communities to support their argument that safety has suffered under deregulation. They point to statistics which show that commuter airlines have a lower safety record than the trunk airlines. It is true that the trunks are safer when measured by fatalities per hundred thousand passenger miles; however, use of such statistics in comparing trunk and commuter safety records is somewhat misleading. For example, a trunk 747 jumbo flying coast-to-coast gets credit for 948,000 passenger miles per take-off and landing, while a commuter aircraft flying 120 miles must make 465 take-offs and landings to equal the passenger miles of the jumbo. A recent study has suggested that a more appropriate standard would be based on fatalities per take-off. By such a measure the commuter airlines had a better safety record than the trunks in three of the five years between 1974 and 1978.[271]

There are legitimate concerns, however, about FAA safety regulations. The authorized force of FAA inspectors has been reduced by twenty three percent since 1981, although the authorization was increased in early 1984 by the Department of Transportation. The FAA is approving a large number of "deviations" from FAA standards.[272] The near miss of two jumbo jets off the coast of Florida in January of 1984 raised fears that the air-traffic control system has not fully recovered from the effects of the PATCO strike; nor has the FAA been immune from political pressures. Consumer opposition to such proposed safety measures as backward seating, shoulder harnesses, and elimination of smoking and alcohol has obviously affected FAA policy.[273]

Cost considerations have played an important role in decisions on collision avoidance devices and life vest storage. However, the Airline Pilots Association (ALPA) has played an important role in safety, and for this they deserve credit for saving many lives. Criticism of safety standards and their enforcement should be directed to the FAA. If 100 hours of flight time is too many from a safety standpoint, as ALPA claims, the regulation should be changed. The FAA should then strictly enforce its regulations across the board.[274]

---

270. *See, e.g.*, Wall St. J., Oct. 18, 1983, at 7, col. 1.
271. HARVARD PROJECT, *supra* note 3, at 152-53.
272. *See Can We Keep the Skies Safe?*, NEWSWEEK, Jan. 30, 1984, at 24-31.
273. *Id.*
274. Levine has examined the argument that safety depends upon economic regulations:

Market entry controlled by FAA safety regulation enforcement is not inconsistent with economic deregulation of the industry. Indeed, airline safety today would be far higher if even half the money appropriated for wasteful economic regulation in the past had been spent instead on safety regulation and enforcement.

VI. CONCLUSION

The history of transportation regulation in the United States proves not only the truth of Stigler's hypothesis,[275] but of a far older one as well: the road to Hell is paved with good intentions. Indeed, it is only recently that the bankruptcy of the "public interest" hypothesis has been exposed—first by scholars, then by President Kennedy in 1962, and by the Kennedy Hearings in 1975. In the double-speak of regulation, competitive fare reductions are "cut-throat" pricing; market dynamics are "chaotic"; price-fixing, criminal in any other sphere when done by industrial robber barons, has become "fare stabilization"; and protective entry control is known as "reducing excess capacity." According to the die-hards, all twenty nine of the thirty members of the American Transport Association who support deregulation don't know what is good for them; the new, lean and more efficient firms which have entered the market, reducing the old trunk's market share, don't deserve to exist; consumers should be limited to choosing an airline based on who wins a "liquor war" or provides a Polynesian pub, rather than on what consumers care about most, namely price; and certain unfortunate consumers should be asked to pay the fares of other consumers who would rather not pay the cost of their own ticket. (Who does?)

The regulators had ninety three years to impose their ideology on the railroads, forty five years to oligopolize the competitive trucking industry, and forty years to accomplish in the airline industry what even John D. Rockefeller failed to do in oil: prevent even a single competitor from entering the industry. Deregulation was given its sternest test by being asked to reverse the slide of three industries in the midst of the worst recession since the Great Depression. In a few short years, deregulation

---

The final argument advanced is that economic regulation is necessary to insure safety. This argument is based on the prediction that an unregulated market would be characterized by the proliferation of financially unstable carriers, and the assumption that financial stability contributes to safe operation. The first claim is simply untrue. The second, while true, does not justify pervasive economic regulation of the CAB variety. Expenditures to preserve high maintenance standards and permit flight cancellations when safety requires do impose short-run financial burdens. But financial stability sufficient to ensure safe operation already is a prerequisite to entry. Additional economic regulation is superfluous. The FAA is empowered to withhold air carrier operating certificates from carriers lacking the financial capacity to operate without such a certificate.

Note, *supra* note 175, at 1429.

275. *See supra* text accompanying note 40.

has accomplished virtually everything the economists had predicted for so long: reduced fares; more efficient allocation of resources; greater service to small communities; a reduction in subsidies, both by government and consumers; increased safety, and deconcentration of power in the industry. In light of its accomplishments and in the face of all the odds, deregulation certainly deserves the same chance the regulators had. Based on the experience of the past few years, deregulation shows every sign of giving the transportation industry a better opportunity to serve the real needs of the consumer, the industry and its employees.