Rejoinder to Comments by Alfred Kahn

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In his comments on my article, Dr. Kahn over-states the benefits of deregulation, under-states its problems, and ignores the many aspects of the deregulation rationale which have been proved fallacious by nine years of experience.

The principal benefit claimed for deregulation by Dr. Kahn is savings for the public, in the form of lower fares. He claims that these savings amount to $11 billion annually. That claim is totally lacking in credibility. To arrive at this $11 billion figure, Dr. Kahn assumed that—were it not for deregulation—improvement of fares would have come to an abrupt halt in 1976. This assumption enables him to credit to deregulation any improvement in fares that occurred after 1976. His approach is flawed on several grounds.

First, it creates an artificial birthday for deregulation—backdating it from 1978 (when the statute was enacted) to 1976. His rationale for this is that the CAB had started to liberalize certain policies at that time. However, anything that happened between 1976 and 1978 occurred under the *regulatory* statute—and merely shows that such statute was not a strait-jacket, but rather provided considerable policy latitude. The *liberalization* of some policies that occurred prior to 1978 was a far cry from the *dismantling* of the regulatory framework. It is merely a form of creative chronology to pretend that deregulation started two years before Congress acted.

Second, Kahn's calculation implies that the level of fares in 1985 can be regarded as a viable, on-going fare level, when in fact it provided a profit inadequate to cover interest payments. For adequate profitability, increased yields above the 1985 level would have been necessary—and, therefore, any fare savings calculated for the 1985 level would have to be considered temporary at best.

Third, in assuming that (without deregulation) fare improvement would have ceased in 1976, Kahn ignores the prolonged trend of declining fares that started long before deregulation. The accompanying chart (Figure 1) indicates the long-term nature of that trend, and the fact that the post-deregulation trend has essentially been just an extension of the previous trend line. This chart effectively refutes Kahn's assumption that fares would have stopped improving in 1976, were it not for deregulation. Indeed, Kahn himself refers to the "very satisfactory decline in fares during the prederegulation decades."

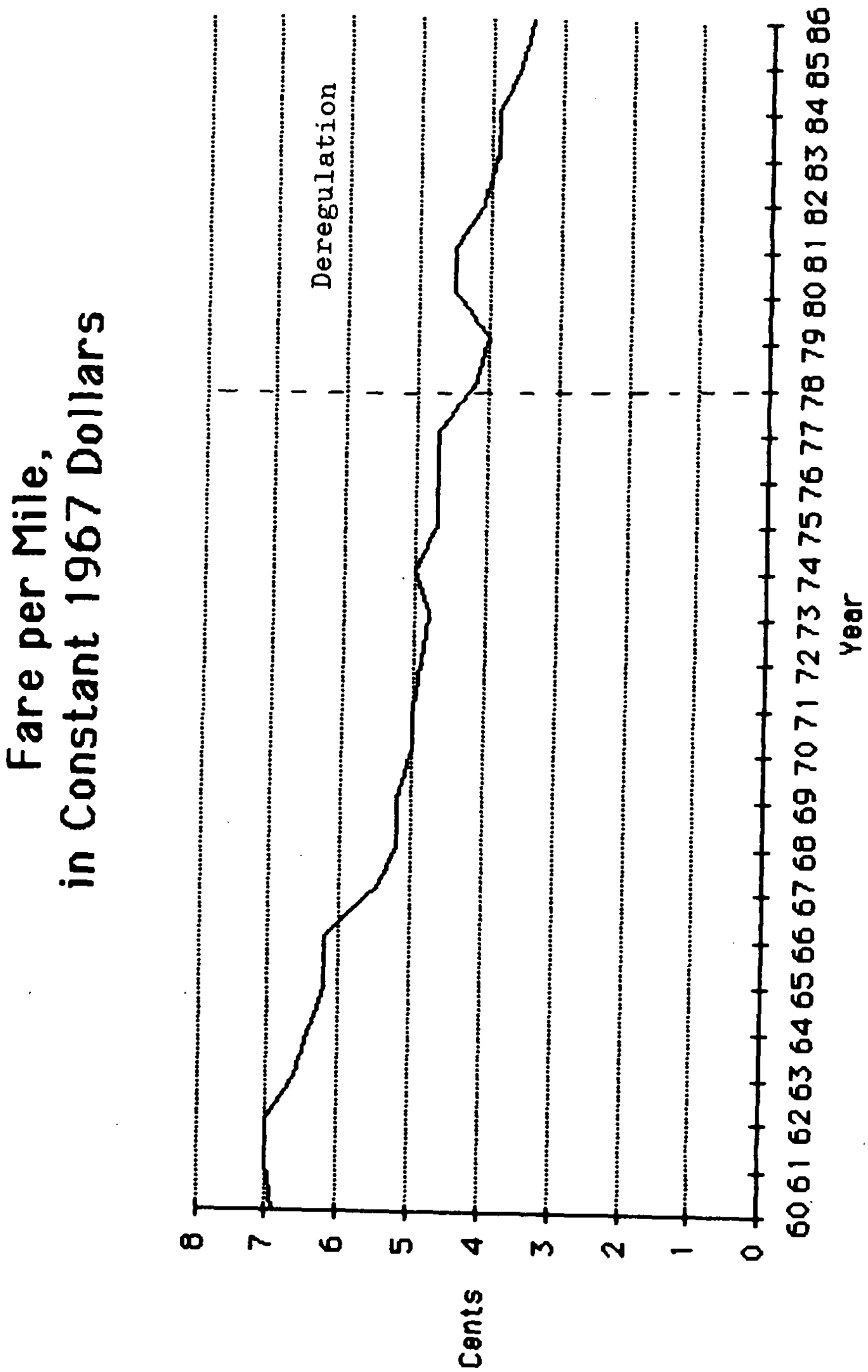
Why then does he assume that such decline would have halted in 1976? The only clue he gives is the statement that the prior trend was "primarily the contribution of technology." The implication is that technology provided some fortuitous windfall, and that once that windfall ended, neither the carriers nor the CAB would have done anything on their own volition to continue any pattern of fare improvement.

The simple answer is provided by Kahn himself, in his text, *The Economics of Regulation*, where he stated: "The fact remains that technology does not develop unassisted by human hands, nor do the benefits of long-run decreasing costs fall as rain from heaven."[1] That comment is especially relevant to this industry. The tempo of airline technology has all along been driven by competitive and marketing pressures to acquire the most advanced equipment. There's no reason to assume that those pressures would have ended in 1976.

But there is still another flaw in Dr. Kahn's assumption. The trend of prederegulation fare improvement was also driven by a number of non-technological factors, all of which would have remained if there had been no deregulation. For example, airline marketers have aggressively pushed promotional pricing, to stimulate discretionary travel, for decades. Indeed, the Super Saver Fare of recent years (which Kahn seems to regard as some landmark in pricing) was basically patterned after the Discover America Fare, which preceded it by a decade, *while the airlines were still regulated.*

Additionally, Kahn's implication ignores the intense, low-fare competition of charter services, which was encouraged by the CAB through steadily broadened operating authorization. He also ignores the effect of CAB actions in rate regulatory proceedings, which limited the costs that

1. 2 A. KAHN, THE ECONOMICS OF REGULATION 101 (1971).


Fare per Mile,
in Constant 1967 Dollars
Deregulation
Cents
0 1 2 3 4 5 6 7 8
Year
60 61 62 63 64 65 66 67 68 69 70 71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86

could be passed on to the public, and kept billions of dollars out of the rate base.

From any standpoint, the suggestion that fares would have stood still in the absence of deregulation lacks foundation in the record, or in logic. The $11 billion claimed annual saving is statistical hyperbole. And without the "billions of dollars" of savings to repeatedly point to, the various problems of deregulation—some conceded by Kahn—lack the compensating offset he attributes to those alleged savings.

There are many other examples of error, inconsistency, or omission in Dr. Kahn's comments. The following illustrate some of them.

Kahn Statement: "In 1986, 90 percent of all passengers traveled on discount tickets, at an average discount of 61 percent below full coach fare. Clearly the benefits of price competition have therefore indeed been extremely widely distributed. . . ."[2]

> *Comment:* Kahn equates a *discount* with a *benefit*—without considering the level of the full "list price" to which the discount is applied. By the fall of 1987, the average full fare level for airline travel had increased by over 150% since 1978—roughly double the rate of general CPI inflation.[3] On some routes, the full fare has increased by 200% or 300% since 1978—treble or quadruple the rate of general inflation.[4] A discount can be provided from such substantially escalated full-fare levels, and still not provide a real benefit. (On the Los Angeles-Sacramento route, for example, a seven-day advance purchase fare of $119 provides a 12% discount from the current full fare.[5] But even that *discounted* fare represents *272% inflation above* the unrestricted fare of 1978.)
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> In any case, the full effect of all 90% of the tickets sold at discount is incorporated into the fare trend data shown in Figure 6 of *Airline Deregulation—A Case Study in Public Policy Failure*[6], and all those discounts have done is merely bring the net average deregulated fare to a trend line similar to that already existing under regulation.

Kahn Statement: "The troublesome disparities that have emerged between fares in dense and in thin markets are not wholly discriminatory."[7]

> *Comment:* The cases of price disparity cited in my article did not relate solely to cases of "thin" vs. "dense" traffic routes. For example, the higher fare for Detroit-St. Louis vs. Detroit-Kansas City cannot be explained by traffic density. Interestingly, Dr. Kahn himself in a 1986 speech referred to "out-

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2. Kahn, *Airline Deregulation—A Mixed Bag, But A Clear Success Nevertheless*, 16 TRANSP. L.J. 229 (1988), at 237 [hereinafter Kahn].
3. Speech by George James, President of Airline Economics Incorporated, to the Transportation Research Board (Jan. 11, 1988).
4. Brenner, *Airline Deregulation—A Case Study in Public Policy Failure*, 16 TRANSP. L.J. 179 (1988), at 197 [hereinafter Brenner].
5. Information from airline telephone reservation system (Jan. 1988).
6. Brenner, *supra* note 4, at 196.
7. Kahn, *supra* note 2, at 237.

rageous" examples of price discrimination.[8]

Kahn Statement: ". . .there is no reason why, when United, Frontier, Continental and People Express became embroiled in intense price competition centered on Denver, US Air and Piedmont—both consistently extremely profitable carriers with the highest average yields per mile among the majors—should have been induced or required to compensate by increasing fares in *their* markets."[9]

Comment: This statement is part of Dr. Kahn's denial that high fares in some markets have been subsidizing below-cost fares in others. His statement implies closed-off carrier systems, in which "intense price competition" exists only on some carriers' routes (e.g., United and Continental in his example), while other carriers (e.g., US Air and Piedmont) are immune therefrom. He states that "the identities of the airlines in the two categories of markets are not necessarily the same." Actually, of course, all major carriers have had a *mix* of different competitive situations. Even before People Express had brought its special brand of low-fare competition to Denver to impact United, it had brought it to Buffalo (to impact US Air), and to Norfolk (to impact Piedmont).

In view of Kahn's perception of US Air as a carrier unaffected by low-fare competition, he might find of interest the following example of price disparity *within* that carrier's system. In January 1988, US Air had an unrestricted one-way fare of $55 from Pittsburgh to New York, to meet competition on that route. Simultaneously, it charged $214 one-way from Pittsburgh to Chicago. The distances are similar (340 miles for the New York trip, 412 miles for the Chicago trip.) Both are high density routes, however, the fare to New York averaged 16 cents per mile, while the fare to Chicago was 52 cents per mile—more than 3 times higher. (Incidentally, the Chicago fare was 3½ times above its 1978 level.)

Kahn Statement: "This is a ludicrously inadequate appraisal of a record of striking improvement in productivity and reduction in cost that can be attributed only to the undeniable increase in the intensity of competitive pressures on the carriers unleashed by deregulation and the freedom it conferred on them to control their own operations."[10]

Comment: As in the discussion of pricing, Kahn has looked at certain improvements since deregulation, without checking back to see how these compared with trends previously existing. He refers to recent gains in productivity per employee. However, productivity gains in the decade *before* deregulation were similar (e.g., Figure 20 of *Airline Deregulation—A Case Study in Public Policy Failure*).[11]

In any event, my article acknowledged that deregulation pressures have led to lower costs in various areas, including particularly wage rates and

8. Speech by Alfred E. Kahn to the Regional Airline Association, *Airline Deregulation: The American Experience* (May 1986) [hereinafter Kahn speech].

9. Kahn, *supra* note 2, at 238.

10. *Id.* at 240.

11. Brenner, *supra* note 4, at 221.

hence labor costs. But it also pointed out that there have been hidden costs associated with deregulation, and that it is not really clear what the overall net cost impact will be in the long run. Kahn does not comment on these hidden costs, with the one exception, noted immediately below.

Kahn Statement: "Brenner offers no support whatever for characterizing this change [toward smaller planes] as inefficient. . . ."[12]

Comment: This is a surprising statement, since I quoted Dr. Kahn himself on this subject. (". . . there are enormous economies associated with the size of plane, up to the limit of the biggest planes available."[13]). Indeed, even in his present comments, he again refers to the lesser cost-efficiency of smaller planes. ("It costs more per passenger to provide service on small planes . . ."). Evidently, Kahn wants to have it both ways. He wants to credit deregulation for the increased frequency afforded by the smaller planes—but is unwilling to admit that there is a price to be paid—i.e., the price in the higher seat-mile cost efficiency of such planes, and their greater contribution to airport congestion.

Kahn Statement: ". . .we could conceivably maximize the 'efficiency' of carrying people between Bozeman, Montana and Montgomery, Alabama, according to Brenner's implicit standard, by providing only wide-bodied jet service once every two weeks. . . ."[14]

Comment: If Kahn really believes that so far-fetched a conclusion flows from my "implicit standard", then he must accept it as flowing from his as well. As quoted above, he too has pointed out that larger planes are more cost-efficient than smaller ones. Obviously, however, it is a gross distortion to leap from that well-recognized fact, to the "straw man" of an absurd schedule from Bozeman to Montgomery.

Kahn Statement: ". . .it is irrational to conclude. . . that the anticipated effectiveness of contestability has therefore been disproved."[15]

Comment: By use of the double negative in this statement, Kahn leaves the reader with the impression that the concept of contestability is still alive and kicking. However, in an earlier footnote, Kahn mentions (but does not indicate the conclusions of) a recent article by Michael Levine in the *Yale Journal of Regulation.*[16] Unless the reader goes to the trouble of getting a copy of that article, he'd have no way of knowing that it spent nearly 100 pages demonstrating that contestability has *not* worked. It is less than candid for Kahn to leave the impression that the contestability theory is still valid—while elsewhere mentioning (but not describing) an article that develops at great length the opposite conclusion.

Kahn Statement: "I have no recollection that in expressing the ex-

12. Kahn, *supra* note 2, at 241.

13. Alfred E. Kahn, William A. Patterson Transportation Lecture, Northwestern University, at 13 (April 28, 1982).

14. Kahn, *supra* note 2, at 247.

15. *Id.* at 233.

16. Levine, *Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy*, 4 YALE J. ON REG. 407 (1987).

pectation that the possibility of entry would prevent grossly monopolistic exploitation, the advocates of deregulation clearly distinguished the roles they expected would be played, respectively, by totally new entrants and by existing carriers invading one another's markets."[17]

Comment: Kahn is trying to downplay the significance of the diminished outlook for participation by "totally new entrants". In fact, new entrants were deemed important enough to be given specific mention in the policy objectives of the Deregulation Act. (Those objectives included: "The encouragement of entry into air transportation markets by new air carriers. . . .") It's also worth noting that, in a 1986 speech, Dr. Kahn referred to the failure rate of new entrants as "frightening," and also referred to the emerging "uncomfortably tight oligopoly"[18]—concerns that find no echo in his present comments.

Kahn Statement: "The average number of carriers *per route* is apparently higher today than it was under regulation."[19]

Comment: The use of the word "apparently" is significant. His footnote indicates that the statement is based on evidence developed in 1984, and has not been brought up to date to take account of the wave of mergers between 1984 and 1987—mergers which have substantially changed this industry's structure.

Kahn Statement: "They [the mergers] have also been *permitted* by a totally, and in my view indefensibly complaisant Department of Transportation. It is absurd to blame deregulation for this abysmal dereliction."[20]

Comment: By attempting to absolve deregulation, Kahn ignores the extent to which the deregulation advocates misjudged the matter of economy of scale in this industry. They proclaimed that such did not exist. When actual deregulation experience made clear that economy of scale *does* exist, industry consolidation became inevitable. The DOT's merger approvals were merely bowing to a pragmatic reality, namely, that the more nearly comparable size of merged systems would permit more effective competition than would an attempt to force continuation of separate entities of widely disparate size.

Kahn Statement: "Contrary to those [predictions] of our opponents, load factors have been consistently higher than in the prederegulation years of the '60s and '70s. . . ."[21]

Comment: This statement is an attempt to rebut my discussion of excess capacity. Kahn continues to ignore the reality of post-deregulation over-capacity, and to treat recent high load factors as a disclaimer of such overcapacity. Rather than repeat the discussion of this subject in my article, a simple answer to Dr. Kahn is provided by the following facts:

- In 1982, the industry's load factor of 59% was 5.5 percentage points higher than the average for the 10 years preceding deregulation.

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17. Kahn, *supra* note 2, at 233.
18. Kahn Speech, *supra* note 8.
19. Kahn, *supra* note 2, at 232.
20. *Id.* at 234.
21. *Id.* at 244.

- Yet, in that same year, the industry had an after-interest loss of over $2 billion.
- And, in that year, one of Dr. Kahn's co-sponsors of deregulation (Michael Levine) stated: "Excess capacity is the single most important threat in existence to the financial health of the airline industry."[22] If increased load factor had the significance attributed to it by Dr. Kahn, then there would have been no reason for Dr. Levine's strong concern about over-capacity as the "single most important threat." Nor would there be a reason (in 1987) for the First Boston Corporation to state: "Airlines have a chronic excess capacity problem."[23]

Kahn Statement: "Thanks in important part to the Essential Air Services Program incorporated in the 1978 Deregulation Act, not a single community that enjoyed a minimum level of certificated service at the time of deregulation has lost it."[24]

Comment: This statement, though accurate as far as it goes, is misleadingly incomplete. It fails to indicate that the Essential Air Services Program has been a temporary *exception* to free market concepts. It provides financial subsidy to assure continuation of service to small communities, and also stipulates that the last carrier in a given city cannot freely exit without government approval. The program was intended to be only transitional, and to expire in 1988. There is no present assurance as to what will happen to communities dependent upon this program, if and when it is indeed terminated, and the totally free market concepts of deregulation are left to apply to such communities.

Kahn Statement: "Any economist would recognize at once that filling seats at least some of which would otherwise be empty with fares that exceed marginal costs represents an unequivocal improvement in economic efficiency. . . ."[25]

Comment: The statement is dangerously wrong, and inadvertently embraces the very problem the industry has had with uneconomic pricing under deregulation. If a discounted fare exceeds just "marginal costs", and if it is used (as stated by Kahn) to fill seats only *some* of which would otherwise be empty, it can be distinctly uneconomic. The missing element in the equation is what would have been paid for the seats which would have been *occupied*, even without the discount fare?

My article fully recognized the value of using a discounted fare to fill empty seats—but it went on to note the accompanying risk: "To the extent that it is used by passengers who otherwise would have been paying full fare, the discounted fare becomes a source of mere revenue dilution, rather than revenue generation." Too often, the industry has fallen into the very trap held open for it in Kahn's above-quoted doctrine. The logical desire to

22. Letter from Michael Levine to Senator Robert Dole (May 10, 1982).
23. First Boston Corporation, AIRLINE REP., May 6, 1987, at 1.
24. Kahn, *supra* note 2, at 246.
25. *Id.* at 242.

fill an empty seat has spilled over into excessive erosion of yield on *existing* traffic. And that is precisely why (since deregulation) the breakeven load factor has risen more than the actual load factor—and why the actual load factor, by itself, has become meaningless as a barometer of efficiency, or of financial health.

Kahn Statement: "The enormous response of travelers to the availability of these new [fare] options is a vindication of deregulation, not a condemnation of it."[26]

Comment: This reference to "enormous response" reflects the widespread impression that deregulation has stimulated a large surge of increased traffic. That is *impression*, not fact. Figure 9 of *Airline Deregulation—A Case Study in Public Policy Failure*[27] indicates that the growth of traffic since deregulation has merely been in line with the growth trend of prior years.

Kahn Statement: "The ultimate public concern about the possibility of destructive competition is that it may result in an impairment in the ability of an industry to finance needed expansions of capacity, and a consequent deterioration in the quality of the services it provides."[28]

Comment: The above statement was made in connection with my claims that the industry has continued to engage in over-capacity. In this statement, Dr. Kahn suggests that if the carriers can continue to finance further additions to capacity, then there is no harm from the standpoint of the public. This overlooks the waste of valuable resources that is involved in the operation of excess capacity in this industry. In addition to the consumption of fuel, each unnecessary schedule places some extra load on the limited airport/airway capacity, and contributes to the congestion and delays the industry has been experiencing.

Kahn Statement: "There is no denying that the profit record of the industry since 1978 has been dismal, that deregulation bears substantial responsibility. . . ."[29]

Comment: This admission is very much in line with my own comments on the financial record. However, Dr. Kahn then blurs the significance of this concession, with a red herring. He quickly shifts to a two-page discussion of "rate of return on annual total invested capital—interest on debt plus net profit after tax." He points out that this measure "has been no lower during the deregulation period than under regulation. . . ."

In the context of what has happened to this industry, that is a meaningless statement. As indicated, this measure includes (without differentiation) the *profits* from operations, and the *interest paid out* to creditors. Both are considered as part of the "return". A carrier can be incurring sizeable losses, be on the verge of bankruptcy—and still it could show a favorable "rate of return", because the very interest payments that are threatening its solvency, would be counted as part of that return.

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26. *Id.* at 242.
27. Brenner, *supra* note 4, at 200.
28. Kahn, *supra* note 2, at 245.
29. *Id.* at 247.

A before-and-after comparison of rate of return *might* be relevant if the relationship of interest payments to profits had not changed. But they have changed radically. In the eight years before deregulation, aggregate industry interest payments were some 40% *less than* operating profits. In contrast, in the first eight years after deregulation, interest payments have been more than *two and a half times larger* than aggregate profits. When there has been so drastic a change in the interest component of "rate of return", it is a bit disingenuous to attribute significance to a before-and-after comparison of such rate of return.

Kahn Statement: "I will make no effort systematically to appraise the fairness with which he [Brenner] has characterized the *expectations* (or 'promises') of the proponents of deregulation about how it would work out..."[30]

Comment: Kahn thus seeks to dismiss (rather than discuss) the attention given in my article to the underlying theories advanced in support of deregulation. My article quoted the statements of deregulation advocates on such basic issues as: cross-subsidy; economies of scale; ability of new entrants to compete with established carriers; market contestability; relationship of price competition to service rivalry; causes of airline overcapacity. I indicated how and why the deregulators' position on such issues failed to consider the realities of airline marketing.

These were not peripheral questions, but instead went to the very heart of deregulation rationale. Because of the fallacious reasoning on these issues, deregulation doctrine rested on quicksand, and the new regime could not work out as promised.

If my quotations from deregulators' statements had been inaccurate, or taken out of context, it would have been a simple matter for Dr. Kahn to cite specific examples. It is a lame excuse for him to opt out of discussing these aspects of deregulation theology, by claiming that it would have required a "massive effort" to do so.

30. *Id.* at 230.