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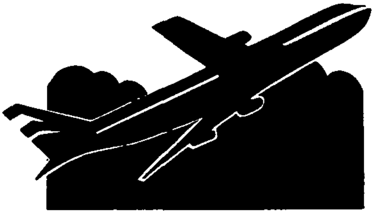

The Effects of Airline Regulation

Five years after the Airline Deregulation Act was passed, some are calling for re-regulation of the airline industry. Opponents of deregulation are blaming the financial demise and difficulties of the old trunk airlines on deregulation. Proponents, on the other hand, contend that regulation would continue to encourage inefficiency and would result in even higher fares if deregulation did not take place. Are the powers of the free market inadequate to provide satisfactory air travel service? Or is government intervention necessary?

There are two prevalent views in contemporary economic thought explaining the driving force behind the regulation of industries. The first view, called the public-interest theory of regulation, assumes that regulation is established primarily for the benefit of society or some large subclass of society at the expense of regulated firms. In this case, the government is the mechanism by which individuals in the economy express their demands to cure market failures such as public goods, monopolies, and spillover problems. Holding to this view, one could argue that the airline industry was regulated for reasons such as national defense or curtailment of monopoly powers. Therefore, the public benefited from regulation.

The second view of regulation, called the private-interest theory, holds that regulation is sought to enhance the wealth of some at the expense of the other members of society. Stigler assumes "regulation is acquired by the industry and is designed and operated primarily for its benefit."[1] In this case, the government is the mechanism by which groups of like-minded people transfer wealth from society to their own particular interest group.[2] Holding to this view, one would argue that the airline firms and aircraft manufacturers benefited from regulation.

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The Beginnings of the Airline Industry

A review of the airline industry's history reveals that without the support provided through regulation, the industry would not have begun or become established as early as it did. The private-interest theory predicted that airline firms lobbied to obtain the benefit of regulation for their industry. The airline industry did, in fact, obtain direct subsidies, control of entry, and price fixing.

The first airline service in the United States began in 1914 and lasted four months.[3] Passenger airlines were seldom successful because of the high cost of service and existing satisfaction with ground transportation. At that time in history, private firms could not provide airline service profitably, so the government was called in to provide the needed support. The resulting history is an example of what can happen when the government interferes with free-market operations.

The first main piece of legislation enacted with regard to the airline industry is the Kelly Act (Air Mail Act of 1925). It led to a substantial increase in commercial air transportation in the United States. In essence, the Post Office provided the income necessary to operate private air carriers through airmail contracts that were previously carried out by the Army. This Act was intended to develop and stabilize the industry rather than regulate questionable practices. That is, regulation was akin to a direct cash subsidy. Under the Kelly Act, eight routes were advertised through which carriers could receive up to 80 percent of postal revenue.[4]

Problems stemming from the Kelly Act led to the enactment of the McNary-Waters Act of 1930. As an amendment to the Kelly Act, it allowed the Postmaster General to extend or consolidate routes as he found necessary to promote public interest. Even though competitive bidding was still utilized to obtain mail carrier routes, strict standards had to be met in order to qualify. This made entry into the industry more difficult.

In 1930, Postmaster General Brown called a meeting in which he coordinated old routes and established new transcontinental routes. The carriers themselves were given the opportunity to decide who should service the various routes. As a result, by 1933, United, American, Trans World, and Eastern airlines collected approximately 94 percent of the $19.4 million paid to airlines for airmail service.[5]

In 1934, a Special Senate Committee of Air Mail and Ocean Contracts alleged the existence of cartels. Consequently, President Roosevelt canceled the airmail contracts and nullified the Kelly Act.

The job of carrying mail was turned over to the U.S. Army Air Corps, which was untrained and ill-equipped for the task. During this time, passenger and express revenues enabled private airlines to continue operating even though losses were incurred. After two months of poor service and several army pilot deaths, Roosevelt opened competitive bidding to private airlines for temporary contracts until Congress enacted new legislation. The award of routes at this time was important in the development of the U.S. airline system because much of the structure remained until deregulation.[6] New firms entered on the shorter routes, but the longer routes were kept by the large airlines already established.

The impact of the Great Depression caused industries to seek Federal aid and protection from "excessive competition." The Civil Aeronautics Act of 1938 developed in such an environment to help the airline industry along to its full potential that seemingly could not be attained through the free-market system. It transferred regulatory authority from the Post Office to the Civil Aeronautics Board (CAB). This act remained the basic statute for controlling airlines until they were deregulated.

The Civil Aeronautics Act required that all air carriers possess a certificate of public convenience and necessity in order to operate. The "grandfather clause" automatically issued certificates to all carriers operating between May 14 and August 22, 1938. In essence, this gave approval to the airline structure which Postmaster General Brown set up and President Roosevelt attempted to destroy because of alleged collusion. Once again, United, American, Trans World, and Eastern were the major airlines. In addition, there were twelve other airlines.

Certificates were awarded for specific routes. Transfers or abandonments of certificates could occur only if the CAB approved. The Board also had the right to: set exact fares, require information, classify carriers and make rules and regulations for those classes, fix subsidies and service mail rates, and approve and disapprove mergers.[7]

The Kelly Act of 1925 and the Civil Aeronautics Act of 1938 were the primary channels through which the carriers utilized the government to provide cartel services during their early years of existence. Further support that the airline industry used the CAB to limit competition is discerned in their reaction to proposals for increasing competition. In the 1940s, "feeder" airlines were proposed to cover short distance, low density routes. It was only after much persuasion and political influence that such a proposal was accepted by the CAB.

The Deregulatory Period

The effectiveness of the cartel services diminished over time. Although price competition was not permitted by the CAB, non-price competition on many routes caused the profit stream to be normalized. Airlines became too large both in terms of labor and capital expenditures. In the late 1960s, publicized studies and criticism against the CAB began emerging. This series of events eventually led to the signing of the Airline Deregulation Act in October 1978.

The criticism of the CAB policies was avoided until the late 1960s primarily because costs were kept down as airlines switched from propeller planes to jets, which were faster and cheaper to operate. In the 1970s, soaring fuel costs, as well as other inflationary factors, caused those benefits to erode. Airlines were granted fare increases to offset higher operating costs. In the meantime, consumer groups began alleging CAB shortcomings including its favoritism toward the industry.[8]

Critics pointed out that the cross-subsidization pricing policy used by the CAB created a false distribution of costs. Fares on high-density and long-distance routes were set above costs to subsidize service to smaller cities with fewer travelers. The CAB justified its actions with the public-interest argument that a wide network of routes was more in the national interest than exact pricing. The CAB contended that the smaller cities would not have received air service if cross-subsidization did not take place.[9]

Critics also claimed that the CAB pricing policy was self-defeating in the long run. When a few airlines were granted the right to service an over-priced route, they competed by improving services because they could not reduce prices. This caused inefficiency and higher quality service than would otherwise have been demanded: more flight attendants per passenger, better meals served more often, and more frequent flights with smaller load factors.[10]

Overcapitalization

Overcapitalization became a problem because the profits an airline was allowed depended on its capital investment.[11] Profits could be increased by increasing investments. Because airlines were competing by increasing flight frequency, a vicious cycle resulted.

Comments and reports against the CAB became more prevalent in 1973. In a speech to the Financial Analysts Federation, Lewis A. Engman, chairman of the Federal Trade Commission, said,

> If you have any doubt that one consequence of the CAB's control over rates and routes is higher prices, you need only look at what happened some years ago in

California when Pacific Southwest Airlines, an intrastate carrier not subject to CAB regulation or entry restrictions entered the San Francisco/Los Angeles market with rates less than half those being charged by the interstate CAB certified carriers TWA, Western, and United.[12]

Engman went on to explain that because of Pacific Southwest Airlines, the CAB was forced to grant the certified carriers a decrease in fares. For that reason, it cost 50 percent less to go from Los Angeles to San Francisco than from New York to Washington even though it was approximately the same number of miles.[13] Fares were 30 percent less for the unregulated intrastate airlines in Florida.[14] Such evidence indicates the airlines could operate at a lower cost in a more competitive environment without regulatory restraints.

When one considers himself in a favorable position, there is no need to be defensive until that position is threatened. The identity of the opponents of President Ford's 1975 legislative proposal to deregulate the industry suggests who might have been the beneficiaries of the existing regulation.

Labor Reaction to Deregulation

The threat of deregulation drew heavy opposition from industry union members who feared losing jobs. The competitive pressures on the main routes caused labor to benefit as a result of regulation. As in Moore's findings for the trucking industry, regulation increased wages.[15] When an operating ratio is used to set rates, the regulatory agency allows rates to increase as the cost of operating rises. Unions are strengthened because management is more willing to grant wage increases knowing that the regulatory agency will compensate for the wage increase with a fare increase. Since the CAB utilized an operating ratio with the airline industry, it is likely that the laborers in the highly unionized airline industry gained as a result of regulation, thus explaining union opposition to deregulation.

Continental Airline's recent bankruptcy based on labor contracts is further evidence that labor benefited from regulation. Labor costs in most airline firms make up one-third of the total operating costs. Today, the management of the old trunk lines are citing high labor costs as a large part of the problem. Consequently, airline firms are instituting pay cuts of up to 20 percent.[16] Newly organized firms that do not have high labor costs are able to operate at a lower cost and charge lower fares.

Consumer Reactions

Consumer opinion supporting deregulation rose as studies such as one by the General Accounting Office were released indicating that the airline industry could have saved nearly $2 billion annually if the Government did not control fares.[17] Consumers did indeed benefit as fares decreased after deregulation occurred. However, a segment of consumers that reacted negatively to deregulation are those who live in small cities. These consumers feared losing airline service as deregulation progressed.

The Reaction of Airline Firms and Manufacturers

The idea of deregulation also drew heavy opposition from a majority of the airline firms and manufacturers. Airline officials initially testified that deregulation would cause insolvency within a matter of months for three major airlines—Eastern, Pan American, and Trans World.[18] They argued that deregulation would lead to less competition because some weaker firms would go bankrupt. A spokesman for the airline industry said they wanted more flexibility to change prices but not freedom to change routes.[19]

In September of 1976, United broke the existing industry anti-deregulation mood by blaming the CAB for its instability and expressing that it did not fear deregulation.[20] By June of 1977, Airwest and Continental joined United in supporting deregulation.[21] Why this change in support occurred is uncertain. However, it can be said that the existing airlines stood to lose just as much by deregulation as they would by continued regulation. With deregulation, they would lose their limited entry status. New firms would come in until economic profits reached zero. As a result, it is likely that some existing firms would be forced to exit the industry. On the other hand, the existing airlines would lose from continued regulation because profits were eroded by overcapitalization and wage increases obtained by unions.

Airplane manufacturers benefited from the overcapitalization non-price competition created in the regulated environment.

Airlines bought more planes when they increased the number of times they flew each route thus providing more business for manufacturers. Airline manufacturers also benefited from deregulation because the increased non-price competition brought on a need for additional aircraft.

Conclusions

Competition was not effectively stifled by the CAB. Although price competition was prohibited, non-price competition emerged in forms such as increased flights, better quality meals, and smaller load factors. Thus, plane manufacturers and some consumer groups benefited from regulation. However, because the profit an airline was permitted to make was based on an operating ratio, labor benefited from the ability to unionize more easily and secure greater wage increases. Thus, non-price competition and the existence of an operating ratio served to route the benefits of regulation away from the airline firms and toward labor and manufacturers.

With the loss of government protection, the airline industry is now passing through a transitional phase. Some existing firms have left the industry and some new firms have entered, as one would expect. Each firm must find and develop its own niche in the free market to survive. I must agree with Edwin J. Colodny, President of US Air, that "re-regulation would be a step backward . . . This is not a time to attempt to unscramble the eggs."

—FOOTNOTES—

[1]George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* (1971), p. 3.

[2]For an in-depth explanation of how the political system is employed by members of society to obtain their desires, see George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* (1971).

[3]George W. Douglas and James C. Miller III, *Economic Regulation of Domestic Air Transport* (Washington, D.C.: The Brookings Institution, 1974), p. 187.

[4]This method involved many difficulties, one of which required the Post Office to complete the laborious task of counting each piece of mail. An amendment of the Kelly Act in 1926 changed the allocation of compensation to a pound basis: $3.00 per pound for the first 1,000 miles and $0.30 per pound for each additional 100 miles. Under this arrangement, it was possible for carrier compensation to exceed postal revenues. In February of 1927, the Postmaster General abandoned charging airmail zone rates and adopted a 10-cent rate per ½ ounce.

[5]Ivor P. Morgan, "Government and the Industry's Early Development," in *Airline Deregulation*, ed. John R. Meyer and Clinton V. Oster, Jr. (Boston: Auburn House Publishing Co., 1981), p. 17.

[6]*Ibid.*

[7]Richard E. Caves, *Air Transportation and Its Regulators* (Cambridge, Mass.: Harvard University Press, 1962), pp. 127–133.

[8]Robert Lindsey, "Airline Deregulation is Weighted," *New York Times*, February 7, 1975, p. 39.

[9]Roger G. Noll, *Reforming Regulation*, (Washington, D.C.: The Brookings Institution, 1971), pp. 17–18.

[10]*Ibid.*

[11]*Ibid.*

[12]Lewis A. Engman, "Regulating Industry," *Washington Post*, October 15, 1974.

[13]*Ibid.*

[14]Lindsey, p. 39.

[15]Thomas Gale Moore, "The Beneficiaries of Trucking Regulation," *The Journal of Law and Economics*, XXI (1979), pp. 327–343.

[16]Mark Clifford, "A Struggle for Survival," *Financial World*, November 15, 1983, pp. 13–18.

[17]Ernest Holsendolph, "Federal Controls on Airlines Seen Increasing Fares," *New York Times*, February 24, 1977, p. 1.

[18]"Ex-C.A.B. Chief Assails Deregulation of Airlines," *New York Times*, August 6, 1975, p. 50.

[19]Holsendolph, p. 1.

[20]Steven Rattner, "United Airlines Took Million Overbookings in Year," *New York Times*, September 8, 1976, p. 52.

[21]Morgan, p. 49.

[22]Edwin I. Colodny, "Airline Deregulation: Friend or Foe?" *USAIR*, January 1984, p. 6.

The Doomsday Myth

WHEN the OPEC nations imposed their oil embargo as punishment for the Western "tilt" toward Israel in the Arab-Israeli War of 1973, it set off a decade of panic about future energy resources. As the OPEC monopoly price rose dizzily toward $36 a barrel (the international price had stood at $2.16 in 1970), the United States made all the wrong moves. Government-imposed quotas kept the oil companies from moving available supplies around to where they would do the most good. And the attempt to control the domestic price level put a premium on wasteful consumption at a time when incentives to new drilling were declining.

Fortunately Americans, in the last year of Jimmy Carter's presidency and during Ronald Reagan's political "honeymoon" month of January 1981, finally woke up to the fact that "letting the government do it" was not the way to get new oil. With fear and trepidation Congress let the price of domestic crude run free. When the per barrel price jumped from a controlled $29 to $36, the gloom-and-doom boys said "We told you so." But as the number of working oil rigs doubled under Reagan, the situation was quickly reversed. A world oil glut developed as wells in Mexico, Canada and the North Sea started producing. OPEC woke up to discover its monopoly had been dissipated. Even with warring Iran and Iraq eliminated as big producers, the other OPEC nations could not stay the glut.

So the big crisis passed into history. In telling the story of how the market, through the instrument of price, gave Arab sheiks their first lesson in the economics of freedom, Charles Maurice and Charles W. Smithson, two authors who call themselves "simple country economists," decided to test the validity of their principles by an appeal to history. The results of their researches are presented in a fascinating book called *The Doomsday Myth: 10,000 Years of Economic Crises* (Hoover