

Essay

Why Weren't the Airlines Reregulated?

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*The economic theory of regulation posits that regulation is a service offered by self-regarding government officials to well-organized interests at the expense of the general public. Airline regulation has often been cited as a classic example, in which a naturally competitive industry was subjected to price and entry regulation, raising fares and suppressing service to the benefit of firms, labor unions, and suppliers at the expense of the traveling public. The history of its genesis is consistent with this view, since the major firms in the industry themselves benefited from informal government intervention and then lobbied for the regulatory framework enacted in 1938. But price and entry protection was lifted in 1978 as the result of a legislative process that the industry bitterly opposed, and twenty-five years of competition has damaged the interests of airlines, labor unions, and suppliers while greatly benefiting the unorganized traveling public. Why didn't the industry and its suppliers and labor unions lobby for and receive protection once the impact of deregulation on organized interests became clear? Does its failure to do so undermine the economic theory of regulation? The explanation appears to lie in the fact that comprehensive regulation tended to make firms alike and align their political interests, and deregulation allowed many different players and strategies to emerge, benefiting some and harming others. Accordingly, the industry was unable to achieve the level of cohesion necessary to undo a popular legislative program.*

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Introduction: The Economic Theory Challenged

The economic theory of regulation<sup>1</sup> doesn't account very well for the enactment and the persistence of airline deregulation. It posits that regulation is brought into being to create and/or transfer rents from politically weak groups to politically stronger groups. Which group is "politically stronger" is usually a function of increasingly concentrated impact and low organization costs. The theory concludes that regulation is generally instituted and/or exercised to entrench existing firms and to promote special interests at the expense of the consuming public. In this view, the expression of political strength that determines the regulatory regime is the ability to help regulators gain utility—appointment, power, or a post-government position—which can be done by organizing votes or contributing resources to help win elections, or otherwise influencing whoever is in a position to appoint or elect regulators and retain them. Given that large sums of money may be at stake, it is often supposed and occasionally demonstrated that the "support" reaches beyond that which is legal.<sup>2</sup> Typically, the theory predicts that the probability of the adoption of a public policy that creates or transfers rents is directly proportional to the degree of organizational efficiency<sup>3</sup> possessed by the potential beneficiaries of the proposed policy when compared with those potentially harmed by it.

But airline deregulation was a policy that principally benefited poorly organized consumers and was adopted over the opposition of a relatively small and very well organized group of regulated airlines. And it has persisted even though deregulation has had spectacularly negative impacts on organized labor, on management, on investors, on the largest firms in the industry, and on assorted other interests. This is not to say that it has been inefficient—it has

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1 This theory is also known as the "public choice" theory of regulation or the "government services" theory of regulation. It is usually contrasted with the "public interest" theory of regulation, which posits that regulation is brought about by public-spirited government actors (legislators or administrators) to serve as a public corrective for inefficiencies and/or injustices brought about by market imperfections or the failure of market outcomes to conform to social norms. While the origin of the theory is usually attributed to Stigler, George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. 3 (1971), it is best compared and contrasted with alternate theories of regulation in Richard Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974).

2 See David Burnham, *At Last, A Real Look at The C.A.B.*, N.Y. TIMES, Mar. 30, 1975, at 142; J.M. Landay et al., *A Suicide Note Accuses C.A.B. Chairman*, N.Y. TIMES, Mar. 9, 1975, at E5; Robert Lindsey, *Two Airlines Face New C.A.B. Charges On Campaign Gifts*, N.Y. TIMES, Mar. 13, 1975, at 81; Richard Witkin, *Braniff Penalized \$300,000; \$3,000 Fine Set for Hammer*, N.Y. TIMES, Mar. 24, 1976, at 55; Richard Witkin, *Nader Group Challenges C.A.B. Head*, N.Y. TIMES, July 31, 1974, at 66; Richard Witkin, *Staggers Bids C.A.B. Head Step Aside in Key Cases*, N.Y. TIMES, Aug. 16, 1974, at 58.

3 The ratio of outcome benefits to the costs of organizing to achieve them.

provided enormous benefits to the public, to unorganized labor, to some municipalities, and to a few new entrant entrepreneurs.<sup>4</sup> But a conventional ex ante calculus would have suggested that the beneficiaries were too expensive to organize and the individual impacts too little (especially since monopoly rents were greatly reduced, and hence not available for distribution) to dominate regulatory politics under the economic theory of regulation. Under the circumstances, several commentators, including me in earlier articles,<sup>5</sup> have wondered whether there was life in a public interest theory of regulation left for dead by students of the subject since the 1960s.<sup>6</sup>

In Part I of this Essay, I enrich and redefine the economic theory of regulation to accommodate the existence of political "slack," which can protect a regulator while she either confers private benefits on organized interests or uses the protection to pursue other-regarding policies that might not pass muster with the polity. While the regulator can influence the amount of slack she has, other forces and actors can make it disappear, forcing the regulator to heed the will of the general electorate. In Part II, I apply this model to airline deregulation and to the question of reregulation. Part III examines in more detail the interests that were impacted by airline deregulation and which would have been affected by reregulation. In Part IV, I briefly contrast the U.S. experience with that of Canada. And finally, I conclude in Part V by proposing some empirical tests of the revised theory as applied to air transport in the U.S. and by offering some general remarks.

## I. The Theory Enriched

If one is comfortable making normative judgments about policy outcomes that create substantial losers as well as winners, one could easily describe airline deregulation as a victory for an idea-driven, consumer-oriented "public interest," although I could certainly address the reader's attention to any number of labor union members, municipalities that lost cross-subsidized large-aircraft service or that invested in later-abandoned airline facilities, investors, lenders, and airline managements who would be willing to quarrel with that assessment. The problem with this approach is that it appears to be impossible to specify a priori precisely what is normatively justifiable, despite some heroic efforts in that direction.<sup>7</sup> Be that as it may, the economic theory of regulation

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4 Steven A. Morrison & Clifford Winston, *The Remaining Role for Government Policy in the Deregulated Airline Industry*, in DEREGULATION OF NETWORK INDUSTRIES 1 (Sam Peltzman & Clifford Winston eds., 2000).

5 Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167 (1990); Michael E. Levine, *Revisionism Revised? Airline Deregulation and the Public Interest*, 44 LAW & CONTEMP. PROBS. 179 (1981).

6 See Jean-Luc Migué, *Controls Versus Subsidies in the Economic Theory of Regulation*, 20 J.L. & ECON. 213 (1977).

7 See, e.g., JOHN RAWLS, *A THEORY OF JUSTICE* (1971). But see ROBERT NOZICK, *ANARCHY, STATE, AND UTOPIA* (1974).

purports to be a positive rather than a normative theory, so I have taken as my task here to see if I can explain the airline deregulation outcome—the creation of large but widely dispersed benefits at the expense of substantial but smaller concentrated benefits that persists and resists reversal—in positive terms using a version of the economic theory. It is my belief that both the deregulation and lack of reregulation of the airline industry can be explained by modifying the economic theory of regulation in two ways:

First, it is necessary to define special interests and their opposites more precisely. I do this by abandoning the “public interest” as a positive rather than normative concept, and instead define a “general interest” that can be specified a priori in positive terms. Thus, the “public interest” becomes a concept that is largely expressive of the preferences of the commentator rather than the polity, while the “general interest” refers to an outcome that would be approved by a fully informed polity according to its accepted aggregation principles and procedures. Whether or not something is in the “general interest” is a fact that is verifiable in principle. In contrast, the “public interest” in this model is a normative concept that is not verifiable, but only arguable. Something is in the public interest if an other-regarding entity can justify it as a public benefit according to whatever norms it regards it as moral or beneficial to promote.

Accordingly, an action that would be approved by the electorate but was inefficient or harmful to a minority (like rent control or segregation) might well be in the “general interest” but not, according to many observers, in the “public interest.” Conversely, an act of courageous conviction that provided moral or economic benefits but was unpopular and would not be approved by the polity if put to an unfettered and informed vote (ending segregation in the South or rent control in New York City) might well be in the “public interest” but not the “general interest.”

Second, the modified theory recognizes that public policy is both costly and time-consuming to formulate and effect, and that the associated costs of doing so are endogenous to the process as well as exogenous. Regulators can increase or minimize the transaction and information costs involved in monitoring and changing policy, and actors like media, academics, policy entrepreneurs, lobbyists, public interest groups, and politicians looking for an issue can increase or lower these costs through their own behavior. The modified form of the economic theory adds to the transaction and organization costs accounted for in the standard form of the economic theory, the information and monitoring costs that are pervasive in any real-world economic or political environment and have been the linchpin of the new organizational economics.

I have promulgated and explicated these modifications in detail elsewhere<sup>8</sup> and will not burden the reader with a fuller explanation here, but the

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8 See Levine & Forrence, *supra* note 5.

key new elements in the analysis are that it explicitly takes into account the existence of "slack" that shields regulators from scrutiny or influence by the general electorate and the constraints introduced by the introduction, reduction, or disappearance of slack through the mechanism of the existence of a short public agenda of very widely publicized issues.

"Slack" is the effect of information and monitoring costs that shield the actions of a regulator from observation by a rational electorate.<sup>9</sup> The operation of the economic theory of regulation implicitly relies on the existence of slack. After all, if all actions by regulators could be perfectly observed and understood and voted on, no regulator in a democratic system could survive instituting a policy that left an institutional polity (that is a political group acting through its ordinarily accepted aggregation rules) worse off than before. Thus, relatively high monitoring and organizing costs on the part of the public or institutional barriers that insulate regulators from influence by the general electorate are necessary to impose rules that benefit special interests at the expense of the general polity or impose unpopular ideological views.

Members of a polity ordinarily find the information necessary to monitor public officials too expensive to be worth acquiring or organizing to act upon, thus creating slack.<sup>10</sup> In the presence of slack, self-regarding regulators can "sell" policies to special interests in return for career support (help in achieving reelection, reappointment, or post-regulatory employment).<sup>11</sup> Alternatively, other-regarding regulators can pursue policies that they believe to be publicly beneficial but which they know would not be supported by the electorate.<sup>12</sup> In the absence of slack, only policies that would be approved by the electorate can prevail, and these will generally, although not always, be efficient policies.<sup>13</sup>

Slack is destroyed when the action and issue that is addressed by the regulator becomes the subject of such intense public scrutiny that the costs to a

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9 The term "slack" was first introduced into the political economy literature by Joseph P. Kalt & Mark A. Zupan, *Capture and Ideology in the Economic Theory of Politics*, 74 AM. ECON. REV. 279 (1984).

10 ANTHONY DOWNS, *AN ECONOMIC THEORY OF DEMOCRACY* (1957).

11 In fact, a general version of the economic theory of regulation makes slack in the political process the normal case and assumes that officials can optimize the amount of slack that they experience. See STEPHEN P. MAGEE ET AL., *BLACK HOLE TARIFFS AND ENDOGENOUS POLICY THEORY: POLITICAL ECONOMY IN GENERAL EQUILIBRIUM* 259-63 (1989).

12 Such behavior is called "Burkean" by Levine and Forrence. See Levine & Forrence, *supra* note 5, at 176-77.

13 *Id.* An inefficient result might be achieved in the absence of slack when economically efficient rents or quasi-rents (e.g., locational, scarcity, inframarginal, asset-specific) accruing to a relatively small and politically weak subclass or to individual firms outside the electorate determining the careers of the relevant regulators are destroyed or transferred by inefficient policies to a general electorate. Residential rent control usually operates in this way, especially in jurisdictions like New York City that have a high percentage of tenant occupiers. Constitutional or electoral structure can also bring about inefficient results that favor minorities at the expense of the majority—consider the impact of giving each state two senators in the U.S. system—but such outcomes are also in the general, if not public, interest where they are built into a democratically accepted structure such as the U.S. Constitution.

citizen of becoming informed on the matter drop to nearly zero. Issues that are so publicized become part of the “public agenda,”<sup>14</sup> the set of issues that are so widely discussed in the media and elsewhere that no member of the polity can easily remain unaware of them. Whether or not an issue is on the public agenda profoundly affects whether policies can be adopted that disadvantage or displease the fraction of the polity necessary to win an election. The public agenda for any polity is very limited at any given time, usually to no more than a very small handful of issues that are pervasively discussed and highly salient. Even the fact of being directly represented on a ballot does not ordinarily make either a candidate or an issue part of the public agenda.<sup>15</sup>

Putting an issue on the public agenda does not automatically lead to less regulation or even better regulation. The presence or absence of slack does not automatically map into “good” policy or “bad” rent seeking in the general case. “Doing something about it” may be the general interest (remember, *not* “public interest”) result, but the “something,” or even doing something about it at all, will not necessarily lead to efficient outcomes. Action will simply tend to lead to an outcome of which an informed polity approves. As in the rent control example, public agenda issues may even involve rent creation and transfer, although in that case, the theory says that the transfer will be to a politically dominant majority of tenants, but with a deadweight loss. Putting an issue on the public agenda simply makes it much harder (or in principle impossible, in the absence of further obfuscation) to generate private rents at the expense of an institutionally-effective voting majority. Much regulation of “hot” issues (those on the public agenda) imposes private costs on non-dominant groups that exceed the benefits conferred on the public groups supporting it. This regulation might not be adopted if there was slack and if the private groups could invest unseen in defending themselves.

In the airline case, regulation as it was, and now any possible reregulation, both involve the transfer of benefits from a consuming majority to an organized industry minority, requiring slack. “Freeing” of the industry made the firms’ interests so diverse that it has so far been impossible to organize a potentially effective industry coalition (still a non-dominant minority of the polity and therefore a “special interest” position in this hypothesis) around a position that would not be opposed by the rest of the minority, even if all this is going on behind the slack curtain.

If one believed this characterization—that airline regulation was created to decrease competition as a way to create and distribute monopoly rents<sup>16</sup>—then the likelihood of deregulation would be inversely proportional to the degree of

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14 See *id.* at 191-94.

15 See, e.g., Clyde Haberman, *Beware: Voters Could Sway This Election*, N.Y. TIMES, Sept. 2, 2005, at B1.

16 A reasonable hypothesis, see LUCILE SHEPPARD KEYES, *FEDERAL CONTROL OF ENTRY INTO AIR TRANSPORTATION* (1951).

competition and consumer benefit that deregulation would introduce, given the original distribution of slack and political salience.<sup>17</sup> In this case, airlines were well organized as they sought regulation<sup>18</sup> to greatly reduce competition among themselves and the general public (which at that time mostly did not fly) was little affected and even less interested. The process started with secret meetings with the Postmaster General in 1930<sup>19</sup> and culminated in the Civil Aeronautics Act of 1938,<sup>20</sup> a Depression-era protectionist statute that regulated both entry and rates. To participate in the airline business in the United States required a Certificate of Public Convenience and Necessity. Sixteen of these were awarded to airlines in operation in May 1938. Although the Act allowed issuance of new ones if they were "required by the public convenience and necessity,"<sup>21</sup> the Civil Aeronautics Board (CAB), created to administer the statute, never in forty years thereafter made the requisite finding to issue another one, although it did create more limited classes of certificates for specialized operations.

In the same way, the CAB had the power to set airline rates after notice and hearing, but, given the multitude of firms and markets, it did not find it practical to do so, despite two major attempts in the 1950s and 1970s. Instead, the CAB used its statutory authority to require notice of proposed tariff changes which it would then suspend and initiate informal negotiations among the airlines to see whether the proposed increase or decrease should be allowed. As long as an airline was losing money, its protests over rate reductions were generally honored. Increases were approved by either approving a filing and suspending any tariff that did not match the increase or by dismissing all pending filings and inviting refiling at the new rate. This system was finally challenged in the courts in *Moss v. CAB*<sup>22</sup> toward the end of the regulated era and the successful challenge undoubtedly hastened the end of regulation as the

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17 There is a variation that suggests that since the amount of rents affected by a change in policy determine how much it is worth investing in that change, there is a countervailing tendency toward changes that increase the amount of surplus to be divided and hence a bias toward efficiency. But this assumes away the role of the political process and the incidence of the costs of changing it that offer the possibility of creating monopoly rents in the first place. Real-world political processes all exhibit features that constrain decision processes in ways that limit the polity's ability to endlessly move from one outcome to another in the cycles postulated by Arrow's Theorem, KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (1951). See Kenneth A. Shepsle & Barry R. Weingast, *Structure Induced Equilibrium and Legislative Choice*, 37 *PUB. CHOICE* 503 (1981) (constraints on legislative action often preclude efficiency-enhancing changes, given particular starting points).

18 For an account of the Air Transport Association's role in the 1938 hearings, see Michael E. Levine, *Is Regulation Necessary?* *California Air Transportation and National Regulatory Policy*, 74 *YALE L.J.* 1416, 1422-23 (1965).

19 For an excellent and detailed description of nearly a decade's worth of government and private activities to organize competitors into an industry cartel, see F. ROBERT VAN DER LINDEN, *AIRLINES AND AIR MAIL: THE POST OFFICE AND THE BIRTH OF THE COMMERCIAL AVIATION INDUSTRY* (2002).

20 Civil Aeronautics Act of 1938, Pub. L. No. 75-601, 52 Stat. 973 (1938).

21 *Id.* § 401 at 987.

22 *Moss v. Civil Aeronautics Bd.*, 430 F.2d 891 (D.C. Cir. 1970).

CAB was forced to set filings for hearing and embarked on a five-year rulemaking to produce a fare formula that would preclude having to hold individual hearings for each tariff filing.<sup>23</sup>

Airline interests became increasingly organized as time went on and they and their co-participants (lenders, labor unions, small communities, and, to a somewhat lesser extent, aircraft manufacturers) made relationship-specific investments that they needed to protect.<sup>24</sup> The potential benefits of deregulation were speculatively thought to be quite large<sup>25</sup> but the benefits were expected to be widely dispersed among air travelers and conferred on firms not in existence or workers not yet hired.<sup>26</sup> As a result, academic calls for deregulation as early as 1949<sup>27</sup> were ignored by the public and by policy entrepreneurs and journalists.

Consequently, when new proposals for airline deregulation emerged in the 1960s,<sup>28</sup> virtually no observers applying the economic theory predicted deregulation as the outcome, and the matter was ignored politically for almost a decade. Very few have used the theory, even in hindsight,<sup>29</sup> to explain the adoption of a policy that destroyed the value of CAB certificates (including their value as implicit loan collateral); destroyed the ability to suppress or greatly delay fare competition by concerted action through the CAB; ended a forty-year de facto moratorium on entry by new firms offering scheduled service in dense or long-haul markets; dramatically revised the route network, making some facilities and fleets obsolete; reduced or eliminated the incentive to maintain cross-subsidized service to smaller communities; and exposed labor contracts that were well above market in wages and work rules to competitive pressure.<sup>30</sup>

Why then was the industry deregulated?

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23 Domestic Passenger Fare Investigation, 62 C.A.B. 613 (1973).

24 See AIR TRANSPORT ASSOCIATION, ANNUAL REPORT 1976, at 9-33, <http://www.airlines.org/files/1976AnnualReport.pdf> (Air Transport Association membership census, budget as of 1975).

25 WILLIAM A. JORDAN, AIRLINE REGULATION IN AMERICA: EFFECTS AND IMPERFECTIONS (1970); Levine, *supra* note 18.

26 See Michael E. Levine, *Financial Implications of Regulatory Change in the Airline Industry*, 49 S. CAL. L. REV. 645 (1976).

27 See Lucile Sheppard Keyes, *National Policy Toward Commercial Aviation—Some Basic Problems*, 16 J. AIR L. & COM. 280 (1949).

28 See JORDAN, *supra* note 25; Levine, *supra* note 18.

29 The most conspicuous exception is Sam Peltzman, *The Economic Theory After a Decade of Deregulation*, 1989 BROOKINGS PAPERS ON ECON. ACTIVITY, MICROECONOMICS 1.

30 As noted above, the CAB created no new “trunklines” (combination carriers of passengers and cargo with no categorical restrictions written into their certificates) between 1938 (the sixteen airlines “grandfathered” by the Civil Aeronautics Act) and 1978, although it did allow limited entry by firms that didn’t operate scheduled service or used limited scheduled service in dense markets to cross-subsidize other obligated service in thin ones.



## II. The Enriched Theory Applied

### A. *To Deregulation*

I have discussed the story of the origins of airline deregulation elsewhere in greater detail,<sup>31</sup> as have others.<sup>32</sup> I think airline deregulation can be explained by the coincidence of: (1) an inflationary period that made the public interested in anything that promised lower prices; (2) an academic story that supported deregulation as a policy that would lower prices to benefit the consuming public and could be translated into something newsworthy for the media and striking for policy entrepreneurs; (3) a combination of political ideology (the Ford Administration) and jockeying between Jimmy Carter and Edward Kennedy for support by centrist Democrats; and (4) unfavorable publicity in suspicious times for widespread direct contact between the regulators and the industry and even a whiff of scandal related to Watergate. The results were several sets of Congressional hearings and an explosion of media coverage that placed the issue on the public agenda, thereby dramatically lowering information and organization costs to the consuming public so that the issue became politically salient<sup>33</sup> and generally popular,<sup>34</sup> thus eliminating the veil of slack that protected the industry and its regulators from public scrutiny.

As mentioned, the elimination of slack was greatly assisted by the political competition between Senator Edward Kennedy and Jimmy Carter in anticipation of the 1980 presidential election, and was magnified by the very public role of Alfred E. Kahn, the first Carter Administration CAB Chairman, an intellectually powerful, attractive, and mediagenic advocate for the policy. Kahn, whose academic treatise on the economics of regulation had advocated airline deregulation, testified before Congress, lobbied the White House, engaged the industry in debate, and was very accessible to the media. Kahn's charisma was supported by the work product of the staff he assembled. This staff included, in addition to myself (in charge of the domestic and international rate, route, and interfirm agreement regulatory staffs), Darius Gaskins (an innovative and energetic Chief Economist, later Chairman of the Interstate Commerce Commission) and Philip J. Bakes (Congressional staff member turned CAB general counsel). It benefited also from the voting and intellectual support of CAB Member Elizabeth E. Bailey, as well as from the important other-branch engagement of then-professor and now-Justice Stephen Breyer as

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31 See Levine & Forrence, *supra* note 5; Levine, *supra* note 5.

32 See, e.g., STEPHEN BREYER, REGULATION AND ITS REFORM 197-221 (1982); MARTHA DERTHICK & PAUL J. QUIRK, THE POLITICS OF DEREGULATION (1985); BARBARA STURKEN PETERSON & JAMES GLAB, RAPID DESCENT: DEREGULATION AND THE SHAKEOUT IN THE AIRLINES (1994).

33 To the point where both candidates for President felt the need to support it explicitly during the 1976 presidential campaign.

34 See *supra* note 32.

a Senate staff member and Mary Schuman of the White House domestic policy staff. The often-disputatious, always articulate, and intermittently amusing interaction of Kahn, Bailey, Bakes, Gaskins, and Levine was displayed in public on a weekly basis due to the adoption of “sunshine” rules<sup>35</sup> exposing agency internal decision-making processes. What was sometimes called the “greatest regulatory show in Washington” (admittedly not a high bar to surmount) attracted media and industry attention and further contributed to the collapse of slack.

The issue and its proponents were promoted heavily in the print and broadcast media,<sup>36</sup> and the promise of deregulation proved to be popular both with the much broader segment of the population that had flown by then as a result of the introduction of jets and excursion fares, and with the very large segment that wished to fly or fly more often but was deterred by the cost of tickets. Airline deregulation as an issue generated so much publicity that members of the public almost had to exert effort not to be aware of it or informed about the arguments over it. This disappearance of slack overwhelmed the industry and its allies as President Carter and Congress responded to the general electorate.<sup>37</sup> The resulting Airline Deregulation Act of 1978<sup>38</sup> and the International Air Transportation Competition Act of 1979<sup>39</sup> deregulated the airlines.

Consider the impact of these statutes on the industry: Of eleven trunklines (including Pan American) that existed at the time of airline deregulation, at least three (Braniff, Eastern, and Pan American) were liquidated directly, often after asset sales. Three disappeared less directly (National was liquidated with Pan Am, Western was absorbed by Delta, and TWA merged with American and liquidated almost immediately). Only five—American, Continental, Delta, Northwest, and United—are still flying. Continental has been through bankruptcy reorganization twice, and United has just emerged from reorganization at the time of this writing. Delta and Northwest are in Chapter 11 reorganization; American and perhaps Continental again are likely, with varying degrees of immediacy and certainty, to follow suit. Of the ten regional airlines existing at the time of deregulation, two were liquidated, three were formed into a mainline operation (US Airways) that has now been reorganized in bankruptcy for the second time, three more were merged and then absorbed

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35 5 U.S.C. § 552(b) (1976).

36 See, e.g., William H. Jones, *Carter Backs Airline Regulation Reform*, WASH. POST, Feb. 24, 1977, at C13; Rudy Maxa, *CAB Chief Cuts Prices in Friendly Skies*; Alfred Kahn, WASH. POST MAG., June 18, 1978, at 8; Carole Shifrin, *CAB Nominee Supports Less Federal Regulation*, WASH. POST, July 26, 1977, at D7; Carole Shifrin, *Far-Reaching Changes in Store for Airlines*, WASH. POST, Oct. 29, 1978, at F1; Winston Williams, *The Airlines Try to Cope with Freedom: The Regulatory Reins Have Been Loosened*; *Company Strategies Are Up in the Air*, N.Y. Times, Apr. 23, 1978, at F1.

37 BREYER, *supra* note 32, at 198-221, 317-340.

38 Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705.

39 International Air Transportation Competition Act of 1979, Pub. L. No. 96-192, 94 Stat. 35 (1980).

by Northwest, and another was merged into a trunkline that subsequently liquidated (Ozark into TWA). Of the Alaskan and Hawaiian airlines, only Alaska has survived without reorganization.

Deregulation generated numerous "poster children"—startups operating outside<sup>40</sup> or subsequent to the CAB-regulated regime that reached significant size—some of which are now major airlines, such as JetBlue, Frontier and AirTran, but most of which by far have liquidated without a trace, some after very short lives, including, among very many, Midway, People Express (nominally merged with Continental in bankruptcy), Air Florida, Altair, Pride Air, Air One, and Columbia Air.<sup>41</sup> A few were merged and absorbed (PSA, New York Air, Air California, and Reno Air). America West has been reorganized in bankruptcy twice and continues to struggle, now merged with twice-bankrupt US Airways. Time will tell about a few of the more recent startup attempts (JetBlue, Frontier, Airtran). Only Southwest has thrived and endured for any substantial period of time without resort to the bankruptcy laws or major financial "workout."

All this bankruptcy reorganization and liquidation, merger activity and transformation has wreaked havoc on creditors, who have seen security impaired and unsecured bonds repudiated; on shareholders, who have been wiped out; and most dramatically on unionized employees working under contracts that were products of the regulated era. Tens of thousands of such employees have lost their jobs. Those who have not have seen their high-paying and work-rule-protected jobs replaced by lower-paying and harder-working ones, often at considerable personal cost. Civic interests have lost some service, or, more often, built facilities to accommodate airlines that ultimately disappeared or reorganized their route networks so that the facilities were not needed and then were left holding the bag for the underlying debt when the airlines repudiated their obligations in bankruptcy. From time to time, "service scandals" have erupted involving stranded passengers, flight delays, denied boardings, imprisonment on snowbound aircraft within sight of the terminal, lost baggage, withdrawal of amenities, and all-around poor customer service. These "scandals" have received extensive media coverage and put pressure on national politicians to "do something." In addition, high fares in some hub markets or on some business-oriented routes have created news stories and intense passenger resentment. This in turn has generated widely-reported political posturing on the part of elected officials and airline executives.<sup>42</sup>

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40 As intrastate carriers.

41 I have neglected to mention by name any number of smaller startups and passed over the many financial reorganizations and changes in morphology of others. See, e.g., T.A. HEPPENHEIMER, *TURBULENT SKIES: THE HISTORY OF COMMERCIAL AVIATION* (1995).

42 Keith L. Alexander, *Passenger Rights Expanded; Airlines' Vow is Effort to Head Off New Law*, WASH. POST, June 8, 2001, at E01; Tom Belden, *Legislation Could Backfire on Consumers*, AUGUSTA CHRON., Apr. 1, 1999, at O39; Laura Goldberg, *Passenger Power: Congress is Moving to*

## B. To Reregulation

Given this history, why has airline deregulation persisted?

Public policies are created at the intersection of interests, institutions, ideology, and information. Even in the formal world of social choice theory, an equilibrium condition chosen from among several that might be in the core set often cannot be restored after it has once been changed.<sup>43</sup> More broadly, policy is not made instantaneously and without political friction and it is not changed without much time and effort. Real-world regulation involves not only interests and organization costs but political institutions that mischaracterize or conceal information<sup>44</sup> and that limit alternatives at any given moment.<sup>45</sup> While this is going on, interests change as people and organizations adapt and invest over time in response to existing policies. Ideologies change as theoreticians, politicians, and events interact over time. All policies are created, applied, and changed through political institutions that facilitate certain expressions of interest and ideology and suppress or impede others. These institutions may change over time as well. And the polity's level of information changes as issues move on and off the public agenda. Finally, to the extent that policy-affecting individuals are independent actors rather than role-playing products of the forces around them, changes over time in the cast of characters can also profoundly affect the outcome of the policy drama. Thus, information acquired over time that, given the same political configuration that gave rise to the original policy, might lead to a different policy often faces decisive differences in any or all of interests, ideology, institutions, and information. And where individuals matter, new players in the cast may well have personal qualities and inclinations or face idiosyncratic personal incentives that affect policy or execution independent of structural constraints.

Why hasn't a coalition of the aggrieved organized some form of reregulation designed to protect or restore their rents or quasi-rents?

The economic theory of regulation would seem at first blush to suggest that deregulation should have been stifled by any of several coalitions that

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*Respond to Complaints About Airlines, But There May Not Be a Real Need*, HOUSTON CHRON., Apr. 4, 1999, at 1; Michael Grunwald, *As 'Soft Money' Flew in, A McCain Crusade Faded; Airlines Thwarted Passenger Rights Bill*, WASH. POST, Oct. 20, 1999, at A01; *McCain to Offer Bill to Help Air Travelers*, N.Y. TIMES, Feb. 14, 2001, at A26; Don Phillips, *Airlines Vow to be Kinder, Gentler*, WASH. POST, Sept. 16, 1999, at E01; Don Phillips, *Passenger-Rights Proposal Gets Stuck on the Runway*, WASH. POST, June 11, 1999, at E04; Cindy Skrzycki, *The Regulators: Has Service Reached New Heights?*, WASH. POST, Dec. 3, 1999, at E01; Frank Swoboda & Neil Irwin, *Airlines' Service Pledge Coming Up Short; Complaints Soar After Carriers' Promises Averted Congressional Action*, WASH. POST, June 28, 2000, at E01; Matthew L. Wald, *Airlines Fail to Ease the Distress of Flight Delays, Report Says*, N.Y. TIMES, Feb. 13, 2001, at A18; Matthew L. Wald, *Report is Expected to Outline Persistent Airline Problems*, N.Y. TIMES, Jan. 29, 2001, at A17.

43 See Alan Schwartz, *Statutory Interpretation, Capture, and Tort Law: The Regulatory Compliance Defense*, 2 AM. L. & ECON. REV. 1, 24-29 (2000).

44 MAGEE ET AL., *supra* note 11.

45 Shepsle & Weingast, *supra* note 17.

might have been formed by creditors, civic interests, unions, and other interest groups to reregulate the industry, either returning it to the status quo ante or imposing on it various uneconomic requirements designed to generate or protect economic rents or quasi-rents created by regime-specific investments. Each firm's route system was prescribed by the government and gave rise to political and infrastructural investments that were not market arrangements and could not be changed without incurring substantial costs. Rate regulation had created incentives for newer, faster, and bigger aircraft, and both airlines and their suppliers were protected from the consequences of uneconomic decisions by a regulatory regime that prevented airline bankruptcies. A combination of politics, regulatory pressures, and arbitration awards had imposed labor contracts and practices on the industry more costly than those that prevailed in competitive markets, but the industry was shielded from more efficient competitors by the entry protection provided by the regulatory scheme. The industry had developed practices, relationships, production decisions, and contracts that depended for their viability on the continuation of the regulatory scheme.<sup>46</sup> When these were disrupted and competitors allowed in, there were enormous financial incentives to try to recreate the conditions that made them viable.

Yet by and large, Congress and the Executive Branch have refrained from doing so. The industry has continued to operate with pricing, route, and service freedom, the freedom to succeed and fail, and the freedom to use labor, pension, and bankruptcy laws to rearrange its contractual commitments to employees, aircraft suppliers, municipalities and infrastructure providers.

The fact that careful econometric analysis says that airline deregulation has been largely successful—social benefits have vastly exceeded costs<sup>47</sup>—must be part of the story, but it seems insufficient as a political explanation and is certainly not in itself an explanation under the economic theory of regulation, which predicts the victory of inefficient rent-creating policies over efficient policies that benefit the less-organized or less-informed.<sup>48</sup> The economic theory explains regulation as a device used to impose inefficiencies that create and transfer monopoly rents. If the airline industry got itself regulated in 1938 and developed solid constituencies that opposed change and then were increasingly

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46 See Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 238-45 (1979).

47 See STEVEN A. MORRISON & CLIFFORD WINSTON, *THE EVOLUTION OF THE AIRLINE INDUSTRY* 6-35 (1995); see also Morrison & Winston, *supra* note 4.

48 There is an odd version of the economic theory proposed by Gary Becker that says that the deadweight loss from inefficient regulation creates pressure for structures that dissipate less value, so that more benefits can be distributed to organized constituencies. Gary Becker, *Comment*, 19 J.L. & ECON. 245 (1976). Thus, inefficient regulation is replaced by more efficient measures in a continuing process, of which airline deregulation is an example. This Panglossian version of regulatory theory, of course, doesn't explain how inefficient regulation arises in the first place or why all inefficient regulation doesn't ultimately wither away to be replaced by an efficient regime, a manifestly false prediction.

discomfited when change occurred, how can we explain the fact that they have not been able to reorganize to achieve reregulation and minimize or eliminate the costs that deregulation imposed on them? What explains the persistence of deregulation as a public success for many and a concentrated private disaster for a potentially influential few?

First, and perhaps most important, what had been an almost unanimous coalition of perceived industry interests changed over time as new firms entered and old firms adapted in different ways to the pressures of new competition. In 1938 when the Civil Aeronautics Act was passed, and again in the 1975-1977 period when deregulation was proposed, there was unanimity among the large airlines as to their preferred policy—regulation by the CAB. This unity ended when United broke ranks in 1977,<sup>49</sup> but there continued to be widespread, nearly unanimous industry opposition to deregulation until passage of the Airline Deregulation Act became a certainty in the late summer of 1978. Admittedly, this opposition began to weaken as the CAB took actions that made it less valuable to certificated incumbents. It adopted numerous actions with respect to both entry and pricing that promoted competition and ended protection. As one industry VP said to me after we issued the instituting order in the *Oakland Service Case*<sup>50</sup> proposing to allow service to Oakland by any airline that wanted to offer it, “If this is the sort of thing you intend to do, who needs you?” (To which I answered, “Precisely.”)

In contrast, there is no “industry position” anymore on most matters of regulation and perhaps no “industry” in the sense that has been used in discussing these matters. The airline industry is a much more heterogeneous collection of firms now than it was in 1978. Successful and struggling new entrants have emerged, and what they want or need is often different from each other and from what the “legacy” carriers want. The legacy carriers themselves differ widely in their financial and strategic situations and in their policy preferences. Several have been through bankruptcy and have input costs competitive with the Low Cost Carriers (LCCs), as new entrants and not-so-new entrants like Southwest are now called. Others are operating under contractual commitments for labor, fleets, infrastructure, and pensions that are left over from the regulated era and make their costs hopelessly uncompetitive. One or two have relatively strong balance sheets and expect to survive a shakeout. All but two others (American and Continental) have filed for protection and reorganization under Chapter 11 since 2001. Of those, only two, US Airways (a “legacy” carrier formed out of airlines holding CAB regional

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49 Although it had been at first part of a unanimous regulated airline industry in opposing deregulation, United, then the largest U.S. domestic airline, concluded in 1977 that network size and scope mattered competitively, that its size meant that it was unlikely to get any or many new route awards in competitive proceedings (the CAB had a tendency to promote industry competitive “balance” through its route awards), and therefore that it could accept competition if deregulation would also confer route entry freedom that would allow it to expand its network scope still further.

50 *Oakland Serv. Case*, 78 C.A.B. 593 (1978) (final order).

certificates before deregulation) and United, have emerged so far. None has the assurance of continuity that came with a CAB certificate before 1978.

The result is that the policies that will best promote profit vary widely among airlines. An airline such as Southwest, which is very well financed and has low unit costs, would be perfectly happy to see some of the legacy carriers liquidate and is certainly uninterested in preserving the present survival-biased Chapter 11 procedures.<sup>51</sup> JetBlue is in a similar situation. In addition to concerns about the effects of Chapter 11 in keeping competitors alive, AirTran and Frontier have complained about predation by legacy airlines pricing “below cost” to compete with them (as has America West, a two-time bankrupt that certainly has not complained about Chapter 11!). They have demanded government action to limit legacy airline competitive responses to LCC initiatives.

Many post-deregulation airlines have also been unwilling to pay the market price for the slots necessary to serve slot-controlled La Guardia and Reagan National airports. They have alleged a conspiracy to keep them from purchasing these slots at “reasonable” prices and lobbied for government intervention to make slots available to them. Unsurprisingly, legacy airlines, for whom these slot portfolios represent important financial and competitive assets, have vigorously opposed this intervention. Southwest, which does not serve these airports and professes not to wish to, does not care. Legacy airlines that have not shed their defined benefit pension plans in bankruptcy (Continental, Delta, Northwest and, to a lesser extent, American), as did US Airways and United, have also lobbied for various measures to redefine and effectively refinance their funding obligations over a long period of time. Airlines have championed their own relief needs while opposing those of others.

This has a direct impact on the politics of reregulation. The Air Transport Association, the most powerful industry trade association, requires unanimity among its members before it can take a position on legislation or regulation. Some of the LCCs (ATA, Southwest, and JetBlue) and all the surviving legacy airlines, whatever their condition, are members. Not surprisingly, the Air Transport Association has rarely been able to agree on a regulatory issue since deregulation. What it can agree on is promoting industry-wide transfers from general funds to the industry, such as the \$5 billion in compensation for the FAA “ground-stop” that followed the terrorist attacks of September 11, 2001. Given the barriers to policy change, the fact that it is almost impossible to

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51 Especially the provisions that give a six-month exclusivity to existing management to put together a financial reorganization plan, usually extended many times to achieve a period as long as several years. United has now emerged from bankruptcy proceedings, but its management's exclusivity was extended for more than three years. This produced rents for labor and especially management, who kept operating under some vestige of the non-viable arrangements while being protected from creditors, who were very much losers in the circumstances. Effective October 17, 2005, the law was changed to limit the exclusivity period to eighteen months, 11 U.S.C.A. § 1121(d)(1), (2) (West Supp. 2005), but this is still a very long period of time, and resolving the conflict among multiple contending plans at the expiration of the exclusivity period will take more time still.

imagine a new regulatory regime or major intervention that could be promoted using the combined efforts of the Air Transport Association increases organization costs for any proponent of reregulatory policy change.

In the same way, others that share a general category with concentrated interests in the regulatory regime have opposing interests with respect to reregulation. Municipalities served by successful and growing new entrants do not want to see these airlines inhibited, especially if they have sponsored new infrastructure investments linked to those airlines. But there are also municipalities that made permanent infrastructure investments based on the intentions and success of particular airlines that are threatened by drastic change and bankruptcy as the legacy airlines readjust fleets and route systems and turn to the bankruptcy laws to repudiate contractual obligations for assets they regard as unnecessary. These bankruptcies can leave the municipalities with indebtedness but no corresponding revenues. In some cases, the airlines involved are legacy airlines, but in others the investments have been made on behalf of LCCs. These municipalities may share an interest in their priority status under the bankruptcy laws, but will intervene politically as appropriate to the nature of the airline on whose behalf the investment was made. This means that they do not speak as one “municipal” or “airport” voice on policies that differentially affect particular airlines.

Some customers, such as those near US Airways’ former Pittsburgh hub, are sorry to see the frequent and convenient service provided by legacy airlines disappear, while those in Philadelphia who use the new services of Southwest worry less about the effects of Southwest’s expansion on US Airways. Travelers to Florida welcome the new free-for-all while those at Minot, North Dakota worry about whether and how they will get service if Northwest goes into liquidation.

Unions opposed deregulation and served as a focus of efforts to prevent it. They have continued since to seek protection from competitive labor markets. In the Airline Deregulation Act of 1978, they were promised public assistance if the number of workers employed in the industry shrank.<sup>52</sup> That assistance never came because in fact airline industry employment has grown enormously since 1978. Unfortunately for the unions, the new employees have been largely nonunion and, where they have been union members, as at Southwest, have worked under contracts and conditions vastly more productive than their counterparts at legacy airlines. As a result, the new employees have very different interests from members of the traditional airline unions in that they want to preserve growth opportunities for the firms that they work for and don’t wish either to halt the “deregulation movie” or rewind it to an earlier time.

This has been a problem for those who would organize brakes on competitive freedom since the early 1980s, but it has become a particularly

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52 Airline Deregulation Act of 1978, Pub. L. No. 95-504, § 43, 92 Stat. 1705, 1750-53.



important phenomenon in the five or six years preceding this writing, during which time the LCCs vastly expanded their market share. The first-generation new entrants (People Express, New York Air, etc.) mostly died or were absorbed in the 1984-1987 period. The second-generation new entrants mostly died or were absorbed in the 1990-1993 period (Reno Air, Vanguard, etc.). There was a political constituency for low air fares, especially in the leisure segment of the market, but there was much less political constraint on business-type fares. As a result, the industry market share of LCCs was still only a little over 7.7% of revenue and 13.7% of passengers as late as 1994 after the shakeout of the 1990-93 period and 10.9% and 17% respectively as late as 1998.<sup>53</sup> The most important non-legacy Air Transport Association of America member was rapidly-growing Southwest Airlines, which often broke with legacy airlines on policy matters, but by 2002 the Air Transport Association included Airtran, Jetblue, Frontier and other LCCs. As of this writing, the LCCs have a market share of approximately 30% of revenue and 37% of passengers, and the legacy airlines have conspicuously been unable to find a fare structure and level that they all find satisfactory.<sup>54</sup>

All this discord in the absence of mediagenic regulatory issues builds slack. The issue of regulation and competition has rarely made the news, let alone the public agenda, with the exception of local interest at hub cities that pay relatively high prices for the abundance of nonstop service they get. Service failures—lost baggage, late departures and arrivals, trapping passengers on snowed-in airplanes—have made the news and occasionally generated hearings, but there has been no previously-crafted policy consensus with respect to those issues comparable to the academic unanimity on deregulation that prevailed in the mid-to-late seventies and it isn't at all clear what reregulatory tool would address them effectively.

Perhaps more interesting than any differences on particular issues has been that managements at the legacy airlines themselves have gotten used to operating without many regulatory constraints and cannot easily see how to adapt themselves back into a regulatory regime (in other words, the management and people inside the major airlines have become an interest group separated from shareholders). Just as these managements replaced those adapted to operating in the CAB-regulated regime who couldn't adjust to the new world, they themselves can't imagine how to run an airline under heavy regulatory constraints. The strong imagine they would gobble the weak and the weak cannot imagine a regulatory regime that could help them much in an era

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53 All airline statistics from U.S. Department of Transportation, Bureau of Transportation Statistics Form 41 Schedule A, Schedule B-1.1, Schedule B-7, Schedule B-12, Schedule B-43, Schedule P-1(a), Schedule P-5.1, Schedule P-6, Schedule P-10, Schedule P-12(a), Schedule T-100, Schedule 2787, and Form 298-C, Schedule F-1, as processed by and courtesy of J.P. Morgan Chase & Co. (on file with author).

54 See, e.g., Keith L. Alexander, *American Fare Cuts Presage Price War; Discounts Up to 85% on Florida Flights*, WASH. POST, Nov. 19, 2004, at E01.

of hub and spoke route structures (mostly common costs in every city-pair market) and its concomitant price discrimination and yield management<sup>55</sup> and pressure from low-cost competitors. No one thinks that it is politically imaginable that the LCCs will be prevented from offering low fares in any foreseeable regulatory regime, now that the public has tasted fare competition.

Airline managements have also made many investments in deregulation-specific assets, from facilities to software to fleets. And non-airlines, including customers and suppliers, have made them as well. The proliferation of fares and the freedom to price discriminate even under competition<sup>56</sup> have stimulated huge investments in revenue management software and the human capital to operate it. This has forced even new entrants and other LCCs that formerly eschewed the techniques to adopt the strategy and the investments, although their systems are often simpler and cheaper than those used by legacy airlines. The enormous growth and expansion in scope of the route system under deregulation has created many opportunities for complementary investments in hard assets and human capital, including even the location of plants and offices by actors with no other connection to the industry.

The development of hub and spoke systems to efficiently maximize service to and among smaller cities and of point-to-point airlines to minimize costs on the densest routes has also created intense but divergent local constituencies. This has been a very important force for policy conservatism, almost like a spontaneous and uncoordinated version of the effects of deliberately placing contracts for key defense systems in many congressional districts. The current rash of bankruptcies and liquidations is putting some of those investments in jeopardy (I can get you a very good price on an enormous maintenance hanger in Indianapolis built with public funding for United), but making others even more precious.

Accordingly, the only voices for reregulation, paradoxically enough, have been some struggling new entrants (see the predation initiative referred to above), one American/Canadian law professor, and one retired professor of public policy. The first academic is for "enlightened" reregulation that would not have the defects of the old regime (without ever specifying what such a structure might look like),<sup>57</sup> and the second is a New Dealer who thinks that all unregulated competition, especially in infrastructure industries, is "wasteful."<sup>58</sup>

One might speculate that deregulation has changed the institutions of government and bureaucratic incentives and capability in a way that made political meddling more difficult. But this is largely illusory. The change in

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55 Michael E. Levine, *Price Discrimination Without Market Power*, 19 YALE J. ON REG. 1 (2002).

56 *See id.* at 24-25.

57 PAUL STEPHEN DEMPSEY & ANDREW R. GOETZ, AIRLINE DEREGULATION AND LAISSEZ-FAIRE MYTHOLOGY 358 (1992).

58 FREDERICK C. THAYER, REBUILDING AMERICA: THE CASE FOR ECONOMIC REGULATION (1984).

institutions was subtle compared to the change in substantive legislation. If anything, airline regulators should have become more politically responsive to interest groups, not less. The Civil Aeronautics Board was nominally an "independent agency" with members nominated by the President but not reporting to the Administration. Constitutionally, it was a "creature of Congress," staffed by civil servants and directed by a small cadre of politically-appointed Members and senior staff ultimately operating under "sunshine" rules. The airlines now are regulated (to the extent regulation remains) by several hundred specialist staff members in the Office of the Secretary of Transportation, reporting to an Assistant Secretary and through the organization to the Secretary and ultimately the President under rules mandating much less process transparency than was imposed on the CAB as an independent agency.

As to the civil servants themselves, about half of the CAB's employees, including virtually all of those working on policy matters, went over to the Department of Transportation (DOT) and became the core of the DOT's airline group. Only recently has retirement significantly changed their composition, although many of the senior DOT airline staff still have CAB backgrounds. The policy preferences of that group have not changed much over time. Without constraints from above, they have been enthusiastic about deregulation as long as there was a continuous and obvious flow of visible benefits—a proliferation of entrants and declining prices. They have become worried about it when the opposite was the case (often because the market had been previously oversupplied for a period, discouraging new investment) and then cyclical demand turned around (allowing price increases on the reduced supply).

While the civil servants have lacked the statutory power to reimpose the ancien régime, they retain considerable residual power over conditions of competition and agreements, especially in the international arena, and the important power to distribute valuable operating rights in limited-entry international markets. They have from time to time become very interested in making proposals designed to "preserve" the advantages of deregulation by imposing new regulations that will encourage new entrants, keep a lid on pricing, or make the competitive process less "unfairly predatory." Some of these rules, such as those governing access to and rates charged by airline-owned computer reservation systems used by travel agents, were enacted and served their intended purpose but persisted beyond their time of usefulness before they were finally buried, as much by the Internet as by the Government. Others, such as the competition conduct rules proposed at the end of the Clinton administration,<sup>59</sup> died merciful deaths but would have created a regulatory swamp from which deregulation would not have returned alive.

What was and is different from 1975-1984 is that the Department is now officially and overtly part of the Administration and thus explicitly subject to

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59 Enforcement Policy Regarding Unfair Exclusionary Conduct in the Air Transportation Industry, 63 Fed. Reg. 17,919 (Apr. 10, 1998).

political and broad policy considerations. Previously, the Administration and even Members of Congress were merely, if they chose to be, “parties” in CAB proceedings in which their advice was made public. Now, the only insulation from the Executive Branch is with respect to route awards in international limited-entry markets and other adjudicative functions (as defined by the Administrative Procedure Act).<sup>60</sup> This creates slack that could support a coalition for reregulation, but which can also be “consumed” as ideological advertising for the Republican Party, behavior that can be used to appeal to a broad constituency or a Burkean minority.<sup>61</sup> As an example, when the DOT staff started a predatory practices policy proceeding<sup>62</sup> in 1998 designed to limit incumbent responses to new entry (a matter that might not have gone far in the Bailey/Gaskins/Levine days at the CAB but that was, surprisingly, explicitly supported by its most influential deregulation-era chairman, Alfred E. Kahn, and might have done well at an independent-agency CAB somewhat insulated from Administration politics), opposition came from many quarters to which the Republicans are responsive and the matter was unceremoniously dropped when the Republicans took the presidency in 2001.

In the same way, the CAB-then-DOT staff and, very publicly, then-again-Professor Kahn, were concerned about the Reagan Administration’s unwillingness to use the antitrust law aggressively both with respect to industry structure and conduct, although the Administration was following policies for the deregulated airline industry entirely consistent with those it pursued in other unregulated sectors. While showing a lingering attachment to traditional regulatory concerns, the Administration showed a certain naiveté about the way both competitive airline markets and the new regulatory politics actually work.

First, it did not recognize the economics of scope and density that make it difficult to support more than one airline’s hub at a city. Second and perhaps more important, the Administration’s view of competitive markets imagined a kind of gentlemanly competition in which losers didn’t complain because winners didn’t play rough. This style never existed in the business world without government enforcement, is widely regarded as protectionist and inefficient and is gone even from modern sports, amateur and professional. In real world competition, competitors try to gain as strong a market position as possible and fight competitors wherever and however it seems worthwhile. They do not observe Marquess of Queensberry rules, but limit themselves only to the degree necessary to avoid antitrust prosecution. Antitrust prosecution is limited by law to preventing mergers that would create a monopoly or to thwarting deliberate single firm attempts to achieve and maintain a monopoly. Fierce, unkind and “ungentlemanly” efforts to take away business from

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60 5 U.S.C. § 554 (2000).

61 See *supra* note 12 and accompanying text.

62 Department of Transportation, Enforcement Policy Regarding Unfair Exclusionary Conduct, 63 Fed. Reg. 49,150 (Sept. 14, 1998).

competitors are explicitly permitted.<sup>63</sup> Efforts to enforce “fair” competition are subject to mistakes, have “chilling” effects on markets, and promote political distortions.

In this world, the choice is never between imperfect markets and perfect regulation, or imperfect regulation and perfect markets. The choice is between imperfect markets and imperfect regulation. The antitrust laws now reflect this, but the losers are never enthusiastic about the outcomes or the methods used to reach them and can always cite some deficiency in the competitive or regulatory process that has brought them to the sad pass in which they find themselves. Accepting that neither markets nor regulation are perfect, the interesting question presented by airline deregulation is why imperfect but freer markets were allowed to continue in the face of pressure from those significantly disadvantaged by them and why there was not more pressure to reimpose regulation, however imperfect.

One might speculate that one factor accounting for the persistence of airline deregulation is changes both in received ideology and party alignment since 1980. Coupled with the institutional change, this means that actions undertaken both in the presence and absence of slack are different from those that obtained in the heyday of regulation. There are always calls for regulation from the liberal wing of the Democratic Party, which retains, against all evidence, a sometimes-hidden and sometimes-overt belief that regulation always produces superior results to those achieved in imperfect markets. And at any given moment, there are industry, labor, and other political interests lobbying for this or that form of protectionist modification to deregulated competition to cure some impact on them of the existing regime. But there has been a thirty-year reduction in the amount of public and political faith in the efficacy of regulation as a way to lower prices or improve service. The currently dominant Republican Party is ideologically committed to that posture, although it does not always act on it.<sup>64</sup>

The liberal wing of the Democratic Party has not controlled both the Presidency and the Congress since 1968. Since the airline deregulation of the late 1970s, the Democratic Party has only controlled the Presidency for two terms, from 1992-2000. It lost control of the Congress in 1994 and has not regained it since. Airline deregulation was initiated in the Ford Administration but achieved by a centrist Democratic President and a Democratic Congress supported by scholars, think tanks, and policy entrepreneurs, many of whom

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63 *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993); *Matsushita Elec. Indus. Co. v. Zenith Radio*, 475 U.S. 574 (1986).

64 See, e.g., Brian M. Riedl, *The Senate Attempts To Prematurely Extend the Bloated Farm Bill Through 2011*, HERITAGE FOUND., Oct. 27, 2005, <http://www.heritage.org/Research/Budget/wm899a.cfm>; Brian M. Riedl, *Another Year at the Federal Trough: Farm Subsidies for the Rich, Famous, and Elected Jump Again in 2002*, HERITAGE FOUND., May 24, 2004, <http://www.heritage.org/Research/Budget/bg1763.cfm>; see also *Sen. Sessions Defends U.S. Farm Subsidies*, [http://www.alpeanuts.com/legislation/leg\\_article.phtml?newsID=1](http://www.alpeanuts.com/legislation/leg_article.phtml?newsID=1).

were Democrats themselves. Any urge on the part of Democrats to backslide was kept in check by the need to convince now-dominant Republicans and failed to gain much in the way of scholarly support.

The Republican Party has been rhetorically committed to free markets for most of that period, but has demonstrated an ability to create and transfer rents when politics required it,<sup>65</sup> so the change in party alignment is not itself a full explanation. Senator John McCain, despite his self-identification as a conservative; market-oriented Republican, certainly has managed to influence air transport policy to favor his Arizona constituents, often at the expense of the general public. As Chairman of the Senate Commerce Committee, he managed in the course of his tenure to carve out a carefully-crafted exception to the National Airport perimeter rule so as to allow constituent America West to serve it nonstop from its Phoenix hub. This exception has now been extended in a similarly limited way to Delta's Salt Lake City hub and Frontier's Denver hub, but United's much-larger Denver hub continues to be excluded. Slots at National have been made available to America West without allowing existing airlines to use them to expand service. As the ultimate transfer, the Air Transport Stabilization Board guaranteed \$380 million out of \$450 million in loans to America West to keep it afloat and then permitted it to use those proceeds to merge with US Airways. The market-oriented solution to each of these issues would have been to eliminate the perimeter rule, continue to permit slot purchases and sales or go to an auction or variable landing fee system, and to leave America West to the tender mercies of private capital markets.

Much of this has been achieved in the wake of various momentary public-agenda "scandals" related to delays, baggage mishandling, pricing, service failures, and such headline-grabbing incidents as Northwest's inability for six hours to get passengers off an aircraft trapped on the ground in a snowstorm at Detroit. Senator McCain has held hearings on these matters from time to time and threatened to reregulate the industry in various ways. The industry has responded with promises to do better (and usually some political benefit for Senator McCain), and the issues have receded back into obscurity.

I do not mean to single Senator McCain out for obloquy, since many senators nominally committed to limited government and open markets have done similar favors for constituents at the expense of the larger public and free-market principles. Indeed, other principles can be and have been sacrificed by other senators on the altar of regulatory politics. For example, consider the support by dairy-state Democrats of regulations that raise the price of milk to the urban poor who are nominally important subjects of their concern. Rather, Senator McCain's performance on these issues despite his general track record as an independent legislator highlights the almost universal use of slack by

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65 See, e.g., James A. Barnes, *Beating the Bushes for Earmarks*, NAT'L J., Feb. 10, 2001, at 415; John J. Fialka, *White House Expresses Concern Over Cost of Senate Energy Bill*, WALL ST. J., June 15, 2005, at A4; Editorial, *The Ethanol Party*, WALL ST. J., May 26, 2005, at A12.

public officials to reward organized special interests through regulation. This universality is what makes the persistence of airline deregulation such an interesting case and generates the imperative to explain it.

Accordingly, the change in party domination can be viewed as an influence on policy, but it is not its sole or perhaps even most important determinant. After all, there appears to be little or no constituency in the Democratic Party for price and entry regulation, even in the face of massive diminution of rents captured by labor unions. A better way to understand the persistence of deregulation in the face of negative impacts on well-organized constituencies is to look at changes in the amount of slack, the perceptions of the electorate that influence what they will support in the absence of slack, and the nature of the reward structure for regulatory actors.

### III. The Interests Affected

Deregulation succeeded against industry opposition because it was supported by a coalition of academics able to highlight concrete examples of lower fares with less regulation, consumer groups, politicians looking for an anti-inflation or pro-free market issue, public disgust with scandals, and charismatic individual spokesmen, all of which excited a media blizzard that lasted for several years. At the moment that deregulation occurred, there is no doubt that much of the electorate was aware of the issue and that most of those who were aware supported the policy. In terms of the Levine and Forrence model, airline deregulation was a general interest policy on the public agenda, slack had been greatly diminished, and it could be opposed only at a public official's peril. Those were the days!

As the old blues song goes, "everybody wants to go to heaven, but nobody wants to die." Everybody wants competition, but nobody likes competitive markets. Consumer groups wanted deregulation because they wanted more competition and lower prices, but they wanted the government to prevent price discrimination, reduce prices at hubs, and police competitive practices. Small communities wanted to benefit from more flights and lower fares, but objected to the fact that deregulated fares reflected the expense of serving thin markets and more flights meant the substitution of smaller propeller aircraft for larger jets. Organized labor could not succeed in opposing deregulation, but was mollified for a time by the fact that the airlines at which they had contracts expanded rapidly, adding dues-paying members for them. Later, they were not so happy when it turned out that the expanded membership could not compete under union contracts with the many new employees in the industry, who were at low-cost airlines that were non-union or worked under contracts that undercut the unions, forcing the firms for which the union members worked to cut back or even go bankrupt.

Aircraft manufacturers and lessors were thrilled by the expansion of the industry, then appalled as their airline customers became tougher purchasers

and much worse credit risks. Big cities were happy with lower fares and more service but confused as airlines came and went, often leaving unpaid infrastructure commitments behind them. Those whose traffic potential turned out not to support hubs found that they were one stop from everywhere, which made them happy, but could fly nonstop only to hubs, which made them unhappy. Those lucky enough to have hubs discovered that they had an abundance of nonstop service, but they paid higher fares than did those who got worse service. Service lapses had occurred before deregulation, but the explosive growth in markets, coupled with the need to control costs to meet fare competition, meant that they happened more often and airlines often could not be as generous in dealing with them as in the good old days of regulation.

In short, deregulation led to markets that looked like other real-world, mostly-competitive markets, warts and all.

Those such as consumer groups that were by general inclination in favor of government intervention on behalf of consumers were as hostile to lack of regulation here as they were elsewhere. They blamed lack of competition, but they really meant that the market hadn't turned out to provide just what they thought it should or to be as gentlemanly and other-directed as they had hoped. Competitors bit, scratched, lied (a little), cheated (occasionally) and sometimes even stole (or at least engaged in sleight-of-hand). That's the way it is out there in the competitive world. The aggregate results were attractive to consumers, but there were many episodes and microresults that were not. And as consumers consistently showed that they cared more about price than quality, the market gave them what they wanted, whereupon they became nostalgic for the service quality of the good old days (but of course wanted it to be restored at the new prices).

New airlines found that competing against dinosaurs that they thought were about to be extinct turned out to be very difficult when the dinosaurs were fighting for their lives, and decided that the deregulation that had given them the freedom to compete needed the active supervision of the DOT.

All this was reported in the press, but there was nowhere near the unanimity of informed opinion that had supported deregulation in the first place. Although many observers had recognized these difficulties, many did not believe that they reflected serious problems with deregulation or justified either a return to the old regime or major intervention. The public remained interested in airlines, perhaps because so many of them had flown by then, but many other issues crowded it off the public agenda. When airline deregulation did surface from time to time, over a bankruptcy, a hub abandonment by a major airline, a service atrocity or fare complaints, arguments and counterarguments flew back and forth and then the matter receded. Complaining to the DOT was not particularly helpful, since it had limited power to help. And complaining to Congress was problematic because when hearings were held, Congress got conflicting advice from apparently respectable and equally politically salient sources.



As noted above, the most dramatic pressure for the government to “do something” tended to arise over the kinds of issues about which regulation can be least effective, like quality of service and response to service emergencies. Consumer problems like lateness and cancellations, baggage mishandling, passenger imprisonment on snowbound aircraft, failure to take responsibility for service interruptions, and the like were the stuff of the most frequent Congressional and DOT oversight. The more fundamental issues like mergers and monopoly were handled first by the Department of Justice, then transferred to the DOT, then finally went back to the Department of Justice, and almost never made it onto the public agenda. Even Congressional hearings on these subjects were covered mostly by the trade press and in the business pages.

Finally, to the extent that individuals are thought to make a difference by serving as catalysts for putting issues on the public agenda and reducing slack, there was only one individual during this period in a position to affect airline regulation who had the media power of an Edward Kennedy, a President (Gerald Ford, Jimmy Carter), or a Fred Kahn, and that was Senator McCain. Although McCain, as we have seen, had intermittent interest in securing favorable government treatment for his Arizona constituent America West and in certain consumer issues (some of which, like nonstop service from National Airport to Phoenix, affected him personally), he had a general ideological bias against regulation, but no consistent interest in structural overhaul of the industry and no source of consistent advice as to what that overhaul should be.

What this suggests is that on the critical dimension of information, the post-deregulation period was quite different from the circumstances of 1975 to 1979. The issue of industry regulation was rarely on the public agenda, so slack was the normal condition. Views about how to use this slack differed widely among interests, instead of being divided in a bipolar fashion between a nearly unanimous industry (and its unions) and nearly everyone else, as in 1975 to 1979. The industry was divided. Consumers were very happy with prices and generally willing to put up, sullen but not mutinous, with the service that went with those prices. Competition grew dramatically, if erratically, in the deregulated era. Ideology was more favorable to markets and less favorable to regulation.

#### IV. Canada: The Other Side of the Coin<sup>66</sup>

Heavily influenced by the widely-publicized successes of airline deregulation south of its border, Canada also deregulated its airline market in its National Transportation Act, which was passed in 1987 and became law in

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66 I am indebted for many of the facts and most of the references in this section to Edward Iacobucci, Michael Trebilcock & Ralph A. Winter, *The Political Economy of Deregulation in Canada*, in *CREATING COMPETITIVE MARKETS: THE POLITICS AND ECONOMICS OF REGULATORY REFORM* (Marc K. Landy, Martin A. Levin & Martin Shapiro eds., forthcoming 2006). The analysis and interpretive conclusions are my own, and those authors are in no way responsible for them.

1988.<sup>67</sup> As an accompanying measure, it declared its intention to privatize its national airline and ultimately did so. But unlike in the United States, one legacy airline, Air Canada, with government encouragement, acquired failing Canadian Airlines in December 1999 and emerged as a clearly dominant firm, with a domestic market share by seat kilometer of around 73% and a market share by seat capacity of 64% in 2002.<sup>68</sup> While strong competition was provided in certain markets by LCCs, especially Westjet, many travelers were dependent on the dominant carrier for service and its vigorous efforts to combat efforts to gain footholds in its market generated allegations of predatory pricing.

Unlike the United States, where such complaints failed to generate intervention either in court under the antitrust laws<sup>69</sup> or, as we have seen, at the DOT, they were more effective in Canada.

Concerns were raised about Air Canada's conduct given its dominance. Unlike in the United States, where a predatory pricing allegation in airlines failed most prominently in the American Airlines case,<sup>70</sup> there was success in obtaining reregulation of fares in Canada. Rather than litigating predation in the courts or the Competition Tribunal under standard predatory pricing provisions, those concerned about Air Canada's position and practices succeeded in getting legislation adopted to restrict airline pricing. Bill C-26 was passed in 1996, and re-imposed a form of regulation on the airline industry, particularly Air Canada. For example, Bill C-26 empowers the Canadian Transportation Agency to review prices on monopoly routes and to disallow and roll back any "unreasonable" fares.<sup>71</sup> And the government also took steps to ensure that Air Canada did not set prices too low by creating special provisions in the Competition Act addressing predatory pricing in the airline industry.

Why would such legislation be enacted in Canada despite its failure to gain any traction in the U.S.?

First, the industry structure was different. The proliferation of business models and firms that emerged and survived in the United States did not find a counterpart in Canada. The only airline sharing Air Canada's interests was Air Canada, and it chose to lower its costs through a bankruptcy that produced the devolution of Air Canada into a whole constellation of firms all owned by Air Canada, each specialized in competing against a particular sort of competitive threat. These firms, which might have had interests in different and competing government policies, were of course coordinated in their political program. The consequent failure of most of the attempts that were undertaken to start new

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67 National Transportation Act, 1987 R.S.C., c. 28 (3d Supp.) (1985).

68 DEBRA WARD, INDEPENDENT TRANSITION OBSERVER ON AIRLINE RESTRUCTURING, AIRLINE RESTRUCTURING IN CANADA: FINAL REPORT 76 (2002).

69 United States v. AMR Corp., 335 F.3d 1109 (10th Cir. 2003), *aff'g* 140 F. Supp. 2d 1141 (D. Kan. 2001).

70 *Id.*

71 Canada Transportation Act, 1996 S.C., c.10, s. 67.2 (Can).

airlines in Canada created drama, and Air Canada's singular dominance created relatively low organizing costs for those seeking protection from it. Unlike in the United States, their interests were easily aligned—fare ceilings offered consumer protection, and fare floors offered protection to competitors that could be sold as a prophylactic against monopoly.

Second, this was an easily understood and appealing news story. The periodic failures plus the constant drumbeat of warning of the only apparently viable low-fare competitor, Westjet, created a David versus Goliath story for the press, with David Westjet seen as seeking help in defending the consumer from monopoly dominance by Goliath Air Canada. The result was reregulation.<sup>72</sup> Once the reregulation was established statutorily, slack re-emerged, allowing Air Canada, with its ongoing contact with the agency and large stake in the outcome, to begin special interest lobbying of the agency as political economy returned to "normal." The agency has recently proposed to relax its restrictions on Air Canada's pricing.<sup>73</sup> This effort was helped by policy entrepreneurship. Evidence has accumulated that, notwithstanding its problems, airline deregulation in Canada has brought benefits. This evidence has generated academic support for policy change, and Air Canada has been able to persuade the government that its pricing policies should be left to the market, and that the government should focus its attention on remaining monopolies in airports and other infrastructure that inhibit entry and raise costs (the lion's share of which are, of course, Air Canada's!).

The Canadian case is not inconsistent with the interpretation of the United States case put forward here. Rather it can be read to support it.

## V. Conclusion

The reasons why deregulation survived in the face of the drastic changes of fortune that it induced among its participants are a function of interests, institutions, ideology, and information. Interests had changed and become more diverse, as firms diverged in character and firms and communities made specific asset commitments based on the deregulated regime. Institutions had changed to make the regulatory authorities more responsive to the Administration of the moment. The ideology of the administrations during the relevant period had changed to become generally more hostile to regulation (if not necessarily to cash wealth transfers). And finally, what was for a time a

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72 See News Release No. H005/00, Transport Canada, Government of Canada Tables Legislation to Protect the Public Interest During Airline Restructuring (Feb. 17, 2000), [http://www.tc.gc.ca/mediaroom/releases/nat/2000/00\\_h005e.htm](http://www.tc.gc.ca/mediaroom/releases/nat/2000/00_h005e.htm).

73 The CANADA TRANSPORTATION ACT REVIEW PANEL, VISION AND BALANCE (2001), <http://www.reviewcta-examenlct.gc.ca/english/pages/final/pdf/finalreport.pdf>, recommended the elimination of this provision. In addition, the government has proposed changing course by eliminating all airline-specific provisions in the Competition Act. See Press Release, Minister of Industry, Minister of Industry Tables Amendments to Strengthen Competition Act (Nov. 2, 2004) (on file with author).

pervasive public attention to an issue that had a clear preponderance of evidence and support on one side became part of the usual political cacophony of recommendation and counter-recommendation, with little eye-grabbing drama to support its presence on the public agenda for any extended period of time. Given the diversity of interests and the institutional inertia of the status quo, airline deregulation has survived.

One might object that there are a large number of moving parts in this explanation and wonder whether it could be empirically tested. It is beyond the scope of this Essay to do so, but there are certainly some tests that could falsify this explanation.

One could study the news media for the four-year period 1975-1978 to measure the frequency, extent and prominence (column inches, front page, business pages, TV news time, "teaser" status, etc.) of stories that mention the possibility of new regulation or deregulation and compare that period with any four-year period since. One could also determine the number of hearings, perhaps weighted by the congressional importance (i.e., was it the committee with regulatory jurisdiction? Was the hearing chaired by a "mediagenic" member?) that raised the possibility of deregulation or reregulation. All this would be done to determine whether the issue reached comparable "public agenda" status after deregulation. This analysis would function as a measure of slack.

If there were little slack, one could study public opinion polls related to satisfaction with prices and quantity of service. In that connection, one could study both polls and experiments to see whether service quality dominated price and schedule as determinants of consumer choice in an effort to measure political salience and determine whether there was general interest support for regulation that might improve service quality but reduce competition and raise prices.

The subjects of the measured hearings could be characterized to determine whether they were designed to reduce slack on issues related to price and entry regulation, and to determine whether political entrepreneurs thought that price and entry regulation would attract general-interest support. To the extent that they were attempts to expose service failures and the remedies discussed were essentially quality regulations with no restrictions on prices or entry, that would tend to confirm the hypothesis. If, on the other hand, the hearings were characterized by an attempt to rid the industry of bad actors and install minimum prices to eliminate cutthroat competition forcing quality cuts, that would tend to falsify the hypothesis.

Where slack could be found, one could study organized industry-wide attempts to resist deregulation or promote reregulation by the Air Transport Association. Did the Air Transport Association take a position on any regulatory issues after United broke ranks in 1977? If so, were any of the issues on which they took a position related to competition? If you could find industry

unanimity or Air Transport Association testimony in favor of restricting competition, that would tend to falsify the hypothesis.

In the presence of slack, one could study the coalitions that supported and opposed any attempt to regulate competition, characterizing them by PAC contributions, congressional representation, and other conventional measures of political support to see whether any credible coalitions in favor of competition regulation emerged. If deregulation remained in the face of slack and a powerful coalition to reregulate, that would falsify the hypothesis.

One could make a case study of the most comprehensive attempt to reregulate competition: the DOT's so-called "guidelines" for competitive behavior proposed in 1998-1999<sup>74</sup> (which failed adoption) to test any conclusions drawn from the above investigations.

In short, both the genesis and persistence of airline deregulation in the face of industry opposition and detrimental effects on well-organized special interest groups are inconsistent with the primitive form of the economic theory of regulation. But it won't do simply to assert that "sometimes regulators try to do the right thing, even in the face of special interests," because that proposition isn't testable. What I have done here is to take a previously-advanced reformulation of the economic theory that allows for other-directed motivation on the part of regulators and the influence of public monitoring and information and apply it to the example of airline deregulation. I have tried to operationalize this reformulation by proposing tests that could be applied to the airline deregulation experience and would help confirm or falsify the hypotheses.

I conclude that deregulation occurred because monitoring costs dropped in a way that allowed the convergence of other-directed regulators and a supportive polity to overcome even a highly organized and uniform special-interest investment in the status quo. Regulation had limited both the population and kind of firms in the industry. They found it relatively easy to organize to protect their interests. But once the issue reached the public agenda, they couldn't prevent changes that benefited a dominant public majority. As the market forces unleashed by competition destroyed uniformity among airlines, enabling some to succeed while others suffered, it became impossible to protect politically the damaged interests of legacy airlines, labor unions, and suppliers. The combination of visible public benefits from lower fares and more service, plus the lack of unanimity on the part of an industry whose interests had been fragmented by the strategic and circumstantial variety allowed by deregulation, made it impossible to mount a 1938-style drive to restore industry stability through government protection.

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74 See *supra* note 59 and accompanying text.

