



1993

The Coming Demise of Deregulation

Richard D. Cudahy

Follow this and additional works at: <http://digitalcommons.law.yale.edu/yjreg>



Part of the [Law Commons](#)

Recommended Citation

Richard D. Cudahy, *The Coming Demise of Deregulation*, 10 *Yale J. on Reg.* (1993).
Available at: <http://digitalcommons.law.yale.edu/yjreg/vol10/iss1/2>

This Article is brought to you for free and open access by Yale Law School Legal Scholarship Repository. It has been accepted for inclusion in *Yale Journal on Regulation* by an authorized administrator of Yale Law School Legal Scholarship Repository. For more information, please contact julian.aiken@yale.edu.

The Coming Demise of Deregulation

Richard D. Cudahy†

Over time, various industries have experienced repeated swings between more and less extensive governmental regulation. This pattern reflects in part the ongoing cycle of economic prosperity and hardship. Using the airline industry as an example, Judge Cudahy demonstrates how problems fostered by deregulation come to the fore in a slumping economy. An exclusive focus on market efficiency may be too simplistic in light of bankruptcies, oligopoly, lost jobs, and chaotic pricing. Even with the enhanced participation of foreign carriers in the U.S. air market, Judge Cudahy anticipates a return to more regulation in the airline industry, and suggests that this trend may apply to other deregulated industries.

Introduction	2
I. A Guinea Pig — The Airline Industry	2
II. Deregulation and Its Problems	5
A. <i>Increasing Market Concentration and Predatory Pricing</i>	5
B. <i>The Social Cost of Economic Efficiency</i>	9
C. <i>Discriminatory Fares</i>	10
III. International Competition — A Dubious Salvation	11
IV. Déjà Vu All Over Again	13
Conclusion	15

†Circuit Judge, U.S. Court of Appeals for the Seventh Circuit. Member and Chairman, Public Service Commission of Wisconsin, 1972-1975, and energy and public utility law writer, teacher and former practitioner. Professorial Lecturer in Energy Law, George Washington University Law School, 1978-79. Member, American Bar Association Coordinating Group on Energy Law (formerly the Special Committee on Energy Law) (1978-1984, 1989-1992).

Introduction

An almost inescapable feature of the economic and political cycle is the swing of the pendulum between regulation and deregulation. When essential infrastructure industries evince structural flaws—on the one hand, monopoly pricing, price discrimination and inadequate service, or, on the other, financial collapse, service abandonments and destructive competition—economic regulation has been the usual prescription. Later, in the name of economic efficiency, deregulation and competition become the universal remedy. Today, while deregulation seems firmly in the saddle, regulation may be ready to stage a comeback of sorts.

In late 1990, I wrote an article exploring, among other things, the relationship between “good” or “bad” economic times and the tendency to regulate or to deregulate the traditional “regulated industries.”¹ Using such a framework, this essay will explore how the pendulum has swung, and where I think it will swing, with respect to a deregulatory guinea pig—the airline industry. Part I examines the current state of the airlines. Part II suggests, in the important context of an economic downturn, three reasons for a possible reversal of deregulation: increasing market concentration and predation; the social costs associated with deregulation; and discriminatory fare structures. Part III skeptically reviews increased international competition, the last best hope for the deregulatory model, as an alternative to regulation. Finally, Part IV outlines a few guiding principles that should govern the regulation/deregulation paradigm, although not attempting to define the form of a possible re-regulation.

I. A Guinea Pig — The Airline Industry

The tendency toward regulation in bad times and deregulation in good presumably applies to industries across the board.² In this article, however, I focus on the airlines because they supply such clear and understandable examples of these trends in action. I am certainly no expert in the airlines as such.³

1. Richard D. Cudahy, *Regulation/Competition: The Swing of the Pendulum*, PUB. UTIL. FORT., Apr. 1, 1991, at 21. The emphasis is on history in that article.

2. See I ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS* xvi (2d ed., MIT Press 1988). Of course, the politics of regulation and deregulation are in step with the economics. “Conservative” politics, inhospitable to government regulation, tends to prevail in boom times when growth is powerful, inflation is a threat, and demand presses against supply. On the other hand, in a depressed economy where demand is slack and surplus resources are a problem, “liberal” politics favoring government intervention tends to dominate. Economics and politics are often subject to the same underlying societal forces, which are cyclical in nature. See, e.g., KEVIN P. PHILLIPS, *THE POLITICS OF RICH AND POOR* xix-xxiii, 63-66, 97-101 (1991).

3. I do have some experience in industry regulation. See *supra* note †; see also *MCI Communications v. AT&T*, 708 F.2d 1081 (7th Cir.) (Cudahy, J.), cert. denied, 464 U.S. 891 (1983).

But I have examined several “regulated industries” and I have chosen the airline industry as a weather vane—a deregulation model—because (1) it was subjected to extensive direct economic regulation in 1938, a year of depression and financial weakness, (2) it was drastically deregulated in the 1970s and 1980s, a period of boom and inflation, (3) its vicissitudes in 1991 grew as it continued in its deregulated state and (4) its deregulated structure seemed particularly vulnerable as the economic downturn deepened. By late 1991, my forecasts of big trouble for the industry structure seemed to have been fulfilled. As expected, the trouble now appears to be ongoing. Eastern, Midway and Pan American disappeared in 1991 while others teetered on the brink. At that time, Trans World Airlines as well as America West followed Continental and others into Chapter 11.⁴ After that, fares in general seemed to be firming.⁵ Then American Airlines tried to lead the industry to a new rate structure designed to simplify fares and reduce business fares.⁶ This was followed by efforts by some of the weaker lines to renew the discounting battle. Predictably, the heavyweights met this competition,⁷ leading to an unseemly spate of heavy, but unsustainable discounting. Then Braniff Airlines went out of business,⁸ and in mid-summer of 1992, the price leaders again attempted to raise fares substantially.⁹

The People Expresses and the Midway Airlines, children of deregulation and exemplars of open entry and unconstrained competition, are now all gone along with the boom that helped create them and keep them afloat. It would be a fair guess that more mergers and bankruptcies lie ahead. We now have what appears to be a potentially oligopolistic industry structure with a quickly shrinking base of huge surviving “competitors” (American, United, and Delta Airlines come first to mind)¹⁰ and a handful of smaller lines, some of which

4. Agis Salpukas, *Bankruptcy Filing is Made by TWA*, N.Y. TIMES, Feb. 1, 1992, at A1; *America West Airlines Files for Chapter 11 Bankruptcy*, N.Y. TIMES, June 28, 1991, at D1; Stanley Ziemba, *Continental Air Files Chapter 11*, CHI. TRIB., Dec. 4, 1990, § 3, at 1.

5. See Edwin McDowell, *Big Bargains in Air Fares Grow Scarce*, N.Y. TIMES, Dec. 12, 1991, at D1.

6. Edwin McDowell, *American Air Cuts Most Fares in Simplification of Rate System*, N.Y. TIMES, Apr. 10, 1992, at A1; Agis Salpukas, *A Call for Discipline in the Airline Industry*, N.Y. TIMES, Apr. 10, 1992, at D1.

7. Robert L. Crandall, *Behind Those Bizarre Air Fares*, N.Y. TIMES, June 14, 1992, at C13; Jesus Sanchez, *Air Fare War Could Knock Small Firms into a Tailspin*, L.A. TIMES, Apr. 18, 1992, at A1. See generally Wendy Zellner et al., *The Airline Mess: Is American's Bob Crandall Part of the Problem—or the Solution?*, BUSINESS WEEK, July 6, 1992, at 50 (describing previous pricing strategies, new fare system, and resulting problems).

8. *Braniff Shuts Down, Blaming Recent Fare War*, N.Y. TIMES, July 3, 1992, at D3.

9. See Edwin McDowell, *Air Fare Plan Fails, American Admits*, N.Y. TIMES, Oct. 17, 1992, at A41 [hereinafter McDowell, *Air Fare Plan Fails*]; Edwin McDowell, *Airlines Tally the Damage from Summer's Fare War*, N.Y. TIMES, Sept. 12, 1992, at A1; Edwin McDowell, *Say Goodbye, for Now, to Lower Air Fares*, N.Y. TIMES, July 6, 1992, at C1.

10. But even Delta may have its problems. See Jonathan R. Laing, *Descent of a High Flier: Delta Air Lines Runs into Stiff Financial Headwinds*, BARRON'S, Dec. 14, 1992, at 8.

seem to have found niches (such as Alaska and Southwest).¹¹ Although there have been periodic efforts to stabilize and raise fare levels,¹² financial results in the industry have generally been unsatisfactory. Moreover, the vagaries of fare *structures* have increasingly confounded the public, although there has been an effort to simplify fare structure beginning in the spring of 1992. At the same time, service may be in jeopardy.¹³ There are, among other things, the perennial complaints about service to smaller cities, the sardine-like conditions of air travel, delays, and meals or the lack thereof.

Intangibles, although perhaps not crucial, pop up in cocktail conversation. The legitimacy of the system comes under question when an historic carrier like Pan American World Airways is swept away in the deregulatory maelstrom. Under the legendary Juan Trippe, Pan American made memorable contributions to international aviation, like opening up Latin America to our air travel and dispatching flying boats across the Pacific. Yet, somehow, Pan American could not get enough domestic business to offset the international revenues that it lost to foreign lines and to the former domestic carriers.¹⁴ Ultimately the airline went into bankruptcy.¹⁵ I am not saying that old and perhaps revered companies deserve immortality because they once made important public contributions; I am merely saying that the public may sense a competitive system out of control rather than simply the survival of the fittest.

For better or for worse, the public has probably perceived this as chaos in the air transportation system rather than as a blow for economic efficiency in the public interest. I do not know how to weigh such historic, intangible values in the big picture of an air transportation system, but I feel confident that the man in the middle seat did not see the loss of Midway, Eastern, and Pan American as *his* victory.

This is certainly not to say that deregulation did not do a remarkable job when economic expansionary conditions helped make it work. Fred Kahn, an early explorer and chief implementer of airline deregulation,¹⁶ and others

11. Stanley Ziemba, *Secret of Southwest's Success: Fun*, CHI. TRIB., Apr. 13, 1992, § 4, at 1; *New U.S.-Soviet Air Routes*, N.Y. TIMES, Sep. 6, 1990, at D2. Northwest and USAir are two other significant but financially questionable factors. As of November 1992, Northwest was apparently in urgent need of a cash infusion, with a bankruptcy filing a distinct possibility. See Agis Salpukas, *Aid Effort for Airline is Reported*, N.Y. TIMES, Nov. 18, 1992, at D1 [hereinafter Salpukas, *Aid Effort*]; Stanley Ziemba, *More Cuts for No. 4 U.S. Airline*, CHI. TRIB., Nov. 17, 1992, § 3, at 1.

12. See, e.g., Doug Carroll, *Airlines Join in 3rd Round of Fare Hikes*, USA TODAY, Oct. 20, 1992, at 1A; McDowell, *supra* note 5.

13. See, e.g., *Fliers Take Turn as Airline Critics*, CHI. TRIB., Sept. 7, 1990, § 3, at 1; Edwin McDowell, *Airlines' Woes Raise Questions on Service*, N.Y. TIMES, July 5, 1991, at D2.

14. Kevin Kelly, *Plane Monopoly: Flying New Order Skies*, IN THESE TIMES, Apr. 24-30, 1991, at 3.

15. Ironically, Pan American was an early supporter of deregulation. See ANTHONY E. BROWN, *THE POLITICS OF AIRLINE DEREGULATION* 103 (1987).

16. Kahn's classic work, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS*, *supra* note 2 (first published in two volumes in 1970 and 1971), explores the issues governing airline deregulation. In 1977 and 1978 Kahn was the Chairperson of the Civil Aeronautics Board, the regulatory authority for

deserve all the credit for that. But in the current economic climate, what comes next?

II. Deregulation and Its Problems

The answer is certainly not more deregulation. As I outline below, the problems of deregulation, not obvious in prosperous times, become vexing as the economic crisis deepens.

A. *Increasing Market Concentration and Predatory Pricing*

Heightened concentration, through merger, bankruptcy and otherwise, increasingly characterizes the airline industry and makes one wonder about the widely accepted premise that airlines are *not* decreasing cost industries with significant natural monopoly characteristics. Some will say the correlation between power and size is due simply to the opportunity for predatory pricing and the big air carriers' leverage from their control of the hubs, their air reservations systems, and their frequent flier programs. Antitrust enforcement may be able to reach some of these factors without attacking size per se. Hence, increasing market concentration may not be the sole, or principal, culprit. Perhaps the results would all have been different with aggressive antitrust surveillance, although it is difficult to see a broad attack on allegedly predatory pricing without the virtual reintroduction of regulation.

In his recent article, Alfred Kahn outlines the possibilities of predatory pricing in the ongoing deregulation of the airlines.¹⁷ Kahn detects as a com-

the airlines. Here he carried out deregulation by administrative edict and implemented deregulation as mandated by Congress. Airline Deregulation Act of 1978, Pub. L. No. 95-504, 92 Stat. 1705 (codified as amended in scattered sections of 49 U.S.C.).

17. Alfred E. Kahn, *Thinking About Predation—A Personal Diary*, 6 REV. INDUS. ORGANIZATION 137 (1991) [hereinafter Kahn, *Thinking About Predation*]. Kahn raised similar concerns in an earlier article. See Alfred E. Kahn, *Deregulatory Schizophrenia*, 75 CAL. L. REV. 1059 (1987).

For the lively debate over various approaches to predatory pricing in general, see PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW* 557-664 (Supp. 1990). In particular, see Phillip Areeda & Donald F. Turner, *Predatory Pricing Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975); RICHARD A. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 184-96 (1976); F.M. Scherer, *Predatory Pricing and the Sherman-Act: A Comment*, 89 HARV. L. REV. 869 (1976); Phillip Areeda & Donald F. Turner, *Scherer on Predatory Pricing: A Reply*, 89 HARV. L. REV. 891 (1976); F.M. Scherer, *Some Last Words on Predatory Pricing*, 89 HARV. L. REV. 901 (1976); Oliver E. Williamson, *Predatory Pricing: A Strategic and Welfare Analysis*, 87 YALE L.J. 284 (1977); Phillip Areeda & Donald F. Turner, *Williamson on Predatory Pricing*, 87 YALE L.J. 1337 (1978); Oliver E. Williamson, *A Preliminary Response*, 87 YALE L.J. 1353 (1978); Oliver E. Williamson, *Williamson on Predatory Pricing II*, 88 YALE L.J. 1183 (1979); Douglas F. Greer, *A Critique of Areeda and Turner's Standard for Predatory Practices*, 24 ANTITRUST BULL. 233 (1979); Paul L. Joskow & Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213 (1979); Roland H. Koller II, *When is Pricing Predatory?*, 24 ANTITRUST BULL. 283 (1979); Phillip E. Areeda, *Predatory Pricing (1980)*, 49 ANTITRUST L.J. 897 (1980) [hereinafter Areeda, *Predatory Pricing (1980)*]; Irwin M. Stelzer, *Changing Antitrust Standards*, Address for Workshop on Antitrust Issues in Today's Economy at Kennedy School of Government (Mar. 5, 1987) (on file with the author).

mon element in the extinction of the upstart low-fare airlines “an aggressive, discriminatory pricing response by the . . . carriers” that have been challenged by the low fares.¹⁸ He describes, for example, a fare slash by Northwest Airlines, coupled with increased frequency of service, on the route between Minneapolis/St. Paul and Newark as a competitive response to the entry by People Express into that route.¹⁹ In an earlier work Kahn defined predatory pricing, at least in part, as “sporadic destructive price cutting only on the specific occasions and in the specific areas in which . . . [new] entrants emerge or threaten to emerge. . . .”²⁰ Kahn, of course, incorporates exclusionary intent as a key element of predatory pricing in this situation. He thereby differs sharply with others who find the search for intent futile or improper, in part because, as my colleague Judge Richard A. Posner has put it, “availability of evidence of improper intent is often a function of luck and of the defendant’s legal sophistication, not of the underlying reality.”²¹

In these circumstances, and looking at the results, I am impressed with Kahn’s general conclusions. Kahn takes issue with those of the Chicago School who regard predatory pricing as virtually nonexistent. These commentators and judges believe it unlikely that a powerful market participant would sacrifice revenue to injure a smaller competitor since, given freedom of entry, the revenue would be difficult to replace later. Kahn disagrees and, if his view of airline pricing is valid, the revenue sacrifice of the big incumbents would seem a worthwhile price to pay for snuffing out the upstarts, even if there were freedom of entry into the market.

In *MCI Communications v. AT&T*,²² I veered toward the Posnerian view—influenced by the practical difficulty of distinguishing evidence of intent to destroy competition from intent simply to compete aggressively. This is still a quite persuasive factor, but, in the case of airline fares, it may be less problematic than the alternative of simply comparing prices with cost. Another possibility, requiring competitively responsive fares to remain in effect for a

18. Kahn, *Thinking About Predation*, *supra* note 16, at 141.

19. *Id.* at 141-42. Kahn also describes the “even more devastatingly effective” example of American’s Ultimate Super Saver, which involved “opening and closing the discount-fare spigot, flight by flight and hour by hour, depending on the progress of sales of full-fare tickets” *Id.* at 142. Carl Icahn, owner of TWA, has also charged American with predatory pricing. *AMR Corp. Wants to Kill Competition—Icahn*, REUTERS, Apr. 19, 1992.

20. JOEL DIRLAM & ALFRED E. KAHN, FAIR COMPETITION: THE LAW AND ECONOMICS OF ANTITRUST POLICY 214 (1954), *quoted in* Kahn, *Thinking About Predation*, *supra* note 16, at 138.

21. POSNER, *supra* note 16, at 189. Similarly, Areeda writes: “[T]he defendant’s intention will normally prove elusive. Even if we identify the persons whose intention is relevant within the firm, the meaning of the evidence will usually be obscure.” Areeda, *Predatory Pricing (1980)*, *supra* note 16, at 899; *accord* A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc., 881 F.2d 1396, 1401-02 (7th Cir. 1989) (Easterbrook, J.).

For a defense of the relevance of intent in predatory pricing analysis, see Greer, *supra* note 16, at 233-61. In addition to Kahn and Greer, Joskow and Klevorick also retain a role for intent in the “second tier” of their proposed analysis. See Joskow & Klevorick, *supra* note 16, at 259.

22. 708 F.2d 1081 (7th Cir.) (Cudahy, J.), *cert. denied*, 464 U.S. 891 (1983).

long time—a presumably sure-fire indicator of intent—is suggested by Kahn. In a memorandum to his fellow Civil Aeronautics Board members in 1978, Kahn suggested that when a major carrier cut prices to meet or beat low-price competition, it should be required to keep its low fares in effect for a long time, like three to five years.²³ Such an approach would certainly help stop “predatory” price cutting but it would seem to create a sticky price system that would be unworkable even with the permissible modifications Kahn suggested.

Kahn’s recent article is a fascinating explanation of how the big airlines have eliminated the low-cost, low-price competition that appeared on the scene after deregulation (but has now largely disappeared) through “predatory” pricing practices. Kahn regards this primarily as an antitrust problem.²⁴ But, to eliminate predatory practices of the sort identified by Kahn, it would seem necessary to reimpose price regulation heavily infused with traditional notions of precluding “discrimination.” I say this because antitrust enforcement is “after the fact,” untailored to the specific circumstances of air transport and insufficiently nimble to keep up with rapidly changing airfares.²⁵

According to Kahn, “[t]here *must* be a way of drawing the antitrust line between the way Northwest Airlines seems to have priced out of Minneapolis/St. Paul [in the above example] and holding AT&T’s competitive prices to fully distributed book costs.”²⁶ There is indeed such a way, but the way is called regulation.²⁷ Such regulation ostensibly would aim to provide an opportunity for efficient but small, low-cost entrants to remain in business and to grow and prosper as long-term competitors. Competitors would have to be saved by avoiding “destructive competition.” No doubt such anti-predation

23. For a presentation of this approach to precluding predatory pricing, see William J. Baumol, *Quasi-Permanence of Price Reductions: A Policy for Prevention of Predatory Pricing*, 89 YALE L.J. 1 (1979). Joskow and Klevorick include a similar element in their proposal for addressing predation: “A price decrease to a point above average total cost would be presumed to be legal unless the price cut were reversed either fully or to a significant extent within a reasonable period of time—for example, two years.” Joskow & Klevorick, *supra* note 16, at 255.

24. Kahn, *Thinking About Predation*, *supra* note 16, at 145.

25. For a discussion of how antitrust policy may overlook special features of the airline industry, see Stephen G. Breyer, *Antitrust, Deregulation, and the Newly Liberated Marketplace*, 75 CAL. L. REV. 1005, 1011-18 (1987) (discussing this problem in the context of airline mergers). In addition, because antitrust policy operates through the mechanisms of rule and precedent and is administered by courts, changing direction is generally a difficult and slow process; regulatory approaches, in contrast, tend to be more flexible. See *id.* at 1043. Finally, even the Civil Aeronautics Board, when it was charged with policing predatory pricing, appears to have had serious difficulty obtaining results under the antitrust approach. See generally Robert G. Berger & Stephanie J. Mitchell, *Predatory Pricing in the Airline Industry: A Case Study—The Policies and Practices of the CAB*, 13 TRANSP. L.J. 287 (1984).

26. Kahn, *Thinking About Predation*, *supra* note 16, at 143 (quoting ALFRED E. KAHN, *THE MACRO-ECONOMIC CONSEQUENCES OF SENSIBLE MICROECONOMIC POLICIES* 13 (1985)). On AT&T’s competitive prices, see *MCI Communications v. AT&T*, 708 F.2d 1081, 1117 (7th Cir.) (Cudahy, J.), *cert. denied*, 464 U.S. 891 (1983).

27. The differences between regulation by an administrative agency and antitrust enforcement in the courts are arguably analogous (but with major distinctions of time and circumstance) to the differences between the First New Deal and the Second New Deal. I cite this historical parallel in my earlier article. Cudahy, *supra* note 1, at 24.

regulation could slip by imperceptible degrees into the mold of the old-time regulation.²⁸ The old style of regulation often handicapped the carriers, strengthening the weak and burdening the strong to maintain competition more evident in service than price.²⁹ There were no new entrants. We would not hope for a return of this heavy-handed pre-1970 regulation, but I am convinced that a true anti-predatory price regime would, in order to be sufficiently flexible, be more regulatory than antitrust in form.

The poor financial results of the airline industry over the last several years may tell us something about "predatory" pricing. As I have noted, the Posnerian school has rejected the possibility of much predatory pricing because it sees the revenue lost in that practice as unrecoverable through later exercise of market power. Others, like Kahn, are persuaded that predatory pricing, identifiable by its intent, can destroy the competitive balance and drive the smaller and newer entrants to the wall. My guess is that both parties to this controversy are equally right and possibly equally wrong. No doubt, airlines irretrievably lose some revenue in meeting and beating competition from price-cutters. In spite of this, the major players may be determined to eliminate this competition even though it means losses all around. Both sides may be mistaken in assuming that all of the players behave in an economically rational way.³⁰ Under the circumstances recently encountered by the airlines, competition has been predominantly destructive, producing many losers and no winners. Part of the problem may be that some of the players are in Chapter 11. Here they are down but not out. Desperate to head off extinction, they may attempt long-odds strategies, the rationality of which may be questionable.³¹ Perhaps this makes for destructive competition and explains why widespread financial distress can go hand in hand with market concentration. Additional study of Chapter 11 may be in order.

While Kahn's warnings regarding predation are certainly worthy of concern, I believe that the *principal* impetus for a possible reintroduction of regulation is likely to be either the airline industry's financial decline, its potentially oligopolistic structure, or both. Oligopoly and financial weakness may be theoretically inconsistent, but these conditions may in fact co-exist in the airline industry. In these circumstances, regulation may be invoked as much to rationalize an industry and assure its long-term health as to provide immediate consumer benefit. This appears to have been the rationale of the Civil Aeronau-

28. Regulation under the Civil Aeronautics Act of 1938 focused primarily on control of entry. The Civil Aeronautics Board (CAB) awarded routes to a carrier based on a showing of public convenience and necessity. Fare levels and design, undue discrimination, service, competitive relationships and other matters were also subject to regulation with varying degrees of rigor depending on administrative policy.

29. See 2 KAHN, *supra* note 2, at 209-220.

30. Cf. Stelzer, *supra* note 16 (arguing that firms which engage in predatory pricing do not act irrationally, since they have objectives other than profit maximization).

31. See Stanley Ziemba, *Competition Transforms Transport*, CHI. TRIB., Nov. 15, 1992, § 7, at 1 (noting that airline executives blame industry troubles on firms operating in Chapter 11 because bankrupt airlines discount fares below cost, and other airlines have to match lower fares to compete).

tics Act of 1938.

In any event, it seems evident that, without some regulation, all the attributes of bigness—some possibly subject to antitrust challenge and some not—gave the big carriers with better balance sheets an insurmountable advantage. Hence, the rapid success of the large and well-financed airlines in crushing the small ones may indeed suggest that there are greater economies of scale and, in particular, of scope in the industry than we have imagined and that the traditional rationale for regulated monopoly or oligopoly ought therefore to be invoked. In 1938 when the airlines were first regulated they were thought to have significant natural monopoly characteristics.³² When they were deregulated in the 1970's they were practically universally thought not to be natural monopolies to any degree. A further examination of the industry as one of decreasing cost or as having some natural monopoly characteristics is certainly in order.

B. *The Social Cost of Economic Efficiency*

The cost calculus of deregulation often overlooks the pain of dislocation. I think the public may be as much concerned with the loss of tens of thousands of jobs on the failed airlines, not to mention major personnel cutbacks by other deregulated businesses like the long distance telephone companies, as with the hope for bargains in fares and other rates. For example, a section of Chicago was economically devastated by the loss of Midway Airlines and thousands of related jobs.³³ The demise of Eastern and Pan American also left distressing voids in the economy. Indeed, as Kevin Phillips notes, "Labor has *always* lost ground during conservative deregulatory periods."³⁴ In times of job loss, the citizen as "consumer" may once more begin to take second place to the citizen as "producer." The great promise of deregulation and competition is efficiency and the optimum allocation of resources, including human resources. When resources are in short supply, efficiency and better resource allocation seem crucial, and attention focuses on the bottom line of cheaper prices. We are then all eager to seize these benefits.

When resources, including people with aspirations for well-paying jobs, begin to go into heavy surplus and visibly outrun demand, there is deep concern about job opportunity in the new environment. This job anxiety begins to overshadow anticipation of bargain fares and other rate advantages which may or may not still be forthcoming on a sustained basis from deregulated industries with declining competition. This is why during the Great Depression it ostensi-

32. See H.R. Rep. No. 1328, 85th Cong., 2d Sess. 69-70 (1958).

33. See, e.g., Steve Johnson, *Losing Airline Cuts at Midway Area's Soul*, CHI. TRIB., Nov. 22, 1991, § 1, at 1.

34. PHILLIPS, *supra* note 2, at 98 n.*.

bly was easier to mobilize people as workers than as consumers. We are again in a period in which the value of one's labor and other resources, and the prosperity of producer institutions, may assume more importance than bargain rates in deregulated industries, which, in any event, may be fleeting benefits.

For these reasons, although it is the ultimate economic heresy, the promise of economic efficiency may seem empty. In fact, a certain amount of inefficiency with the promise of more jobs may appear more immediately attractive.

C. *Discriminatory Fares*

On a somewhat more conventional level, regulation may need to be invoked against various sorts of discriminatory fare structures. For a long time, the big bonanza of deregulation came in the form of cheap fares for non-business travelers on heavily traveled routes. American Airlines has apparently tried to lead the industry away from extreme and unjustified differences between business and non-business fares. At the same time in a somewhat related development, doubt has arisen about how well drastically reduced vacation fares can remain available with diminished competition.³⁵ On the other hand, there seems to be no limit to the proclivity of financially distressed airlines to cut fares in an effort to continue operating. This is the essence of destructive competition.

Price elasticity of demand, or in less academic jargon, charging "what the traffic will bear," has presumably called the tune everywhere. Thus, business travelers with uncertain departure dates and propensities to travel at peak times have paid very heavily in relation to discretionary passengers. There has been too large a differential between these passenger classes, as is indicated by recent revisions like those attempted by American in 1992. In addition, big users of travel services have been able to negotiate cheaper fares for their people, although again the American fare simplifications sought to restrict or end this practice.³⁶ Short hauls with low density and little competition have commanded extraordinarily high prices. The list of arguably discriminatory practices is a long one. The extent to which all of this can be justified by marginal cost analysis is not clear to me, although I would guess that a good deal of it can. Nonetheless, the appearance of equity among fares, not to mention fare stability, has suffered.³⁷ Apparently, the price inelasticity of business travel has been overestimated, and this was one factor leading to the American-led reductions.

35. See, e.g., Lauren R. Rublin, *Fare Wars Are Hell: At Least for the Airlines' Bottom Line*, BARRON'S, July 6, 1992, at 15; Stanley Ziemba, *Fare Cuts New Blow to Airlines*, CHI. TRIB., May 29, 1992, § 3, at 1.

36. See *Airlines Threaten to End Corporate Discounts*, WALL ST. J., Dec. 9, 1991, at B1; Doug Carroll, *Air Carriers Re-evaluating Corporate Fares*, USA TODAY, Nov. 12, 1991, at 1B.

37. See, e.g., Alison Leigh Cowan & Edward A. Gargan, *Mirage of Discount Air Fares is Frustrating to Many Fliers*, N.Y. TIMES, Apr. 22, 1991, at A1.

We may, at least before fare simplification, have had a situation analogous to the big shipper bias at the turn of the century when John D. Rockefeller's Standard Oil destroyed competition by demanding and getting lower railroad rates than its competitors.³⁸ Statutory enactments remedied this bias by giving more authority to the Interstate Commerce Commission to regulate interstate rates.³⁹ The practices that have flourished under deregulation are the very essence of what would traditionally have been regarded by regulatory agencies as "discrimination." Although there has been improvement under the American-led reform, it is hard to see such a reform enduring without regulatory support.⁴⁰

I have always in the past, as a regulator and a judge, been willing to support the concept that economically efficient prices were by definition not unduly discriminatory and, therefore, met statutory demands with respect to discrimination.⁴¹ But, I think that today some of us may have weakened in our commitment to theoretical economic efficiency as a justification for what has been, at least in appearance, pervasive "discrimination." This follows a universal tendency to recoil from extreme or suspect applications of economic efficiency when fairness is implicated.⁴²

III. International Competition — A Dubious Salvation

As a means of restoring more vigorous, sustained, and presumably beneficent competition in the industry, it has been suggested that foreign international carriers be allowed to compete in domestic travel within the United States.⁴³ Thus, for example, Japan Air Lines could compete with United Airlines on the San Francisco to New York run just as United competes with Japan Air Lines on the San Francisco to Tokyo run. Unqualified internationalists and free traders, whose views seem dominant in this country at the moment, would welcome this as a means of perpetuating deregulated air travel while ostensibly assuring the strong and enduring competitive forces in the industry needed to

38. HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW, 1836-1937* 150-51 (1991).

39. The Elkins Act of 1903, Pub. L. No. 57-103, 32 Stat. 847 (codified as amended in scattered sections of 49 U.S.C.), prohibited big shipper rebates and required shippers to file and maintain their shipping rates. The Hepburn Act of 1906, Pub. L. No. 59-337, 34 Stat. 584 (codified as amended in scattered sections of 49 U.S.C.), empowered the Commission upon complaint to prescribe reasonable rates in the face of unreasonable existing rates. Finally, the Mann-Elkins Act of 1910, Pub. L. No. 61-218, 36 Stat. 539 (codified as amended in scattered sections of 49 U.S.C.), permitted the Commission to suspend proposed rate changes and unilaterally condemn rates so long as such changes were reasonable upon judicial review.

40. See McDowell, *Air Fare Plan Fails*, *supra* note 9.

41. See JAMES C. BONBRIGHT, *PRINCIPLES OF PUBLIC UTILITY RATES* 374-75 (1961).

42. See Stelzer, *supra* note 16. *But see* Fishman v. Estate of Wirtz, 807 F.2d 520, 577 (7th Cir. 1986) (Easterbrook, J. dissenting in part) (describing economic competition as a "bruising rivalry" that does not have to be "fair").

43. See Christopher P. Fotos, *Free Trade Agenda Nears Test with "Open Skies" Policy*, AVIATION WK. & SPACE TECH., Aug. 17, 1992, at 31; Peter Passell, *Economic Scene: And Then There Were 3*, N.Y. TIMES, Nov. 14, 1990, at D2.

make such deregulation work.⁴⁴

However, I cannot imagine this scheme of things being attempted without a substantial reinstatement of regulation. The threat of predatory and other uneconomic pricing, whether real or imagined, by international carriers on United States domestic routes would call for continuing regulatory scrutiny. There would also seem to be increased service concerns if international carriers operated freely on domestic routes. International carriers might find it economically attractive to serve domestically the large cities they already reach on international flights, but too expensive and problematic to provide extensive service to smaller localities. In any event, it would make no sense to turn over the very sinews of domestic commerce to foreign control merely to rescue deregulation, unless there are other substantial benefits, such as reciprocal rights for our carriers in other countries. It is important that we weigh possible risks to vital national interests, including that of national defense, against possible benefits, such as the invigoration of competition.

Various foreign international carriers are already in the process of entering the U.S. domestic market by purchasing interests in U.S. carriers.⁴⁵ KLM, for example, owns a piece of Northwest (and the two carriers hope to unite as one airline);⁴⁶ British Airways has shown interest in buying into USAir;⁴⁷ and Air Canada, Lufthansa, Scandinavian Air Systems, Aeromexico and perhaps others are interested in Continental (which is currently operating in Chapter 11).⁴⁸ The vociferous objections by large domestic carriers with international routes to foreign ownership of even minority interests in U.S. domestic lines

44. In this connection, the national airlines serving the domestic European market are apparently moving toward deregulation. Roger Cohen, *Europe Plans Deregulation of Airlines*, N.Y. TIMES, June 23, 1992, at D1.

45. John Cushman, Jr., *Foreign Airlines Can Raise Stake in U.S. Carriers*, N.Y. TIMES, Jan. 24, 1991, at A1; Agis Salpukas, *The Big Foreign Push to Buy into U.S. Airlines*, N.Y. TIMES, Oct. 11, 1992, at C11. This of course would have the effect of giving secondary domestic carriers linkage to an international route system, presumably strengthening both the domestic and the foreign carrier.

46. Agis Salpukas, *Plan Set in Northwest-KLM Link*, N.Y. TIMES, Sept. 10, 1992, at D1. Due to Northwest's financial straits, the Department of Transportation approved its operating merger with KLM in November of 1992. Agis Salpukas, *U.S. Backs Merger of Northwest Air and Dutch Carrier*, N.Y. TIMES, Nov. 17, 1992, at A1.

47. Stanley Ziemba, *Big Stake in USAir will Expand British Airways' Access to U.S.*, CHI. TRIB., July 22, 1992, § 3, at 1. As this Article went to press, British Airways abandoned its plan to purchase a major stake in USAir due to the Department of Transportation's imminent refusal to approve the deal without reciprocal concessions from the British government. Richard W. Stevenson, *British Air Drops Plan to Purchase Big Stake in USAir*, N.Y. TIMES, Dec. 23, 1992, at A1; Stanley Ziemba, *British Airways Calls Off "Invasion"*, CHI. TRIB., Dec. 23, 1992, § 3, at 1.

48. *Aeromexico, Hurwitz Team up as Bidding for Continental Rises*, CHI. TRIB., Oct. 6, 1992, § 3, at 3; Adam Bryant, *Lufthansa in a Bid for Continental*, N.Y. TIMES, Sept 17, 1992, at D1; *New Partner for Bid*, THE FINANCIAL POST, Oct. 6, 1992, at 15; Agis Salpukas, *Air Canada in Bid for Continental*, N.Y. TIMES, Aug. 28, 1992, at D1. In November 1992, Continental selected Air Canada as its preferred partner, and hoped to emerge from Chapter 11 in early 1993. Agis Salpukas, *Continental Picks Air Canada Bid for a Merger to End Bankruptcy*, N.Y. TIMES, Nov. 10, 1992, at A1 [hereinafter Salpukas, *Continental Backs Air Canada's Offer*].

demonstrate the daunting difficulties of foreign entry into our air market.⁴⁹ The political weight of large domestic carriers with international route systems is arrayed against foreign internationals allied with weaker domestics. As of November 1992, the demands for foreign participation in the domestic industry were clamorous. These demands appeared to be primarily dictated by the financial difficulties of the domestics.⁵⁰ However these developments play out, the demand for regulatory intervention with respect to the domestic-foreign confrontation will be irresistible in the long term.

IV. Déjà Vu All Over Again

As all this suggests, some sort of regulation may be back in the airline industry before too long.⁵¹ Arguments based on economic efficiency will not carry the day if competition has gone sour, predatory pricing goes unchecked, stability and fairness in rate structures cause concern, and inadequate service sparks consumer wrath. At the end of the trail, there are questions about the financial viability of the industry. As I pointed out in my earlier article,⁵² this is essentially the swing of the pendulum. It is by no means a criticism of deregulation per se, which has served the admirable purpose of sweeping away an outdated methodology of control replete with heavy burdens on efficiency. But, as I have noted earlier, there are many reasons to believe, particularly when the economy is in trouble, that the airlines and other great infrastructure systems⁵³ may move once more in the direction of a regulatory resurgence. The carriers, as much as the public, may demand it. The roller coaster pricing of the spring and summer of 1992 must lead to dissatisfaction. First, cheap, half-price tickets cause a stampede to buy, followed by jammed airports and crowded flights; then, attempted price increases are made more abrupt and distasteful by the unaccountable bargains that preceded them.

Some have said that the free market system is driven, among other things, by greed and fear in differing proportions and intensities. These forces tend to

49. See, e.g., Mindy Fetterman, *British Airways Gets an Earful*, USA TODAY, Oct. 2, 1992, at B2; Elisabeth Niejahr, *United Blasts British Air's Bid on USAir*, CHI. TRIB., Aug. 11, 1992, § 3, at 1; Agis Salpukas, *Battle Lines Drawn in USAir Deal*, N.Y. TIMES, Oct. 3, 1992, at A35. Others, including former presidential candidate H. Ross Perot, have criticized opening U.S. markets to foreign competitors. See *Transcript of 3d TV Debate Between Bush, Clinton and Perot*, N.Y. TIMES, Oct. 20, 1992, at A20; see also Daniel M. Kasper, *Open Our Skies to Foreign Airlines*, N.Y. TIMES, Oct. 12, 1992, at A19 (critical of opening U.S. markets to foreign airlines without winning reciprocal concessions). Perot's comments were met with an open letter from USAir head Seth E. Schofield, stating that the merger of USAir and British Airways would preserve jobs in the U.S. *USAir Chairman Responds to Perot Remarks*, PR NEWSWIRE, Oct. 20, 1992.

50. See, e.g., Salpukas, *Aid Effort*, supra note 10; Salpukas, *Continental Backs Air Canada's Offer*, supra note 47.

51. It is a safe bet that it will be called something other than regulation.

52. See Cudahy, supra note 1.

53. This generally includes transportation, communication and energy providers.

give us our direction, with greed finding full scope in an expanding economy and fear inhibiting loss in a declining one. But I think the time may be coming when market forces alone will not be trusted to carry the whole burden of the public interest in basic infrastructure industries.

In this connection, one of the more dramatic steps taken in the deregulation of the airlines was the complete liquidation of the independent regulatory agency, the Civil Aeronautics Board.⁵⁴ The deregulators burned their bridges behind them and presumably left no easy way for an insidious regulatory bias to creep back into the industry picture. I think this was a mistake. It was a step taken on the assumption that the move to deregulation was a part of a secular movement not to be reversed in the foreseeable future. My own view that regulation and deregulation are the two stages of a pendulum-like swing would suggest the wisdom of keeping regulatory institutions on a skeletal or shadow basis when deregulation is in vogue. I think that this approach actually might help avert extreme swings in regulatory policy. Consistent with that purpose, if regulation is reinstated, it should be a modest and carefully tailored regulation having a minimal impact on economic efficiency.

All these aspects of regulation and deregulation are matters of degree and timing. We can all remember the golden years when People Express was the flagship of deregulation. Courageous, low-cost entrepreneurs launched new vehicles into the skyways. But we are now in a much more defensive phase, with growth at a temporary plateau and planning and regulation more obviously under consideration. The pendulum is swinging here, for the moment at least, on a different frequency than in most of the former Soviet bloc, although I expect that part of the world will, in due course, experience the phases familiar to us.

I will not attempt to define here with any particularity what form the coming regulation may take. It would presumably move against predatory pricing if that can be identified. It might impose some restrictions on the abandonment of routes and reintroduce the concept of the obligation to serve. It might also intervene modestly in the structure and to some extent the level of fares. There is certainly a great deal of regulatory potential beyond that, such as in the control of entry, but I would hesitate to predict how much of it, if any, might be invoked. This will not be a tidy process. The basic theme of deregulation—that free markets and free competition most efficiently allocate resources and provide the most at the cheapest cost for the consumer—is a powerful argument. There are other arguments, however, that are particularly strong during a time of economic downturn. Pricing may have been predatory, competition may have declined or become more malignant, fares may eventually rise,

54. Certain residual functions of the Civil Aeronautics Board were transferred to the U.S. Department of Transportation. See Civil Aeronautics Board Sunset Act of 1984, Pub. L. No. 99-443, 98 Stat. 1703 (codified as amended at 49 U.S.C. § 1551(b)(1)(C) (1988)).

fare structures may be unfair, and service may be suffering. Basically, I think the size and scope of airline operations in a big country like the United States confer an advantage on the most extensive and well-financed participants in the market. In difficult economic times many of the smaller and less well-financed operators will go to the wall. There will be increasing concentration in the industry, and competition will weaken. It is then that regulation in some form may be reinstated. Hopefully it will not be a suffocating, ultra-protectionist regulation but a common-sense regulation designed to carry a major infrastructure industry through bad times as well as good. And these same principles should apply beyond the airlines to all the infrastructure industries.⁵⁵

Conclusion

Joseph Schumpeter correctly described capitalism as “Creative Destruction.”⁵⁶ For a couple of years, at least, the airlines seem to have known more destruction than creation. But none of us are guaranteed continuous growth and prosperity even through flawless manipulations of the Federal Reserve Board or of tax policy.

Economic activity and its political analogues are inherently cyclical, and regulatory institutions must be attuned to the cyclical nature of things. A good deal of the time, competition advances innovation and growth, but there is indeed sometimes such a thing as destructive competition. We have apparently known destructive competition, linked to predatory pricing, in the airline industry and may continue to know it. Competition in this industry has been destructive because on balance wealth has been destroyed and both tangible and intangible values have been undermined.⁵⁷ Competition itself has been weakened, and for that reason a return to some form of regulation is likely.

55. For the case against deregulation in other industries, see generally PAUL S. DEMPSEY, *THE SOCIAL AND ECONOMIC CONSEQUENCES OF DEREGULATION* (1989); Paul S. Dempsey, *Running on Empty: Trucking Deregulation and Economic Theory*, 43 ADMIN. L. REV. 253 (1991); Paul S. Dempsey, *Market Failure and Regulatory Failure as Catalysts for Political Change: The Choice Between Imperfect Regulation and Imperfect Competition*, 46 WASH. & LEE L. REV. 1 (1989).

56. JOSEPH SCHUMPETER, *CAPITALISM, SOCIALISM, AND DEMOCRACY* 83 (1942).

57. For a more rigorous approach to the subject of destructive competition, see 2 KAHN, *supra* note 2, at 172-251.

