Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Airline Deregulation

TO THE EDITOR:

David R. Graham and Daniel P. Kaplan ("Airline Deregulation *IS* Working," *Regulation*, May/June 1982) refer vaguely to critics of deregulation. They do not, however, examine those critics' premises in detail.

The basic problem is easy to outline. In the old days, three airlines offered me seats from New York to Los Angeles. Although I was "free to choose" one, to use Milton Friedman's phrase, this left the others with empty seats. Now, seven companies fly the route, and when I choose one, six have empty seats. The wider the choice and the greater the head-to-head competition, the greater the number of empty seats. There is no way to reduce overcapacity without restraining—that is, regulating—choice. This problem is crucial in any industry where the product or service cannot be stored as inventory.

Some of the authors' assertions are also misleading:

- When Braniff expanded in 1978, *Fortune* analyzed the matter at great length (March 1979), concluding that Braniff was a good bet because it was "widely conceded to have one of the smartest management teams in the business." It is popular now to picture Braniff as having been stupid all along; Graham and Kaplan define its "management error" as "foreseeing neither the recession nor the coming rise in fuel prices and interest rates." But since hardly anyone predicted all three of these events, it is more plausible to conclude that Braniff suffered more from the huge overcapacity caused by deregulation than from having hitherto bright managers suddenly lose their marbles.
- Classical economic theology tells us that the "market" instantly responds to lower demand in a recession by reducing supply. Graham and Kaplan should tell us why the airline industry did not do so.
- Graham and Kaplan praise World Airways as one of the carriers whose lower costs and fares reflect the new efficiency. They do not mention that World stepped forward in March 1982 to ask the Civil Aeronautics Board to set a rate floor on transcontinental routes that would at least cover demonstrable costs. It is highly misleading to argue that "consumers are better off" when prices on such routes are well below costs, since it is obvious that such prices cannot be sustained.
- Graham and Kaplan must realize that commuter airline service to small communities is far from equivalent to regular service. Even the movement of airmail has been affected (shades of the old days!). Moreover, the commuter airlines have long been a special safety problem.

There are two other related points that badly need wide attention:

First, regulation does not by itself lead to overcapacity in big planes or inflated labor costs. The forms of service competition that have long afflicted the airlines are not unique to price-regulated industries, but occur wherever competition is dominated by large firms. The typical example is that of four service stations on a single street corner. Meanwhile, a case can be made that needed modernization through the purchase of fuel-conserving planes is being dangerously delayed as small airlines rely upon second-hand fuel-guzzlers.

Second, *any* industry, if it is to remain viable, must be regulated in some fashion. Only the form of regulation is a matter of choice. Price supports, tariffs, quotas, government purchase of surplus output, and self-regulation (by large firms) of prices and production are among the typical forms, and there are others. By compelling the airlines (and the truckers, and soon the bus operators) to engage in totally free competition, we are making these industries *exceptions* to the norm. The advocates of deregulation have yet to point to a single industry that operates in a totally unregulated way.

The debate remains much too limited, a fact for which industry must bear some blame. The only way to achieve efficiency in any transportation industry is to recognize that each city-pair is a natural monopoly. This becomes obvious when the full requirements of a transportation *system* are taken into account. These days, for example, the small airlines are more cartelized than ever, since they must share equipment, mechanics, gate space, and other resources. None of them is capable of building a *system*, including a computerized information system. One day, we will accept, as other countries long ago accepted, the need for airline regulation.

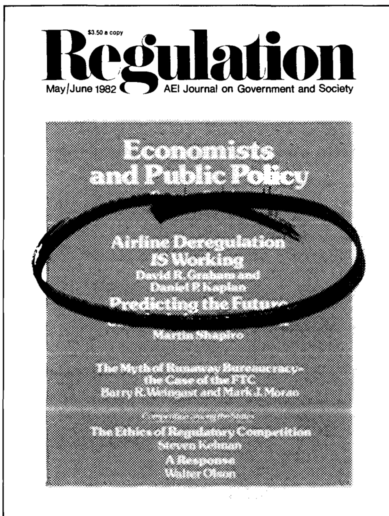
Frederick C. Thayer,
University of Pittsburgh

TO THE EDITOR:

I have always been an advocate of airline deregulation and I agree with Graham and Kaplan that it is working. Nevertheless, it has developed a very severe anomaly. Many short routes, such as those out of Roanoke, now have extremely high fares and less service than they did under regulation. Piedmont, for example, is doing very well by exploiting areas where it is the only carrier and charging competitive rates elsewhere. When it cuts back on service in its monopoly areas, it frees planes that it can transfer to the competitive areas.

Alfred Kahn recently pointed out that U.S. Air charged $19.50 from Buffalo to Newark—matching People Express's fare—but $98.00 from Buffalo to Albany. I asked him why People Express did not divert at least one plane to the Buffalo-Albany route. He could not answer. I would also like to know why People Express does not fly out of Roanoke. Apparently there are many such anomalies across the country that neither Kahn nor I understand. Since there should be a lot of idle planes around, why do we not see, let us say, ex-Braniff pilots flying ex-Braniff planes on these routes?

Gordon Tullock,
Virginia Polytechnic Institute



DAVID GRAHAM and
DANIEL KAPLAN respond:

Thayer fears there is too much competition in the airline industry and Tullock fears there is too little—at least at Roanoke, Virginia. Tullock's proposed solution, which is to attract People Express to Roanoke, is far less drastic than Thayer's, which is to re-regulate the industry.

People Express has found it profitable to serve relatively short but heavily traveled routes by offering several flights spread throughout the day on aircraft designed to serve more than a hundred passengers. It entered the Buffalo–New York market in the summer of 1981 with five flights a day in each direction. At that time the Roanoke–New York market was only one-eighth as large as the Buffalo–New York market; fewer than a hundred air passengers a day left Roanoke bound for New York. That is why Roanoke was not an obvious candidate to support such an operation.

We cannot predict when, if ever, People Express or another low-cost carrier will enter low-density routes like Roanoke–New York and Albany–Buffalo. Although the industry has changed rapidly since deregulation, airline managements have still not fully adapted their fleet mix, route networks, and prices to the competitive marketplace. And while new airlines have grown rapidly, they still account for only a small fraction of traffic. As the industry evolves, low-cost carriers may emerge to serve the thinner markets. Certainly service is improving for many small communities.

Thayer argues that the industry should be regulated because a passenger's decision to fly on one airline means that every other airline on the route must fly with an empty seat. That would be true only if each airline on a route maintained enough capacity to serve the entire market, which is clearly not so. In fact, even though new carriers have been entering many markets, the percentage of seats filled has risen under deregulation rather than fallen. Neither the hotel nor the rent-a-car nor any other service industry can store its output, yet they all seem to manage somehow without government intervention in their pricing and service decisions.

Contrary to Thayer's contention, airline markets are behaving precisely as "classical" (neo-classical, actually) economics would predict. As the demand for air travel has fallen, fares have tended to fall to the point where the incremental revenues from a flight equal the out-of-pocket costs of operating the flight. The prices being charged on some routes are too low to cover overhead costs, but they do cover the airlines' out-of-pocket costs. While some of the prices on transcontinental routes in particular cannot be sustained in the long run, consumers are better off letting the market, rather than the government, sort out who is best able to serve each route. Eastern's recent decision to suspend its New York–San Francisco service and TWA's decision to drop its Chicago–Los Angeles route suggest that just such a sorting-out process is at work.

A Green Light for Trucking Efficiency?

TO THE EDITOR:

Robert Mabley and Walter Strack ("Deregulation—A Green Light for Trucking Efficiency," *Regulation*, July/August 1982) offer a glowing view of the Motor Carrier Act of 1980. They give the impression that anyone not directly involved with the trucking industry as a shipper, trucker, or regulator belongs to a class of "economists" and others who are opposed per se to any form of motor carrier regulation. This is simply not so. Many "economists," ourselves included, may in theory oppose regulation of a perfectly competitive industry that generates no externalities, but also realize that transportation may require a "second-best" solution.

Mabley and Strack's central contention is that trucking rates, or at least the rise in trucking rates, have declined since deregulation. The first problem with this finding, which they mention but then ignore, is that it is difficult if not impossible to measure the overall rate structure. Trucking services are heterogeneous: a ton-mile of grain is not the same as a ton-mile of steel or automobiles. Combining rates across industries and regional markets creates a classic aggregation bias.

They point out that a great many independent rate changes have taken place since 1980, but rightly note that it is hard to compare independent rate proposals because of the way they are counted. Many or most such proposals consist of minor exceptions to general rates, highly specialized services, and so forth. New entrants who file specialized rates of their own may in practice charge the published bureau rates. There is also no way to tell how much actual rates differ from proposed rates. Furthermore, previous ICC actions have required many rates to be independently announced that were once published in a single bureau rate.

Nevertheless, the authors proceed to count and compare such independent rate proposals. They pick 1975 as a base year to set alongside 1980 and 1981 for comparison, since all three were recession years. But the three years are not really comparable; the present downturn is much more severe and has lasted longer than the earlier one. They also provide little substantive evidence on the actual content of these independent rate changes. Of the three examples they give (multiple tender discounts and the rates filed by Overnight Transportation and Transcon Lines), the last-named was canceled before it ever went into effect, and multiple tender discounts had already been incorporated into the rate structure before deregulation. Various shippers' groups also contend that whatever discounts there may be are discounts from an increasing general level of rates.

Mabley and Strack say that "everyone agrees that the rates are decreasing (or at least increasing at a decreasing rate). . . ." But "everyone" must have neglected to examine the recent history of less-than-truckload rates. They have not only been rising, but rising *faster* than ever before: they are up 50 to 70 percent since July 1980.

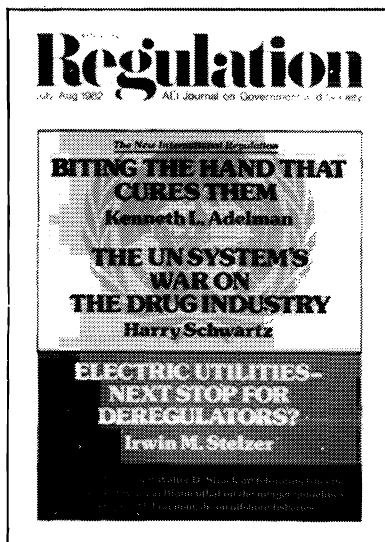
The data the authors do give is at times unrelated to their case. They state that the fall in the value of operating rights is concrete evidence

that reform has affected rates. But while writing off the value of operating rights will make the accounting profits of a carrier fall, it will not necessarily depress its rates. In fact, if carriers set rates on a "cost-plus" basis so as to achieve a certain level of profit whatever the rate level, such write-offs should cause rates to *rise*. And if regulation has "forced" carriers to restructure their rates in line with marginal costs, as Mabley and Strack seem to contend, then rates should remain unchanged. Like a lump-sum tax, the loss of the capital value of the rights affects only average, not marginal, costs. In any case, the authors have not shown any correlation between rates and either the book or the market value of operating rights.

Efficiency in the industry was not a sudden creation of the 1980 act. Russell Murphy has shown that a sample group of carriers had an average annual growth rate of 9.1 percent between 1975 and 1980. Published bureau rates increased 9.7 percent in the same period. In other words, rates and costs rose at about the same pace. The authors should define the "efficiencies" they are talking about: do they mean cost efficiencies, or technical efficiencies?

They may well be right that small-community service is now better than before. But the ICC shipper study they cite is probably self-serving at best, since the commission is legally required to ensure some degree of service to small communities and is thus sitting as a judge of its own performance. Anyway, the ICC study found that only 9 to 10 percent of shippers thought the quality of service improved after the law was passed. And the authors' Florida data suggest that small communities may be paying lower rates, but *not* small *shippers;* quite the contrary.

On perhaps the most important issue, industry structure, the authors' empirical evidence is again unconvincing. The sheer increase in the number of carriers, without any data on the size of the total market or the distribution of market shares, is meaningless as a measure of concentration, since concentration is a function not of the absolute number of entities but of their relative size. They acknowledge that most grants of new authority are being issued to existing carriers, which is a sign of *increased* concentration. Even evidence that more outsiders are entering would not be an a priori reason to assume less concentration, unless we knew who those entrants were. Certainly one



cannot say that the entry of IBM and Xerox into the small computer industry has made it more competitive. Preliminary estimates we have seen indicate that concentration is indeed increasing in trucking, although we agree with the authors that it is too soon to tell. Certainly capital barriers to entry exist for truckers carrying general commodities in less-than-truckload shipments.

On profitability, the authors note that 21 publicly traded carriers enjoyed a 25.3 percent return on net worth in 1981. As they point out, however, there were over 22,000 carriers in that year, not many of which were publicly held. In a study of 131 motor carriers, Ervin Silberman has found the industry's financial condition to be miserable indeed. Although the financially powerful are surviving in some form or other, the weak are not very profitable and new entrants will probably leave the market about as fast as they enter. The groundwork of future concentration in the industry is being prepared today.

The economic function of profit is to attract resources to an industry that should expand. Losses are staggering in the trucking industry. Yet firms are forming a queue to enter new routes and, stranger still, these would-be entrants appear to be the same firms that are already in the industry. Perhaps they sense long-term profit opportunities or perhaps they harbor a theological belief in competition.

In sum, the authors have failed to prove their case on any count. This is not to say deregulation has failed. Rather, we argue simply that the results, in both magnitude and direction, are not as clear as the authors seem to believe. Perhaps trucking efficiency is flashing a "yellow light" for caution—so that we should look both ways before proceeding full speed ahead down the road to deregulation.

Grant M. Davis and
William A. Cunningham,
University of Arkansas

ROBERT MABLEY and
WALTER STRACK respond:

Although Davis and Cunningham may not believe that trucking rates have fallen, the trucking industry does. In November 1981, fifteen trucking firms told the ICC they knew of at least 208 rates that were being discounted as of that September, the discounts ranging from 5 to 50 percent. (The ICC denied the firms' petition for a rate floor, rightly noting that even to consider such a petition would "stifle legitimate competition.") In July 1982, the American Trucking Association also petitioned the commission to establish rate floors, citing several of the discount plans we mentioned in our article. Is less-than-truckload traffic being discounted? Yes, according to the ATA petition: "The applicability of the volume discounts is generally limited to less-than-truckload traffic which would otherwise be subject to class rates." Clearly, multiple tender and promotional rates, too, apply to less-than-truckload traffic.

Davis and Cunningham dismiss the ICC's study on small community service, but they offer no evidence that contradicts its findings. That is because there is none.

Their discussion of the value of operating rights reveals a poor grasp of basic economic theory. First they argue that the loss of the value of these rights would, as an extraordinary accounting cost, cause rates to rise. That a cost-plus rule would result in higher rates, however, is irrelevant. And to suggest that carriers would adhere for long to higher rates in a futile attempt to recoup accounting losses is silly. With competition, market forces, not a businessman's rule-of-thumb, control rates.

Perhaps sensing that their reasoning fails to ring true, Davis and Cunningham next argue that when operating rights lose their value, rates should not rise after all but should remain unchanged. This is wrong too. The loss in the value of operating rights is not a cost; it stems from the loss of future excess prof-

its. It does not represent a change in average costs, as Davis and Cunningham claim. The value of the rights by definition equals the present value of the stream of excess profits expected in future years. These anticipated excess profits have disappeared because competition is expected to push rates down toward costs. This is surely not a novel or difficult argument.

Finally, the writers seem to confuse the notion of concentration within individual markets with that of overall concentration in an economy. We discussed the first kind of concentration, in which context our statements are correct and those of Davis and Cunningham wrong. The expansion of an existing carrier into a market it has not previously served, all else being equal, will decrease concentration in that market. Whether the new entrant is a large or a small firm is irrelevant. We do not doubt at all that IBM and Xerox have provided vigorous new competition in the market for small computers.

We find nothing in the letter to make us modify our conclusions. The combined weight of the preliminary evidence and the conclusions of economic theory puts a strong burden on the opponents of the Motor Carrier Act to show that reform has not served the public good.

Active Judges and Passive Restraints

TO THE EDITOR:

Your "Perspectives" piece on the D.C. Circuit Court of Appeals' recent "air-bag" decision (*Regulation*, July/August 1982) seems to me to distort the basis for the decision, and in the process to distort the case itself. The decision does not state "a theory of judicial review and of required administrative process that may impede all deregulatory initiatives by agencies." In the main, it applies relatively uncontroversial principles of administrative law, and stands alongside a number of well-established decisions that give the beneficiaries of regulation a right to judicial review of agency decisions.

I agree with most of the general principles in your "Perspectives" analysis. In particular, I am troubled by the D.C. circuit's use of Congress's failure to act on the subject of passive restraints as a reason to suspect that it favors them. A few of the principles in your analysis seem wrong, however, and others seem irrelevant to the air-bag case.

For one thing, you acknowledge that the D.C. circuit is right to apply the "arbitrary and capricious" test differently in different contexts; you then complain that it should not *say* it is doing so. Here you say that "hypocrisy is the beginning of virtue." I am unable to see why. The arbitrary and capricious test must be applied to a bewildering array of decisions in numerous substantive areas. Surely a court ought not to apply the same level of scrutiny to all such decisions and, equally surely, Congress has never intended to require the courts to do so. In the Administrative Procedure Act (APA) Congress set forth a general test for reviewing agency action and inaction, but it would be foolhardy to pretend that that test applies in the same way to all agency decisions, and even worse to adopt such a pretense knowing that it is just that.

It is of course wrong to suggest that deregulation should be subject to stricter review than regulation itself, and I do not believe that the air-bag decision stands for that principle. But it is just as wrong to say that deregulation ought to be subject to more deferential review than regulation. Deregulation is often a good thing, but decisions to deregulate must conform to the governing substantive statute and the APA itself. This is the basic lesson of the air-bag case. Read in context, Judge Abner Mikva's reference to "danger signals" was, I believe, a means of saying only that the decision to do away with the air-bag regulation should not be treated as deferentially as a decision not to proceed at all. In this setting, deregulation is a kind of affirmative act that should be treated like any other such act. I would not read the court's opinion to stand for any broader proposition.

As I read the opinion, it stands for something like this: The Department of Transportation had previously decided in favor of a detachable belt standard and had substantial evidence for doing so. President Reagan's Department of Transportation acknowledged that such a standard would be desirable if it would increase nationwide seatbelt use by 13 percentage points or more, and some evidence on the record suggested that it would in fact do so. Nonetheless, the agency decided to rescind that standard—without seeking more evidence or attempting a sufficient explanation of why there would be a less than 13 percentage point increase. Indeed, the department did not investigate alternatives, much less supply a justification for the idea, set forth in the *Regulation* piece, that the whole notion of passive restraints was a bad one. At least as characterized by the court, the department's explanation of its rescission of the air-bag requirements seemed even thinner: there was no discussion of the benefits and costs of relying only on air bags if detachable belts were not required.

I do not pretend to know whether the D.C. circuit's discussion of the record's evidence was altogether fair, and I suspect that one could develop a plausible basis for the decision from a published explanation. But that question basically involves a factual dispute; the key point is that D.C. circuit applied well-accepted principles of judicial review to its understanding of the facts. No special burden was placed on efforts to deregulate as a whole.

More generally, the decision seems to me a part of a very salutary development, one which has been endorsed by the Supreme Court and many lower courts. For a long time now, the federal judiciary has offered beneficiaries of regulatory statutes the same sorts of protection that it gives to regulated industries. When an industry challenges a regulation, the court is available to ensure that the regulation is lawful and neither arbitrary nor capricious. When a statutory beneficiary challenges a regulation, the court should be available for the same purposes. In both cases, the court should not displace decisionmaking authority vested in the agency, but should nonetheless ensure that the agency based its decision on statutorily relevant factors and gave a reasoned explanation of its decision. As Judge Harold Leventhal frequently said, that is what the rule of law is all about. In the main, the opinion in the air-bag case seems to exemplify these points, and thus to be a fine illustration of the value of judicial review of agency action.

Cass R. Sunstein,
Assistant Professor of Law,
University of Chicago

TO THE EDITOR:

The editors' piece on the decision in *State Farm Mutual Automobile Insurance Co.* v. *Dept. of Transportation* covered the court's arguments well. I noted no comment, however,

(Continues on page 52)

(Continued from page 5)
on what seems to me a striking fact: it was a private company that brought the suit against the government! It would appear, on the surface anyway, that the insurance industry as a whole supports air bags. If so, is not that a judgment of some worth and weight? I can understand that auto producers would not want to raise their production costs, and it could be that consumers care nothing for the externalities that their injuries and deaths in auto accidents may cause. But insurers would seem to be interested in reducing those injuries and deaths, and State Farm seems to perceive air bags as a useful device to accomplish that reduction. Is not the reviewer omitting an important private judgment in the case by focusing only on the logic of the decision?

James W. Kuhn,
Columbia University,
Graduate School of Business

THE EDITORS respond:

Courts generally apply the "arbitrary and capricious" test strictly when they decide whether an agency has shown a substantial basis in fact before proceeding on a proposed regulation. They apply the test more deferentially when they review an agency's decision not to regulate. The implicit principle is that an agency is usually being more arbitrary, or at least more dangerously arbitrary, when it thoughtlessly regulates something than when it thoughtlessly leaves citizens alone. Yet we do not tell agencies formally, "you may be more arbitrary and capricious, if you wish, in the case of negative actions"; we hope to keep them from being arbitrary and capricious at all. This is our salutary "hypocrisy."

Although the court went into great detail trying to delineate the exact contours of its split standard, in doing so it lost sight of the standard's essential function: to determine whether the agency's actions were reasonable under the circumstances. Rather than formally redefine the standard anew as situations arise, it would be far better to let any split standard develop through a common-law approach.

We also argued that to the extent there is any sliding standard, the air-bag rule would fall into the part of the scale giving the courts the narrowest scope of review. There is indeed a substantive asymmetry between efforts to impose burdens and efforts to remove them. This is seen in the idea of "prosecutorial discretion"; an agency is much freer to refuse to punish a wrongdoer than it is to punish an innocent, even though what Sunstein calls the "beneficiaries of regulation," the victims of the first wrongdoer, are thereby denied their day in court. Second, courts review policy or political questions more deferentially than factual questions, and the air-bag decision was emphatically of the former variety: over a whole decade each administration had reversed the action of its predecessor.

Since courts regularly say they will sustain an agency decision that was not arbitrary or capricious, even if they would themselves have come out with a different result, they would implicitly sustain any of several original rules based on the same record—and surely would have done so here. Yet the air-bag decision implies that although the agency could have justified either Rule A or Rule B on its original record, it may not later switch from Rule A to Rule B without new evidence that proves the need *for that switch.* This runs counter to common sense. An agency's actions should be judged in their entirety, not piecemeal.

Sunstein seems to agree with us that the air-bag case is a "pure" APA case, not involving congressional intent. Thus it differs from the other two major deregulatory moves struck down by courts this year—on Davis-Bacon and on emissions "bubbles"—in both of which congressional sentiment or statutory language was at issue. It is worth mentioning again, therefore, that the court's opinion in the air-bag case leaned heavily on the remarkable idea that Congress "almost" endorsed the air-bag scheme.

As Kuhn notes, it is interesting that insurance companies support passive restraints. Interesting, but not surprising. If the rule produces any benefit at all the insurers will reap much of it in increased profits attributable to lower damage claims, at least until rates adjust to reflect the change (and perhaps they will not adjust, given state regulation). But the insurers will pay none of the costs in money and inconvenience. They could easily put their money where their mouth is by offering lower rates for automobiles equipped with passive restraint systems. This should simultaneously attract profitable business, let consumers capture some of the financial benefits of the systems—and, if it worked, make the regulation largely superfluous. ■

Statement required by the Act of August 12, 1970, Section 3685, Title 39, United States Code, showing the ownership, management and circulation of REGULATION, Publication No. 01470590. Published bimonthly (six issues annually), at annual subscription price of $18.00, at 1150 Seventeenth Street, N.W., Washington, D.C. 20036 for October 1, 1982.

The names and addresses of the Publisher and Managing Editor are: Publisher, William J. Baroody, Jr., 1150 Seventeenth Street, N.W., Washington, D.C. 20036; Managing Editor, Anne Brunsdale, 1150 Seventeenth Street, N.W., Washington, D.C. 20036.

The Owner is the American Enterprise Institute for Public Policy Research, 1150 Seventeenth Street, N.W., Washington, D.C. 20036, a nonprofit, educational organization.

Known bondholders, mortgagees, and other security holders owning or holding 1 percent or more of total amount of bonds, mortgages or other securities: None.

The purpose, function, and nonprofit status of this organization and the exempt status for federal income tax purposes have not changed during preceding twelve months.

	Average No. Copies Each Issue during Preceding 12 Months	Actual No. of Copies of Single Issue Published Nearest to Filing Date
Total No. Copies Printed	10,763	9,500
Paid Circulation		
Sales through dealers and carriers, street vendors and counter sales	230	341
Mail subscriptions	5,180	5,141
Total Paid Circulation	5,410	5,482
Free Distribution by Mail, Carrier or Other Means—samples, complimentary, and other free copies	2,307	2,404
Total Distribution	7,717	7,886
Copies Not Distributed		
Office use, left over, unaccounted for, spoiled after printing	3,046	1,614
Distributed to news agents but not sold	0	0
Total	10,763	9,500

I certify that the statements made by me above are correct and complete.

(Signed) William J. Baroody, Jr., Publisher