

Cato Institute Policy Analysis No. 12: Deregulation and Re-Regulation of Transportation

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Executive Summary

Transportation deregulation has produced enormous benefits for consumers and shippers. Airfares are down sharply; trucking rates have fallen; the nation's railroads are offering new services. A few years ago, passenger and freight transportation were among the most heavily regulated industries in the United States. Now federal regulation has been totally eliminated for air freight, and air passenger controls are being phased out. Furthermore, in 1980 Congress passed the Motor Carrier Act and the Staggers Rail Act, which significantly reduced Interstate Commerce Commission control over truckers and railroads. Unfortunately, there are disturbing signs that this progress may be halted and in part reversed.

This wave of deregulation stems from a growing recognition that government controls of transportation have not fostered the public interest. Scholars have long recognized that regulatory agencies tend to protect the interests of the industries they regulate. Studies by experts representing the whole spectrum of political persuasion, from the Nader-left to the American Conservative Union-right, have confirmed that regulatory agencies reduce competition at the expense of the public. Typically, industry-oriented individuals are appointed to commissions, often from industry itself or from Capitol Hill. Once in office, regulators perceive their duty as protecting the financial health of the companies they regulate. The easiest way to accomplish this is to reduce competition, thereby increasing rates and creating monopolies.

Deregulation

Air cargo was the first sector to be deregulated. Starting in November of 1977, operators of scheduled freighter service could apply for unlimited domestic all-cargo service. On April 1, 1978, charter carriers could apply for the right to carry cargo nationwide; in November of 1978, any firm could offer cargo service by air. The results have been highly successful. Though some rates did go up, service was expanded to many communities that had not been served well prior to deregulation. A number of shippers, however, did complain of sharply increased rates. Nevertheless, the average revenue per ton-mile went up less rapidly in 1978, the first year of deregulation, than did average revenue during the previous four years.[1] During the next year, fuel prices doubled and rates were increased greatly; average revenue rose nearly 12 percent in 1979 and 13.5 percent during 1980.[2] Shippers, however, must have liked the deregulation since revenue ton-miles rose 5.7 percent for certificated carriers between 1977 and 1978 compared to an annual rate of 1.8 percent over the previous four years. For noncertificated carriers the growth was a rapid 28.9 percent in the first year of deregulation as opposed to a rise of only 9.2 percent annually for the 1973-77 period.[3]

Deregulation of air cargo was followed by removal of controls on passenger airlines in 1978. Total deregulation of the airlines has not yet taken place: The Civil Aeronautics Board retains authority over routes until the end of this year,

and it has authority over domestic rates and fares, mergers, and acquisitions until the end of 1982. The Board is due to go out of business at the end of 1984.

Most observers agree that deregulation of the airline industry has been highly successful. Airlines have taken advantage of the relaxed entry requirements to enter new markets and to increase competition in many areas. Several new low-cost airlines have begun serving, very profitably, medium-density markets with significantly lower fares. Air fares, especially in long-haul markets, have been reduced or at least held below the levels that would have existed under regulation, considering the increase in fuel costs and other inflationary factors. During 1980, average fares in the top 100 markets were actually 13 percent below the level permitted by the CAB fare formula.[4]

Deregulation of the airlines has also led to an improvement in load factors. Prior to 1978, airlines were selling only about 51 to 56 percent of their seats. After the Board began to liberalize their policies, load factors increased to around 60 percent and the average number of seats available in an aircraft was also expanded. The net result was a more efficient utilization of airplane equipment.[5]

Most complaints about deregulation of airlines have dealt with the suspension of service to small communities. Advocates of deregulation underestimated the number of small communities that temporarily would lose service after deregulation. Since there was no evidence that airlines were subsidizing service to small towns, as proponents of continued regulation argued, they failed to see that deregulation would open up new highly profitable markets. Airlines faced with technological and market limits on rapidly increasing their capacity found it worthwhile to withdraw from profitable but small markets in order to enter more lucrative ones. As the major airlines have a chance to adjust their capacity, however, they will return to at least some of the smaller markets.

Over all, the statistics indicate that small towns have not lost much service. The number of departures per week at non-hubs (the smallest category of commercial airports) is virtually unchanged from the number prior to deregulation. The number departing from small hubs in 1980 was down only 3.5 percent from 1977.[6] On the other hand a CAB staff study[7] indicates that travel-time from small hubs to other small hubs has decreased nearly 10 percent, and from large hubs to small by nearly 6 percent. Thus, service has been improved for passengers traveling to or from small communities

The improvement in service to small communities is due to the substitution of small commuter airlines for the major airlines. The commuters, operating smaller prop planes, can offer more frequent service than the trunk carriers with large planes. This has meant more convenient service but possibly in less comfortable and less safe aircraft. Moreover, many of the commuter airlines have been only marginally profitable. In the summer of 1981, when the Federal Aviation Administration required a cutback in service by the airlines due to the air traffic controllers' strike, several of these carriers went out of business, temporarily stranding some communities.

Next, Congress turned its attention to the trucking industry. The Motor Carrier Act of 1980 (MCA) substantially relaxed controls on trucking. Its most significant provision shifts the burden of proof from the applicant to the protestor. Formerly the applicant had to show that any requested new authority was "required by the present or future public convenience and necessity"; now the protestor must show that it is "inconsistent with the public convenience and necessity." Only those motor carriers that have authority to offer the proposed service are permitted to file protests. Furthermore, a diversion of revenue from existing carriers is not to be construed in itself as inconsistent with the public convenience and necessity. Under the Act, the Interstate Commerce Commission must provide procedures to permit carriers to reduce restrictions on their operating authority, such as gateway requirements, narrow property definitions, restrictions on return hauls, restrictions on service to intermediate points, and narrow territorial limitations.

In the short period since trucking was partially deregulated, rates have decreased, especially for truck-load shipments; service to small communities has improved; and complaints by shippers have declined. Improved service and lower rates by for-hire carriers have led to a decline in private carriage,[8] suggesting that shippers now find it economically efficient to hire carriers. The Wall Street Journal reported that the results of deregulation were: "discounted rates, more truckers, improved service, service innovations and more Teamsters Union concessions on work rules." [9] According to a Harbridge House, Inc. survey of 2,200 manufacturers, 65 percent were getting lower trucking rates under deregulation.[10]

A Federal Trade Commission staff paper submitted to the Motor Carrier Rate Making Study Commission in March of this year found that the MCA produced none of the disastrous results that the industry had forecast.[11] The paper concluded:

During the first year following passage of the MCA, a substantial number of firms were permitted to enter the trucking industry and existing carriers took advantage of increased freedom to expand the scope of their operations. Competition among an increasing number of carriers has created downward pressure on rates and forced firms to increase productivity e.g., by seeking removal of restrictions on operating certificates and by seeking concessions from labor. Lower rates and costs will insure that society gets more out of each dollar spent on trucking service. Increased competition also means that the monopoly profits made possible by protective regulation are being squeezed out of the system.

In 1980 Congress also passed the Staggers Rail Act, which provided the railroads with considerable new pricing freedoms. ICC jurisdiction over rates is now limited to railroads that exercise "market dominance." Hence, nearly two-thirds of railroad rates are free from maximum-rate regulation. Railroads also have been given more freedom to reduce rates. Any rate that is equal to or exceeds variable cost cannot be considered unreasonable. The results of this partial deregulation appear to be very good. Crediting the beneficial effects of the Staggers Act, the executive vice-president of the Association of American Railroads claimed that "our 1981 earnings will be at their highest level in more than 30 years. Despite the recession in 1981, our freight traffic has declined only four-tenths of 1 percent. . ."[12]

This Act also extended the Commission authority, originally granted in the Railroad Revitalization and Regulatory Reform Act of 1976 (commonly referred to as the "4-R Act"), to grant exemptions from regulation for particular traffic. Starting in 1979 with fresh fruits and vegetables, the ICC has used this power to exempt from regulation the transportation of a growing list of products. Railroads responded by reducing prices when demand was low and equipment available and increasing rates during periods when demand was high and rail cars in short supply. Railroads offered low backhaul rates to fill up trailers, containers, and freight cars that previously had returned empty. The exemption of fresh fruits and vegetables has been very successful and permitted a number of Western railroads, such as the Santa Fe, the Burlington Northern, the Southern Pacific, and the Union Pacific, to increase their business significantly. The railroad share of the market for perishables increased from 11 percent to almost 15 percent within one year.[13]

In March of 1981 the ICC deregulated most aspects of piggyback traffic. This has led to lower rates and more traffic. Even though 1981 was a recession year for transportation, piggyback traffic actually increased compared to the previous year. In comparison, motor carrier traffic declined about 15.5 percent during 1981 from the previous year.[14] Some railroads, however, do not view this as a blessing, arguing that lower piggyback rates have simply diverted box car traffic to this lower-priced service. The CSX Corporation successfully requested that citrus pomace be exempted from regulation. This product had been carried almost exclusively by truck, but with the new authority the railroad authorized its sales people to compete on prices on the spot and have secured a profitable new business.

More recently, some railroads have asked the Commission to exempt coal exports from regulation. Here the objective is to raise rates. Nevertheless, the railroads are constrained from exploiting any monopoly position by foreign competition for coal and by competition for export coal from different regions. Conrail, a major carrier of export coal, has, within the last few months, reduced coal export rates. A deregulation-minded Commission surely would approve the request to deregulate these rates, but we will have to wait to see what it decides.

The Staggers Act set a precedent in authorizing railroads to enter into contracts with shippers. To date, these new contracts have dealt principally with the coal industry. For example, Illinois Central Gulf negotiated a 20-year contract with Hoosier Energy in which Hoosier agreed to advance \$9 million to improve the roadbed. In return, Hoosier will receive a lower rate. Other contracts have eliminated empty backhauls for unit trains, provided a three-railroad-unit train to haul phosphate, and made Conrail competitive with trucks on some short hauls. The contract freedoms authorized by the Staggers Act may be very beneficial to the nation's railroads.

In 1981, Congress enacted the Northeast Rail Service Act, which required that the ICC grant within 90 days all Conrail abandonment requests filed prior to December 1, 1981, unless an offer to purchase or subsidize operations is tendered.

This has permitted Conrail to rid itself of miles of lightly used track at the saving of millions of dollars. If such a provision were extended to other railroads, it would free the railroad industry of the burden of servicing many low-demand areas.

Re-Regulation

Under the Carter administration, the CAB had proposed restrictions on the antitrust immunity of airlines participating in the international aviation cartel, IATA. Early in the Reagan administration, the CAB announced that it would lift antitrust immunity for rate-making on the North Atlantic run. Faced with protests from foreign governments, the President asked the CAB to postpone its order. Subsequently, the administration has worked out with the CAB, and supposedly European governments, an agreement to permit participation in IATA rate-making in return for authorizing a range in which carriers could freely price. The proposed bottom of the range, however, is above the lowest rates currently charged, so the impact will be to eliminate the lowest fares.

While it may be premature to panic, there is growing pressure to bring back some airline regulation. World Airways, which had led the movement toward lower fares, has asked the CAB to end the "disastrous and completely irrational" fare wars. The administration proposed "sunsetting" the CAB early, and finally abandoned the task when it became apparent that amendments to such an act would restore much airline regulation. Besides Braniff, several other airlines may go bankrupt in the near future. If that happens, there will be a strong effort to bring back regulation, even though at this date it would be ineffective in restoring profitability to the industry. Basically, the airline industry overexpanded during the period right after deregulation, and some carriers made bad management decisions. There must be a reduction of capacity in the industry, and bankruptcy may be the only logical way.

Recently the administration proposed legislation to Congress which would exempt from the antitrust laws agreements by the maritime industry on rates, profit sharing, cargo sharing, and capacity limitations. The antitrust laws often have been used for anti-competitive purposes and are a form of regulation that may be unnecessary in free markets. However, entry into the maritime industry is strictly controlled through the granting of subsidies by the U.S. government and by foreign governments. Where entry is not free, no exemption from the antitrust laws for collusion is appropriate. Moreover, such an exemption will not benefit the American merchant marine, which is saddled with much higher costs than foreign carriers because of restrictive government requirements. By requesting such legislation, the Reagan administration shows a lack of concern for promoting competition.

The Reagan administration may be in the process of reversing the deregulation trend in surface transportation through the appointment of industry-oriented individuals, who may well turn back the clock. The progress that had been made in deregulation of transportation is directly attributable to the appointments by Presidents Ford and Carter of people who came from outside the regulated industries. These individuals were mainly from academe; many were economists. Two economists, Alfred Kahn and Elizabeth Bailey, led the CAB in a major effort to deregulate the airlines. Congress enacted legislation only after observing that CAB-instituted reforms were leading to lower fares and better service. Darius Gaskins, an economist, with the aid of Marcus Alexis, also an economist, and Thomas Trantum, a Wall Street securities specialist, reduced entry restrictions in trucking and freed rail rates for a number of commodities. This, in turn, led Congress to consider legislation. The Motor Carrier Act, which reduced barriers to entry significantly, was the result of pressure from the ICC, which threatened to deregulate the industry if Congress failed to act.

The new administration, on the other hand, appointed Reese H. Taylor, Jr. to head the ICC, an amiable lawyer from Nevada who formerly chaired the Nevada Public Utilities Commission. Prior to his appointment, Taylor had represented the Arizona Motor Tariff Bureau. He recently argued against permitting entry into the taxi industry in Nevada. According to the New York Times,[15] Taylor was first suggested by Edward Wheeler, the lawyer for the Teamsters Union, which has bitterly opposed deregulation. Before his death in May, Frank Fitzsimmons, president of the Teamsters, is reported to have given President Reagan a letter naming Taylor as his choice. Nothing in Taylor's record indicates that he knows or understands deregulation issues. In fact, he fits the mold of earlier appointees who support industry regulation.

What is particularly distressing about this appointment is that Reagan's own ICC transition team emphasized the importance of selecting a chairman who was clearly identified with deregulation to underline the administration's

commitment to the free market. The ICC transition team's emphasis on continued deregulation was echoed by both Reagan's Task Force on Regulatory Reform, chaired by Murray Weidenbaum, now chairman of Reagan's Council of Economic Advisers, and by the Transportation Policy Task Force, whose membership included Drew Lewis, currently Secretary of Transportation.

The administration has made its policy quite clear on the regulation of surface freight transportation. Immediately upon taking office it asked Darius Gaskins, the deregulation-minded ICC chairman, to resign. Once Taylor was appointed, both deregulators Alexis and Trantum resigned, leaving for several months no one on the Commission in favor of continuing the reduction of regulation. However, three new commissioners, Malcolm M. B. Sterrett, J. J. Simmons, and Frederick N. Andre, have been sworn in recently, and Heather S. Gradison has been nominated for a seat. The three new commissioners testified during their confirmation hearings that they believe in less regulation of surface transportation. Andre is replacing Charles L. Clapp, a long-time regulator and strong supporter of Chairman Taylor.

During the first months after Taylor was appointed, the Commission attempted to construe the Motor Carrier Act in the most restrictive way. Applicants for general commodity certificates were denied because they could not show that they had shippers who wanted to use their services for all possible commodities, and requests for authority to serve wide territories were restricted to particular cities. These rulings appear to be inconsistent with the spirit of the Motor Carrier Act of 1980.

For example, Hagen, Inc., a trucking firm in Sioux City, Iowa, applied for authority to haul general commodities nationwide. It asserted that a 50-state grant would allow it to consolidate its numerous and fragmented authorities. The ICC's review board granted authority only for "transporting essentially the traffic of those shippers at the points or facilities where shippers demonstrate a need for service." Hagen was authorized to haul chemicals between Terra Chemicals International, Inc., at points in 17 states, and other points in the country. Other similarly limited authority was granted.[16]

In other cases the Commission has limited certificates to only the commodities listed in the application. The requirement in the Motor Carrier Act of 1980 to permit carriers to broaden their property definitions seems to have been overlooked. The new chairman has called tariffs that give lower rates to specific shippers "discriminatory" and "illegal." Taylor's attitude toward rate competition can be illustrated in his opinion in a recent case. The majority voted not to suspend or investigate a discount tariff proposed by Roadway Express. In his dissenting opinion, Taylor argued for suspending the tariff because:

Adherence to the statutory proscription against predatory rates is perfectly consistent with encouraging rate competition. . . . Promotional discounts of 34 and 50 percent may not necessarily result in predatory rates. However, when the issue is raised with regard to discounts of this magnitude, it is incumbent on the proponent to at least deny the allegations and present some supportive cost evidence. Roadway Express did neither. Instead, it defended its proposal with irrelevant analogies to retail stores, shopping centers, and the airline industry. . . . Since investigation without suspension would have been a meaningless gesture, I would have suspended the proposed discounts in order to obtain information necessary to make an informed decision. (Traffic World, September 21, 1981, p. 84.)

The ICC chairman has vowed to strengthen enforcement of the regulations applying to motor carriers. He has requested more tariff examiners to scrutinize rate changes and cut back substantially the role of the Office of Policy Analysis, which had been a vigorous supporter of less regulation. The New York Times has described Taylor's pronouncements as having a "chilling effect." [17]

For the trucking industry, the deregulation movement apparently has been stopped. How the new Commission will treat the Staggers Act and railroads is unclear at this time, but Taylor's attitude toward rate competition, as reflected in his dissent, does not auger well. The Commission has recently split, 2-2, on the issue of abandonment of lightly used rail lines with the chairman voting against the railroads' requests. A recent split commission decision on a Conrail request to cancel some joint rates for the movement of grain and grain products also does not auger well. Conrail had petitioned the ICC to cancel these rates because it failed to earn enough on the shipments to cover its operating costs. A number of railroads that participated in the movement protested. Commissioners Taylor and Gilliam voted against the Conrail request on the grounds that some of the smaller railroads will be financially endangered. Clearly the

objective of deregulation is to remove regulatory bodies from the business of protecting one carrier from the actions of others. In this case, shippers did not object because they expected lower rates. Commissioners Gresham and Sterrett upheld Conrail while the newest member, Fred Andre did not participate.[18]

Recently Taylor has been claiming to be in favor of deregulation and that his actions have only been to carry out the law. The ICC sent a bill to Congress to abolish the needs test for the granting of new certificates, and in his letter accompanying the bill, Taylor concluded that "an entry standard, based on public need, is no longer useful." [19] However, he also wants a more stringent fitness criteria that includes "financial fitness, operational fitness and safety fitness." Taylor's letter went on to say:

More specifically, with respect to financial fitness, an applicant would only need to describe its present or future financial capability to provide the proposed service. In evaluating financial fitness, the Commission would consider the problems that can be caused to the shipping public through the cessation of operations by a carrier . . . We would envision that operational fitness would encompass the applicant's plans, knowledge, or experience to conduct the proposed service. With respect to operational fitness, the Commission's concern should be whether the applicant will be capable of performing the service within a reasonable period of time without undue risk to the public.

While Chairman Taylor may have become a deregulator, he has resisted the idea of simply eliminating all entry controls. When the proposed new entry standard was sent to Congress, Commissioner Gresham wrote that "unless this proposal is revised substantially, it easily could be used to retreat to the less competitive oriented regulatory environment which predated the Motor Carrier Act of 1980 and led to a greater degree of regulatory control over the motor carrier industry."

As Commissioner Gresham points out, a fitness test can become a significant barrier to entry. Already the U.S. Court of Appeals for the Fifth Circuit, New Orleans, has struck down the practice of the Gaskins-Alexis Commission of granting wide authority to applicants.[20] It contended that inadequate consideration was given to the fitness of the carrier and whether the carrier was willing and able to provide the service. No consideration was given to whether the carrier might add equipment or move into new territory without the necessity of requesting new authority each time it wished to expand its operations. The Commission split, with Chairman Taylor voting no, on whether to appeal the decision, which might be overturned by the Supreme Court.

Taylor's cautious attitude toward reducing regulation, unfortunately, appears to stem from the White House. The New York Times reported in early December that President Reagan had assured the Teamsters of his opposition to trucking deregulation. He told them, "we can't do it all at one time" and it must be phased in." Since only these two statements were in quotes, it is not clear what or how strong President Reagan's position really is. Nevertheless, Reese Taylor can fairly conclude that his go-slow attitude is consistent with White House wishes.

The administration has been wrestling with a bill to deregulate the intercity bus industry. Under the Carter administration the ICC, the Department of Transportation, Congress, and major bus companies were very close to an agreement on total deregulation of bus lines. While Greyhound has been willing to face an unregulated market with free entry, smaller bus firms have not. Taylor has been working on a bill to deregulate the bus industry, which would make it easier for firms to begin new service and drop old routes that are unprofitable; unfortunately, it also provides for a fitness test for all new applicants. This test would serve to slow new entrants and continue the monopoly position of some existing carriers. At this point, however, there is still no agreement on a bill.

The good news is that it may be too late to reinstitute regulation of the airlines, although the advance toward deregulation of the international aviation environment may be halted. The bad news is that the steam appears to have gone out of the deregulation movement, at least for surface transportation. Much good has come out of the deregulation movement, and hopefully, the recent period simply has been a slowing of momentum and not a change in direction. Total deregulation of transportation is highly desirable, and it would be a shame if the ICC survives to celebrate its 100th birthday in 1987. As long as some regulation remains, there will be inefficiencies forced on the American economy, and the public will pay more than necessary for transportation.

FOOTNOTES [1] Andrew S. Carron, *Transition to a Free Market: Deregulation of the Air Cargo Industry* (Washington, D.C.: The Brookings Institution, 1981), Table 8, p. 33.

- [2] Ibid.
- [3] Ibid., Table 5, p. 27.
- [4] David R. Graham and Daniel P. Kaplan, "Developments in the Deregulated Airlines Industry," Office of Economic Analysis, Civil Aeronautics Board, June 1981 (mimeo), Table 2, p. 25.
- [5] Ibid., Table 7, p. 45.
- [6] Computed from *ibid.*, Table 9, p. 53.
- [7] Ibid., Table 11, p. 60.
- [8] "Statement of Marcus Alexis, Acting Chairman, Interstate Commerce Commission, Before the Subcommittee on Surface Transportation of the House Committee on Public Works and Transportation on the Motor Carrier Act of 1980," June 10, 1981, pp. 3, 4, 11, and 12.
- [9] Wall Street Journal, June 30, 1982, p. 30.
- [10] Ibid.
- [11] "Regulatory Reform and the Trucking Industry: An Evaluation of the Motor Carrier Act of 1980," Denis A. Breen, Bureau of Economics, Federal Trade Commission, March 1982.
- [12] Traffic World, February 1, 1982, p. 11.
- [13] "Background on Transportation," Association of American Railroads, July 20, 1981.
- [14] Traffic World, February 1, 1982, p. 11.
- [15] June 9, 1981, Section IV, p. 1.
- [16] MC-127042, Sub. 304, Hagen, Inc., Extension - General Commodities, Nationwide.
- [17] November 11, 1981, p. D 17.
- [18] Traffic World, April 26, 1982, p. 41.
- [19] Traffic World, February 22, 1982, pp. 30-32.
- [20] American Trucking Associations, Inc. et al., v. Interstate Commerce Commission and the United States of America, in the United States Court of Appeals for the Fifth Circuit, No. 81-4026 (October 1, 1981).