AIRLINE RE-REGULATION FOLLY

AN ISSUE PAPER PREPARED BY

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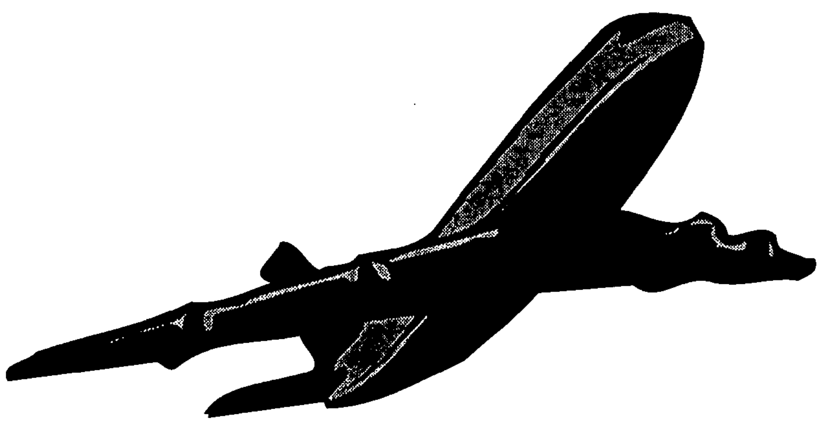

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Introduction

Airline deregulation has been a tremendous success. Study after study, by various institutions in and out of government, have highlighted the success of airline deregulation.

Individual consumers and businesses all over the country save tens of millions of dollars each year as a direct consequence of airline deregulation. And Virginians have participated in these savings and continue to do so today.

Major, and not-so-major, airports have recently completed expansion or are planning expansions over the next couple of years. Airline travel is projected to increase to such levels that these investments are prudent.

Now, the Department of Transportation in Washington D.C. is proposing that discounted airline tickets be regulated by the federal government.

This author of this study sponsored by the Thomas Jefferson Institute shows how successful de-regulation has been in the airline industry and why the federal government should remain a promoter of this policy rather than reintroducing regulation. Just as airline de-regulation by President Jimmy Carter helped lead the battle against government regulations in general, re-regulation of this industry might open the door to increased government regulation of our economy.

Virginia's economy is expanding as is the national economy. Business is prospering and competition continues to thrive here in Virginia and throughout the country. The "era of big government" is supposed to be over. Yet, the proposal to re-regulate the airline industry ticket prices seems to be a reversal of twenty years of proven success in limiting the federal government's involvement in the marketplace. Virginia needs to encourage lower airline ticket prices at such airports as Richmond and Roanoke, but this would be better accomplished through the marketplace rather than government regulation.

This study, "Airline Re-regulation Folly," represents the views of the author and not necessarily those of the Thomas Jefferson Institute for Public Policy or its Board of Directors.

Michael W. Thompson
Chairman and President
July 1998

Airline Re-regulation Folly

By
Peter J. Ferrara

Executive Summary

Airline deregulation was adopted 20 years ago, with broad bipartisan support. It has succeeded beyond the expectations of its proponents:

--Airline ticket prices today are almost 40% lower, after inflation, than before deregulation, saving consumers about $20 billion per year.

--Deregulation has resulted in more flights for more passengers. The total number of airline flights has increased from just over 5 million in 1978 when deregulation was adopted to 8.2 million in 1997. Total passenger miles flown and number of passengers carried have each increased two-and-a-half times during that period.

--Safety is sharply up as well. Fatal airplane accidents per year have fallen almost 50% since deregulation. Moreover, fatalities per million miles flown have been only 7% as large since deregulation as before.

--Overall competition has increased under deregulation. The number of airlines has increased 144% since deregulation, from 79 in 1978 to 95 in 1997. The number of effective competitors per route has increased 30% during this time. In 1996, about 18% of passenger miles were flown by airlines that did not exist before deregulation, the highest proportion since the beginning of deregulation.

--All of these benefits have occurred in virtually all markets – small, medium and large.

--These same benefits can be seen locally in the Richmond and Washington, DC markets. Fares are down or stable, the number of passengers served has soared, and competition has increased substantially.

Yet, President Clinton's Department of Transportation (DOT) is now proposing to reverse this highly successful policy. Under proposed new regulations, DOT would begin to re-regulate airline ticket pricing and ultimately routes. Moreover, it proposes to do so in a most perverse way - by restricting major airlines from <u>reducing</u> air fares and expanding the availability of low cost, discount seats.

This proposal is advanced to counter so-called predatory pricing by airlines. Predatory pricing is a business strategy of setting prices below costs until all competitors

are driven out, and then raising prices to monopoly levels. But such proposed predatory pricing does not seem to be raising prices in the airline industry, as prices are sharply down since deregulation, not up. Moreover, even though predatory pricing has always been illegal under the antitrust laws, not one case of predatory pricing has been proven in the entire history of the domestic airline industry. Finally, competition since deregulation has increased, not declined, so "predatory pricing" – if it exists -- does not seem to be preventing competent new competitors from succeeding.

In the name of stopping phantom predatory pricing, DOT's proposed regulations will only harm consumers, as they will prevent price reductions and greater discount seating. Instead of such reregulation, policies should be adopted to increase competition and service in the airline industry, such as privatization of airports, privatization of air traffic control, congestion pricing for use of airports, and reduced airline taxes.

Airline Re-regulation Folly

By Peter J. Ferrara

Overview of the Issue

For years, free market advocates argued that deregulation in many industries would produce broad and powerful benefits. Twenty years ago, this view prevailed in regard to the airline industry. Wide ranging deregulation was adopted with broad bipartisan support. The result has been sharply reduced prices, increased service, greater safety and more competition. These results have occurred in the local markets in and around Virginia as well.

Yet, President Clinton's Department of Transportation (DOT) is now proposing to start reversing this highly successful Carter era policy. Under proposed new regulations, the Department would begin to reregulate airline ticket prices. Moreover, it proposes to do so in a most perverse way – by restricting major airlines from reducing air fares and expanding the availability of low-cost, discount seats.

The rationale for this upside-down policy is to prevent supposed "predatory pricing", under which a company will cut prices below costs until it drives out all competitors, then raise prices to monopoly levels. But this is a solution in search of a problem. Airfares are sharply down, not up. So predatory pricing does not seem to be working to increase fares. Moreover, even though predatory pricing has always been illegal under the antitrust laws, there has not been one proven case of predatory pricing in the entire history of the domestic air line industry. Finally, competition since deregulation has increased, not declined. So "predatory pricing" does not seem to be preventing competent new competitors from succeeding.

This report will discuss these issues in more detail. First, it will discuss the success of airline deregulation. Secondly, it will discuss the new regulations proposed by DOT and their rationale – to counter predatory pricing. Thirdly, it will discuss alternative policies to enhance competition in the airline industry and improve its performance.

The Success of Airline De-regulation

Before the Airline Deregulation Act of 1978, the Civil Aeronautics Board regulated every detail of the airline industry. Most importantly, it determined what routes each airline could fly and what air fares each could charge. It even determined whether a new airline could enter the industry. It also regulated levels of service, employment policies, finances, business structure, cargo and other factors.

But under the 1978 Act and the subsequent Civil Aeronautics Board Sunset Act of 1984, all this regulatory power was eliminated and the CAB was phased out. The Federal Aviation Administration (FAA) retained authority to regulate air safety. The overwhelmingly beneficial results of this deregulation surprised even the most ardent advocates of reform.

Prices Down

Airline ticket prices today are almost 40 percent lower, after inflation, than before deregulation. This price reduction saves consumers about $20 billion per year, according to Robert Crandall, senior fellow in Economic Studies at the Brookings Institution, and Jerry Ellig, senior research fellow at the Center for Market Processes at George Mason University.[1]

Moreover, airline ticket prices have fallen substantially in virtually all markets, small, medium and large. Steven Morrison, professor of economics at Northeastern University, and Clifford Winston, a senior fellow at the Brookings Institution, report that prices in small hub markets have fallen almost 60 percent as much as in large hub markets, and 90 percent of this difference in pricing is due to higher costs of serving the smaller markets.[2]

Similarly, an April 1996 U.S. General Accounting Office study found that "the average fare per passenger-mile, adjusted for inflation, has fallen since deregulation about as much at airports serving small and medium-sized communities as it has at airports serving large communities."[3]

The primary reason for these reduced prices is that after deregulation airlines were allowed to compete on price. Moreover, new airlines were allowed to enter the industry, and their competition further reduced prices. All this price competition also forced airlines to cut costs and reduce expenses, allowing even lower prices. In addition, some new airlines specialized in low cost, discount prices for basic, no frills, discount service, reducing prices even more. Southwest Airlines has been the most successful of these new discount airlines, and it is now the sixth largest domestic air carrier.

Service Up

Deregulation has resulted in more available flights for more consumers. The overall number of airline flights increased from just over 5 million in 1978 when the airlines were deregulated to 8.2 million in 1997 – a 63 percent increase. Airlines flew 5.7

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[1] Robert Crandall and Jerry Ellig, "Economic Deregulation and Customer Choice: Lessons for the Electric Industry" (Washington, DC: Brookings Institution, 1997).
[2] Steven Morrison and Clifford Winston, "The Fare Skies: Air Transportation and Middle America," The Brookings Review, Fall 1997.
[3] U.S. General Accounting Office, "Airline Deregulation: Changes in Air Fares, Service and Safety at Small, Medium-Sized and Large Communities," GAO/RLED-96-79, April 1996, p. 3

billion passenger miles in 1997, more than twice as many as in 1978, when they flew 2.5 billion passenger miles. In 1997, airlines carried about 600 million passengers, up about two-and-a-half times from 250 million in 1978.

Moreover, increased flights have resulted for markets of all sizes. The 1996 GAO study found that in 1995, small community airports as a group had 50 percent more scheduled commercial departures than in 1978; medium-sized community airports had 57 percent more departures; and large community airports had 68 percent more departures.

The primary reason for this increased service is that under deregulation airlines were freed to expand service, and new airlines were freed to enter the market, at will. But the key development particularly for expanded service to smaller markets was the innovation of hub-and-spoke operations. This system replaced the old approach of flying from City A to City B and back again. Under the new approach, all flights over large regions fly to the hub and from there to the final destination, then back to the hub and home again.

This method of operation greatly increases the available flights and destinations for passengers at any city on an airline's system. For example, take an airline under the old approach with 25 planes flying each day from one city to another and back again. The airline offers customers at the various cities it serves 25 flights and destinations going out each day, and 25 flights and destinations going back each day, for a total of 50 flights and destinations. But with a hub-and-spoke operation, each of the 25 flights going to the hub offers its passengers another 25 flights and destinations going out again to the spokes on the other side of the hub, and the same when the planes come back to the hub. So with the same 25 planes, this airline now offers its customers at the various cities it serves a total of 625 flights and routes going to the hub and out to the spokes on the other side, and another 625 flights and routes coming back to the hub and out again to the original 25 cities, for a total of 1,250 flights and routes each day.

Consequently, any small city on a spoke in such a system can be connected to 25 other cities with just one flight leaving the original small city each day. Additional flights going to the hub later in the day offer access to those 25 cities at different times each day. Morrison and Winston report in their 1986 book for the Brookings Institution, The Economic Effects of Airline Regulation, that feasible flight alternatives had increased as much as 20 percent to 30 percent for passengers from small cities under deregulation, primarily due to new hub-and-spoke operations.

Moreover, airlines are now bringing into service smaller jet aircraft designed to provide service economically to smaller cities. These aircraft will lead to even more available flights and destinations for these cities.

Safety Up

Despite all the competition and cost pressure under deregulation, safety has nevertheless improved dramatically as well. Between 1939 and 1978, fatal airplane accidents averaged six per year. After deregulation, from 1978 to 1997, the average was only 3.5 per year, a decline of almost 50 percent.

Moreover, fatal accidents per million miles flown have only been 7 percent as large since deregulation as before deregulation. During the 20 years since deregulation, fatal accidents have averaged only 0.0009 persons per million miles flown, compared to 0;.0135 before deregulation.

The 1996 GAO study found no statistically significant difference in safety improvements for airports serving small, medium and large communities.

Competition Up

Finally, overall competition has increased under deregulation as well. The number of airlines competing for passengers has increased 144 percent since deregulation, from 39 in 1978 to 95 in 1997. From 1977 to 1997 the number of effective competitors per route increased by 30 percent. In 1996, about 18 percent of passenger miles were flown by airlines that did not exist before deregulation, the highest proportion since the beginning of deregulation in 1978.

Moreover, economists Morrison and Winston report that such competition has increased in markets of all sizes – small, medium and large, though it has increased less in the smaller markets.

The Local Impact

Many of these same effects can be seen in the local markets in Richmond and Washington, D.C. Service to the Richmond market has exploded, with the number of passengers served by scheduled flights soaring by 60% since deregulation. Competition has also increased, with the average number of competitors serving Richmond per route climbing from 1.84 in 1979 to 2.17 in 1997. Fares overall in the Richmond market have experienced virtually no increase after inflation in the 20 years since deregulation. Moreover, since deregulation, more than twice as many markets served from Richmond have experienced a fare decrease after inflation as have experienced a fare increase.

In the Washington, DC market, covering both Reagan National and Dulles airports, air fares have declined by almost 5% since deregulation. More than twice as many markets served from Washington, DC have experienced a fare decrease since deregulation as have experienced a fare increase. Service is up, with the number of flights served by scheduled flights increasing by 40%. Competition has increased sharply as well, with the average number of competitors per route in the DC market increasing from 1.8 in 1979 to 3.1 in 1997.

Re-regulation Folly

On April 6, 1998, DOT released its proposed new regulations in its "Proposed Statement of Enforcement Policy on Unfair Exclusionary Conduct by Airlines." The statement was published in the Federal Register for public comment.

The statement indicates that DOT's concern is what it considers to be excessively high air fares. But it proposes to address that concern in an odd way - by restrictng the freedom of major airlines to reduce prices and expand low cost, discount seating. The new regulations include guidelines that would sharply restrict such reduced pricing strategies to meet new competition. If an airline violated the guidelines, it would be subject to a trial before newly established DOT administrative law judges. If the airline's actions hurt a small competitor or new entrant or drove them from the market, then DOT would impose regulatory sanctions.

The rationale behind these pricing restrictions is to counter the supposed practice of "predatory pricing". This term is used for a supposed business strategy of reducing prices below costs until financially weaker competitors, in this case primarily small airlines or new entrants, are driven out of business by the losses from attempting to match these below cost prices. With this competition removed, the predatory company or companies can then raise their prices above market levels and earn monopoly profits.

But as a practical matter, this business strategy is unworkable, as is widely recognized in both business and academic quarters. First, at below cost prices, the supposedly much larger predatory company would be losing far more on its much larger volume than the smaller companies would on their much smaller volume. For this strategy to even begin to succeed, the larger company would have to be able to weather far larger losses in absolute dollars than the smaller predatory target companies. And even if the larger predatory company did succeed in outlasting the competitors, it would then be stuck with enormous losses to make up.

Secondly, if the larger, predatory company did succeed in driving out competitors, when it tried to recoup its losses by raising prices to above market levels, it would attract new competitors to this now high profit market. These new competitors would drive prices back down to market levels, and the large, predatory company would never be able to recover its earlier predatory pricing losses, let alone win above market monopoly prices. This is especially a problem in the airline industry, where the central asset in the business – jet aircraft – are the most mobile assets in history. These aircraft can be re-deployed to enter new markets almost instantly.

For precisely these reasons, the Supreme Court stated in Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574, 589 (1986), "predatory pricing schemes are rarely tried, and even more rarely successful." Similarly, the former Civil Aeronautics Board explained,

> Most today recognize that predation is an irrational – and therefore unlikely – strategy in situations where the predator cannot reasonably expect to reap monopoly profits for a sustained period after driving the target company from the market, because of the high costs of predation.
>
> . . .
>
> There is no reason to conclude that entry or exit is so difficult in this market that a predator could charge supracompetitive fares for the sustained period necessary to recoup losses incurred during the period of predation.

Air Florida, Inc. v. Eastern Air Lines, Inc., CAB Order 80-3-194, 85 C.A.B. 2063, 2065 (March 28, 1980).

In a later related order in that case, the CAB quoted from the Congressional Record in the debate over airline deregulation, saying,

> Predatory pricing would also be impossible under airline reform. Such pricing tactics by the larger airlines are sensible if a competitor, once driven out of a market, cannot reenter it. Only then can the predator raise his prices (and his profits) after the competition is gone. This cannot be the case in the deregulated environment because carriers could always enter new markets at will aided by the most mobile capital investment in history today – the modern jet aircraft.

Air Florida, Inc. v. Eastern Air Lines, Inc., CAB Order 81-1-1012 (Jan. 21, 1981).

Experience bears out this analysis. Even though predatory pricing has always been illegal under the antitrust laws, not one case of predatory pricing has been proven in the entire history of the domestic airline industry, whether through government enforcement actions, available civil suits by competitors, or complaints to regulatory bodies. In fact, since deregulation, neither DOT nor the former CAB found any example of predatory pricing in the 25 cases before those agencies where the issue was raised. In addition, as discussed above, since deregulation competition has increased markedly. So-called predatory pricing does not seem to be preventing new competition.

The problem is that in imposing regulation to stop non-existent predatory pricing, DOT will discourage and prevent the very price reductions and discount seating availability that would benefit consumers. As the Supreme Court said in Cargill, Inc. v. Monfort of Colorado, Inc., 479 U.S. 104, 122n.17 (1986),

> [T]he mechanism by which a firm engages in predatory pricing – lowering prices—is the same mechanism by which a firm stimulates competition; because cutting prices in order to increase business often is the very essence of

competition...[;] mistaken inferences...are especially costly, because they chill the very conduct the antitrust laws are designed to protect.

Similarly, two of the leading authorities in antitrust law have stated in regard to predatory pricing, "Ill-conceived or ill-defined rules impose heavy social costs by deterring legitimate pricing and by both increasing and complicating litigation." P. Areeda and H. Hovenkamp, Antitrust Law 226 (1996).

Or as James Gattuso, Vice President of the Competitive Enterprise Institute, states,

[R]ules against below-cost pricing are likely to cause more harm than good. They are every weak competitors dream. If your rival is underpricing you, drag him into court. The prospect of years of litigation would certainly make anyone think twice about lowering prices to beat, or even meet, the competition.[4]

Similarly, Adam Thierer of the Heritage Foundation states that DOT's proposed regulations " will have a chilling effect on industry competition by discouraging fare wars that offer consumers significant savings."[5]

For these reasons, DOT should withdraw its confused and unnecessary proposed new regulations regarding low cost airline pricing. These regulations are analagous to the Vietnam war policy of destroying a village in order to save it. DOT should leave enforcement of the antitrust prohibition on predatory pricing to the Justice Dept.

Alternative Policies to Improve Airline Competition

Instead of returning to tried and failed policies of regulating airline fares and routes, Federal, state, and local authorities should adopt policies to improve airline competition by removing government barriers to such competition. These policies would include the following.

Privatize Airports. Existing airports should be sold off to private companies that would maintain and expand them in return for fees charged for their use. Such private operators should also be allowed to establish new airports.

This would expand capacity for airline competition to the full extent dictated by market demand. Congested airports and hub operations would be subject to new and full competition from new entrants.

(examples coming to add to this section)

[4] James Gattusso, "Don't Outlaw Cheap Airfares," Wall Street Journal, April 8, 1998. P. A22.
[5] Adam Thierer, "20th Anniversary of Airline Deregulation: Cause for Celebration, Not Reregulation," Heritage Backgrounder No. 1173, Heritage Foundation, Wash., DC, April 22, 1998, p. 1

Privatize Air Traffic Control. The cumbersome and bureaucratic air traffic control system run by the FAA is another barrier to airline competition. Outdated equipment, inadequate staffing, and lack of market incentives for top performance reduce the capacity of the current air transportation system overall.

This air traffic control system should be privatized. The new operators would charge fees for their service paid by the airlines. Air traffic control operators, which may include several competing firms across the country, would then expand to cover the full level of air transportation services demanded by the market, with the most cost efficient, effective, modern equipment and all necessary staffing. These private operators would also have full market incentives for top level performance.

(being "beefed-up" to show that this will increase safety, not hinder it.)

Adopt Congestion Pricing. Airports should be allowed to adopt congestion pricing, charging more for flight slots at peak times of demand. This would move smaller, less essential flights, and small private planes and recreational aircraft, to periods of excess capacity (during non-peak periods) or to new airports designed to serve them. As a result, more capacity would be available for new or expanded major airlines to broadly serve the general public during these peak times.

Reduce Airline Taxes. A broad array of mostly Federal taxes on domestic airlines costs these airlines almost $8 billion per year. Reducing these burdens sharply would enable new airlines to enter the market and smaller ones to expand, increasing competition.

CONCLUSION

DOT's proposed new airline regulations should be withdrawn. Deregulation of the airline industry has been a huge success, and DOT's proposals would only begin to reverse that success. DOT proposes to adopt such re-regulation to counter a phantom problem of predatory pricing that does not exist. Along the way, the regulations would perversely restrict the very reduced airline ticket prices and expanded discount seating that would most benefit consumers and that competition is supposed to achieve. As a result, consumers would only be harmed by this re-regulation.

Here in Virginia, deregulation has proven successful as it has throughout the nation. Our airline consumers should not be saddled with having to pay higher ticket prices because of the ill-conceived proposals of the federal Department of Transportation.

Federal, state and local governments should adopt instead policies that would promote airline competition by removing current government barriers to such competition.

About the Author

Peter J. Ferrara is General Counsel and Chief Economist at Americans for Tax Reform in Washington D.C. He served in the Justice Department from 1992-93 as a policy advisor to the Attorney General and was counsel at the Washington, D.C., law firm of Shaw, Pittman, Potts & Trowbridge from 1983-1992. He has also taught law, worked in the Reagan White House and in the Department of Housing and Urban Development. Ferrara is a graduate of Harvard College and Harvard Law School.

"... a wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities."

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1801

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