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Deregulatory Schizophrenia

Alfred E. Kahn†

Professor Handler has rarely slipped in his long and distinguished career, but I'm afraid he slipped this time. First, he invited Judge Breyer to give what he knew would be a thoughtful, judicious paper, admirably reflecting the inevitable schizophrenic tension between a strong belief in economic deregulation wherever even highly imperfect competition is feasible, and an equally strong belief in vigorous enforcement of the antitrust laws.¹ Next, he doubtless assumed that his selection of commentators would produce a fine symmetry. Professor Schwartz could be counted upon to lean heavily on the antitrust side of the balance, skeptically viewing deregulation as unleashing big business to work its will on competitors and consumers.² And since I had helped deregulate the airlines, I'm sure he reasoned I would take the opposite position, that the government should simply stop interfering with the free market.

Aware as I am of the typical New Yorker's perception of our country's geography, I should have warned Professor Handler that Ithaca is not a suburb of Chicago. While prepared to defend enthusiastically the deregulations with which I have been involved, I feel equally strongly that they have greatly accentuated the importance of antitrust enforcement. That puts me squarely in the schizophrenic center that, as I read him, Judge Breyer also occupies.

Why do I characterize that position as schizophrenic? After all, there is in principle no necessary inconsistency in espousing both deregulation and antitrust. I agree thoroughly with Judge Breyer that the antitrust laws are not just another form of regulation but an alternative to it—indeed, its very opposite.³

At the same time, once antitrust enforcement moves beyond proscribing naked horizontal price fixing and group boycotts—as Judge


3. The fundamental objection to economic regulation as it was practiced in the industries from which we have eliminated it was that regulation was rabidly anticompetitive. I find it impossible to understand, therefore, how a strong antitrust exponent like Professor Schwartz can even by implication defend the late, unlamented cartelizations of trucking and airlines.
Breyer, Professor Schwartz, and I believe it should—it necessarily involves governmental interference with trade practices that are not in most cases unequivocally anticompetitive. On the contrary, most of them can be legitimately described, at least in part, as ways of competing. As a result, people with our convictions—perhaps I should confine this confession henceforth to my schizophrenia alone—are inescapably open to the charge of wanting to handicap the competitive struggle, to protect competitors from competition. Indeed, I have for this reason been accused of being a crypto-reregulator. And in a way the accusation is justified.

My conception of antitrust is one that necessarily involves competitive handicapping: There are some practices in which some businesses may safely be permitted to engage but others may not, because in the latter case, but not the former, they would probably have anticompetitive consequences. For example, in his administration of the modified final judgment that terminated the antitrust suit against AT&T, Judge Greene is undeniably engaging in differential handicapping of various members of the telecommunications industry—in short, regulating it. His intention, of course, is not to regulate. Preserving equality of competitive opportunity is not, in principle, the same thing as suppressing or supplanting competition. The notion that preserving competition requires keeping the Bell Operating Companies (BOC’s) out of areas in which they would compete with companies that depend on them for access to local networks is fully consistent with the philosophy of the antitrust laws. Nevertheless, that notion justifies proscriptions that are incontrovertibly regulatory; they clearly impede competition between the BOC’s and their rivals.

Because the restrictions on the uses to which the BOC’s may put their own technology are both anticompetitive and countertechnological, I expect those restrictions will not survive many more years. Moreover, I

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6. In some ways, moreover, Judge Greene has clearly crossed the boundary between antitrust and pure regulation. This is most apparent in his forceful expressions of hostility to the efforts of the telephone companies to diversify their operations, on the ground that in so doing they are proposing to shirk their public service responsibilities. In support of this attitude, he expresses the same opinion Professor Schwartz expresses in his Comment, to the effect that we will have good telephone service only if the Bell managements are forced to keep their noses to that single grindstone. See id. at 874-75. Whether that view is or is not correct—and I defy Professor Schwartz either to show me any empirical evidence in its support or to explain what effect prohibiting the BOC’s from fully exploiting their own technology wherever it leads is likely to have on their ability to retain or attract high-quality managers—it is indistinguishable from the views and policies of most public utility regulators, and its psychology is blatantly regulatory. I fail to see any logical connection between this view and Judge Greene’s responsibilities under the antitrust laws.
incline to Judge Breyer's view that their removal is additionally desirable because they prevent the BOC's from offering new services in markets in which they are not now dominant—indeed, in which they would offer effective competition to the companies already in those markets.

At the same time—to return to my contention that there is an inescapable tension between antitrust and deregulation—the Bell System did use its control over access to the local exchanges to impede competition. Thus, to remove, in the interest of competition, restrictions on the permissible activities of the BOC's actually threatens the fair competitive opportunities of rival purveyors of some of these services.

In this connection, Judge Breyer unduly minimizes the special problems of preserving competition when some of the rivals remain subject to rate base/rate-of-return regulation of part of their operations. As long as a company is prevented by regulation from fully exploiting its monopoly power, it has a clear incentive to cross-subsidize its competitive offerings from its regulated ones—an incentive exposed in a historic article by Averch and Johnson.7 Judge Breyer belittles the Averch-Johnson tendency on the ground that regulators are unlikely to permit the earnings in excess of the cost of capital that are its other necessary condition. That is not what the capital markets are telling us. The current 1.55 average ratio of the market to book values of the Bell regional holding companies' common stock tells us that investors expect them to earn a good deal more than the cost of capital. I suspect, however, that in actual practice regulators have been excessively effective in preventing the threatened cross-subsidization; that is the direction in which the more powerful forces have impelled them. Indeed, the tendency of regulators to require overcharging of the potentially competitive services, provided largely to big business customers, has induced the entry of competition.

In any event, the solution to the danger that firms might cross-subsidize their competitive operations with their monopoly ones is not to prevent conglomerate growth. It is rather to sever the financial link between the revenues and costs of the former and the revenue requirements of the latter. That would eliminate the danger, unique to the public utility situation, of genuine recoupment from captive customers of losses incurred in serving others.

To return to my schizophrenia thesis, life is much simpler for the economists and lawyers who believe that the mere incantation of "contestability" holds the answer to all possible concerns about the viability of competition in deregulated industries. According to this view—sel-

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dom articulated as baldly as I will here—the comparative ease of entry that helped recommend deregulation of the airline and trucking industries also makes antitrust not very important. As Professor Baumol has pointed out, even a single-firm monopoly is incapable of producing harmful results in the face of perfect contestability of the markets in which it sells; a monopolist in that situation will behave exactly as a pure competitor. By the same token—it is rarely observed, but follows logically—we need not in those circumstances worry about horizontal price-fixing conspiracies either, because the conspirators will be unable to raise prices above the competitive level. In short, if contestability were perfect, there would be no need for antitrust laws at all.

That is very close to the position the Department of Transportation has in effect taken in blithely dismissing objections by the Department of Justice to the Northwest-Republic and TWA-Ozark mergers, each of which combined a pair of direct competitors accounting between them for some eighty percent of the departures from Minneapolis/St. Paul and St. Louis, respectively. Those city points are not economically significant markets: What travelers demand is transportation from one city point to another. For travelers who fly longer distances with stops or plane changes in those cities, for example, the market clearly embraces the opportunity to fly instead via Chicago, Denver, Atlanta, Kansas City, or Dallas/Fort Worth. There is genuine competition over different hubs. But for traffic originating or terminating in Minneapolis/St. Paul or St. Louis, the mergers sharply reduced the number of competitors—on many routes from two to one.

In my opinion, the contestability of airline markets does not afford travelers sufficient protection in those circumstances. I am aware of six studies of airline pricing since deregulation. Every one of them has reached the same two conclusions. The first is that market concentration ratios make a significant difference in fares—which is another way of saying that a competitor in the market is worth six potential contestors in the bush. The second is that actual entry, and especially entry by new firms, has been by far the most powerful competitive force. The second conclusion strongly confirms Judge Breyer’s recommendation that we be

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extremely sensitive to what Professor Bain termed the "condition of entry" into recently deregulated industries.

It seems to me absolutely incontestable that the likelihood of entry into any industry is itself powerfully affected by the previous practices of the incumbent firms. The recent history of the airline industry provides ample documentation of that proposition. Entry, particularly by genuinely new firms, has clearly become much more difficult, and some of the reasons for the change should be instantly recognizable by anyone familiar with antitrust.\[11\]

One of the reasons has been the development and control of computerized reservation systems (CRS's) by the dominant carriers. I have nothing to add to Judge Breyer's inevitably schizophrenic discussion of this problem.\[12\]

The second reason is the wave of recent mergers. Here again I agree with the Judge. An industry that is suddenly deregulated after forty years of comprehensive cartelization will inevitably experience a considerable amount of competitive shakedown, and so must be accorded a good deal of freedom to restructure itself. Such restructuring has to include mergers.

Moreover, the mergers, as well as the close operating agreements that have proliferated between major carriers and commuter airlines, confer clear benefits on travelers. For example, the conversion of interline connections, where you change both planes and airlines, into online, where you change planes but not airlines, has made travel more convenient. The mergers of Northwest with Republic and Delta with Western have improved the ability of those companies to compete for long-haul business with the extensive route systems of United and American. For this reason, and also because Texas Air had proved to be an aggressive cost and price cutter, when that company acquired Eastern Airlines the price of Delta Airlines stock went down, clearly suggesting that the merger was widely expected to make Texas Air and Eastern more competitive with Delta.

Finally, despite these mergers, market concentration in the industry—correctly measured—has diminished since deregulation. The fact that the top eight firms now have a greater share of the total national traffic than during the late 1970's conceals the fact that in city pair mar-

10. See J. Bain, Barriers to New Competition 1 (1956).
11. Of course, one important reason for the sharp diminution in the opportunity for new entry has been the success of incumbent carriers, under pressure of competition, in reducing their costs, and this is clearly unexceptionable. Indeed, it probably represents the greatest single success of deregulation. The aggressive entry by low-cost carriers during the years immediately following deregulation accomplished its social purpose, and in so doing drastically reduced the need as well as the likelihood of its continuation.
12. See Breyer, supra note 1, at 1035-38.
kets, one after another, the number of active competitors has typically increased. The removal of the detailed route restrictions administered by the Civil Aeronautics Board has converted all of the top eight firms into actual or potential competitors on all of their routes.

Still, even apart from the direct suppression of horizontal competition that has resulted from some of these mergers, I don't see how anyone can avoid being worried about the cumulative process of competition by preemption that they have entailed. It is not merely—probably not even primarily—the ability to offer better service that motivates the linking of route systems; rather, it is the ability to control traffic. Once the Department of Transportation swallowed the elephant of United's acquisition of the trans-Pacific assets of Pan American (thereby reducing from three to two the number of U.S. competitors in this closed market, and dismissing the Antitrust Division's proposed divestitures that would have created a third viable competitor), it would have been difficult for the Department to strain at the gnat of Northwest's attempt to acquire Republic in order to gain additional feed to support its operations competing with United. Delta's reluctant acquisition of Western was evidently similarly compelled by the need to assure itself feed to support its transcontinental operations in competition with the vaster route systems of United, American, and Texas Air.

Moreover, consider the effect that this linking of route systems has on the ability of smaller rivals to challenge the major carriers on individual routes. There is a widespread view among commuter airline companies that entry or even survival in that business, which has been one of the most dynamically competitive parts of the industry, is virtually impossible except in tight alliance with a single major carrier. More than fifty such alliances have been consummated in the last few years. And consider the bearing of all those alliances on the expectation that the commuters would be one of the main sources of potential competition with the majors: So long as they were unaffiliated with the trunk carriers, they were always in a position to emulate former local and regional carriers such as Allegheny Airlines (now U.S. Air) and Piedmont, which had before deregulation exchanged passengers dutifully with the major carriers, but afterward invaded the long-distance markets in direct competition with them.

These developments have brought me to the same position as Judge Breyer and Professor Schwartz—a virtual per se opposition to any major mergers that would substantially increase concentration in the aggregate.

13. But see D. Pickrell & C. Oster, A Study of the Regional Airline Industry 81 (Staff Study, Economic Analysis Div., U.S. Dep't of Transp. 1986) (concluding that "the available data do not provide any indication that regional carriers who remain independent are at a significant competitive disadvantage").
I think the Department of Transportation's dismissal of some of the complaints of the Justice Department were unconscionable. And I can't understand why both of these agencies evidently refused to consider requiring some additional disposals of assets and routes when Texas Air, with its control or imminent control of New York Air, Continental, and Eastern, was permitted also to acquire People Express. On the basis of pre-merger traffic figures, this gives Texas Air not just twenty percent of total traffic nationwide, but some fifty-seven percent of the total departures from Newark and LaGuardia combined and undoubtedly much higher shares of individual north/south markets on the east coast.

On the other hand, I think Professor Schwartz's worries about our ending up with only three or four carriers are probably unfounded, although if we run into a major recession, who can be sure? I doubt that even the Reagan Administration would permit a merger among the six largest carriers—American, United, Delta/Western, Northwest/Republic, Texas Air, and TWA/Ozark. In any event, the industry is so much more competitive now than it was under regulation that I simply cannot understand his evident nostalgia for the previous situation. The possibility that competition may weaken is no reason to have systematically suppressed it in the first place.

I turn now to the third set of practices that have in my view reduced the likelihood of entry and raised antitrust-like concerns: the pricing responses of incumbent companies to price-cutting entrants.

On the eve of total deregulation, in October of 1978, I dictated a long memo to my fellow members of the CAB. We were on the verge of letting World Airways and Capitol Airways enter the transcontinental markets with proposed $99 fares, and I was concerned that if we didn't do anything about defining in advance the permissible competitive response of the incumbents, they would simply be driven from the market, taking with them the competitive spur they promised to provide. I take the liberty of quoting portions of that memo:

It is now something like 13 or 14 months since we made our effort—aborted by the President—to modulate the competitive responses of incumbent carriers to the new and newly intensified competition they were getting from charters operating under our liberalized regulations and from Freddy Laker.

I think even those of us who thought that effort was a good idea at the time would . . . probably agree that the abortion proved to be a good thing, because it provided us with the justification and stimulus to move much more forthrightly and with a far greater sense of urgency than would otherwise have been possible along the road to further liberalizations of charter rules and opening up scheduled authority to supplementals. . . .

In any event, I don't think the concern itself about assuring a genu-
inely fair opportunity for innovators and new entrants to compete on the basis of their relative efficiency was in any sense illegitimate, or in any way in conflict with our basic intention to open this industry to competition. On the contrary, while students of the antitrust laws differ in their assessments of the necessity for protecting disadvantaged competitors from competitive tactics of their stronger rivals in the interest of preserving competition, I don't think any of them deny the desirability of the antitrust laws pursuing this goal.

. . . .

The immediate occasion for this memorandum—and a good reason, I believe, for trying to formulate such a policy explicitly—is our imminent decision in favor of multiple permissive entry in the Transcontinental case. If in fact World Airways goes ahead with its $99 fare, we may expect—indeed welcome—a competitive response by the incumbent carriers. I do not believe that our best hope for success of this innovation . . . is a policy of laissez faire.

There are basically two ways to protect innovators (and I don't want to explain more than once that my goal here is not to protect them as such—however much even that might be justified on grounds of fairness to World—but to ensure that innovations will continue to be forthcoming, that the structure of the market will remain permanently more competitive, and that new competitive offerings such as World's or their equivalent not be eliminated from the marketplace by competitive responses that prove themselves to be temporary—all this on the assumption that innovations like World's would under proper conditions prove to be economically sustainable).

One is to give the innovator a period of protected, exclusive enjoyment of access to the market and exploitation of his new idea . . . .

. . . [W]hether or not we decide to give World such temporary protection—and it is not the main purpose of this memorandum to argue that point—I submit we must be concerned about the nature of the competitive response the incumbent carriers will make, and we had better be thinking concretely and quickly about what kind of a response we are willing to permit.

I recognize at once the possibility of an opposing view—that we need not worry, since free entry into this market will be a sufficient protection against predation, because the predator will not enjoy any opportunity to earn monopoly profits when and if the entrant has been driven from the market.

I don't know if any of you holds so extreme a view, and whether, therefore, I need spend any time explaining why I do not share it. Freedom of entry de jure is not the same thing as freedom of entry de facto. It is no small venture to enter the market for Transcontinental scheduled service in competition with United, TWA, American, and Pan Am; and I certainly do not have total confidence that, if we permit a totally unregu-
lated competitive response by these carriers and it is permitted to abort or eliminate the World and Capitol ventures, they will not in fact return to the placidity of the present kind of pricing in these markets; and if they do, I have no confidence that we might quickly expect another such challenge, with the lesson of a World and a Capitol driven from the market fresh in the minds of potential entrants.\textsuperscript{14}

I take some perverse satisfaction in quoting from that memorandum because the events of the last few years have, I think, demonstrated the legitimacy of the concerns I expressed there. This does not mean I think the game is lost; the airline industry is still highly competitive. One powerful reason for this, however, was the entry of such aggressive low-cost, price-cutting carriers as World, Capitol, Air Florida, and People Express—and, as I feared, they are gone.

As for the increasingly respectable view among economists that predation is nothing to worry about—why incur the cost of driving a rival from the market when you’re unlikely to be able to sustain monopoly profits because rivals can always reenter?—my answer then was and still is: Does anybody really think that new price competitors will come to the consumer’s rescue as promptly as their defunct predecessors? As I once heard Irwin Stelzer observe, a hiker might not pay much attention to a “no trespassing” sign standing alone, but if he sees the field behind it littered with bodies of previous trespassers, it’s reasonable to suppose he will respect it.

These considerations don’t resolve the dilemma presented to policymakers by incumbents’ selective deep price cuts in response to unruly competition. How can a policy predicated on a recognition that predation is indeed possible—whether in intent or in effect—nevertheless avoid doing more harm than good? Should the antitrust agencies really get into the business of directly regulating the level and availability of Ultimate Supersavers, which must have played a major role in the demise of People Express? Those deeply discounted fares, confined in principle to filling seats that would otherwise go empty with highly demand-elastic passengers, look like the clearest examples of the kind of price discrimination that contributes unequivocally to economic efficiency. But how can we prevent the incumbent carriers from making many more such bargains available in markets where they face competition from a People Express than in markets where they face no such competition?

In attempting to resolve such dilemmas, it is important to recall that the most ardent cartelizer-regulators, too, have justified their unhealthy proclivity for setting floors under prices in terms of preventing predation and discrimination. Such concerns, translated into governmental inter-

\textsuperscript{14} A. Kahn, Towards a Policy for Dealing with Competitive Responses 1-4 (Oct. 19, 1978) (unpublished manuscript) (on file with the \textit{California Law Review}).
ventions, run the obvious risk of suppressing more competition than they preserve. And yet, as I observed in that memorandum eight years ago: 

Remember we are dealing here not with initial innovations, but with *selective discriminatory responses* to an innovation, whether defensive or predatory. Our sense of whether the cost of such a policy would outweigh the benefit will of course depend upon our assessment of the dangers of predatory responses . . . . I cannot formulate any such assessment that satisfies me, but I suggest the dangers are sufficient to justify our considering [it] . . . .\(^\text{15}\)

I still do not know the answer to those questions. My self-diagnosis of schizophrenia is an honest one. I trust that I have demonstrated, however, that one can be concerned about the sustainability of competition and unsatisfied by ritualistic incantations of contestability without necessarily being a reregulator, crypto- or overt. The fundamental assumption of the antitrust laws—that laissez faire is not a sufficient recipe for the preservation of a competitive economy—is as valid today as it was ninety-seven years ago.

\(^\text{15}\) *Id.* at 6-7 (emphasis in original).