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Leave It to the Market

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Introduction

As the globalization of the economy and the introduction of new technologies make our world ever more complex, those in government — whether in elected positions or administrative structures — are taking on an ever larger number of more and more complex issues. Increasingly, almost anyone aggrieved by almost any aspect of life — whether social or economic — seems to feel that government should "do something" about the presumed wrong.

Since politicians are highly motivated by constituent calls for action, the public policy agenda grows more and more crowded, thus complicating already complex issues by reducing the resources available for study and limiting — sometimes almost completely eliminating — the time needed for contemplation, review, and discussion.

Examples abound. Should Microsoft be forbidden to embed a particular functionality in its graphic user interface — or be constrained from competing with others who use the internet as a distribution channel? Should the Bell companies be forbidden to enter the long distance markets before long distance providers have access to local markets — and if so, what precise cost allocation methodologies should be used in setting the prices local phone companies charge the long distance providers willing to compete locally? Have federal health care regulations functioned as intended, or are inept regulators and bureaucratic naiveté the real cause of widespread concern about rising health care prices and falling health care quality? Is the Social Security system at risk or not? And who can forget Senator Moynihan's dramatic assertion — as yet unchallenged to my knowledge — that virtually no one in the

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Senate understands either the basic tax code, or the changes voted into law as the Taxpayer Relief Act of 1997.

Governments, it seems to me, are all too willing to develop and implement poorly thought out and hastily adopted "solutions" to problems which would be better left to the wisdom of free markets.

Government and the Airlines

The airline industry, one of the most visible components of the nation's infrastructure, is also a profoundly misunderstood industry, and I shall elaborate on my thesis — that government should do less about fewer things — by providing some background about the business, as well as some examples of government actions, and inactions, whose results have been — and are likely to be — quite unlike what their legislative and administrative patrons imagined.

1998 marks the twentieth anniversary of the Airline Deregulation Act, which radically changed the way the country's airlines do business, and ushered in a period of dramatic change. Prior to 1978, for almost half a century, the airlines had operated as a highly regulated quasi-utility, with each carrier permitted to fly only those routes, and charge only those prices, explicitly authorized by the Civil Aeronautics Board. The Airline Deregulation Act freed the domestic carriers to fly where they chose, and to charge what they wished.

The theory behind airline deregulation was that competition would lead to more and better service at ever-lower fares. And in a macro sense, that's exactly what has happened. Despite large-type headlines to the contrary, *average* airline fares remain a bargain. Average fares last year were forty percent lower than they were twenty years ago, when measured in constant dollars. And since 1990, consumer prices in general have risen twenty percent faster than average airline prices.

Over the years, market forces have transformed the industry in ways never imagined by the deregulation theorists who pushed through the dramatic changes of 1978. While there are some characteristics that the airline industry shares with many other industries — in particular, the competitive value of being the low cost producer — there are several factors which combine to make the airline business genuinely unique. These include very "soft" brand loyalty; a chronic oversupply of an instantly perishable product; a near-perfect marketplace, created by electronic distribution channels, in which every consumer knows instantly of every product offering; a combination of high fixed and low marginal costs; low entry barriers and high exit barriers. These and other factors make ours an especially challenging business, and render many classic business solutions less than useful.

Most lawmakers and academics had no idea how profoundly these characteristics — and the emergence of new competitors able to employ low cost labor, used planes, route flexibility, and lots of imagination to offer new service and lower fares — would change the industry. Some policy makers actually believed that the industry would restructure itself into a niche business, with the established carriers operating Ritz Carlton airplanes, the low cost airlines operating Motel 6 airplanes, and other competitors operating in-between airplanes — all on the same routes.

Those active in the business — while uncertain about the actual outcome — knew that the assumptions on which many law makers were proceeding were hopelessly naive. But the limitations of analysis, and the nirvana promised by reformers — lower fares and better service for all — swept away the warnings of the practitioners.

As time has passed, the market has created new structures to replace the vanished regulators.

As time has passed, the market has created new structures to replace the vanished regulators: great hubs that offer frequent service to virtually anywhere, but make it difficult to sustain non-stop service in small markets; complex pricing structures that recognize the different value of airline seats sold at various times with different conditions of use; powerful scheduling and price allocation tools that allow airlines to optimize the trade-offs between asset utilization and the varying appetites of different consumers for alternative mixes of price and product features.

However, these market structures have also produced some politically unpalatable side effects. While prices generally are lower, they are higher in small markets than in large ones; absent the coercive power of regulation, airlines have withdrawn service from communities too small to support it; and in many small markets turboprop rather than jet service is offered. And as the major carriers have sharpened their wits and their competitive tools, it has become increasingly difficult for new entrants, which lack network strength, to find defensible niches.

All this has created an outcry by those who feel either disenfranchised or overcharged, and there are now calls coming from many quarters in Washington for various new rules which would amount to a fairly substantive re-regulation of an industry only recently deregulated. Government – confronted with unanticipated consequences – seems inclined to make new rules which will themselves have unintended consequences.

The inadequacy of regulatory analysis, and the probability of unintended consequences, is well illustrated by the government's inability, when deregulation occurred, to anticipate all the ways in which a market-driven airline industry would behave. One good example is the way in which airlines used the nation's bankruptcy laws in the 1980s and '90s. Unlike other businesses, airlines cannot economically discontinue their activities. The network nature of an airline means that its assets always have a higher present value in operation than in liquidation. The net present value of continuing to operate airline assets, even at a loss, is likely to be much higher than the liquidation value of the assets.

That reality has led many failed airlines to use the U.S. bankruptcy laws to permit continued operations — thus preserving their network value — while simultaneously repudiating prior obligations, negotiating reduced aircraft lease payments, persuading debt holders to accept equity for debt exchanges, and wringing concessions from unions. These peculiar statutes — which are quite different from bankruptcy laws in most other countries — account for a large part of the extreme cyclicality of our industry. After a carrier enters bankruptcy, it typically offers lower prices to sustain its traffic. Its competitors — recognizing that they will be better off matching the lower prices than allowing traffic to be diverted — do so, setting off the fare wars that plagued the industry throughout the 1980s and reduced most U.S. carriers to non-investment-grade credits by the mid-1990s. Absent these unique rules, failing airlines would have no choice but to be more competitively prudent, knowing that the consequences of failure would be the real losses associated with liquidation.

By failing to understand how the bankruptcy laws would impact the deregulated industry, and failing to amend the statutes appropriately when their misuse became commonplace, the government weakened the competitive capacity of the more successful U.S. carriers, and paved the way for still another policy failure — immunizing alliances between U.S. and foreign airlines from the effects of U.S. anti-trust laws.

International Airline Alliances

For several years, the U.S. government's primary international air transportation objective has been to negotiate liberalized "open skies" agreements with major U.S. trading partners. While open skies agreements which create new service opportunities for U.S. airlines are a commendable goal, the lever the government has used to induce foreign governments and national carriers to accept such deals — offering immunization from U.S. anti-trust laws to alliances between U.S. and the national carriers of countries which agree to open skies — has, in more cases than not, resulted in less rather than more competition, and has cost the U.S. a substantial part of the international aviation preeminence it would have enjoyed absent such tactics.

It is unlikely that the U.S. would ever have adopted the idea of immunized alliances if the airline industry had been healthy in the early 1990s. But it wasn't. In those years, with the U.S. economy stagnant, the airline industry — in both the U.S. and Europe — found itself in deep recession. A number of U.S. carriers were in or approaching bankruptcy, and several European airlines were in serious difficulty. The desire of carriers on both sides of the Atlantic to combine without merging, and the desire of the U.S. to induce other countries to accept open skies, found common ground in the idea of alliances with anti-trust immunity, a concept implemented by means of a technique called codesharing. Codesharing is a joint marketing technique whereby two carriers sell each other's services as if they were their own, thus creating a combined network with a common label — e.g., KLM flights labeled as Northwest flights and Northwest flights labeled as KLM flights — and giving customers the impression that a journey on two different airlines is really on a single carrier. In exchange for the U.S. grant of immunity, the host country of the foreign flag carrier agrees to an "open skies" regime permitting any U.S. carrier that chooses to fly there from the United States.

When the first such alliances were proposed, American and other carriers strenuously opposed their approval. We felt then — and continue to feel — that codesharing offers consumers few benefits relative to traditional interline connections between carriers. Moreover, we knew that since most consumers prefer to stay on a single airline rather than make interline connections, codesharing between two airlines with a hub on each end of a transatlantic flight would — at least in smaller markets — make it impossible for independent carriers to compete.

Despite these objections, the U.S. has approved a series of immunized codeshare alliances, and the results — as we expected — have differed substantially from those forecast by the theoreticians.

Immunized codesharing alliances which operate in small markets — where a combination between a U.S. carrier and the national carrier of the country in which the European hub is located can attract virtually all passengers whose ultimate destination lies beyond the foreign hub — are extremely anti-competitive. A number of such markets have become monopolies of codeshare partnerships since the alliances were created, New York-Zurich, New York-Brussels, Chicago-Munich, Miami-Frankfurt, and Washington-Frankfurt among them.

Immunized codesharing partnerships affect traffic flow across an airline's entire network, and their existence compels all carriers — even those who would prefer to compete independently — to create such combinations. As the number of immunized alliances increases, the analytical tasks involved in evaluating them become ever more complex, which inevitably enhances the influence of politicians and regulators.

This is well illustrated by the proposed alliance between American Airlines and British Airways, now being evaluated by regulatory authorities in the United Kingdom, Brussels, and the United States. This proposed alliance has become the subject of much controversy and loud assertions – principally by our competitors – that it will be anti-competitive.

No more interesting example of "up is down, truth is fiction" could be found. When AA/BA is approved, every major U.S. carrier will be permitted to fly to London Heathrow from its domestic hubs. Since London is a large local market — generating sufficient local traffic to enable carriers without a "beyond London" codeshare arrangement to fill their planes — AA/BA is the most pro-competitive of all the alliances, rather than the least, as some spinmeisters would have the public believe. Nonetheless, it is beyond me how any congressman, senator or departmental aide without airline industry experience could possibly evaluate, with any accuracy, the conflicting claims of the contesting parties. We would have all have been better off had the anti-trust laws not been jiggered to accomplish a particular political goal.

Conclusion

The bottom line is that government should change fewer things less often, and work harder at understanding the probable outcomes of the changes it does make, than it does today.

Deregulation is a sound principal, and airline deregulation has worked well for most people in most places. Nonetheless, it would have worked far better — and we would have a far healthier U.S. airline industry today — if its probable outcomes had been more carefully anticipated, and if its implementation had been integrated with appropriate changes to U.S. bankruptcy laws.

And while liberalized aviation agreements which present real opportunities for more competition are an appropriate goal of U.S. aviation policy, rewarding countries which agree to open skies with anti-trust immunity for business combinations between their national carriers and U.S. airlines has been severely detrimental to consumers who travel in small non-stop transatlantic markets, and to U.S. carriers who would have preferred to compete independently rather than collaborate.

Twenty years after the Airline Deregulation Act, it is clear that our customers – who tell us daily where to fly, when to fly, what kind of service to offer and what to charge – are wiser than any government is likely to be. History has shown that the market is almost always wiser, and vastly more efficient, than even the most enlightened government. We'll be better off by far when governments everywhere discover that truth.

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