Is Deregulation Dead?

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The word is getting around Washington's regulatory agencies, congressional committees, and law offices that deregulation is dying, and might even be dead. The recently adjourned Ninety-eighth Congress turned a cold shoulder to the Reagan administration's proposals to deregulate natural gas and loosen banking regulation, and it nearly enacted several obnoxious new regulatory statures, including one that would have slapped statutory price controls and discriminatory taxes on telecommunications markets. This was a sharp reversal from the three previous congresses, which had passed a string of laws relaxing federal control of the airline, surface transportation, and financial services industries. And the prospects for the Ninety-ninth Congress are discouraging. Well-financed campaigns are underway to pass new or restored controls over the railroad, banking, and telecommunications industries. No one knows whether the Reagan administration, preoccupied with the debates over taxing and spending, will get around to proposing additional deregulation measures, or will be able to stave off re-regulatory bills as successfully as during its first term. The regulatory agencies themselves remain, for the most part, firmly in the hands of deregulators. But they are under increasing, irredentist pressure from Congress, constituent groups, and the D.C. Circuit Court of Appeals, which has shown itself hostile to even the most straightforward deregulatory measures. The agencies have been obliged to weaken or abandon a number of promising reform proposals, and several reforms that have made it to the *Federal Register* have come to grief in the courts (such as, most recently, the Interstate Commerce Commission's decisions to decontrol the railroads' export coal and boxcar traffic).

What is going on here? Are we seeing yet another earnest reform movement running out of gas after a few fast laps? The answer is no—not exactly. When one digs beneath the won-loss records in the agencies, courts, and Congress, one finds a different and more complex pattern: a pattern that is reassuring in one respect, but worrisome in another.

The deregulation argument, as it emerged in the academic and policy journals in the 1960s and 1970s, and in the agencies and Congress in the 1970s and 1980s, was aimed almost exclusively at the three core features of economic regulation: government control of market entry, exit, and prices. It is astonishing how far this argument has succeeded in the political world, sweeping away numerous price, entry, and exit controls in securities, banking, transportation, communications, and even some agriculture markets. While no one can specify precisely how changing interests and ideas brought these policy changes about, one can at least enumerate the most important causes.

First, a large number of economists turned their attentions to the economic effects of price, entry, and exit controls, and reached conclusions that were, for the most part, unequivocally negative and supported by decades of market evidence in regulated markets. Kenneth Arrow as well as George Stigler, Brookings as well as AEI threw their weight behind the deregulation argument and contributed detailed studies that went unrebutted and appeared unrebuttable.

Second, the economists' arguments against price, entry, and exit controls were easily reduced to simple propositions with wide intuitive appeal. Why should Smith be denied the "right" to truck newsprint from Maine to New Jersey, solely at the behest of Jones who had earlier been granted such a right? Why should Jones be required to drive his truck back to Maine empty? Why should the federal government set interstate airline fares, when unregulated service in California was much cheaper than interstate service back East? Why should bankrupt railroads by forced to service lines that cost more to operate than shippers would pay for? Why could banks pay depositors toasters but not money?

Third and fundamentally, technological and demographic changes in the 1960s and 1970s eroded the structure of the traditional regulatory programs and the political coalitions that had created and preserved the programs in the first place. Dramatic advances in techniques of processing and transmitting information wrecked havoc with the pricing and market-allocation rules that were the foundation of communications and financial services regulation, and created new constituencies eager to crash the regulatory barricades. Less dramatic advances—such as the realization that truck trailers could be designed to transfer from trucks to railroad cars—had the same effect on ICC pricing doctrines. Patterns of air commerce began changing too quickly for the Civil Aeronautics Board to controls, and a growing number of airline firms came to realize that the increased market risks of unregulated rates and routes might be worth the gamble.

Deregulation of prices, entry, and exit remains incomplete, or course. Well-organized coalitions of consumer and competitor groups have so far successfully resisted deregulation of several important energy, railroad transportation, and telecommunications markets. *But the recent trend is likely to continue for at least the next several years, and is unlikely to be reversed in markets that have already been deregulated, for the simple reason that the underlying causes persist.* In the formative era of regulation (the 1890s through the 1930s), changes in production technology were slow enough that the always-slow political process often had time to take charge—the river ports obtained significant protection from railroading, and later on the railroads obtained significant protection from trucking. This seems not to be the case, now and for the immediate future; the pace of market change has quickened while the pace of lawmaking remains incorrigibly slow.

In the case of communications and financial services regulation especially, technology-drive change continues to proceed too quickly for would-be regulators to keep up. Those in the Congress who want to frustrate communications arrangements that “bypass” local telephone systems can hardly find the words to describe what it is they want to tax or how the tax can be collected; “all intra-LATA communications methods that are new” will hardly do. Last year much of “it” barely existed as the lawmakers wrote, and as “it” emerges so will the coalitions of producers who wish to keep it untaxed and unregulated. As the current difficulties of state regulators demonstrate, it is well-nigh impossible even to monitor the existence of black market intra-LATA communications.

As another example, there is considerable support in Congress for “controlling” and “rationalizing” service and market diversification by banks, but everyone involved realizes that the market is driving the political process rather than the other way around. The banking committees will huff and puff at each other, at the Comptroller of the Currency, and at the Federal Deposit Insurance Corporation, and they may well slow or alter market developments at the margin, but substantial further deregulation is inevitable. For the near future as in the recent past, financial entrepreneurs will find the markets, and sufficient number of customers, more quickly than the politicians can stamp them out.

An additional favorable circumstance is that the regulatory agencies, which are uniformly more sympathetic to deregulation of prices and entry than their congressional overseers, have at their disposal a faster and more agile technique of lawmaking than the congress: informal rulemaking. By exercising its regulatory authorities at a certain time and in a certain way, an agency can precipitate a new *status quo* that is difficult for Congress to reverse—because statutory lawmaking is a long and arduous process, because it is biased (more so than rulemaking) towards ratifying rather than altering the *status quo*, and because the “chaos” predicted by opponents of each deregulatory move (strong evidence of which might galvanize Congress into action) invariably fails to materialize. The recent actions of the Comptroller of the Currency and the FDIC, freeing “non-bank banks” and state chartered banks to penetrate new markets, are dramatic cases in point. The non-bank banks and the state banks, once unleashed, will not easily be leashed, and are more likely to create pressures for further deregulation than for re-regulation.

Another example is the ICC's deregulation of the railroads' export coal and boxcar traffic. As mentioned earlier, both decisions were recently vacated by the Court of Appeals for the D.C. Circuit. Both decisions will, however, almost certainly be vindicated within a year or two. The Commission's decisions may be reinstated by the Supreme Court, which is both more sympathetic to deregulation and more deferential to the administrative agencies than the D.C. Circuit. But regardless of what the Supreme Court does, the economic evidence is available for the ICC to reinstate its original decisions on remand, using the court's opinions as blueprints for "appeal proof" decisions. And one way or another, Congress is unlikely to respond to pressure from shipper groups to reverse the deregulation decisions by statute. Already both decisions have been in effect for more than a year, and the shippers' initial predictions of skyrocketing rates and restricted services have not come to pass. On the contrary, some new kinds of price and service arrangements, favorable to both shippers and railroads and quite likely the result of deregulation, have already begun to appear. This repeats a pattern from earlier ICC railroad-deregulation actions, where the initial decisions was fought as a zero-sum contest over "revenues" between railroads and shippers, but where the result turned out to be not a somewhat larger slice for the railroads, but rather a market expansion benefiting everyone concerned. If this pattern continues in the cases of export coal and boxcar traffic, it is difficult to see what concrete evidence the shippers will use to persuade Congress that the ICC is "out of control" and ushering back the day of Gould and Harriman. At most the shippers will have a few negative anecdotes, and the railroads will have a few positive anecdotes plus general data that the unregulated rates have not increased much; whereupon Congress will properly turn to more serious matters.

Regulation of prices, entry, and exit is only half the story, however. The other half is government supervision of arrangements *within* regulated industries where two or more firms (usually competitors) agree to provide certain services (final or intermediate) as joint venturers. Supervision of such arrangements has always been an important party of the apparatus of economic regulation, but until very recently it was "inside baseball"—technically arcane and little-noticed beyond the regulated firms and the trade publications. Now, rather suddenly, controversies over intra-industry coordination have moved to the top of the agencies' dockets—propelled there by earlier decisions to decontrol entry and prices—and are attracting attention in the press and the Congress. Most of the current talk about the death of deregulation is inspired by these controversies, and indeed the prospect that they will yield sound economic policies anytime soon is very much in doubt.

This is most conspicuous in the case of telecommunications regulation. For decades, issues of intra-industry coordination were suppressed because the industry was so thoroughly dominated by the Bell System. The only active public regulation was of “separations” of revenues between federal and state jurisdictions, and “settlements” of revenues between Bell and non-Bell companies; this regulation was highly informal and even friendly, since all the parties shared a common goal—maintaining law basic exchange rates. For a time, the rate and direction of technological change cooperated with the regulators and the regulated firms, producing continuing cost reductions in long-distance transmission and in terminal equipment that were used to finance low basic rates.

But then the process got out of hand: the cost reductions created pressures, eventually irresistible, for independent entry in the long-distance transmission and terminal equipment segments, and Bell’s treatment of the new entrants became the basis of the Justice Department’s successful antitrust suit. If there was a coherent economic theory behind the suit, it was that the Bell operating companies’ monopolies in local distribution gave them the ability, and the structure of the Belly System gave them the incentive, to engage in exclusionary and predatory practices harmful to Bell’s new rivals (and their customers) in the adjacent, naturally competitive markets. On this theory, the disintegration of the Bell System decreed in the Modified Final Judgment would have followed as a matter of course. AT&T Communications and AT&T Information Systems, large and important firms but operating in competitive markets where entry and expansion have become easy, would have been deregulated. The divested operating companies would have been left, to the extent of their remaining natural monopolies, to the state regulatory commissions. This would have involved no federal supervision of their arrangements with various equipment vendors and intercity transmission companies (since their incentive to engage in exclusionary and predatory practices had been eliminated), and little federal supervision of the extent of their own business operations (a routine matter of boundary-drawing for the local regulators). The one residual problem would have been the general level of the local operating companies’ charges for connections to their systems. As monopolists, they could charge “too much” to interstate carriers and devote the excess to subsidizing basic local service, and their local regulators would naturally be agreeable; in the limit, they might even try to reestablish their own “captive” interstate transmission services as a new source of cross-subsidy for local service. Their ability to do this would be temporary, however, due to the emergence of “bypass” systems—and it would be limited even in the short run by the prompt and thorough deregulation of AT&T Communications.

Needless to say, this has not been the way things have turned out. The Federal Communications Commission has effectively deregulated the rates and services of the “other common carriers,” but it still regulates those of AT&T Communications. It may do so liberally (it recently approved AT&T’s “Optional Calling Plan”), but it still does so on the basis of administrative concoctions of service costs, and it has hinted broadly that AT&T can forget about widespread deaveraging of MTS rates. The Commission has proposed that AT&T might eventually be deregulated, but the "other" carriers now argue that *this* would open the door to "predatory practices" by AT&T; the Commission may not exactly agree, but its attachment to cost-based ratemaking and hostility to rate deaveraging suggests and obvious common ground.

The FCC is also regulating the "access charges" local telephone companies may charge intercity transmission carriers—not only the general level of charges to all carriers but the differentials that may be charged to different carriers for different kinds of connections. The latter is pure anachronism according to the implicit economic logic of divesture; its logic is instead political, a boost to the same group of AT&T competitors who inspired the antitrust suit in the first place, intended no doubt as a parting, temporary boost but more than likely to become permanent. The former, which takes the form of setting "local access charges" (replacing intra-Bell transfers and interconnection charges to outsiders under the old regime) and of establishing new federal "end user access charges" to finance part of the local access charges, is more justifiable, as noted above. And one is grateful that the FCC has come up with a compromise access charge arrangement that seems likely to satisfy the concerns of Congress and the state regulators while moving towards a more efficient telephone rate structure. But this only emphasizes the point that regulation of arrangements among firms in the communications industry is not receding along with rate and entry controls, but if anything is becoming more detailed, elaborate, and "political."

Finally, the scope of businesses the divested Bell operating companies may engage in is not being left for them to work out with their state regulators. Instead, these matters are now a matter of detailed and angry contention before the D.C. District Court and the Antitrust Division. There is a (wholly deductive) economic argument that a regulated monopolist will try to lever its way into adjacent, unregulated markets as a means of earning more than its regulatory agency permits. This, however, was not the argument of the antitrust case, and to the extent the problem is real the state commissions have at least as much incentive and ability to control it as anyone else. Under the argument of the antitrust case the divested companies and their regulators might try to lever their local distribution monopolies into interstate transmission monopolies in order to maintain the local rate subsidies. But this is implausible as both markets become increasingly competitive and diverse, and especially so when one envisions several local, interdependent monopolies trying the gambit at once. At worst one would be faced with a blizzard of bilateral monopoly bargaining impasses, and it is most unlikely that a court or agency could resolve such impasses more effectively than the bargainers themselves.

There is, of course, a third argument why the divested companies might want to grow into adjacent markets: the economics of scope in telecommunications may indeed be substantial, and may have been greatly underestimated by the Antitrust Division in its preoccupation with business tactics it thought were "exclusionary" or "predatory." Thus, the new program of monopoly regulation launched by the Modification of Final Judgment may be a matter of applying the abstract logic of the case down to the last detail, or it may be a matter of protecting the cases' logical infirmities from the rebuttal of the marketplace. Either way, federal supervision of the affairs of several of the most important firms within the communications industry is hardly on the wane.

In summary, it appears that price and entry deregulation in the telecommunications industry, along with the disintegration of the Bell System, has led to more rather than less government supervision of the organization of production within the industry. There are aspects of the new regime which almost all economists would applaud, especially the FCC's *original* access charge plan (which was, however, watered down considerably in response to political pressures). But given the problematic character of the government's economic case against the Bell System, the large and intractable uncertainties concerning patterns of cost and demand in telecommunications markets, and the inherent tendency of the political process to obstruct efficient economic arrangements, one cannot say with any confidence that the new regime is superior to the old one.

The story over at the ICC begins in a different place but is otherwise remarkably similar. The railroad business has long been characterized by a high degree of service collaboration among independent firms, similar to the pattern now emerging in the telecommunications business. Two railroads may collaborate in providing service between their two separate markets, they may be competitors in some markets and collaborators in other markets, and they may offer joint services in a market that one or both serves independently. If one road runs from New Orleans through East St. Louis to Chicago, and another road runs from East St. Louis through Chicago to Buffalo, then the two must make joint operating and financial arrangements to move traffic between New Orleans and Buffalo. If two roads run into Chicago but only one has a switching track running to a particular customer's plant, then the two must make arrangements if the customer demands service from both railroads. The ICC as long supervised such arrangements, setting "joint rates" and "divisions of revenues" on "through routes" of two or more roads, and ordering railroads to provide "reciprocal switching" services to each others' customers. In some periods (the 1920s) the Commission exercised these powers aggressively, with a view towards "solving the strong road/weak road problem"—and with calamitous results. In other periods (the 1950s and 1960s) the Commission was relatively passive, conducting "inter-territorial divisions cases" that literally ran on for decades—but still *not* permitting the railroads to negotiate their joint rates and revenue divisions independently while the lawyers argued.

The Staggers Rail Act of 1980 made substantial changes in the ICC's powers over railroad rates and abandonments, but did relatively little to affect its powers over joint rates, revenue divisions, inter-road switching, and related matters. Nevertheless, shortly after the Act's passage the Commission began taking a lenient approach (under its traditional "public interest" standard) towards railroads that proposed to cancel disadvantages joint service arrangements and negotiate new arrangements directly with other roads. The controversy this has provoked in the world of railroading has been more heated and extensive than any of those involving rates and abandonments. At first the railroad industry itself was divided, because many roads believed they were doing better on average with regulated service arrangements than they would through direct negotiations. Soon most of the major roads realized that if independent service arrangements were to be the order of the day, they too should take advantage of the policy wherever it could help them—and soon the Commission was receiving and approving tariffs canceling thousands of officially prescribed joint rates, many of them from firms that were simultaneously challenging other railroads' cancellations in court. Shipper groups, most of whom had been passive bystanders at first, grew concerned that inter-railroad disputes might leave them with poorer or more circuitous service or none at all, and began filing complaints of their own. The briefs in these cases could, with a little editing, be filed directly with the FCC or with Judge Green. They are filled with vague allegations of predatory pricing or exclusionary practices said to arise from monopoly power in adjacent markets, or from the regulation of monopoly power in adjacent markets, or from the competitive process itself. One gets the impression, reading these documents, that many of America's largest and most successful business firms believe that their competitors and suppliers have no capacity or incentive whatever for organizing production efficiently, and that two firms that compete in some markets cannot possibly arrange stable joint service ventures in these markets or even in other markets.

These firms are not so naïve. Many railroads and many railroad shippers believe that the railroad network is still substantially overbuilt, and that an efficiently organized industry would be rather smaller than the current one, with important distributive consequences. Pricing and exiting freedom are crucial steps towards a more efficient industry, but they are incomplete, since prescribed through routes, rate divisions, and switching arrangements can also be used to compel the continuation of uneconomic services. The ICC< anxious to quiet growing congressional concern over the joint service issue, has opened an informal proceeding involving all of the railroads and shipper groups, and hopes to negotiate a compromise policy similar to the FCC's compromise over access charges. At this writing, no one can predict how it will turn out.

The Civil Aeronautics Board has naturally been less concerned with joint service arrangements than the FCC or the ICC; airline passengers, unlike railroad cars and electrons, can switch themselves. But as the CAB heads into the sunset at the end of the month, the remaining live controversies over airline regulation (apart from the Department of Transportation's revival of entry regulation in the good name of safety regulation) all concern those few areas where inter-airline coordination is important: interline agreements over tickets and baggage handling, joint marketing arrangements with travel agents, and joint computer reservations systems. The Board did the right thing in deregulating ticket marketing a few years ago, then spent two years battling (successfully) a threatened reversal by the Congress. In the more difficult case of the United and American computer reservations systems—where the issues are analytically identical to the railroad switching and local telephone monopoly issues discussed above—the Board issued a set of moderately prescriptive rules this fall as its last important act, but these rules have satisfied no one, so an antitrust-divestive suit is underway and Senate hearings are scheduled for early next year. And now the *Wall Street Journal* reports (December 3, 1984, page 12) that Continental and other smaller airlines have accused the major airlines of abusing voluntary ticket and baggage interline agreements, and may ask DOT to reinstitute prescribed agreements (under some new authorities over "unfair" airline practices Congress recently gave the Department).

The list of instructive examples could be extended, but the essential point should be clear. While deregulation of prices, entry, and exit seems likely to continue, the prospects are much less bright for deregulation for intra-industry arrangements among supplier firms. It may be that issues of intra-industry coordination are simply more difficult for a regulatory agency to resolve in a way that a stable equilibrium of its constituency groups will support, since the issues involve conflicting interests within the regulated industry as well as conflicts between the industry and its customers and suppliers. Of course, price, entry, and exit deregulation also involve divergent interests within industries. The issues of intra-industry coordination are, however, rather narrower than issues of pricing and entry; they involve not whether anyone can enter a certain market or whether everyone in the market can set their prices freely, but rather whether one or a few specific firms (United Air Lines or Conrail or C&P Telephone) will be required or forbidden to act in a certain way with respect to other specific firms. It seems plausible that the immediate economic consequences of such issues to a given firm will be larger and easier to comprehend in advance than broader issues of free entry and pricing. If these disputes are more often zero-sum contests where the stakes are fairly clear, as opposed to positive-sum contests where the stakes are fairly uncertain, this implies that regulators and legislators will have greater difficulty resolving them in any durable fashion.

Some of the issues described earlier as industry coordination issues could also be described as pricing and entry issues. AT&T Long Lines' financial arrangements with local Bell and non-Bell operating companies were a matter of intra-industry coordination, but AT&T Communications' prices are, according to the Modification of Final Judgment, prices of a final service. (You will see this by examining your monthly telephone bill, and you will soon be asked to select your long-distance carrier explicitly.) The MFJ program for the Bell operating companies is a form of reverse entry control, where everyone *except* certain firms are free to enter certain markets. It is in these areas, however, that the circumstances described earlier in this paper are most likely to lead to an erosion of regulatory controls in the foreseeable future. GTE, MCI, and other of AT&T's competitors have acknowledged that AT&T should be deregulated *eventually*, so it may only be a matter of time. The growth of bypass technologies is certain to weaken the case for limiting the growth of the Belloperating companies, and in time the Antitrust Division and the D.C. District Court might be persuaded.

Elsewhere, however, regulation of intra-industry arrangements is likely to be resistant to technological change. So long as a market is served by more than one or a few suppliers, and it is profitable for suppliers to collaborate directly in producing certain complimentary goods (whether "intermediate" or "final"), the suppliers will need to negotiate over the terms of their collaboration, and will obtain more or less favorable terms according to the strength of their positions in factor and consumer markets. The businessman's complaints against his collaborator/competitor in these situations has had a highly perverse influence on antitrust law in a wide variety of industries over a long period of time—suggesting that their legal or political appeal is little affected by changing economic circumstances.

It is true that the Antitrust Division and the courts have recently been listening seriously to the economist's refutations of the businessman's complains, but this is primarily in areas were the complaints are pure grousing at the hardships of the commercial world. Where a plausible monopoly is involved, or even a case of substantial market power, the economist's arguments become "two handed," just as in the case of price regulation of natural monopolies. This explains why the current Antitrust Division, which has done so much to jettison baseless doctrines concerning predatory and exclusionary practices, also prosecuted the AT&T case to victory. The question for economists, as the issues of exclusion and predation within industries emerge anew in the regulatory agencies, is how much market power justifies detailed supervision of a firm's arrangements with other firms in its industry. If the power of a Bell operating company is enough, is a railroad's ownership of witching lines between a terminal yard and shippers also enough? If an airline's market position is not strong enough to justify rate regulation, is it nevertheless strong enough to justify regulating the firm's treatment of other airlines' tickets, or its knowledge of how many passengers it has book on its flights?