Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Perils of an Oil "Windfall Profit Tax"

TO THE EDITOR:

In recent weeks, some in Congress and in the media have called for reinstitution of a "windfall profit tax" on domestic crude oil production. ("Déjà Vu" (*Regulation*, Vol. 13, No. 3, 1990) warned of such a prospect.) They argue that relatively high fourth quarter 1990 oil company earnings are the direct result of political events rather than company initiatives and hence should be taxed away and distributed to others in society. While different legislators would offer somewhat different forms of such a tax, generally they would shape it like the previous U.S. oil windfall profit tax—a price-based tax—that was in effect between 1980 and 1988.

Given the present social consensus that U.S. foreign oil dependence probably is excessive, it is difficult to understand legislator enthusiasm for a renewed version of a windfall profit tax. The main result of the previous version was to reduce the incentive to invest in and produce domestic crude oil and natural gas (the two generally are discovered together). We estimate that its peak impact curtailed U.S. hydrocarbon production by about 1.7 million barrels per day of oil equivalent. Moreover, even today, because of its effect during the 1980s on the finding and development of oil and gas reserves, domestic production is less by several hundreds of thousands of barrels per day. Such quantities affect oil and gas prices, keeping them higher than otherwise by increasing U.S. demands in world markets. Also, economic efficiency is adversely affected because oil and gas that could be produced more cheaply in the United States without a windfall profit tax instead are imported at higher resource cost.

As for fourth quarter 1990 oil company profits, a number of points should be kept in mind. First, because of various writeoffs, fourth quarter 1989 oil industry profits were the lowest of any quarter in the 1980s. Because of this, 1990 fourth quarter comparisons are unusually favorable.

Second, because of events surrounding the Iraqi invasion of Kuwait, the price of crude oil in the fourth quarter was unusually high compared with previous quarters and, indeed, compared with the first month of 1991. Present prices in the oil future markets suggest that, barring unforeseen events, levels reached in the fourth quarter are unlikely to recur anytime soon.

Third, oil company profitability, as measured by return on equity or on total assets, has been below the average return elsewhere in the economy since 1983, including the first three quarters of 1990. Thus, higher earnings in the fourth quarter may only bring the industry toward the U.S. average, not set it apart.

And fourth, higher crude oil prices in the fourth quarter stimulated a turnaround in domestic crude oil production, from steady decline to rapid increase. Production by year's end had nearly reached the previous year's level after falling several hundreds of thousands of barrels per day by midsummer. It is exactly this sort of market response that a new windfall profit tax would threaten.

Strangely, no one advocating a new windfall profit tax on domestic oil ever has advocated a "windfall subsidy" when oil company earnings drop, or windfall taxes on rising residential real estate values or other commodities. Evidently, legislators distinguish some windfalls from others. Also, by discouraging domestic oil and gas through a windfall tax and thus raising world energy prices, other forms of energy and of energy-saving goods are provided "windfalls." Since these two result merely from political actions, should they be subject to windfall taxes as well?

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Revisiting the Sherman Act

TO THE EDITOR:

Thomas J. DiLorenzo ("The Origins of Antitrust: Rhetoric vs. Reality," *Regulation*, Vol. 13, No. 3, 1990) asserts that "the Sherman Act was never intended to protect competition. It was a blatantly protectionist act designed to shield smaller and less efficient businesses from their larger competitors." He argues that members of Congress opposed the trusts for a variety of populist reasons, even though the trusts really were a good thing.

Speaking entirely for myself and not the U.S. Department of Justice, I am unconvinced of the beneficence of the trusts, and I very much doubt that there is any way that we can reliably estimate their effects. I also see little point in questioning the motives of members of Congress who supported the Sherman Act. In any event, these are historical issues entirely unrelated to the policy issues presented by antitrust today. From a policy perspective, the issue is what Congress actually did rather than why it was done.

It is most interesting to note that Congress did not outlaw the trusts. It appears that Congress would have done so if it were possible, but it was not. This fact may call into question some of the arguments about motives offered by DiLorenzo. When the Sherman Act was passed, members of Congress knew it would not affect any of the accursed trusts one iota.

Senator Sherman introduced a bill that was designed to deal comprehensively with the trust problem, but it was not enacted. A group of senators led by George of Mississippi and including Hiscock of New York, Reagan of Texas, and Vest of Missouri argued that the bill was unconstitutional. The reason was that the only constitutional authority to act was the commerce clause, which authorized the regulation of interstate commerce, and interstate commerce was defined very

narrowly in 1890. The trusts were not engaged in interstate commerce.

Senator Sherman attempted to defend the constitutionality of his bill, but his efforts were to no avail. His bill was rewritten first by the Finance Committee and then again by the Judiciary Committee, which inserted the critical qualifier that limited the application of the bill to restraints of "trade or commerce among the several states, or with foreign nations." After this final rewrite, the bill was quickly passed. As enacted, the Sherman Act may have applied just to railroads and ocean shipping. When the government used its new weapon to attack the sugar trust, the Supreme Court held that the act did not apply because manufacturing was not interstate commerce. Of course, that is no longer the case.

It is also important to note that the Sherman Act is not on its face "blatantly protectionist." Indeed, the Sherman Act is not blatantly anything. The words of the statute could hardly have been less clear. The Supreme Court recognized this in noting that "the Act has a generality and adaptability comparable to that found to be desirable in constitutional provisions." Thus, what Congress really did was to provide the courts a virtually clean slate on which to write. Sherman Act law has developed as a common law.

Common law involves a process of groping toward sensible rules. That process can be long and painful, and in the case of the Sherman Act it may be fair to say that it has been. It took 70 years for the Supreme Court to declare that the antitrust laws were designed for "the protection of *competition*, not *competitors*" and perhaps 15 more for the Court to make much use of this dictum. Over the past 15 years, however, antitrust law has been recast in a way that is far from the "blatantly protectionist" intent that DiLorenzo imputes to Congress.

The watershed year was 1977. In that year the Supreme Court limited treble damages to direct purchasers *(Illinois Brick Co.* v. *Illinois)*, abolished per se rules for nonprice vertical restraints *(Continental T.V., Inc.* v. *GTE Sylvania, Inc.)*, and precluded suits by competitors that really were complaining about competition *(Brunswick Corp.* v. *Pueblo Bowl-O-Mat, Inc.)*. Borrowing a phrase from Robert Bork, in 1979 the Supreme Court termed the Sherman Act a "consumer welfare prescription."

In terms of DiLorenzo's argument, the *Brunswick* case is the most important. It introduced the concept of "antitrust injury," and held that private parties can use the antitrust laws only to redress injuries to competition. This decision has been subsequently reinforced by *Cargill Inc.* v. *Monfort of Colorado, Inc.*, which like *Brunswick* involved a merger, and by *Atlantic Richfield Co.* v. *USA Petroleum Co.*, which involved alleged resale price maintenance.

In keeping with the *Sylvania* theme of relaxing restrictions on vertical restraints are *Monsanto Co.* v. *Spray-Rite Service Corp.* and *Business Electronics Corp.* v. *Sharp Electronics Corp.*, which made it far more difficult for a terminated, price-cutting dealer to maintain that the termination was the product of resale price maintenance, and *Jefferson Parish Hospital District No. 2* v. *Hyde*, which restricted the application of the per se rule for tying.

Limits were placed on the application of the per se rule for horizontal restraints by *Broadcast Music* v. *Columbia Broadcasting System* and *NCAA* v. *Board of Regents of the University of Oklahoma*, which held that the rule could be applied only in situations in which "the practice appears to be one that would always or almost always tend to restrict competition and decrease output," and *Copperweld Corp.* v. *Independence Tube Corp.*, which rejected the notion that a horizontal conspiracy could exist within a single corporation.

Finally, in *Matsushita Electric Industrial Corp.* v. *Zenith Radio Corp.*, the Supreme Court made it more difficult for unsuccessful competitors to maintain that they were the victims of predation and encouraged the district courts to grant summary judgment in antitrust cases.

These cases, particularly *Matsushita* and *Brunswick*, have had a remarkable effect. The district courts now frequently grant defendants' motions for summary judgment. The groping process is not complete, and there continue to be poorly reasoned antitrust opinions, but it is not possible to read a large volume of recent district court and court of appeals opinions and come away from the experience believing that the Sherman Act is "blatantly protectionist." As the Seventh Circuit recently held, "The modern conception of the Sherman Act is of a statute that seeks to protect consumers from monopolistic practices rather than competitors from competitive practices."

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Raising a Credible Threat

TO THE EDITOR:

I very much enjoyed the article by Professor Boudreaux, "Turning Back the Antitrust Clock" (*Regulation*, Vol. 13, No. 3, 1990). It was particularly pleasing to observe that the last article I wrote before giving up academics for politics is still being read. Professor Boudreaux's analysis of my "Predation and Competition in Antitrust: The Case of Nonfungible Goods" (*Columbia Law Review*, Vol. 87, No. 8, 1987) surely doubles its total readership!

The heart of Professor Boudreaux's criticism is that, whereas he grants I developed an internally logical model of nonprice predation, it was not proven to have occurred.

Actually, my article in the *Columbia Law Review* gave several instances of its actual occurrence, perhaps the clearest being the location of grocery stores in urban centers recounted in an economic study in Canada. My model is very simple: a new store opens, one of the old ones (on a typically short lease) relocates at lease end next to the new one, and the new one dies.

The big question for Professor Boudreaux was whether the old one would then move back to its former place. What does it matter? Either way, there are fewer stores (by one) than if the predation had not occurred—that much less choice for the consumer. Or, to use the example Boudreaux prefers, Honeycomb cereal enters between the sugar level of Sugar Smacks and Life, Life becomes sweeter, and Honeycomb leaves. Whether Life returns to its prior position of sweetness is immaterial to proving consumer loss: there is one less alternative than the market could have sustained.

The only insight I suggest that my article had, and it is not so great, was that the costs incurred by Life in so moving are less than the costs it imposed upon Honeycomb.

Prove it to yourself by drawing a straight line, representing an even dispersal of consumers of cereal. Put Quaker Oats at one point, then equally space Life, then Sugar Smacks, then Cap'n Crunch. Enclose the area closest to each brand with parentheses. Now place Honeycomb within one of those parentheses, and create a space enclosing that part of the line closest to it. The parentheses around Honeycomb will enclose less than those around Life. And when Life moves to a position just next to Honeycomb,

the size of Life's parentheses stays the same, while that of Honeycomb gets smaller.

Honeycomb thus knows that, if it enters, Life can hurt Honeycomb more than Life hurts itself. That makes Life's predation a credible threat, so that Honeycomb does not enter at all. (This works in two dimensions as well, as I show in the article.)

And that is the flaw in the Chicago-school argument. Chicago-school enthusiasts extrapolate from the fact that price predation always hurts the predator as much as the victim to conclude that nonprice predation does too. It does not, and that is what makes nonprice predation more credible.

Incidentally, I am proud to call the University of Chicago my economic intellectual home; I hold a Ph.D. in economics from "the University." Because I hold it so dear, I do not like to see its teaching oversold. Thanks for giving me the chance to get back into academic debate; it sure beats what I hear in Congress!

Tom Campbell
Member of Congress
Washington, D.C.

In Praise of Smoke Screens

TO THE EDITOR:

I write in praise of smoke screens. Thomas DiLorenzo ("The Origins of Antitrust: Rhetoric vs. Reality, *Regulation*, Vol. 13, No. 3, 1990) attacked antitrust by writing that "a major political function of the Sherman Act was to serve as a smoke screen," originally to reassure the public that the monopoly problem was being addressed, even while tariffs were being raised. Maybe and maybe not. But surely antitrust currently serves a valuable and underappreciated role as a smoke screen.

Consider oil. When Assistant Attorney General Rill was called before Congress to discuss the then-hot issue of wintertime oil price hikes, he said, "Senator, you can count on us doing an aggressive job in this matter." More recently, Rill responded to the clamor over the escalation of petroleum prices following the Iraqi invasion of Kuwait by starting an investigation and promising to pursue it "aggressively." Assuming the oil companies did not engage in conspiracy, the second investigation, like the first, should not result in litigation. But the antitrust safety valve may have prevented ill-advised congressional responses to constituent pressure.

Similarly, consider airlines. Many consumers have favorite stories of seemingly bizarre airline pricing, and economists' explanations are not always satisfying. Pressure to reregulate is building. It is being restrained by the perception that antitrust officials are addressing problems in airline competition.

When airlines announced significant lock-step fare increases in the face of congresssional concern about prices, DOJ's Antitrust Division promptly launched an investigation, and the division is now conducting a broad inquiry into the domination of airline hubs. This may lead to sensible suggestions such as abolishing frequent-flier programs, as recommended by Severin Borenstein ("Dissipating the Airline Deregulation Dividend," *Regulation*, Vol. 13, No. 3, 1990). Even if it does not, the mere existence of this antitrust safety valve will have served an important role if it helps prevent reregulation.

Professor DiLorenzo could object that current government initiatives in oil or airlines may result in harmful litigation, and the costs of that ligitation (or even the current investigations) are greater than any benefits. But at least he should recognize, as I presume he does, that a balancing process is required.

Stephen Calkins
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Wayne State University Law School

P.S. I cannot resist noting an irony revealed by comparing Professor DiLorenzo's piece and the article by William Shughart ("Private Antitrust Enforcement," *Regulation*, Vol. 13, No. 3, 1990). Shughart protested that "one of the most troubling aspects of private antitrust enforcement is the frequency with which firms bring suits against their competitors." Yet if Professor DiLorenzo is correct, this is exactly what Congress intended!

Laissez Fares!

TO THE EDITOR:

Severin Borenstein is one of a growing number of academics who believe that, while airline rate and entry deregulation was a good thing, we have gone too far in adopting "laissez faire" policies ("Dissipating the Airline Deregulation Dividend," *Regulation*, Vol. 13, No. 3, 1990). The views of Borenstein seem to be gaining ground, in large part because the failure to complete the task of deregulation has resulted in increased congestion and dissatisfaction. Of the air travel industry's three major operational components—the airlines, the airports, and the air traffic control system—only the airlines were deregulated, and they only partially. The other two components of the air travel system continue to operate as government monopolies. That has created major bottlenecks and reduced the quality of air service.

Rather than identifying these government-sponsored shortcomings, Borenstein argues instead for more political control of the airline industry—including heightened antitrust regulatory scrutiny, bans on various airline operating policies, and eliminating frequent-flier programs. Borenstein's views are not atypical, of course. Many academics support the view that although markets achieve much on their own, with a little help, they could do brilliantly.

The first element of Borenstein's argument is that "competition" is a good thing and deregulation has given us an insufficient amount of it. In his discussion Borenstein confuses two meanings of competition. One use of the term focuses on the number of airlines operating (more airlines mean more "competition"). A second use of the term views competition as a process for improving consumer welfare (more competition means better service/price offerings). Borenstein relies on the first, static definition as he concludes that competition is declining. Carriers are "dominant." "Natural" and "marketing" (unnatural?) advantages raise "entry barriers," which further reduce "competition" and increase the "power" of the "dominant" carriers. All this is bad because "almost certainly fares... would fall if there were active competition." Significantly, the second, rivalrous view of competition finds comfort in many of the practices Borenstein criticizes.

The nub of Borenstein's worries are the hub-and-spoke systems that have evolved under deregulation. Hubs mean "concentration," a phenomenon that always bothers the neoregulators. Prices, Borenstein argues, are higher at hubs than elsewhere because hub

competition is limited. Borenstein's analysis is based on fare data he has collected for various routes. In a more detailed work (referenced in the article) Borenstein explains how he adjusted his data to account for a range of specific factors and then sought to explain the remaining discrepancies. Borenstein examines three possible explanations for the higher fares he finds at dominated hubs. First, he asks whether these discrepancies are illusory. Second, he considers whether the services offered by hub carriers are superior to those offered by nonhub carriers. Third, he questions whether such discrepancies are simply inherent in the hub-and-spoke system and unreachable by government action.

Borenstein's first claim (that fares are higher) may or may not be true. It is certainly prey to the classic economic error of assuming that list prices are what people pay. Borenstein ignores the fact that, in today's world of pervasive frequent-flier awards, fares and costs may differ sharply. This may be important. Although frequent fliers constitute only about 6 percent of all passengers, their travel represents more than 40 percent of all trips (and probably a much higher percentage of full-fare travel). For such passengers list prices should be discounted to reflect the rebates travelers receive when they cash in the frequent-flier awards.

Such adjustments are not easy. The effective discount will vary widely by customer. That such adjustments are difficult, however, does not mean that they can be neglected. Indeed, Borenstein's apparent "discrepancies" might be largely explained by his failure to adjust "full-fare" tickets to account for the frequent-flier credits such travel earns.

But let us accept the differences in list prices as meaningful and turn now to Borenstein's second point—that variations in hub service quality cannot explain such fare differences. Note that Borenstein does not deny that hub service is qualitatively superior. He concedes, "When it comes to air travel, people who live in cities with hub airports probably are better off than people who live in nonhub cities." Borenstein contends, however, that higher quality service will not command a higher price in competitive markets.

Let us first consider the way in which the hub system has affected travel costs. Borenstein overlooks the extent to which deregulation has changed transportation economics—for both airlines and their passengers. Consider the costs of shifting an aircraft from City A to City B, for example. The costs include not only fuel, labor, and meals consumed in transit, but also any change in the short-term earnings potential of that aircraft. If the aircraft moves to a city where business is profitable (for example, to the airline's hub), the costs are lower than for a comparable move to a city that is not a hub for that airline. Route costs therefore depend on the specifics of each airline's schedules and the fluctuating demand and supply it faces. The costs of serving a single route are very difficult to estimate from outside (or indeed even inside) the system. Distance may well be among the least significant factors governing costs, for example.

The type of service offered to passengers at hub and nonhub cities differs sharply. At hubs passengers are offered frequent direct (indeed, nonstop) service to a large number of spoke cities. That service is provided largely by the "dominant" carrier. At nonhub cities passengers face primarily change-of-plane service (save to hub cities) and must pick among competing grids. Passengers at hub cities can also elect to travel via a competing grid, of course, but then they forgo direct routing. In effect, airline deregulation has resulted in a differentiated product depending on whether one is traveling from a hub or a nonhub city. A direct comparison between the two types of service is difficult. As noted, Borenstein does not dispute that hub service is generally of superior quality.

Borenstein argues that this is irrelevant, however. According to him, only costs matter in a "competitive world." But Borenstein must know that this is not quite right. Regulatory economists have long recognized that in situations where products exhibit flat or declining marginal costs, "optimal departures from marginal cost pricing" may be necessary and efficient. Marginal cost pricing may or may not cover the costs of serving a specific route. If not, then efficiency considerations suggest that the airline should charge different prices to different passengers to recover more revenues from those passengers who place the greatest value on air travel and who are least likely to quit traveling because of price increases. Thus, we should not be surprised to discover that fares differ appreciably, and that business fares are generally much higher than tourist fares.

Of course, the fact that prices are influenced by service quality does not mean that the airlines are free to charge whatever they wish. Some passengers, especially those with other options, will be lost if air fares are raised, and new entrants may also be attracted to the market. "Potential" competition—a concept dismissed by Borenstein—is a real phenomenon. Airlines have many ways to test the profitability of a new route, and they have often done so under deregulation by entering and then leaving markets that do not prove attractive. Moreover, airlines can enter a market with highly selective pricing policies (triple mileage on Los Angeles-San Francisco flights during January and February, for example) designed to entice specific customers. Nor is it costly to link grids if the costs of direct flights rise excessively. A passenger can fly from a hub city to another hub city and then to his destination. (Note that passengers selecting this process are, in effect, acting just as passengers at a nonhub city.)

Naturally, the fare on such multisegment routes must be lower than the fares charged for the direct flight if anyone is to use them (although again note that such discounts may occur as specific frequent-flier discounts rather than as fare differences). Borenstein recognizes that such grid-linking arrangements often occur (noting, for example, that United offers only flights to its Chicago and Denver hubs from Northwest's Minneapolis-St. Paul hub), but he does not appreciate that this is the nature of grid competition. For efficiency reasons it may be that no other form of competition can be expected, and none is needed. A world in which service quality does influence prices still leaves the American public better off.

But can we do better? Borenstein seems to believe we can. He understands that hubs allow economies of density—more effective utilization of capacity, higher load factors, and more flights—and he must realize that this requires that passenger flows be concentrated on one carrier. But while Borenstein values such flow-concentration economies, he acts as if these gains could be attained if traffic were divided among many carriers. How this is possible is never made clear. Dispersing traffic among several airlines would directly reduce the economies of density hubs were created to exploit.

It seems Borenstein would accept the "natural advantages" gained by airlines at their hubs, but he is far

less supportive of the "marketing devices" airlines use to enhance their hub positions. Borenstein is unhappy about frequent-flier programs, airline-provided commissions to travel agents, limits on airport capacity, and "lax" antitrust enforcement of airline mergers. He even seems unhappy about advertising—since it may differentially benefit the established airline. To address these "problems," Borenstein would ban frequent-flier programs, restrict computer reservation systems, and restrict contractual arrangements between airlines and airports.

Consider Borenstein's views on frequent-flier programs. He does not like them. If air fares must be discounted, then Borenstein would force the benefits to go (wherever possible) to the business traveler's employer, not to the individual. As an analyst, I can sympathize with Borenstein here. If list prices more accurately reflected travel costs, analysis of the industry's performance would be more straightforward. Unfortunately, markets exist to advance consumer welfare, not to simplify the task of the academic.

Borenstein provides other reasons for opposing frequent-flier programs, of course. He argues that they are "tax scams" through which employees receive untaxed, in-kind benefits. We must suppose that Borenstein also opposes employer-provided medical insurance and child care plans. Borenstein's main point, however, is that such programs result in "inefficient decisions" by travelers. He implies that employers are somehow duped as employees waste time and money pursing frequent-flier awards. I suppose Borenstein also assumes that the Christmas gifts provided to purchasing agents by attendant suppliers or the attention showered by hotel and airline managers on convention planners also leads them to betray their unsuspecting corporate employers.

In reality, firm managers are well aware of incentives likely to distort employees' decisions. Companies may impose rules prohibiting their employees from accepting gifts, favors, or frequent-flier rewards as a result. The fact that few do so suggests that employers find frequent-flier programs effective ways of selectively rewarding their most travel-harried workers.

Frequent-flier rewards are akin to the discount coupons available for a wide range of consumer products. Coupons are one way of discounting prices. They permit producers to appeal to the most price-sensitive customers without lowering prices for everyone. Frequent-flier award programs are very complex and continuously change as airlines seek to reward those customers most vital to their continued profitability. Simply reducing fares, although beneficial to the corporation, would weaken the incentives for an individual traveler to concentrate his travel on any one airline. Frequent-flier programs, on the other hand, offer many ways of targeting price changes more carefully. For example, there are several classes of frequent fliers, and assignment to a class is determined by the number of miles flown on the airline. In higher classes travelers obtain multiple mileage credit, that is, their discounts increase. It would be much more difficult to provide additional rewards to the more-frequent frequent flier through a general fare discount.

Borenstein's concern over volume-based airline commissions to travel agents stems from much the same confusion over whether a firm or a government regulator is more likely to advance efficiency. Yes, a travel agent might mislead a customer and encourage her to purchase a less desirable flight, but the same potential exists in an encounter with a real estate agent, an insurance agent, or even a clothing store sales clerk. There is little evidence that such fears are well founded or that any regulatory intervention could improve the situation. Markets discipline such practices in many ways: by the need to provide quality to ensure repeat business, by the comparison shopping endemic in our society ("Oh, how much did you pay for your seat?"), and by the fact that honesty is a profitable business policy. Note that Borenstein does not suggest that we abolish travel agents; he just wants people to worry more.

Surprisingly, Borenstein does not even discuss the more significant forces limiting the ability of the air travel system to provide more user-friendly services—the political mismanagement of airports and the air traffic control system. To these we should also add cabotage laws that prohibit foreign carriers' competing on domestic routes. These failures do indeed suggest (Borenstein notwithstanding) that the remaining problems of airline deregulation are the fault of government. Airline deregulation mandated greater operating efficiences and thus necessitated the shift to hub-and-spoke distribution systems (the savings of such systems are massive). That shift required that the airlines redeploy planes and staff around the nation. The airlines were able to move those resources under their control, but they were not able to shift air traffic controllers or reallocate airway trust fund revenues to expand capacity accordingly. The Federal Aviation Administration responds to its political overseers, not to consumer needs. The result has been needless congestion and discontent. Borenstein would have done well to have examined this problem rather than the creative marketing arrangements that airlines have used to advance consumer welfare and profitability.

That the nanny airline reregulators are again gaining a hearing—even in such market-oriented publications as *Regulation*—says much about current political realities. Those favoring deregulation should renew their efforts. Department of Transportation and Justice officials should reconsider their hasty handicapping of the computerized reservation system, and DOT, in particular, should move aggressively to free airport and air traffic control capacity. Rather than finding ways to oppose specific pricing or privatization policies, policymakers should encourage the broadest possible experimentation.

Fred Smith
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Averting Airline Reregulation

BORENSTEIN responds:

In responding to my analysis of airline competitiveness, Mr. Smith criticizes my standard economic use of the term "competition." He proposes a revised definition, one that applies to a world in which companies strive not to make large profits, but to make the greatest possible contribution to human welfare. I suppose in this world each manager is trying to demonstrate that he or she is a better citizen than other executives in the industry. In the real world firms are trying to make money. The pursuit of profits usually benefits society as a whole, but it is logically possible that it can lead to behavior that hurts consumers. Despite Mr. Smith's assertion, the absence of government intervention does not necessarily equate to competition. Much of the recent

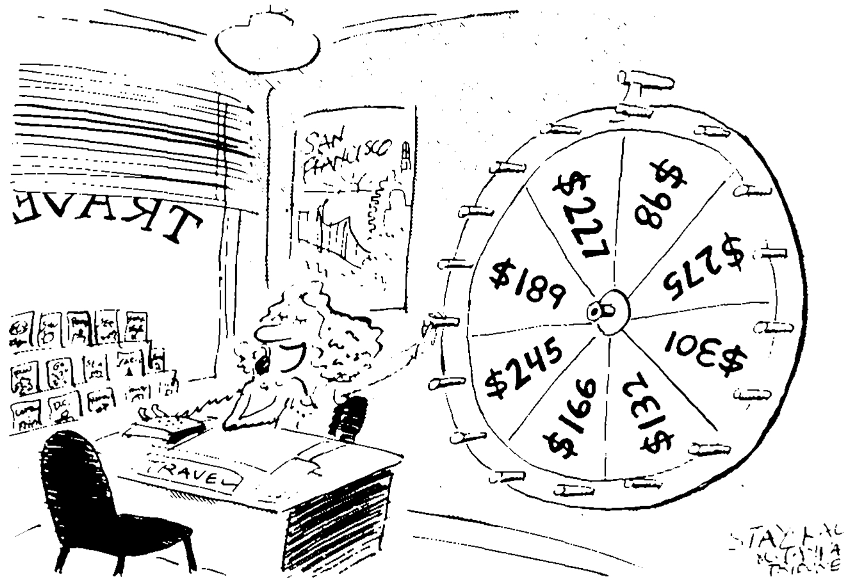
empirical work on airline competition seeks to determine how consumers have fared as hub concentration has increased. Mr. Smith sees no need to read those works. He already knows the answer: only government intervention can harm consumers, because laissez faire capitalism always improves consumer welfare. That is not economics. That is religion.

Mr. Smith practices this religion with a fervor and sloppiness that is, unfortunately, much too common. He seems to think that the mere suggestion of a cost-based explanation for suspect pricing practices negates any empirical demonstration of market power. He begins by suggesting that the value of frequent-flier bonuses "might" explain the higher prices that I find at hubs than on flights between nonhubs (which, by the way, are transaction prices, not list prices). Yes, they "might," but they do not. As explained in my *RAND Journal of Economics* article cited in the paper, the allegedly greater value of frequent-flier bonuses for people flying to or from hubs is very unlikely to explain more than a 2 percent average price difference. Such an upper bound estimate is not so difficult to come up with, but it does require looking at the data.

Mr. Smith is amazed that I "concede" that people who live around hubs are probably better off than people who do not. Such "concessions" are easy to make when one views the issue as one of economics rather than ideology. In fact, I began my article by "conceding" that airline deregulation has greatly benefitted consumers, benefits I would not like to see lost to reregulation or monopolization.

Next come the smoke and mirrors. Mr. Smith explains that the workings of an airline network are much too complex for anyone outside the industry to fully understand, and that the relative costs, operating plus opportunity costs, of flying to different destinations "might" well differ among routes of similar distance. True enough, but where is the explanation for the strong relationship between dominated airports and higher prices? Is complexity the explanation or is it just the reason that we should never study airline pricing? Mr. Smith clearly has not, or he would know that in every major study of airline competition, distance is the most significant determinant of prices.

Mr. Smith instead appeals to a general theory of optimal monopoly



"YOU WANT TO KNOW THE AIR FARE FROM TAMPA TO WASHINGTON ?.. JUST A MINUTE, PLEASE !"

regulation—Ramsey pricing—which (in theory) allows a regulator to confer the greatest possible total benefits on consumers plus producers, given that the firm must cover its costs to stay in business. Now we are back to economics, but unfortunately the application of the theory is strained at best. Is Mr. Smith suggesting that airlines are trying to maximize the sum of consumer benefits plus profits rather than just profits? That does not sound like capitalism to me.

New airlines will be attracted to enter any markets that are overpriced, Mr. Smith argues, because potential competition "is a real phenomenon." Yes, it is, but where is the evidence on the effectiveness of potential competition—evidence based on data, not theology? The real studies of potential competition effects in the airline industry—done by a wide variety of researchers with differing views of the industry—have found small or insignificant effects. No study has found that potential competition creates nearly as much downward pressure on prices as the presence of actual competitors. The implication of Mr. Smith's letter that airlines can enter and exit markets at little cost has been dismissed as excessively sanguine by even those people who espoused such theories at the time of deregulation.

My advocacy of banning frequent-flier programs seems to really get Mr. Smith's goat. He supposes that my opposition to such an untaxed fringe benefit means that I am also opposed to untaxed medical and child care benefits. Does Mr. Smith think that the federal government has as much interest in subsidizing Hawaiian vacations for tired business executives as in promoting adequate health care? I do not.

No, Mr. Smith, employers are not duped by the gifts that airlines give to their employees. Firms know the effect of frequent-flier programs, but the costs of controlling these effects are large. Airlines generally will not permit a traveler to hold separate memberships for personal and business travel. This greatly complicates the employer's monitoring task. Simply prohibiting collection of these gifts is virtually impossible, unless the employer is going to open all of the employee's personal and business mail. Requiring that the bonus flights be used for business travel is quite difficult since such trips must often be booked well in advance and occur at offpeak times. Mr. Smith's analogy between frequent-flier bonuses and personal Christmas gifts from suppliers is nearly accurate: If a supplier gave a purchasing agent free trips to Hawaii for Christmas, the purchasing agent might very well betray his corporation's best interests.

Mr. Smith's aversion to real data is so great that he refuses to recognize them when they are given to him. He says that I offer little evidence about the effect of commission-override

programs, yet I cited a survey of travel agents in which more than half stated that their airline choices were significantly affected by these undisclosed payments. Another recent survey by the General Accounting Office confirmed this conclusion. It would be nice if honesty were always the best policy, but the real world is not so nice.

Finally, I would ask the reader to take another look at Mr. Smith's entire letter. Imagine an airline industry with only one or two firms and notice that his arguments apply equally well. That is the case because his letter is a generic defense of concentration: Dominant firms *may* enjoy lower costs. Their behavior *may* be to price above their costs for efficiency's sake. Entry of new firms *may* occur if prices rise much above costs. All of these arguments *may* be true, but they can be proven only by looking at the data, not by preaching the gospel. In this case the data do not bear them out.

For Mr. Smith to call me a "deregulation critic" is undiluted consumer fraud. I was one of the economists at the Civil Aeronautics Board in 1978 who worked to implement airline deregulation. Now I am advocating policies that could help to prevent a return to regulation. It would be nice if we could all live in the world that Mr. Smith conjures up, where successful public policy can be based only on political and economic theories. Unfortunately, in the real world facts keeps raising their ugly head. The facts in the airline industry just do not support Mr. Smith's theories.

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Congressional Hypocrisy

TO THE EDITOR:

Consistency has never been a hallmark of members of Congess or, for that matter, many of the nation's political leaders. Rep. William Ford, however, has taken inconsistency to the ranks of the worst form of hypocrisy. He has done this by violating the spirit of a major labor law he has fervently supported for nearly 20 years.

In the early 1970s Rep. Ford introduced legislation (titled the National Employment Priorities Act) that, if passed, would have required major employers to give up to two years of notice before they could close a plant or lay off employees. At the time, he railed against plant closings and firings because such actions by employers "cause irreparable harm—both economic and social—to workers, communities, and the nation." He waxed eloquently concerning the "tragically" high costs the affected workers' families must incur.

In later years when he reintroduced his favored bill, he recounted how "victims of plant closings typically suffer from hypertension, abnormally high cholesterol and blood sugar levels, a higher incidence of ulcers, respiratory diseases, unduly high propensities to gout and diabetes, and hyperallergic reactions," not to mention an assortment of mental disorders that increase the nation's count of murders, suicides, and cases of spouse and child abuse.

In 1988 when he introduced the plant closing bill that ultimately became law (Ronald G. Ehrenberg and George H. Jakubson, "Why WARN? Plant Closing Legislation," *Regulation*, Vol. 13, No. 2, 1990), which requires employers of 50 or more workers to give a minimum of 60 days' notice before a plant closing or layoff, the *Wall Street Journal* reported that Rep. Ford pleaded with his fellow members, "There isn't an American worker... who doesn't deserve to be told 60 days before his or her job is eliminated."

Those were the days, however, when Rep. Ford was not in charge. Recently he was elected chairman of the House Education and Labor Committee, at which time the sincerity—or lack thereof—of his former comments became fully evident. He fired the committee's entire staff, *giving them only two weeks' notice.*

Technically, Rep. Ford or any other member of Congress does not have to give 60 days' notice to the staffs they fire. As noted, the bill applies only to firings of 50 or more workers. In addition, in passing the law, Congress did what it always does: it exempted itself from the law.

Yet, Rep. Ford cannot get off the hook so easily simply because his printed words, filled with passion, on the issue of notice for *all* workers are extensive and because he has repeatedly castigated private employers who gave little or no notice, suggesting that they were nothing short of coldhearted, reckless, irresponsible, and anti-American. The conflict between his words and deeds must make his constituents and the rest of the country worry about his stewardship of the education committee.

Admittedly, the plant closing law was an immense congressional mistake. The law, which necessarily imposes a cost on employers, forces workers to give up wages and fringe benefits in the form of, for example, health and life insurance for another fringe benefit called plant closing notice that many do not need or do not want (as evident from the fact that many worker groups have not negotiated extensive plant closing notice) The law also imposes what amounts to a tax on American businesses and workers at a time that they have to compete in a global market for capital that can literally be sent to other more hospitable countries at the speed of light and the cost of a telephone call.

Nevertheless, the plant closing requirement is law. There are three good reasons for forcing Congress to obey both the letter and the spirit of the laws they pass, whether concerned with plant closings, race and sex discrimination, or the environment. First, equal application of the law to all, regardless of whether they are members of Congress or not, is consistent with what the Founding Fathers meant when they wrote that all people are created equal under the law.

Second, equal application of laws reduces the opportunities for blatant legislative hypocrisy—the type practiced by Rep. Ford.

Third, equal application of laws would encourage Congress to be more considerate of the private costs of its legislative ventures. It would ensure that members of Congress would be marginally less inclined to take liberties from the rest of us that they retain themselves.

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