

ECONOMIC DEREGULATION IN THE UNITED STATES: LESSONS FOR AMERICA, LESSONS FOR CHINA

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Over the past decade, the federal government of the United States has eliminated or substantially reduced the regulation of price and entry in domestic aviation, trucking, railroads, interstate buses, ocean shipping, long-distance communications, energy, and financial institutions. In addition, the federal government eliminated the general controls or guidelines on prices and wages throughout the economy.

The focus of this paper is on the lessons that might be learned from the U.S. experience with economic deregulation. For the United States, deregulation has caused certain problems but, in general, the net benefits have been higher than first expected. Although the political and economic system in China is very different from that in the United States, the American experience with economic deregulation may also provide some important general lessons for China.

Political Lessons

For a political economist, the political lessons from the U.S. experience with deregulation are the most intriguing, seeming to defy much of the conventional wisdom. The processes that led to deregulation of most of the above industries shared the following five general characteristics.

First, deregulatory actions were initiated by the regulatory agencies. About the same time that economists concluded that the regulatory commissions were "captive" of the regulated industries, the commissions began to prove them wrong. The Federal Communi-

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cations Commission (FCC) was the first to declare independence, allowing competition in telephone terminal equipment in 1968 and progressively broader competition in long-distance communication beginning in 1969. The Civil Aeronautics Board (CAB), following an internal staff study, began to relax price regulation of domestic airlines in 1976. The Interstate Commerce Commission (ICC) broadened the allowed bands on trucking rates in 1976 and relaxed entry controls in 1978. These and other commission actions provided tests of the effects of partial deregulation before Congress considered changes in the regulatory legislation.

Second, there was very little popular support for deregulation, even though consumers would be the major beneficiaries. Consumer satisfaction with airline and telephone service was especially high, and the general public was only vaguely aware of most forms of economic regulation. The support of general business groups for deregulation was late to develop and was broad but not deep.

Third, opposition to deregulation by the regulated firms was first broad but was not sustained. The prospect that the regulatory commissions, with presidential support, would pursue deregulation under the existing law led to the erosion of opposition to the regulatory reform legislation by the regulated firms. The strongest and most enduring opposition to deregulation was from the labor unions in regulated firms. In retrospect, it appears that both the regulated firms and their unions underestimated the extent to which deregulation would undermine the wage structure in these industries.

Fourth, the substantial reduction in economic regulation began during a period in which there was a sizeable increase in the "social" regulation of health, safety, the environment, and the uses of energy. The reduction of economic regulation, thus, did not reflect a general reaction against regulation but was a response to conditions specific to the deregulated industries.

Fifth, a number of conditions appear to have been associated with the selective success of the deregulation movement: There was a convergence of *elite* opinion on deregulation issues, including a near unanimity of economists; both the support and the opposition to economic deregulation was bipartisan; the deregulation measures were represented as pro-consumer rather than pro-business; a developing concern about increasing general inflation broadened the support for deregulation; some amount of deregulation was possible without new legislation; and the support of three presidents was necessary to sustain the momentum for deregulation by the commissions and to speak for the general interest.

In their recent book, *The Politics of Deregulation*, Martha Derthick and Paul Quirk (1985) reflect on the political lessons from U.S. deregulation and conclude that the deregulation measures were

achieved through the politics of ideas—specifically through the fusion of expert analysis with public opinion—and suggest that the political victory of a diffuse interest over particularistic interests, though due in part to special features of these cases, was not an aberration. Rather, it shows that the U.S. political system has a greater capacity for transcending narrow interests than has generally been acknowledged.¹

My hope is that “the politics of ideas,” a concept that the Chinese may have invented, has a similar success in China.

Economic Lessons

For economists, although not for many others, the economic effects of the deregulation of price and entry in the targeted industries were less surprising. A review of these effects, however, is useful in evaluating the prospects for similar measures in other industries and other countries.

Transportation

The general effects of the deregulation of domestic transportation have been expanded service, lower rates, and higher productivity.

Since Congress approved the Airline Deregulation Act of 1978, the number of city-pairs served by more than one airline increased by 55 percent, flights to smaller cities increased by 20–30 percent, and service has been expanded to 140 additional airports. About 90 percent of air travelers now use discount fares, and average real discount fares declined about 10 percent on short flights and 35 percent on long flights. Airline productivity also increased. Since the CAB initiated partial deregulation in 1976, the percentage of passenger seats occupied increased from 55 to 60 percent, and airline productivity increased by over 7 percent. On net, the effects of domestic airline deregulation appears to have increased benefits to travelers by about \$11 billion and by about \$4 billion to the airlines.²

The effects of the substantial deregulation of trucking are similar. Since Congress approved the Motor Carrier Act of 1980, the number of authorized carriers has nearly doubled, and the restrictions on the

¹Bruce K. Maclaury in his Foreword to Derthick and Quirk (1985, pp. vii–viii). This book is the best summary of the conditions that led to the deregulation of airlines, trucking, and communications.

²These figures were compiled from the *Economic Report of the President* (1986, 1988).

licenses of many existing carriers were removed. A recent survey found that average real rates declined about 25 percent for small shipments, and other surveys indicate a general improvement in service.³

The Staggers Rail Act of 1980 authorized a partial deregulation of rail rates. Most bulk commodities are now shipped at private contract rates; average real revenues per ton have declined about 11 percent for coal and 33 percent for farm products, despite a small increase in the average distance shipped. Rail-car utilization increased about 10 percent and ton-miles per employee increased 44 percent in the first four years, substantially increasing the profitability of what had recently been a sick industry.⁴

(Experience under the Bus Regulatory Reform Act of 1982 and the Shipping Act of 1984 has been too brief to provide comparable summaries.)

Several related developments also merit attention. A concern has been expressed that deregulation of the commercial transportation industries may have compromised safety, even though the government maintained safety regulation of each of these industries. The facts are otherwise. Airline accident and fatality rates continued to decline after deregulation. Truck accidents were also lower, except in one year. Rail accidents due to track defects are sharply lower. Truck and rail deregulation has contributed to a reduction of about \$100 billion in the total logistics costs of American industry, about one-third due to lower freight rates and one-third to lower inventories (Barnekov 1987).

There are a number of other conditions in the airline and trucking industries, however, that should be recognized. Several airlines and many trucking firms have gone bankrupt, finding that they were unable to be competitive under their prior labor contracts. Airlines found that they could hire qualified new employees at wages up to 50 percent lower than under the labor contracts of the existing carriers. This discovery led to a rapid increase in new airlines and in wage concessions and two-tier wage systems in the older airlines. Similarly, most of the new trucking firms pay less than the union rates of the older firms. In retrospect, it is now clear that the major beneficiaries of economic regulation were neither the consumers nor the owners of regulated firms but rather the workers and managers in these firms.

³See *Economic Report* (1986, p. 161).

⁴On railroad deregulation, see Barnekov (1987).

Communications

The partial deregulation of telecommunications was the result of a series of FCC decisions and a major antitrust case, without any change in legislation. Local telephone services are still regulated, but most other services have been substantially deregulated. More than 200 firms now offer long-distance telephone and data services at substantial discount below the AT&T rates, and the market for telephone equipment has expanded rapidly. The full effects of the breakups of AT&T are yet to be realized. The separation of the regional telephone companies from AT&T was expected to reduce long-distance rates and to increase local rates, and this is what happened; in the first four years following separation, real interstate rates declined about 12 percent and real local rates increased about 12 percent (Crandall 1987). These actions have also reduced the power of the communications union, leading to a reclassification of thousands of jobs to reduce average labor costs; the union has been transformed from a militant bargainer to a promoter of AT&T's long-distance services. Although these measures have been strongly supported by business users of telecommunications services, they are not to date well received by the general population.

Energy

Oil prices were first directly regulated as part of the general price and wage controls in 1971 but were unfortunately maintained when these other controls were phased out. As a consequence of the two oil shocks, these controls became increasingly burdensome. After approval of the "windfall profits" tax on domestic oil, Congress scheduled the termination of the oil price controls for September 1981. President Reagan terminated these controls immediately after his inauguration in January 1981; after a small initial increase, real oil prices have generally declined since March 1981. Within two years, domestic oil well completion was nearly 50 percent higher than in 1980, and production (exclusive of Alaska) increased slightly, reversing a 10-year trend and despite a decline in real oil prices. The energy "crisis" of the 1970s was ended by the stroke of a pen. By 1983, the administration and Congress were considering ways to maintain the domestic price of oil.

The wellhead prices of natural gas were first regulated as a consequence of a court decision in 1954. This regulation did not impose extraordinary costs until the first large increase in oil prices in 1974. Following a severe shortage of natural gas in the winter of 1977, Congress approved the Natural Gas Policy Act of 1978, legislation that was designed as a deregulation measure but was all too clever.

The act authorized the phased decontrol of all “new” gas discovered after 1977 but maintained price controls on more than 20 categories of “old” gas. This policy would have caused only minor problems if not for the second large increase in oil prices in 1979–80. The results of the controls were somewhat surprising. Consumers did not benefit from the continued controls on the price of old gas, because delivered gas prices, after a short lag, moved in parallel with oil prices. The primary effects of the controls were to increase the margins of the pipelines and distribution companies and to reduce the production of old gas, risking the loss of old gas reserves equal to 1–3 years of consumption. The substantial decline in real oil prices in the 1980s has reduced the short-run problems of the remaining gas controls, but provides a good opportunity for their removal. A comparison of the experience with oil and gas decontrol suggests that abrupt general decontrol requires more political courage but causes far fewer problems than phased partial decontrol.

One other remnant of the energy regulations implemented in the 1970s has also been abolished. In 1987, Congress repealed the Fuel Use Act, which had prohibited utilities and industrial firms from building new boilers dependent on oil and natural gas. The repeal of this act has made it possible to add capacity in smaller increments, more quickly, and with much lower environmental effects than is possible with a coal-fired plant.

Financial Institutions

For the most part, changes in financial regulation were forced by major developments in the financial markets. Commercial and savings banks had been subject to interest rate ceilings on their deposits since the 1930s. These ceilings led to severe problems only when market interest rates increased rapidly, first in the late 1960s and again in the late 1970s. Small depositors were especially harmed by these ceilings. The development of the money market mutual funds in the 1970s offered savers deposit-like accounts with market interest rates and led to an erosion of deposits in the banking system. Congress finally responded to these developments in 1980 by approving the gradual removal of interest rate ceilings by 1986. Another law in 1982 authorized banks to offer new types of accounts to both small and large depositors. These new types of accounts proved to be very popular and were estimated to increase the interest payments to depositors by \$3.6 billion a year with no significant effect on interest rates to borrowers. Other provisions of the 1982 legislation permit the acquisition of a failed bank by an out-of-state bank or by a bank of a different type.

General Price and Wage Controls

In August 1971, President Nixon imposed general price and wage controls as part of a larger program that ended the Bretton Woods agreement on exchange rates. This was the first peacetime use of general price and wage controls in the United States. Although these controls seemed effective for a year or so, they only deferred the measured inflation. The consumer inflation rate increased from 4.3 percent in 1971 to 11 percent in 1974 as these controls were phased out (except for oil).

After the severe recession of 1974–75, the consumer inflation rate declined to 5.8 percent in 1976. A continued concern about inflation, however, led President Carter to impose a new system of “voluntary” price and wage guidelines in 1977; these guidelines were supposed to be enforced by public exposure and by denial of government contracts to those who exceeded the guidelines. Carter’s guidelines proved to be no more effective, however, than Nixon’s controls, and the consumer inflation rate increased to 13.5 percent in 1980.

The major lesson of this experience is that general price and wage controls are not sufficient to restrain inflation in the presence of a rapid increase in total demand. Although some politicians and economists continued to believe that the controls were valuable, President Reagan believed otherwise. Shortly after his inauguration in January 1981, Reagan abolished the price and wage guidelines and the office that monitored those guidelines. After another severe recession in 1981–82, the consumer inflation rate declined to 3.2 percent in 1983, and a moderate growth of total demand has maintained inflation at about this rate for five years. The major lesson that one should have learned from this experience is that monetary restraint is both necessary and sufficient to reduce inflation, sometimes at the expense of a temporary reduction of output. Moreover, price and wage controls, as with any form of economic regulation, reduce the general productivity of the economy. From 1973 through 1980, for example, U.S. output per hour increased at an annual rate of only 0.5 percent; since 1980, in contrast, productivity has increased at an annual rate of about 1.5 percent. Reagan’s judgment on these issues proved to be correct: Inflation is best reduced by monetary restraint, not by price and wage controls, and the reduction of both inflation and regulation is likely to increase general productivity.

Unresolved Problems

Our government, unfortunately, has not yet addressed the complementary measures that are probably necessary to sustain the dereg-

ulation of several industries. Some change in the procedures for rationing the congested airspace and airports, for example, is probably necessary to sustain airline deregulation. Similarly, some change in the procedures for rationing the frequency spectrum is probably necessary to sustain the deregulation of communications.

The most urgent problem, however, involves the financial institutions. The combination of interest rate deregulation and the current structure of deposit insurance is not viable in the long run, because banks now have an opportunity to shift more of their risks to the insurance system; some reregulation is probable unless the deposit insurance premiums or rules are changed. The total net worth of the savings banks, by commercial accounting standards, is close to zero, and this system is very vulnerable to an increase in interest rates. Bank failures continue to increase, and the current reserves of the deposit insurance agencies may be insufficient. The administration and Congress have not been willing to address the laws, almost unique to the United States, that restrict national banking or the right of banks to own or underwrite equities in nonfinancial firms.

Federal economic regulation has been substantially reduced during the past decade, but a great deal remains to be done. American agriculture is still plagued by marketing orders that limit production or set price floors on a range of products. Regulation of the frequency spectrum has inhibited the use of some communications technologies. The potential for deregulating the uses of energy, the supply of natural gas, and the production of electricity have yet to be realized. Our financial system is still cartelized by region and type of loan. Labor regulation restricts a wide range of relations that would be preferred by both employers and employees. International air travel is still subject to both price and entry regulations, railroads are subject to archaic work rules, and shipping between domestic ports is still restricted to American ships. One should recognize that many of the effects of deregulation cannot be anticipated. The general success of the economic deregulation to date, however, strengthens the case for reducing or eliminating most of the remaining types of price and entry regulations.

Some General Lessons for China

Without a specialist's understanding of China, I am cautious about offering suggestions for economic reform. Yet, in the spirit of trying to learn from each other about issues of common interest, let me summarize two general lessons from the American experience that should apply in any country: (1) As a rule, regulation is neither nec-

essary nor sometimes sufficient to achieve the shared goals of a national community; and (2) regulation is often the most costly means to achieve these goals, both in terms of individual freedom and economic efficiency.

Let me illustrate the application of these lessons to three major goals of contemporary Chinese policy: reducing the growth of total population, maintaining a rough balance of payments, and reducing the rate of general inflation. My understanding suggests that some policy changes could achieve these goals without the restrictions on individual freedom and economic efficiency inherent in current policies.⁵

Population

As I understand, China is now attempting to reduce the growth of total population primarily by regulating the number of children per family. Effective enforcement of these regulations, by either sanctions or social pressure, is probably sufficient to meet this goal, as indicated by the sharp decline in the crude birthrate from 1970 through 1976. But such regulation is not necessary to reduce population growth. Both the long historical record and current cross-country comparisons indicate a strong negative relation between birthrates and the levels of urbanization, industrialization, and economic development. The birthrate in all of the high-income countries is now below the reproduction rate. But it is most important not to misinterpret this evidence. The most careful evaluations of this evidence indicate that *lower birthrates are a result, not a significant cause, of economic development*. The sustained economic development of China would reduce both the birthrate and death rate by different processes, and the rate of growth of total population would gradually decline without any specific policies to affect this rate.

Moreover, to an American, a limit on the number of children per family would be an intolerable restriction on individual freedom. Some rural parents may want more children because of the greater opportunity of rural children to contribute to family income. Some urban parents are surely more caring, better parents than others. As one of three sons and now the father of three daughters, my views on this issue may be biased, but children with brothers and sisters seem less "spoiled" and more prepared for adult life than are single children. In our political system, the government must bear the burden of proving that regulation of specific activities serves some

⁵The basic source for my understanding of economic conditions and policies in China is Perkins (1988).

broader interest. There are no obvious reasons to restrict the freedom of each family to choose the number of children consistent with its own conditions and preferences.

The goal of reducing the growth of total population in China can probably be achieved by other policies that involve less restriction on the freedom of individual families. Education and the general availability of contraceptives has proven effective in reducing the number of unwanted births. Welfare programs and the tax code can be designed to influence the choice of family size. Such indirect policies can limit the total number of births without restricting the freedom of each family to make this choice. Such policies will lead some families to make mistakes in this choice. The very concept of freedom, however, means the right of an individual to make his own mistakes as long as they do not affect the rights of others.

Balance of Payments

Similarly, I understand that China is now attempting to achieve a rough balance of international payments primarily by limiting the net foreign exchange available to each firm. In effect, this limitation has required each firm to maintain its own balance of payments. The several effects of this constraint on the economy should be recognized. One effect has been to limit the opportunity of firms to specialize in either exports or imports, because each firm must earn about as much foreign exchange by exports as it uses to purchase imports. A second effect has been to limit foreign direct investment to a much lower level than was expected when the Joint Venture Law was approved. A third effect, given the large excess demand for imports, has been to strengthen the power of the bureaucracy relative to the market in the allocation of foreign exchange, with the consequent problems of favoritism and the incentives for corruption. The current controls on access to foreign exchange are probably the most important policy that limits the potential for increased integration of China into world markets.

Two types of policies would reduce the costs of these foreign exchange controls consistent with any desired level of the total balance of payments. One alternative would be to devalue the yuan. A substantial devaluation of the yuan, however, would probably be necessary to eliminate the excess demand for imports, given the extensive system of foreign quotas on products exported by China and the "soft budget constraint" on many Chinese firms. Most economists would support the relaxation or, preferably, the elimination of the many U.S. quotas on textiles, apparel, and other Chinese exports, but the near-term prospects for such changes are not encour-

aging. The soft budget constraint on Chinese firms can best be tightened by reducing government subsidies that offset the losses of individual firms. In the absence of these changes, a major devaluation of the yuan would probably be necessary.

The only effective alternative would be policies that would increase saving by Chinese families and firms or reduce the dissaving by the government. One should recognize that the current account balance of any country is the difference between saving by residents of that country and investment in that country. China, or any country, can increase domestic investment only by increasing domestic saving or by reducing its current account balance. As long as China, for whatever reason, wishes to maintain a rough balance on its international accounts, increased investment must be financed from increased saving. The major source of potential saving, as well as the best way to tighten the soft budget constraint, may be to reduce the discretionary subsidies to Chinese firms.

Inflation

For good reasons China also wants to maintain a roughly constant general price level, but the primary policy to constrain inflation has been the control of the prices of individual goods and services. Such controls have never proved sufficient to restrain inflation for a sustained period, and they cause severe misallocations and often social unrest. In some cases, the relaxation of price controls increases the measured price indices, but that is usually a statistical illusion. Price controls increase nonprice types of rationing—by queues, favoritism, bribery, and a deterioration in the quality of goods and services. A relaxation of such controls, thus, sometimes increases measured prices but reduces these other types of rationing that are not reflected in the measured price indices.

Most of the variation of inflation in China, as in other countries, is due to an increase in the money supply relative to the level of output.⁶ In the long run, monetary policy is sufficient to determine any level of general prices or the general inflation rate. In addition, it is especially important to allow increases in specific prices that would increase output, whatever their immediate effect on the measured price indices. China has ample reason to be concerned about the increased inflation rate since 1984, but the most effective response would be a combination of monetary restraint and “supply-side” economic policies to increase output, not the futile and costly reimposition of controls on specific prices.

⁶See Cheng (1987) and Chow (1987).

Conclusion

The most important general lessons from the American experience with economic deregulation are the following:

- Deregulation was politically possible, on occasion even politically fashionable, despite the forceful opposition of some groups.
- Deregulation generated substantial benefits to consumers and substantial opportunities for new firms.
- Deregulation undermined the wage structure of some unions and the easy life of managers in the previously regulated firms.
- Deregulation led to a substantial increase in productivity in the affected industries and contributed to a general increase in productivity in the economy, creating benefits that were much larger than the losses.

The road to deregulation is not without rocks or detours, but it is the road to prosperity and opportunity. A government that represents the nation, rather than the interests of specific groups, will choose this road. Economic deregulation has been supported by the past three administrations in the United States. The increasingly confident government of China has the opportunity to choose this same road.

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