Alfred Kahn 1917–2010

Remembering the father of airline deregulation

BY SUSAN E. DUDLEY | *The George Washington University*

When my 17-year old son and I flew from Washington to Massachusetts for a recent three-day weekend, we paused to thank Alfred Kahn, the person arguably most responsible for the $100 round-trip fare that made the trip possible. When I was my son's age, such an excursion would have been an unthinkable luxury; air travel was reserved for businessmen or the wealthy.

Fred Kahn, the "father of airline deregulation," passed away on December 27, 2010 at the age of 93.

I had the honor of interviewing Professor Kahn just six months before his death in his offices in Ithaca, NY. He was charming and witty, with a sharp mind and clear memory of the people and events that led to the successful deregulation of airlines (in which he was instrumental as chairman of the Civil Aeronautics Board) as well as telecommunications and electricity (which he helped initiate as chairman of the New York Public Service Commission).

The interview was part of The George Washington University Regulatory Studies Center's ongoing oral history project focusing on the scholars and policy entrepreneurs who were instrumental in the historic deregulation of traditionally regulated industries in the 1970s and 1980s. The move toward deregulation was driven, in part, by scholarly literature in antitrust, law, and economics that showed that regulation of private sector prices, entry, and exit tend to benefit the regulated industries, often at the expense of consumers. Rather than offer a cure for "natural monopoly," economic regulation was the principal cause of some quite unnatural monopolies. Policy entrepreneurs relied on this academic research to foster competition in several previously regulated industries, with resulting improvements in innovation and consumer welfare.

Fred Kahn was influential both as a scholar and a policy entrepreneur, and his ideas and actions altered the relationship between government, industries, and consumers. In our July 2010 interview, he looked back on his career and shared his perspectives on the drivers and conditions for reform, his evaluation of the long-term impact of his reform efforts, and some insights into the lessons we can apply today. This article — a tribute, really — includes quotations from that interview, which was his last.

Early Years

Alfred E. Kahn was born in New Jersey in 1917, the son of Russian-speaking Jewish immigrants from what is now Poland. His father worked in a silk mill. After finishing high school at the age of 15, Kahn went to New York University and graduated first in his class at the age of 18. He continued to earn a master's degree there and, in 1942, received a doctorate in economics from Yale.

He spent several years working in Washington, DC at the Brookings Institution and the Justice Department before World

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ILLUSTRATION BY MORGAN BALLARD

War II. He then served in the Army before beginning his academic career as an economics professor and chairman of the economics department at Ripon College in Wisconsin. In 1947, Kahn joined the faculty of Cornell University, where he remained until his death, serving as chairman of the economics department, dean of the college of arts and sciences, and a member of Cornell's board of trustees. He was also involved in the founding of NERA Economic Consulting (formerly National Economic Research Associates) and continued to consult and serve as a testifying witness on behalf of NERA clients until his passing.

When we spoke, he admitted that he started off as an "early institutionalist," influenced by Thorstein Veblen, and skeptical of markets, competition, and consumer choice. What he called his "radical change" came when he realized that "regulation was being used as an instrument of cartelization." By the late 1960s, he had written three books on topics ranging from the British international situation, to antitrust, to integration in the oil industry, and decided to write "*the* book on microeconomic policy." Part of the book was to cover direct regulation, but as he researched the subject (initially focusing on antitrust and cartelization in the chemicals and energy industries), he began to explore marginal cost pricing. What he had originally envisioned as one part of a text turned into two volumes, which became his seminal and widely used text *The Economics of Regulation*.

In 1974, he had written his magnum opus and completed five years as dean of Cornell's College of Arts and Science. The popular professor and his wife were looking forward to a sabbatical year in southwestern France when the governor of New York asked him to chair the state's public service commission, responsible for electricity, gas, telephone, and water regulation. His friend and former graduate student, Irwin Stelzer, urged him to take the job, arguing "you've just written the book [urging marginal cost pricing for utilities] and here's your chance to do it." Kahn accepted the chairmanship and never regretted it. He and his wife loved Albany and, instead of the sabbatical, they started a tradition of going to France to celebrate every fifth wedding anniversary.

New York PSC

One objection raised to his confirmation to the NYPSC by the New York Senate was his long association with AT&T, on whose National Economic Advisory Council he had served. That was ironic because, as a council member, he had pressed for competition. In 1969, he wrote a "grand competitive strategy for AT&T which, as far as I know, was never read by anybody, and certainly not acted on," urging the company to "stop blocking competition, and get ahead of it." Even earlier, in 1956, as a staff economist on the White House Council of Economic Advisers, he objected to a Federal Communications Commission decision allowing AT&T to bar customers from using a clip-on "Hushaphone" device that AT&T argued would interfere with voice quality. He argued, "All the person on the other end of the phone has to say is 'Take that damned muffling device off your phone!'"

Though he took a leave of absence from Cornell to chair the NYPSC, Kahn remained a teacher at heart. He treated his staff, the media, and the public as if they were his graduate students, carefully explaining the strategy and logic of his efforts to encourage greater competition. His knowledge and intellect were buttressed by his famous warmth, humor, and informal style. He encouraged staff to join him in his daily swims (which had a drawback, as he discovered he "couldn't swim and talk at the same time") and was known to give interviews in his stocking feet. He told me:

> I'm a very good actor. I've acted all my life. I loved to explain things. I regarded reporters as students in a graduate seminar. Explaining economics to the press made them my students for life. It was wonderful. I came with the right background and right combination of

> liberalism — Barack Obama liberalism — and respect for competition, which carried me beyond what most respectable people believed. I had the perfect background and a lifelong belief in plain English — in addition to which I'm a ham.

During his third year on the NYPSC, the state legislature passed a law requiring commission proceedings to be public. He recalled,

> My colleagues didn't like it but I loved it. It became quite a show. I was preaching marginal cost pricing and explaining it at generic hearings and in opinions. It was a source of great satisfaction. It was so much fun!

The Wisconsin Public Service Commission beat New York to implementing marginal cost pricing (in the Madison Gas rate case), but Kahn was "certain the Wisconsin staff read my book." His first opinion, a rate hearing for Long Island Light Company, was an "elementary exposition of marginal cost pricing." Interveners moved that he disqualify himself because he had prejudged the issue in favor of marginal cost pricing, but his fellow commissioners disagreed.

In 1975, he brought his professorial wit to Washington as a key witness at Senator Ted Kennedy's 1975 Judiciary Subcommittee on Administrative Practice and Procedure hearings on airline deregulation. Before the hearings, he had not known the subcommittee's general council, a young Harvard professor named Stephen Breyer, but they became good friends. He told me he emphasized in his testimony that "if you regulate in one way and suppress competition, it will turn up in other ways," using airlines to illustrate. "If you don't let them compete on price, they will compete on in-flight entertainment, more sumptuous meals, free baggage, and commodious seating." He quoted Federal Trade Commission chairman Phil Elman, who had said to him, "the businessman who is happy to have an empty seat next to him on which to put his hat would be less happy if he knew he was paying for the hat's seat." But he did not advocate deregulation at the time.

Civil Aeronautics Board

Kahn was thoroughly enjoying his work at the NYPSC in 1977 when President Jimmy Carter asked him to move to Washington to chair the Civil Aeronautics Board. Kahn initially resisted for several reasons. First, he was agnostic about the viability of unregulated competition in an industry arguably prone to destructive competition. Second, he was concerned about the national energy problem and was not interested in "making it easy for people to jet all over the world." Third, he had sympathy for the need for regulation to cross-subsidize low-volume routes and times. Finally, he would have preferred to serve as chairman of the FCC. He used a comparative-advantage argument to suggest that he and the president's chosen FCC chair, Charles Ferris, switch roles, arguing that no matter how little Ferris knew about airlines, it could not be less than he knew, but that he must know more about telecom regulation, having served on the NYPSC.

President Carter eventually persuaded him that airlines were where regulatory reform was going to start, so he extended his leave from Cornell and headed to Washington to chair the CAB. He said, "I realized I was being a pioneer, so it was very exciting."

When he came to the CAB, he knew the commission was responsible for awarding routes (a power it used to limit competition and entry into new markets) and regulating service and fares. But Kahn was surprised by how picayune the decisions were that he was expected to make. He once got a call in the middle of the night from a carrier trying to determine whether its application to transport sheep from Virginia to England had been approved. "The matter was urgent, because the sheep were in heat!" he said, adding,

> Every Board member had an assistant who would carry around pieces of paper requesting permission to fly. It was absolutely absurd. Regulators were like the Dutch boy at the dike. Every time it springs a leak, you put a finger in it, until you run out of fingers.

Alan Greenspan, in his 2007 book *The Age of Turbulence*, quotes Kahn (whom he called a "wisecracking economist from Cornell University") as saying to a congressional committee in 1978 testimony, "Is it any wonder that I ask myself every day: Is this action necessary? Is this what my mother raised me to do?"

As CAB chairman, Kahn was invited to give a talk to airline executives at an exhibition showcasing newly acquired European aircraft. But he demurred, saying "I don't know one airplane from another; to me they're all just marginal costs with wings."

Kahn is now called the "father of airline deregulation," but he told me he did not set out to deregulate airline rates completely, at least not right away. It soon became clear to him, however, that neither limited "regulatory reforms" nor gradual, phased deregulation would be successful.

Kahn credited his staff with contributing to his transformation. He depended on people like his chief assistant, Michael Roach, and his chief economist, Darius Gaskins (who later went on to deregulate trucking as chairman of the Interstate Commerce Commission). When considering deregulation at Midway Airport in Chicago, small would-be competitors asked for two years of exclusivity to protect themselves; Kahn was sympathetic and considered it, but when he asked his staff for their views, they gave the idea a "thumbs down" and he denied the request.

Speaking to a conference of New York security analysts, he was asked to describe what a deregulated industry would look like. Who would emerge successful? He responded, "If I knew what was the most efficient and rational arrangement, I'd continue to regulate," adding that a major benefit of competition is that it produces unexpected outcomes. Looking back, he told me:

> I never felt I knew all the answers, but believed in experimental trying and following my instincts. I didn't come to CAB with a prescribed pre-determination. I was driven to it by the experiences — and by my belief in the principles of marginal cost pricing.

Opposition | He faced intense opposition from most industry executives and labor unions. The pilot unions "hated me," he recalled. After he suffered a severe car accident six years ago, a former union official expressed regret that Kahn had not died, as he would like to have "pissed on his grave." The CAB chairman tried to respond with "great civility" to the many "unpleasant letters" he received from pilots. He wrote to them that he was "disconcerted by the pain [increased competition] would bring to some people," but that "they had a privileged position; they were enjoying the benefits of monopoly profits," and that he "was interested in the public."

The consummate educator, he argued sincerely that labor would benefit from the expansion of employment opportunities that competition would bring. But he admitted that he "failed to realize that, competing with Southwest Airlines, you're not going to have captains making $400,000 a year for 20 hours of work a month." He came to recognize that there "was no way of having competition beneficial to the public [while retaining] these restrictive work rules and exorbitant pay."

Labor unions were not the only ones who complained to the CAB chair about his deregulatory efforts. Stelzer, his friend and former student who had encouraged him to take the NYPSC appointment, sent a formal letter complaining that, on a recent flight, he had to sit next to a "hippie, who obviously hadn't bathed in months and undoubtedly paid a much lower fare" than Stelzer did. Kahn responded,

> Dear Dr. Stelzer:
>
> I have before me your complaint about your recent experience. … Before taking any action, we are waiting to hear from the hippie.

In response to a letter from Sen. Barry Goldwater protesting a CAB action in the southwest, Kahn responded,

> Dear Senator Goldwater,
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> This comes from an admirer. I do strongly suggest that you read a book by an acquaintance of mine, *Conscience of a Conservative*.

"I can't say he became a great supporter," Kahn told me, "but I never had a complaint from him again.

One argument used against deregulation was that airlines would charge discriminatory rates. "The word 'discrimination' was being used sloppily," Kahn argued. If, regardless of your race, creed, nationality, or hair length, you could call and get the same peanuts fare, that was not discrimination. In one of his first speeches at a conference with people from the Department of Transportation (whom he considered cartelists), he recalled using an analogy to beef. To avoid discriminatory pricing, should producers be forced to charge the same price per pound for filet mignon and suet?

He found a modern analogy in the "cry for net neutrality in telecom rates." He dismissed the concern expressed by some academics that "if service providers are allowed to offer priority service to some uses of the Internet (and some users have to have priority), 'it will leave small, poor businesses to the equivalent of a wagon on a winding road.'" But "that's a case of not understanding what's discriminatory," he told me.

Felicitous Convergence of Circumstances

So how did the deregulation of airline rates succeed, in the face of such strong opposition from the airlines and unions and their political supporters? Kahn explained that it was the product of a "felicitous convergence of circumstances."

> First you had the ubiquitous problem of inflation. It was primarily a monetary problem, but it was not hard to persuade — well it was hard, but by demonstration you could show that the introduction of competition in industries where competition had been systematically repressed by government produced reduced prices.
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> Then you had this convergence intellectually of enlightened conservatives and liberals led by Ted Kennedy. The Ford administration had already decided it was for deregulation, but it was never going to succeed on its own because it was a conservative administration. It took a combination of the conservatives and 20th century liberals (which is what I am), advocates of competition, and the convergence of inflation.
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> In the airline case, we had something very persuasive. Load factors for the decade before 1976 were 51.3 percent on average. The planes were half full. Phil Elman's "business man and his hat" story epitomized the opportunity. We also had evidence from intrastate airlines [not subject to CAB regulation], which operated at higher load factors and lower fares.

Inflation and the empty seats were also putting pressure on the airlines, and some came to the CAB seeking the right to discount fares below the CAB-approved rates. The previous board, chaired by John Robson, had begun to liberalize charter rules:

> One of [Robson's] last acts was admitting Freddie Laker's Sky Train, which was a cause of great regret for me, because I wanted to be the one to do it!

Despite those pressures, when Kahn took over the CAB, industry leaders were still almost unanimously opposed to deregulation. United Airlines was the exception; as the largest airline, it was never granted new routes because the CAB's policy was always to give routes to the smaller carrier. United wanted international routes, particularly to Asia, but was denied.

Finally, Kahn said, other airlines began coming on board, once they realized deregulation was coming:

> In the spring of 1978, I gave a talk to Cincinnati airport operators, called "A Funny Thing Happened on Way to Cincinnati." Albert Casey, who was chairman of the Board of American Airlines, a major holdout, finally came out and said, in effect, "If you're not going to protect us, get out of our way."

The crumbling of industry opposition to deregulation paved the way for passage of the Airline Deregulation Act, signed in October 1978, which began the phase-out of rate regulation and the elimination of the CAB altogether on January 1, 1985.

Airline deregulation paved the way for other economic deregulation, including trucking, rails, energy, and telecommunication. Kahn suggested in our interview that the "visibility of airfares" was a main reason why airline deregulation came first. It was "easy to condemn the mess of more regulation leading to more regulation." He also appreciated the early support of the Consumer Federation of America and Ralph Nader (who later disappointed him by deserting the cause of deregulation).

I asked him about his strategy as chairman:

> Strategy? I didn't have one. I would encounter an irrationality and I would work it for all it was worth. And I picked up on all these beautiful empty seats. A lot had been done by Robson, and I approved more "peanuts" fares. I didn't set out to deregulate. You see, there's a part of my intellectual background that's Veblen — skeptical of the folklore of capitalism and the free market. I knew I wanted marginal cost pricing, but that was regulatory. My first step was on airline bumping rules, where it seemed so clear that simple economics [called for allowing airlines to compensate bumped passengers], but I was not ready to just open everything. It was only over time I came to talk more simply about deregulation.
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> It was a gradual revelation, but I came to see that it gets worse if you go slow. Initial bills were about regulatory reform, and limited flexibility, and opportunity. In the end, it became clear to me you can't manage the process.

Council on Wage and Price Stability

After just 16 months at the CAB, Kahn accepted President Carter's request that he become "inflation czar" as chairman of the Council on Wage and Price Stability. Elsewhere, Kahn has characterized the move as an application of the Peter Principle. He recalled it as a "catastrophic decision for me":

> I really hated the job and have no pride at all in what I accomplished at CWPS. I had no stomach for setting guidelines [for wages and prices]. I thought it was futile. I was not a macroeconomist and didn't belong in that position, but accepted out of great loyalty and admiration for Jimmy Carter.

He would have lunch periodically with then–Federal Reserve Board chairman Paul Volker, who told him, "I've got the only weapon [to fight inflation] in town, and sooner or later I'm going to have to use it." Kahn agreed that his own efforts weren't working, but he "gave it his best effort" and tried not to dilute the message. He felt his job was to "frighten people without frightening them." When admonished not to use the word "depression" in public speeches, he famously substituted "banana." He later changed the code word to "kumquat" when banana producers objected.

He conceded that the CWPS did make a contribution to regulatory reform through a small staff that submitted critiques of proposed regulations through public comments filed on the rulemaking records of federal agencies. When President Ronald Reagan abolished the CWPS in 1981, he transferred that group of analysts to the Office of Management and Budget to staff the newly formed Office of Information and Regulatory Affairs, which continues to review proposed regulations today.

A Professor and a Performer

Professor Kahn's lack of enthusiasm for his role of inflation-fighter notwithstanding, the media loved him then, and throughout his career. His personal charm and honesty certainly contributed to his success. When I met him at the age of 93, he was still energetic, warm, and engaging, breaking out into song and self-deprecatingly calling himself a "showoff" and "egomaniac." He said he always treated people honestly and openly, as if they were his graduate students ("and you don't fudge to graduate students"). He remembered with regret one instance where he did not respond fully to a reporter's question.

> And I remember feeling so bad about it that I went back to the reporter and said, "I fudged to you and I'm really sorry because as a rule I never try to mislead anyone."

His candor occasionally landed him in hot water with his colleagues and even the president (like the time a reporter asked him if he could defend the defense budget and he replied in a word, "no"). As the chair of an independent agency, though, he felt less constrained by politics than legislative or executive branch officials:

> Look at the power I had! I don't think I ever thought of it that way, but I had the independence to be idiosyncratic.
>
> I didn't give a damn. I could go back to teaching. I was unwilling to deceive. All I had was my principles. Well, I also had a sense of humor and I was smart, but I was not going to get into the game of trying to deceive people.

In our discussion a few months before his death, he did not see himself as an "apostle of deregulation." He called himself a 20th century liberal ("I love Barack Obama"), yet he was not apologetic about the effect of airline deregulation on certain companies or workers because he knew competition in the airline industry has brought huge, and at the time unforeseen, benefits to the American public.

I asked what advice he, a true American hero, would offer young academics interested in public policy. He said, "There's no substitute for grappling with real problems in policy," adding, "it does help to be boss." But he refused to be called a "hero." "I'm just a little old professor, who's also a performer," he said. And perform, he did. R

READINGS

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