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INTRODUCTION

The deregulation successes of the last five years comprise some of the most significant achievements of the government reform movement. Rarely have the policy conclusions from academic studies been so directly translated into government action, especially action which seemingly reverses a long established pattern of increasing government control of the American economy. Yet, in contrast to the voluminous studies of the benefits and costs of deregulation, practically no work has analyzed the critical problem of how to manage the required *transitions* from regulation to competition.¹

Managing the transition to deregulation deserves serious study for several reasons. Perhaps most important is the possibility that, without a politically acceptable transition, deregulation may be doomed. Despite the economic efficiency gains available to society through deregulating an industry, such as trucking, the redistributive consequences of the movement away from regulation may adversely affect some interest groups enough to allow them to block implementation successfully. Unless these problems are recognized and managed well, deregulation will be a difficult policy objective to reach. Even after Congress has passed authorizing legislation and the deregulation process has begun, serious problems in the management of the transition can cause a policy reversal back to regulation. For example, many analysts worry that natural gas prices will never be deregulated completely in 1985, as planned, because the market price of unregulated gas is rising faster than the scheduled increases in the regulated prices (designed to eventually eliminate the price gap).² Difficulties in designing and implementing a transition may also limit the extent to which deregulation is carried, and inefficiencies created by the transition mechanism itself may consume much of the efficiency gains to be achieved by deregulation. Finally, decisions made during the transition may affect the magnitude of the eventual efficiency gains. As an example, the recent wave of railroad and airline merger applications to the Interstate Commerce Commission (ICC) and the Civil Aeronautics Board (CAB) present the agencies with important decisions. Mergers, once consummated, may be difficult to reverse; so, to the extent that they reduce actual or potential competition, the deregulated industries may be less competitive than anticipated.

Besides anticipating the potential problems associated with a transition and contemplating possible solutions, we can now finally begin to analyze the successes

1. One notable exception is Robert Dorfman, Agenda for Research on the Transitional Effects on Regulation, Public Interest Economics Foundation Conference, May 1979, in forthcoming book.

2. Natural Gas Policy Act of 1978.

and failures of the deregulation transitions that have occurred within the last five years. The Airline Deregulation Act passed in 1978,³ the 1977 *HBO* decision⁴ eliminated one of the major impediments to cable television deregulation, fixed brokerage commissions were eliminated in 1975,⁵ and in 1978 and 1979 natural gas and oil prices were started on paths toward eventual decontrol.⁶ Learning from the experiences of ongoing transitions should enable Congress and the regulatory agencies to plan for better management of future transitions to deregulation, which may be considerably harder. Analyzing the problems of moving a regulated industry to a competitive one may also help in designing transitions from one regulatory regime to another, such as the Environmental Protection Agency's new air pollution control approaches,⁷ and from complete to only partial regulation, such as in the health services area.⁸

In May of 1980, forty scholars gathered at Duke University for a two-and-a-half day conference on Managing the Transition to Deregulation in order to further our knowledge of how to design and implement effective transitions to competitive markets. The participants came from universities, regulatory agencies, nonprofit research institutions, and regulated firms. Their training spanned economics, law, political science, decision sciences, and policy analysis. The Duke Center for the Study of Business Regulation commissioned the six papers in this volume for the conference, which was supported by the Center and the National Science Foundation.

Besides focusing on the central problem of how to manage the transition, the conference and these six papers explored two other important and related sub-themes: first, for which kinds of industries will the transition to deregulation pose the most difficult problems; and second, why is much of traditional American economic regulation being dismantled while the government's role in the rest of the economy has been expanding, especially in the area of social regulation?⁹ The first of these sub-themes is related to the main problem in that effective management of the transition is more crucial in some industries than others, so good design requires identifying which industries will present the most difficult transition problems. Also, the transition management approach depends on how easy or difficult it will be to accomplish the transition. Thus, for example, both the paper by Darius W. Gaskins, Jr. and James M. Voytko¹⁰ and that by Clark C. Havighurst¹¹

3. The Airline Deregulation Act of 1978, Pub. L. No. 95-504.

4. *Home Box Office v. FCC*, 567 F.2d 9 (1977).

5. The Securities Acts Amendments of 1975.

6. The Natural Gas Policy Act of 1978, *supra* note 2, and the Windfall Profits Tax Act of 1979.

7. See, for example, Michael T. Maloney and Bruce Yandle, *Bubbles and Efficiency*. REGULATION at 49-52 (May/June 1980).

8. See Clark C. Havighurst, *Health Planning for Deregulation: Implementing the 1979 Amendments*, 44:1 LAW AND CONTEMP. PROB. at 33 (1981).

9. Many of the observations which follow were made by the panel members of the Summary and Integration Session—Edmund W. Kitch, Merton J. Peck, and Sam Peltzman—as well as by the six commissioned papers.

10. Darius W. Gaskins, Jr. and James M. Voytko, *Managing the Transition to Deregulation*, 44:1 LAW AND CONTEMP. PROB. at 9 (1981).

11. Havighurst, *supra* note 8.

discuss the optimal rate of deregulation, identifying conditions under which the "let 'er rip" approach is desirable and conditions under which a more gradual approach is preferred. The second sub-theme is also related to the transition management problem, for we must understand why deregulation is politically possible, as well as economically desirable, in order to anticipate problems with the transition and to design the transition to avoid them. To make the transition successful, effective management of the transition should enlist the same forces that make deregulation itself feasible in some cases but not in others.

Of all the papers, the Gaskins-Voytko study most directly addresses the major issue of the conference—how to manage the transition to deregulation. It enumerates nine major transition problems, suggests several possible solutions to each problem, and evaluates the conditions under which the solutions are useful. Gaskins and Voytko support their analysis with examples concerning the regulation and deregulation of the trucking, railroad, airlines, oil, natural gas, bus, air cargo, and coal-slurry pipeline industries. Their framework can be easily used to evaluate the transition problems encountered in specific industries, such as the health services industries discussed in Clark C. Havighurst's paper and the cable television industry analyzed in the paper by Stanley M. Besen and Robert W. Crandall.¹²

Havighurst argues that a careful reading of the 1979 National Health Planning and Resources Development Amendments and their legislative history shows that these amendments require a substantial deregulation of the health services industry. Each specific health service must be evaluated by local and state health planning agencies to determine whether the market will effectively allocate the service, and if so, then the agencies must allow market forces, rather than regulation, to control costs and respond to consumer preferences. So, the deregulation movement in Congress, which previously had focused on traditional economic regulation (e.g., the CAB), has now turned its attention to a significantly different but heavily regulated industry wherein at least some services can be more cheaply and responsively supplied through market forces. The partial deregulation of health services is also consistent with the provisions of the Regulatory Flexibility and Administrative Reform Act¹³ which would require all economic regulatory agencies to select the least anticompetitive alternative when making any policy decision.

Besen and Crandall provide a detailed history and analysis of the twenty-year regulatory history of the cable television industry, tracing the surprisingly rapid transition first from no regulation to extensive regulation and then back through near complete deregulation. Despite a series of academic and FCC-sponsored studies of the industry all showing that cable growth had little impact on UHF and VHF broadcasting revenues, the Commission reversed itself and promulgated rules to protect broadcasters in the late 1960s and early 1970s. However, further empirical evidence, two significant court cases, rapid technological advance, and a

12. Stanley M. Besen & Robert W. Crandall, *The Deregulation of Cable Television*, 44:1 LAW AND CONTEMP. PROB. at 77 (1981).

13. S. 2147, 96th Cong., 1st Sess. (1979).

weakening of broadcaster opposition to cable television all combined to reverse the tight regulation that seemed so firmly entrenched in 1972.

The papers and the discussion which followed them provide four answers to the first sub-theme of the conference—that of identifying which characteristics of deregulation affect the ease of the transition. First, the less the market structure is changed by deregulation, the easier the transition is to accomplish. On this point, the airlines and cable television deregulation transitions ought to be relatively simple because the number of firms in each industry will not be significantly affected by deregulation, whereas in the health services and telecommunications industries, the number of providers of service and the market concentration could change drastically after deregulation.

Second, transitions are easier to design where the cross subsidies inherent in the regulations to be eliminated are least pervasive. After careful study showed that the subsidies of smaller city airline service were not significant, this problem ceased to be an issue in airline deregulation. In contrast, ICC railroad regulation is more difficult to dismantle because it has created a system in which high-density routes subsidize low-density routes. Similarly, the combined federal and state regulation of the telephone industry has been designed to allow local business service to subsidize local residential service, while excessive long-distance revenues subsidize local services, implying difficulties in telephone deregulation.

Third, managing a transition is easier if the parties hurt by deregulation are either politically weak or can be placated by various forms of compensation. The service guarantees to small cities and the employment assistance program for labor effectively eliminated the opposition from these two groups to airline deregulation and the ensuing transition. But in oil and natural gas decontrol the energy-consuming public and the public-interest lobbies presented a much more potent barrier. As an example, their opposition to oil price decontrol forced passage of the windfall profits tax, a highly complicated and costly mechanism for mitigating their opposition.

Finally, the transition is easier the more competitive or “contestable” will be the deregulated industry. Although Clark C. Havighurst argues convincingly that regulation itself is a primary barrier to competition for some health services, the inadequate design of third-party payment systems and the structure of United States tax laws conspire to sap the vigor of possible competition in this area and make the transition problem much more serious. Trucking deregulation exemplifies the other extreme, with the cost structure of the industry providing no support for the natural monopoly argument for regulation. Airline deregulation provides an intermediate case in which some concern has been raised about the residual market power that may remain in this oligopolistic industry.

Elizabeth E. Bailey and John C. Panzar¹⁴ address this last issue directly in their paper. They apply the theory of contestable markets to an analysis of the effects of

14. Elizabeth E. Bailey and John C. Panzar, *The Contestability of Airline Markets During the Transition to Deregulation*, 44:1 LAW AND CONTEMP. at 125 (1981).

the Airline Deregulation Act of October 1978.¹⁵ Data from the first year-and-a-half of the deregulation transition allow them to answer the question of whether, when fully deregulated, the United States city-pair airline markets will be contestable enough to induce carriers to price at the cost of providing service. Despite significant economies of scale in servicing any particular city-pair market, the primary capital costs (i.e., the aircraft) are not fixed; they can be “flown” from one city-pair to another. So the theory predicts that potential entrants, facing no cost disadvantages, will provide sufficient threat of competition to constrain carriers to set prices near cost.

Although the available data are imprecise and the industry was still partially regulated during the year-and-a-half following the Act, the data support two conclusions. First, medium- and long-haul city-pair markets served by local service carriers were almost perfectly contestable, for the local service carriers held fares low enough to keep the larger truck carriers from entering most of their markets. And second, routes served primarily by truck carriers are not perfectly contestable because, upon deregulation, significant entry occurred, which forced fares down in those markets. Competition, both real and potential, appears to be sufficiently strong to justify airline deregulation and to mitigate one major problem associated with the transition.

The papers by Barry R. Weingast¹⁶ and Michael E. Levine¹⁷ address directly the second sub-theme of the conference—the explanation of simultaneous dismantling of traditional economic regulation and the continuing popular support for social regulation. Weingast bases his explanation on a model of the political process that characterizes the policy equilibrium reached by the interaction between a regulatory agency, interest groups, and politicians. The agenda-setting power of Congressional committees with regulatory oversight responsibilities forms the key element that guarantees the existence of a policy equilibrium. Policy changes, either towards further regulation or towards deregulation, occur because of shocks to the political system, for example, heavy prodding by the President, judicial intervention, significant changes in public opinion that shift the relative balance of key interest groups, modifications in Congressional structure, and economic analyses of policy issues. Weingast applies his model to explain the pattern of regulation of the railroad, trucking, airlines, broadcast, telephone, and nuclear power industries.

Levine uses the recent history of airline deregulation to develop an alternative theory to Weingast’s that casts doubt upon the validity of the revisionist theory of regulation, which views regulation as a wealth transfer mechanism benefiting organized minorities at the expense of the unorganized majority. Under the revisionist paradigm, Congress, regulatory agencies, and favored groups conspire to establish a process that favors all three parties. While this theory has been explained in several closely related ways, most members of the economics and

15. The Airline Deregulation Act of 1978, *supra* note 3.

16. Barry R. Weingast, *Regulation, Reregulation, and Deregulation: The Political Foundations of Agency-Clientele Relationships*, 44:1 LAW AND CONTEMP. PROB. at 147 (1981).

17. Michael E. Levine, *Revisionism Revised? Airline Deregulation and the Public Interest*, 44:1 LAW AND CONTEMP. PROB. at 179 (1981).

political science professions generally accept it. Levine argues that, although explaining the growth of regulation, the theory fails to explain the successful movement to deregulate the airline industry. In its place, he proposes a modified form of the until now discredited public-interest theory of regulation, which attempts to explain regulation as a public response to correct market failures. He argues that Congress and regulatory agencies generally do attempt to regulate economic activity to further the public good, but are sometimes "misled" by private interests seeking their own private gain, or are at least temporarily induced to participate in an administrative system that rewards regulators for benefits they provide regulated groups. However, eventually the public learns the truth about the regulatory system and either dismantles it or reforms it to be more responsive to the public interest.

The Havighurst analysis of the movement of the health services industry towards service-by-service deregulation provides support for Levine's revised public interest theory of regulation. Although lucrative for hospitals and doctors, the continued escalating cost of medical care finally convinced Congress that health planning agencies could not solve the problem. Those agencies operate under a perverse set of incentives, and even if acting in the true public interest, they possess too little information or control to limit effectively the health service cost increases. Acting in the public interest and recognizing the possibilities for more competition for some health services, Congress reversed some of its earlier mistakes.

The cable television deregulation might also appear to provide support for Levine's revised public interest theory of regulation because the FCC, recognizing an earlier mistake, unlocked its regulatory shackles. But the theory's applicability collapses upon taking a closer look. Besen and Crandall argue that, except for a few large-market broadcasters, the coalition of broadcasters, networks, and film distributors that once opposed cable has shifted its attention to efforts aimed at profiting from the lucrative (and inevitable) growth of cable television. They conclude their study with yet another explanation: the lesson that "regulation can be dismantled—even its cartel-like strain—when it no longer matters."¹⁸

While the history of cable television development might support the Besen-Crandall thesis, the significant consequences of airlines, trucking, oil and gas deregulation demonstrate that their theory is not a general one. Perhaps the best interpretation of the cable deregulation story is as a special case which supports neither the Levine revised public interest theory, the Weingast thesis, nor the other private-interest theories of regulation.

Several other explanations for the deregulation movement were suggested at the conference, although none so well-developed as those of Weingast and Levine. The "Congressmen have bigger fish to fry" theory argues as follows: Congressmen are willing to support deregulation of a few, highly visible industries in order to protect themselves against the charge of supporting special interests over the public interest, while increasing numbers of even more important economic activities are

18. Besen & Crandall, *supra* note 12, at 82.

government controlled and thus available to them for providing special services for constituents. Another theory argues that Congressmen also win popularity with their constituents through their efforts to "improve" the regulatory system. Change toward an increasing rather than decreasing scope of regulation is preferred because of the added possibilities for Congressmen to intervene for their constituents; however, if industries like airlines and trucking are already tightly regulated, then the only *change* a Congressman can promote is toward deregulation. This theory predicts long cycles of increasing regulation followed by deregulation, with possibly differing cycles for differing types of industries and regulation.

One more limited explanation recognizes that technological advance can force regulatory reform. The Besen-Crandall paper explains how the fast pace of development of cable television technology has virtually forced the relaxation of the industry's regulation. But the opposite result can also occur. The development of trucking as an alternative to railroads for shipping freight led to a quite different outcome—ICC regulation of the trucking industry. Some scholars point to rapid inflation as an important contributor to the explanation for the successful deregulation of airlines, arguing that airline deregulation resulted in lower air fares, which provided Congressmen a tangible response to their constituents' concerns with inflation. This inflation response argument is certainly consistent with the Weingast theory because it provides another reason for the relative increase in power of the public interest constituency.

Other scholars argue that the logic of the economic arguments supporting deregulation of industries such as airlines, trucking, and cable television must eventually carry the policy debate over deregulation. Certainly Levine's theory accepts this argument, since economic efficiency gains are an important "public interest." Weingast's theory argues that the economic arguments affect a policy decision only to the extent the arguments are useful to policy-makers in supporting their *own* interest in the policy debate. Finally, some analysts credit much of the success of the deregulation movement to key regulators within the agencies, such as Chairmen Alfred E. Kahn of the CAB, Darius W. Gaskins, Jr. of the ICC, and Charles Ferris of the FCC. However, even if one accepts the importance of the leadership provided by these pro-deregulation administrators, a complete theory of deregulation must explain why these men and women were appointed as commissioners and allowed such great power to effect reform.

Designing and implementing an effective transition to take an industry from regulation to completion are difficult problems requiring imaginative approaches as well as careful analysis. The six papers in this volume offer new, provocative, and highly useful ideas for understanding when deregulation is possible and how to manage the transition to competition. If Barry Weingast's model has any validity, then the unusually large shifts in the composition of Congress, the regulatory agencies, and the Presidential initiatives expected as a result of the recent election should bring many new developments to test the theories in the papers.

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