Chapter 3

The politics of deregulation

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The triumph of the regulatory reform movement in numerous policy fields has been one of the great watershed developments in recent American political history. It is also one of the clearest examples ever of the power of intellectual analysis to overturn a deeply entrenched political regime. What is most striking about this episode is that as recently as 1975, deregulation seemed to be an academic idea without a political constituency.

What I intend to do here is to trace the sources of this transformation in the political and regulatory arenas, and to hazard a few guesses as to where it may be headed. Is this likely to prove a fleeting episode or an enduring transformation of the political system? In its origins, economic regulation was sold as a means of constraining the predatory practices of monopolies. But from the outset, its focus was at least as much on regulating and restraining competition. As regulation gradually reached out beyond the railroad industry to other segments of the economy, the central rationale of regulation became predominantly one of concentrating on the evils of unrestrained competition in trying to constrain it.

The high tide of this anti-competitive sentiment, which was very strong before the 1930s, occurred during the Great Depression. Indeed, most of the regulatory statutes that have been deregulated in recent years are ones that were enacted during that period. Until about 1950, criticism of the regulatory regime was almost exclusively a province of the legal profession, and it was concerned mostly with the procedural rules of fairness. During the 1950s, beginning in the early part of that decade, a new pattern of behavioral analysis emerged, and it led to criticisms of regulation right across the board, that is, from one social science perspective after another.

Political scientists produced studies maintaining that regulatory agencies had been captured by those they were supposed to be regulating. Economists often associate this critique with George Stigler, an economist at the University of Chicago. What Stigler provided a couple of decades later was an economic explanation of why the phenomena that the political scientists had described in the 1950s occurred. Legal scholars joined in. For example, Louis Jaffe of the Harvard Law School wrote an article on why it is that regulators are pro-regulatory even more than they are pro-industry. That is, whenever regulations go wrong, the solution is more regulation to prop up a system, as opposed to thinking about any other ways to deal with it.

In the late 1950s, the economists entered the debate, led most notably by transportation analyses done by John Meyer, Merton Peck, and others. Their argument initially centered on transport regulation; it was similar to, though not as sophisticated as Michael Porter's case presented in this book. They contended that, with the growth of new transportation modes in the twentieth century, the transportation industries had become increasingly competitive and that the railroads' economic power no longer was a real source of monopoly or oligopolistic power. They argued that regulation for the purpose of managing this competition was counterproductive. Accordingly, the appropriate solution would be less regulation rather than more.

It is interesting to ponder why this critique arose at that time. If one were an intellectual historian, one would concentrate on things like the fact that America had had a couple of decades of prosperity by then, and so the tendencies of American economists to favor competition could emerge in a way that would not have been so easy to do in the 1930s. But that is not the complete explanation. Certainly another factor was that the railroads were collapsing economically, and what one had was an industry that had long been regulated as a monopoly dying of competition.

The problem of explaining how this phenomenon could have happened under a regime of regulation presented a fascinating intellectual challenge. The new criticism quickly swept the profession, achieved the status of orthodoxy within economics, and generated a modest political response. As early as 1962, President Kennedy sent a pro-competitive bill on surface transportation regulation to Congress. The bill never got out of committee in either house of Congress, and a pattern that persisted over the next fifteen years was thereby established; one of economics' orthodoxy being unable to elicit any effective political result. The fate of these bills re-enforced the political science critique of regulation in that the main protectors of the regulatory programs who were flushed out by these political initiatives proved to be the regulated parties themselves. It turned out that the protectors of regulation were not the consumers but the shippers – the producers of the services. Their ability to defend their captured regulatory programs appeared to be beyond challenge. The iron triangle of interest group, congressional committee, and bureaucratic agency seemed unbreakable.

The political environment was changing in ways that were assumed to demonstrate chinks in the capture theory, but these chinks did not, in the first instance, lead to less regulation; rather, they led to more regulation. The new American populism that burst forth in the 1960s placed a high priority on direct participatory democracy, on economic equality, on hostility to business and the profit motive, on suspicion of certain features of big government. I will not go into the movements: civil rights, anti-poverty, anti-war, environmental, consumer. Instead, I will focus on the main regulatory outcome during the late 1960s and early 1970s – the rise of the new social regulation. The wave of new regulatory programs was directed at health, safety, and environmental protection, and each program was associated with more, rather than less, regulation. One thing was clear about the new agencies that were created, however: They were not captured, at least not in the early years, and not by the companies they were supposed to be regulating. This gave rise within a few years to a rethinking within the academic world of the various possible outcomes of regulation.

Why did social regulation triumph during this period while the critique of economic regulation had such little impact? First, a majority of the public favored increased health, safety, and environmental protection. There was no comparable constituency for increased economic competition; it was hard to make the case that citizens had much stake in it. Second, the American economy was booming and inflation rates were low. It was the economy that had dominated the world for several decades after the Second World War; American political leaders did not seem to have much reason to worry if the new regulation imposed inefficiencies on the economy. These appeared to be inefficiencies that the nation could afford as a luxury, and politicians had to decide whether it was worth taking sizable political risks to rectify them.

There was not even a substantial business constituency in favor of reform. The businesses that had the most intense stakes in regulation were largely accommodated by the regulatory regime. For example, in interstate freight transportation, the largest shippers could escape the effects of regulation by utilizing private or contract trucking, which was virtually exempt from regulation. Agricultural shippers had also achieved an exemption. So those left in the cold were mainly consumers – small businesses and larger companies – for whom freight was a major cost item. If they occasionally thought about pressing for regulatory relief, the last thing that they considered feasible was a broadside attack on the entire regulatory regime itself. They would pursue specific types of relief.

A few pro-competitive stirrings were felt during this period, and these were most obvious in telecommunications, particularly with matters like the telephone terminal equipment decision in 1968 that allowed competitors to AT&T to sell such equipment, and the decision in 1971 allowing private line long-distance telephone services as a competitive area. But these were peripheral adjustments associated with even greater regulation of AT&T to prevent it from using predatory practices to eliminate incipient competition. The pattern of regulation continued to be one of preoccupation with the dysfunctions of competition rather than the benefits of competition.

What happened in the mid-1970s to change this pattern? The most dramatic change was clearly in the macroeconomy. Following the oil crisis of 1973, inflation emerged as public enemy number one in the United States. Policymakers were desperate for remedies and did not have many. They especially lacked remedies that did not create negative side effects. That is, you could impose wage/price controls or tighten the money supply, but such approaches had considerable costs. No one thought that regulatory reform offered any major anti-inflationary benefits, but the consensus among economists was that at least the anti-inflationary benefits would be real and would not harm the economy in other ways. Intense concern emerged about lagging productivity growth in the economy. Just a few years earlier the economy was so dynamic that any negative impact of regulation seemed trivial, but no longer. The potential benefits of regulatory reform in this way became significant. A whole generation of economists had been trained in the irrationality of anti-competitive economic regulation. Many of them had moved into key positions in government and were producing reports calling for less regulation. For years, they merely lacked a political constituency. Now an opportunity began to emerge.

Conservatives had mobilized a backlash to the social regulatory initiatives of a few years earlier. One of their chief targets, however, was excessive government regulation. When their leaders talked about regulation, they spoke mainly of the new social regulation, to them the most evil of the villains. But they also talked about the irrationality of economic regulation.

The consumer movement, which had not even existed in a serious way a dozen years earlier, was a major force, but it was coming on hard times in the mid-1970s. With the conservatives moving into high gear in the United States, the prospects for more social regulation were essentially nil. The consumer movement had always been in favor of more government, but in this political environment, regulatory reform looked like an attractive change of pace. But it was one that required a shift of alliances because in the 1960s the consumer movement in America had been allied with organized labor in pressing for social regulation. Shifting to an alliance with business and conservative organizations was not so easy, but the consumer leaders made the change. In this context some politicians, led initially by Senator Kennedy and later by President Ford, perceived an opportunity to gain political support from this constituency by pressing for less economic regulation.

First the politicians went after the airline industry, which had been widely regarded as a thoroughly competitive industry. Being a relatively small industry, it did not have an important political base. It was also one that charged prices that were highly visible to consumers because it dealt directly with the public. One interesting sidelight to this familiar story is that when Alfred Kahn came to the chairmanship of the Civil Aeronautics Board in 1977, he was committed to produce more efficient regulation of the sort that Michael Porter indicated is sensitive to corporate strategies. Within a year, though, he became convinced that efficient regulation was an oxymoron. It could not be done, he concluded. The only solution was to eliminate regulation in this industry, and he pursued that strategy successfully, quickly becoming the most popular bureaucrat in Washington.

What is astonishing is that the rising tide of pro-competitive sentiment soon became a tidal wave engulfing all three branches of government. A bit of luck was operating in the sense that the early stages of airline deregulation coincided with economic upturn, so it was possible to have reduced prices and increased profits at the same time. But it also became clear that deregulation had touched a responsive cord with constituencies stretching across the political spectrum (leaving out organized labor), and that it might offer lots of people in Washington a chance to make their marks on history. In this context, numerous agencies that had long been considered to be the most captured by client politics began to move vigorously in a different direction.

The telecommunications case seemed to be intrinsically a harder one, because telephone service looked at least like a natural monopoly, or had until recently. And so as technological change undermined the natural monopoly argument during the 1960s, 1970s, and into the 1980s, the FCC had to react. As was mentioned previously, it took tentative steps around 1970, but at the same time it was increasing its regulation of AT&T, which tried hard to reverse this trend with congressional action. The firm mounted a major campaign in 1976 and again in 1977, but failed. When the FCC pulled back from its commitment to competition in the mid-1970s, it was prodded by the courts in a pro-competitive direction.

Illustrative of this was the Execunet case, which was the first MCI effort to offer per call rather than private line competitive services with AT&T. The FCC rejected the service, but the Circuit Court of Appeals for the District of Columbia overruled them, saying for the first time that the Federal Communications Act did not authorize the FCC to propagate monopoly for monopoly's sake. The court maintained that it had to make a powerful case-by-case rationale if it was going to do so. This decision was upheld by the United States Supreme Court when it refused *certiorari* in 1979, and the FCC decided not to proceed further. In this situation, AT&T did not have much choice but to pursue wider authorization to compete, rather than try to suppress competition in its historic monopoly markets. Meanwhile it was encountering pro-competitive sentiment in the Antitrust Division of the Justice Department and in the Federal District Court, leading ultimately to the divestiture settle- ment of 1982. Remarkably, the thrust of pro-competitive sentiment, so different from the sentiments and theories that had dominated American politics in the 1930s, 1940s, and 1950s, had penetrated to the heart of what had seemed to be the most powerful and secure monopolistic area of regulation in America.

Clearly, the pace of technological innovation and its thrust in expanding the potential for competition gives no sign of abating in the foreseeable future. Indeed, naturally competitive possibilities seem to be cropping up all the time. The unlikely consensus among consumers, conservatives, and academics in their organized expressions in favor of competition wherever it can thrive, still seems rock solid despite the problems that emerged in the airline industry. As Alfred Kahn said, Congress did not repeal the antitrust laws when it deregulated the airlines. Hence some issues concerning the re-emerging concentration in the airline industry may be an antitrust problem rather than a regulatory one.

It is impossible to know what the consequences of a major economic downturn might be. However, it does seem inconceivable that the competitive genies that are out of the bottle can be put back in. The commitment to new pro-competitive initiatives might flag, but even that is far from clear. The current period, after all, is not like the 1920s, when the intellectual foundations for the anti-competitive regulatory acts of the 1930s were laid in the trade association movement and the activities of the Federal Trade Commission. Few economists would argue today, as they did in the 1930s, that in a new depression, suppressing competition would be a plausible path to a renewed prosperity.

In short, we have here a policy revolution that provides remarkable evidence of the power of ideas in American politics. This revolution attests to the system's capacity to reach at times for the broad public interest, at least as intellectuals understand it, rather than narrow, highly organized interests. Moreover, we have a policy revolution that seems likely to prove extremely durable.