COMMENTARY

IS THIS REALLY NECESSARY?

AIRLINE DEREGULATION: CRASH LANDINGS AND THE PARACHUTE OF ARISTOTLE

Having collected almost 100,000 frequent flyer miles on USAir, I decided to visit my son at his school in North Carolina. I got my "certificate" and called USAir over one month before the flight. This was October, not a holiday in sight. I asked for a reservation. All flights were open—I could fly direct, and I could leave whenever I wanted. Then I mentioned that this would be paid by a frequent flyer mileage certificate. "Oh, well, we do not have space for you on any of those flights," Fay of USAir explained in a practiced monotone. "Well, what do you have?" "We have a red-eye going into Pittsburgh which will connect into North Carolina the next day, and the trip back is pretty much the same; it will have to be the all-nighter with two stops and plane changes, taking a day and a half." "Wait a second, a moment ago you told me you had space everywhere. Now you have nothing and the flight's more than a month away in a non-traffic period. How come?" "Well, we only allocate some of our seats for the frequent flyer program." "Oh, I don't remember seeing that in the ad...how many seats on the twelve direct flights I cannot get have you reserved for frequent flyers?" "I cannot give you that information."

Airline Deceptive Practices

I had just been the victim of a classic "bait and switch" unlawful business practice. You advertise a benefit to bait consumers; then you either disparage or even refuse to provide the advertised bargain, "switching" the consumer to a high-profit product or service.[1]

And it wasn't just USAir. Southwest Airlines did the same thing the following year. They widely advertised their "buddy fare"—on certain flights over certain periods, buy one ticket and get another for your buddy for free. But it turns out they do the same thing—reserve a very small number of seats for the program to attract customers, and then force them to pay full fare in order to get the flights they need.

Then I got my American Airlines mileage statement. They have now declared that my mileage may "expire" and they are going to start subtracting mileage earned more than a given number of years ago. Needless to say, this was not the focus of the "American Advantage" advertising campaign when I signed up.

These and other airline deceits are justified on an interesting legal basis. To those who object, the airlines point to a small-print clause in an obscure document saying that "rules are subject to change." In other words, we can promise you whatever we want, but we will not be held to our representations because of a clause—which we wrote—giving us the right to change the rules anytime we want to do so. We reserve the right to give ourselves permission to lie to you. This theory has never been tested in court as a defense, probably because no attorney wants to risk the ridicule of raising it.

Airline Unfair Practices and Anticompetitive Results

These practices are, regrettably, symptomatic of a much deeper malaise affecting the nation's air carriers. Beyond the open gauntlet of advertising deceit is a collection of competitive abuses warranting greater concern. Most of them have arisen following the Airline Deregulation Act of 1978[2] and the subsequent dismantling of the Civil Aeronautics Board in 1985. First, there has been increasing concentration of ownership. During the last quarter of 1986, a spate of mergers occurred, and the trend is clearly in the direction of consolidation. In California's market alone, USAir bought out PSA, American Airlines gobbled up Air California, Delta took over Western Airlines, and Alaska Airlines captured Jet America.

Although economists will point to theoretical "ease of entry" into the airline industry, one has to have gates at the airports. Major airports grant long-term leases; Los Angeles and San Francisco airport leases, for example, last from ten to thirty years. Buying a competitor, or driving him out of business, may not result in effective new competitive entry.

Second, the contest to decide who is bought or driven out is not based necessarily on fair market competition where the firm with the best service or most efficient operation prevails. For example, some airlines control the travel agency computer systems booking much of the nation's travel. When the system of American Airlines or United Airlines is used, one does not have to guess to predict that the layout of fares, the order of presentation, and other marketing techniques used by the airlines controlling the computer booking systems will favor their own flights. Of course they do.

But the most major unfair practice currently extant and thriving favors the "deep pocket" carrier, or the carrier with an area of monopoly power which may be exploited to cross-subsidize operations where it has competition. The consumers in the monopoly market are egregiously overcharged so that one competitor may drive out of business possibly more efficient carriers in another market.

The competitive pattern in this industry has increasingly degenerated into price discrimination and predation, leading to bankruptcies and "industry shakeouts," which then become tight oligopolies acting as cartels. That is, once the aggressive price competitors are either purchased or driven out, the sagacious deep pocket survivor will likely benefit from a resulting "I will fight no more forever" oligopoly—the economic term for a shared monopoly.[3]

If one of the carriers is particularly large, it will likely set the rates. Quite apart from the mutual advantage, none of the small competitors dares to compete if it believes that the larger firm can and will go below cost if it is sufficiently irritated, financed by either its larger size or by its surfeit of monopoly business in other markets.[4]

To be sure, the model of the free market may dictate a challenge where prices are excessive. The reality, however, usually is not a challenge, but conservative actions to maintain the small marketshare which gives the large entrepreneur "cover"—the patina of a non-monopoly—while all participants eventually move toward the extraction of excessively high prices. This is not a zero sum game; it is better to achieve a higher rate of return on a small marketshare than to risk a competitive war which will have to be lost by you. And once the large entrepreneur has actually demonstrated a willingness to go below cost to drive others out, the lesson is easily learned. In the real world, entrepreneurs would rather make friends with a stronger bully than risk annihilation—so long as the bully makes room for their comfortable operation. Although at odds with economic theory, this human pattern seems rather obvious to anyone who is not seeking—or has not already obtained—a Nobel prize in economics.

This predictable pattern is exactly what has been happening in the airline industry: occasional but vicious price wars, followed by bankruptcies, mergers, and then oligopoly leading to price increases and service diminution. When they see this dynamic, the free market-obeisant economists like to argue that all is well—the market is supposed to shake out the inefficient. True, but the market should be doing so based on performance in the marketplace and the exercise of consumer choice, not based on deep pockets or unfair practices. And the result should allow continued new entry and vibrant competition between the increasingly efficient survivors. That is not what is happening.

Let's take an example. On March 6, 1990, it cost $480 to fly round-trip from San Diego to Sacramento. One could fly to Europe for less than it cost to go from California's second largest city to its capital. [Of course, the airlines are smart enough to give a huge discount to legislators and government personnel, who fly at one-fourth the regular price.] The market was a tight oligopoly with USAir as price leader. Southwest Airlines was virtually the only competitor "on the make" and willing to price independently. But Southwest did not then serve San Diego–Sacramento. A lack of airport gates in Sacramento was one impediment. But in markets where Southwest offers competition to these same carriers, fares are one-fourth to one-third the per passenger mile rate of the $480 San Diego–Sacramento charge. Thankfully for some of us, Southwest entered Sacramento; immediately, fares from San Diego to Sacramento were magically cut to one-fourth the previous level.

This pattern is not one of fair or effective competition. It is one of price discrimination and predation. USAir is determined to drive Southwest out of business—not by providing better or less expensive service, but by cross-subsidizing from excessive charges where it does not face Southwest competition to accommodate very low fares where Southwest appears.

This pattern appears to mimic to some extent the pricing expected during healthy price competition, except it has two drawbacks. First, while it is going on, it grossly misallocates resources. Passengers pay distorted prices where carriers are not engaged in battle. For example, Alaska Airlines has a virtual monopoly on intra-Alaska air travel. It is not surprising that the fares from Juneau to Anchorage, Fairbanks, or other cities in Alaska are much, much higher per passenger mile than they are in Alaska's California operations (where it faces competition from Southwest). Alaska also uses its reservoir of monopoly power to finance its contest in California. While this is going on, people travelling in Alaska are paying unfair and excessive charges for air travel.

Second, although those of us in San Diego are delighted to be the subject of a price war, it is a Pyrrhic and temporary victory for us. At some point the war will end, usually one of three ways: Southwest will be bought out to get rid of the annoyance; Southwest will be driven out of business; Southwest will join the club. Then prices will go up—and if there is not another Southwest in the wings (sorry) to challenge prices and go for marketshare, the prices will rise slowly but inexorably without the benefit of service, efficiency, or other entrepreneurial improvement.

Needed: Refined Regulation

So are we saying that the airlines should not be deregulated? No, the regulatory system in place twenty years ago was fundamentally a cartel operation protecting the most inefficient carriers from competition. In fact, the net effect of deregulation has been positive. But the long-range prognosis is bleak. Because in the process of deregulation, the government has not fully absorbed the obvious: that the choice is not between regulating to the maximum comfort of those regulated and a competitive system where they do whatever the hell they want.

Another model exists—one of refined regulation. It is governed by the following maxim: We stimulate maximum competition, but we regulate in a targeted fashion where market prerequisites preclude effective competition or where there are external costs in the absence of regulation. We may want to deregulate an industry—that is, end an intrusive paternalistic system of price controls, entry barriers, licensing, standards, and the rest of it. But we need not do so *carte blanche*. We may decide *not* to deregulate as to a part of an industry where competition is lacking; and where we do rely substantially on competition, we maintain the deceptive advertising, antitrust, and unfair competition prohibitions which properly apply to the competitive sector.

At least theoretically, the competitive sector of the marketplace is also subject to societal safeguards and limitations. If you lie, you are punished. Deceptive advertising is actionable. You cannot engage in unfair competition without sanction. Price discrimination with the intent or effect of lessening competition is unlawful. Predatory practices violate Business and Professions Code section 17000 *et seq.* And so on. Not only are these laws applied properly to this particular industry, but much greater scrutiny is justifiable given the common carrier nature of the industry and the tendency toward oligopoly. And finally, where the passenger volume or other market features are not amenable to real and continuing competition, there must be regulatory oversight—including rate review. The framework underlying these positions should not be controversial. Economic actors have a choice: either they compete in a fair and useful manner or, if they degenerate to a structure inhibiting price competition and noncompetitive prices are likely, they are regulated. You either compete or, if you have a monopoly or cartel, you are regulated in a way to preclude the abuses flowing from that lack of competition. You do not get the cartel *and* a blank check for the public to sign. That is the principle. And it is that basic.

Applying this principle of refined regulation to airlines or insurance or the plethora of other businesses to which it should apply is not difficult. Either a relevant submarket in a given geographic market of such an industry has workable and effective competition or it does not. If it does, regulate only as you do the competitive sector generally—for deceptive advertising, antitrust, unfair competition, and perhaps to inhibit or assess external costs (*e.g.*, pollution or safety). But these areas are not subject to barriers to entry, rate controls, detailed standards, and agency supervision. If effective competition is lacking, then target the regulation to prevent the abuse arising from the market flaw at issue.

This means that we properly do not "deregulate" all airline markets or, as we discuss in the comment below, all insurance or all aspects of savings and loans. We discriminate based on the economic condition and state of competition within relevant markets—conditions which may vary within an industry. And we may properly regulate competitors in one market as to maximum price, while allowing competition to dictate prices for the very same industry with other competitors and a different economic reality some-place else. It is possible to distinguish between situations where you regulate and situations where you do not, and that need may vary within a single industry. Hence, the pattern we now insist upon—we either regulate or we do not regulate, without regard to particulars—is wrong. It is universal, but it is wrong.

In the case of airline regulation, as with many others, we commit the sin of generality—applying the same basic system across markets of varying regulatory need. We impose a single cookie cutter, as if it is impossible to vary the system within a single industry and its regulatory scheme. And the cookie cutter—either all regulation or total passivity—is applied *in extremis* reflecting excess in one direction, and then the other, *seriatim*. First, we have no regulation at all. Then airlines are subjected to detailed regulation by the Federal Aviation Administration and the Civil Aeronautics Board covering fares, routes, and virtually all aspects of operation.[5] Then when we wake up and realize that we have been running a cartel at public expense, we deregulate. But in doing so, we move to the other extreme and regulate *nothing*. We forget about deceptive advertising law. We forget about basic antitrust and unfair competition law. We lack the ability to differentiate what should be regulated and the ability to gauge when it should occur, so we don't do it at all, even in some markets which have only one carrier and monopoly power prices become obvious. This will probably go on until the abuse becomes so egregious that political pressure builds. Then there will be the inevitable explosion, sad tales, dramatic testimony, media exposés, and we'll move back again to gratuitous, costly, and unnecessary regulation—eventually controlled by the industry and inevitably framed to keep the most inefficient carrier in the history of the world in operation.

The Prescription of Moderation

Aristotle counselled "moderation, moderation in all things." His advice well applies to the state as regulator. Yes, try to let competition do it, but watch it carefully, and enforce the laws refined over many years to assure a fair contest where consumer sovereignty decides the marketplace winner. Then, where you find narrow areas and markets where the prerequisites to competition are not present—as perhaps in lightly travelled airline markets—regulate in rifle-shot fashion to address the abuses created by those flaws. This might mean nothing more than limited maximum rate regulation where oligopoly or monopoly occurs. Apply different degrees of regulation *within* the industry. Meanwhile, enforce strongly all of the safeguards against market abuse normally applied to preserve fair competition.

Mattox II and the Pendulum Swing to Laissez Faire

Proof of the extent of the "hear no evil, see no evil" problem in the airline industry as deregulation has led to a combination of classic competitive abuses is provided by the infamous *Mattox II* case of 1990,[6] recently affirmed by the U.S. Supreme Court in *Morales v. TWA*.[7]

By way of background, the leading case in defining the primary jurisdiction of airline regulation has been for years *Nader v. Allegheny Airlines, Inc.*[8] In *Nader*, the plaintiff had a confirmed reservation on an Allegheny flight. He was bumped and sought damages for breach of contract, *et al.* The defense asserted that the system of airline regulation by the Civil Aeronautics Board was comprehensive; because the Board (together with the FAA) regulated all aspects of the fare/reservation system as well as routes, baggage rules, and virtually every aspect of airline practice, the common law of contracts and torts was superseded by this regulatory system. The defense buttressed its argument with the fact that the Board was indeed considering the issue of reservation bumping. The Supreme Court held that there was no absolute occupation of the field, and that unless the CAB specifically permitted a practice which breached a common law principle of contract or tort law, the underlying common law applied. The *Nader* case was allowed to proceed.[9]

But now we have deregulation in the airline industry. We have decided to let the marketplace prevail in an industry which (economists point out) has small, discrete units of production which may be adjusted to traffic volume, moved, bought, and sold (the planes). Hence, so long as safety is assured, it is not a natural monopoly but is amenable to effective competition. Congress removed most of the jurisdiction of the Civil Aeronautics Board and, with the enactment of the Sunset Act of 1984, the limited federal powers left were transferred to the Department of Transportation. This included the standard authority of all regulators to police deceptive advertising.

On November 14, 1988, the attorneys general of Texas and several other states notified TWA, Continental, and British Air that they were engaged in deceptive advertising under guidelines adopted by the National Association of Attorneys General in 1987. What the airlines were doing was advertising a price, and then when the ticket was bought, adding on substantial "surcharges" for "fuel" and "tax." This allowed them to charge more than their competitors while advertising a lower price—which in turn forced competitors to engage in like deception to compensate. The defense argued, incredibly, that state deceptive advertising statutes were preempted by the "regulatory" authority of the now fangless Department of Transportation—on the basis that it had been transferred the power to regulate deceptive advertising. The Fifth Circuit Court of Appeals—in a decision which can only be described as bizarre—held that the current *non*regulation system preempts state regulation and state deceptive practice laws. Only the regulator (the Department of Transportation) may enforce them. Good luck. Further, the court implied that this delegation of authority to DOT covers deceptive practices and all "unfair acts." Hence, unless DOT stops it, it's Katie bar the door.

The Supreme Court's opinion on this issue is even worse. In a 5–3 decision, the Court held that the guidelines adopted by the National Association of Attorneys General, which required accurate disclosure of the exceptions and conditions to advertised "fare bargains," are economically undesirable. Its logic, drawn from the seemingly unfathomable well of University of Chicago ignorance, is that it is a good idea for the airlines to deceive people because more people are thusly attracted to the airlines, resulting in higher utilization and lower fares.

I am not making this up. "Accordingly, airlines try to sell as many seats per flight as possible at higher prices to the first group [price-insensitive business travelers], and then to fill up the flight by selling seats at much lower prices to the second group [price-conscious pleasure travelers]....In order for this marketing process to work, and for it ultimately to redound to the benefit of price-conscious travelers, the airlines must be able to place substantial restrictions on the availability of the lower priced seats (so as to sell as many seats as possible at the higher rate), and must be able to advertise the lower fares."[10]

Let's stop here for a moment. What the Court is here saying is that it is ideal to have "value of service" pricing, where the prices vary according to ability to pay. Such an arrangement only works in a cartel setting to extract monopoly power profits. In a competitive market, the business fares would be cut until fully distributed costs are reached. The Court is here pretending that the airline industry, instead of being a low-fixed-cost enterprise with small units of production (planes) highly mobile and able to adjust by route and schedule, is a high-fixed-cost enterprise with enormous unavoidable excess capacity requiring price reductions to marginal cost to maximize efficiency.

This is, of course, mostly nonsense. Certainly, few if any economists ever to study this industry would agree with the economic underpinnings of the Court's view. But even if one were to posit the need for fare reductions to prevent empty seats, it is possible to do so without lying. Instead, the Court notes that "requiring too much information in advertisements can have the paradoxical effect of stifling the information that customers receive."[11] The attorneys general were not suggesting the reprinting of the telephone-book-sized tariffs with every advertisement, but the prohibition of deceit. It is possible to advertise a lower rate, even one with conditions, clearly and without deception. Every other industry is theoretically under such an obligation. And it is important that this obligation not be subject to only one single means of enforcement. The American system of checks and balances works because we do not vest in a single entity final authority to create or continue an abuse. Virtually every other industry subject to regulatory control is also subject to public prosecutor or private suit where it deceives. That multitude of alternative enforcers creates an important check. The Supreme Court's option, with little support in the legislative history cited, confines this important check to a single institution—and one historically vulnerable to corruptive capture.

We have moved from a system of industry sycophants protecting existing air carriers from competition to a system run by ideologues who have infinite faith in a market god which deserves a measure of respect but which is not properly deified. There is ground in the middle. To occupy it requires a sense of particularity; a willingness to regulate sometimes and someplaces, and to know why one and not the other.

Perhaps, perchance, somewhere along the evolutionary cycle, and before the end of time, someone will set the pendulum in the middle. Let us all hope we shall not have to wait the eons necessary before we are graced by another Aristotle to teach us the simplest of truths to still its swing: moderation, moderation in all things.

FOOTNOTES

1. Often, bait and switch is accomplished by stocking or obtaining a limited number of the bargain "bait" advertised, knowing that only a small proportion of those who are likely to respond to the ad will be able to obtain it. The limited numbers available are not disclosed. Here, the offense is particularly egregious because USAir cannot argue, as is common: "I only bought nine of those low-priced stereos (although I advertised to two million people) because nine was all I could get." Here, the limitation on supply is self-created and gratuitously manipulated. They *have* the product promised; it is available—but only if you pay full fare. For a discussion of the circumstantial evidence sufficient to establish bait and switch practices, *see Tashof v. FTC*, 437 F.2d 707 (D.C. Cir. 1970).

2. 49 App. U.S.C. § 1301 *et seq.*

3. If only two to six carriers dominate a certain route, there may well be implicit collusion at some point, particularly if they learn of each other's fares at or before effectuation. In the long run, lowering fares will simply result in reductions by competitors, leading to the gradual realization that following a price leader up in an eventually established pattern benefits all of the participants—it is not a zero sum game, and all can win at the expense of the consumer.

4. Although free market economists like to deny the possibility of such behavior, it is easily demonstrable. Businesspersons do not, in fact, conform to the mindset as attributed by economists. That is, they are not idiots. Typically, free market economists like to argue that such an oligopoly will not deviate from properly competitive prices because the low barriers to entry will attract newcomers if the large firm starts to go too high, and that the smaller existing competitors will also likely lower prices to attract a larger marketshare. Such an analysis misunderstands human psychology. The new entrant and the existing smaller carrier will not challenge the market leader if they believe that the leader will retaliate by going below cost to hurt them. They believe in maximum revenues as economists assume, but they believe more strongly in survival, which economists do not assume. Perhaps one of the problems is the difficulty of quantifying the desire for security. Economists tend to think that if something cannot be quantified, it does not exist.

5. See, for example, the proceedings necessary to obtain but a third carrier from San Francisco/Oakland to New York/Newark in 29 C.A.B. 811 (1959).

6. *TWA v. Mattox*, 897 F.2d 773 (5th Cir.), *cert. denied*, __U.S.__, 111 S.Ct. 307 (1990), *later proceedings*, 924 F.2d 1055 (5th Cir. 1991), 949 F.2d 141 (5th Cir. 1991), *aff'd in part and rev'd in part sub nom. Morales v. TWA, et al.*, __U.S.__, 60 U.S.L.W. 4444 (June 1, 1992).

7. *Morales v. TWA*, __U.S.__, 60 U.S.L.W. 4444 (June 1, 1992).

8. 426 U.S. 290 (1976).

9. The *Nader* decision is consistent with the notion of coextensivity of remedy. The Court viewed itself as the decisionmaker for basic societal contract and tort disputes; it is not displaced merely because of the presence of a regulatory system unless that system has previously considered and ruled contrary to the underlying common law policy. The approach of that Court—but certainly not the *Morales* Court—is well vindicated by a long series of plaintiff cases across a panoply of abuses theoretically addressable by regulatory agencies. The most serious abuses within the real estate industry (multiple listing group boycotts, extortionate behavior, price fixing), banking industry (NSF check overcharges and impound account excesses), insurance industry (bad faith refusal to pay claims), and many others have been brought before the courts and adjudicated favorably to plaintiffs. None of them were brought by regulators. Although each industry has comprehensive regulatory systems, none ever entertained these problems—notwithstanding decades of abuse and the violation of numerous statutes.

10. *Morales v. TWA*, *supra* note 7.

11. *Id.*

BEYOND AIRLINES: THE FAILURES OF MODERN DEREGULATION

To regulate or not to regulate; that is not the question. As we argue above, we are jeopardizing the deregulation of airlines by assuming that the question is one of paternalistic control industry-wide, or abandonment to competition—even where unfair or ineffective. We have failed to deregulate intelligently, to apply refined regulation, and to continue deceptive advertising and fair competition enforcement which maintains the ground rules making competition effective. Not only in the airline industry, but in trucking, savings and loans, banking, cable television service, local exclusive franchises, and more recently in telecommunications have we *not* learned the lesson of Aristotle preached in the comment above.

The errors in each case have a common thread: an inability to understand that the issue is not whether to regulate, but how to regulate. There is always some degree of regulation; even in the Smithian *weltanschauung* of University of Chicago naiveté, the marketplace is defined by the larger society. The rules and mores of transactions are unavoidable. I have put my manufactured article on the truck to go to your store; if it is damaged, who pays? If the smoke from my stack prevents you from using your property nearby or injures your family, do I pay the damages so created or not? All sorts of complicated rules exist; they cannot be avoided. From bills of lading to the meaning of warranties, the issue is never whether there should be some sort of interference in a "natural marketplace." There is no natural marketplace; there never has been one. Its invocation is simply a device to beg the issues (what are the rules? how much interference should there be? for what purpose? in what manner?) so they are not decided or addressed.

What we have done repeatedly is to subject whole areas of the economy to substantial regulation, and then as the political pendulum swings to the right, we have deregulated. But time after time we have done so by the act of simple release from the previous regime of regulation. We have done so as if there is some kind of natural law to which all such systems will return upon the mere withdrawal of the state. The state is the "problem," and its removal subjects the industry to the beneficence of the invisible hand. Regrettably, most of the impetus behind this assumption emanates from a school of free market economics whose adherents are more akin to disciples than to scholars. They do not pursue truth; they manifest faith in a doctrine with all of the characteristics of a religion. And their system of belief has the basic attraction of religious doctrine: Its rules are internally consistent, and it seems to explain almost everything.[1]

But often our systems of regulation which we have created were designed to address market flaws which remain after deregulation and warrant some adjustment. Often, the act of regulation itself has created market flaws which are exploited during the deregulation transformation.

The market is, indeed, a force to behold. And its benefits are now being acknowledged across a panoply of varied cultures and in the homes of its ancient enemies. So use the market, consider the market, give it presumptive status perhaps, look for ways to interject its ability to allocate resources with efficiency and in response to arguably the purest of democratic forces—votes by purchase. But understand what the prerequisites are for market function consistent with its beneficial features. Understand the nature of its limitations and of the flaws which it may well carry. Consider scarcity, natural monopoly, imperfect information, adhesion, economic coercion or bullying, collusion, deceit, external benefits, external costs.

Error #1: Overregulation

There are two extremes in juxtaposing the flaws of the marketplace against its benefits. The first extreme is to use the existence of flaws as an excuse to abrogate the benefits of the marketplace in unjustified ways. The trucking industry has accomplished this by claiming that minimum and collusively set prices are necessary in order to assure a margin of profit for trucking to finance safety standards. The common justification for regulation is to find some health and safety string, and pull it.

Modern courts have long since surrendered their role as a constitutional check on meritless economic regulation—all that is required is the invocation of "safety" or "health." Never mind that there is no real nexus between the regulatory system and the value invoked to justify it. Giving truckers a price floor may guarantee more revenue and may keep in business more marginal carriers, but it does not assure that the extra money is spent on safety. There are ways to encourage safe performance without wholesale pricing freedom with proceeds to be spent wherever the recipient desires. There are many alternative regulatory means which connect to the safety or other justification. But the courts do not want to examine the difficult justifications. They do not want to challenge either the expertise or the good faith of legislators or regulators. They want a bright-line test. Invoking a health and safety concern seems to provide it.

The result of this judicial license, and the political power of profit-stake interests, has been a great deal of unnecessary regulation for cartel purposes. When the Board of Landscape Architects decides to license those who design golf courses to confine such business to California "architects," it is hardly protecting consumers needing the state's assurance of competence (the justification for most licensing regulatory systems). When the Board of Accountancy, consisting in majority of practicing certified public accountants, adopts a rule providing that only CPAs may use the word "accounting" or "accountant" in describing their services, it is not regulating for public health or safety—although it is assuredly invoked. When marketing orders use the power of the state to tax consumers of wine, milk, cheese, eggs, avocados, and beef to finance promotional ads stimulating increased consumption of these supposedly under-ingested products, health and safety justifications are certain to be catechistically invoked—and will suffice to sustain the regulatory act.

Error #2: Underregulation

The second extreme is represented by airline regulation discussed above, but hardly confined to it. It occurs usually following deregulation. Telecommunications have been deregulated and the net effect, as with airline deregulation, has been beneficial—at least for the short run. But here also regulators have gone to the other extreme and are allowing monopoly loop operations which remain to give cross-subsidy advantage to the utility as it competes in the private competitive sector. The regulator is not watching below-cost practices. The regulator is permitting the monopoly loop to obtain excess profits by allowing rate increases by pass-through formulae. The long-run result may be highly damaging because the same basic error is being made as with airline deregulation: In moving from regulation to deregulation, there is excessive reliance on a marketplace where there are serious anomalies. Where the existence of strong monopoly power and the underlying importance of the industry dictate more vigilant application of standard antitrust and unfair practices law, it is instead suspended or waived to allow the abuses which led to the regulation in the first place to proliferate.

Other examples loom around us. The allowance of exclusive franchises—lawful monopolies—by local governments for trash hauling or cable service, for example, may be arranged without the requirement of competitive bidding or rate regulation. State law understandably prohibits our cities and counties from letting a public construction project of over $10,000 without competitive bidding because of the corruption which has resulted historically from bribery to obtain local business. But in the deregulation of local government activities and of cable, we allow multi-million-dollar exclusive franchises to be awarded without any bidding and without any required or likely rate regulation. And the local jurisdiction may collect a "franchise fee" based on a percentage of the take—reducing further the impetus to regulate.

And, of course, the ultimate example we have just all experienced: the savings and loan debacle. Same story, lesson still not learned. When we determined it advisable to deregulate savings and loans to make them more "flexibly able" to compete with other financial institutions, did we calculate fully the market-affecting consequences of federally insured deposits assuring them profits if they won and publicly financed relief if they lost? Did we deregulate thoughtfully, taking into account market flaws and human nature? The question is now regrettably rhetorical.

Error #3: The Failure to Refine Regulation

Sometimes an industry requires tight price regulation in one of its relevant geographic or product markets, and sometimes it does not. Natural monopoly, for example, warrants maximum price regulation—and there may be markets in many industries which may be served efficiently by only one provider while much of the industry is subject to meaningful price competition. Why must we either overregulate the entire industry, or ignore what are obvious regulatory needs? In addition to enforcing generic statutes designed to protect the marketplace where it can potentially work (deceptive advertising statutes, antitrust law, unfair practices prohibitions), we can arrange for *conditional* maximum rate and entry controls—where natural monopoly or other flaws preclude its efficacy.

As we argue above, airline regulation is a prime candidate for both vigorous competition in some markets—enhanced by enforcement of those laws designed to further fair competition—and perhaps for specific entry and maximum rate controls in markets where the limited number of viable competitors precludes real competition.

Another prime example is insurance regulation. In most states, there is both exemption from antitrust laws—no assured competition—and little meaningful regulation. The worst of all worlds. In California, we certainly improved matters by subjecting the industry to antitrust law through Proposition 103 in 1988. And the proposition was sophisticated enough to recognize that elements of both competition *and* regulation are appropriate within a single complex industry. However, the proposition failed to take the final step. Rate review is triggered by the size of an increase proposed by an insurance company.[2] The optimum system would examine the insurance submarkets and require rate-of-return maximum rate regulation for any such submarket where available tests for workable competition are not met. If they are met, the rates would be set by the marketplace. Review would not occur. If competition is lacking to assure market-set prices, there is a fair rate of return review, whatever the rate proposed. Such a system obeys the basic prescription we here advance: If there is a reason to regulate, regulate there and to that extent. Apply the rule where there is the reason for the rule.

What is interesting is the extent to which we sometimes are so unrefined in our regulatory systems that we overregulate and underregulate within the same system. That is, we quite often overregulate in the formulation of entry barriers. Not only is the admission to an industry, trade, or profession often too high, but it is often unrelated to the purpose of the regulation. A refined system of regulation requires the system to address its *raison d'etre* time and again. But attorneys are licensed based on a single general examination at the age of 25—never to be tested again, and never tested in the actual area where their skills are relied upon. The same goes for physicians. Here are two areas where regulation is amply justified—we properly do not rely on the marketplace. But then what do we do? We regulate in a way very distantly related to our purpose. The result is that we do not optimally accomplish our purpose. A refined system of regulation of attorneys would test attorneys in their actual area of practice, be it immigration, antitrust, criminal, or tax law. The examination would not be difficult or off-point, but would ascertain that the practitioner in that area knows the basic cases and understands the basic procedures. The test would be given once every five years to assure continued competence. The same process would rightfully guide physician licensure. The underlying principle? Regulate narrowly and specifically to accomplish the stated goal.

The most egregious example of the blunderbuss "know nothing" school of public policy is easily found at the highest levels. Take the Dan Quayle Council on Competitiveness. This Council has taken over the role of the previous "Bush Task Force"; that is, it oversees the regulatory review functions of the Office of Management and Budget (OMB) exercised through the Office of Information and Regulatory Affairs. Operating outside due process, the Administrative Procedure Act, public review, the hearing process, *et al.*, this group can pull any federal regulation it dislikes for "review." Instead of following a procedure where financially neutral officials representing the long-range interests of the people hear evidence from all sides, duly noticed, and in public, we have the spectacle of those with a vested profit stake in policies engaging in private appeals to officials who have not weighed the evidence, but who are—let's face it—more interested in the weight of available campaign gold than in the weight of evidence. This is not refined regulation.

The "Council" is now pushing a "moratorium" on regulation—all of it—so business can recover. It pleads that it will except serious health and safety related rules from the ban. But that is hardly refined. Many rules prohibiting corrupt business practices are rightfully implemented; many rules are desired by honest businesses knowing that the failure to adopt an industry-wide standard means that they are forced into injurious practice themselves to stay even with competitors. Sometimes a standard must be imposed from the outside and across the board for the benefit of all. The whole notion of a "moratorium" rests on the demagogic and lazy assumption that all rules are the same, or that perhaps they can be divided easily into two categories: those necessary for health and safety, which are okay, and all the rest, which are not. Some rules are unnecessary, gratuitous, self-serving, and more costly than alternatives—including their nullification. Others are important for many reasons. But they have to be analyzed on their merits. One cannot say with any intellectual honesty that a regulation is "bad" or "good" without reference to what it does. Why is that so hard for some people to understand?[3]

California has followed the federal example with its own Ueberroth Competitiveness Report. Here is the same problem. All would be better if government simply "got out." Got out of what? Where? Well, says Ueberroth, almost everywhere. Among other things, we should repeal the Corporate Criminal Liability Act. This is a law which makes the unremarkable statement that a corporate manager who knows of a "hidden defect" which is likely to cause death or great bodily injury has an obligation to notify the workers if it endangers them, or Cal-OSHA if it threatens consumers. Cal-OSHA is then supposed to notify the appropriate regulatory agency for a review. So if you find out a product of yours is going to cause people to die or become disabled, you have to tell an agency so they can check it out. Wow, *that* is certainly unreasonable. *Query*: Under what definition of civilization would we countenance the contrary proposition? If you know your product will kill and maim (through its normal and expected use), you shall (or may) keep it to yourself and let it happen without letting anyone know. But if we are in the world of the regulatory demagogue, that is fine, because we do not then engage in refined regulation; we engage in a series of caveperson grunts: regulation bad...ugh...business good....regulation make business do things they no want...ugh, that bad....regulation stop...good happen...belch.

The import of all of this ponderous prose? The *how* of deregulation is as important as the threshold decision to deregulate. Too many treat the entire matter as a "yes" we regulate or "no" we do not, as if that decision ends the inquiry. As the current crop of twelve-year-olds likes to blurt....NOT!! A decision to regulate, or to deregulate, begins the inquiry. But we seem unable to begin it. It's as if our policymakers have adopted the ten-second attention span of the mass media.

The airline industry has been joined by local government exclusive franchises (covering trash, sports arenas, ambulance services, *et al.*), telecommunications, savings and loans and financial institutions, trucking, the cable industry. A long and costly line has marched before us, one that is apparently part of a long and costly line to come. Having ignored history, we seem condemned—as the cliché goes—to repeat it. The prediction is not meant to resonate cynicism, but the pendulum has swung from unfettered marketplace to overly burdensome regulation controlled by those on the inside, and now to irresponsible deregulation absent even the modicum of competition-maintaining and fairness-assuring measures we apply generally.

The question before the house is not that we have erred; can there be any doubt of that? It is rather how much of a price we shall have to pay before we begin to think.

FOOTNOTES

1. The market economist religion is actually built upon a traditional theism. There is an all-permeating god: the market. It is defined as whatever is after the removal of state "intrusion." If that market is left "alone" to function, all things will emerge as they should in the long run. Voltaire's Pangloss has the same view in the classic essay *Candide*: All is as it should be no matter what happens because god controls all and all is according to his plan; whatever happens is predestined to be for the best. There is precious little difference between the faith creating the "optimism" skewered so devastatingly by Voltaire centuries ago, and the faith of Nobel prize-winning market economists in the unfettered majesty of their god.

2. Insurance Code section 1861.05 (added by Proposition 103, section 3). Note that the prior approval review of insurance rates is triggered by a proposed rate adjustment of 7% for personal lines of insurance or 15% for commercial lines. However, the Commissioner has the authority to entertain objections by others to rate increases which do not meet this test, or to *sua sponte* examine a rate on his or her own. Ideally, the Commissioner would develop a test by rulemaking keyed to the degree of competition extant in a subline of insurance where a rate change is sought.

3. Five examples of regulations delayed by this undifferentiated moratorium—allegedly excluding "health and safety" rules—are those which would: require infant formula manufacturers to report consumer complaints and results of tests for microbiological contaminants; tighten rules for preventing industrial accidents involving toxic chemicals; prohibit sale of child safety seats that are dangerous when adjusted in certain seat positions; prevent hospitals from using inability to pay as a reason for denying treatment to emergency patients or women in labor; and require warning labels on certain toys, balloons, marbles, and other children's playthings with small parts.