REGULATORY REFORM

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# A MORE OPTIMISTIC VIEW

*The interactions of exchange, ideas, and individuals can lead to further deregulation.*

BY DAVID R. HENDERSON

*"If the whole world were to be covered with asphalt, one day a crack would appear in that asphalt; and in that crack, grass would grow."*
—Ilya Ehrenburg

Peter Van Doren and Thomas Firey lay out well the facts about the substantial reduction in regulation from the late 1970s to the early 1980s and somewhat beyond. They also express some pessimism about the prospects for future deregulation. All of their arguments hold water. But the prospects for further liberalization aren't as grim as they suggest. They underestimate the powerful interactions between gains from exchange, ideas, and individuals who seek change, which can open the way to more economic freedom.

My thesis is as follows: Gains from exchange contain the seeds of their own expansion. When economists and other intellectuals provide evidence that deregulation increases gains from exchange, either these intellectuals, bureaucrats, or others often draw on this evidence to seek deregulation. They don't always succeed, but they do sometimes, and one success can lead to others.

Van Doren and Firey's story about one of the biggest successes—the deregulation of airlines—illustrates the important role of individuals and ideas. Nothing inherent dictated that Stephen Breyer would latch onto airline deregulation as the cause that he urged Ted Kennedy to pursue. Nothing inherent dictated that two bureaucrats and an appointee at the Civil Aeronautics Board (CAB) would become energized and push internally for deregulation. Yet had they and Breyer not done so, it might not have happened. There are similar stories about other successful deregulations both in the United States and other countries.

In each case, it was not obvious that the political forces were

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arrayed in favor of market liberalization; they often favored the status quo. But in each case, specific people grabbed the issue and ran with it. Also, in some of the cases, those who pushed for deregulation could draw on economists' studies that showed regulation's harmful effects. That's why the work of *Regulation*, the Cato Institute, and other think tanks is so important. Occasionally activists and even bureaucrats will grab our ideas off the shelf and run with them.

In what follows, I show the important role of exchange, ideas, and individuals who ran with these ideas in creating some of the most successful deregulation outcomes we have had.

## AIRLINE DEREGULATION

I remember sitting on a Hughes Air West flight from Los Angeles to Palm Springs in 1974. The young couple beside me was scrutinizing a map because they had thought, correctly, that Los Angeles was much closer to Las Vegas than to San Francisco, and yet the fare to Las Vegas was much higher. I explained to them that because L.A. and San Francisco are both in California, that route was not subject to federal regulation. Therefore, a solely intrastate airline, Pacific Southwest Airline (PSA), had arisen to take advantage of this loophole in the law. PSA was outside the airline cartel that the CAB was enforcing, and PSA competed with the larger carriers by cutting fares. The federally regulated carriers responded by lowering their fares to compete with PSA.

Over the years, many people noticed the California anomaly and a similar one in Texas. Southwest Airlines was then just a regional carrier with services between Dallas, Houston, and San Antonio. Southwest, similarly, charged much lower fares than were charged on comparable city pairs that crossed state lines. Passengers in California and Texas noticed their gains from such low fares and those revelations likely generated some of the public support for airline deregulation.

But deregulation would probably not have gotten nearly as far were it not for the support of intellectuals—some lawyers, but mainly economists—who systematically studied the effects of airline regulation. In his 1964 presidential address to the American Economics Association, George Stigler pointed out that from the founding of economics as a discipline in the 18th century until the early 1960s, almost all economists—although willing to advocate or oppose regulation—avoided studying its effects. As only Stigler could put it: "The economic role of the state has managed to hold the attention of scholars for over two centuries without arousing their curiosity.... Economists have refused to leave the problem alone or to work on it." But there were a few exceptions in the profession. And one of the areas in which many of these exceptions worked was airline regulation.

Three early exceptions were Lucile Keyes, Richard Caves, and Stigler's student Sam Peltzman. As early as 1949, Keyes had seen through the public-interest rationale for airline regulation, pointing out that the CAB's actions protected airlines from competition. In 1962, Caves, a Harvard economist, wrote a scholarly, evidence-filled tome in which he argued the CAB was suppressing competition. Such a restriction on freedom to compete was difficult to reconcile with the public interest. In 1963, Peltzman, a graduate economics student at the University of Chicago and later an economics professor there, wrote a piece in the *New Individualist Review* that presented a concise, carefully reasoned, empirical case against federal regulation of air fares and entry into the airline industry. While we take for granted today that economists will actually study the effects of government regulation, Keyes, Caves, and Peltzman were pioneers in that research.

Another early exception was a lawyer named Michael Levine, who had also been trained in economics. In 1965, Levine wrote a study in the *Yale Law Journal* pointing out how well the air passenger market worked—and how low air fares were—in the unregulated California market.

With some customers informed about the high price they were paying for airline regulation, and with a core of economists and lawyers writing about the high cost of regulation, the stage was set for deregulation. In their book, *The Politics of Deregulation*, political scientists Martha Derthick and Paul Quirk tell the fascinating story of how airlines (as well as trucking and telecommunications) were deregulated in the late 1970s. The important punch line is that John Maynard Keynes was approximately right when he wrote that what matters in the long run is not special interests but the ideas of academic scribblers. The early critics of regulation had such a large effect on the thinking of the economics profession, and of other academics who paid attention to regulation, that one deregulation advocate, Roger Noll, testified to Senator Kennedy's subcommittee:

> The nice thing about being a student of industrial organization and regulation is that … you never have to run the risk of being dead wrong [in] saying regulation has been foolish in a particular sector. I know of no major industrial scholarly work by an economist or political scientist or lawyer in the past 10 years that reaches the conclusion that a particular industry would operate less efficiently and less equitably [without] than with regulation.

Because of the scholarly work critical of regulation and because of the publicity much of this work was given, the view that economic freedom in the airline industry was good and regulation was bad became widespread among not only academics but also policymakers in the Gerald Ford and Jimmy Carter White Houses, in Congress, and even among some regulators. A number of lawyers and economists joined the cause, with Carter-appointed CAB chairman Alfred Kahn being the most prominent, working both on Capitol Hill and in the regulatory agencies to achieve more economic freedom in the industry.

Interestingly, although Kahn is now rightly considered the father of airline deregulation, even he had many doubts about the wisdom of deregulating quickly. Still, he felt compelled by the prevailing intellectual climate to do so. In a Jan. 24, 1978 memo, Kahn wrote to one of his agency's directors, Roy Pulsifer, who had once been a strong advocate of regulation:

> I do not myself know to what extent I declare a commitment to gradualism insincerely, merely to reassure Congress and the industry that I am not a madman, and that I am solicitous of the financial fortunes of the industry, and anxious not to impair them. I am sure I do so also because I don't believe in any economic prediction with more than, say, 65% conviction. Undoubtedly an additional reason is my lack of opportunity to have absorbed the work of others who have studied this industry. (Italics in original.)

Parenthetically, Pulsifer's story, told by Derthick and Quirk, is also interesting. He was an assistant director of the CAB's Bureau of Operating Rights. He had become persuaded by the economics literature of the promise of deregulation and pushed internally for it. Derthick and Quirk write, "When we interviewed him in his office in the CAB in 1980, he had become a radical libertarian, with a picture of the famous free-market economist, Milton Friedman, displayed on his desk."

A member of the CAB staff, lawyer J. Michael Roach, came to believe in deregulation through what he called a "Paul-on-the-road-to-Damascus" experience that he recounted to Derthick and Quirk. In 1969, he had been tasked to write the board's decision in a route case. He was given the name of the winning airline and no other information, so he crafted the board's "reason" for its decision. Afterward, the board did not change a word of what he wrote. This convinced him that the CAB's rationales for route awards were not the real reasons, but just made-up justifications for decisions reached on other grounds.

Interestingly, the airline deregulation story illustrates that the public choice view of regulatory agencies being captured by the industry they regulate, though applicable, is not the last word. It was precisely staffers and commissioners in the CAB who pushed for deregulation.

Ironically, one of the main economists who believed that regulatory agencies are captured by the regulated was Stigler. Why is this ironic? Because he, more than any other single economist, was responsible for the economics profession's shift to using empirical data to study the actual effects of regulation. These studies helped convince some of the regulators and thus helped pave the way for deregulation.

## URUGUAYAN FINANCIAL DEREGULATION

Consider another example of gains from exchange, along with ideas and a particular individual, leading to deregulation. The setting was Uruguay in the 1970s, where a particular policymaker was at the right time and place. President Juan María Bordaberry authorized finance minister Alejandro Vegh Villegas to liberalize trade and currency exchange. In a 1983 *American Economic Review* article, University of California, Los Angeles economist Arnold Harberger explains:

> Vegh's most telling blow for deregulation and liberalization consisted in allowing Uruguayans complete freedom to undertake unlimited transactions in foreign currency, without any need for permission or even personal identification.

To implement such a policy required getting rid of whatever regulations might obstruct it. One obvious obstruction was all direct regulations controlling foreign exchange. But that's not all. The Uruguayan government had imposed ceilings on interest rates that, combined with Uruguay's high inflation, caused Uruguayan savers to earn a negative real interest rate on their savings. Once the foreign exchange controls were gone, Uruguayans had free access to the burgeoning and unregulated Eurodollar market. Who would lend domestically at artificially low interest rates when there were much larger gains from exchange available in international markets? Therefore, interest rate ceilings were dead. As Harberger writes:

> It was as if, by pulling out a single critical card, Vegh brought down a whole house of cards that had been built up over years of accumulating regulations. One story goes that Jose Gil Diaz, who was then Undersecretary of Finance and later became Central Bank president, came to Vegh with two armfuls of papers, saying these were the more than 500 Central Bank circulars and regulations that had been rendered null and void under the new policies!

## THE CASE OF UBER

The emergence of Uber, the ride-sharing service, in the last eight years is an interesting illustration of the power of gains from exchange to cause deregulation or, at least, prevent new regulation.

One of the most durable regulation-backed monopolies of the 20th century was the taxicab monopoly. In city after city, local governments granted monopoly rights to cab companies and limited the number of permits, often in the form of "taxi medallions," that a cab operator needed to operate legally. This led to high fares and, often, sporadic service.

A good measure of the monopoly rents created by the taxicab monopoly is the price of a medallion. In New York City before Uber and Lyft came along, medallions sold for as much as $1 million. At an interest rate of 5%, that's $50,000 in monopoly rents per year.

But in 2008, Travis Kalanick and Garrett Camp, frustrated by their trouble hailing a cab in Paris, mused about an information technology solution that would connect willing drivers with those wanting rides. Thus was born Uber.

One's natural reaction—certainly mine—is probably that their product was illegal under the taxicab laws. But they argued that because Uber would not own cars but would simply connect drivers and passengers, it was not a cab service any more than are classified ads or bulletin boards offering ride-sharing. In most parts of the United States and in many parts of the world, their argument has prevailed.

But why did Uber prevail? It wasn't just the logic of its argument. Logical arguments about what the law actually says don't always work against an angry, energized interest group such as cab drivers and permit (medallion) owners. What Uber had going for it, besides its argument, was a less-concentrated, yet still energized interest group on its side: Uber users and—to some extent—drivers. The users and drivers had a benefit from Uber that further regulation, or an uncharitable interpretation of existing regulation, would keep them from getting. They saw gains from exchange and insisted on keeping them.

The stories of airline deregulation, financial deregulation, and Uber are anecdotes. Economists tend to look down their noses at anecdotes and instead respect "hard data"—that is, large aggregates of numbers—as the only and most important evidence. But surely an anecdote about a huge change in an important sector of an economy bears more weight than an anecdote about how, say, your Uncle Fred responded to price controls.

## BIG DEREGULATION IN INDIA AND THE SOVIET UNION

Belief in the value of economic freedom spreads in two ways. One is by those who initially didn't believe in freedom seeing evidence of its value that is so striking that they change their minds. The other is that they are persuaded on a more abstract level by those who believe in freedom. Both are important.

And both are what happened in large parts of the world to influential people in the last 30 to 40 years. Many stories I could tell would end up repeating large parts of a tremendous book by Daniel Yergin and Joseph Stanislaw, *The Commanding Heights*. The subtitle carries much of the book's message: "The Battle between Government and the Marketplace that Is Remaking the Modern World." Still, I do want to discuss some of the highlights from that book. They make the case for the spread of the belief in freedom among influential people.

Consider Manmohan Singh, an Indian socialist who had served as secretary of the South Commission, a commission peopled by believers in state intervention. Singh earned his undergraduate economics degree at Cambridge and his doctorate at Oxford, and made his living as a central planner. In 1987, he took a little trip to East Asia, which launched him on an ever-bigger intellectual journey. Departing for South Korea, he knew that as recently as 1960 India's per-capita income rivaled South Korea's. But in just one generation, South Korea's per-capita income had reached 10 times that of India.

Singh noted two main factors behind this difference. First, whereas East Asian governments supported business (an aside: they would have done even better if they had been impartial, as many of them learned in the 1998 East Asian crisis), India's government heavily regulated them. Second, the East Asian governments had captured the benefits of trade, both on the import and export side, in contrast to India's almost sealing off the border to trade. Clearly, this is an example of a person who was convinced by seeing the results of (relative) freedom.

Singh went on to become finance minister under Prime Minister Narasimha Rao and, together with commerce minister Palanniapan Chidambaram, began to open the Indian economy to trade and foreign investment. They also dismantled the "Permit Raj," India's system of heavy regulation. Within weeks, Rao's government cut subsidies for domestic products and exports, reduced tariffs and trade barriers, eliminated licenses for 80% of industry, and eliminated the requirement that large firms get permission to expand or diversify. Invoking Mahatma Gandhi's vision of self-reliance, Singh stated, "Self-reliance means trade and not aid."

Another convert to economic freedom was Russian economist Yegor Gaidar. Gaidar, grandson of Arkady Gaidar, one of the heroes of the Communist Revolution, lived in Havana during the first years of communism there. One of his family's frequent house guests was Che Guevara. But when his family moved to Belgrade, he noticed that the Yugoslav economy was somewhat more open than Russia's, and that Yugoslavians benefited as a result. He started to think that "market socialism" was a better policy than state socialism. That led him to explore other ideas. He went on to read the works of Janos Kornai, the Hungarian economist who demonstrated the destructiveness not only of central planning, but also of "market socialism." Gaidar was persuaded. Asked later in life which Western writers most influenced him, he replied, "Of course, [Friedrich] Hayek."

In November 1991, Gaidar was made deputy prime minister of the Soviet Union and minister for finance and the economy. He and his team proceeded to end many price controls, liberalize trade, cut military procurement, and slash subsidies. It wasn't enough, of course, as much of industry still remained in the hands of the state. But privatization followed, and without Gaidar's relatively free-market proposals, the expansion of freedom in the Soviet Union and—after that country dissolved on the day after Christmas, 1991—Russia would likely not have happened as fast.

Before going on, let's stop and note an empirical regularity: people who see the horrible, inhumane consequences of oppression are often led, by that fact alone, to question whether there's a better way. Once they ask the question, the odds that they will conclude that there is a better way are better than zero. This helps illustrate the point made in this article's opening quote by the Soviet-era author Ilya Ehrenburg: oppression carries with it a basic instability.

## POSTWAR DEREGULATION IN WEST GERMANY

Before June 20, 1948, the whole postwar German economy was suffering from the huge cost of the previous war as well as from the detailed price controls that Hitler had imposed and that the Allied occupation authority continued to enforce. Because the controlled prices were so far below what would have been the free-market prices, virtually every good was in short supply and people resorted to barter as a way of feeding their families. It is estimated that one-third to one-half of business-to-business exchanges in the zones occupied by the British and Americans were also in the form of barter.

But on June 20, 1948, all that changed. On that day, Gen. Lucius Clay, the military governor of the U.S. zone, instituted a currency reform in which a small number of new Deutsche marks were substituted for a larger number of Reichs marks, with the result that the money stock contracted by 93%. Clay's chief economic adviser was Ludwig Erhard, a pro-freedom German economist. Erhard, understanding the importance of free-market prices, lobbied for authority to get rid of price controls. Rather than repeal them gradually, he did it almost overnight and the shops started filling with goods immediately. In fact, it was no coincidence that the Soviet blockade of Berlin started on June 24 of that year, just four days later. The Soviets saw quite clearly that the freed economy was recovering quickly and they did their best to hobble the one part they could: Berlin. Also, the occupying authority cut marginal income tax rates for the median German from 85% to 18%.

The effect on the German economy was electric. In just six months, industrial production grew by over 50% and continued to grow in leaps and bounds. By 1958, industrial production per capita was over three times as high as its level in the first six months of 1948.

Now consider the important role of two individuals in West Germany: Erhard and Konrad Adenauer. What would have happened had Erhard not been the adviser to Clay? Clay may well have listened instead to the Social Democratic Party's main economic spokesman, Lothar Kreyssig. In June 1948, Kreyssig, arguing that decontrol of prices and currency reform would be ineffective, advocated central government direction. In this view, he was joined by labor union leaders, the British authorities fresh from their own experience with detailed economic controls, most German manufacturers who had gotten comfortable with Hitler's regulations, and some of the American authorities. Had Clay not listened to Erhard, the expansion of West German economic freedom might never have happened.

How did Erhard emerge as an important player? Before and during the war, he had refused to join the Nazi Party and was, therefore, kept out of academia. In 1944, at the height of the war, he created his own think tank, financed by German industrialists, to plan a free-market direction for Germany after the war on the assumption that Germany would lose. His courage and independence brought him to the attention of the occupying authorities, who were desperately seeking Germans unsympathetic to Nazism. Now imagine that he had succumbed and gone along, even if grudgingly, with Nazism. He might not have come to Clay's attention, and even if he had, he might not have had the clarity that his independent thinking gave him.

Moreover, Erhard required political cover: support from a person esteemed by Germans and yet respected by the occupying authority. Such a person was Adenauer. He was removed as mayor of Cologne in 1933 because he refused to fly Nazi flags over the city hall when Hitler visited, and he was later imprisoned for part of the war as an opponent of the Nazi regime. After the war, he became chancellor of Germany and was one of Erhard's key political supporters. Had Adenauer not taken such a courageous stand during the 1930s, his political stature would not have been as great and he might not have been chancellor, which means that Erhard might not have been able to continue keeping the German economy relatively free of regulation. Just like Jimmy Stewart's George Bailey in *It's a Wonderful Life*, these two men did make a positive difference in their community.

## INDIVIDUALS AND IDEAS MATTER

One common interpretation of history is that whatever happens is inevitable; that because great historical forces are at work, particular ideas and individuals do not matter for the outcome. This Marxist-like view is one that, interestingly, Stigler embraced. In fact, his statement of this viewpoint was the main part of his 1978 presidential address to the Mont Pelerin Society in Hong Kong.

Stigler argued that Society members who thought their ideas could change the world were mistaken because, he asserted, policymakers were already making judgments rationally and in their own self-interest. So, for example, there was no point in explaining to politicians that their tariffs on steel hurt consumers more than they helped the domestic steel industry. The policymakers already knew that and wanted to help producers at the expense of consumers. Therefore, there was nothing important that a believer in freedom could tell a politician.

After his speech, I asked him if one could summarize his message with the statement that you can't tell people they are making mistakes because they already know everything they need to know. He said yes. Then why, I asked, did he bother giving the speech? Wasn't his goal to persuade the potential activists at the Mont Pelerin Society of something they didn't already believe?

What Stigler overlooked is that politicians, like the rest of us, have imperfect information. That he failed to note the import of this simple fact is shocking given his important role in getting economists to start thinking seriously about the economics of information. It's also shocking given his role in systematizing the economic analysis of regulation.

Politicians, like everyone else, have imperfect information about the world and, specifically, about the effects of various government policies. That's just a simple fact. Further, the kind of information they receive about the effects of government policies will be systematically biased in a particular direction.

As Stigler and others before him (Anthony Downs and Gordon Tullock, to name two) had pointed out, government policies will tend to impose small per-capita costs on a large number of people in order to generate large per-capita benefits for a much smaller number of people. The beneficiaries from government policy, because they each benefit so much, will have a *loud* voice in emphasizing the benefits of the policies they favor. The losers from government policy, because each of them loses only a little, will have a very quiet voice in emphasizing the losses from government policy. So, for example, when the issue of import quotas on sugar is debated in the Senate and House of Representatives, the advocates of sugar quotas—who each gain thousands (and in a few cases, millions) of dollars annually from the quotas—will be very active in the debate, pointing out to wavering congressmen the gains in jobs created in the domestic sugar industry. The few hundred million consumers of sugar, though, each of whom loses between $10 and $50 a year, will not even be informed about the debate. A politician who simply pays attention to what he hears, therefore, will tend to favor restricting imports, even though it can be shown that the cost to consumers exceeds the gains to domestic producers.

In his book, *The Culture of Spending*, James L. Payne reports that of a total of 1,060 people who testified before 14 House and Senate committees in selected years in the mid-1980s, 1,014 of them, or 95.7%, were in favor of the government programs. There were only seven opponents, or 0.7% of the overall number of witnesses. In other words, proponents outnumbered opponents 145 to 1. It was this finding that led Payne to refer to congressional hearings as "rump hearings"—that is, hearings with only one faction attending.

Because politicians hear mainly from the beneficiaries of government policies, many of them can easily believe that most government policies produce net gains for society. You need to live in Washington or Ottawa or any capital city for only a short time to see how insulated politicians usually are from information about the negative consequences of their policies. Adding to that insulation is the fact that one important group of beneficiaries is the government bureaucracy. Payne found that of the 1,060 congressional witnesses mentioned above, 673 were government officials (497 of them being federal administrators), including 65 members of Congress. In other words, 63.5% of those testifying were government officials.

The combination of imperfect and biased information causes many politicians not to know—and possibly not even to suspect—that their policies cause widespread harm. Thus, what looks like a stable political equilibrium may in fact be an unstable equilibrium that could change with enough politicians acting on good information. Indeed, there are probably knife-edge equilibria that could be upset if just a few influential politicians change their ideas.

An observer and participant who knows far more than I of efforts to implement economic freedom in Latin America is UCLA's Harberger, whom I cited above. He was one of the main economics professors at the University of Chicago who taught the "Chicago boys," the economists from Chile and other Latin American countries who returned home in the 1970s and 1980s and implemented various pro-freedom reforms. Harberger agrees that individuals matter. He referred to

> my long-standing conviction that successful economic policy in developing countries is very far from being the product of pure forces of history—something that happens when it happens because its time has come. Far from it, in every case about which I have close knowledge, the policy would in all probability have failed (or never got started) but for the efforts of a key group of individuals, and within that group, one or two outstanding leaders.

So take heart, readers of *Regulation*. Gains from exchange will always be with us and people will always want more of them. Ideas, which *Regulation*, the Cato Institute, the Hoover Institution, and so many other free market groups are so good at creating and publicizing, matter. And there will always be some creative and entrepreneurial activists who draw on these ideas to help deregulate further. R

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