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1. memo	Edward Schmults to James Baker re industrial policy and the 1984 campaign, 2p	9/13/83	~~B6~~ 2/17/12 FDB

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MEMORANDUM FOR JAMES A. BAKER, III

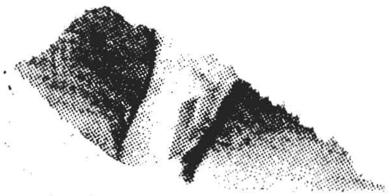
FROM: JAMES CICCONI

SUBJ: "Industrial Policy"

The concept of a national "industrial policy" is drawing increased attention w/in the Democratic Party, in part due to exposure ~~to~~ given it by neo-liberal theorists seeking to redefine the Party's intellectual base. ~~Reich's new~~ The publicity given to Reich's recent book is indicative of this.

The term itself is used rather loosely, but in its broadest sense ~~is~~ "industrial policy" resembles a social contract between industry, labor and government; its goal is to revitalize American industry ~~(including the blue collar industries), though (according to some), this would include blue collar industries~~ while progressing toward full employment. If there is force in this as a political issue (and the Democrats seem to sense there is, though the jury is still out), it is in "industrial policy" as a concept, as a framework for cooperation and thus progress. ~~This may~~ It may not be possible to flesh out

...or to El ... uuring ... ter Administration, is professo... of international relations at Simmons College.



Before Industrial Policy

By Robert Z. Lawrence

WASHINGTON — Do we need an industrial policy to restore the competitiveness of United States manufacturers in world markets? Looking at our economic performance in the last two years, we might be tempted to say yes. But before taking the irreversible step of conferring enormous benefits on big business and labor, we should be sure that we are not confusing transitory economic troubles with long-term trends.

Since 1980, our economic performance has created much cause for concern. Manufacturing employment has dropped by 1.5 million jobs, largely because of foreign producers' inroads in the domestic market. Jobs related to manufactured exports accounted for a third of that loss. A major portion of the decline occurred in the auto industry, which has the political and economic clout to call attention to its difficulties.

But this poor economic performance developed simultaneously with an unprecedented rise in the value of the dollar to 25 to 30 percent above its 1980 value, as measured against other currencies. This is the same as imposing an excise tax of 25 to 30 percent on all of our exports.

An overvalued currency usually takes 18 to 24 months to take its toll on exports, since most trading companies work with long-term contracts. Thus, it was not until the middle of 1981 that the damage to our exports became visible. Unless the dollar declines soon, America's manufactured exports could drop by 1985 to barely half of what they were in 1980. And the calls for industrial policy would undoubtedly rise in urgency.

A more heartening picture of United States competitiveness emerges from a look at the preceding decade. In the 1970's, United States companies — aided only by a few small declines in the dollar's value — contended with the same forces that have been blamed for recent declines in the manufacturing base: surging competition from Japan and the developing countries, and growing government intervention and protection in Europe. Nevertheless, between the first oil-price shock, in 1973, and 1980, employment grew modestly in American manufacturing, even though it declined in every other major industrial economy. Without the jobs created by trade between 1973 and 1980, American industrial employment would have declined.

Moreover, the manufacturing jobs created by trade directly in export industries and indirectly in suppliers to those industries outnumbered those jobs lost to foreign competition by 280,000. The job gains related to trade were diffuse. Of the 52 sectors that make up the manufacturing base, only 11 suffered job losses from trade. Leather and footwear was the only sector in which employment fell more than 5 percent because of trade.

The evidence notwithstanding, many people still blame foreign competition for many of our economic ills. One reason is that imports are highly visible while exports are not: We see the Toyotas crowding our highways, but not the American computers that equip foreign offices.

It is also easy to exaggerate the destructiveness of trade by confusing its effects with structural changes in the domestic market. High-technology manufacturers, which have enjoyed strong domestic sales, have also posted the highest gains in net exports. Many basic industries, while posting small gains in exports, have been hit hard by slumping domestic demand. Even in the highly visible automobile industry, trade could be blamed for only 7.9 percentage points of a total decline in employment of 29.3 percent between 1973 and 1982. Lower domestic demand accounted for the rest.

The recent erosion in the United States' trade performance does not necessarily reflect inherent deficiencies in our industrial system. As econometric evidence confirms, the deterioration is the predictable result of a global recession and a strong dollar. The dollar in turn reflects the Federal Government's economic policies: tax cuts to promote growth and tight monetary policy to fight inflation.

If we want to cure our industrial ailments, we should first look at our monetary and fiscal policies. While a strong dollar has enabled us to finance record trade and budget deficits, it has sabotaged our manufacturers in foreign markets. The first step to aiding our manufacturers is to liberalize monetary growth while raising taxes and cutting Government spending.

Many of the United States' trade, regulatory and labor policies could stand improvement. But the evidence from the 1970's strongly suggests that with appropriate monetary and fiscal policies, United States companies can compete with foreign manufacturers. We need not protect and subsidize our firms for fear that they cannot.

Robert Z. Lawrence, a senior fellow at the Brookings Institution, is author of "Is Trade De-industrializing America?" a study published in this fall's Brookings Papers.

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*John B. Oakes is the fo
Editor of The New York T*

...their suspect ... ons, as distinct from ...ng a repudiation of them.

...tion. I don't doubt that many within that opposition will disown some of their own ideas seeing them in Reagan's hands, or that within a short time he will ... the three of them will likely have a lot to do with it.

Charles L. Schultze

The Wrong Cure for the Wrong Illness

Why we should forget about an industrial policy.

The latest fad in economic policy—following hard on the heels of supply-side economics—is *industrial policy*. The core of industrial policy has two elements: a diagnosis of what is wrong with the American economy and a specific remedy for its ills.

The *diagnosis* is that America is de-industrializing. A number of older heavy industries are declining, and America is no longer at the cutting edge in the newer high-growth, high-tech industries. Even in periods of prosperity, the private market channels investment and other resources to the wrong places. Older, declining firms can't get the funds and the time to rehabilitate themselves. Promising new firms can neither get the venture capital nor afford the extensive R&D needed to compete effectively in world markets. As a consequence, workers laid off in the older industries have a hard time finding jobs, and when they do, it is likely to be in the low-pay, low-skill service industries. We are in danger of becoming a nation of hamburger joints, motels, and boutique shops.

The *remedy* is federal government intervention to create an industrial structure different from what market forces would generate on their own. The government would provide trade protection, low-cost loans and other aids to older and "essential" declining industries in an effort to rehabilitate them (protecting the losers), and would promote through various forms of assistance, newer firms and industries with high growth potential (picking the winners). An industrial development board would be created to accomplish this objective, directed—or at least advised—by a tripartite body representing business, labor and the public.

In fact, there is no evidence that America is de-industrializing. The period since 1970 has been a difficult time for the economies of all advanced countries. But during the decade of the 1970s, before the recent recession began, American manufacturing performed quite well by almost all standards compared with the manufacturing sectors of most other countries. The United States was one of only three advanced industrial countries (Italy and Canada being the others) in which manufacturing employment increased during the decade. In Germany, a country often cited as an example of industrial success, manufacturing employment fell substantially. U.S. manufacturing output rose at a slower rate than in Japan but faster than in Germany and more rapidly than the European average. Exports of American manufactured goods doubled—again less than the rise in Japanese exports but more than the increase in Europe.

U.S. manufacturing output did suffer very heavily, relative to the rest of the economy, in the recent recession. From 1981 through the fourth quarter of 1982, GNP fell by 2.2 percent while manufacturing output dropped 10.6 percent. But manufacturing output always rises and falls more than GNP during business cycles. Following that pattern, manufacturing production rebounded at a 17 percent annual rate during the first three-quarters of this year while GNP was rising at a 6 percent rate.

Moreover, very high interest rates in the United States during the last several years led to an overvaluation of the American dollar abroad, penalized our exports and encouraged imports, a development that had a particularly depressing effect on manufacturing industry. But the overvaluation of the dollar was obviously not caused by structural problems in American industry; it was principally driven by bad macroeconomic policies—a combination of extremely tight money and huge budget deficits.

Even if industrial policy were addressed to a real, rather than an imaginary problem, our political practices would not permit an effective policy of that kind to be carried out. There are many important tasks—far more than Ronald Reagan imagines—that only governments can do. But the one thing that the American political system cannot do well at all is to choose among particular firms, industries and regions, coldbloodedly determining, on grounds of economic efficiency, which shall prosper and which shall wither. The government often adopts policies that have the indirect consequence of harming various groups. But the American political system's equivalent of the Hippocratic Oath is, "Never be seen to do direct harm."

The formal and informal institutions of our political structure are designed to require the government to get consensus among those affected by its policies and as much as possible to eschew invidious choices among specific firms and individuals, penalizing some and rewarding others. Thus we have an Economic Development Administration, created to help depressed areas, whose eligibility criteria are broad enough to encompass over 80 percent of the counties in the United States.

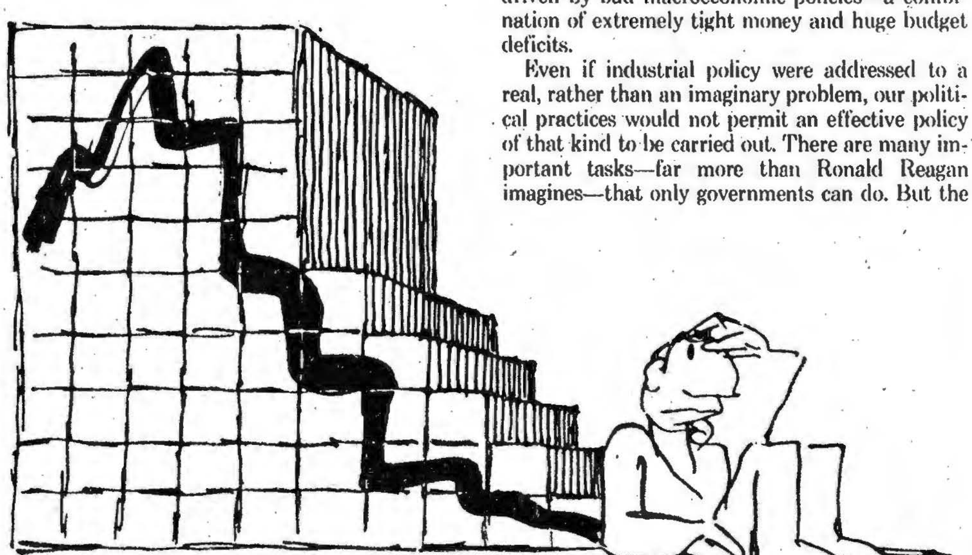
To be anything more than a political pork barrel, the systematic provision of assistance to declining industries would have to call for some very hardheaded choices among particular firms, cities and groups of workers—that the Youngstown plant can live but the one at Weirton must close; or that the cotton and synthetic textile industries have a reasonable chance to rehabilitate themselves but the wool textile and shoe industries are hopeless cases and must shrink; or that competitive status in world markets requires American steel and auto workers to give up the large increases in wage and fringe premiums, relative to the all-manufacturing average, which they built up over the past 15 years.

Can anyone seriously imagine a new industrial development bank being left alone to make such decisions—even if it knew how?

Most likely, under an American industrial policy some assistance would be made available, under relatively loose criteria, to all industries in trouble; those with the loudest squeak might get a little extra grease; and the "losers" would back subsidies for the "winners" in return for the latter's support on issues of trade protection.

The American economy is indeed suffering from a misguided mix of macroeconomic policies. It would undoubtedly benefit from a combination of lower federal budget deficits and easier money. But what it doesn't suffer from is "de-industrialization," and what it doesn't need is a new government agency charged with protecting the losers and picking the winners.

The writer, who was chairman of the Council of Economic Advisers in the Carter administration, is a senior fellow at the Brookings Institution.



By Ohlsson

THE WHITE HOUSE
WASHINGTON

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Julian Martinez
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Cip Guerra
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call Herndon
~~call Shirley re SW Bdr Cp~~
~~(Tower)~~
~~call Will Ball re judgeship~~

Coleman → EM

JAMES W. CICCONI
Office of James A. Baker, III
456-2174

U.S. Department of Justice
Office of the Deputy Attorney General

The Deputy Attorney General
Washington, D.C. 20530

PERSONAL & [redacted]

September 13, 1983

MEMORANDUM

TO : James A. Baker, III
Chief of Staff and
Assistant to the President

FROM : Edward C. Schmults
Deputy Attorney General

SUBJECT: Industrial Policy and the 1984 Campaign

It is now clear that the Democratic Party intends to promote a national "industrial policy" as one of the major themes of the 1984 Presidential Campaign. Already, Walter Mondale, Gary Hart, Fritz Hollings, and other Democratic politicians have identified industrial policy as an alternative to this Administration's economic program. In my view, it is also clear that we should examine "industrial policy" in a systematic fashion in order to develop a well-thought-out, coordinated Republican response in the upcoming election year.

It might appear tempting to dismiss industrial policy as simply a warmed-over version of traditional Democratic calls for increased government spending and intervention, and to adopt a rigid stance of total opposition to any industrial policy. This, I believe, would be a mistake. Democratic politicians undoubtedly would counter (indeed, they already have) that at present we have a national industrial policy, consisting of the existing array of antitrust, tax, labor, and other laws that influence kinds and types of economic activity.

Thus, the question is not whether to have a national industrial policy, but rather what kind of industrial policy we should have. The Democrats will charge that the Administration's failure to think through the overall implications of existing economic programs will doom our efforts to maintain long term economic growth and to succeed in the international competitive arena. Furthermore, the Democrats will assert that they have developed a concerted strategy to reemploy workers in the smoke-stack industries, promote innovation, and meet foreign competition. Lastly, a rigid stance on our part will position us wisely as being against planning but not "for" anything.

Fortunately, we <u>can</u> make a credible case that the Administration is indeed developing a coherent national industrial policy -- a policy that is superior to the Democratic alternatives. The Administration's policy features sound economic and tax policies, as well as the strengthening of intellectual property rights, antitrust reforms aimed at protecting process patents and promoting research and development, and other measures to achieve innovation and economic growth while minimizing unwarranted interference in private sector decision-making. On the other hand, Democratic versions of industrial policy would involve costly handouts and interventions in private industry decisions that can be shown to have been counterproductive when attempted in other leading countries, such as Japan.

In sum, rather than being a nay-sayer by rejecting industrial policy out-of-hand, we would be far better advised to seize the initiative and turn this debate to our advantage. The elements of the President's policy are in place but we must work on how to package them in a form the public will understand. We should have some good "zingers" ready, such as "we don't need a return to Washington of the same planners who wanted to break up GM a few years ago -- how wrong they were -- now we are struggling to keep our automobile companies afloat and competitive."

Clearly, a great deal of work is required if we are to package a Republican market-oriented version of industrial policy, and to successfully explain the flaws inherent in Democratic proposals. To this end, I suggest that a senior-level working group be formed to develop an Administration position on industrial policy issues. The working group could draw on expertise within the Administration in different areas of economic policy. The working group should be formed as soon as possible.

P.S. Attached is the very interesting <u>New York Times</u> piece that I mentioned on the telephone. Obviously, our policies should continue to build upon America's strengths.

E.C.S.

Attachment

Economic Scene | Roger M. Kubarych

U.S. Gains In Technology

TALK has it that the United States is losing ground in the race to develop the fast-growth, high-technology industries critical to economic success. But the evidence mustered by economists tends to support the opposite thesis: That we have a longstanding comparative advantage in what ought to be called "high-creativity" industries.

These are industries like medical diagnostic equipment, satellite communications, computer-aided industrial design, fiber optics, lasers and biotechnology that marry computers with something else. And they include computer hardware and software producers themselves.

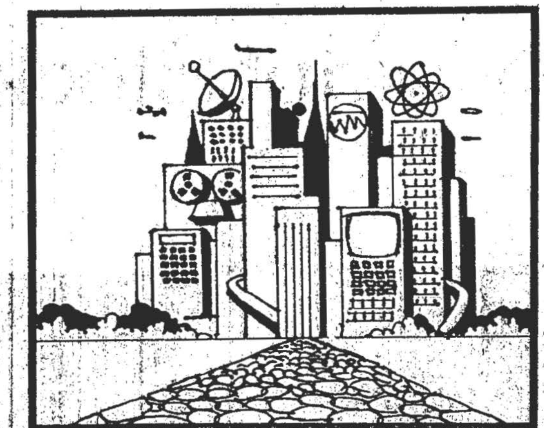
• • •

United States trade figures, for example, show a large and generally growing surplus in manufactured products that are research-and-development intensive, and a deficit on the rest.

Or look across countries, as Robert Lawrence, an economist at the Brookings Institution, has done, at employment expansion in high-growth relative to low-growth manufacturing. The share of jobs in high-growth industry rose 8.9 percentage points in the United States, compared with 6.8 percentage points in Japan and only 4.9 in Germany between 1973 and 1979 (the latest data available).

Other indicators: We earn from abroad nine times what we pay for royalties and fees, and have more scientists and engineers per capita devoted

Roger M. Kubarych is senior vice president and deputy director of research at the Federal Reserve Bank of New York. Leonard Silk is on special assignment.



Redinger

to research and development than other countries.

This advantage stems mainly from economic roots, and two special strengths stand out:

First, to be successful in tomorrow's industries you have to be good at managing creative professionals. We are. It means you need player-managers to direct creative units. They are people capable of giving substantive guidance, not just formal, control-oriented oversight. You see it in sports, the movies and the arts: Bill Russell with the Celtics, Sylvester Stallone and Rocky, and Bernstein conducting Bernstein.

Second, you need expert *translators*, people who can span the gap between the scientists, engineers and designers creating new products and the outside world.

Why should we be better than most countries in managing creative professionals? Here are a few observations:

¶We like small businesses and respect people who run them. Even very large, ostensibly hierarchical, high-creativity companies seek to stimulate a small-business attitude in new product units.

¶We expect creative professionals to have fun, so enlightened managements set up buffers to protect creative people from dull bureaucrats who dislike change.

¶We are team players. And creative professionals generally work best as a part of teams.

¶Venture capital is there for bright ideas. Abroad, venture capital is skimpy. Evidence: In 1982, 130 American venture capital companies had $2.6 billion of investments. Such investments came to less than $300 million in Britain and Japan together, according to recent estimates.

¶We are a magnet for creative professionals from other countries, frustrated by outdated management styles.

But well-managed professionals are not enough. That's why good translators are needed.

• • •

To begin with, they organize people to educate potential customers, often businessmen who may lack sufficient technical training to be informed buyers of high-creativity products and services.

Also, translators are the go-betweens with the investment community, since without adequate financing creative shops break up. Finally, they communicate with government and regulators.

But even those who grant that our comparative advantage is real are worried about two questions:

First, If other countries achieve some technological breakthroughs can we lose it quickly? Answer: Relax, copy and adapt. To be first is not necessary to be most profitable.

The second question is, how does this high-creativity advantage help in the slow-growth, smokestack industries? Answer: Retire slow learners. Then get new top management that will install the high-creativity products and services that will make the processes more productive. What's really needed are good listeners to absorb what the translators are saying.

Democratic Opposition to Industrial Policy

Charles Schultze, Carter's Council of Economic Advisers Chairman and Johnson's Budget Director, this week published an article sharply criticizing "industrial policy," which has been endorsed by most Democratic Presidential candidates and for which there are a number of bills pending in Congress. Industrial policy has become a catchall phrase, but to most informed observers, it means government allocation of resources among specific industries through outlays, tax subsidies, or special protection.

Schultze's article was timely. The Senate Governmental Affairs Committee is currently marking up a trade reorganization bill. Senate Democrats are trying to attach an industrial policy amendment to the reorganization bill. In Thursday's markup, Schultze's arguments were cited as reasons for not adopting the industrial policy amendment.

Industrial policy advocates make four points, each of which is effectively rebutted by Schultze. First, the U.S. needs an industrial policy because it is "deindustrializing." Schultze argues that the U.S. is not deindustrializing. Total U.S. employment grew 24 percent in the 1970s. In contrast, the next best performer was Japan with a 9 percent increase. West German employment actually fell.

Second, other countries, especially Japan, have used industrial policy to promote vigorous growth. Schultze argues that Japan's high savings and investment and good labor-management relations have been more important than industrial policy.

Third, government is more capable of predicting industrial "winners" and "losers" than the market. Schultze argues that government does not have any special ability to outguess the market. A government panel in Washington lacks the resources to identify each opportunity in products ranging from front wheel drive autos to personal computers to health fitness centers. Washington could not possibly know if there are sufficient resources available (e.g., ideas, capital, worker skills, management abilities) for each and every opportunity there is in the market.

Fourth, the American political system is capable of choosing among industries on the basis of economic efficiency, rather than political expediency. Schultze argues that our democratic system could not direct resources toward the winners and away from the losers because: a) it is concerned more with "fairness" than with "efficiency" and b) it tends to be more responsive to special interests than to the general economic interest.

Industrial policy advocates often argue that government already allocates resources toward some industries and away from others. For example, the timber industry annually receives $455 million in special tax breaks, while the semiconductor industry gets none.

Schultze argues that it is curious logic to cite examples of how political pressures distort the industrial structure as reason for entrusting even more economic decisions to the same political system. The surest way to increase unwarranted subsidies and protectionist measures is to legitimize their existence under the rubric of industrial policy.

Office of Policy Development
September 30, 1983

Democrats Press Case for Industrial Policy

Despite the strong economic recovery and harsh criticisms of "industrial policy," many Democrats are still calling for implementing an industrial policy for the United States. A number of prominent Democratic groups have issued or will be issuing reports proposing such a policy:

- Senator Edward Kennedy chaired a Senate Democratic Policy Committee task force, which recently issued a report calling for presidential advisory committees to plan competitive strategies for targeted industries. Senator Byrd predicted that the proposal will be the foundation for Democratic legislation next session. Interestingly, the report generally avoided using the term "industrial policy."

- Democrats on the House Banking Subcommittee on Economic Stabilization recently introduced legislation to create an $8.5 billion Federal industrial bank to make loans and financial guarantees to "smokestack" and emerging industries. The bill will probably be the principal legislation on industrial policy considered in the House next session.

- Lane Kirkland, Felix Rohatyn, and Irving Shapiro head an Industrial Policy Study Group at the Center for National Policy that plans to issue a report in January.

- Bob Strauss and Gillis Long (D-LA) cochair a House Democratic Caucus group that plans to issue a report in January outlining the details of an industrial policy plan.

Despite criticisms from many sides, the proponents of industrial policy continue to press their case. Stronger economic recovery and declining unemployment may force Democrats to rely more on industrial policy since it is the only "new" economic idea they can offer.

Growing momentum for industrial policy would result in: first, greater difficulty for the Administration to resist industrial policy legislation in Congress; and second, development of the foundation of a viable economic program on which a Democratic Presidential nominee can run. Walter Mondale, in particular, has strongly endorsed industrial policy.

The public is skeptical about the ability of industrial policy to work. However, Democrats have largely managed to avoid arousing this skepticism by keeping their proposals vague. Yet they have managed to gain credit among organized labor and "smokestack" industries for proposing "innovative" ideas. So long as industrial policy proposals remain vague, the Democrats will be able to have the best of both worlds. The recent industrial policy proposals may offer an opportunity for critics to hit a solid target.

Office of Policy Development
December 2, 1983

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chased 700 hours of fresh programming from the West, including the ultracapitalist "Dallas." One hit that won't be shown: "The Winds of War." Polish officials apparently turned the mini-series down after deciding it had anti-Polish overtones.

IP? Don't Mention It

Industrial policy could be a promising campaign issue for the Democrats—if they can ever bring themselves to mention it. Last month a task force of 13 Democratic senators released a study of American business called "Jobs for the Future—a Democratic Agenda," which discusses ways to help domestic industry modernize and compete more successfully in international markets. When photocopies were first made available, the study bore a subtitle, too: "A Report on Industrial Policy." But by the time it was printed and distributed, the subtitle was gone. One important supporter of industrial policy thought the deletion a prudent move. Said Chrysler chairman Lee Iacocca, "If you use the phrase 'industrial policy' . . . you scare people to death with thoughts of central planning."

■ Although several Reagan officials have denounced industrial policy as the first step to socialism, the administration is about to take its own little stroll in the forbidden field. On Dec. 6 Commerce Secretary Malcolm Baldrige and Labor Secretary Raymond Donovan plan to announce the formation of a "steel advisory committee" to study ways of aiding that ailing industry. Made up of representatives from the government, the steelworkers' union and steel corporations, the committee will be asked to issue a report by late summer—just in time for its recommendations to be used in the presidential election campaign. "Don't ask me if this is industrial policy," says a senior administration official. "That's a banned word around here."

A Media Melee in the White House

Like almost everything else in the White House, the question of who will produce candidate Reagan's campaign commercials has turned into a squabble between the Reaganauts and the moderates. Presidential Counselor Edwin Meese III and pollster Richard Wirthlin, who guided previous Reagan campaigns, favored Am-
[illegible]r to Ireland Peter Dailey, 53, Reagan's 1980 media adviser.
[illegible] III contended that Dailey had been
[illegible] But Baker

THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

Date: November 21, 1983 **Number:** CA168833 **Due By:** ______

Subject: Cabinet Council on Commerce and Trade Meeting of November 22, 1983

	Action	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☑
Attorney General	☑	☐
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☐	☑
Transportation	☑	☐
Energy	☑	☐
Education	☐	☑
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CCHR/Simmons	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/	☐	☐

REMARKS:

The Cabinet Council on Commerce and Trade will meet on Tuesday, November 22, 1983 at 10:30 AM in room 175 of the Old Executive Office Building. The agenda is as follows:

Industrial Policy Legislation CM421 (the background paper for this agenda item was distributed to you on November 7, 1983).

Airline Industry Performance Review CM216 (paper is attached).

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
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MEMORANDUM TO THE CABINET COUNCIL ON COMMERCE AND TRADE

FROM: Elizabeth Hanford Dole

SUBJECT: Airline Deregulation and Industry Update

INTRODUCTION

Considerable public debate has recently been focused on airline deregulation and the performance of the airline industry under deregulation. This memorandum provides a framework for understanding the origins of airline regulation, the reasons which led to passage of the deregulation act, and industry performance since deregulation, including the most recent industry financial performance.

BACKGROUND ON AIRLINE REGULATION AND DEREGULATION

The Federal Government played an active role in the very early development of the Nation's airline industry. Comprehensive Federal safety legislation, defense expenditures, aid to airport development, Post Office subsidies, and other intervention greatly influenced aircraft design, engine and airframe development, the system of airports, and airline route structures. However, public and Congressional dissatisfaction with early industry economic and safety performance culminated in the passage of comprehensive economic regulatory legislation in 1938 which was modeled on a regulatory pattern already accepted and well established in the surface transportation field. The major features of the 1938 Act included control over entry, inter-carrier relations, and rates and fares.

The principal arguments for this regulatory scheme included:

1. Uncontrolled entry would result in destructive competition and inadequate attraction of capital.

2. Competition would threaten the maintenance of industry labor standards and possibly the safety of industry operations.

3. Inadequate investment would indirectly result in a weakening of national defense interests.

4. Air transportation should be treated as a public utility since the disruption of service resulting from competition would not be in the public interest.

Unfortunately, economic regulation produced a number of undesirable economic effects. The Civil Aeronautics Board's liberal merger policy resulted in increased industry concentration. Instead of allowing ailing companies to fail, the Board encouraged the merger of such companies with other, more financially viable carriers, driving up average industry costs. In the early 1970's, the Board instituted a five-year "route moratorium," a policy of refusing to grant or even hear applications for new routes, thus removing the threat of potential competitive entry. At the same time, the Board's pricing formula permitted the cross-subsidization of short-haul markets by long-haul markets, penalized carriers whose load factors were better than industry "norms," and discouraged price experimentation. This combination of Board merger, route, and pricing policies seriously distorted industry performance.

As the Council of Economic Advisors 1975 Annual Report noted, regulation of the domestic airline industry brought about a "non-optimal choice of price and quality." Since fares were regulated by the Board, the airlines tended "to compete on the basis of scheduling." The resulting "excess capacity" caused the traveling public to pay "higher fares because of the regulation-induced excess capacity."

AIRLINE PERFORMANCE SINCE DEREGULATION

The evidence available during the deregulation debate in the mid-1970's indicated that deregulation would place strong competitive pressures on industry costs. It was believed that new entrants, with non-union labor, lower wage rates, and less restrictive work rules would provide this competitive impetus. These pressures have, in fact, been demonstrated in numerous measures to improve productivity (for example, increased aircraft utilization and seating density) by the major carriers since 1978.

The carrriers have, with the exception of labor costs, already taken many of the cost-saving measures available to them. Labor costs, on average, comprise 38 percent of the industry's operating expenses, and since in some cases labor costs for new entrants are as much as 50 percent lower than for their unionized competitors, we have witnessed numerous attempts to reduce labor costs and adjust restrictive work rules by the major carriers. Examples of the different approaches taken include:

1. Employee profit-sharing and ownership plans in exchange for wage and work rule concessions.

2. Independent company audits as a basis for opening negotiations with unions on labor concessions.

3. Seeking the protection of the bankruptcy court while at the same time offering lower wages and substantial changes in work rules.

4. Establishment of a low-cost subsidiary with substantially lower cost structures.

The industry's current labor problems were not unforeseen during the deregulation debate. It was well recognized that the Board's pricing policies did not penalize inefficient carriers; higher industry costs were simply passed through as higher fares. In such an environment, management had little incentive to hold the line on excessive wage demands or unreasonable work rules. It was apparent in 1978 as it is today, labor concessions and work rule changes must be made in order for the major carriers to compete with the new entrants.

A 10-year labor protection plan (Section 43) was added to the Airline Deregulation Act to provide financial compensation and "first-right-of-hire" to displaced employees. These provisions were intended to cushion the effects of deregulation on airline employees. The Federal Government has not yet acted on the financial assistance but has almost achieved final rules on "first-right-of-hire."

Proponents of deregulation also believed that deregulation would bring about a proliferation of airline price and service options. This has occurred. We have witnessed a tremendous shift in the industry's fare structure which has gone from a system based on "equal fares for equal distances" and industry-wide average costs to one based more on carrier-specific and market-specific costs. Many carriers have also consolidated service in hub-and-spoke type operations and offer new and different classes of service.

It was recognized that, under deregulation, major carriers might abandon the short-haul, low-density markets that the Board had previously required to be cross-subsidized. It was also expected that commuter airlines would replace the major carriers with smaller, more efficient aircraft which would be better suited for these markets. As additional protection, the Act included the small community service subsidies to ensure continued airline service for some 555 communities for at least 10 years. Under the exit provisions of the Act, 137 small communities in the 48 states lost all their large jet service. However, departures at these communities, in aggregate, increased about 12 percent between March 1978 and March 1983. Overall, CAB subsidy payments, which are now determined by service requirements in a specific market instead of on a carrier's overall performance, have been reduced from $71.7 million in 1978 to $42 million in 1983.

We are convinced that deregulation has served the best interests of the traveling public and that, over the long run, will prove equally beneficial to the aviation industry. According to a recent CAB study, convenience of service--times of departure, number of flights, and availability of connecting flights at hub airports--has generally improved for small as well as large communities. The traveling public has a much greater diversity of discount prices and service options to choose from today than before 1978. During the period 1978 through 1982, while the airline industry cost index rose 87.4 percent and the consumer price index rose 59.2 percent, air fares rose only 46.4 percent. We therefore see no reason for turning back the clock to the rigid constraints and high costs of economic regulation. Deregulation is delivering what it promised: a more efficient airline system accessible to more Americans than ever before.

INDUSTRY SAFETY

Opponents of deregulation have raised the specter of unsafe operations as a reason to reimpose economic regulation. Economic deregulation, however, did not deregulate safety. FAA continues to assure that all its safety regulations are met. Airlines must meet the same or higher certification, operational, and maintenance requirements today as were effective before deregulation. These requirements apply across the board to new entrants and established carriers alike. Moreover, the FAA maintains particularly close surveillance over carriers experiencing financial difficulty.

EFFORTS TO RE-REGULATE

It is noteworthy that many of the current arguments for economic re-regulation of the airline industry are the same as or similar to those arguments made in the 1930's. For example, Senator Andrews has recently introduced legislation that would bring a measure of so-called "pricing stability" to the industry; i.e., new fares would require 60 days notice before being introduced and, once in effect, could not be changed for 90 days. This legislation would greatly reduce the pricing flexibility which permits the industry to quickly respond to changing economic and market conditions. Travel agents are also fighting a CAB decision to make airline ticket marketing more competitive by 1985.

RECENT FINANCIAL RESULTS

The airline industry earned an estimated $428 million during the third quarter of 1983, a sharp improvement over the third quarter of last year. Overall financial results were good for the industry: American and Northwest Airlines reported record profits, Pan Am experienced its second consecutive quarter in the black, and Western Airlines achieved its highest profit in five years. Certain other carriers, such as Republic and Eastern, continue to experience financial difficulties.

The improvement in industry third quarter financial performance is attributed to the combination of increased traffic, improved yield, and continuing productivity improvements. To be sure, large losses in the first quarter placed the industry in a $56 million loss position through the first three quarters. Nevertheless, if the industry continues to maintain yields, hold down costs, and if traffic holds steady or increases (preliminary October results indicate traffic will be up ten percent), it should experience a profit for the year.

A more detailed discussion of industry performance and a comparison of individual air carrier results is presented in the attachment.

ATTACHMENT

Airline Industry Financial Performance
Third Quarter 1983

The airline industry, including major, national, and new entrant air carriers, reported a profit of some $428 million during the third quarter of 1983, an improvement of $228 million over the same quarter last year. (The financial results for Continental Airlines, which filed for protection under Chapter 11 of the Bankruptcy Code on September 24, are not included.) The highlights are as follows:

- In the third quarter, major carriers reported net and operating profits higher than any quarter since 1978. If current trends continue, the industry will be virtually guaranteed an annual profit for 1983.
- Seven of the ten major airlines showed improvement in earnings over the third quarter of 1982, and eight of the ten majors reported profits.
- American and Northwest Airlines reported record quarterly profits.
- Pan American experienced a major turnaround, reporting a net profit of $77 million, its second consecutive quarterly profit, thus putting the company in a good position for attaining profitability in 1983.
- Western Airlines, which has been having financial problems, earned $17 million, its best third quarter in five years.
- Only Republic and Eastern Airlines reported net losses ($12 and $34 million, respectively).
- The earnings performance of the national carriers remained solidly profitable. Totals for those carriers reporting shows no significant change since 1982.
    - Of the carriers reporting, all were profitable, except for Pacific Southwest Airlines, which incurred a marginal loss.
    - Several carriers, including Alaska, Piedmont, and Southwest Airlines had strong earnings.
    - World Airways, which had been experiencing financial problems, earned $13 million, compared to a loss last year.
    - The only national carrier expected to incur a major third quarter loss is Air Florida which has not yet reported its results.
- The new entrants continued to show mixed performance, but with an overall improvement.

<u>Improvement in Traffic and Yield</u>. The improvement in the financial performance of the majors during the third quarter can be attributed to the combination of increased traffic, improved yield, and significant cost controls.

- Revenues increased 8.3 percent; traffic increased 6.7 percent; and average yield (cents per passenger mile) increased 1.6 percent.

- Traffic remained strong throughout the third quarter, increasing 5.4 percent in July, 5.1 percent in August, and 10.5 percent in September.

- Average yield, which had been declining since 1980 due to widespread fare discounting, bottomed out in the third quarter.

On the cost side, expenses increased 4.9 percent, slightly more than capacity increased (4.7 percent). Declining fuel prices and the fact that some carriers have obtained significant wage and work rule concessions from their unions have helped to keep these increases under control.

Year-to-Date and Full-Year 1983. The industry reported much improved earnings for the third quarter and a small profit in the second. However, with the large losses in the first quarter the industry remains in a loss position for the first nine months ($56 million). The strong earnings performance of the third quarter portends an overall profit for the year--the industry's first in four years. A continuation of recent trends with regard to yield, cost control, and traffic (preliminary October results now being reported indicate that the increase in traffic for the month will be about 10 percent) should assure a profit for the fourth quarter.

AIRLINE INDUSTRY THIRD QUARTER AND NINE MONTHS, 1983
NET EARNINGS' RESULTS

($ Millions)

	THIRD QUARTER			NINE MONTHS		
	1983	1982	Change 1983-82	1983	1982	Change 1983-82
Majors:						
American	101	18	+83	112	(23)	+135
Continental*						
Delta	10	(16)	+26	(55)	(12)	- 43
Eastern	(34)	(33)	- 1	(129)	(87)	- 42
Northwest	45	27	+18	39	8	+ 31
Pan Am	77	(29)	+106	8	(212)	+220
Republic	(12)	(6)	-6	(115)	(12)	-103
TWA	75	65	+10	(33)	(20)	- 13
US Air	24	16	+ 8	51	47	+ 4
United	59	97	-38	74	(37)	+111
Western	17	3	+14	(25)	(4)	- 21
Totals	362	142	+220	(73)	(352)	+279
Nationals:						
Air Florida*						
Alaska	10	7	+ 3	15	10	+ 5
Aloha	0	3	- 3	(2)	2	- 4
Capitol*						
Frontier	1	15	-14	(15)	23	-38
Hawaiian*						
Ozark	1	4	- 3	(2)	8	-10
Piedmont	25	17	+ 8	14	26	-12
PSA	(3)	5	- 8	(5)	30	-35
Southwest	12	11	+ 1	30	25	+ 5
Wien*						
World	13	(3)	+16	(13)	(35)	+22
Totals	59	59	0	22	89	-67
New Entrants:						
Jet America	3	0	+ 3	0	(6)	+ 6
Hawaii Express*						
Midway	(1)	1	- 2	(9)	0	- 9
Muse	1	4	- 3	(2)	1	- 3
New York Air	2	(4)	+ 6	4	(16)	+20
Pacific Express	(1)	(4)	+ 3	(7)	(12)	+ 5
People Express	3	2	+ 1	9	3	+ 6
Totals	7	(1)	+ 8	(5)	(30)	+25
THE INDUSTRY	428	200	+228	(56)	(293)	+237

* = has not reported yet.