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Fred Kahn at 100 - A Brief Look Back at the Man and the Principles He Championed

by

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1. Introduction

On Oct. 17 of this year, Fred Kahn would have turned 100. While he is no longer with us,[1] the principles he championed endure and it is only fitting that we take a moment to pay homage to this Renaissance man. Fred wore many hats throughout the course of his career, and they all came together in a magical way to pave the way for the major contributions that he made to economic regulation and competition policy.[2] He possessed a unique ability to communicate complex ideas in terms policymakers could readily understand. On this score and on so many others he was without peer.

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[1] Robert D. Hershey Jr., "Alfred E. Kahn Dies at 93; Prime Mover of Airline Deregulation," *The New York Times*, December 28, 2010. The URL for Professor Kahn's obituary is available at http://www.nytimes.com/2010/12/29/business/29kahn.html.

[2] See the excellent "appreciation" by Joshua Z. Rokach, "What Would Alfred Kahn Do?" *The Electricity Journal,* March 2011 at 89-91.

I corresponded with Fred for many years prior to first meeting him in person in the summer of 1996. We were both slated to testify in a state telecommunications proceeding. Fred arrived the day before the hearing to attend a luncheon. I was in a conversation with the lead counsel in the case when Fred first appeared. He would have been hard to miss. He was wearing a powder blue sport coat of the sort one might don for a championship shuffleboard tournament. The attorney took one look at him and gasped, "Oh no, I hope he does not wear that godawful coat to the hearing tomorrow." I just chuckled and remarked, "That is Fred Kahn. Do you really think it matters what he wears to the hearing?"

The next day, just as the attorney had feared, Fred showed up at the hearing in his powder blue sport coat. He took the witness stand and was immediately pummeled with questions about cross subsidies, price elasticities, and universal service. At one point, Fred was asked about the effectiveness of policies governing cross subsidization. He immediately cut to the chase by zeroing in on the inefficiencies associated with untargeted subsidies in rural areas. "I have no animus against Robert Redford, I regard him as a very attractive man, to wit, but I mean why should people in Vail, Colorado, have subsidized telephone rates?"[3] The Commissioners erupted in spontaneous laughter. The great communicator had driven his point home and brought down the house in the process . . . the powder blue sport coat be damned!

2. Economist, Regulator and Part-time Actor

Fred Kahn laid claim to being the last surviving student of the great economist Joseph Schumpeter.[4] Schumpeter aspired to be a great economist, a great horseman, and a great lover.[5] While he readily conceded that he had only achieved two of the three, no one knows for sure which two.[6] In similar fashion, Fred Kahn aspired to be a great economist, a great regulator, and a great actor. Like his mentor, he realized two of the three, and in this case we know which two.

Professor Kahn's contributions to the economics literature are extraordinary by any measure. These are memorialized in a curriculum vitae that runs more than 30 pages. His publication record includes over 130 articles – many in the economics profession's most prestigious journals. In fact, of Professor Kahn's first 10 publications, seven appeared in the *American Economic Review*, the *Journal of Political Economy,* or the *Quarterly Journal of Economics*. In addition, he published eight books, including his world-renowned, two-volume treatise, *The Economics of Regulation* – still a hallowed reference in the field almost 50 years after it first appeared. Perhaps we should have expected nothing less from someone who graduated *summa cum laude* and first in his class from New York University – at the age of 18!

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[3] Testimony of Alfred E. Kahn before the Kansas Corporate Commission in Docket No. 190-492-U on Behalf of Southwestern Bell Telephone Company, August 1996 (Hearing Transcripts) at 2055.

[4] In fact, according to Kahn biographer, Thomas McCraw, Fred indicated that "Schumpeter was the *de facto* director of his dissertation during the 1940s." Private correspondence, December 28, 2008. This is confirmed in an undated letter from Schumpeter to Kahn that provides detailed comments on the individual chapters of his dissertation. Letter on file with the author.

[5] Thomas K. McCraw, PROPHET OF INNOVATION, Cambridge MA: Harvard University Press, 2007 at 4.

[6] He did, however, allude to the fact that "things were not going well with the horses." *Id*.

Fred was never content simply to "preach" from the Ivory tower and let others do the heavy lifting. He took several leaves from academia to preside over the implementation of the economic principles that he championed.[7] These include such high-level government appointments as chairman of the New York Public Service Commission, economic advisor to the president (Carter) on inflation, chairman of the Council on Wage and Price Stability and chairman of the Civil Aeronautics Board (CAB), among others.

As chairman of the CAB, he led the charge to deregulate the nation's airlines. The annual welfare gains associated with airline deregulation are estimated to exceed $25 billion (in current dollars).[8] Of course, Fred would not want you to forget that airline deregulation occurred when a Democrat occupied the White House. It is widely known that Professor Kahn felt that he was better suited to head the Federal Communications Commission rather than the CAB, once remarking that "I really don't know one plane from another. To me they are all marginal costs with wings."[9] But President Carter had other plans for him and his leadership of the CAB through the turbulent political economy of deregulation is now legendary.

More than a decade ago, when the lights literally went out in California, the U.S. Congress once again turned to Professor Kahn to help it understand the source of this market failure. He was no stranger to the U.S. Congress, having testified before the Senate or the House no less than 70 times previously. Fred Kahn has been the "great communicator" of economic principles for more than 60 years and he continued to advise Fortune 500 corporations and governments throughout the world until the final few weeks of his life. He had been a regular commentator on the *Nightly Business Report*.

In addition to his stellar record of economic research and public service, Fred Kahn was first and foremost a teacher and mentor to countless students and young economists just beginning their professional careers. I am fortunate to count myself in those ranks. More than 30 years ago, when I was first starting out, I had written a paper on a public utility's obligation to serve as the carrier-of-last-resort for its franchised service territory.[10] A colleague encouraged me to send this paper to Professor Kahn, who had written extensively on this topic.[11] I scoffed at this

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[7] See Thomas K. McCraw, PROPHETS OF REGULATION, Cambridge MA: Harvard University Press, 1984, Chapter 7.

[8] The annual welfare gains associated with airline deregulation were estimated to be on the order of $6 billion annually in 1977. Steve A. Morrison and Clifford Winston, THE ECONOMIC EFFECTS OF AIRLINE DEREGULATION, Washington D.C.: Brookings, 1986. It is estimated that an additional $4 billion in welfare gains are attributable to deregulation of selected international routes with an additional $4 billion possible should deregulation expand to additional routes. Clifford Winston and Jia Yan, "Open Skies: Estimating Travelers' Benefits from Free Trade in Airline Services," *American Economic Journal: Economic Policy*, Vol. 7(2), 2015 at 370-414.

[9] McCraw, 1984 Op. Cit. at 224.

[10] Dennis L. Weisman, "Default Capacity Tariffs: Smoothing the Transitional Regulatory Asymmetries in The Telecommunications Market," *Yale Journal on Regulation*, Vol. 5(1), Winter 1988 at 149-178.

[11] Alfred E. Kahn, "The Tyranny of Small Decisions: Market Failures, Imperfections and the Limits of Economics," *Kyklos*, Vol. XIX, January 1966 at 23-47; and Alfred E. Kahn, THE ECONOMICS OF REGULATION, Vol II. Cambridge MA: The MIT Press, 1988 (First Published in 1971), at 236-41. For a more recent discussion of this problem, See Dennis L. Weisman, "Are the Electric Utilities Aboard the 'Train to Ithaca'?" *The Electricity Journal*, Vol. 30(5) June 2017, 6-9.

suggestion, contending that "I might as well send this paper into a black hole" as send it to someone of Kahn's stature – a person I believed to be far too busy and important to take the time to read an unsolicited manuscript from a junior economist he had never met. But my colleague was persistent and the paper was duly sent to Professor Kahn.

Late one afternoon, about two weeks later, the postman for our building appeared at the door of my office. He informed me that he had a letter for me from Ithaca, N.Y., from someone named "Fred Kahn." This postman was a bit of a surly fellow, not unlike the Newman character on *Seinfeld*. When I excitedly reached for the letter, he immediately pulled it back, announcing with an impish grin that 17 cents in postage was due and I must pay this sum before taking possession of the letter. This was a bit of a problem, as I had no money with me and my colleagues had left for the day. Yet the postman refused to release the letter. I can honestly tell you that this is as close as I have ever come to assaulting an employee of the federal government.

Finally, after scrounging around in my desk for an interminable amount of time I was able to cobble together the obligatory 17 cents. The counsel that Professor Kahn provided to me in that (several-page) letter led to a substantially revised draft of my paper, my first major publication in economics, and a professional association and friendship that has been one of the great treasures of my life. I still have that letter and to this day it remains the best 17 cents that I ever spent.

In the winter of 2005, I invited Fred to campus to give a university-wide address;[12] it was standing room only. Fred was characteristically brilliant, charming, and funny. He began his talk by recounting the various positions he held in and outside of academia and what he had learned over the course of his journey. He reflected upon his time as Dean of Arts and Sciences at Cornell and how he quickly realized that a "Dean is to the faculty what a fire hydrant is to a dog." The audience roared approvingly with thunderous laughter and applause – everyone, that is, except our dean, who, as luck would have it, happened to be seated next to me – the miscreant responsible for bringing Professor Kahn to campus. Fred was unapologetic; he always called them the way he saw them . . . and thank goodness for tenure!

There is more you should know about Professor Kahn. Since 1982 he served as a consultant to the American Heritage Dictionary (the right words were always more important than the right equations to Fred). In his spare time, Fred was a fan of theatrical comedy and not just as a spectator. With a preference for Gilbert and Sullivan, he appeared in countless plays on the Cornell campus and surrounding areas – word has it to critical acclaim. He could recite line and verse from a seemingly uncountable number of plays, songs, and poems, and these were frequently interjected into his policy counsel.

Lastly, Fred was a self-proclaimed and thoroughly unrepentant chocaholic. I always thought the chocolate was necessary to fuel his boundless intellectual energy. Each holiday season I would set out in search of some chocolate delicacy to send his way. This was always followed up with

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[12] Alfred E. Kahn, Economic Deregulation, *1975 to 2005: the Airlines and Telecommunications*, Kansas State University, Manhattan, KS, February 15, 2005. This section is based, in part, on my introduction of Professor Kahn at this event.

a gracious note or telephone call in which Fred supplied a detailed analysis comparing last year's example with the current vintage. And, of course, there was always enthusiastic discussion of the latest economic issue that had piqued his interest. Oh, how I miss those conversations. But good memories and sound principles sustain us, and this leads me to the penultimate section of this essay.

3. The Kahn Principles

In all the industries in which he participated, including commercial aviation, electric power, telecommunications, and transportation, Professor Kahn relied upon a core set of economic principles to inform his policy analysis. These principles are listed below, followed by a brief discussion of each.

Principle 1. **Economic Regulation Should Seek to Emulate the Competitive Process**

Professor Kahn observed that:

> the single most widely accepted rule for the governance of the regulated industries is regulate them in such a way as to produce the same results as would be produced by effective competition, if it were feasible.[13]

It is important to underscore the fact that Professor Kahn did not believe that regulation should seek to mandate competitive outcomes *per se*, but rather serve to foster the competitive process. The distinction is subtle but important.[14] The competitive process is principally one of innovation and discovery and he believed that it was important to "discover" whether competition was feasible in the industry.

The need for continued regulation may well be an artifact of economically inefficient rate-design policies of the past that served to curb the intensity of competition. If regulation has served to peg prices below efficient levels, regulators would, as a matter of course, observe less competition and hence less substitutability between services than would be present otherwise. It is therefore necessary to ensure that regulation has not robbed the competitive process of the necessary *oxygen*.

Principle 2. **Even Imperfect Competition May Be Preferred to Economic Regulation**

In similar fashion to his teacher, Professor Kahn believed that regulation could serve as a substitute for competition, but it could just as easily be an impediment to competition. He had faith in markets and imperfect competition today could, in many cases, be expected to lead to less imperfect competition tomorrow. His instincts were to give competition every opportunity to succeed without propagating it artificially.

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[13] Alfred E. Kahn, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS, New York: John Wiley and Sons, Vol. I, 1970 at 17.
[14] Joseph A. Schumpeter, CAPITALISM, SOCIALISM AND DEMOCRACY, New York: Harper Torchbooks, 1975 (first published in 1942 by Harper & Brothers) at 104-106.

Whether competition is possible is discoverable with a policy that opens market competition, but it is not discoverable with a policy that closes markets to competition (or discourages entry with inefficient prices). Indeed, As Judge Frank Easterbrook observed: "[T]he economic system corrects monopoly more readily than it corrects [regulatory] errors. . . . in many cases, the costs of monopoly wrongly permitted are small, while the costs of competition wrongly condemned are large."[15]

***Principle 3.* Dynamic Efficiency Trumps Static Efficiency**[16]

Joseph Schumpeter believed that the regulator's preoccupation with the price variable was fundamentally misplaced and that product/process innovation was more important than static price competition.[17]

> Economists are at long last emerging from the stage in which price competition was all they saw. As soon as quality competition and sales effort are admitted into the sacred precincts of theory, the price variable is ousted from its dominant position. … But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition which counts, but the competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest-scale unit of control for instance) – competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives.[18]

Professor Kahn harbored similar sentiments and these came to the fore in the course of implementing the 1996 Telecommunications Act. He recognized that unduly liberal network sharing policies designed to instill pricing discipline came at too high a cost – reduced investment and market innovation.

> Second, wherever mandatory sharing, for the sake of jump-starting the entry of competitors, would interfere with the more creative and dynamic investment in facilities-based competitive entry and innovation by incumbents and challengers alike, it is the latter that must take primacy.[19]

Political economy readily explains why dynamic efficiency typically gets short shrift.

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[15] Frank Easterbrook, "The Limits of Antitrust," *Texas Law Review*, Vol. 63(1), 1984 at 15.

[16] Static efficiency is comprised of both allocative and productive efficiency. Allocative efficiency refers to the relationship between the price of the service and the underlying marginal (incremental) cost of the service at a given point in time. Productive efficiency is concerned with production at the lowest possible cost. A firm is technically efficient if it uses the minimum amount of inputs to produce its output. Dynamic efficiency concerns the optimal investment over time in capital formation, product and process innovation.

[17] For a similar viewpoint, see James C. Bonbright, PRINCIPLES OF PUBLIC UTILITY RATES, New York: Columbia University Press, 1961 at 53.

[18] Schumpeter, 1975 Op. Cit. at 84.

[19] Alfred E. Kahn, WHOM THE GODS WOULD DESTROY, OR HOW NOT TO DEREGULATE, Washington DC: AEI-Brookings Joint Center for Regulatory Studies, 2001 at 22.

> To wit, regulators and their overseers can directly observe the behavior of prices, but products and services that do not find their way to market but would have otherwise are often unobservable, at least in the short-run which is the tenure of most regulators.[20]

Like his teacher, Professor Kahn believed that competition and regulatory policy should focus on the long run and market distortions (absent insurmountable barriers to entry) were only transitory.[21]

Principle 4. Prices Should Reflect the Marginal Cost of the Service

Professor Kahn was ardent in his conviction that it was in deviating from marginal-cost pricing where regulation had gone wrong.[22] From his pioneering work on time-of-day (peak/off-peak) pricing in electric power to discounted fares in commercial aviation to rate rebalancing and the pricing of directory assistance and network elements in telecommunications, he was emphatic that marginal cost provided the requisite guidance.

> Once you abandon marginal cost, it is not *difficult* to find another measure of cost that will serve that purpose, it is hopeless. This is not a question of looking for a black cat in a room in which all the lights have been turned out. *There is no cat there*.[23]

He further counseled that the only measure of costs than can be defended on a principled basis is the actual, forward-looking incremental cost of the regulated firm. Professor Kahn recognized the inherent temptation for regulators to "engineer" the marginal cost measures that they conjectured might be possible if only the regulated firm were "efficient."[24] He railed against this economic falsehood.

> In unregulated markets, prices tend to be set on the basis of the actual costs of the incumbent firms, and they should be. The economic purpose of prices set at incremental cost is to inform buyers – and make them pay – the cost that society will *actually* incur if they purchase more or would *actually* save if they reduced their purchases, entirely or partially. These can only be the costs of the supplier whose prices are being set, not some hypothetical ideal producer. Moreover, such

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[20] Glen O. Robinson and Dennis L. Weisman, "Designing Competition Policy for Telecommunications," *The Review of Network Economics*, Vol. 7(4), December 2008, at 537, note 108.
[21] See Dennis L. Weisman and Glen O. Robinson, "Lessons for Modern Regulators from Hippocrates, Schumpeter and Kahn," in NEW DIRECTIONS IN COMMUNICATIONS POLICY, ed. by Randolph J. May, Durham NC: Carolina Academic Press, 2009 at 3–37.
[22] McCraw, 1984 Op. Cit. at 224.
[23] Alfred E. Kahn, "The Uneasy Marriage of Regulation and Competition," *Telematics,* Vol. 1(5), September 2004 at 12.
[24] For a discussion of this problem and its distortionary effects, see Dennis L. Weisman, "The Inefficiency of the Efficient-Firm Cost Standard," *The Antitrust Bulletin*, Vol. XLV(1), Spring, 2000 at 195-211.

prices give challengers the proper target at which to shoot – the proper standard to meet or beat and the proper reward if they succeed."[25]

***Principle 5*. Protect the Integrity of the Competitive Process Not Competitors**

Professor Kahn did not pull any punches in expressing his disdain for asymmetric regulation designed to "handicap" incumbent providers and ensure the survival of their rivals.[26, 27]

> Subsidizing competitors at the expense of incumbents is a cheap way of getting political credit, but it is not a way of encouraging efficient competition—or, in the long run, of promoting consumer welfare.[28]
>
> The regulator tends as a matter of constitutional preference … to convert the maintaining of the "level playing fields" into an interference with the contest itself. Regulators move from trying to assure a fair and equal start to ensuring an equal finish; to preserve whatever the regulator conceives to be the proper market shares of the various competitors.[29]

Professor Kahn shared these views with the honorable Stephen Breyer, his "intellectual soulmate" on the U.S. Supreme Court and fellow traveler on airline deregulation.[30]

> A second special policy risk of deregulation is that government policymakers will protect competitors instead of protecting competition. This is a problem familiar to students of antitrust. It arises when regulators or antitrust enforcers confuse means with ends by thinking that the object of the law is to protect individual firms from business risks rather than to bring consumers the price and production benefits that typically arise from the competitive process. Where deregulation is at issue, the consequence of misdirecting protection is to threaten to deprive the consumer of the very benefits deregulation seeks.[31]

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[25] Alfred E. Kahn, Timothy J. Tardiff and Dennis L. Weisman, "The 1996 Telecommunications Act at Three Years: An Economic Evaluation of Its Implementation by the FCC," *Information Economics and Policy*, Vol. 11(4), December 1999 at 329-330.
[26] See Alfred E. Kahn, "Bribing Customers to Leave and Calling It 'Competition'," *The Electricity Journal*, Vol. 12(4), May 1999 at 88-90.
[27] But, of course, this cut both ways. In responding to a charge by the Airline Pilots Association that he was anti-labor, Professor Kahn responded "If I'm any-thing, I'm anti-excessive government interference . . . And I am *particularly* against government being used to protect powerful business interests by giving them special grants of monopoly privilege." McCraw, 1984 Op. Cit. at 288.
[28] Alfred E. Kahn, LESSONS FROM DEREGULATION: AIRLINES AND TELECOMMUNICATIONS AFTER THE CRUNCH, Washington D.C: AEI-Brookings Joint Center for Regulatory Studies, 2004, p. 38.
[29] Kahn, 1984 Op. Cit. at 9.
[30] Breyer, then a professor at Harvard Law School, served as the "stage manager" for the hearings convened by Senator Edward Kennedy's subcommittee on airline deregulation in 1975. In this role, he developed the questions put to the industry and the CAB. McCraw, 1984 Op. Cit. at 266-68.
[31] Stephen Breyer, "Anticipating Antitrust's Centennial: Antitrust, Deregulation, and the Newly Liberated Marketplace," *California Law Review*, Vol. 75, 1987 at 1018.

Principle 6. **There Is No Halfway House Between Regulation and Competition**

The deregulation of commercial aviation in the United States was done on a flash-cut basis which was a marked departure from the gradual approach taken in other industries (e.g., telecommunications).[32] Professor Kahn reasoned that between the extremes of thorough regulation and free competition, regulated competition was the worst of all worlds.[33] Regulators would simply not be able to resist the temptation to "tinker" with the competitive process. He did not favor "tenure" for regulators, but a natural sunset for regulatory intervention whenever possible. A regulator was most successful when he put himself out of a job. True to his principles, he made sure to the turn out the lights at the CAB when he left.

These six economic principles are the foundation of Professor Kahn's regulatory philosophy. He believed fervently that competition, true competition, was a *blood sport* and regulators had no business interfering to soften the blows. Many of the incumbent airlines that prospered under regulation failed under competition; the old AT&T suffered a similar fate.[34] Professor Kahn would shed no tears. He had learned that success and failure are part and parcel of Schumpeter's *perennial gale of creative destruction* – a heartless winnowing process that maximized consumer welfare over the long run.

4. Conclusion

In an age in which economics has become increasingly formal, Fred Kahn was a man of words rather than equations.[35] His policy counsel was firmly grounded in political economy and he played to an audience far larger than his fellow economists. His keen intellect made him a great economist; his political acumen and sense of timing made him a great regulator; and his acting prowess made him a great communicator. The combination proved unstoppable. In an article commemorating Fred's 90th birthday, Professor Glen Robinson and I observed that "In a very real sense, every modern-day student of regulation and competition policy is a student of Kahn and his teachings . . ."[36]

By any measure, this was a remarkable career brimming with significant accomplishments and selfless public service – one most befitting that of a *Renaissance man*. To paraphrase the writer William Manchester, "this is an example of how a life should be lived."[37] Fred Kahn was not just one of the leading economists and social scientists of his generation, he was a national

[32] For a discussion of why transportation differed from telecommunications and electric power in this regard, see Alfred E. Kahn, LETTING GO: DEREGULATION THE PROCESS OF DEREGULATION, East Lansing: The Institute of Public Utilities and Network Industries, 1998, Chapter II.
[33] Kahn, 1984 Op. Cit. at 8-9.
[34] Weisman and Robinson, 2009 Op. Cit. at 7-11.
[35] See Robert H. Frank, "A Champion of Plain English," *The New York Times*, January 8, 2011.
[36] Robinson and Weisman, 2008 Op. Cit. at 512.
[37] William Manchester, ONE BRIEF SHINING MOMENT, Boston: Little, Brown and Company, 1983 at 7.

treasure. Truly one for the ages, we are not likely to see someone of his unique talents and magnetic personality pass our way again.[38] He was one of one; he was Fred.

Acknowledgements

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[38] Perhaps Kahn biographer, Thomas McCraw summed it up best in an exchange shortly after Fred's passing. "He was the most likable and down-to-earth great man I ever met." Private correspondence, January 4, 2011.