

Regulation and the Nature of the Firm: The Case of U.S. Regional Airlines

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Abstract

The organization of airline networks, and particularly of the interaction between the less dense parts of the network with the more dense parts, is a particularly good example of the operation of two of Professor Coase's main points in "The Nature of the Firm" and subsequent articles: first, that the choice of institutions chosen to organize production is a function of economic circumstances, including regulation, technology and contractual arrangements inside the firm and second, that there is no general outcome that economic theory predicts, but rather that the result always depends on the particular circumstances and choices available and that it will change as circumstances change.

The institutional arrangements for service to the less dense city-pair markets in airline networks have been profoundly influenced by regulation, technology and labor contracts, especially for pilots. As these influences have changed over a period of seventy years, such service has been offered through operations fully vertically integrated with the denser markets, by wholly-owned subsidiaries contractually linked but effectively directed by the parent firms that owned the networks, by partly owned subsidiaries, by separate firms integrated by contracts that allowed network managers to direct schedules and prices but left production to the contracting firm, by arms-length negotiations between entirely separate firms that left production, route and pricing decisions to be negotiated between them, by contracts with other firms on terms dictated by the regulators, and by firms operating pursuant to scheduling and equipment choices dictated by government contracts and subsidies, operating either in coordination with a larger network or independently.

Regulation clearly inhibited or prevented the search for the most efficient coordination of production. Before the Airline Deregulation Act of 1978 only one mode of production and coordination was adopted nearly exclusively on an industry-wide basis at any one time, although that mode changed over the years. After deregulation, a wide variety of arrangements were tried and a number remain in competition with one another. No single equilibrium has emerged. As Coase predicted, the arrangements adopted depend very much on particular circumstances.