

# Free Sex Chat?

BY CHRISTOPHER HIXON

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**W**hy would the operators of websites like *hotlivesexchat.com*, *allfreecalls.net*, and *freecalls2theworld.com* route phone calls to their services through rural American towns like Riceville, Iowa? To take advantage of complicated telecommunications regulations and make a bundle of money from American consumers of long-distance telephone calls.

The Federal Communications Commission regulates the fees that local telephone carriers can charge long-distance carriers for calls originating from the long-distance carrier's network. The local carriers initiate the process of setting those rates by filing schedules of rates with the FCC. The FCC, in turn, evaluates the proposed rates to ensure that local carriers receive a "reasonable" rate of return based on projected costs and projected volume of calls routed through the local carriers' networks.

The operators of sex chat lines, conference bridges, and other high call volume operations make millions of dollars in profits through a form of regulatory arbitrage. Website operators advertised the services over the Internet as free or as limited to the cost of the long-distance call and contracted with local wire-line phone carriers to provide the services and split the revenues created by the increased call traffic. The federally mandated rates that the local carriers could charge were based on historically low levels of cost and call volume, so the rates were set by FCC regulators at relatively high levels per minute of access. When the call volume increased dramatically, the local carriers extracted huge payments from the long-distance carriers. The local carriers then split the payments with the Internet-based application providers through private contractual arrangements.

For example, when a long-distance customer of Verizon placed a "free" call to an Internet-based service like Male Box (an "all male, all gay" chat line), the call was routed through the switching equipment of a carrier like Farmers Telephone of Riceville, Iowa. Farmers Telephone then charged Verizon to connect the call on a per-minute basis at inflated rates set by FCC regulators. Farmers Telephone then split the profits with the operator of Male Box.

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**COSTS** The profits generated by this regulatory arbitrage came from the pockets of all long-distance customers. FCC regulations prevent long-distance phone carriers from passing access charges back to the customers who place the calls, forcing the long-distance carriers to distribute the charges among all of their customers. Thus, in the example above, all Verizon long-distance customers would have paid artificially higher rates to pay for the calls to the Internet-based services.

This type of call traffic stimulation is socially wasteful for two reasons. First, it induces the owners of calling services to locate their equipment in the local carrier's service area solely in order to collect high access charges even if it would be more efficient for those services to be located elsewhere. Second, it artificially inflates all long-distance users' rates by distributing the regulated cost of the calls to all long-distance customers instead of to the callers who actually made the calls.

Beyond artificially driving up demand for long-distance calls, the regulatory regime of intercarrier access charges imposes significant costs on consumers in the form of forgone benefits caused by the higher price of long-distance service. Consumer demand for long-distance service is very responsive to price changes.

Thus, access charge regulations that inflate the price of long-distance service cause consumers to consume less long-distance service, generating significant reductions in consumer welfare. My Mercatus Center colleague Jerry Ellig estimated that, as of 2002, the cost of each \$.01 interstate access charge reduced consumer welfare by \$300 million.

**SOLUTION** The FCC could solve the problem of call traffic stimulation and help reduce the burden on consumers of the regulatory regime of interstate access charges through an approach that avoids additional regulation and allows market forces to work.

To solve the problem, the FCC could forbear, in situations where call traffic stimulation occurs, from enforcing regulations that prevent long-distance carriers from passing access charges on to the customers who made the calls. If the long-distance carrier passes the charge back to the customer placing the call, it creates an incentive for the caller to take into account the total cost of the call. Faced with a significant surcharge, customers of chat lines and conference services would

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likely switch to service providers that do not generate these surcharges. This would remove the profit incentive for service providers to team up with local carriers that impose high access charges, effectively eliminating the incentive for call traffic stimulation.

This solution would end the practice of call traffic stimulation almost immediately. It would create a market incentive for the long-distance customer to avoid services that incur unreasonable access charges. It would also provide an incentive for the Internet-based service providers to fund their services through means other than access charges.

The rules that prevent itemized pass-through of access charges are intended to subsidize rural customers at the expense of urban customers by forcing the long-distance carrier to average charges across all customers. Ideally, the subsidization of rural telephone customers would be funded through direct payments from general tax revenues, as those payments would be more transparent, allowing for a more informed political debate on the costs and tradeoffs of the policy. In addition, a direct funding mechanism would have much less distortionary effects on people's behavior. However, this approach would require Congress to overhaul completely the way that the federal government subsidizes rural phone

customers and is unlikely to be politically viable at this time.

Regardless of the way in which rural phone customers are subsidized, the practice of call traffic stimulation does not reduce their rates. Rather, it merely transfers wealth to the local carriers, third party service providers, and possibly the users of the services. Regulations that have the effect of subsidizing another customer's use of chat lines, conference services, and other services that are traditionally used to stimulate call traffic demand do not contribute to the policy's goals.

Another way the FCC could solve the problem of call traffic stimulation would be to forbear from enforcing regulations that force long-distance carriers to interconnect at mandated rates when the long-distance carrier has evidence that the local carrier is improperly stimulating increased demand. If the FCC did not enforce the mandatory interconnection rules in this circumstance, the long-distance carrier could simply refuse to connect its customers with the local carrier that is engaging in the practice.

Critics of this market-oriented approach might argue that the long-distance carrier could improperly cut off calls to customers of local carriers in order to avoid paying access charges.

However, market competition would limit this option. For example, Verizon would be constrained from improperly cutting off calls because it would risk losing customers to another long-distance carrier, like AT&T, that allows access to customers of the local carriers in question. Since access charges would still be regulated, forbearance by the FCC would not give long-distance carriers the opportunity to cut off calls simply as a ploy to negotiate lower access charges across the board.

The local carriers themselves would have an immediate incentive to stop the practice of call traffic stimulation since they could lose customers to competing local carriers who offer access to other customers on other networks. Even if a local carrier in a rural area like Farmers Telephone faces little competition from wireless, satellite, Voice over Internet Protocol, and other wire-line providers, it would still have an incentive to stop the practice of call traffic stimulation because the alternative would be to lose all long-distance revenue.

If the FCC were to choose either of these approaches to address the problem of call traffic stimulation, market forces would end this wasteful practice. No longer would clever operators of Internet-based services be able to team up with the owners of local telephone carriers to fleece American consumers by taking advantage of a flawed system of regulation. **R**

# Bush at Midnight

BY VERONIQUE DE RUGY

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**L**ame duck presidents' ability to achieve anything in the last months of their presidency has been compared to "a balloon with a slow leak that shrinks with each passing week until it hits the ground." And yet in his last days in office, President Bill Clinton managed to rush through an unprecedented number of "midnight regulations" ranging from tightened water quality rules to increased mandatory energy minimum efficiency standards for air conditioning, heat pumps, and washing machines. Thus we should wonder, with the George W. Bush administration entering its last year in the White House, what regulatory changes will they make before the clock strikes midnight?

Virtually every modern president has made some regulatory change in the final days of his administration. But it was not until the regulatory outburst of President Jimmy Carter's final days, before Ronald Reagan entered the Oval Office, that the term "midnight regulation" was coined. At the time, the Carter administration set the record for the number of pages printed in the *Federal Register* during the midnight period — the full three months of November and December in presidential election years and the following (inauguration) January — with over 24,000 pages.

Clinton's unprecedented passage of midnight regulations

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in late 2000 sparked a renewed interest in the use of presidential power in the period between an election and a new administration assuming control. During its last three months in office, the Clinton administration published more than 26,000 pages in the *Federal Register*.

To be sure, this sudden outburst of regulatory activity is not just a characteristic of Democratic administrations. In 2001, my Mercatus Center colleague Jay Cochran examined pages in the *Register* for each quarter going back to 1948 and found that when the White House switches party, the volume of regulation in the outgoing administration's final quarter averaged 17 percent higher than the volume of rules issued during the same period in non-election years. According to the analysis, the sudden outbursts are systemic and cross party lines.

Recently, another of my Mercatus colleagues, Anthony Davis from Duquesne University, and I took a second look at the existence of the midnight regulation phenomenon. We used an extended data set — from 1948 to 2007 — and we examined monthly data instead of quarterly data. We also measured the extent of regulation differently: the number of *Federal Register* pages in the current month as a percentage of total pages during the calendar year as opposed to the log of pages published. This change allows us to capture the increase in regulation activities during the post-election months for a given administration relative to the administration's annual output.

With a few exceptions, our results are quantitatively and qualitatively consistent with Cochran's. They confirm a positive



relationship between post-election months and regulatory output. We also find that the legislature is a significant contributor to the existence of midnight regulations. In other words, the more days Congress is in session the month before the start of the midnight period, the more regulations will be promulgated. In addition, our data show a positive relationship between the rate of cabinet turnover and regulatory output. The higher the rate of the executive branch turnover — for example, when the entire cabinet is about to be replaced because the incumbent president has lost reelection — the more regulations will be issued during the midnight period. As the rate of the executive branch turnover diminishes — such as following a successful reelection — fewer regulations will be issued.

**EXTENDING INFLUENCE** So what is behind this phenomenon? According to political scientists William Howell and Kenneth Mayer, midnight regulation occurs when “political uncertainty shifts to political certitude.” They explain that during the last 100 days of his administration, a president knows exactly who will succeed him — his policy decisions, his legislative priorities, and the level of partisan support he will enjoy within the new Congress. If the sitting president (or his party) lost the election, he has every reason to promulgate last-minute regulations to tie his successor’s hands. And even if the president or his party did not lose the election, midnight regulations attempt to extend the outgoing president’s influence beyond the day he leaves office.

But is this an effective strategy? One would think that the incoming president could easily undo the midnight regulations of his predecessor. But political and legal obstacles prevent extensive repeal. Yes, presidents can issue executive orders, proclamations, and rules to overturn actions taken by their predecessors. They can also block the implementation of the outgoing president’s orders. However, more often than not, incoming presidents cannot alter orders set by their predecessors without paying a considerable political price or confronting serious legal obstacles.

According to a 2003 *Administrative Law Review* article by Andrew Morris, Roger Meiners, and Andrew Dorchak, the 1996 Congressional Review Act provides the new administration with one means of dealing with midnight regulations. Under the act, Congress may disapprove agencies’ rules by introducing a resolution that, if adopted by both houses of Congress and signed by the new president, can nullify an agency’s rule. However, the vote needs to be taken within 60 days of the official publication of the regulation in the *Federal Register*. This significantly limits the ability of Congress to deal with most regulations of the midnight period.

Also, Howell and Mayer explain, “not only does it take time, but changing the status quo probably means taking on interest groups who are reticent to give up ground that they have just won.” President George W. Bush certainly experienced difficulties altering the December 2000 Clinton regulation that drastically tightened the standards for arsenic in drinking water. In spite of a public outrage at the time the rule was issued, Bush faced considerable opposition when he tried to scrap the rule three months later and finally lost the battle.

In fact, a recent *Wake Forest Law Review* paper by Jason M. Loring and Liam R. Roth confirms that the passage of midnight regulation is a winning strategy for an outgoing president who wishes to project his influence into the future. The authors track the regulations passed in the midnight period of former presidents Clinton and George H. W. Bush as well as the incoming administrations’ responses to those regulations. Based on a selected sample of midnight regulations passed by those presidents, the authors find that only 9 percent of George H. W. Bush’s last-minute regulations were repealed and 43 percent were accepted without amendment by Clinton. Only 3 percent on Clinton’s regulations were repealed by George W. Bush and a staggering 82 percent were accepted without changes.

Why should we care? While some midnight regulations may provide real benefits that exceed costs, most result in more harm than good and cater to special interests rather than the public interest. That is why they are hurried into effect without the usual checks and balances.

There is little doubt that the current Bush administration is already preparing its regulatory legacy by actively writing rules that will secure some of its priorities about mineworker protections, airline security, and fuel efficiency. We can only hope that the inevitable increase in regulatory activity will be based on the best science and be subjected to public scrutiny and cost-benefit analysis. **R**

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before Congress  
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