# 40. Telecommunications

***Congress should***

- allow the free sale and ownership of the broadcast spectrum;
- repeal 47 U.S.C. sec. 254, which imposes a heavy regulatory tax on consumers and businesses to subsidize universal service;
- keep the Federal Communications Commission from extending harmful interconnection and unbundling rules to new high-speed data backbones;
- maintain cable television deregulation (holding cable rates down destroys investment and deters new competition); and
- finally eliminate the FCC.

Decades of experience with telecommunications regulation teach a simple lesson: regulation stifles competition and growth. By contrast, the computer and software industry, largely unfettered by regulation, is one of the most vibrant, competitive, and innovative sectors of the economy. In 1996 Congress tentatively deregulated some aspects of the telecommunications industry. But the work of deregulation is not done.

## *Recognizing That Regulation Doesn't Work*

The rapid pace of change in the telecommunications industry makes regulatory micromanagement harmful for two reasons. First, regulators cannot adapt regulations fast enough to keep up with changes in the industry. Cellular phones were delayed for 10 years by the FCC, at a cost to the economy estimated by National Economic Research Associates at $85 billion. Regulators' attempts to adjust to change create further uncertainty and delay.

Second, regulators are most friendly to familiar technologies and see new competition as an attack on regulatory goals. MCI had been using microwaves to send signals over long distances in competition with AT&T

for decades, but competition was held back by the FCC. For years the FCC suppressed cable to protect television broadcasters.

In enacting the Telecommunications Act of 1996, Congress recognized that traditional regulation hurt businesses and consumers. Local and long-distance phone companies were permitted to enter one another's markets and to compete with cable television. Cable operators were freed from rate regulation. The antitrust consent decrees that had brought the business planning of the Bell Companies, AT&T, and GTE under the jurisdiction of the federal courts were terminated. But the act did not go far enough in freeing the industry to manage its own affairs.

While the act did remove some statutory barriers to competition, the FCC retains the authority to impose formidable barriers of its own. The act delegated at least 80 matters to the FCC. A statute that makes it illegal for Company A to compete with Company B is not a good thing. But allowing competition only if Company A spends two years wrestling with regulators and subsidizes Company C is not much better. Regulatory discretion is not the same thing as freedom.

Congress should take five steps to move the telecommunications industry toward an efficient market structure.

### *Privatize the Electromagnetic Spectrum*

Once, mainly television and radio broadcasters and a few primitive point-to-point devices used the electromagnetic spectrum. Now, the spectrum is used by satellites sending voice, data, and video communications; cellular phones; personal communications services; pagers; wireless local area networks; and wireless Internet access. The wireless sector of the economy is ready to leap ahead into the 21st century.

But the current regulatory structure for spectrum allocation and assignment holds the industry back. Early in the history of broadcasting, government claimed the electromagnetic broadcast spectrum as public property. The only way to prevent interference, the theory was, is to have the government allocate blocks of spectrum to particular uses and then assign licenses to those frequencies within a certain area to individual users. For example, a certain range of frequencies is set aside for FM radio, and would-be broadcasters apply for licenses to provide FM service to particular regions or cities. In 1993 spectrum licenses began to be distributed by auction, rather than by hearings or lotteries. That reform did not go far enough.

The government, not the marketplace, still decides which ''blocks'' of spectrum will be used for what services. The slowness of this process

costs the economy tens of billions of dollars. A Progress and Freedom Foundation analysis estimates that a six-year delay in bringing personal communication service technology to the market cost the economy $9 billion.

Even if delays could be eliminated (history suggests that they could not), it makes no sense for government to dole out spectrum to some industries and close it off to others. Bureaucrats cannot know better than entrepreneurs how to use spectrum. Consumers should not be forced to pay more for mobile phone service because the government thinks that spectrum that could be used for mobile telephony should be used only for advanced television.

Furthermore, the current spectrum allocation system allows licensees to benefit from the use of assigned portions of the spectrum only temporarily. Licenses are not full property rights. As residents of the former Soviet Union learned the hard way, private property rights are central to a thriving economy. Temporary licenses make investment in the industry more risky and less rewarding. David Colton, author of a report prepared for the Reason Foundation, cites estimates that auctioning off full property rights in spectrum could raise from $100 billion to $300 billion in revenues.

Anyone (including foreign investors) should be able to use any part of the spectrum to provide any service, as long as he complies with rules against interference. Rights in spectrum should be full property rights, freely transferable.

### *Repeal Universal Service Laws*

Lawmakers erroneously enshrined an expansive concept of universal service in the Telecommunications Act of 1996 by extending subsidies to cover advanced services for the first time. The universal service provisions are incompatible with competition and should be repealed.

The FCC first formalized a universal service policy in 1970. Revenues from artificially high prices on long-distance phone service subsidized artificially low prices for local phone service. That meant that the FCC could not allow competition—competition would force long-distance prices down. There would be no money left to subsidize local services.

Even when the FCC could hold back competition no longer, business users and intrastate long-distance customers paid more, so local service could cost less. As competition grew between providers of local business phone service, the monies that had been siphoned from business users to residential users began to dry up.

The answer in the Telecommunications Act of 1996 was to make all telecommunications service providers pay something toward the universal service subsidy. But competition will force all service providers to move prices toward costs. No business will be able to charge extra. Businesses with the least healthy balance sheets will be hit the hardest.

It's unfair to ask some telephone customers to pay more so that other customers can have lower bills. Subsidizing service to rural areas is particularly unjust. Many rural telephone customers are wealthy. And people live in rural areas by choice. Some things cost more in urban areas (housing) and some cost more in rural areas (transportation). People should bear the consequences of their decisions to live where they do.

History suggests that competition will work better than subsidies to bring services to the poor and to rural areas. By 1920, after a period of competition between independent telephone companies, rural households in the United States had the *highest*, not the lowest, levels of telephone service. In Ohio, Indiana, Illinois, and Kansas, subscription levels ranged from 60 to 70 percent. More recently, intense competition in the computer industry has illustrated how quickly prices come down when free markets are unleashed. Competition, not subsidies, will make even advanced services accessible to the poor.

Finally, subsidizing ''high-cost'' areas sets up a self-fulfilling prophecy that investments in rural and mountainous areas will be unprofitable. Satellite communications and innovations like rural switching centers mean that companies *can* provide affordable service to those areas at a profit. But holding prices below market rates means that no one will invest in those innovations or try to compete against the subsidized incumbents.

Universal service subsidies impose a massive tax on telephone consumers. The universal service provisions of the Telecommunications Act of 1996 should be repealed.

### *Reexamine New Interconnection Regulations*

The interconnection obligations imposed on telephone companies by the Telecommunications Act of 1996 were drafted with the best of intentions. Unfortunately, good intentions do not necessarily make good law. Legislators should begin rolling back interconnection regulations.

Ordinarily, no one gets to use his competitor's facilities to help him compete. A moving company is not obligated to carry other companies' shipments on its own trucks. But that is precisely what interconnection requires. In comparison with the obligations imposed on almost any other industry, interconnection obligations are an extraordinary remedy.

Requiring one company to connect with its competitor violates the first company's property rights and provides a subsidy to the second company. Even if an invasion on property rights can sometimes be justified to prevent monopoly (which was argued in the case of the companies that once formed the old Bell system), lawmakers should move carefully to make the invasion as limited as possible.

Instead of proceeding with caution, the Telecommunications Act of 1996 imposes interconnection obligations broadly on *all* telephone companies, regardless of whether the companies threaten to monopolize anything. Interconnection was assumed to be a cure-all for sick markets, all benefit and no cost, and the drawbacks of interconnection were never explored.

First, the interconnection obligations contained in the act embroil telecommunications companies in an enormously complex and political regulatory apparatus, embodied in the FCC's 700-page interconnection order. Connecting two communications networks requires businesspeople to wrestle with difficult issues of engineering, pricing, and billing. The act makes already uncertain negotiations less likely to proceed smoothly by giving the parties to the negotiations the option of playing political games in the federal or state regulatory arena.

Second, the act gives interconnecting companies almost complete parity with the incumbent service provider. That gives interconnecting companies little incentive to develop their own networks. They can be parasites on the incumbent networks indefinitely. Incumbents are less likely to undertake the expense of building new networks, knowing that those networks will be used by competitors. Too generous interconnection could diminish the chances of facilities-based competition. Expansion of unbundling requirements to new data networks—as the FCC has recently proposed in response to several Bell companies' petitions to build new high-bandwidth backbone and carry interstate data traffic—will be particularly devastating.

Third, mandated interconnection is a form of subsidy; property is taken from one company to be used by another. The more generous the interconnection rights, the greater the subsidy. Expansive interconnection brings into existence a plethora of feeble competitors, all dependent on others' networks. Thus, expansive interconnection will lead to weak competitors who must use the political process to survive.

Because the costs of the interconnection regulatory apparatus probably outweigh the benefits, Congress should consider repealing the interconnection obligations entirely. Congress might also consider second-best alternatives. First, reform the interconnection laws so that companies that never

had government help in maintaining monopoly power need not allow their networks to be used by competitors. Second, give companies that benefit from interconnection incentives to build their own networks, and make it harder for parasitic competitors to survive. Start by

- removing the FCC's authority to require unbundling of new data networks;
- amending the interconnection provisions to sunset on a clear, certain date;
- reforming the law so that companies need not offer complete parity in interconnection agreements; and
- discouraging companies entering interconnection negotiations from manipulating the regulatory process.

### *Complete Cable Television Deregulation*

The debate over cable television regulation has raged for decades. Cable rates have been regulated (by state and municipal governments in the 1970s), deregulated (by the FCC and Congress in the Cable Act of 1984), reregulated (by the Cable Act of 1992), and rederegulated (by the 1996 Telecommunications Act). Now pundits, lawmakers, and regulators are talking about reregulation again. This prolonged and aggravated regulatory uncertainty about the future of cable has decimated capital investment in that industry and violates fundamental principles of fairness. Leaving that issue aside, can regulation be justified because cable is some kind of natural monopoly?

On the pro-regulatory side of the debate, we observe the relative rarity of two cable systems competing in the same area, called ''overbuild.'' In overbuilt areas, cable companies sometimes engage in price wars; one exhausted victor ultimately prevails. One argument for regulation is that this competition is wasteful, inefficient, or destructive—instead, a price-regulated monopolist should be selected by local authorities.

But that is a grave mistake. The contest itself—and the possibility of its revival in the future with the advent of a new competitor—checks the market power of the surviving cable company. And consumers in the marketplace—not a government franchise authority—should decide which company is to survive and serve. Competition between competing cable companies is no more wasteful than competition between grocery stores or between DBS and cable television. And, while the cable market may not always behave exactly as we want it to, regulators do not work perfectly

either. The licensing process in which cable companies strove to please local governments to win a monopoly franchise was notoriously corrupt.

Finally, and perhaps most important, it is most probable that the ''market power'' of cable television will be eroded by competitors that do not provide cable television service. The canals in 18th-century England looked a lot like natural monopolies. It is difficult to imagine two competing companies each building a canal to serve the same route. But then, along came the railroads. The cost structure on which the canal's ''natural monopoly'' was based was eroded by a new technology. There was nothing natural about the canal monopoly at all; it was simply a function of technology, and technology changes, along with costs. Correctly described, the market the canals served was, not the market for transporting goods and persons by water, but simply the market for transporting goods and persons—so railroads, not other canals, provided the stiffest competition.

Similarly, the market for cable television service is not the market for transmitting news, entertainment, and advertising by satellite or microwave to cable headends and beyond to fiber and coaxial cable networks, ultimately terminating at your television set. Rather, cable serves the entire market for news and entertainment. Newspapers, theatres, Blockbuster, the Internet—and of course home satellite dishes and broadcasters—also serve this market.

The danger of regulating a ''natural'' monopoly—cable television or anything else—is that the regulation itself will shut down competition from other technologies. Suppose cable prices are high and cable services are earning high profits. That is the best incentive possible to drive other entrepreneurs to develop new ways of distributing news and entertainment in competition with cable. When cable rates are held down by regulation, cable stagnates as capital dries up. And potential competition stagnates, too. Who wants to enter a market where competitors' prices are held below the market price by regulation? That is predatory pricing with a vengeance.

### *Growing, Growing, Gone: Abolishing the FCC*

Before the Telecommunications Act of 1996 was passed, there was much talk of downsizing or eliminating the FCC. Many leading telecommunications analysts had recognized that the FCC was an extraordinary institutional impediment to free markets in telecommunications. The rapid pace of innovation meant that markets changed too fast for commissions of experts to follow—let alone try to lead. Central planning for the ''public interest'' died with the Soviet Union. Telecommunications markets should

be governed by the same general laws that govern every other industry. As it has in Silicon Valley, true freedom for telecommunications could be expected to bring an explosion of innovation.

Talk of abolishing the FCC has died up since the 1996 act was passed. The idea behind the act was that the FCC must continue to grow now, so that competition could be born, and then perhaps the FCC could be phased out or restructured later. The act was not truly deregulatory and thus left the FCC intact to perform an enormous number of tasks. Staffing levels continued to grow. Planned cutbacks were never implemented. The fundamental fallacy here is that the FCC and continued regulation are good for competition. The view that competition will arrive only if the FCC is there to create it is a myth.

Other countries have recognized that freeing telecommunications markets means drastically downsizing telecommunications regulatory agencies and limiting the agencies' discretion. Those countries include the United Kingdom, New Zealand, and even Guatemala. Because the United States lost its nerve, we are no longer the leaders in returning telecommunications to the free market.

Despite the 1996 act, the long-term goal must be to *eliminate* the FCC, as the ultimate step in freeing telecommunications.

## Conclusion

The regulatory strictures on the telecommunications industry were created with good intentions. But this regulatory regime and the litigation that goes along with it have severe consequences: the market works less efficiently; the uncertainty of the regulatory system deters investment; the regulatory system is used to impede and delay competition. Telecommunications entrepreneurs should be freed to develop a communications infrastructure for the 21st century.

### Suggested Readings

Bell, Tom W., and Solveig Singleton, eds. *Regulators' Revenge.* Washington: Cato Institute, 1998.

Colton, David. ''Spectrum Privatization: Removing the Barriers to Telecommunications Competition.'' Reason Foundation Policy Study no. 208, July 1996.

Gasman, Lawrence. ''Universal Service: The New Telecommunications Entitlements and Taxes.'' Cato Institute Policy Analysis no. 310, June 25, 1998.

Mueller, Milton. *Universal Service: Competition, Interconnection, and Monopoly in the Making of the American Telephone System.* Cambridge, Mass.: MIT Press, 1996.

*The Telecom Revolution: An American Opportunity.* Progress and Freedom Foundation, Washington, 1995.

*—Prepared by Solveig Singleton*