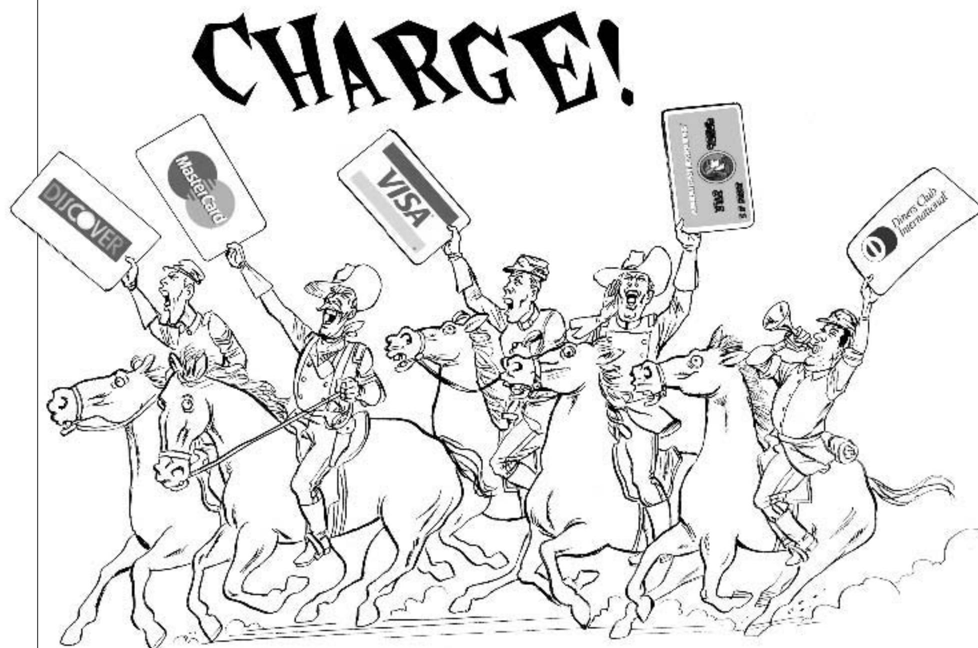
The **Mercatus Center** at George Mason University is an education, research, and outreach organization that works with scholars, policy experts, and government officials to bridge academic theory and real-world practice. The center's Regulatory Studies Program works within the university setting to improve the state of knowledge and debate about regulations and their impact on society. More information about the center can be found on the Web at www.mercatus.org. For the latest federal regulatory developments, visit www.regradar.org.



KEVIN TUMA (3)

Regulation Z

STATUS: Federal Reserve comment period closes March 28.

The Federal Reserve Board of Governors recently announced that it is beginning a review process of the revolving credit disclosure requirements of its Regulation Z. The regulation implements provisions of the 1968 Consumer Credit Protection Act, more popularly referred to as the "Truth in Lending" law. Although the act was significantly amended in 1980 and various parts of the resulting regulations have been modified since then, this is the first time since 1982 that Regulation Z has been reviewed in its entirety.

The Fed's current review focuses on the disclosure requirements for open-end or revolving credit accounts not secured by a home. In other words, it applies mainly to consumer credit card accounts, both merchant-specific and general-purpose bank cards such as VISA and MasterCard. The Fed plans to review other credit facilities under Regulation Z (such as home mortgages) later.

The original rationale for truth-in-lending requirements was to "assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit." Survey results seem to suggest the law has achieved its intended effect. As Thomas A. Durkin observes in a 2002 *Federal Reserve Bulletin* article, consumer awareness of credit card annual percentage rates has "increased from 27 percent of credit card holders before Truth in Lending, to 63 percent in 1970 (15 months after implementation), to 71 percent in 1977, and in 2000 to 85 percent and 91 percent respectively, for the 'narrow' and 'broad' definitions of awareness employed in the 2000 survey."

But disclosure and awareness are not ends in themselves. An important but unstated corollary of the rationale for increased disclosure and awareness is that better-informed consumers make better choices about their use of consumer credit. Some policymakers are questioning whether that is happening, because consumers' use of credit has grown significantly. Since 1970, for example, consumer credit has grown at better than an 8 percent compound annual rate through the third quarter 2004, or more than twice the rate of real GDP growth over the same period. So it would seem that consumers' appetite for credit has risen apace with their awareness of credit costs.

There may be value in studying the relationship between the awareness of credit terms and the use of credit, because it is not altogether clear how that relationship operates. As Durkin points out, "disclosures might even increase [consumers'] credit use if the required disclosures either confirm their previous view that credit is affordable or increase their confidence that using credit is a desirable option." That last point is particularly interesting in that it may signal the emergence of a moral hazard problem. It is possible, in other words, that for some consumers, disclosures may decrease attention to other credit terms or may induce some consumers to assume more debt than they otherwise might.

In any event, the point in raising the possibility of regulation-induced moral hazard is not to argue that it occurs (or that it does not), but simply to suggest that we do not know. Rather than fine-tuning the disclosures themselves in an attempt to capture that remaining 10 percent or so of consumers who are not well-informed, the Fed might perform more of a public service by facilitating systematic research into the extent to which better disclosures of credit costs and improved use of consumer credit relate to each other.

—Jay Cochran, III

Cooling Water Intake

STATUS: EPA comment period closes March 24.

The Environmental Protection Agency has been working for the last few years to reduce the amount of fish killed or injured when water is used for cooling purposes at energy, manufacturing, and industrial facilities. In 2003, the EPA issued "Phase II" regulations governing larger power plants. It is now accepting comment on a "Phase III" rule, which would cover water intake structures at smaller power plants and other facilities. The problem is, the agency is having trouble explaining how the regulations will produce benefits greater than their costs.

When the EPA conducted its analysis of costs and benefits for the proposed Phase II rule, it found the rule did not meet the requirements of President Bill Clinton's Executive Order 12866, which requires agencies to "adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify its costs." The EPA discovered that, on an annual basis, the regulations would cost more than $18 million to save $80,000 worth of fish.

Determined to move forward, the agency got creative in its calculation of benefits. It reasoned that not only do fish have value to recreational fishermen and consumers, but they also have "non-use" value for people who simply are pleased to know the fish exist. Most people share the feeling that animals should not be needlessly injured, and the EPA took that sentiment a step further by putting a price tag on Americans' collective caring about fish.

The agency's analysis ran into obstacles, however, because there is no market value for feeling fondly about fish. When people purchase fish at the market, the price provides a good estimate of how much they value the fish. However, trying to estimate how much they value the fish they did not buy (and that remain uncaught) is far more difficult and may be impossible.

Undaunted, the EPA found a contingent valuation survey that queried people about their non-use value for wetlands. After some heroic statistical gymnastics to convert the value of wetlands to the value of fish, the agency calculated that the annual non-use value of the common forage fish, which the rule would protect, is between $14 million and $27 million a year.

The estimates suggested that we are willing to pay between $61 and $113 per pound for fish that we do not eat, compared to what we pay for fish at our neighborhood grocery store. This was clearly an implausible result derived from questionable methods, and in the final Phase II rule, the EPA was embarrassed into dropping the non-use estimates.

Nevertheless, the agency still believes that non-use values are not only real but they represent a substantial sum. As it moves forward with Phase III regulations, the EPA proposes to conduct an original contingent valuation survey to figure out how people really feel about the loss of the fish.

As the EPA demonstrated in its first attempt to estimate the existence value of fish, this is not an easy exer-

cise. What the agency seems less willing to explore, however, is whether it is a worthwhile exercise. Should stated gains and losses in subjective utility that do not correspond to market values play a significant role in government analysis?

Further, if the EPA is going to do a survey to find out how people really feel about underlying real resources, should it not be balanced and conduct the same analysis for all the real resources involved in the decision? Would the fish rule make electricity production less energy efficient? How do people feel about that? Are we extracting more material—coal, or cement—from mines in order to comply with the regulations? Do people have non-use values related to mining? Are we using up more depletable resources in order to save resources (fish) that are easily renewable? Or are we causing more intensive use of hydroelectric plants, thus killing more fish than we are saving?

The EPA's case for further regulation of cooling water intake structures is weak, so it hopes to manufacture benefit figures to justify the costs. If it succeeds in using surveys to elicit stated non-use values, this may set a dangerous precedent. If we begin to sacrifice the values that we know are real in favor of values that may be imaginary and that have no bounds, it is difficult to know where to stop.

—Daniel Simmons and Susan Dudley

ESA Permit Revocation

STATUS: In effect as of January 10.

When Congress enacted the Endangered Species Act (ESA) in 1973, it broadly prohibited the "taking" (killing or harming) of listed species. The prohibition created disincentives for landowners to conserve habitat, so Congress, the Fish and Wildlife Service (FWS), and the National Marine Fisheries Service (NMFS) have subsequently made attempts to moderate those incentives. (See "The Endangered Species Act Turns 30," Winter 2003-2004.)

In 1982, Congress amended the ESA to create "incidental take permits" that allow landowners to take a species in some circumstances. Under the amendment, if a landowner created and committed to a "habitat conservation plan" and met a series of other requirements, he could negotiate with the FWS or NMFS to receive an incidental take permit that would allow him to "take" a species so long as "such taking is incidental to, and not the purpose of, the carrying out of an otherwise lawful activity."

Few permits were granted initially, but starting in the mid 1990s, the FWS and NMFS granted them with much more frequency. At the same time, the two agencies issued a new regulation called the "No Surprises" rule that provided assurance to permit-holding landowners that, so long as they abide by their commitment to implementing habitat conservation as well as any other terms specified in the permit, the government would not require the landowners to contribute any additional resources to the protection of species. Interior Secretary Bruce Babbitt described the rule's intent when he said, "We've got to establish one simple common-sense principle, and that is one bite at the apple—take a good one—thrash it out, but then say to the developer, 'Okay, a deal's a deal—there aren't going to be any surprises.'"

For a period of time, a series of lawsuits over violations of the Administrative Procedures Act put the No Surprises rule on hold. Once the FWS addressed the legal challenges to No Surprises, it finalized the rule in 1998.

Soon thereafter, the agency began work on a permit revocation rule. In December of 2004, the FWS issued the new rule, detailing the circumstances under which an incidental take permit could be retracted. Specifically, the rule states that the FWS can invalidate a permit when the "continuation of the permitted activity would . . . appreciably reduce the likelihood of the survival and recovery of the species in the wild." This amorphous test gives the agency substantial regulatory leeway because it could claim almost any change "would appreciably reduce the likelihood of survival and recovery."

In adopting this standard, the FWS has reduced the regulatory assurance provided by No Surprises and thus has made habitat conservation a less attractive and viable option for landowners. This is a potential problem considering that 80 percent of the threatened species reside partially or entirely on private land. While it remains unknown to what extent the FWS will seek to revoke permits, the revocation rule certainly has the ability to increase the prevalence of the already well-documented preemptive habitat destruction that occurs in response to the ESA.

Though it is difficult to mediate the conflict between development and species protection as well as the clash between environmentalists and landowners, the FWS's regulatory schizophrenia is not likely to create the proper incentives for the private conservation of species. Some landowners will voluntarily protect species, but many will not. To induce this second cohort to engage in species protection, the FWS should concentrate more on limiting the liability that landowners face.

—John Shoaf and Daniel Simmons

What's Next for Telecom?

By Jerry Ellig

On the same December day that the D.C. City Council said taxpayers would not simply give Major League Baseball a new stadium in the nation's capital, the Federal Communications Commission announced its new rules governing the "unbundling" of local telephone networks. In both cases, the message was the same: "If you don't build at least some of it, you can't come."

For eight years, the FCC has sought to write rules implementing the 1996 Telecommunications Act that federal courts would uphold. Among other things, the 1996 legislation requires incumbent local telephone companies to make elements of their networks available for lease by competitors at regulated prices. A network element must be leased if regulators decide that the competitor's ability to compete would be "impaired" if it does not have access to that element. Courts continually concluded that the FCC failed to enunciate a clear principle defining when lack of access to a network element impairs a competitor.

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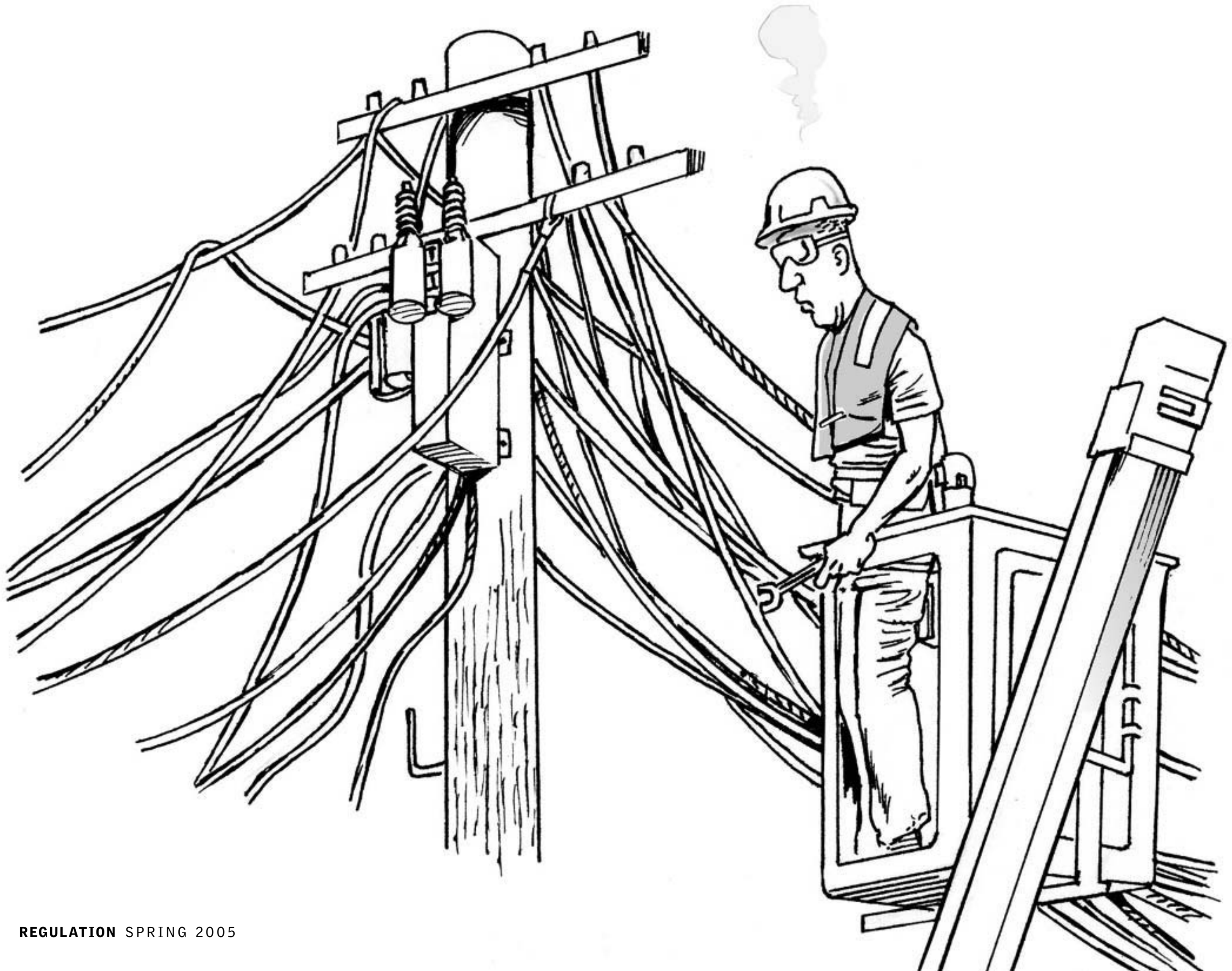
In its previous three rulemaking attempts, the FCC also maintained that incumbents must make available a package of all local network elements needed to provide local service—the "unbundled network element platform." Essentially, that allowed competitors to lease the local phone network at rates lower than those available under the "resale" provisions of the Telecom Act, which require incumbents to sell their service to competitors at a wholesale discount. The new rules eliminate the requirement that incumbents must make the platform available after a one-year transition period.

Henceforth, competition in the residential market for the incumbent local phone companies will not come from competitors selling the same services using the incumbent's network. Instead, competitors will have to build at least some of their own facilities, such as the switches that route calls.

This change represents a victory for outgoing FCC chairman Michael Powell's vision of competition between different infrastructure owners instead of competition between multiple firms using the incumbent's infrastructure. He justified the transition period as necessary to "provide time for quickly emerging alternatives—not the least of which include cable telephony, wireless, and VoIP—to root in the market." (One might also add local competitors



KEVIN TUMA

who use the incumbent's wires but build out the rest of their own networks.)

If the FCC is serious about intermodal competition, its work has just begun. Several significant reforms are necessary to ensure that facilities-based competition will flourish. Key issues include intercarrier compensation, universal service, spectrum management, and broadband policy.

INTERCARRIER COMPENSATION Different telephone companies—such as local, long-distance, wireless, and rural carriers—pay each other vastly different prices per minute when they exchange traffic. In particular, long-distance "access charges" extract subsidies from users of long-distance service so that local phone companies (especially rural carriers) can hold the monthly charge for local residential service below cost. Long-distance access charges average between 1.0 cent and 1.6 cents per minute, but the actual cost of access is measured in tenths of a cent.

Voice over Internet Protocol (VoIP) does not pay access charges, even when a caller uses VoIP to talk with someone on the regular telephone network. But Internet phone providers do pay business rates for their connections to the regular telephone network, which means that they provide some degree of subsidy to local residential service. Regulators must choose whether to bring VoIP under the cross-subsidy tent (which would hamper the technology's diffusion) or leave VoIP free from access charges. A prudent approach would be to leave it free from access charges, but eventually include it in a reformed intercarrier compensation system that charges carriers only for the actual cost of access.

UNIVERSAL SERVICE The FCC requires telephone companies (both wireline and wireless) to make mandatory "contributions" that fund subsidies to high-cost rural phone companies, Internet service to schools and libraries, and programs that help low-income people pay their phone bills—in that order. Most scholarly studies find that those programs do very little to bring phoneless households onto the telephone network. The programs increase telephone subscription at an annual cost of between $1,500 and $11,000 per additional subscriber.

Companies pay a percentage of their interstate revenues to cover those subsidies. The "contribution factor" (i.e., tax rate) for the first quarter of 2005 was 10.7 percent. Because the demand for wireless service is highly sensitive to price, the universal service tax discourages consumers from getting or using wireless phones. MIT economist Jerry Hausman estimates that the excess burden associated with additional wireless taxes is 72 cents for each dollar raised, far exceeding the excess burden associated with more general forms of taxation.

As with access charges, universal service charges threaten to stunt the growth of VoIP. Internet phone services are currently exempt from making universal service contributions. The FCC, however, declared in November that VoIP is an interstate service and is considering whether to impose universal service charges.

SPECTRUM MANAGEMENT The FCC licenses equipment to use the electromagnetic spectrum. In the past decade, it has auctioned off many of those licenses, which is a vast improvement over previous distribution methods such as comparative hearings and lotteries. However, regulators still allocate spectrum among various uses, and license holders have limited ability to sell or lease their licenses to others who might want to offer different services. That policy severely limits the amount of spectrum available for wireless communications.

Approximately 170 MHz of radio spectrum are used for wireless service. Various FCC reports have identified between 183 and 438 MHz of unused or little-used spectrum that could be reallocated for mobile phone, fixed wireless telephony, and wireless broadband. Even the larger figure represents only 23 percent of the most valuable spectrum.

A 2004 study by the Manhattan Institute's Thomas Hazlett and coauthors estimates the effect on consumer welfare of reallocating up to 200 MHz of that spectrum to mobile phone service. Industry sources have suggested that 200 MHz would be needed to complete nationwide rollout of "third generation" wireless services. The per-minute price of wireless service would fall by 50 percent, generating an increase in consumer welfare of $77.4 billion per year. Such a change would make the price of wireless the same as or lower than the price of local wireline service, in spite of the cross-subsidies that the latter receives.

The FCC announced in December that it will auction another 90 MHz of spectrum for wireless, but consumers will have to wait until the auction concludes in 2006 before they receive any benefits.

BROADBAND POLICY Broadband regulation affects telephone competition in several ways. VoIP generally requires a broadband connection, so wider use of broadband makes Internet phone service a more credible competitor. In addition, a favorable regulatory climate for cable modem service could increase cable companies' desire to offer cable telephony so that they can sell the much-vaunted "triple play" of voice, video, and data services.

Key regulatory initiatives would be to free cable modem and DSL from threats of price and access regulation. Cable modem faces such threats because the Ninth Circuit Court of Appeals declared in 2003 that it is partially a telecommunications service rather than an information service; information services are regulated less heavily. The Supreme Court will hear the FCC's appeal this year. DSL faces even greater threats because it is considered a telecommunications service, and so it is critical that regulators credibly derail those threats. Freeing up spectrum allocation could also make more spectrum available for wireless broadband.

CONCLUSION In declaring that incumbents must no longer lease their entire local networks to competitors, the FCC opted for a vision of facilities-based competition that promises a diminishing role for regulation. To make that vision a reality, regulators should aggressively act to remove barriers that hamper competition from wireless, VoIP, and cable modem services. R