Readings

Competition Meets Telecommunications Regulation

Changing the Rules: Technological Change, International Competition, and Regulation in Communications
edited by Robert W. Crandall
and Kenneth Flamm
(The Brookings Institution, 1989), 424 pp.

Reviewed by John T. Wenders

The U.S. telecommunications industry can best be described as a regulatory cartel in which a balance of interests was struck. The industry, long dominated by the Bell System, got regulation that assured its profitability and largely protected it from competition and the antitrust laws. The politicians and regulators got a toll (long distance)-to-local subsidy that benefitted their strongest political constituency—residential subscribers.

This balance of interests was politically efficient because it maximized the vote-getting that drives the political-regulatory mechanism. But it was very economically inefficient and resulted in greatly overpriced toll usage and perverse incentives. Inevitably, market forces began to tear it apart.

This volume of essays, the result of a conference at the Brookings Institution in 1987, provides an excellent discussion and many data on the recent history and status of the telecommunications industry. As the volume well illustrates, the major remaining inefficiencies and competitive barriers are still regulatory and political. The major weakness of this book is its lack of any substantive analysis of how the political-economic mechanism works in this industry, so that there are few realistic suggestions about how the existing structure might be altered to produce a more efficient outcome. How can we change, at the margin, the balance of interests that produces the still inefficient outcome?

The quality of the papers in the volume is uniformly very high, and they are accessible to the general reader. The three key essays, comprising 50 percent of the volume, are by Kenneth Flamm on technological change, by Robert W. Crandall on the local operating companies, and by Leonard Waverman on U.S. toll competition.

Flamm's essay documents in detail the rapid technological change that has driven transmission (primarily) and switching costs down in the postwar era. Technological advances have reduced the cost of providing toll relative to local services and have unleashed market forces creating pressures for corresponding price changes. Thus, the struggle for the overpriced toll market continues today. As Flamm argues, however, compared with the unregulated computer industry, these technological changes were implemented slowly. He also argues that "communications hardware costs dropped much less rapidly than those of computers" and points out that switching prices fell sharply only after the AT&T divestiture. He concludes that the perverse incentives of rate-of-return regulation were responsible for both the slowed introduction of new technology and the toll market's higher than competitive prices.

Waverman's analysis of the toll market accepts the notion that natural monopoly—the existence of economies of scale and scope—is a legitimate reason to regulate. He then shows that such conditions do not exist in the market and concludes that the toll market is largely competitive. Waverman is right on both scores, but searching for proof in cost data is a fruitless exercise. Data generated by regulated monopolies probably has little relationship to the cost structure that would occur under open competition. Natural monopoly cost conditions might be found simply because the market was regulated as a monopoly.

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Further, natural monopoly theory fails to provide a credible reason for real-world regulation because it presumes perfect regulation to carry out its idealistic prescriptions, but perfect regulation does not exist in this or any other industry.

Crandall focuses his analysis on the question of whether the divested Bell operating companies (BOCs) should continue to be prevented by the Modification of Final Judgement (MFJ) from integrating forward into long-distance markets or backward into equipment and information services. As the Department of Justice initially held —before it got cold feet—in the triennial review of the MFJ, Crandall concludes that the line-of-business restrictions on the BOCs should be kept in place until the states adopt alternatives to protective cost-based local rate-of-return regulation. (Do not hold your breath.) Crandall finds that the old integrated AT&T probably did use its control of the local operating companies to prevent entry into toll and terminal equipment markets and that it did favor Western Electric as a supplier. But he also concludes that the alleged subsidization of competitive services by regulated markets was unlikely. The old Bell System's foreclosures of outside competitors are probably irrelevant in debates on the proper range of activities for the divested BOCs. The equal access system is in place, and the terminal equipment market has been completely deregulated. Potential problems remain if the BOCs are allowed to integrate backward into equipment manufacturing, but these difficulties result from the perverse incentives created by local rate-of-return regulation. Crandall's finding that AT&T did not engage in cross subsidization of its competitive operations is not surprising since the whole political thrust of regulation was just the opposite—to use revenues from the various toll markets where the political constituency was weak to subsidize local markets, especially residential service, where the political constituency was much stronger.

As Crandall points out, by far the largest economic distortions in the industry result from the continued overpricing of toll services. These pricing policies arise from the politically motivated allocation of local accounting costs to the local access services needed by the retail toll carriers. Thus, Crandall's (and Waverman's) proposals to improve competition in the retail toll market will have little effect on efficiency there because the major source of inefficient toll pricing is the overpricing of local access. As long as this is controlled by the regulatory process, no amount of massaging of the competitive conditions in the retail toll market will amount to much.

Aside from the very useful and nontechnical descriptions of much of the recent history of the industry, Flamm's, Waverman's, and Crandall's essays also contain many useful data on costs, prices, and market shares.

This volume also includes interesting and competent reviews of international telecommunications generally (Eli Noam), Japan (Tsuruhiko Nambu, Kazuyuki Suzuki, and Tetsushi Honda), the developing countries (Ashoka Mody), technical standards (Stanley M. Besen and Garth Saloner), national security (Ashton B. Carter), and the technical growth of the telecommunications and computer industries (Nestor E. Terleckyj). An essay on the situation in the United Kingdom, where the same problems were tackled in a different way, could have been useful.

The striking feature on the international scene is the remarkable similarity across countries of the general thrust of both regulation and market forces. In general, regulation produced an overpricing of toll and international services for the benefit of local (and postal!) service, a resistance to technological change, heavy-handed protection of the incumbent monopoly carriers, and the inevitable gnawing of market forces for reform wherever service was overpriced or otherwise restricted. Apparently the laws of both the political and economic markets work much the same in all democracies.

Whatever our complaints about the distortions created by regulation in the United States, we can take some consolation from the fact that it was usually much worse in the rest of the world, where outright government ownership often prevailed. Imagine what U.S. telecommunications would be like if—as in most of the West—they were run by the Postal Service! For years, as Flamm's essay points out, the Bell System led the world in introducing new technology, and the United States has been at the forefront of liberalization and deregulation. Only the United Kingdom and Japan have made similar efforts. While the United States still has a way to go, especially in severing decisionmaking from politics and opening up the local markets, overall the U.S. telecommunications service is the best in the world.

Still political-regulatory forces do not reform themselves. The progress made by the FCC and, inadvertantly, by antitrust enforcement has been bitterly opposed by political forces and state regulators. A new short-run balance of economic and

political forces has been reached. But the ball is still squarely in the political arena as various regulatory commissions, Congress, and Judge Greene continue to define the rules of the game establishing the competitive and noncompetitive environments. Activity is now dominated by self-interested jockeying and rent-seeking. Most of the disinterested policy recommendations in opposition to further liberalization are based on either the spectre of what the BOCs could do by acting irrationally, for example by cross subsidizing, or what they might do because of the perverse incentives of state regulation, for example by gold-plating the rate base. Public policy is also hampered by the tendency to use introspective tests, which need information that is largely unknowable, rather than to have faith in market processes, where the information actually is, to sort out matters. Further progress will come about only by the inevitable work of the market as it seeks out every niche where regulation has produced uncompetitive results.

Applying the Double Standard

Japan's Unequal Trade
by Edward J. Lincoln
(Brookings Institution, 1990), 164 pp.

Reviewed by William A. Niskanen

One might hope that a responsible policy institute would provide some balance to the inflamed rhetoric about Japan's trade practices. Unfortunately, this book by Edward J. Lincoln, a senior fellow in the foreign policy studies program at the Brookings Institution, does not provide that balance.

Lincoln acknowledges that Japan has lower tariffs and fewer quantitative restraints on manufactured imports than that of any other major nation, including the United States. Moreover, he recognizes that trade balances are primarily determined by macroeconomic conditions and are not much affected by trade policies. And he favors the liberal trade principles embodied in the GATT over a system of managed trade.

Nevertheless, Lincoln concludes that the U.S.



"HERE'S YER PROBLEM- THIS HERE LITTLE JAPANESE DOO-DAD IS BLOCKING YER TRADE FLOW!"

government should continue to pressure Japan to change those domestic government and business practices that may limit its import of manufactured products. He makes three arguments for this conclusion:

- Japan is now an economic superpower, and a failure to change its trade patterns may undermine the world trading system.
- U.S. trade pressure and more open Japanese markets may be necessary to maintain our mutual security relations.
- Japan's policy of protecting emerging high-technology industries gives the Japanese an advantage in international competition.

But Lincoln applies a double standard. A similar case has been made that the newly aggressive U.S. trade policy is the major threat to the world trading system and our mutual security relations. And there is no consistent pattern that indicates that protection of infant industries leads to increased international competitiveness.

Japan *is* different. Most of Lincoln's book is an attempt to demonstrate that the differences in Japanese trade patterns reflect a system of implicit protection. One chapter reviews the numerous studies that attempt to explain Japan's unusually low rate of manufactured imports. Most of this difference is explained by the same conditions that explain the rate of manufactured imports in other countries. Whether the Japanese rate reflects implicit protection depends on such technical issues as whether one should control for the distance to major markets. One chapter documents Japan's unusually low rate of intraindustry trade. One chapter summarizes Japan's major unusual domestic policies and business practices, both of which Lincoln describes as "distorted." And another chapter describes the

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many dimensions in which Japan is changing rapidly. In this regard he should have mentioned that Japan is becoming especially open to U.S. exports. The Japanese share of U.S. merchandise exports, for example, increased from about 9 percent of total U.S. exports in 1980 to over 12 percent in 1989.

Lincoln concludes that continued U.S. pressure on Japan is justified by the observation that "its current behavior remains at odds with the pattern of other industrial nations." He may not appreciate the irony that the focus of the initial Super 301 charges was on three Japanese practices that are quite similar to those affecting the same industries in the United States. He is wrong in concluding that "overwhelming evidence proved that [the 1986 semiconductor agreement] was not being implemented"; the U.S. government never released the evidence on which it based the charge of third-country dumping, and the basic agreement did not commit Japan to purchasing a specific share of semiconductors from imports. He appears not to understand that U.S. trade policy is now the primary threat to the GATT. For nearly 40 years, under U.S. leadership, the industrial countries developed a system of mutually agreed rules about allowable trade practices and a common dispute-settlement process. In recent years, however, the U.S. government has increasingly resorted to unilateral pressure to change the domestic practices of other nations that may limit our exports, even when such practices are wholly consistent with GATT rules. Japan has been the special target of this pressure, but we are all its victims. This reviewer is saddened by yet another academic rationalization of the unilateral bullying that has become the dominant tactic of U.S. trade policy.