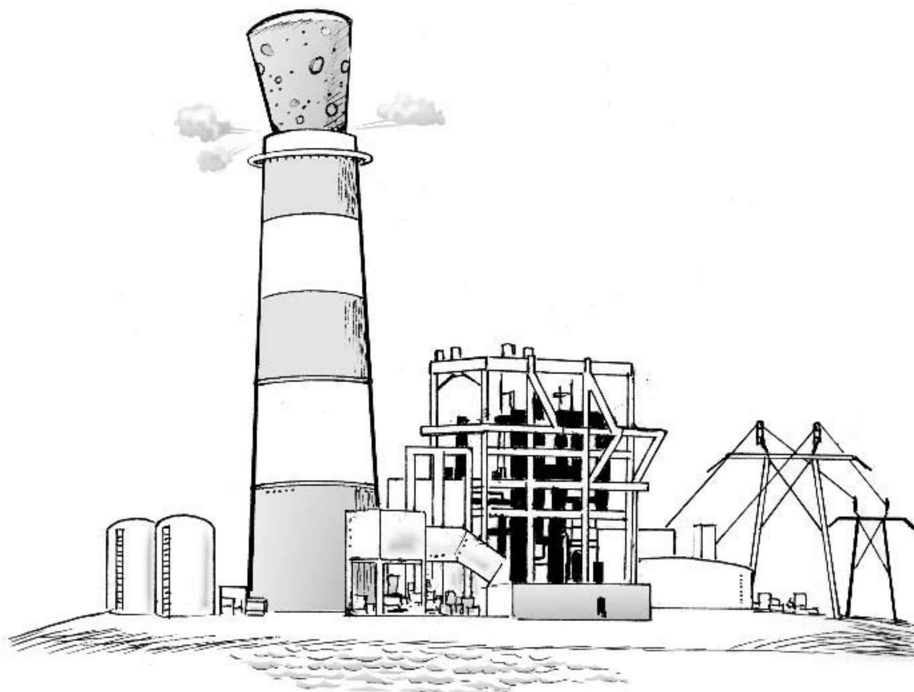
The **Mercatus Center** at George Mason University is an education, research, and outreach organization that works with scholars, policy experts, and government officials to bridge academic theory and real-world practice. The center's Regulatory Studies Program works within the university setting to 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 (2)

Mercury Emissions

STATUS: EPA considering public comment

Last January 30, in an effort to reduce human exposure to mercury, the Environmental Protection Agency proposed a regulation to require coal-fired power plants to lower mercury emissions. While mercury is clearly toxic to humans at high doses, the EPA presented no evidence that Americans face any health effects at current levels of exposure or that the proposed rule will result in a decrease in human exposure to mercury.

The EPA expects the mercury emissions regulations to cost American citizens $8.2 billion in capital costs, and an additional $1.6 billion to over $4.5 billion per year in operating costs. The agency is unable to quantify any benefits directly from reducing mercury levels, but instead justifies its proposal by relying on the ancillary reductions in other pollutants such as sulfur dioxide (SO_2) and nitrogen oxides (NOx), which contribute to ambient particulate matter levels.

While it is difficult to quantify the benefits of reducing mercury emissions from utilities, the agency's approach is analytically incorrect and misleads policymakers and the public as to the desirability of the proposal. SO_2 and NOx emissions from power plants are already regulated; the regulation of mercury emissions should stand on its own. To make Americans better off, the benefits of regulating mercury should outweigh the costs, as required by President Bill Clinton's Executive Order 12866. The EPA does not demonstrate that with this proposed rule.

The proposal embraces market incentives with a cap-and-trade system to help achieve reductions at lower cost. While economic incentive mechanisms, such as cap-and-trade, can be an efficient way to achieve environmental goals, they do not help us identify sound policy goals. If focused on the wrong metric (e.g., reducing mercury emissions when the health benefits are presumed to derive instead from particulate matter emissions) or on capping emissions without knowing whether this will produce any health benefits, trading mechanisms alone cannot ensure socially desirable outcomes.

Moreover, by creating a legal "cartel" to whom emissions allowances are allocated, a cap-and-trade system can impose substantial additional costs on consumers. Those additional costs do nothing to reduce emissions, but tend to be wasted in the rent-seeking contest to acquire emissions allowances — further undermining an already questionable benefit-cost calculation. **— Daniel Simmons**

IP-Enabled Services

STATUS: FCC considering public comment

The Federal Communications Commission has asked for public comment on a wide variety of issues related to the regulatory status of "Internet Protocol (or IP)-Enabled Services" that people use to communicate with each other in various ways. Those services include instant messaging, interactive games, gambling, virtual private networks, maps, various video services, and (perhaps most significantly) Voice over Internet Protocol (VoIP) telephony. Key issues include whether IP-enabled services should be subject to economic regulation, pay access charges to local telephone companies, or make contributions to federal universal service programs.

The FCC is rightly suspicious of the claim that IP-enabled services should be subject to regulation of prices or entry. There is no evidence that those services can or would be monopolized.

IP-enabled services are currently treated as business telephone customers. Unlike long-distance phone companies, they do not pay access charges to local phone companies. Access charges subsidize below-cost local telephone service, so that all Americans can have a cheap local phone line. A considerable empirical economics literature finds that access charges generate significant consumer costs while doing little or nothing to increase the number of people who subscribe to local phone service. The FCC has effectively recognized this, as evidenced by its longstanding efforts to substitute fixed "subscriber line charges" for usage-based access charges, along with a more recent initiative to create a uniform regime governing interconnection between all types of phone companies. The wisdom of extending the old policies to cover a new competitor is questionable — especially since IP-enabled services already contribute some subsidies to residential phone service by paying business phone rates, which usually exceed the cost of providing the service.

The FCC also asks whether IP-enabled services should contribute to federal universal service programs, which subsidize phone service for low-income consumers, subsidize "high cost" phone companies, and fund discounts on Internet service for schools and libraries. Economic research shows that those "contributions" (or taxes) generate significant costs for consumers over and above the amount of money they transfer to favored recipients. The "excess burden" associated with the taxes on long-distance and wireless, for example, was approximately $2.6–3.0 billion in 2003. That excess burden represents the value of long-distance and wireless services that consumers and producers forego because the universal service contribution factor raises the price of those services.

For now, the FCC seems inclined to keep most IP-enabled services free from access charges and universal service contributions, treating them similarly to e-mail and other applications in which computers communicate with each other. In a decision earlier this year, the FCC even declined to apply those charges to Internet telephony, as long as the calls are routed solely over the Internet and never use the "public switched telephone network."

The key controversy involves phone calls where one party uses the conventional telephone network and the other uses an IP-enabled voice service. In this case, the IP-enabled service must interconnect with the conventional telephone network. Such interconnection makes IP telephony a more significant competitive threat to the conventional phone companies, and it also gives regulators an opportunity to extract payments with which to subsidize conventional local phone service.

The rise of IP telephony presents the FCC with a stark choice. It can try to perpetuate the current practice of overcharging consumers for some services in order to guarantee every American a cheap local phone line or it can reform the cross-subsidy policies that are threatened by the rise of this new competitor. **— Jerry Ellig**

Regulators' Budget

STATUS: New Mercatus-Weidenbaum report released

Each year, the Mercatus Center at George Mason University and the Weidenbaum Center at Washington University in St. Louis examine the president's submitted *Budget of the U.S. Government* to track the expenditures of federal regulatory agencies and the staff needed to run those agencies.

The 2005 *Budget* articulates "three overriding national priorities: winning the war on terror, protecting the homeland, and strengthening the economy." It commits to hold the growth of total discretionary spending to 3.9 percent and to reduce the growth in non-defense, non-homeland security spending to 0.5 percent, below the rate of inflation.

The "Regulators' Budget" — the portion of the *Budget* directed at administering and enforcing federal regulations — exceeds the 3.9 percent overall goal. The 2005 *Budget* requests outlays for regulatory activities of $39.1 billion, a 5.5 percent nominal (4.2 percent real) increase over the appropriated 2004 *Budget*.

The allocation of fiscal regulatory expenditures among the different departments and agencies reflects national concerns about homeland security and corporate governance. Though regulatory enforcement and administration in the Department of Homeland Security comprises 43 percent of the Regulators' Budget, that budget declined in fiscal year 2004 and is budgeted to increase by only 1 percent in 2005. The proposed budget of the Security and Exchange Commission, on the other hand, reflects two years of significant increases for regulatory activities (42.1 percent in 2004 and 44.5 percent in 2005 in real terms). The Regulators' Budget also includes large increases in outlays at the Environmental Protection Agency, the Food and Drug Administration, and the Patent and Trademark Office.

Staffing at the federal regulatory agencies is expected to reach an all-time high of almost 242,500 in 2005.

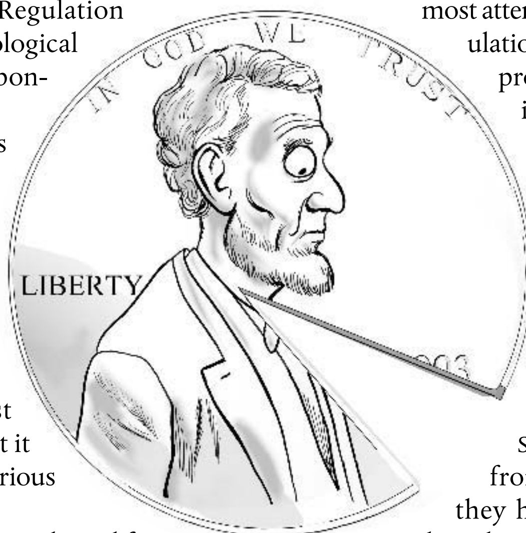
— Susan Dudley and Melinda Warren

Modernizing National Equity Markets?

By Jonathan Clarke

The Securities and Exchange Commission is considering sweeping reforms that will profoundly change the regulatory environment of national equity markets. SEC Chairman William Donaldson notes that the reforms, which are collectively known as Regulation NMS, "will result in the most significant modernization of the National Market System since the original rules were adopted after the National Market System legislation in 1975." But, with respect to Chairman Donaldson, I believe Regulation NMS has the potential to stifle technological innovation and decrease market responsiveness to investors.

At the center of Regulation NMS is the trade-through rule, which requires an order be routed to the market with the "best" available price. The rule's supporters contend that it will increase market liquidity, facilitate trading integration across markets, and benefit investors by forcing brokers to find the best available price. Detractors argue that it will hinder competition among the various marketplaces.



A natural way to discriminate between those different views is to compare transaction prices on the New York Stock Exchange, which has a trade-through rule, to the NASDAQ Stock Market, which has no such rule. Recent scholarly research suggests that trading costs, as measured by the bid-ask spread, are not substantially different across the two markets. In other words, the presence of a trade-through rule has not led to lower prices for investors. This sentiment is echoed in the SEC's own proposal, which notes that, "even without a trade-through rule, the NASDAQ market does not appear to lack competitive quoting in most actively traded securities."

The SEC also needs to understand that investors are not always focused on achieving the best price. They are also concerned with, among other things, speed of execution, anonymity, and certainty of execution. Taking into account those non-price dimensions, the NASDAQ Stock Market has flourished. A number of different markets now trade NASDAQ stocks. Orders can be routed to various electronic communications networks and crossing systems, each specializing in different dimensions of best execution. Thus, investors have the ability to choose their trading venue based on the factors important to them. That choice is largely missing for the NYSE-listed securities. Approximately 93 percent of trading volume in NYSE-listed securities is executed through its relatively slow auction market.

Another significant problem with the trade-through rule is that it will require market linkages between trading platforms. Past experience suggests that this will be challenging. Currently, the Intermarket Trading System (ITS) electronically links together the NYSE, AMEX, and various regional stock exchanges. The ITS was developed in the late 1970s and early 1980s, and has not kept pace with technological innovations. Because no one "owns" the ITS, there is little incentive for any of the connected market centers to invest in technological upgrades to the system. Any future replacement for the ITS would likely experience the same underinvestment problem.

While the trade-through proposal has garnered the most attention, other proposals contained in Regulation NMS could hurt investors. The SEC is proposing a ban on the quoting of stocks in increments finer than a penny. In "sub-penny" trading, the price of a stock can be displayed beyond two decimal places. For example, a price $3.811 could be quoted instead of $3.81. The SEC is concerned that the increasing use of sub-pennies will negatively impact market liquidity. Interestingly, market centers appear to recognize the concerns raised by the SEC and have voluntarily moved away from quoting in sub-pennies. However, they have retained the flexibility to quote selected securities in sub-pennies.

Mandating a one-cent minimum price increment ultimately hurts investors by forcing them to pay artificially high spreads on certain securities. Market centers, and not the SEC, are in the best position to determine for which securities the benefits of sub-penny quoting outweigh the costs.

Regulation NMS promises to dramatically alter the landscape of U.S. securities markets. Unfortunately, the law of unintended consequences suggests that the trade-through rule and the sub-penny pricing proposals in particular are likely to create as many problems as they may solve. Although the SEC aims to bring the U.S. regulatory structure up to date, Regulation NMS has the potential to stifle innovation. The trade-through proposal, if enacted, would give market centers disincentives to invest in new technology and would force them to adapt to an antiquated system of market linkages. The sub-penny quoting proposal would lock in a one-size-fits-all solution that could actually harm investors. The SEC might better serve the investing public by allowing competitive forces in the marketplace to determine prices, pricing increments, and trading attributes. R

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