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.

Executive Order 13422

STATUS: In effect, but may be challenged by Congress

Concepts like "market failure" and "good guidance practices" might seem uninteresting compared to other Washington political discussions. But changes, involving these concepts, to the executive order governing review of agencies' regulations have actually led to hearings and legislative proposals to block the changes.

Until January, the Bush administration's regulatory review procedures were outlined in Executive Order 12866, which was adopted during the Clinton administration. In January, the Bush administration issued Executive Order 13422, which made several changes to EO 12866.

First, each agency's regulatory policy officer, who must approve new regulations, must now be a presidential appointee. Since some fear that this change increases the president's influence over agencies' regulatory decisions, it has ignited the usual battle over whether the president is actually allowed to manage the executive branch of government. Congressional committee chairs would prefer to have regulatory agencies solely responsible to them, so they are understandably put out by this assertion of presidential authority.

Second, significant agency documents that provide guidance on how to comply with regulations must now be submitted to the Office of Management and Budget for review. A significant guidance document is one that would have an economic effect of $100 million or more, create a serious inconsistency with some other agency's actions, materially alter the budgetary impact of federal programs, or raise novel legal or policy issues. Thus, guidance documents from agencies that would have the same kinds of effects as major new regulations are now subject to OMB review.

Third, the agency must identify in writing the market failure or other systemic problem the regulation is intended to solve. This represents two subtle differences from EO 12866. Agencies must now put the justification for the regulation in writing, which enhances transparency. In addition, the new language says agencies must identify "the specific market failure ... or other specific problem it intends to address." President Clinton's executive order said the agency must identify "the problem it intends to address (including, where applicable, the failures of private markets or public institutions that warrant new agency action)." In other words, agencies must now identify the market failure or other problem they are trying to solve, whereas before they had to identify the problem they were trying to solve, which might be a market failure or something else. Got it?

It is something of a mystery why the requirement that a market failure be identified has generated controversy. It imposes no new analytical requirements; agencies are still free to justify new regulations by identifying a market failure or some other problem. The slight change in emphasis might mean agencies are supposed to consid-

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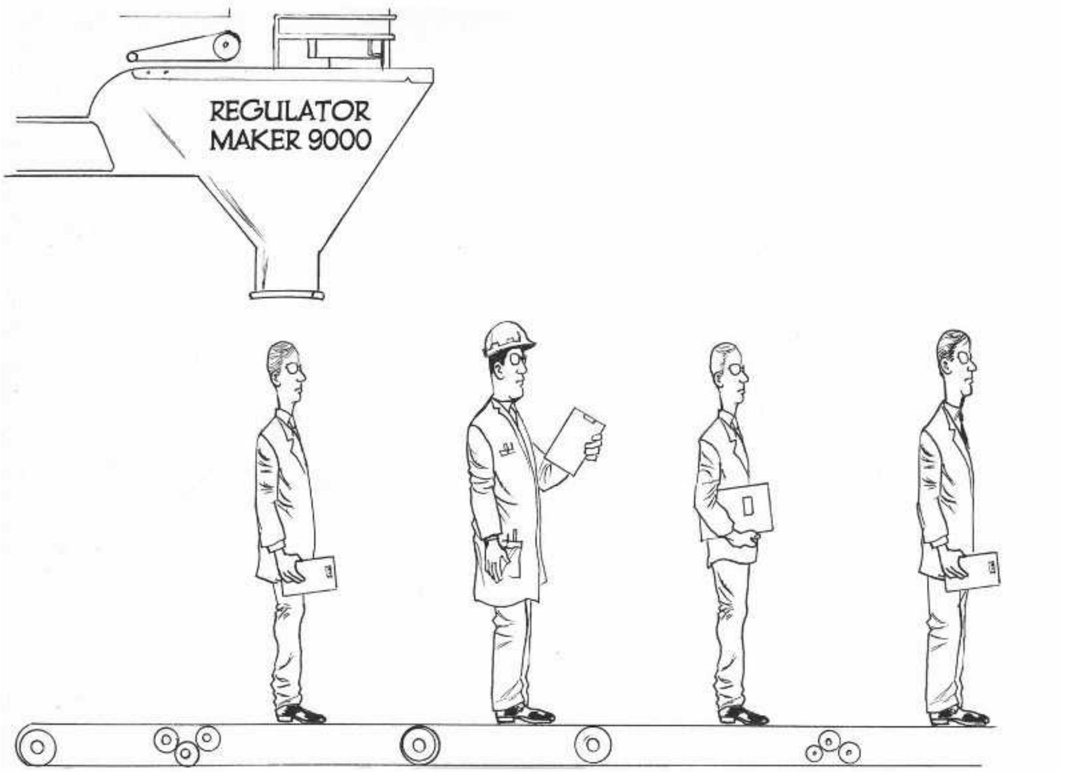

er the possibility of market failure first — the way most economists instinctively approach regulatory issues.

Critics of the market failure approach to identifying where government intervention is appropriate fall into multiple categories. Some of them claim that markets never fail, others believe that markets fail at virtually everything, and still others believe that the concept is irrelevant because policymakers usually do things for other reasons. Yet others accept the concept of market failure but point out that governments may also fail and need correction and that, even where there is market failure, government may not be able to make the situation better.

The House of Representatives has voted to prohibit the administration from implementing the changes in EO 13422, but a Senate appropriations subcommittee declined to do so in July. Whether the prohibition makes it into the fiscal 2008 budget bill — and whether the administration would veto a budget bill over this issue — remains to be seen. **— JERRY ELLIG**

Regulators' Budget

STATUS: 2007 report now available

Regulations impose social costs on individuals and businesses beyond the direct tax dollars expended to write and enforce them. Not only are there costs associated with compliance, but regulations can restrict opportunities and choices, thus imposing opportunity costs.

Those latter costs are difficult to measure, so efforts to track the change in regulatory activity over time often depend on proxies. One proxy is the size of the *Code of Federal Regulations* (often measured in number of pages or feet of shelf space occupied by the *Code*), which provides a sense of the flow of new regulations issued during a given period. The latest edition of Clyde Wayne Crews' regular *Ten Thousand Commandments* report found that the 2006 *Federal Register* contained 74,937 pages, a 1.4 percent increase over 2005's 73,870 pages. Those page counts are down from 2004's record-high 75,676 pages. In 2006, according to the report, agencies issued 3,718 final rules, a 6 percent decline from 2005's 3,943 rules.

Crews' figures comport with the findings in the latest edition of the *Regulators' Budget* series, prepared by the Mercatus Center at George Mason University and the Murray Weidenbaum Center at Washington University in St. Louis. The series relies not on number of *Federal Register* pages or rules, but on the budgets and staff sizes of federal regulatory agencies. The latest edition of the *Regulators' Budget,* titled "Growth in Regulation Slows: An Analysis of the U.S. Budget for Fiscal Years 2007 and 2008," finds that President Bush's proposed 2008 Budget calls for $46.6 billion in expenditures on regulatory activities for fiscal year 2008, a 1.7 percent increase (in real, inflation-adjusted terms) from fiscal year 2007. This represents a lower rate of growth than previous years. Estimated 2007 outlays were 5.2 percent greater in real terms than fiscal year 2006 expenditures. The 2008 Budget calls for expenditures that are 51.8 percent higher than in 2000 — an increase in real spending on regulatory activities of $13.2 billion between 2000 and 2008.

The requested level of staffing on regulatory activities in fiscal year 2008 is 251,595 full-time equivalent workers, or 7,385 (3 percent) more employees than in fiscal year 2007. This reflects a 43 percent increase over staffing levels in 2000, largely attributable to the Transportation Security Administration's employment of over 57,000 airport screening agents in 2003 (currently down to 43,000 agents).

Consistent with the president's "Budget Message" statement that his "highest priority is the security of our Nation," the 2008 Budget requests the largest dollar and staff increases for regulatory components of the Department of Homeland Security.

Although the *Regulators' Budget* projected rate of growth for 2008 falls below the rate of inflation (1.7 percent versus 2.4 percent), it nevertheless stands in contrast to the objective expressed in the Budget of "hold[ing] the rate of growth for nondiscretionary spending to one percent, well below the rate of inflation."

— JERRY BRITO AND MELINDA WARREN

Considering Net Neutrality

By Jerry Brito and Jerry Ellig

Should economic regulation be adopted only after proponents have empirically demonstrated that a market failure exists? Or is some prophylactic regulation justified to prevent market failures that have not yet occurred but may happen in the future? Two regulatory agencies — the Federal Communications Commission and Federal Trade Commission — have independently wrestled with those questions in considering the arguments for and against "net neutrality" regulation.

In April, the FCC issued a Notice of Inquiry seeking information about broadband industry practices that would help it determine whether new net neutrality regulation is needed. In June, the FTC released a staff report summarizing the results of a two-day workshop it conducted on net neutrality, as well as research conducted by the commission's Broadband Task Force. In both cases, the agencies have sought information rather than proposing new rules.

IS THERE A MARKET FAILURE?

In its Notice of Inquiry, the FCC asked very specific questions, such as:

- Do providers treat different packets of data in different ways? How and why?
- Are there specific examples of packet management practices that commenters consider reasonable or unreasonable?
- Do providers de-prioritize or block data packets containing material that is harmful to their commercial interests, or prioritize packets relating to applications or services in which they have a commercial interest?
- Do broadband providers charge upstream providers for priority access to end users?

The FCC explicitly pled with commenters to "provide specific, verifiable examples with supporting documentation, and [to] limit their comments to those practices that are technically feasible today." Unfortunately, many commenters did not heed that call.

Close to 10,000 comments were submitted in the docket. The vast majority of the comments were brief text comments or e-mails, akin to form letters, sent at the urging of groups such as Free Press, Common Cause, and FreedomWorks. If one uses the FCC's comment search engine to exclude the brief comments, only 143 comments remain. Of those, many are simply letters on behalf of some organization or another expressing support for one side of the issue and offering no answers to the FCC's specific questions. Only 66 of the 143 comments are longer than two pages. Of those 66, only 20 comments suggest the need for regulation of broadband industry practices, and of those 20, none put forth any significant empirical evidence to suggest that there currently exists a market failure justifying regulatory intervention.

Some of the comments, such as the one issued jointly by the Consumer Federation of America, Consumers Union, and Free Press, chide the FCC for focusing on the wrong issue in its search for empirical evidence of consumer harm. The commenters take issue with previous FCC decisions that classify broadband as a (less regulated) information service, then proceed to offer their own theory of a "structural" market failure that implies bad things could happen. Other commenters, such as the Center for Democracy and Technology, suggest that the two years that broadband has been classified as an information service do not provide a long-enough time frame for abuses to manifest themselves.

The FCC's questions were clear and well-crafted to elicit evidence of market failure, if indeed such problems currently exist. The meager responses fail to make a case for net neutrality regulation on the basis of existing abuses.

IS MARKET FAILURE LIKELY? Many commenters suggest a prophylactic justification for neutrality regulation by appealing to the possibility of harmful behavior. The Open Internet Coalition states that "a network provider may have the ability and incentive to exclude rival content, applications or portals from its network." BT Americas, the American arm of British Telecommunications, writes that "U.S. broadband providers now have the incentive and ability to unfairly discriminate in price and quality." The National Association of State Utility Consumer Advocates writes of "the economic incentive and the potential" for providers to engage in anticompetitive discrimination. Google claims that broadband incumbents have "the incentives and ability to discriminate against third party applications and content providers."

The phrase "incentive and ability" appears repeatedly in comments that argue for net neutrality regulation. Those comments typically cite theoretical economic models that demonstrate why, under certain assumptions, a dominant firm would have incentives to discriminate. Such models may be an accurate depiction of reality if their assumptions are true and there are no countervailing factors in the real world that might lead to different results. But citing a theoretical possibility is not the same thing as demonstrating empirically that the possibility is highly likely, or even likely, to occur. Other, more competitive, outcomes are equally plausible — even in markets with a small number of competitors.

Counting competitors, calculating market shares, or calling broadband a "duopoly" is not sufficient to prove a "structural" market failure. Not even using the word "duopoly" a tire-

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some 34 times or the phrase "cozy duopoly" 11 times, as one comment does, is sufficient to prove market failure.

There are three reasons that market structure is only one part of the puzzle. First, economic theory and empirical evidence both demonstrate that markets with a small number of competitors can still produce competitive behavior. Second, there is substantial evidence of competitive conduct in consumer broadband, such as rapid price reductions and increases in speeds. Third, additional competition, in the form of wireless broadband backed by substantial investment, has just begun entering the market.

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Barriers to entry also require subtle analysis. Broadband markets are not "perfectly contestable"; entrants must shoulder some "sunk costs" that they might not be able to recover if they leave the industry. However, the presence of multiple actual and prospective competitors using a variety of technological platforms suggests that broadband is far from being a "natural monopoly." The relevant issue, therefore, is not whether barriers to entry exist, but whether they are so high that they make monopolistic behavior likely to succeed.

Commenters offered numerous theories suggesting what *could* happen, but "could" is not the same as "likely." A rigorous analysis demonstrating that market failure is likely must define the relevant market, determine whether there is significant market power in that market, determine whether profit incentives for discriminatory behavior outweigh profit incentives for avoiding such behavior, and then determine whether the net effect of such behavior would be likely to help or harm consumers.

FTC FINDINGS In a report issued after the FCC's initial comment period closed, the FTC staff extensively summarized arguments for and against net neutrality regulation. They concluded that there is little evidence of actual discrimination and little empirical evidence that would help assess whether discrimination that harms consumers is likely. A two-day FTC workshop held in February produced no more empirical evidence of anticompetitive discrimination than the FCC Notice of Inquiry produced.

The FTC staff concludes that there is little evidence of actual anticompetitive conduct by broadband providers: "[T]here is little evidence to date of consumer harm from anticompetitive practices by ISPs or any other network operators; the allegations of anticompetitive conduct focus mainly on effects that may occur if certain actions, such as exclusive agreements or vertical integration, are undertaken in the future." Besides an isolated case of VoIP-blocking by a small rural ISP that occurred before the deregulation of broadband services, the closest thing to actual discrimination the FTC staff could find was statements by some network operators that they would like to prioritize certain data traffic or to provide other types of quality-of-service assurances to content and applications providers and/or end users in exchange for a premium fee.

"With respect to discrimination," the FTC staff notes, "broadband providers have conflicting incentives related to blockage of and discrimination against data from non-affiliated providers of content and applications." Whether network owners have sufficient incentive to discriminate against others' content and applications in ways that harm consumers is ultimately an empirical question. Unfortunately, little or no empirical analysis exists to guide policymakers: "It appears that, thus far, little attention has been paid in the net neutrality debate to the question [of] how possible harms and benefits from such discrimination might be assessed in the broadband Internet access context."

Given the lack of evidence of market failure, the FTC staff urges caution:

> In evaluating whether new proscriptions are necessary, we advise proceeding with caution before enacting broad, ex ante restrictions in an unsettled, dynamic environment.… Based on what we have learned through our examination of broadband connectivity issues and our experience with antitrust and consumer protection issues more generally, we recommend that policy makers proceed with caution in evaluating proposals to enact regulation in the area of broadband Internet access. The primary reason for caution is simply that we do not know what the net effects of potential conduct by broadband providers will be on all consumers, including, among other things, the prices that consumers may pay for Internet access, the quality of Internet access and other services that will be offered, and the choices of content and applications that may be available to consumers in the marketplace.

A TALE OF TWO CULTURES? The FCC's Notice of Inquiry produced no more evidence of market failure than the FTC's workshop and research. If the FCC proposes net neutrality rules anyway, that will say as much about the differing cultures of antitrust and regulatory agencies as it says about the merits of the issue. **R**