TELECOMMUNICATIONS & TECHNOLOGY

GROUNDHOG DAY AT THE FCC

Consumers don't benefit from "reflexive protectionism."

BY DENNIS L. WEISMAN

In the movie *Groundhog Day,* weatherman Phil Connors (Bill Murray) is sent to the annual event in Punxsutawney, Pa., to report on whether Phil the groundhog sees his shadow. Connors becomes caught in a time loop in which he relives the same day over and over again, until the repeated experiences lead him to a personal revelation.

We appear to be experiencing a similar phenomenon at the Federal Communications Commission with its most recent effort at protectionism: Title II "net neutrality" regulation for broadband. (See also, "What Hath the FCC Wrought?" p. 50.) The agency's previous forays into protectionism in both the long-distance and local telephone service markets (along with others, such as broadcasting) were worrisome because of their intra-industry protectionism—they protected new market entrants from entrenched industry competitors. The Title II initiative is even more worrisome because it reaches beyond the telecommunications industry to ban innovative applications of telecommunications technology for purposes of product differentiation out of concern that small firms may be disadvantaged.

The basic idea underlying protectionism is relatively simple: protect fledgling competitors in the early stages of their development so they have an opportunity to grow into robust competitors able to stand on equal footing with larger rivals. This role has proven difficult for regulators to resist because shielding smaller competitors from the rigors of competition is as instinctive as it is misguided. Protectionism cannot be dismissed on purely theoretical grounds—it is an empirical issue, but the FCC's track record here has little to recommend it as having expertise on when protectionism is appropriate. The pattern is remarkably similar across each of the FCC's forays into the realm of what I call "reflexive protectionism"—and the worst may be yet to come.

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PROTECTING LONG-DISTANCE COMPETITORS

During the introduction of competition in the traditional landline long-distance market, the FCC's protectionism manifested itself in the form of "hit them high and hit them low." The agency prohibited AT&T from reducing its retail prices at the same time that it conferred large discounts on smaller interexchange carriers for switched access (i.e., the rates paid to local exchange carriers for the origination and termination of long-distance messages). This pricing umbrella was designed to ensure that smaller carriers survived and enabled the FCC to tout the presence of hundreds of providers in the long-distance market. There is a natural temptation for regulators to mistake mere rivalry (or the number of competitors) for competition. But increasing the absolute number of competitors in a market is of no particular significance if it does not yield lower prices, higher rates of innovation, and greater choice for consumers. This is where the FCC's policies fall well short of the mark.

In a 1986 law journal article, then FCC chair Mark Fowler and two other agency officials acknowledged that the commission's protectionist policies in the long-distance market—specifically those related to creating artificial margins (propping up retail prices while maintaining low access prices) so that competitors remain financially viable—may have harmed consumers:

> It can be argued, for instance, that some of the Commission's regulatory actions in the interexchange market that were designed to promote competition during transition, such as highly discounted access pricing for [other common carriers] and restrictions on competitive pricing responses by AT&T, in fact have encouraged entry by uneconomic providers and uneconomic construction of excess capacity. If this is true, the gradualist approach to deregulation of interexchange markets will have resulted in substantial, unnecessary costs for society that never would have been incurred in a truly competitive marketplace. Moreover, this approach will have directly increased

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> consumer costs by requiring regulated firms to charge higher prices to protect competitors during the transition.

This same consumer-harming dynamic is in play in the Title II initiative today.

That's not to suggest that some competitors will not fail; they have and they will. Indeed, to borrow language from a 2008 article I co-wrote with University of Virginia law professor Glen O. Robinson, "if we do not see competitors fail, we do not see real competition" because failure is an essential part of the competitive process in all industries in which market forces reign. Regulators can attempt to protect firms from failure, but the moral hazard problem this protectionism creates does not strengthen the competitive process to the benefit of consumers. Rather, it weakens the competitive process to the *detriment* of consumers. Not wanting to see competitors fail on their watch, "regulators inevitably find themselves hostage to inefficient competitors," as Robert Crandall noted in these pages ("Telecommunications Policy in the Reagan Era," Fall 1988). Regulators must therefore not mistake protecting the viability of individual competitors with protecting the integrity of the competitive process.

PROTECTING LOCAL COMPETITORS

In implementing the 1996 Telecommunications Act, the FCC embarked on a protectionist path eerily similar to that which it followed in the long-distance market. The agency ordered incumbent providers to unbundle the network elements underlying virtually every retail service that they offered at prices based on the suspect "TELRIC" costing methodology designed to produce artificially low access rates. (The economic principle of cost-based rates was transformed into the uneconomic principle of rate-based costs.) The FCC's "helping hand" proved to be anything but in terms of enhancing consumer welfare. As Robinson and I observed in our 2008 article,

> Infant industry type arguments might have inspired the adoption of liberal access policies apart from any price subsidy. We do not know of any evidence on this point, but assuming it could be descriptively true, we think it is normatively objectionable for the reasons we have explained. Economics is not biology. The moral imperatives that animate our support for human infants to increase the likelihood of their survival do not apply to infant firms. In fact, to the extent that such nurturing artificially increases the likelihood of survival of infant firms, it can, and we believe does, undermine the vigor of the competitive process to the detriment of consumer welfare. At a minimum there must be a reasonable expectation that the social benefits of such nurture for infant firms exceed the costs.

Once again, the FCC's approach produced more heat than light. Despite large-scale entry into local telephone service markets amidst staggering misallocations of capital, there is scant evidence that such entry resulted in significant downward pressure on prices, but ample evidence of repressed innovation and investment.

IS PAID PRIORITIZATION A PROBLEM?

So, twice the FCC has attempted to encourage competition artificially in telecommunications markets through protectionist policies, and twice it has succeeded only in reducing consumer welfare in violation of the Hippocratic oath to "First, do no harm." We might think that in light of this history the FCC would be somewhat reticent with its latest effort at reflexive protectionism—that of Title II regulation of broadband—but we would be wrong. The FCC's third-such attempt has the potential to inflict even greater harm because it represents a case of inter-industry protectionism. The FCC now proposes to extend its helping hand outside of the telecommunications industry, to "promote" innovation and investment in the general economy. Apparently, it would be discriminatory for an industrial policy this inefficient and ill-conceived to be confined to just one industry.

In proposing a ban on paid prioritization, the FCC seeks to protect small providers of content from large providers. The agency's contention is that this ban on prioritized access will yield a net gain in innovation. Without the ban, smaller providers would purportedly be competitively disadvantaged because they do not have the deep pockets of the large providers. In other words, they claim not to be able to afford the prioritized access that broadband providers are willing to sell and at least some content providers are willing to buy in the course of a purely voluntary exchange. Hence, if the smaller providers cannot afford prioritized access, then it should not be available to any of their bigger rivals—full stop.

This argument does not hold up to careful scrutiny. The "deep pockets" concern about large providers having an unfair advantage is largely irrelevant with efficient capital markets because investors will beat a path to your door if they credibly believe you have a better mousetrap. Hence, by invoking this argument, the smaller providers have essentially conceded either that (1) they do not have a better mousetrap (in which case society is better off if they fail, and fail quickly, so that capital can be reallocated to a higher-valued use); or (2) they actually have a better mousetrap and have simply failed to convince potential investors of such. If it is the latter, then "what we have here is a failure to communicate" and the FCC has no constructive role in protecting these small providers. A communications failure does not equate to a market failure.

It is important to fully grasp the magnitude of what the FCC is proposing with its Title II initiative for broadband and its consequences for dynamic efficiency. Imagine the government prohibiting carbon fiber manufacturers from selling their product to Ford because smaller automobile manufacturers cannot afford the high-priced input to produce trucks and automobiles. This is essentially what the FCC has done with its ban on paid prioritization: it has directly interfered with and undermined the competitive process by preventing some content providers from differentiating their service offerings on the grounds that it would be too expensive for other providers to replicate. The FCC would have us believe that this is a forward-looking industrial policy for the world's largest market economy, but it reads more like a propaganda speech introducing a new and improved five-year plan that begins with the words, "Fellow Comrades."

CONCLUSION

It is the relentless struggle for survival among firms as part of what Joseph Schumpeter famously described as the "perennial gale of creative destruction" that ensures that consumers enjoy the greatest number of choices for products and services at the lowest possible prices. Regulators should not be in the business of protecting competitors; they should be in the business of fostering the competitive process to maximize the benefits to consumers.

The economics literature establishes that innovation is a principal driver of growth in domestic product and consumer welfare over time. Robert Solow, the recipient of the 1987 Nobel Prize in Economics for his pioneering work on the sources of economic growth, observed in his Nobel lecture that "the rate of growth ... depends entirely on the rate of technological progress." In other words, as goes investment and innovation, so goes the wealth of a nation. In designing industrial policy for technologically dynamic industries, the government should focus less on controlling market power and more on unleashing the power of markets.

And yet, with its Title II initiative for broadband, the FCC has done precisely the opposite. There is no record of market power that needs controlling, and its confounding plan to encourage innovation is to first stifle it. Good luck with that plan.

It is Groundhog Day at the FCC and the skies are cloudy, but there is no sign of revelation or spring. *R*

READINGS

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