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The Faulty Berkman Report: "The Fallacy of Overlooking Secondary Consequences"

by

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The late journalist and economist Henry Hazlitt once warned of "the fallacy of overlooking secondary consequences."¹ In Hazlitt's words, the great fallacy consists of "the persistent tendency of men to see only the immediate effects of a given policy, or its effects only on a special group, and to neglect to inquire what the long-run effects of that policy will be not only on that special group but on all groups."² Hazlitt's classic book, *Economics in One Lesson*, is a concise exploration of the persistence of this fallacy across a range of economic policies pursued by government, including various regulatory policies as well as "make work" projects, commodity price controls, and inflation.

Unfortunately, this very same focus on specific, immediate effects and disregard for general, secondary longer-term consequences pervades a recent report recommending changes to U.S. broadband policy. *Next Generation Connectivity: A review of broadband Internet transitions and policy around the world*³ (hereinafter "the Berkman Report" or "the Report") is a misguided plea for drastically expanded government regulation of broadband networks in the United States.

The Recovery Act charged the Federal Communications Commission (FCC) with preparing and presenting a National Broadband Plan to Congress by February, 2010. As part of the process for assembling its roadmap for American broadband

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technology policy, the FCC tasked the Berkman Center for Internet & Society to prepare a report examining several foreign nations' national broadband policy initiatives and evaluating prior studies that ranked nations according to broadband capabilities.⁴ The FCC's July public announcement of its commissioning of the Report seemed to suggest the completed report would emphasize data that the FCC, in turn, could rely on in creating a data-driven National Broadband Plan. It is now clear, however, that the published Report isn't a reliable straightforward comparison of deployment, adoption, speeds and prices of broadband technology among different countries that one might have expected – or at least hoped for. Instead, through its selection of data and its analysis, the Berkman Report is a judgment-laced call for the implementation of onerous "open access" regulatory policies through government-managed "competition" and open-ended monopoly regulation.

As the Berkman Report recounts, several foreign nations have implemented sweeping government broadband initiatives. The Report touts the deployment of broadband that it attributes to those initiatives. A number of foreign nations have imposed "open access" mandates on dial-up Internet service and are now beginning to extend those mandates to high-speed broadband service.⁵ Some nations are even imposing such regulations on wireless broadband networks.⁶ Justifiably referred to as "forced access" by its policy opponents,⁷ such regulations typically include requiring that network providers give marketplace competitors access to their networks at the wholesale level or even access to their infrastructure facilities for collocation at government-set rates. The thinking behind such "open access" regulations is that high fixed costs of building new infrastructure and facilities serves as a barrier to marketplace entry by competitors. Therefore, government must mandate that incumbents operate their networks as open platforms and lease their infrastructure to competitors in order to create more competitive choices for consumers. The Report insists that these "open access" regulatory regimes have played an important role in deployment of information services in those countries.

It is hardly unexpected that a correlation can be found between certain "open access" policies and Internet adoption or broadband deployment in a given nation. After all, even undesirable public policies won't grind investment and adoption in broadband to a total halt where there is consumer demand (and government subsidies) for new, higher-quality services. In particular, incumbents who have already sunk costs into advanced broadband infrastructure should be expected to try to make a return on their investments the best they can even where government policies are less-than-favorable to additional investment. For-profit businesses still need to invest their money somewhere, and sometimes industries bet, at least in the short term, that they can outlast the reign of particular regulators or the duration of particular unsound regulatory policies.

However, correlation is not the same as causation, particularly in a complex marketplace involving many intervening factors affecting investment and innovation. "Open access" may coincide with some incumbent investment or expansion, and it certainly has the ability to stimulate, at least in the short term,

new entrant spending , though not necessarily on new, competing facilities. But it is easy for policymakers to miss the hidden effects of regulation that so concerned Hazlitt. In this context, there is the broadband infrastructure investment that would have happened if there had been *no* regulation, with private companies pursuing ventures from which they could expect to get a return on their investment.

Also relevant but easy to miss is the cost borne by foreign taxpayers to fund their nation's broadband deployment. In *Economics in One Lesson*, Hazlitt related the obvious truth that producers, consumers, and taxpayers are overlapping categories: "Each one of us is a producer, consumer, taxpayer."⁸ Government subsidies that reduce prices for people in their capacity as consumers come at the cost of people in their capacity as taxpayers. As Hazlitt wrote: "Who subsidizes the consumer will depend upon the incidence of taxation. But men in their role as taxpayers will be subsidizing themselves in their role as consumers."⁹ Now the Berkman Report does acknowledge in passing that foreign nations' broadband initiatives were funded by foreign governments themselves rather than the private sector alone.¹⁰ But the hidden or long-range costs to taxpayers of entrenching a system of publicly-funded and/or government-managed broadband access competition instead of private sector-funded facilities-based competition isn't seriously factored into Berkman Report's overall picture. An overemphasis on the supposed monopoly rents paid to incumbents broadband providers makes it easier, but nevertheless wrong, for the Report to overlook direct taxes or indirect ones in the form of regulatory costs that one might characterize as monopoly rents paid to government. Nonetheless, the opportunity costs of government policies must be taken into consideration in any comprehensive analysis of major public policies.

The underlying working assumption of the Berkman Report seems to be that incumbent broadband access providers enjoy a position of market power that allows them to charge consumers prices much higher than would otherwise prevail under market conditions. If this is indeed the assumption, the Report nowhere provides any market power analysis. (It does, however, present an unbundling econometric analysis.¹¹) Then again, the Berkman Report could be working on the assumption that *no* market power needs to be shown before imposing facilities- or network-sharing regulations. The Report dismisses facilities-based competition and instead emphasizes government-managed competition. Viewing the costs of entry into the broadband access market as too high to attract new competitors, the Report suggests that facilities-based competition is probably futile and would most likely result in unnecessary duplication of competing broadband facilities. With its seeming embrace of a "wasteful competition" rationale,¹² the Report's recommended "open access" policy lends itself to the unending regulation of almost every conceivable aspect of broadband infrastructure technology.

Of course, the Berkman Report cannot endorse its "open access" regulatory approach without acknowledging the U.S.'s own tumultuous experiment with such policies under the Telecommunications Act of 1996. The Report insists that

the U.S. once had its policy pretty close to the foreign "open access" model it so highly touts,¹³ and it urges a revitalization and expansion of that same policy for wireline broadband. In doing so, it engages in a whitewashed retelling of the FCC's unbundled network element/unbundled network element-platform (UNE/UNE-P) saga that simply ignores the costly downsides and opportunity costs stemming from the FCC's unbundling regulations. Senior Judge Stephen F. Williams of the U.S. Court of Appeals for the District of Columbia Circuit acknowledged the opportunity cost question in reviewing the FCC's old unbundling rules, writing that "the existence of investment of a specified level tells us little or nothing about incentive effects. The question is how such investment compares with what would have occurred in the absence of the prospect of unbundling."¹⁴ On that point, Judge Williams explained: "Each unbundling of an element imposes costs of its own, spreading disincentive to invest in innovation and creating complex issues of managing shared facilities."¹⁵

According to the Berkman Report, there appears to be no economic downside to the UNE/UNE-P regulatory mandates. Nowhere in the Report is there any reflection of the reduced incentives for incumbent broadband access providers to undertake the risks and costs of implementing innovative upgrades to their networks when their competitors maintain a legal right to lease network elements at below-market government-set rates. Under forced sharing regulations of this kind, incumbents face a reduced return on infrastructure investment while competitors enjoy free rides to the extent those risks and costs exceed rates. Aside from incumbent infrastructure investment disincentives, the Report similarly fails to acknowledge the disincentive to new entrants to undertake risks by investing capital in their own facilities. By throwing in the towel on real facilities-based competition policy in favor of government-managed competition, the Report apparently assumes there is no need to consider the unintended consequences for infrastructure investment incentives.

Thus, the Berkman Report's revisionist history entirely ignores empirical evidence of the real-world, deleterious economic incentive effects of unbundling regulations. For instance, in an analysis of UNE/UNE-P unbundling regulations under the Telecommunications Act of 1996, economist Robert Crandall observed that "the economic and regulatory environment forced incumbent local carriers, including the Bell companies, to reduce their capital spending more than their major rivals in local communications markets, namely, the cable companies and wireless companies."¹⁶ Crandall found that in 2002 Bell company capital spending fell the most in states that were reducing their UNE rates.¹⁷ Economist Thomas Hazlett has made similar observations of network "disinvestment" attributable to unbundling regulations: "Investment in local telecommunications networks declined precipitously in the period coincident with the implementation of extensive network sharing, as measured by the increase in UNE-P lines."¹⁸ Enormous regulatory compliance costs also resulted. In addition to engineering expenses required for incumbents to meet unbundling requirements, successive sets of unbundling rules raised successive legal challenges.¹⁹ According to Crandall, the data demonstrates that infrastructure investments and network

upgrades by such companies climbed once those unbundling rules began to be scaled back.²⁰

Meanwhile, UNE/UNE-P unbundling regulations induced a flurry of wireline competitive entrants that relied heavily upon FCC-mandated access to incumbent facilities. As Crandall determined, "by the end of 2003 nearly two-thirds of all entrants' lines reflected little more than the resale of the incumbents' services."²¹ "Even more significant, reliance on the unbundled platform has been associated with lack of growth in the new entrant use of their own lines."²² Devoting substantial sums of money to marketing and promotional activities designed to lure incumbent customers away, such competitors had reduced incentive to finance their own facilities.²³ Developing conditions for sustainable, long-term wireline voice competition for consumers proved elusive under UNE/UNE-P regulations. In the end, local wireline saw new "competitors" without seeing corresponding increases in capital investments, as incumbents lost customers and revenue to competitors. And countless of the new "competitors" fell into bankruptcy or just faded away,²⁴ unable to sustain their businesses absent the guarantee of government resale rates.

While acknowledging that the unbundling provisions of the Telecommunications Act of 1996 was directed primarily to telephone voice services and did *not* have Internet access in mind, the Berkman Report's version of U.S. unbundling history tells us that the FCC's decision to extend unbundling policies to Internet access was thwarted by resistant incumbents and by federal courts' disagreement with their policies.²⁵ By the Report's preconceived account, the failure of UNE/UNE-P in the U.S. was really a failure to heed the visionary judgment and expertise of its regulators.

So how have open access policies succeeded in foreign nations when the fate of those policies proved so different in the U.S.? "In some countries," the Berkman Report reads, "the moment of the shift in the relative professionalism, independence, and power of the regulator in relation to the incumbent, and its will and capacity to engage in enforcing a competitive playing field, are widely seen as the moment of takeoff for their present generation of broadband deployment."²⁶ In other words, in other countries the technocrats triumphed over the incumbents. By the Berkman Report's rationale, in order for the U.S. to sustain a successful "open access" 2.0 regime, its regulators must be accorded greater "professionalism, independence, and power." In this view, more "engaged" U.S. regulators can impartially weigh the costs and benefits of "open access" policies relative to incumbents and competitors, both as to Internet access and content, to stimulate broadband competition and deployment.

So, according to this story line, a successful "open access" policy for the U.S. depends upon the ability of government regulators to manage advanced communications technologies on a nationwide basis. This is an ultimately unrealistic view. Giving regulators more power and independence is no panacea or solution to stimulating broadband investment or competition. In a dynamic market such as advanced broadband, regulatory mandates concerning network

capacity, engineering and other complexities invariably raise even further complications and problems. For instance, network neutrality regulatory mandates that broadband access providers treat all bits of data traffic on their networks alike heighten Internet traffic congestion dilemmas for networks. They also make the task of policing and taking action against piracy and other forms of malicious activity more problematical. Imposing a simple data traffic non-discrimination rule becomes anything but simple if broadband access providers hope to pursue different, innovative solutions to give all of their customers reliable broadband speeds and services since regulators would then be faced with how to treat different network management solutions.²⁷ Advanced information services like broadband that transcend the capabilities of voice or traditional common carrier services make regulatory mission creep an even more likely possibility.

In sum, the Berkman Report urges a force-fit of the generally highly regulatory broadband regimes employed by several foreign social democracies on the American broadband marketplace. It relies on a falsely optimistic picture of the ability of government regulators to direct investment on a nationwide basis for the deployment and operation of advanced technologies. And it presents a highly selective and thereby misleading account of the FCC's prior attempts to impose on broadband networks open access policy through unbundling regulations. These glaring weaknesses in the Report undermine its usefulness to American policymakers. The FCC, in particular, should recognize those shortcomings and discount or disregard the Report's regulatory recommendations accordingly.

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¹ Henry Hazlitt, *Economics in One Lesson* (1962.ed) at 10.

² *Id.*

³ Berkman Center for Internet & Society at Harvard University, *Next Generation Connectivity: A review of broadband Internet transitions and policy around the world* (Report) (October 14, 2009), available at: http://www.fcc.gov/stage/pdf/Berkman_Center_Broadband_Study_13Oct09.pdf.

⁴ See Federal Communications Commission (FCC), *Public Notice: Harvard's Berkman Center to Conduct Independent Review of Broadband Studies to Assist FCC* (July 14, 2009), available at: http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-291986A1.pdf; see also FCC, Public Notice: Comments Sought on Broadband Study Conducted by The Berkman Center for Internet and Society, GN Docket Nos. 09-47, 09-51, 09-137 (October 14, 2009), available at: http://hraunfoss.fcc.gov/edocs_public/attachmatch/DA-09-2217A1.pdf.

⁵ See Report, at 76.

⁶ See Report, at 152-161

⁷ See, e.g., Adam Thierer and Clyde Wayne Crews Jr., *What's Yours is Mine: Open Access and the Rise of Infrastructure Socialism* (2003) at 2 ("While portrayed as a benign, pro-consumer, competition-enhancing intervention, open access is in reality *forced sharing*, not competition"); *id.* at 9 ("Forced access regulation is essentially at war with private property rights"); Adam Thierer, "The Fiction of Forced Access 'Competition' Revisited," Tech Liberation Front Blog (September 13, 2009), available at: <http://techliberation.com/2009/09/13/the-fiction-of-forced-access-competition-revisited/>.

⁸ Hazlitt, at 131.

⁹ Hazlitt, at 126.

¹⁰ See Report, at 13.

¹¹ See *id.*, at 138 *et seq.*

¹² See, e.g., *id.* at 76 (referring in Table 4.1 to "approaches to share costs, risk, and facilities, rather than focusing primarily on creating redundant facilities to assure competition").

¹³ See Report at 83.

¹⁴ *U.S. Telecom. Assoc. v. FCC*, 290 F.3d 415, 425 (D.C.Cir. 2002).

¹⁵ *Id.* at 427.

¹⁶ Robert W. Crandall, *Competition and Chaos: U.S. Telecommunications Since the 1996 Telecom Act* (2005), at 69.

¹⁷ *Id.* at 70.

¹⁸ Thomas W. Hazlett, "Rivalrous Telecommunications Networks With and Without Mandatory Sharing," 58 *Fed. Comm. L.J.* 477, 491 (2006). See also Jeffrey A. Eisenach and Thomas M. Lenard, "Telecom Deregulation and the Economy: The Impact of 'UNE-P' on Jobs, Investment and Growth" *Progress on Point* 10.3 (Progress & Freedom Foundation) (January, 2003) at 11 ("There is a broad and growing body of empirical research suggesting that current UNE policies deter investment. This research is grounded in generally accepted economic theory, which suggests that firms' investment decisions are determined by the expected 'net present value' (NPV) of the investment. Simply put, firms will invest in new facilities when they believe they can make money from doing so"), available at: <http://www.pff.org/issues-pubs/pops/pop10.3unepimpact.pdf>.

¹⁹ See, e.g., *Verizon Communs., Inc. v. FCC*, 535 U.S. 467 (2002); *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366 (1999); *Covad Communs. Co. v. FCC*, 450 F.3d 528 (D.C.Cir. 2006); *US Telecom. Assoc. v. FCC*, 359 F.3d 554 (D.C.Cir. 2004); *US Telecom. Assoc. v. FCC*, 290 F.3d 415.

²⁰ See Crandall, at 127; see also Jeffrey A. Eisenach, "Broadband Policy: Does the U.S. Have It Right After All?" *Progress on Point* 15.14 (Progress & Freedom Foundation) (September, 2008), at 10-11 (discussing studies and trends in telecommunications network infrastructure investment increases after the FCC began exempting broadband infrastructures from mandatory unbundling), available at: <http://www.pff.org/issues-pubs/pops/2008/pop15.14USbroadbandpolicy.pdf>.

²¹ Crandall, at 37. See also Robert W. Crandall, "The Remedy for the 'Bottleneck Monopoly' in Telecom: Isolate It, Share It, or Ignore It?" 72 *U. Chi. L. Rev.* 3, 19 ("There is no innovation in this [unbundling] process, simply an increase in marketing expenditures to convince consumers to change the billing address for their local carrier").

²² *Id.*

²³ *Id.* ("Thus it appears that noncable entrants stopped investing in their own facilities, perhaps because of the adverse outcomes for those who did so before the 2000 collapse in CLEC stock values, but also because the environment created by regulators provided passive resellers of incumbent services more attractive returns than did investing in their own switches or even their own complete networks"). See also Randolph J. May, "When Friends Agree to Disagree: Data and Regulatory Philosophy," FSF Blog (Free State Foundation) (September 12, 2009) (discussing ISP competition under FCC unbundling regulations), available at: http://freestatefoundation.blogspot.com/2009/09/data-and-regulatory-philosophy_12.html.

²⁴ See Hazlett, 58 *Fed. Comm. L.J.*, at 497 ("Market and financial analysts reached a broad consensus that the resale opportunities put into place by regulation suppress incumbents' and competitors' investments in network facilities. The generous profit opportunity seemingly awarded new competitors disappears in retail discounts and customer acquisition costs").

²⁵ See Report, at 82.

²⁶ *Id.*, at 78.

²⁷ See Crandall, 72 *U. Chi. L. Rev.* at 21 ("Mandating network sharing at long-run incremental cost-based prices invites disputes over network design and is likely to undercompensate network owners for the risk of the premature obsolescence of their sunk facilities. Both of these problems are likely to reduce capital spending and the deployment of new technologies").