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On Market Power and the Power of Markets: A Schumpeterian View of Dynamic Industries

by

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In a market or private enterprise economy, the norm is reliance upon competitive forces to provide the requisite discipline on prices and quality. Governmental intervention in the form of economic regulation is warranted only in exceptional circumstances, typically some type of market failure.[1] This observation raises the fundamental question whether most economic regulation of the telecommunications industry—given the rapid rate of technological change and increasing competitive intensity—is still justified. That is to say, do the benefits of pervasive economic regulation exceed their corresponding costs in the U.S. telecommunications industry today?

This question is, of course, of much more than academic interest. While there have been some reductions in traditional direct regulatory intervention over the past decade, such as moving away from rate-setting in the context of specific rate

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[1] A market failure refers to conditions in which market forces alone are insufficient to provide for an efficient allocation of resources. Economies of scale/scope and production/consumption externalities can give rise to market failures.

proceedings, the urge to continue public utility-type regulation of the telecommunications industry is alive and well. Pro-regulatory advocates vociferously push adoption of proposed new regulatory regimes, such as net neutrality, open access, and unbundling mandates, which are likely to prove just as intrusive as the old ones. In this paper, I contend that a Schumpeterian view of dynamic efficiency is much more conducive to conferring benefits on consumers than a static efficiency view. In considering the continuing role of regulation of communications providers, whether in the context of more traditional older forms of regulatory control, or newer ones such as net neutrality or open access, it is important that legislators and regulators appreciate the difference between the dynamic and static views.

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Passage of the 1996 Telecommunications Act was a watershed event in the history of telecommunications policy in the United States. In essence, it envisions substituting a policy of "competition-enabling" for direct regulation as the central constraint on market power of the incumbent providers. In many ways, the reason that the Federal Communications Commission (FCC) had to travel such a torturous road in implementing the 1996 Act was its failure to distinguish clearly and consistently between "regulatory-ratemaking" and "competition-enabling" policy objectives. To quote Justice Breyer: "The Telecommunications Act is not a ratemaking statute seeking better regulation. It is a deregulatory statute seeking competition."[2] The FCC's confusion over this important distinction led it to adopt overly broad network sharing rules that encouraged imitation at the cost of innovation and, as a result, brought investment in the telecom sector to a virtual halt.[3] In case we need to be reminded, firms do not share well with rivals and when forced to do so are likely to take their "marbles" and go home, or at least try in various ways to do so.

In commenting on the boom and bust in telecommunications markets and the regulators' culpability in it, Michael Powell, the immediate past chairman of the FCC, observed that regulators attempted to drive the price of entry close to zero in telecommunications markets and, as a result, succeeded in attracting primarily arbitrageurs rather than genuine innovators.[4] And yet, it is widely recognized in the economics literature that dynamic efficiency (the introduction of innovative new services and production methods) is more important than static efficiency (the alignment of prices with economic costs) in terms of conferring benefits on consumers. This is particularly likely to be the case in technologically dynamic industries, such as telecommunications.

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[2] Verizon Communications v. Federal Communications Commission, 535 U.S. 467, 543-544 (2002). (Breyer, J. dissenting).

[3] See, for example, Alfred E. Kahn, Timothy J. Tardiff and Dennis L. Weisman, "The 1996 Telecommunications Act At Three Years: An Economic Evaluation of Its Implementation by The FCC." *Information Economics and Policy*, 11(4), December 1999, pp. 319-365; and Dale E. Lehman and Dennis L. Weisman, *The Telecommunications Act of 1996*: *The "Costs" of Managed Competition*, Washington D.C.: AEI Press and New York: Kluwer, 2000.

[4] *Telecommunications Reports*, "Powell Recommends Simplicity in New Law for IP Services." April 1, 2005.

After being repeatedly rebuked by the courts—itself quite telling in light of the *Chevron* doctrine's[5] promise of judicial restraint in overturning expert opinions by regulatory agencies—the FCC revised its onerous unbundling rules, albeit grudgingly, and sought to place increased reliance on market forces. But there is an important distinction between finding religion in setting sound competition policy and *pinball policymaking* in which regulatory agencies change their policies only when they encounter an immovable obstacle in the form of the review courts.

Whereas the FCC has more recently signaled some willingness to be guided by general competitive trends in the industry rather than whether sellers have monopoly power at a single moment in time,[6] there are strong inertial tendencies toward traditional market share/market power analysis despite their well-known shortcomings in technologically dynamic industries. This probably explains why the FCC has approved only two applications (Omaha, Nebraska and Anchorage, Alaska) requesting it to forbear from requiring incumbent providers to share network elements with rivals at regulatory prescribed rates. Regardless of how competitive these two markets may be, they hardly seem like hotbeds of competitive activity compared to the major metropolitan areas for which a slew of forbearance applications was recently rejected by the FCC. A careful reading of these decisions confirms that the FCC is still relying too heavily on the myopic calculus of "market-share-equals-market-power" to inform its decision-making.

In the course of a recent regulatory proceeding in Canada to examine the scope of the network unbundling obligations imposed on the incumbent providers, a Cable TV CEO was quoted as saying that he felt no real pricing pressure from the telephone companies.[7] Similar concerns have been raised about what are alleged by some to be continually rising cable rates in the U.S. What is the regulator to do? The static regulator is inclined to consider actions to control cable prices *today* – perhaps by putting in place more liberal unbundling rules in an attempt to increase the number of market providers. The dynamic regulator, one willing to take the long view, is more likely to see that the real problem lies not with the paucity of providers, but with the fact that the incumbent providers may be reluctant to make costly investments in infrastructure improvements, including fiber to the home or node, when there is the risk that they will be forced to share these innovations with rivals at prices that are not fully compensatory. Is regulation the problem or is it the solution? The dynamic regulator favors the lighter hand, one that emphasizes intermodal over intramodal competition, as the natural path to eliminating the need for economic regulation over the long-run.

The operative tradeoffs between imitation and innovation have a long history in the economics literature and in the works of the renowned economist Joseph Schumpeter, in particular. Historically, regulators have not been particularly receptive to these types of arguments, perhaps because the loss to consumer welfare from products that fail to

[5] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).
[6] See FCC, In the Matter of Petitions of AT&T and BellSouth for Forbearance Under 47 U.S.C.§ 160(c) from Title II and *Computer Inquiry* Rules with respect to Broadband Services. WC Docket 06-125, Memorandum Opinion and Order, Released October 12, 2007, ¶¶ 20, 23, 34-35.
[7] Catherine McClean, "Shaw Expects Price Increases for Cable and Telcos." *The Globe and Mail*, October 27, 2007.

find their way to market but would have in the absence of intrusive regulation are difficult to measure and are, in any event, largely unobservable to the regulators' constituency. Nonetheless, it is important that policymakers recognize that some of the highest social costs of excessive regulation are likely those not directly observable: welfare losses from innovative new services and production processes that are not developed but would have been otherwise.[8]

The Nobel Laureate, Milton Friedman popularized the adage that "there is no such thing as a free lunch." The economic regulation counterpart to this observation is simply that "there is no such thing as a free expropriation." That is, the regulator can usurp the incumbent firm's property rights today—say, in the form of unduly broad unbundling and sharing rules—but not without incurring a cost tomorrow measured in terms of reduced incentives for investment in infrastructure and productivity improvement. Yet, investments in infrastructure and productivity improvement serve as key drivers of economic growth. Competition, of course, can be an impetus to innovation. And yet, when the ability of a firm to appropriate the returns from its investments is weak, as it is under mandatory network sharing at non-compensatory prices, higher market concentration (less competition) may give rise to higher levels of innovation.[9] That is to say, the competition that spurs innovation is not the clone-reseller type of competition created at the hand of the regulator through forced network sharing. The explanation for this should be obvious—it is difficult to outrun your shadow!

With his now famous reference to the "perennial gale of creative destruction,"[10] Schumpeter stressed the importance of the competitive process over the competitive outcome. He understood that new services are by definition competitive services because they reflect the interminable struggle on the part of the firm to innovate in order to differentiate its products and services from those of its rivals. This, in fact, is the hallmark of the competitive process and rivalrous behavior. In Schumpeter's view, to focus solely on the price of the product as a measure of competition was to ignore an essential feature of competition in a market economy. In certain cases, the product differentiation may amount to a difference of kind rather than degree and may lead to temporary monopolies for the innovator. In this case, even though there may be limited rivalry in the short run for this new product, the path to its development is very much the fruit of the competitive struggle on the part of all firms in their continual quest to secure a market advantage, even if that market advantage should prove to be short-lived. Unlike

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[8] The combined welfare losses associated with regulatory delays in the offering of voice messaging and the licensing of cellular service in the United States were estimated to be in excess of $100 billion. See Jerry Hausman, "Valuing the Effect of Regulation on New Services In Telecommunications." *Brookings Papers on Economic Activity, Microeconomics*, 97, 1997, pp. 1-54.

[9] Richard J. Gilbert, "New Antitrust Laws for the 'New Economy'", Testimony Before the Antitrust Modernization Commission, Washington D.C., November 2005, p. 8. ("Economic Theory is ambiguous on the relationship between competition and innovation. Competition can reduce innovation incentives, particularly in markets where property rights are weak and it is difficult for firms to appropriate the value of their innovations.")

[10] Joseph A. Schumpeter, CAPITALISM, SOCIALISM, AND DEMOCRACY, Harper Torchbooks, 3d. Ed., 84.

most regulators, Schumpeter understood the critical distinction between competition and government-created rivalry.[11]

Dominance was not the dirty word for Schumpeter that it is for most regulators. He would scoff at the notion of a "level playing field." For Schumpeter the playing field was always in motion and success in the marketplace may mean that you had forced the other guy to play on a playing field that was upward sloping. It is the regulator's subversion of this process—continual meddling to level the field in the middle of the game—that poses the far greater risk to consumer welfare. As Professor Alfred Kahn has observed, "The regulator tends as a matter of constitutional preference … to convert the maintaining of the 'level playing fields' into an interference with the contest itself. Regulators move from trying to assure a fair and equal start to ensuring an equal finish; to preserve whatever the regulator conceives to be the proper market shares of the various competitors."[12]

Schumpeter viewed competition as a process of discovery and learning played out over time. His great insight was to recognize that while the regulator was fixated on the "snapshot," virtually all of the relevant market information was contained in the "movie." Indeed, as McNulty has observed, "the classical concept of competition as a guiding force … is not only different from that of the neoclassical concept of competition as a state of affairs; the two are incompatible in a fundamental sense, reflecting precisely the difference between a condition of equilibrium and the behavioral pattern leading to it."[13]

In yet another example, the FCC continues to enforce media ownership rules that impose market share limits on cross-ownership of radio, television and newspaper outlets. Under what conceivable product market definition can the FCC fail to consider alternative distribution outlets that technology has wrought, including the Internet, in limiting any real mischief that may derive from significant cross-ownership of more traditional media outlets? It may well be that it is only through such a cross-ownership business model that newspapers can endure over the long run *a la* the failing-firm defense. Do we really need such market share restrictions today? Do they pass any credible cost-benefit test? The FCC seems perennially to be regulating through the rearview mirror - time and again failing to grasp the manner in which the pace of technological change is so thoroughly and irreversibly transforming the telecommunications marketplace. What we witness all too frequently at the FCC is the regulatory equivalent of *Ground Hog Day*.

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[11] See Raymond L. Gifford, "Regulatory Impressionism: What Regulators Can and Cannot Do." *The Review of Network Economics*, 2(4) 2003, p. 475. (A short time horizon, political pressure to show gains in competitive entry, and a plastic rate methodology – all this gives the regulator ample room to furnish the aesthetics of competition.")

[12] Alfred E. Kahn, "The Uneasy Marriage of Regulation and Competition." *Telematics*, 1(5) 1984, p. 9.

[13] P.J. McNulty, Economic Theory and the Meaning of Competition. *Quarterly Journal of Economics*, LXXXII, 1968, p. 648.

At the outset of this discussion, I posed the question whether most economic regulation of the telecommunications sector in the U.S. today passes the cost-benefit test? A credible case can be made that it does not. Lest my criticism of the FCC be deemed unduly harsh, it is not clear that any regulatory authority armed with any known set of regulatory tools could keep up with the dizzying pace of technological change in telecommunications markets. The real question then is whether it constitutes an act of hubris to even try.

Be that as it may, the real issue is not whether to regulate the telecommunications sector, at least in terms of continuing some oversight, but in delineating the proper scope of that regulation. To wit, in crafting regulatory rules that focus on the control of market power rather than on unleashing the power of markets, the FCC has not only failed to protect consumer welfare, it may have "gone as far as to join the other side."[14]

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[14] In a 1960's ballad entitled *Tonsils*, a physician explains to a frightened child (comedian Bill Cosby) why he must have his tonsils removed.

> Your tonsils…guard your throat, you see. They stand there. There are two guards. They have hand grenades, bazookas and everything. And anything bad that comes into your mouth, they fight it off. See. Well, uh, in your case, your tonsils have lost the war. As a matter of fact your tonsils have gone as far as to join the other side, you see. And they are going to kill you if we don't cut them out….

William Cosby, *Wonderfulness*, Warner Bros. Records (First Released In 1966).