

Good politics, bad policy

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By Thomas Hazlett

Despite their proud boasts of introducing competition into local telephone markets, regulators are once again taking aim at an exciting new competitive entrant.

The first shots rang out in September, when the state of Minnesota ruled that Vonage, an internet telephone provider, was guilty of delivering telecommunications services without a licence. California regulators followed in October, directing six voice-over-internet (VoIP) providers to apply for state telephone licences. The aim is to move the unregulated net phone suppliers into the regulated system, where taxes will be levied and regulatory burdens imposed.

The states are kicking up a storm. Vonage filed suit against Minnesota, and on October 16 a federal judge set it free from state jurisdiction. In California, the net phone companies - perhaps inspired by the recent electoral uprising - unanimously defied the licensing order. The Public Utilities Commission now ponders its next move.

The problem for regulators is that local telephone rates today include a bloated package of regulation-induced charges. Such taxes (hidden and explicit) are generally doled out in subsidies for below-cost rural services and cheap residential connections for low-income households, and to fund such "public interest" goals as information technology for schools. The costs associated with padding users' bills - particularly in long-distance charges and business services - are ignored. The perverse outcomes embedded in this system are legion, exemplified by the poor urban-dweller who pays artificially high long-distance bills to underwrite subsidised local phone service to a CEO's Aspen ski chalet. This system constitutes what is universally known as "good politics."

Unregulated competitors wreak havoc on this jumble by injecting a dose of economic rationality. The entrants target customers paying prices fattened by regulation. Vonage's phone service, which lays atop a cable modem or DSL connection, offers home users unlimited local and domestic long-distance calling for about \$35 a month. With a similar bill for broadband service, residential customers pay about a \$75 monthly tab. That is far above what most households pay for phone services, but for users paying high long-distance charges - i.e. those funding the subsidies - it can be a bargain. Customers held hostage to regulation-by-taxation (as Richard Posner famously described the regulatory temptation to block competitive entry, directing the profits generated to fund popular projects) are making a break. State regulators, vigilant in protecting cross-subsidies, want to block this exodus by subjecting the new technologies to the old rules.

The states do have a legal point. Using if it looks like a duck logic, the function of VoIP is analogous to plain old telephone service. It makes little sense to subject close substitutes to distinct rules. VoIP carriers respond that their technology is completely different - but this points to re-crafting the old rules for new situations, not abandoning them altogether.

The superior argument for waiving regulatory rules for the new technology is that such regulations are barriers to entry. By eliminating taxes and regulations, we encourage the emergence of competitive services and networks. This properly focuses attention on the damage such rules inflict on investment and innovation undertaken by all providers - new entrants as well as more

established, non-VoIP providers. Such damage includes under-investment in serving high-cost rural areas through efficient alternatives such as terrestrial wireless or satellite. Instead, the argument over regulatory lines becomes legalistic and arcane.

Just as in Richard Epstein's column a fortnight ago, which described the hair-splitting debate over regulating cable modem services, lawyers ask: are phone calls delivered over the internet properly deemed "telecommunications" (which are regulated) or "information services" (largely deregulated)? This exercise, which requires that policy makers differentiate between synonyms, prompts one to wonder how the internet would have impacted Shakespeare's famous dictum – first kill all the lawyers. (According to an informal online poll, "adding torture" appears to be the leading candidate.)

The result in *Vonage vs Minnesota Public Utilities Commission* is a happy one, in that state regulators were themselves blocked from imposing barriers in the path of Vonage. But it merits comment that US District Court Judge Michael Davis places VoIP into "information" services largely on the basis of its distinctive handsets. That is, when using Vonage's service, the customer's equipment is different than the standard telephone unit used to dial a call over the traditional local exchange. This definitional stab allows the judge to slice an unregulated path for internet phone customers on the grounds that "the Court finds ample support for the proposition that Congress intended to keep the internet and information services unregulated."

Such technical distinctions are shaky. In truth, the (proper) motivation for this result is what one FCC commissioner has dubbed the "nascent technologies doctrine." To keep the new stuff coming, don't regulate it out of existence.

Grand debates over service definitions essentially boil down to this rule: if the network already exists, go ahead and impose inefficiency for political purposes. Innovation and investment may well be bruised, but the damage will be subtle to the naked eye.

Brand new rivals, on the other hand, are liable to die in public. No need for corpses on display. Get rid of those toxic rules - until these entrants become strong enough to absorb taxes and regulations by merely reducing capital expenditure. The economic destruction may be widespread, but the inefficiencies will be little noticed by the voting public. This rule obtains not just for "telecommunications" or "information" services, but for "good politics" everywhere.

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