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REGULATING THE DIGITAL ECONOMY

Beyond Ideology: A Results-Based Approach

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Throughout the long history of the relationship between markets and government, the drafting of regulation has all too often been driven by the ideological winds of the moment. But raw ideology is a poor road map for guiding regulatory policy, for two reasons. First, the nuanced "real world" rarely conforms to the purity offered by either an unquestioning loyalty to the superiority of the market or the unchallenged assumption that government can correct every market failure. Second, the ideological mood of the American people vacillates over time, creating the prospect that ideologically driven regulation will whipsaw regulated entities, effectively precluding growth-enabling innovation.

So we are faced with the question: To what set of principles can we turn to drive the formation of welfare-enhancing regulatory policies? This is an easier question to ask than to answer. Indeed, as John Stuart Mill observed in the nineteenth century:

> There is, in fact, no recognized principle by which the propriety or impropriety of government interference is customarily tested. People decide according to their personal preferences. . . . [M]en range themselves on one or the other side in any particular case, according to this general direction of their sentiments; or according to the degree of interest which they feel in the particular thing which it is proposed that the government should do; or according to the belief they entertain that the government would, or would not, do it in the manner they prefer; but very rarely on account of any opinion to which they consistently adhere, as to what things are fit to be done by a government.

The question still lingers today. As noted by President Obama, a policy goal of the present Administration is to "root out regulations that conflict, that are not worth the cost, or that are just plain dumb." But determining which regulatory constraints are "just plain dumb" is not easy.

Fortunately, elusive though they may seem, such principles do exist; they emerge from an examination of the evolution of regulation over the past 50 years. For instance, a pre-1970s comparison of interstate (regulated) and intrastate (deregulated) airline traffic provided powerful testimony that a price-deregulated airline industry promoted economic welfare better than a regulated industry. Similar practical comparisons gave us evidence that led to the successful bipartisan deregulatory efforts in the rail, trucking, and long-distance telecommunications industries. On the other side of the regulatory coin, actual failures in the financial sector, not ideology, led policy-makers to increase regulatory scrutiny in that industry.

The fact that the regulatory dial has, on occasion and in specific industries, been turned up or down provides economists and policy-makers with the

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ability to observe directly when, and under what industry conditions, regulation—or deregulation—has resulted in welfare improvements. This suggests that the design and evolution of regulation be driven not by ideology but by the practical results that the policy design or change causes. "Results-based regulation," or RBR for short, is an approach that can sidestep the problems of an ideologically driven regulatory regime and ensure that we never lose sight of the purpose of regulation.

What is results-based regulation? Broadly speaking, it rests on five principles for regulators:

Recognize the inevitability of imperfection. All market-governance mechanisms are, in practice, imperfect. All too often, a perfectly competitive market structure is held as a standard against which to judge the merits of regulatory intervention. Such a comparison pits the merits of an ideal regulatory construct against an imperfect market-based governance mechanism. In that case, the costs imposed by the shortcomings of market-based resource allocation are judged against an unobserved and unrealizable ideal regulatory mechanism. Alternatively, others too often pit the real-world imperfections associated with the practice of regulation against idealized market allocations that would occur in a perfect market mechanism. The reality is that, in practice, neither regulation nor markets will realize their ideal. Policy-makers in an RBR world must examine how market-oriented governance compares with more centralized regulatory structures.

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Smartly evolve regulation with technology and other institutions. In the presence of disruptive technological innovation and the evolution of complementary—or competing—regulatory structures, regulators must be vigilant about the need to adapt and reform existing practices. While a certain regulatory approach may be superior at one point, that may not hold true forever. For example, among the most prominent institutional changes of the twentieth century has been the maturation of the consumer and competition protections now afforded by the Federal Trade Commission (FTC) and the Antitrust Division of the Department of Justice. The statutes enabling these agencies provide them with wide-ranging authority to halt "unfair methods of competition," to block "contract[s], combination[s] . . . or conspirac[ies] in restraint of trade," and to halt "monopoliz[ation] or attempts to monopolize" in the conduct of interstate commerce. Similar intrastate consumer- and competition-protection agencies have also been created. While debates can, and do, exist about the level of consumer protections these agencies provide relative to sector-specific regulation, there can be little doubt that the design of sector-specific regulation should evolve with these complementary and, arguably, substitutable institutions to promote economic welfare.

Benchmark and experiment relentlessly. Wherever possible, regulators should engage in counterfactual scrutiny of alternative market-governance mechanisms. Such scrutiny creates the prospect of observing how these mechanisms work or fail. Opportunities for these empirical exercises can be found where there are different mechanisms in different jurisdictions. Differences may exist between states' regulatory structures and federal market governance, and also across countries. The ability to examine the economic consequences of changes in policy measures over time also provides an opportunity to improve policy-making.

Use empirical analysis, not abstract theory. In assessing the merits of alternative regulatory mechanisms, policy-makers should heavily weight empirical evidence collected from actual markets over abstract and formulaic tests. Theory can be useful in framing the outlines of economic behavior and policy-making, but when imposed at the highest level, the ability of theory to discriminate among different regulatory governance mechanisms becomes attenuated. The result is that reliance on high-level theory alone creates the profound risk that well-intentioned policy-makers will draw incorrect inferences. A "boots on the ground" effort to scrutinize alternative governance structures will more reliably provide sound guidance to policy-makers than higher-level theorizing about the consequences of potential policy changes.

Focus on end-state economic measures. When considering alternative governance structures for a market, policy-makers should focus on tangible, end-state measures of economic value. The best instances of regulatory and deregulatory policy-making over the past half-century have sprung from policy-makers' emerging proclivity to focus on "retail" economic metrics such as price, output, investment, and innovation. This focus on retail economic metrics is in contrast to the historical appeals by some regulators to the vaguely—if ever—defined "public interest" standard, which creates very difficult "eye of the beholder" possibilities that have no tangible link to governance mechanisms that promote economic welfare. This focus also deviates from the historical tendency of regulators to seek to advance regulation by largely focusing on improving internal, incremental regulatory processes.

The principles of RBR offer useful guideposts for the important regulatory policies of the day, including how to preserve and enable an open Internet—perhaps the most consequential regulatory policy dilemma facing our economy today.

Consider that for roughly a decade, a massive debate has been waged over the merits of economic regulation of the Internet. The debate is largely between partisans from two ideological camps. One camp passionately champions treating Internet infrastructure as if it were a public utility and regulating it as such under Title II of the Communications Act. The other camp, equally passionate, argues that extending a Title II suite of regulations to Internet-based communications services would deal a crushing blow to both investment and innovation. While the partisans have held fast to their positions, a series of court battles has increasingly led many to conclude that, by either legislation or brutish regulatory efforts, the nation must choose to endorse one camp or the other.

Under this thinking, policy is doomed to move forward along one of two extreme trajectories—either providing a laissez-faire green light to the emergent communications platform of the twenty-first century, or extending a telephone-centric twentieth-century regulatory framework into the new and vibrant Internet ecosystem. The partisans have, however, established too narrow a set of choices for Internet governance.

Plainly stated, the "sailing between Scylla and Charybdis" choice offered by the two ideological camps is inapt. Indeed, there is a solution in the 1996 Telecommunications Act that allows for a deft response to the dilemma of Internet regulation. It resides in Section 706 of the act, which provides the Federal Communications Commission (FCC) with the authority to use "regulating methods" to "encourage the deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans." Section 706(b) also charges the Commission with "determin[ing] whether advanced telecommunications capability is being deployed to all Americans in a reasonable and timely fashion." This language provides a clear policy tool to regulators for establishing Internet-related regulations under existing law.

Of course, the mere fact of legal authority does not necessarily make the economic case for exercising that power. In this instance, however, Section 706 provides for congruence between legal authority and sound economic policy-making. By setting the FCC's sights on the practical measure of industry output—in this instance, the deployment and expansion of Internet infrastructure and advanced telecommunications services—Section 706 actually enables the FCC to both spur investment and innovation along the Internet value chain. Moreover, it provides the FCC with the ability to guard against anti-competitive behaviors.

Consider the following. Monopolies raise prices and reduce output. Anti-competitive oligopolistic practices that elevate prices are achieved by reducing output. And price discrimination—which occurs when a provider charges different prices in different markets for the same good or service—diminishes economic welfare when it reduces output relative to uniform pricing. Thus, a suite of regulations premised on increasing output is by its very nature capable of ensuring competitive behavior. In this way, Section 706 smartly aligns the economic policy rationale for Internet governance with the traditional antitrust tools that focus on the output-reducing effects of firm behaviors. While less familiar than the public-utility-style price regulation embodied in Title II, the authority in Section 706 provides regulators a more economically sound, pro-growth basis for assuring that a firm's behavior promotes output.

Importantly, using Section 706 allows the nation to move forward without *ex ante* Title II regulatory rules imported from an era of public-utility regulation of telephone service. Imposing such rules risks proscribing novel, output-enhancing business practices by sweeping them in with anti-competitive practices that should be halted. And such extensions of the traditional regulatory apparatus to innovative Internet services (voice, data, and video features, among others) would create the profound risk of stifling the rich innovation that has become the hallmark of the high-tech sector. This is especially troubling, as an RBR lens provides clear evidence that public-utility-style regulation has been a poor stimulant of innovation.

And just as surely, the Section 706 approach provides regulators with sufficient teeth under existing law to halt incumbent firms' business behaviors that constrict new entrants' ability to expand. In particular, with burgeoning demand for new voice, video, and data communications anytime, anywhere, and on any device, output growth should be a normal feature of a well-functioning Internet ecosystem and should be reinforced by the steady pace of innovation.

Against this backdrop, a vigilant FCC may use its Section 706 authority to ensure the continued growth in the deployment of advanced telecommunications capabilities. And it can use this authority to take corrective actions in the event of untoward behavior by firms that retard output. If, for instance, incumbent Internet service firms were to undertake anti-competitive behaviors that subsequently denied the ability of new providers of Internet applications or content to expand competitively, this denial would *discourage*—rather than, as indicated in Section 706, "encourage"—the "deployment on a reasonable and timely basis of advanced telecommunications capability to all Americans." In such instances, the enforcement authority of the FCC under Section 706 would become both relevant and apt.

Telecommunications policy faces the challenge of identifying and implementing regulatory policies that promote both consumer and economic welfare. This simply cannot succeed through an unwavering adherence to dogmatic predispositions. Instead, regulatory policies will evolve best if they are rooted in non-ideological principles that are consistent enough to advance innovation and economic growth while simultaneously protecting consumers. At the same time, these principles must be fluid enough to adapt to the rapidly evolving technological climate created by the Internet.

The results-based regulatory principles proffered here are designed with these goals in mind. In the telecommunications industry, the application of RBR principles can be seen to open policy channels where entrenched ideological posturing offers none. In the case of the modern debate regarding net neutrality, RBR principles point toward a practical solution, grounded in Section 706 of the Telecommunications Act. This will permit the continuation of the light-touch regulatory approach that has proven successful to date and will also afford the full measure of regulation should it be needed to promote economic welfare.

It is time to move past the last decade's ideological feuding toward the practical issue of how to design Internet governance. A regulatory regime focused on the common-sense economic indicators of Internet output and deployment, consistent with an RBR approach, offers that path. D