



Legislating entrepreneurship: an oxymoron?

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.....Can the passage of a federal law help entrepreneurs? This is not just an academic question. It arises frequently in federal policy discussions regarding the Internet, most recently during the net neutrality debate.

I am a skeptic. Fostering entrepreneurial markets requires decisive commitment to a set of regulatory rules. However, passing major new legislation is rarely decisive; more frequently, it signals the opening of a multiple-act legal and regulatory soap opera.

This point is not widely appreciated or acknowledged. Many politicians speak as if they have never thought about the topic. Yet, the events following the passage of the 1996 Telecommunications Act, which I'll use as my example throughout this column, amply illustrate the typical response to new legislation.

Recent experience

For several decades, visionary policy makers had tried to inject more competition into the formerly monopolized communications markets. It could not be done all at once, to be sure. Still, there had been steady progress in one segment of communications after another.

It is an oversimplification, but not much of one, to say that the 1996 Telecommunications Act intended to further that progress. It aimed to preserve competition in segments where it had sprouted, such as competitive equipment markets and long-distance telephony. It also aimed to seed competition where it had not

taken root, in segments such as local telephone service, for which competition existed in only a few locales.

The Telecom Act meant a major change in competitive policy. It did not fly below anyone's radar screen. It had numerous political sponsors. Its ambitious aims were thoroughly debated. The administration of the time actively engaged in the policy-shaping conversation. Every major firm affected by the law had something to say about it. So did every regulatory agency that would enforce it.

At first, the Act's passage seemed to ratify the definitions and rules embedded in many prior decisions nurturing exploration of the commercial landscape. However, this clarity soon faded. In retrospect, expecting it not to appear naïve.

Several different factors turned good intentions awry. Among them, different firms pushed the boundaries of the statutory rules as written, an unsurprising behavior in dynamic markets. Some of this pushing arose as an unintended consequence of ambiguous or poorly considered legal language. Some arose as new market conditions raised issues that lawmakers had not foreseen. Indeed, much of the pushing was *not* obviously problematic. Even when it was, regulators knew what to do.

For example, the 1996 Act contained a set of rules for the entry and compensation of competitive local exchange companies—that is, the firms who competed in local telephone markets against incumbent local exchange companies. Some

entrants used the rules as intended. However, as a by-product of Internet growth, some companies discovered ways to collect revenues under the "reciprocal compensation" rules without actually doing anything marginally productive. Economists typically call such behavior "regulatory arbitrage" and consider it a distortion, since it contributes nothing to the goals of a piece of legislation.

Most well-intentioned legislators do not set out to write rules that induce regulatory arbitrage. Nevertheless, it happens. Firms are clever and will do what they can to get away with what they can. That said, anyone who looked at this particular example came to the same conclusion: Even though the behavior was legal from a literal perspective, it was not behavior that Congress had intended to induce.

In such settings, regulators usually intervene because they can act faster than legislators. Indeed, in this case, the FCC did act, conducting a thorough staff investigation, holding public hearings, and then issuing a rule in February of 1999 that eliminated the distortion. This new rule came only a few short years after the Act's passage—as fast as the agency could realistically act when faced with such an issue.

My only point (so far) is that such events are inevitable and mostly uncontroversial. Even in the best of circumstances, identifying, analyzing and resolving issues takes time, even when agencies scrutinize regulatory arbitrage and the issues are transparent.

Disputes over legal language

What happens when the issues are not so transparent? Competing firms invariably come to different interpretations of the same statute. These disputes tend to have a trajectory less satisfying than that of our first example.

In the case of the 1996 Act, for instance, local telephone companies and their potential competitors fought over the rules designed to facilitate competitors' entry into the market. Given the aims and language of the Act, such rules were necessary. Questions remained, however, over the rental price for an incumbent local exchange company's equipment.

This particular question involved multiple hearings at the FCC, cases at several different courts, and hearings at many state regulatory agencies—not to mention a multiplicity of firms. Each hearing and court decision pursued partially overlapping issues. Some provisions took several years to reach a settled state. Others were not settled until last year, almost a decade after the Act's passage.

Broadly speaking, competing interpretations are almost unavoidable after new laws. When hundreds of millions of dollars in profit depend on the resolution of legal nuance, firms will choose try to get their preferred interpretation. After all, these firms' managers have a duty to try to further their stock holders' interests.

Moreover, such disputes are rarely trivial. Almost by definition, they cover every "key provision" of an act, because a "key provision" is one that governs the distribution of large sums of money. Who wouldn't fight to interpret a rule that governs the distribution of several hundred million dollars?

Once again, I am not taking a side on the merits of the dispute in this example. I am merely pointing out that the passage of a major piece of legislation inevitably raises competing interpretations of key provisions, and thus leads to lengthy and uncertain disputes.

What is the impact?

Where does this leave us? Step back from the specifics of these examples and

consider the impact such fights have on firm behavior.

Investment does not magically spring out after every piece of legislation. Legal disputes can wind their way from one court to an appeals court and back to the original court for reconsideration. A regulatory fight might move to a new forum, such as a state regulatory hearing, and, given a particular set of decisions, back into the federal hearing at the FCC. The details are less essential than the simple fact that nobody knows for sure what the outcome of a dispute will be or when it will emerge.

Considered individually, any of the disputes I have described might have seemed worthwhile at the time; their collective result might be far less so. Frequent court fights and regulatory reinterpretations introduce risks into forecasting returns on private investments—for incumbents and entrepreneurs alike. They force every major firm to watch Washington DC or the courts for regulatory decisions. The result is almost always discouraging for investors and entrepreneurs.

Indeed, the experience after the 1996 Act was rather discouraging. Despite the Act's intent to take regulatory review out of the calculus of entrepreneurs and their investors, its passage did the opposite. Battles over the Act's interpretation placed frequent policy review in the center of every commercial infrastructure firm's strategy. The battling also made policy reviewable by courts and regulators—*after* many firms and investors had made huge commitments. This was not the sort of environment that builds confidence about future returns on investments.

I might add a historical note to this observation. The actual events of my illustration took place in the late 1990s, the era with the largest privately funded investment in entrepreneurial ventures in United States history. It was also an era in which demand grew spectacularly; business and household investment in information and communications technology more than doubled over a five-year period—from 1995 to 2000—partially in response to the enormous

opportunities opened up by the diffusion of the Internet.

In other words, what I have just described occurred during the most *inviting* set of commercial circumstances this market has seen in several decades (or is likely to see for several more decades). It was a period when all firms explored the Internet market's potential.

The legal environment made a good time much worse than it could have been. As a society, we cannot rewind the clock to make this policy right a second time. It is simply a lost opportunity.

Regulatory risk is hard to eliminate

Entrepreneurial firms and venture capitalists already take on risk, and they do so gladly when the potential commercial payoff is large. However, they avoid markets in which a few regulatory decision makers or judges can alter the fundamental returns on investment. Regulatory risk might be sufficient to keep many venture capitalists out of new markets.

The calculus at incumbent firms is similar—although, arguably, informed by a lower taste for risk. As with the entrepreneurial firms, additional regulatory risks from a lengthy and uncertain process of policy interpretation will keep many incumbent firms out of the markets, even in the face of lucrative opportunities.

Recent historical experience demonstrates why competition policies that promote entrepreneurship must reduce the regulatory risk that follows the passage of major legislation. A long, drawn-out, reversible policy process creates a discouraging situation for all investors.

But recent experience also demonstrates why legislation fostering a competitive environment so often, despite best intentions, leads to a discouraging outcome.

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