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From: Coffee House

Tech Policy and the Financial Crisis

By Reed Hundt - October 21, 2008, 11:28AM

Here's a contribution from my friend Peter P. Swire:

As a professor of both banking regulation and technology policy, there are striking similarities between the anti-regulation positions of John McCain in these two key sectors. Under the pressure of the current financial crisis, McCain has recently backed off of his laissez faire positions and admitted that the government must play a greater role in housing and financial markets. His unrepentant positions on technology policy, however, reveal the intellectually flawed approach to government regulation that has led both to the financial mess and to mistakes in technology issues such as broadband deployment, net neutrality, and privacy online.

Financial meltdowns & consumer fraud

In the United States, there have been exactly three episodes of pure free-market ideology in the past century. Each episode has culminated in a system-wide meltdown in the financial sector, along with massive consumer fraud.

For most people, the end of the free-market excesses of the Roaring Twenties came with the stock market crash of 1929. For financial historians, though, a more serious threat to the financial system was the collapse of the banking system by 1933. This led to the banking holiday at the start of Franklin Roosevelt's term, and the creation of federal deposit insurance (a move several European countries have adopted just this month). Widespread problems of securities fraud led to the creation of the Securities and Exchange Commission. The worst single fraud was perpetrated by Samuel Insull, who gulled over half a million mostly small investors into losing their life savings in a utility holding company scheme.

The free-market period of Ronald Reagan was capped by the savings & loan bailout of 1989. The core mistake was to permit S&L;'s to have "free market" powers to plunge into risky new activities, including real-estate development (always risky when the market turns down) and junk bonds (the name alone suggests the level of risk). This deregulatory strategy was fundamentally flawed because the S&Ls; could use government-insured deposits to fund these ventures. The result was what we have seen again in the current moment -- the financial firms get the profit on the way up, but taxpayers foot the bill on the way down. The price tag for the 1989 bailout bill was $90 billion (that seemed like a lot of money at the time). The poster child for consumer fraud was Charles Keating, whose holding company notably fooled many seniors to shift their life savings from insured deposits into soon-to-be worthless securities in his holding company.

The administration of George W. Bush is now ending with the current, frightening financial meltdown. The crashes seem to have taken almost exactly eight years from the start of a "new era" of deregulation: 1921 to 1929, 1981 to 1989, and 2001 to today. On the system-wide level, U.S. and other governments are now spreading the taxpayer safety net to unheard-of parts of the financial system, including insurance companies and investment banks. As with the savings & loans, "deregulation" has created horrendous incentives to take the money and run -- Wall Street paid out over $30 billion in bonuses in 2007 alone, and now taxpayers

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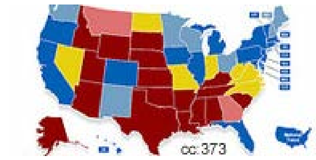

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are bailing out those same firms. And, once again, systemic meltdown is accompanied by harm to ordinary consumers. Many foreclosures occurring now result from lenders who used a hard sell to refinance safe fixed-rate mortgages into the floating-rate mortgages that explode upward in price after two or three years.

Government and Market Failures

Ronald Reagan famously said in his first inaugural: "Government is not the solution to our problem; government is the problem." This free-market ideology is precisely half right. But a 50% score on this test is not good enough. The ideology correctly sees government failures. But it ignores market failures.

The economist Arthur Pigou gets credit for developing the idea of a market failure early inthe 20th Century. Generations of economists and public policy students learned about externalities, such as when a factory gets to put the costs of its air pollution on the people who live downwind. The Pigouvian answer was for the government to correct the market failure, such as by making the polluter pay for the effects of the pollution. The health, safety, and consumer regulations of the 1960s and 1970s were designed to correct for such market failures.

This market failure story, though, is incomplete. By the 1980s, think tanks such as the Cato Institute and the Heritage Foundation were emphasizing the related idea of a "government failure." The general point is important and true -- sometimes there are market failures, but the failures of government regulation can be even larger. In such cases, the market failures are not worth correcting. A related point came from the "public choice" movement, led by Gordon Tullock and Nobel Prize economist James Buchanan, Jr. They criticized the view that regulation was a public-spirited effort to correct for market failures. Instead, they described regulation as "rent seeking," an attempt by interest groups to use the power of the state to enrich themselves.

The idea of government failure thus began as a useful correction for over-enthusiastic regulators. In the best current approaches to assessing regulation, there is careful assessment of both market and government failures. The problem, though, came when free-market enthusiasts reached a deeply flawed conclusion -- there are only government failures, and few or no market failures worth addressing.

Tech Policy and the Free Market

The technology policy of John McCain exemplifies this flawed view, for important issues such as net neutrality, broadband policy, and online privacy.

The net neutrality debate, at its core, concerns the role of the cable and telecomm companies that control the "last mile" to the home. Net neutrality supporters, including Senator Obama, are concerned that these Internet providers will pick and choose which content gets to the home, at what speed and what price. For instance, an Internet provider might make a deal with one online movie company, while slowing down the speed of downloads from competing movie companies. As a result, web sites could have to bargain with each of the "last mile" companies, a complicated mess that would reduce the range and quality of content to consumers.

Net neutrality is a complex set of issues, calling for a nuanced response, but John McCain flatly rejects any regulations in the area. Instead, he said the policy "focus should be on policing clearly anticompetitive behavior." Regulations are bad because of government failure, and the market should be policed at most by antitrust law.

The problem, though, as detailed in *Washington Monthly*, is that McCain "oversaw, and often encouraged, the incredible competition-stifling consolidation in the telecom industry." While Chair of the Senate Commerce Committee, he "supported nearly every merger." And the McCain position has been reinforced by conservative federal judges who have made it far more difficult to police anticompetitive behavior. In my antitrust class, the symbol for this trend is the 2007 Twombley case, where the Supreme Court held that major telecomm companies could win a disputed case even before discovery began, essentially because plaintiffs' economic theory did not match the majority judges' free-market views.

This never-intervene inclination has resulted in lagging deployment of broadband. In 2001, at the beginning of the Bush era, the United States rated fifth in the world in broadband deployment. Today, we're 22d and falling, and the typical speed that

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counts as "broadband" is an order of magnitude slower than in countries such as Japan and France. The always-merge and never-regulate approach of recent years has prevented the development of more competitive and open approaches to broadband that have succeeded elsewhere. With less broadband, the U.S. will lose competitively in the creation and deployment of innovative online applications.

Finally, McCain believes the market will solve all the problems of protecting privacy online. In his policy paper on privacy, the primary government role is to "promote a culture of personal security through consumer education initiatives." There are well-known market failures in the privacy area, such as the fact that companies holding your data aren't the ones who get hurt if your information or identity is compromised. Senator Obama recognizes that newly-emerging privacy problems call for careful attention, in areas such as electronic health records and location data (now that your cell phone reveals your location wherever you go). For Senator McCain, however, the problems of government once again always outweigh the problems in markets.

In conclusion, looking at both financial markets and technology policy, we see crucial problems with both markets and government regulation. The free-market ideology of recent years sees only half of the problems -- the government ones. For the financial crisis and the future of our technology, getting it half-right is simply not good enough.

Peter Swire is the C. William O'Neill Professor of Law at the Ohio State University, and a Senior Fellow at the Center for American Progress Action Fund. He has taught and written on banking regulation, antitrust, the law of cyberspace, and privacy law.

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Well stated. It has been on McCain's watch that AT&T; has reassembled itself, a la Terminator 2, and innovation has devolved into lobbying.

McCain clearly has no grasp of technology; It made me gasp when he dropped the 'putting medical records online' bit during the last debate; It is clear that privacy and data security should *not* be left to the market, because data thefts are endemic. If anything, there should be much stiffer penalties for failing to secure sensitive data.

Unfortunately, it appears that the lobbyists are winning out against innovation; is 'piracy' really such a fundamental problem that there needs to be a 'copyright czar?' I doubt that the sponsors of this cabinet level position are thinking of somebody like Larry Lessig, either.

Posted by **Dave Bowman**
October 21, 2008 2:17 PM | Reply | Permalink

Our nation's nearly 1,400 facilities-based broadband providers will be quite surprised to read that the high-speed Internet market is not competitive. These providers invested more than $60 billion last year to enhance U.S. communications infrastructure. That's more than the federal government invested annually to build the nation's highway system and put a man on the moon combined.

We agree that broadband deployment is critical. Broadband investment is how we get there. What makes it possible? A constructive policy environment that recognizes that regulation is ill-equipped to keep pace with rapid technology innovation. In fact, private sector broadband investment exploded in the wake of government decisions that offered certainty to the marketplace that the Internet would not be regulated like a rotary phone.

There is a vital role for innovative public-private collaboration, particularly in reaching rural communities. Those partnerships are underway today

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throughout the country. But punishing the Internet for Wall Street's woes will hardly advance broadband deployment, economic recovery or the myriad advances that broadband promises—from health care and education to jobs and greater energy independence. Our goal should be continuing this progress, not choking off the investment that's making it real in our communities.

Tom Amontree
SVP, Strategic Communications and Industry Affairs
USTelecom – The Broadband Association

Posted by **Tom Amontree**
October 22, 2008 5:26 PM | Reply | Permalink

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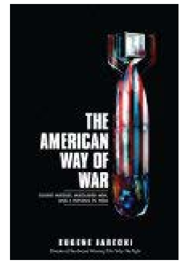

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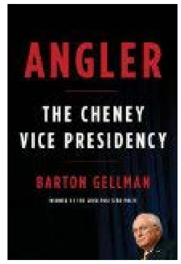

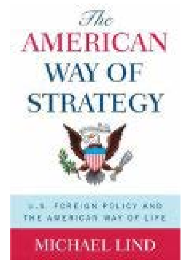

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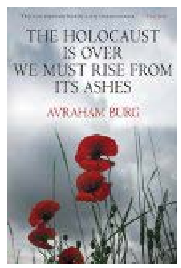

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