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## 25 Years after the Bell Breakup

*By Bruce M. Owen*

Long distance calls today are commodity items, yielding average revenues of less than 8 cents per minute. When the government sued AT&T for monopolizing the long distance business, in 1974, the corresponding number was about $1 per minute, in today's dollars. Can we attribute this remarkable change to the competition made possible by the breakup of AT&T in 1983? The government won a major victory in the trial ten years later, and Bell System management agreed to settle on the government's terms. 2008 is the 25th anniversary of the breakup.

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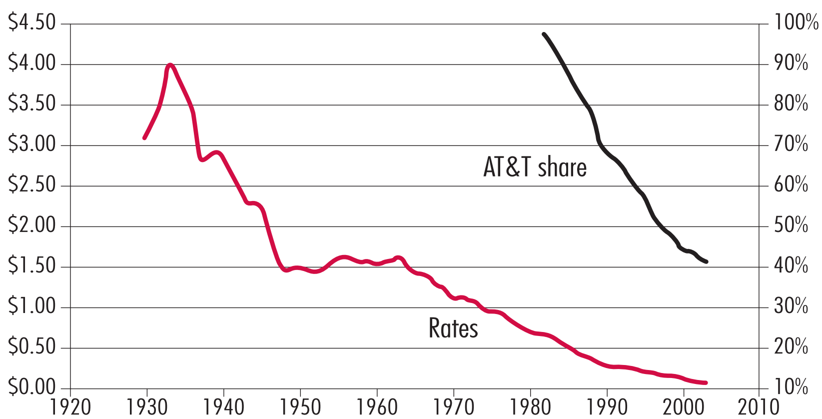
**Figure 1: Long Distance Telephone Rates and AT&T Market Share[1] (2004 dollars)**




[1] Source: FCC, Trends in Telephone Service, various years. Rates are expressed in terms of average revenue per minute for interstate and international voice calls. Market share is of inter-LATA revenues.

### About The Author

**Bruce Owen** is the Morris M. Doyle Professor in Public Policy in the School of Humanities and Sciences and Director of the Public Policy Program at Stanford University. He is also the Gordon Cain Senior Fellow in Stanford's Institute for Economic Policy Analysis and Professor, by courtesy, of Economics. From 1981 to 2003, he was CEO of Economists Incorporated, a Washington DC economic consulting firm. Prior to co-founding Economists Incorporated, Mr. Owen was the Chief Economist of the Antitrust Division of the U.S. Department of Justice and, earlier, of the White House Office of Telecommunications Policy. He was also a faculty member in the Schools of Business and Law at Duke University, and before that at Stanford University. His research interests include mass media and telecommunications, regulation and antitrust, economic analysis of law, economic development and legal reform, and intellectual property rights. Owen was involved in policy decisions related to the government's antitrust suit against AT&T during four administrations from 1970 to 1981.

AT&T had enjoyed a monopoly since the end of the "competitive era" of US telephone service in the 1920s. The company's public and government relations staffs were superbly effective, and much of its successful resistance to competitive entry had for decades been grounded in strong support from state and federal regulators for AT&T's natural monopoly claims.

There can be little doubt that most AT&T executives took the company's dominance as matter of right, a right that Bell System managers believed they exercised, overall, in the public interest. If challenged, they defended the company's unique position on technical and engineering grounds. To them, a system in which decentralized market actors determined the size and shape of the telecommunications network would be an engineering nightmare that could end only in disaster. Preservation of the single-entity Bell System justified virtually any means required to forestall competition, up to and including defiance of what they saw as irresponsible regulatory policies and even federal court orders.

Antitrust law is used primarily to promote competition for the benefit of consumers. Antitrust enforcement officials to a remarkable extent believe that competition is a good thing, and that more of it is better than less. These views are as strongly and sincerely held as the beliefs of Bell System managers described above. In the late 1960s the Antitrust Division of the US Department of Justice undertook to introduce competition doctrine to regulatory agencies, state and federal. Under the vigorous leadership of Donald I. Baker, the Division set out to urge regulators in transportation, banking, securities exchanges, professional licensing and telecommunications to rely more on competition and less on supervised cartels or monopolists. The Division's competition advocacy included formal filings in administrative rulemaking proceedings, lobbying, congressional testimony, and efforts to affect public opinion. These activities were an important component of the Ford and Carter Administrations' deregulation programs, which did succeed in increasing competition, especially in transportation and financial markets.

In telecommunications, the Division's competition advocates around 1970 allied themselves with a small group of FCC staff officials, a small telecommunications policy office in the White House, and a few academics, to promote competitive entry in long distance telephone service and telephone equipment. The Division closely observed AT&T's very public and defiant resistance to the very idea of competition, and the company's methodical exploitation of its process rights as a means to preserve its monopoly. Even a palpable change of heart at the FCC, which by around 1972 had embraced the idea of at least limited competition in long distance, seemed powerless to force the Bell System's local operating companies to permit competing long distance companies to interconnect on equal terms with AT&T's long distance service. Congress showed no sign of taking up the challenge. It began to seem that AT&Ts strategic political and process advantages would be an insurmountable hurdle for competitors.

One of AT&T's most powerful tools in resisting competitive entrants was the mechanics of administrative due process, the law that governs the decision-making of regulatory agencies. In administrative law, an incumbent firm has all the advantages that arise from the presumptive legitimacy of the status quo. To obtain a license, and then to obtain interconnection services, entrants were required to show that competition would serve the public interest, in an environment where every relevant state and federal regulator had repeatedly endorsed the economic superiority of monopoly. The Bell System could and did take advantage of its right to participate in and delay licensing processes and to appeal grants of licenses, and then to refuse to connect with the entrants, and then to file tariffs with rates lower than the entrants'. At each step, it had the process-based ability to impose substantial costs and delays on the entrants.

To antitrust officials, it seemed that only an intervention from outside the ambit of regulatory and congressional policy making could succeed in establishing competition in the industry. As true believers, antitrust officials had far less fear than other officials, including many in the Departments of Defense and Commerce, that the consequences of competition would be disastrous. It seemed that a heroic intervention was the only hope for rescuing the U.S. government's telecommunications regulatory system from usurpation by the very company it was designed to control.

The economic theory of the case was that the local Bell operating companies, as regulated monopolists, could increase their profits by integrating vertically into related competitive markets and, in effect, paying themselves too much for supplies such as equipment and interconnection service. Regulation provided the incentive, and vertical integration offered the opportunity, to exclude competitors from the related markets, such as long distance service. To permit a regulated monopolist to engage in such a strategy undermined the whole point of regulation (to keep prices below monopoly levels), and also injured consumers of the related products and services. This theory explains the relief sought by the Government: permanent isolation of the regulated local monopolies from all other related (and potentially competitive) businesses. The local operating companies were to remain regulated and quarantined. All other parts of the Bell System were to be competitive and eventually deregulated.

The government faced two important legal hurdles: Proving that Bell managers had committed "bad acts" (acts of monopolization, attempted monopolization, exclusionary pricing, refusal to interconnect, and so on), and demonstrating that regulators were helpless to prevent Bell's anticompetitive behavior. The second hurdle was tricky: for half a century most regulators had applauded and endorsed Bell's monopoly and supported Bell's efforts to maintain it. Only in the years immediately prior to the lawsuit had the FCC attempted, in a very gingerly way, to introduce competition.

In essence, the government claimed that the central problem was institutional. Regulation, ostensibly intended to protect consumers from monopoly prices, had instead provided the means to maintain an inefficient single provider of telephone service. From the Chicago-School perspective favored by Stanford Law School Professor William Baxter, who headed the Antitrust Division at the time of the settlement, the real disease was the encroachment of government regulation on market forces, and the solution was a strict quarantine-of the regulators no less than the monopolist.

## A feature of regulation?

The government's decision to seek the dissolution of the Bell System grew from impatience with what seemed an intolerable but isolated institutional failure. AT&T managers had simply outplayed their regulators. From today's perspective, however, this seems much less a regulatory failure than a systemic "feature" of economic regulation in the United States. In a nutshell, administrative regulation tends to replace all or part of market resource allocation with a political process designed to allocate and preserve economic rents. In the case of the Bell System this feature of regulation in a certain sense worked too well. But the more general point is that regulation is a political mechanism completely at odds with the goals of modern antitrust policy.

Ideally, a political system like ours, intended to defuse potentially lethal squabbles over the division of economic and political power, should permit adjustments to be made relatively smoothly as underlying conditions change. After World War II a revolution took place in electronic technologies related to computing and transmission of data. In addition, economic growth caused vast increases in the volume of communications, undermining AT&T's claim that there was room for only one supplier of efficient size. Both forces, together with the Bell System's conservative reluctance to roll out new technologies, created entrepreneurial opportunities of growing significance-and these were stymied by the effectiveness of AT&T's legal and political resources. The result was prolonged delay in the release of economic and technical forces for change. AT&T's hegemony was defended successfully for far too long.

Economists argue, with various caveats, that competitive markets allocate resources relatively efficiently, maximizing the value to consumers of goods and services produced from limited means. Much evidence supports this view. Political theories, not necessarily at odds with competition, acknowledge the tendency of humans to disagree, often violently, on how to divide society's economic bounty. Successful political systems find ways to create coalitions among powerful interests that agree to forego violence in favor of a less costly and dangerous method of dividing the pie. Rational coalition members should also agree to avoid shrinking the pie they seek to divide. Ideally, participants therefore should prefer to rely on market allocation, except when there are market imperfections that regulation would mitigate.

But political mechanisms for the division of wealth are themselves imperfect. Wealth includes more than tangible things. It includes the value of rights defined in political and legal process. Agreement on legal and political process limits the ways in which wealth can be transferred from one interest to another, and process therefore presents opportunities for the creation of rents which rights holders cannot readily be paid to forego. Further, even in the absence of illiquid or inalienable process-grounded rights, there is no guarantee in the real world that all mutually advantageous transactions will close.

The result is two rational motivations for favoring regulatory supervision of markets. The first is traditional: mitigation of market failures, such as externalities and monopolies. The second is no less traditional: rent seeking by political interests, the modern equivalent of tax farming and crown monopolies, in this case exercising procedural rights to preserve rents. Both motivations for regulation give rise to potential welfare gains or losses. Tolerance for inefficient rent seeking may be the price we pay for certain goods, including process safeguards and political stability, but because regulation is imperfect there is no guarantee that the benefits will exceed the costs. In other words, both markets and sustainable political systems contain flaws that can explain regulation, but may not justify it.

The rules of due process are, in general, conservative. They resist change in the allocation of rights among current rights holders. Rights are worth having, of course, only to the extent the state will recognize and enforce them. Due process enhances the value of rights chiefly by delaying change. The "temporary" injunction, for example, is often, in present value terms, far more valuable that the discounted prospect of a distant final judicial decision. In the regulatory arena, the original concern with substantive "regulatory takings" has long since been replaced by a focus on granting procedural rights that effectively permit the endless postponement of a day of reckoning. (In an infamous case of bad economic reasoning, the Supreme Court not long ago held that a moratorium of indefinite length on development in the Tahoe Basin caused no economic harm to land owners because the moratorium eventually would end!)

## The outcome

Today there is far more competition in telecommunications than before the breakup; prices have fallen dramatically, and technical innovation has accelerated. A significant part of these improvements is due to increased competition in long distance service and equipment manufacturing, but the larger part probably is due to technological change and falling costs in the electronics industry. Even local telephone service, which was not a target of the antitrust lawsuit, is becoming more competitive, thanks to falling prices for cell phone services and VOIP competition from cable television companies. Although the name "AT&T" lives on, the Bell System is gone, and no one firm today has hegemony of telecommunications service.

And yet, in an important sense, nothing fundamental has changed. The clean, platonic separation of competition from monopoly markets agreed to by the Antitrust Division and AT&T management in 1982 was rejected out of hand by the trial judge, Harold Greene,

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who consequently spent the rest of his career as an industry regulator. Judge Greene in many ways replaced the functions of the FCC and administrative law with his own court's version of due process, and the Bell operating companies took full advantage, causing delay after delay in the implementation of the settlement's access provisions and gradually winning back many of the rights they had lost to enter related businesses.

A 1996 effort by Congress to streamline the process of promoting local telephone competition led nowhere, except back to the FCC and the administrative process. While the remedies in the settlement probably did contribute to the emergence of increased competition, they could not induce the surviving regional operating companies, now largely reassembled, to compete with each other. But most of the competition that we see today is the result of end runs around the machinery of regulation and due process by new technologies, especially wireless and the Internet-driven growth of digital transmission and broadband local distribution.

The structure of regulation and administrative due process was essentially unaffected by the upheaval. The FCC and the courts today again rule the industry, and, together with Congress, regularly intervene to protect economic rents from competitive attacks, or to impose dubious remedies for perceived potential market failures, most recently efforts to preserve so-called "net neutrality." It is difficult to avoid the conclusion that our political and legal systems simply prefer regulation to competition.

The most important distinction between telecommunications in 1974 and now is that where there was a monolithic economic and political interest, masked in an ideology of engineering and a culture of service to the public, there is today a much less concentrated spectrum of competing economic and political interests shaping the variety and pricing of telecommunications services. The pie is much bigger, and the dollar value of the combined economic rents doubtless is also larger, even if a smaller percentage of the pie. Competitive markets now play a bigger role in telecommunications, and technological innovation is to a much lesser extent hostage to a conservative engineering mentality, but it remains difficult for any competitor to thrive without the patronage of key representatives and commissioners.

## The Future

The goal of the antitrust suit was to create a competitive and therefore unregulated long distance telephone industry. The industry did become much less monopolistic, thanks in major part to new technology, but it certainly did not become deregulated. Both Congress and the FCC continue, and will continue, to find reasons to regulate. Today the major focus of demands for regulation include taxes on (some) telephone services to support subsidies to providers of other (e.g., rural) services, calls for "fairness" in pricing bundled services, and calls for regulation of access to the Internet. The modern view of antitrust policy is in direct conflict with the political purposes of regulation, and this seems unlikely to change.

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