

Post Neoclassical Economics: Legal Issues

*Prof. Barbara A. Cherry
Dept. of Telecommunications
Indiana University
Presented at
The New Economics of ICT
CITI, Columbia University
March 20, 2009*

Introduction

- ✧ A market economy requires an institutional infrastructure to sustain it.
- ✧ Deregulatory policies in essential industries are shifting the boundaries among industry-specific and general business regimes.
- ✧ The historical, temporal sequencing of the co-evolution of these regimes is important for assessing the implications of deregulatory policies.
- ✧ The increasing complexity, globalization, and high-speed technologies of markets are creating critical challenges for institutional governance to support sustainable policies and economic activities.

Introduction

- ✧ A complexity theory perspective is important for framing inquiries
 - ✧ To understand the implications of deregulatory policies.
 - ✧ To design institutional governance to support sustainable policies.
- ✧ We appear to be at the brink of a phase transition for legal/policy-making systems
 - ✧ To provide the necessary *regulatory resilience* (adaptive policy-making processes and policies)
 - ✧ Yet be constrained by the *rule of law*.
- ✧ The difficulties in responding to the financial crisis is exemplary of this challenge for institutional governance.

3

Institutional Infrastructure for Markets

- ✧ Markets are social constructions, and a market economy requires an institutional infrastructure to sustain it. (North, 1990)
- ✧ Government plays a critical role in providing such an institutional infrastructure through the creation of rules (e.g. property rights system; contract principles; enforcement mechanisms).
- ✧ For sustainability of a market economy, the *rule of law* must also be an emergent property of the legal/policy-making infrastructure.
 - ✧ To constrain the government's own behavior.
 - ✧ To enable cooperation among strangers to conduct business.

4

Development of Industry-Specific and General Business Regimes

- In the U.S., there has been a general *institutional progression* of regulation
 - from common law to statutory law to administrative agencies.
 - in response to limitations of the existing regime to adequately respond to technological, economic and societal changes.
- Within the progression of institutional change, new *bodies of law* have evolved and changed over time.
- The co-evolution of institutional change and bodies of law have created *coexisting industry-specific and general business regulatory regimes*.

5

Importance of the Temporal Sequencing in the Evolution of the Regimes

- The general business regulatory regime (antitrust and consumer protection) largely ***post-dates*** that of the industry-specific regimes (common carriers and public utilities).
- *Understanding this temporal sequencing is critical* for understanding the implications of deregulatory policies that are shifting the boundaries among the regimes.
- Unfortunately, some analyses falsely assume that the general business regime can adequately solve (industry-specific) problems it did not evolve to address.

6

Legal Gaps Created by Deregulatory Policies

- The resultant shift in the interrelationship among the regimes under deregulatory policies may generate *legal gaps* for issues that may no longer be adequately addressed by either regime.
- Examples of shifting interrelationships among regimes
 - Telecommunications /Antitrust
 - Telecommunications/Consumer Protection

7

Legal Gaps Created by Deregulatory Policies: Telecommunications/Antitrust

- Telecommunications/Antitrust
 - *Verizon v. Trinko* (2004)
 - Neither recognition nor repudiation of essential facilities doctrine
 - (Mis)interpretation of antitrust savings clause in TA96
 - *Bell Atlantic v. Twombly* (2007)
 - Raises standard for pleading antitrust claim of unlawful agreement v. parallel conduct
 - *Pacific Bell v. Linkline* (2009)
 - Telecommunications carrier has no antitrust duty to deal

8

*Legal Gaps Created by Deregulatory Policies:
Telecommunications/Consumer Protection*

- Telecommunications/Consumer Protection
 - Classification of broadband access to the Internet as an information service: Elimination of common carriage affects both wholesale and retail markets
 - Network neutrality debate
 - FTC acquires jurisdiction
 - Litigation under state consumer protection laws
 - Detariffing
 - Conflicts among Circuit Courts of Appeals as to applicability of the filed rate doctrine after detariffing => inconsistencies as to whether or not consumer protection or other common law actions are preempted

9

*Constructing New Regulatory Interfaces
Under Deregulatory Policies*

- Such legal gaps require the construction of new regulatory interfaces to address desired social goals.
- Broadband
 - Constructing a federal regime under FCC's Title I ancillary jurisdiction
 - FCC's Internet Policy Statement (itself, not legally enforceable)
 - Modification of universal service related objectives
 - Broadband mapping laws
 - Broadband stimulus package
 - Redefine "universal service" under sec. 254 to include broadband?

10

Importance of a Complexity Theory Perspective

- ✧ The economy and legal/policy-making systems are coevolving, complex adaptive systems (CAS).
- ✧ A complexity theory perspective is important for framing inquiries
 - ✧ To understand the implications of deregulatory policies.
 - ✧ To design institutional governance to support sustainable policies.
- ✧ A complexity theory perspective shows that sustainable policies
 - ✧ Require *regulatory resilience* (adaptive policy-making processes and policies)
 - ✧ That must be constrained by the *rule of law*.

11

Importance of a Complexity Theory Perspective: Properly Framing Inquiries

- ✧ What critical legal rules are necessary to enable sustainable development of essential network infrastructures with the emergent properties of widespread availability, affordability, and reliability?
- ✧ Historically in the U.S., common carriage and public utility legal principles enabled essential infrastructures (e.g. transportation and communications networks) to develop with such emergent properties.
- ✧ The elimination of such principles for applicability to broadband access services in the U.S. has given rise to the network neutrality debate – which is symptomatic of the need for the deeper inquiry as to what critical legal rules will enable development of a broadband infrastructure with the desired emergent properties.

12

At the Brink of a Phase Transition in Policy-making

- ✧ The increasing complexity, globalization, and high-speed technologies of markets are creating critical challenges for institutional governance to support sustainable policies and economic activities.
- ✧ The financial crisis is exemplary of system failure at the interface of markets and institutional governance.
- ✧ The difficulties in responding to the financial crisis are exemplary of this challenge for institutional governance, suggesting that we may be at the brink of a phase transition in legal/policy-making systems.

13

Examining the Financial Crisis

14

Deregulatory Policies and Failure of Government Adaptation

- ✧ "Our nation's financial markets are in the midst of their darkest hour in 76 years. We are in this situation because of an adherence to a deregulatory approach to the explosive growth and expansion of America's major financial institutions. Our regulatory system failed to adapt to important, dynamic and potentially lethal new financial instruments as the storm clouds gathered. There is now a total breakdown in the trust necessary for a free and functioning market."

Arthur Levitt, *How to Restore Confidence in Our Markets*, Wall St. J., Oct. 22, 2008, p. A15

15

Turbulence in Financial Markets Reflects the Behavior of Complex Systems

- ✧ Following quotes from the WSJ, Sept. 15, 2008:
 - ✧ "Monday will be a day of reckoning for the financial markets," quoting Carlos Mendez, senior managing director of ICP Capital.
 - ✧ "We are entering uncharted waters here," quoting a top executive of a big bank.
 - ✧ "We have never seen anything like this," quoting analyst Glenn Schorr.
 - ✧ "It is utter chaos here," quoting a trader.
 - ✧ "Mr. Paulson's line in the sand ... set off a weekend of brinkmanship and drama unseen on Wall Street in modern terms."

16

Challenges of Institutional Governance Reflects Properties of Complex Systems ...

- ✧ "Officials grimly concluded that while Bear Stearns wasn't too big to fail, it was too interconnected to be allowed to fail in just one day."

Greg Ip, *Central Bank Offers Loans to Brokers, Cuts Key Rate*, Wall St. J., Mar. 17, 2008, p. A1.

- ✧ Several top financial regulators justified government intervention on the basis that the systemic risk to the economy offset concerns of moral hazard.

Kara Scannell & Sudeep Reddy, *Officials Say They Sought To Avoid Bear Bailout*, Wall St. J., Apr. 4, 2008, p. A1.

17

... Including Unintended Consequences From the Collapse of Lehman Brothers

- ✧ "The genesis and aftermath of Lehman's downfall illustrate the difficult position policy makers are in as they grapple with a deepening financial crisis. They don't want to be seen as too willing to step in and save financial institutions that got into trouble by taking big risks. *But in an age where markets, banks and investors are linked through a web of complex and opaque financial relationships, the pain of letting a large institution go has proved almost overwhelming.*"

Carrick Mollenkamp et al, *Lehman's Demise Triggered Cash Crunch Around Globe*, Wall St. J., Sept. 29, 2008, p. A1 (emphasis added).

18

*Challenges of Institutional Governance:
Failure of Government Adaptation*

- ✧ Some assert that government failed to adapt regulation despite the existence of warnings and calls for intervention.
- ✧ Warren Buffet referred to derivatives as “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.”

Peter Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. Times, Oct. 9, 2008, p. A1.

19

*...Due to Ideological Reliance
on Markets to Self-Regulate*

- ✧ Alan Greenspan
 - ✧ Referred to the financial crisis as “a once-in-a-century credit tsunami”
 - ✧ Stated that “those of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief.”
 - ✧ Conceded a flaw in his ideology of placing faith in the self-correcting power of free markets and that his belief in deregulation had been shaken.”

Testimony before the U.S. House Committee of Government Oversight and Reform, Oct. 23, 2008.

20

*Challenges of Institutional Governance:
Inherent Problems With Emergency Legislation*

- ✧ Upon hearing that Mr. Bernanke and Mr. Paulson, wanted bailout legislation passed in a matter of days, Senate Majority Leader, Harry Reid, stated:

... "This is the United States Senate. We can't do it in that time frame." Oct. 2, 2008.

21

*Importance of Preserving the Rule of Law
While Pursuing Short Term Emergency Legislation*

- ✧ "[T]he solution should respect the rule of law..."

Glenn Hubbard, Hal Scott, Luigi Zingales, WSJ, Sept. 24, 2008, p. A29.

- ✧ "The bailout plan would allow Paulson to act with utter and absolute impunity - without review by any agency or court of law. After reading this proposal, I can only conclude that it is not just our economy that is at risk, Mr. Secretary, but our Constitution, as well.' "

WSJ, Sept. 24, 2008, quoting Sen. Dodd at U.S. Senate Banking Committee Hearing, p. A3.

22

*Challenges of Institutional Governance:
Regulatory Reform for Prospective Stability*

- ✧ “[W]e are in a crisis of economic institutions, not just a financial crisis.... The next [U.S.] administration will need to engineer a thoroughgoing overhaul of the regulatory system.”

Prof. Gerald Davis (U. of Michigan), Oct. 14, 2008.

- ✧ National regulatory reform must also be coordinated with “either a reform of one of the existing [international] institutions, or the creation of a new one.”

UK Prime Minister Gordon Brown, Oct. 15, 2008.

23

*Response Requires a Phase Transition
in Institutional Governance*

- ✧ “For 30 years, the nation’s [U.S.] political system has been tilted in favor of business deregulation and against new rules. Bu that is about to change, now that the government has been forced to intervene in the once high-flying financial industry to avert an economywide crash.... An expansion of the government’s role in financial markets is certain....”

Jackie Calmes, *Both Sides of the Aisle See More Regulation, and Not Just of Banks*, N. Y. Times, Oct. 14, 2008, p. A15.

24