The Political Economy of Deregulation: The Case of Intrastate Long Distance

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Abstract
Observed variation in the decisions of state regulators to deregulate AT&T in the provision of intrastate interLATA telecommunications services provides useful data with which to test the economic theory of regulation against its principal alternative—the public interest theory. An empirical model of the decision to deregulate is specified and estimated. Our results lend empirical support to the economic theory of regulation and fail to support the public interest theory. The results also help to explain the lethargic pace of deregulation of this industry.

"Undoubtedly, the greatest surprise in telephone industry deregulation has been the absence of deregulation, for the industry continues to be almost as highly regulated today as twenty years ago" R. W. Crandall (1988, 323).

1. Introduction

Deregulation represents a major public policy reversal. It has been called the public sector’s equivalent of a hostile takeover bid in the private sector. With deregulation of an industry, regulatory “management” is replaced by the invisible hand of market forces. Price, output, and investment decisions that were formerly governed by regulatory rules and procedures are set free to respond to market signals. Moreover, in industries that have been regulated for decades, such a dramatic shift in policy is perceived by many participants as a leap into
the unknown. It inevitably involves uncertainty concerning ultimate impacts on the part of all affected parties. 2

To the extent that regulatory controls represent binding constraints on regulated firm behavior, the elimination of those controls can be expected to result in an alteration of the firm’s price and output choices. Such alteration, in turn, can have important and far-reaching effects on a number of diverse parties. Consumers may experience price changes, and these changes may be different for different groups; competitors may face an intensification of competitive rivalry; regulators, their staff, and professional intervenors may confront an abrupt decline in the demand for their services; and legislators may feel the wrath, gratitude, or indifference of all of the above. Thus, in any decision to deregulate, there are numerous parties whose interests will be affected. This is particularly true where substantial cross-subsidization policies have accompanied regulation, as they frequently do. Under the economic (or interest group) theory of regulation, the affected parties, in turn, can all be expected to exert an influence on the decision to deregulate. An alternative perspective, suggested by the public interest theory of regulation, suggests that the decision to deregulate is predicated on broader measures of whether the public will benefit from deregulation.

In this paper, we present an empirical model of the individual states' decisions to deregulate the prices of intrastate interLATA long-distance telecommunications services. 3 Our model specification is generally guided by the two principal prevailing (and competing) theories of regulatory behavior—the economic theory of regulation and the public interest theory of regulation. The paper is organized as follows. In Section 2, we provide some historical background on this industry and present our basic conceptual model. In Section 3, we describe the variables used to represent the economic theory of regulation, and in Section 4 we describe the variables associated with the public interest theory. Section 5 describes our data and presents our empirical results. Section 6, then, concludes the paper.

2. Background and Conceptual Model

Since the divestiture of AT&T from the Bell Operating Companies in 1984, the long-distance industry has been subjected to what has been referred to as asymmetric regulation. That is, while the primary purpose of the divestiture order was to spin off the potentially competitive long-distance industry from the monopoly facilities of the local exchange companies, 4 the divested AT&T “inherited” traditional rate-of-return regulation. At the same time, however, the newer entrants into the long-distance industry have never been subjected to traditional public utility style regulation.

While this policy of asymmetric regulation is indefensible on economic grounds, 5 regulatory bodies at both the state and federal levels have been surprisingly slow to eliminate traditional regulatory controls on this market. By the end of 1988, only 14 states had formally ended rate-of-return regulation of AT&T, while the remaining states continued to apply traditional rate-of-return controls to this firm’s pricing decisions. The existence of disparate state-level (de)regulatory policies creates an interesting opportunity to empirically examine alternative theories of regulatory behavior. Specifically, why have some states eliminated traditional regulatory controls over AT&T while others have not? 6 And how successful are the alternative theories in answering this question?