

Testimony of Randolph J. May

President, The Free State Foundation

**Hearing on “The Future of Universal Service:
To Whom, By Whom, For What, and How Much?”**

before the

Subcommittee on Telecommunications and the Internet

Committee on Energy and Commerce

U.S. House of Representatives

June 24, 2008

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Mr. Chairman and Members of the Committee, thank you very much for inviting me to testify. I am President of The Free State Foundation, a non-profit, nonpartisan research and educational foundation located in Potomac, Maryland. FSF is a free market-oriented think tank that, among other things, does research in the communications law and policy and Internet areas.

It is appropriate to hold a hearing to reexamine the existing universal service regime. In the twelve years since passage of the Telecommunications Act of 1996, the communications landscape has changed dramatically as a result of vastly increased facilities-based competition. This increase in competition – for example, with mobile phones becoming nearly ubiquitous and cable companies already providing digital voice service to over 16 million customers -- is due in large part to technological developments enabled by the transition from analog to digital technologies. It is also due in part to the removal or reduction of some legacy regulations.

The upshot is that the existing universal regime needs serious reform if telecommunications services are going to be provided in the most cost-effective and economical manner so that overall consumer welfare is enhanced. The fact of the matter is that new competitive entrants and new technologies have rendered the existing system wasteful, inefficient, and competition-distorting.

Just a few basic figures up front to provide perspective for my contention that the current system needs a substantial overhaul. In order to finance the various universal service subsidies, consumers now pay a surcharge, in effect a “tax,” of 11.4% on all their interstate and international calls. In contrast, in 2000 the surcharge was 5.5%. The

doubling of the USF tax burden in such a short period is an easy-to-understand measure of how fast the subsidies funded by the surcharge have grown under the existing system. Much of the increase, of course, is attributable to the rapid growth in the high-cost fund, and my testimony today focuses mainly on that fund. The subsidies to support providers in high-cost areas grew from \$2.2 billion in 2000 to \$4.5 billion today. A final significant figure: Since the passage of the 1996 Act, Census Bureau data show that the percentage of households with a telephone has hovered close to 94%, give or take a percentage increase or decrease due to what appears to be routine fluctuation. Examination of the Census data shows that income level is the key independent variable driving penetration. Lower income households tend to fall below the national average penetration rate.

As I transition from highlighting these few but nevertheless key data points to a future-oriented discussion of the principles that should guide reform of the current regime, I want to make clear I support the notion that government has an appropriate role to play in helping ensure that communications services are available to all Americans. Of course, such role may vary over time, so that what may have been appropriate 50, 25, or even 10 years ago, may not be appropriate now. The basic questions to be asked and answered in thinking about the future of universal service are the ones identified in the hearing's subtitle, which might be rephrased as follows: What is the mission? If the mission requires subsidies to achieve its objective, who should receive them? And how should any subsidies be financed?

Before providing thoughts on these questions, I want to set forth two interrelated fundamental public policy principles that should guide reform of the system. First, market forces, rather than subsidies, should be relied on to the greatest extent possible to achieve

the identified objective. This is more important today than ever because, under a properly constructed regime, increasing competition and new technologies should drive down the cost of making communications services widely available. Second, as John Mayo, a member of the Free State Foundation's Board of Academic Advisors and Professor of Economics and former Dean of Georgetown University's Business School likes to say: If there are to be subsidies, they should be targeted *narrowly* and financed *broadly*. Anyone familiar with the current universal service system knows it is at odds with these fundamental principles.

Without elaborating all the specific "at odds" here, I will simply point out the first principle is disregarded when subsidies are provided to carriers serving geographic areas in which market forces already have resulted in existing service and when subsidies are provided to persons who require no subsidy, but who would in any event acquire service at market prices. The second, related principle is disregarded because rather than targeting subsidies narrowly and contributions broadly, the current system targets subsidies broadly (to areas and persons who don't need them) and funding narrowly (contributions from only one kind of communications service).

Ignoring these sound principles is the reason that the current USF surcharge is 11.4% per interstate call. Like any tax, the surcharge distorts economic behavior. Here the effect is to suppress demand for the relatively price-elastic calls subject to the surcharge. Economists have estimated the consumer welfare losses from the suppression of this demand for telephone services in the billions of dollars. The adverse impact on consumers negatively impacts the entire economy.

So what should be done? Congress should recognize that the goal of “universal service” as originally conceived – to make voice service ubiquitously available -- has generally been achieved. While the extent to which the existing universal service regime is responsible for such achievement is debatable, no matter. Once in a while victory should be declared, the cannons silenced, and the bugles triumphantly sounded. The high-cost fund should be permanently capped at its current level. As I pointed out earlier, approximately 94% of American households have voice telephone service, and this figure has remained steady for more than a decade. This may well be the “natural” high mark for telephone penetration at any one time. But if the penetration level is to be increased at all, almost certainly it will be by virtue of even more vigorous efforts to target low-income persons to sign up for the existing Lifeline and Link-up programs, not because unfocused subsidies continue to be disbursed.

To the extent there are identifiable remaining high-cost areas without any affordable service, I would rely on competitive mechanisms, such as reverse auctions, to select a provider of last resort. This is the most efficient and most technologically and competitively-neutral way to make service available in those areas. In my view, Rep. Barton’s Staff Discussion Draft does a good job of envisioning how such a reverse auction system would work to drive costs down over time, or to at least halt the steady growth in costs experienced under the current regime. Consistent with the principle enunciated earlier, I would finance the remaining subsidies through a telephone numbers-based contribution system. This broad-based financing system, which is also adopted in the Barton Staff Draft, by taxing relatively price-inelastic access (with exceptions for low-income subscribers) rather than much more price-elastic usage, is a more

economically efficient funding method. It would have less adverse impact on consumer welfare and the overall economy.

Now I understand the question whether a reformed regime should be extended explicitly to include subsidies for broadband services is front-and-center. In light of the importance of the widespread broadband availability to the nation's economic and social well-being, this is entirely appropriate. In considering the question, it is very important to have in mind the principles I have enunciated and the lessons we have learned – or should have learned – from the existing regime. To the maximum extent possible, market forces should be relied upon to make broadband service widely available. If any subsidies are deemed necessary, they should be focused narrowly and funded broadly.

I know there is controversy, depending upon one's perspective, concerning how well we are doing in this country regarding broadband deployment and how well we are doing vis-à-vis other nations. There have been separate hearings on this subject, and it may well be useful to have more. From my perspective, I want here simply to point out that, by most measures, the nation has witnessed remarkable progress in a short time. The FCC's most recent broadband data, now almost a year old, show that more than 99% of the nation's zip codes have at least one in-service high-speed provider, and more than 99% of the nation's population lives in those zip codes. There are over 100 million high-speed lines in service, and over 65 million of these serve primarily residential end users. This represents a rapid dispersion of broadband availability. This success is attributable primarily to the private sector responding to market forces, with more than \$100 billion – and still counting -- of investment. The success is not attributable in any significant way to government subsidies. And it is important to understand that market forces have

spurred this rapid deployment in large part because broadband providers have not been subject to traditional common carrier regulation that prevailed in an earlier monopolistic era. In furtherance of promoting any “universal service” policy regarding broadband, policymakers should retain this minimally regulated environment that has encouraged so much private sector broadband investment in a relatively short time.

If policymakers determine that, despite the progress already achieved through market forces, some subsidies nevertheless are desirable to achieve more ubiquitous deployment at a faster rate, such subsidies should be narrowly focused on selected high-cost geographic areas where service is unavailable or on low-income persons who otherwise cannot afford service. In keeping with the principle of financing broadly, funding for any such subsidies should come from general Treasury appropriations. Carefully targeted subsidies should be awarded through some form of competitive bidding process to determine which provider, consistent with meeting defined service parameters, is the least cost provider. Any broadband subsidies deemed necessary should not be disbursed or financed through an unreformed universal service regime that resembles the existing one. To do so would perpetuate a system that is economically inefficient, wasteful, and competition-suppressing. It would saddle the broadband world – and the American public – with an outdated relic of the narrowband world.

A last note of caution in considering whether broadband needs any “universal service” subsidies. Policymakers should have in mind the distinction between availability and use. As shown above, broadband service is now available to most of the nation’s consumers. But there are many different “demand-side” reasons that people may not subscribe. John Horrigan at the Pew Internet & American Life Project has done much

good work in this area. His research shows that the nature of unmet demand has many dimensions, and that price often plays a minimal role in acquisition decisions. Factors include lack of computers at home, and concerns relating to usability of computers and the Internet; security of online information; and relevance of online content. The point here is that there are different demand-side reasons why people do not take broadband service where it is available. These reasons will not be addressed by subsidies directed towards increasing broadband deployment. This is another way of saying that, before adopting any new subsidies, policymakers must carefully consider the costs and benefits of such expenditures.

Thank you for giving me the opportunity to testify today. I will be pleased to answer any questions.