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A HISTORY OF CRONYISM AND CAPTURE IN THE INFORMATION TECHNOLOGY SECTOR

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Abstract

This paper documents the evolution of government-granted privileges, or “cronyism,” in the information and communications technology marketplace and in the media-producing sectors. It also shows that cronyism is slowly creeping into new high-technology sectors. This influence could dull entrepreneurialism and competition in this highly innovative sector since time and resources spent on influencing politicians and capturing regulators cannot be spent competing and innovating in the marketplace. Cronyism will also negatively impact consumer welfare by denying consumers more and better products and services. Additionally, consumers might end up paying higher prices or higher taxes due to government privileges for industry. Finally, this paper offers strategies for stalling and diminishing the cronyism already taking root in the high-tech sector.

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A History of Cronyism and Capture in the Information Technology Sector

Adam Thierer and Brent Skorup

I. Introduction

“Cronyism,” which generally refers to an anticonsumer and corrupting affiliation between government and special interests, is a growing bipartisan concern today.¹ “Cronyism” is popular shorthand for government-granted privileges or favoritism,² which come in many flavors and have many economic and social costs.³ This paper documents the evolution of government-granted privileges in the information and communications technology marketplace and in the media-producing sectors.

Various political privileges have been dispensed in the traditional communications and media markets, most often in the form of regulatory favoritism. Cronyism and government-granted privilege are also creeping into the modern high-tech and Internet-related sectors, most notably in the form of generous tax credits. This paper inventories some of the tax privileges that communications and media companies enjoy today.

The danger of creeping cronyism in the high-tech field is that it will dull entrepreneurialism and competition in this highly innovative sector. The opportunity costs of pursuing favors are significant. Time and resources spent influencing politicians and capturing regulators could instead be spent competing and innovating in the marketplace. Cronyism can

¹ Michael De Groote, *Crony Capitalism: Why the Tea Party and Occupy Movements Should Be Friends*, DESERET NEWS, July 9, 2012, <http://www.deseretnews.com/article/865558699/Crony-capitalism-Why-the-tea-party-and-Occupy-movements-should-be-friends.html>; *39% Say U.S. Has Crony Capitalist System*, RASMUSSEN REPORTS (Jan. 18, 2012), http://www.rasmussenreports.com/public_content/business/general_business/january_2012/39_say_u_s_has_crony_capitalist_system.

² David R. Henderson, *The Economics and History of Cronyism*, Mercatus Center at George Mason University (July 27, 2012), Mercatus Research, at 5, 7, [“under cronyism the government rigs the market for the benefit of government officials’ cronies. . . . In short, cronyism plays favorites.”]

³ *Id.* at 19. [“Cronyism is not simply a zero-sum game that takes from some and gives to others; it is negative-sum. The losses to the losers substantially outweigh the gains to the winners. In short, cronyism destroys wealth.”]

thus negatively impact consumer welfare in two ways: not only does it deny consumers more and better products and services, but they also may pay higher prices or higher taxes extracted by the corporate-government agreement. Moreover, economic growth slows as entrepreneurs pursue unproductive influence and capture activities rather than productive entrepreneurship.

Cronyism also raises the specter of greater government control of the Internet and of the digital economy more generally. When policymakers dispense favors, they usually expect something in return. They may also become accustomed to having greater informal powers over the sector receiving favors. That result would be highly unfortunate for the information technology sector, since the Internet has largely developed and thrived in an unregulated environment.⁴ Indeed, the Internet's decentralized, bottom-up nature has been crucial to its success.⁵ By contrast, Washington's slow, administrative control of industries represents the antithesis of the digital economy. To avoid a predictable decline in innovation and consumer welfare, we offer strategies for stalling and diminishing the cronyism already taking root in the information and communications technology marketplace and in the media-producing sectors.

II. Whence Government-Granted Privileges?

Before exploring how cronyism affects communications, media, and high-tech markets, we first discuss the economic theory of regulation and the insights of the public-choice school of economics in particular. These insights help explain why cronyism and government-granted privilege are such persistent political problems.

⁴ Jason Oxman, *The FCC and the Unregulation of the Internet* (Office of Plans and Policy, Federal Communications Commission, Working Paper No. 31, July 1999), http://transition.fcc.gov/Bureaus/OPP/working_papers/oppwp31.pdf; GORDON TULLOCK, ARTHUR SELDON & GORDON L. BRADY, *GOVERNMENT FAILURE: A PRIMER IN PUBLIC CHOICE* 93 (2002). [“the Internet has developed largely as a spontaneous order without a central coordinating authority.”]

⁵ Adam Thierer, *Does the Internet Need a Global Regulator?* FORBES, May 6, 2012, <http://www.forbes.com/sites/adamthierer/2012/05/06/does-the-internet-need-a-global-regulator>.

A. The Economic Theory of Regulation

Under the traditional “public interest” theory of regulation, lawmakers and regulators are assumed to be enlightened and benevolent actors⁶ who can identify and correct market failures, thereby maximizing social welfare or other public interest objectives.⁷ Public interest goals typically include lower prices, quality service, widespread access or “universal service,” and other health, safety, or social regulations. Regulation is assumed to further these objectives.

This view was predominant in the first half of the 20th century, but beginning in the 1960s and '70s, various economists and political scientists began rigorously documenting the shortcomings of the public interest theory of regulation. Scholars associated with the Chicago and public-choice schools of economics primarily led the rethinking of the traditional textbook theory of regulation.⁸

Today, most economists agree with law professor Fred S. McChesney’s assessment that “the notion that government regulates in some disinterested, ‘public interest’ fashion to repair market failure has crumbled. Too much regulation is demonstrably at odds with the general welfare for any such public-interest explanation now to be taken seriously.”⁹ Indeed, the authors

⁶ RANDY T. SIMMONS, *BEYOND POLITICS: THE ROOTS OF GOVERNMENT FAILURE* 42 (2011). (“For more than one hundred years the basic vision of bureaucracy has been that efficiency is promoted by professional, nonpartisan administration directed by a strong executive. . . . Scientific management of public agencies . . . is based on the belief that ‘right-minded’ managers, who are not motivated by profit or other selfish goals, will protect the public interest while managing government agencies, programs and properties.”)

⁷ DAVID L. KASERMAN & JOHN W. MAYO, *GOVERNMENT AND BUSINESS: THE ECONOMICS OF ANTITRUST AND REGULATION* 518 (1995); BARRY M. MITNICK, *THE POLITICAL ECONOMY OF REGULATION: CREATING, DESIGNING, AND REMOVING REGULATORY FORMS* 91–93, 242–79 (1980).

⁸ Richard M. Ebeling, *Milton Friedman and the Chicago School of Economics*, 56 *THE FREEMAN*, no. 10, 2006, <http://www.thefreemanonline.org/columns/from-the-president/milton-friedman-and-the-chicago-school-of-economics>. The public-choice school is also called the Virginia School because of affiliated scholars at the University of Virginia and George Mason University. Peter J. Boettke, *Virginia Political Economy: A View from Vienna*, 5 *MARKET PROCESS*, no. 2, 1987, at 7, reprinted in PETER J. BOETTKE & DAVID L. PRYCHITKO (EDS.), *THE MARKET PROCESS: ESSAYS IN CONTEMPORARY AUSTRIAN ECONOMICS* 244, 260 (1994); DENNIS C. MUELLER, *THE ‘VIRGINIA SCHOOL’ AND PUBLIC CHOICE*, Center for the Study of Public Choice (1985).

⁹ FRED S. MCCHESENEY, *MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION* 156 (1997).

of two of the leading textbooks on economic regulation conclude that “the fundamental problem with the public interest theory of regulation is that it simply does not perform well empirically,”¹⁰ and that it “has lacked supporters for several decades . . . [because of] the large amount of evidence that refutes it.”¹¹

Scholars from these two schools of thought documented numerous deficiencies with the public interest theory of regulation and, in the process, developed an “economic theory of regulation,” which applies economic analysis and insights to explain how law and regulation are actually formulated. We focus on two of the most important insights flowing from the economic theory of regulation since they are especially relevant to modern cronyism: rent-seeking and regulatory capture.

Rent-seeking. Nobel prize–winning economist James M. Buchanan perhaps best described public-choice analysis as “politics without romance.”¹² Public choice strips away the “public interest” and “common good” gloss sometimes associated with government regulation and public resource management.¹³ Instead, using the tools and assumptions of economics, public-choice analysis shows how political actors are frequently as self-interested and prone to mistakes as private actors.¹⁴ “Much of the growth of the bureaucratic or regulatory sector of government,” noted Buchanan, “can best be explained in terms of the competition between

¹⁰ KASERMAN & MAYO, *supra* note 7.

¹¹ W. KIP VISCUSI, JOHN M. VERNON & JOSEPH E. HARRINGTON JR., *ECONOMICS OF REGULATION AND ANTITRUST*, 326, 2nd ed. (1998).

¹² James M. Buchanan, *Politics without Romance*, 19 *POLICY*, no. 3, 2003, at 13.

¹³ SUSAN E. DUDLEY & JERRY BRITO, *REGULATION: A PRIMER* 17 (2012). (“Public choice analysis posits that government officials are not systematically engaged in maximizing the public interest, but are attempting to maximize their own private interests. . . . In particular, public choice is concerned with the economic waste inherent in efforts to change laws or regulations in order to privilege one group over another.”)

¹⁴ SIMMONS, *supra* note 6, at 51. (“Public choice is the study of political or public choices using the tools and assumptions of economics.”)

political agents for constituency support through the use of promises of discriminatory transfers of wealth.”¹⁵ For these reasons, public-choice scholars often speak of “government failure,” the public sector analog to “market failure.”¹⁶

“Rent-seeking” and “rent extraction” are the mechanisms behind how legislation and regulation often work in practice.¹⁷ “Rents” in this context generally refer to “the above-normal profits of a privileged firm.”¹⁸ As applied to political activities, rent-seeking could more simply be thought of as privilege seeking, or an effort to secure favorable tax or regulatory treatment.¹⁹ “Rent seeking as popularly perceived refers to legal and illegal activities to obtain special privilege,” notes Gordon Tullock, along with Buchanan one of the intellectual godfathers of the public-choice school.²⁰ Or, more simply, as economist Randy T. Simmons argues, rent-seeking comes down to “obtaining more wealth and income through political action.”²¹

Rent-seeking primarily describes the *demand* side of political favoritism: the favorable treatment that affected parties seek. The *supply* side—the dispensing of favors by political actors—is also important. In this “rent extraction” model of regulation, McChesney notes, “Politicians are seen not as mere brokers redistributing wealth in response to competing private demands, but as independent actors making their own demands to which private actors respond.”²² They also threaten to hand out punishments (by destroying or expropriating private

¹⁵ *Id.* at 16.

¹⁶ TULLOCK ET AL., *supra* note 4.

¹⁷ Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AMERICAN ECONOMIC REVIEW, 1974, at 291.

¹⁸ Matthew Mitchell, *The Pathology of Privilege: The Economic Consequences of Government Favoritism*, Mercatus Center at George Mason University, Mercatus Research, 17 (July 9, 2012), <http://mercatus.org/publication/pathology-privilege-economic-consequences-government-favoritism>.

¹⁹ David R. Henderson, *Rent Seeking*, THE CONCISE ENCYCLOPEDIA OF ECONOMICS, 2nd ed., <http://www.econlib.org/library/Enc/RentSeeking.html>.

²⁰ TULLOCK ET AL., *supra* note 4, at 44.

²¹ SIMMONS, *supra* note 6, at 62.

²² MCCHESENEY, *supra* note 9, at 157.

rents) and can obtain payments from interested parties in exchange for *not* punishing them. McChesney refers to this process as “extortion by politicians” in that policymakers are often “paid not to legislate.”²³

Regulatory capture. Capture theory is closely related to the rent-seeking and government failure theories developed by public-choice school scholars. A long line of economists and political scientists have documented how affected parties often “capture” the regulatory process and use it for their own ends.²⁴ The public interest theory of regulation failed to anticipate the recurring reality that special interests frequently have the ear of regulators and extract substantial benefits at the expense of the general public.

Scholars developed a new theory of regulation to help explain why the traditional paradigm was incomplete.²⁵ In particular, University of Chicago economist George Stigler’s pioneering work in developing the economic theory of regulation revealed how “as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit.”²⁶ The explanation was straightforward: “The state—the machinery and the power of the state—is a potential resource or threat to every industry in the society. With its power to prohibit or compel, to take or give money, the state can and does selectively help or hurt a vast number of industries,”²⁷ Stigler wrote. Thus, a strong incentive exists for affected interests to capture “the machinery and the power of the state,” since, as McChesney noted, “government regulation had the power to create benefits that were unavailable other than through politics, or were more

²³ *Id.* at 41.

²⁴ Adam Thierer, *Regulatory Capture: What the Experts Have Found*, TECHNOLOGY LIBERATION FRONT, Dec. 19, 2010, <http://techliberation.com/2010/12/19/regulatory-capture-what-the-experts-have-found>.

²⁵ VISCUSI ET AL., *supra* note 11, at 328–46.

²⁶ George Stigler, *The Theory of Economic Regulation*, 2 BELL J. OF ECON. & MAN. SCI., no. 1, 1971, at 3. A broader discussion of capture theory can be found in VISCUSI ET AL., *supra* note 11, at 327–46.

²⁷ Stigler, *supra* note 26.

cheaply available through politics.”²⁸ Sam Peltzman and other Chicago School scholars would refine Stigler’s model to construct a more robust economic theory of regulation and explain the prevalence of capture within political systems.²⁹

Many other scholars have identified capture as a recurring problem, especially in regulated network industries.³⁰ Most concur with UCLA economist Harold Demsetz’s conclusion that in many network sectors or utility industries, “regulation has often been sought because of the inconvenience of competition.”³¹ The histories of the railroad and airline industries provide particularly egregious examples of regulatory capture.³² Each industry used its

²⁸ MCCHESENEY, *supra* note 9, at 9–10.

²⁹ Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON., 1976, at 211–40; Gary Becker, *A Theory of Competition among Pressure Groups for Political Influence*, 98 QUAR. J. ECON., 1983, at 371–400.

³⁰ Anthony Downs, *An Economic Theory of Political Action in a Democracy*, 65 J. POL. ECON., no. 2, 1957, at 135–50; William A. Jordan, *Producer Protection, Prior Market Structure and the Effects of Government Regulation*, 15 J.L. & ECON., no. 1, 1972, at 151–76; Mark Green & Ralph Nader, *Economic Regulation vs. Competition: Uncle Sam the Monopoly Man*, 82 Yale L.J., no. 5, 1973, at 876; Barry Weingast, *Regulation, Reregulation and Deregulation: The Foundation of Agency-Clientele Relationships*, 44 LAW & CONTEMP. PROBS., 1981, at 147–77; Bruce Yandle, *Bootleggers and Baptists: The Education of a Regulatory Economist*, 3 REGULATION, no. 3, 1983, at 12–16; Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD., no. 1, 1987, at 101–18; J. J. Lafont & Jean Tirole, *The Politics of Government Decision-Making: A Theory of Regulatory Capture*, 106 QUAR. J. ECON., no. 4, 1991, at 1089–127.

³¹ Harold Demsetz, *Why Regulate Utilities?* 11 J.L. & ECON. no. 1, 1968, at 61.

³² Thomas Frank, *Obama and Regulatory Capture*, WALL. ST. J., June 24, 2009, <http://online.wsj.com/article/SB124580461065744913.html>. [“The first federal regulatory agency, the Interstate Commerce Commission, was set up to regulate railroad freight rates in the 1880s. Soon thereafter, Richard Olney, a prominent railroad lawyer, came to Washington to serve as Grover Cleveland’s attorney general. Olney’s former boss asked him if he would help kill off the hated ICC. Olney’s reply, handed down at the very dawn of Big Government, should be regarded as an urtext of the regulatory state: ‘The Commission . . . is, or can be made, of great use to the railroads. It satisfies the popular clamor for a government supervision of the railroads, at the same time that that supervision is almost entirely nominal. Further, the older such a commission gets to be, the more inclined it will be found to take the business and railroad view of things. . . . The part of wisdom is not to destroy the Commission, but to utilize it.’”] THOMAS K. MCCRAW, PROPHETS OF REGULATION 263, 1984. (“Clearly, in passing the Civil Aeronautics Act [of 1938], Congress intended to bring stability to airlines. What is not clear is whether the legislature intended to cartelize the industry. Yet this did happen. During the forty years between passage of the act of 1938 and the appointment of [Alfred] Kahn to the CAB chairmanship, the overall effect of board policies tended to freeze the industry more or less in its configuration of 1938. One policy, for example, forbade price competition. Instead the CAB ordinarily required that all carriers flying a certain route charge the same rates for the same class of customer. . . . A second policy had to do with the CAB’s stance toward the entry of new companies into the business. Charged by Congress with the duty of ascertaining whether or not ‘the public interest, convenience, and necessity’ mandated that new carriers should receive a certificate to operate, the board often ruled simply that no applicant met these tests. In fact, over the entire history of the CAB, no new trunkline carrier had been permitted to join the sixteen that existed in 1938. And those sixteen, later reduced to ten by a

respective regulators (the Interstate Commerce Commission and the Civil Aeronautics Board) to promote cartelization and market protectionism.³³ When capture occurs, it lessens not only the innovation that would flow from other market entrants and entrepreneurs but also innovation by the regulated entity itself, which shifts its focus to controlling the regulatory process and sheltering itself from disruptive change.

Some of the most important work on capture theory has been done by left-of-center scholars and policy advocates. In 1973, well-known consumer advocates Mark Green and Ralph Nader noted that “a kind of regular personnel interchange between agency and industry blurs what should be a sharp line between regulator and regulatee, and can compromise independent regulatory judgment. In short, the regulated industries are often in clear control of the regulatory process.”³⁴ Later, during the Carter administration, congressional Democrats (including the late Senator Edward Kennedy), future Supreme Court Justice Stephen Breyer (who worked as Senate staffer at the time), and liberal consumer advocates like Green and Nader led deregulation efforts because they became convinced that regulation was harming consumer welfare by limiting competition and driving up prices.³⁵

Economist Alfred Kahn, a self-described liberal Democrat, was a central figure in the deregulatory efforts of the 1970s, both in and out of government.³⁶ In 1970, he published a meticulous two-volume study of the regulatory process titled *The Economics of Regulation* that

series of mergers, still dominated the industry in the 1970s. All these companies . . . developed into large companies under the protective wing of the CAB. None wanted deregulation.”)

³³ KASERMAN & MAYO, *supra* note 7, at 523. [“the CAB and ICC strictly controlled (prohibited) entry into domestic air service and severely limited entry into trucking for many years.”]

³⁴ Green & Nader, *supra* note 30, at 876.

³⁵ RICHARD H. K. VIETOR, *CONTRIVED COMPETITION: REGULATION AND DEREGULATION IN AMERICA* 14, 50–52 (1994); MCCRAW, *supra* note 32, at 266–68, 293–96.

³⁶ Adam Thierer, *Alfred Kahn—an Appreciation*, TECHNOLOGY LIBERATION FRONT, Dec. 28, 2010, <http://techliberation.com/2010/12/28/alfred-kahn-an-appreciation>.

became a seminal text in the field.³⁷ In it, he identified how capture was a particular problem for regulated network industries:

When a commission is responsible for the performance of an industry, it is under never completely escapable pressure to protect the health of the companies it regulates, to assure a desirable performance by relying on those monopolistic chosen instruments and its own controls rather than on the unplanned and unplannable forces of competition. . . . Responsible for the continued provision and improvement of service, [the regulatory commission] comes increasingly and understandably to identify the interest of the public with that of the existing companies on whom it must rely to deliver goods.³⁸

In 1977, President Jimmy Carter appointed Kahn to serve as chairman of the Civil Aeronautics Board (CAB), and Kahn promptly set to work to dismantle the anticonsumer airline cartels sustained by government regulation.³⁹ Kahn and the CAB achieved a veritable public policy revolution in just a few short years. Not only did they comprehensively deregulate airline markets, but they also got rid of the entire regulatory infrastructure in the process. They did so largely based on Kahn's fear about "the inexorable tendency of regulation in the competitive marketplace to spread" and be captured by special interests.⁴⁰ Comprehensive deregulation and agency abolition was, therefore, viewed as the logical and necessary step. Consequently, the Civil Aeronautics Board Sunset Act of 1984 formally abolished the CAB.

B. A Taxonomy of Government-Granted Privileges and Their Costs

Many other scholars (and journalists) outside the public-choice and Chicago schools have identified and analyzed the growth of what has been alternatively called the "interest group

³⁷ In his Pulitzer Prize-winning book, *Prophets of Regulation*, Harvard Business School professor Thomas K. McCraw called Kahn's *Economics of Regulation* "one of the most important books ever written on the subject" and noted that it catapulted Kahn into a career in public service as a regulatory reformer. MCCRAW, *supra* note 32, at 233.

³⁸ ALFRED E. KAHN, *THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS*, 12, 46 (vol. 2, 1971).

³⁹ Philip J. Weiser, *Alfred Kahn as a Case Study of a Political Entrepreneur: An Essay in Honor of His 90th Birthday*, 7 REV. NET. ECON., 2009, at 601, <http://www.silicon-flatirons.org/documents/conferences/2008.09.05-207/WeiserKahnCaseStudy.pdf>.

⁴⁰ Quoted in MCCRAW, *supra* note 32, at 272.

society,”⁴¹ “receivership by regulation,”⁴² and “client politics.”⁴³ All these concepts share a common insight that flowed from Mancur Olson’s 1965 book, *The Logic of Collective Action*: when benefits are concentrated and costs are dispersed (across all taxpayers, for example), we can expect groups to form to take advantage of those benefits.⁴⁴ Those bearing the dispersed costs will have less of an incentive to form groups to counter those receiving the benefits.⁴⁵ This tendency explains why some government programs and regulations become so entrenched and why rent-seeking self-perpetuates.⁴⁶

These scholars’ research and insights have supplemented and reinforced the public-choice and Chicago School scholars’ findings. As a result, the economic theory of regulation has altered the way recent generations of economists, political scientists, journalists,⁴⁷ and even the general public analyze and evaluate regulatory policy activities and decision making. While the economic theory of regulation cannot explain all regulatory decisions or developments, it does explain with dismaying consistency how self-interested motives lie behind many political decisions.⁴⁸

⁴¹ JEFFREY M. BERRY, *THE INTEREST GROUP SOCIETY* (1989).

⁴² THEODORE J. LOWI, *THE END OF LIBERALISM: THE SECOND REPUBLIC OF THE UNITED STATES* (2nd ed., 1969, 1979).

⁴³ James Q. Wilson said that client politics “occurs when most or all of the benefits of a program go to some single, reasonably small interest (and industry, profession, or locality) but most or all of the costs will be borne by a large number of people (for example, all taxpayers).” JAMES Q. WILSON, *BUREAUCRACY*, 76 (1989).

⁴⁴ MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965).

⁴⁵ SIMMONS, *supra* note 6, at 64. (“The difficulties of supporting the general interest are compounded when concentrated interest groups are considered. A reason the politician faces more powerful incentives to spend than to economize is . . . small groups who benefit from government expenditures have more incentives and cheaper means of organizing than do the diffused taxpayers.”)

⁴⁶ Michael Giberson, *Concentrated Benefits and Dispersed Costs*, KNOWLEDGE PROBLEM, Oct. 17, 2010, <http://knowledgeproblem.com/2010/10/17/concentrated-benefits-and-dispersed-costs>.

⁴⁷ JONATHAN RAUCH, *GOVERNMENT’S END: WHY WASHINGTON STOPPED WORKING* (1994); TIM CARNEY, *THE BIG RIPOFF: HOW BIG BUSINESS AND BIG GOVERNMENT STEAL YOUR MONEY* (2006); CHARLES PETERS, *HOW WASHINGTON REALLY WORKS* (1993).

⁴⁸ Political scientist James Q. Wilson has pushed back against the economic theory of regulation and suggested it does not fully appreciate the ways in which politics differs from economics. He argued that “the politics of regulation follows different patterns, mobilizes different actors, and has different consequences depending, among

These insights have become even more pertinent as concerns about crony capitalism have increased in recent years. This increased concern has led to more focused, fine-grained research examining the many different ways that government favoritism corrupts the political process and capitalism. Mercatus Center researcher Matthew Mitchell has crafted a taxonomy of “the various ways in which government-granted privileges diminish the gains from exchange, threaten economic growth, and undermine the legitimacy of government and the private sector.”⁴⁹ He identifies 10 categories:

1. Monopoly privilege
2. Regulatory privilege
3. Subsidies
4. Loan guarantees
5. Tax privileges
6. Bailouts
7. Expected bailouts
8. Tariffs and quotas on foreign competition
9. Noncompetitive bidding
10. Multiple privileges

Most of the forms of privilege at work in the communications and media sectors fall into categories 2, 3, and 5: regulatory privilege, subsidies, and tax privileges. Examples of each are discussed in sections III and IV.

other things, on the perceived distribution of costs and benefits of the proposed policy.” JAMES Q. WILSON, *THE POLITICS OF REGULATION*, 361–63, 371–72 (1980).

⁴⁹ Mitchell, *supra* note 18.

Mitchell also identifies the various economic and social costs associated with government-granted privilege. The costs most relevant to the sectors we focus on here are the following:

- monopoly costs
- inattention to consumer desires
- unproductive entrepreneurship
- loss of innovation and diminished long-run economic growth
- loss of legitimacy (of both government institutions and capitalism itself)

Several of these concepts are interrelated, as Tullock has explained:

Drawing the bulk of intelligent and energetic people in society into an activity that has no social product, or may have negative social product, is more important in explaining the stagnation of these societies than the direct social cost of the rent seeking. . . . [L]obbyists in Washington . . . are very intelligent and energetic people. . . . They are the kind of people we would like to have driving forward in production. Most, however, are on the other side—seeking special privilege. Unfortunately this collection of highly intelligent and energetic people who could make real contributions to society are reducing its efficiency.⁵⁰

There are also other costs, including the misallocation of investment into not just rent-seeking activities but also into the less-productive industries that receive favors. It is worth keeping these various costs in mind during the following examination of case studies from the history of communications, media, and copyright.

III. Analog-Era Case Studies of Government-Granted Privilege

This section documents several examples of government-granted privilege at work in the communications and media sectors historically. First, we note how many scholars have documented the persistent problem of regulatory gaming in communications and media policy, especially at the Federal Communications Commission (FCC).

⁵⁰ TULLOCK ET AL., *supra* note 4, at 49.

A. The Persistence of Regulatory Privilege in Communications and Media Policy

The most common forms of cronyism at work in the information sector have been what Mitchell classifies as “monopoly privilege” and “regulatory privilege.” Specifically, the dangers of regulatory capture and gaming are omnipresent in this sector, especially at the FCC. As economist Gordon L. Brady explained in 2002,

Despite the global changes in the international telecommunications market, the FCC remains a prime target of rent seeking. It retains the ability to bestow, deny, or reallocate rents among private parties through regulatory decisions and thus to affect the value of property rights in the telecommunications industry. Its portfolio of monopoly powers that engender rent seeking include setting rates, granting licenses, and exercising other powers that govern the nature of competition among the firms.⁵¹

Former and current FCC officials agree both that capture has been an ongoing problem at the agency and that it has imposed real economic and social costs. Reed Hundt, FCC chairman during the Clinton administration, has noted that “the FCC has suffered, from time to time, a reputation for agency capture by special interests, mind-boggling delay, internal strife, lack of competence, and a dreadful record on judicial review.”⁵² Likewise, current FCC commissioner Robert McDowell notes that many telecom and media companies “suffer from the ‘please regulate my rival’ malady of an industry that has been regulated too much and for too long. History is replete with such scenarios,” he says, “and the desire for more regulation for competitors always ends badly for the incumbent regulated industry in the form of unintended and harmful consequences.”⁵³ Economists refer to this as “cost predation” or “raising rivals’ costs.”⁵⁴

⁵¹ Gordon L. Brady, *Applying Public Choice to Telecommunications*, in TULLOCK ET AL., *supra* note 4, at 106.

⁵² Reed E. Hundt & Gregory L. Rosston, *Communications Policy for 2006 and Beyond*, FED. COMM. L.J., Jan. 2006, at 1, 31, <http://law.indiana.edu/fclj/pubs/v58/no1/HundtPDF.pdf>.

⁵³ Robert McDowell, *The Siren Call of ‘Please Regulate My Rival’: A Recipe for Regulatory Failure*, Speech Before the Associazione Ego and Puntoit, Italian Parliament, Aula Dei Grupi Parlamentari, Rome, Italy (June 28, 2012), at 5, <http://www.fcc.gov/document/commr-mcdowells-speech-possible-itu-regulation-internet>.

⁵⁴ Fred S. McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 J. LEGAL STUD., no. 1, 1987, at 104.

McDowell's assessment is correct, but the gaming at work in this sector is not limited to efforts to have the government regulate rivals. These interests are also often looking for special favors and treatment, and all too often, they get it, as communications and media policy scholars have meticulously documented. Thomas Hazlett, a former chief economist at the FCC, has noted that the FCC's initials might as well stand for "forever captured by corporations."⁵⁵ Tim Wu, author of *The Master Switch*, has documented the reality of regulatory capture in the heavily regulated communications and media sectors:

Again and again in the histories I have recounted, the state has shown itself an inferior arbiter of what is good for the information industries. The federal government's role in radio and television from the 1920s through the 1960s, for instance, was nothing short of a disgrace. . . . Government's tendency to protect large market players amounts to an illegitimate complicity . . . [particularly its] sense of obligation to protect big industries irrespective of their having become uncompetitive.⁵⁶

The cronyism and capture that surround the FCC can impose more widespread social and economic costs, such as those outlined in the previous section. Harvard University law professor Lawrence Lessig has noted that

economic growth requires innovation. Trouble is, Washington is practically designed to resist it. Built into the DNA of the most important agencies created to protect innovation, is an almost irresistible urge to protect the most powerful instead. The FCC is a perfect example. . . . With so much in its reach, the FCC has become the target of enormous campaigns for influence. Its commissioners are meant to be "expert" and "independent," but they've never really been expert, and are now openly embracing the political role they play. Commissioners issue press releases touting their own personal policies. And lobbyists spend years getting close to members of this junior varsity Congress.⁵⁷

Even more damning are the words of communications policy experts and former FCC officials David J. Farber and Gerald R. Faulhaber:

⁵⁵ Quoted in *Weather or Not, Here It Comes: Transcript*, ON THE MEDIA, Apr. 30, 2004, <http://www.onthemedial.org/2004/apr/30/weather-or-not-here-it-comes/transcript>.

⁵⁶ TIM WU, *THE MASTER SWITCH: THE RISE AND FALL OF INFORMATION EMPIRES*, 308 (2010).

⁵⁷ Lawrence Lessig, *Reboot the FCC*, NEWSWEEK, Dec. 23, 2008, <http://www.thedailybeast.com/newsweek/2008/12/22/reboot-the-fcc.html>.

When the FCC asserts regulatory jurisdiction over an area of telecommunications, the dynamic of the industry changes. No longer are customer needs and desires at the forefront of firms' competitive strategies; rather firms take their competitive battles to the FCC, hoping for a favorable ruling that will translate into a marketplace advantage. Customer needs take second place; regulatory "rent-seeking" becomes the rule of the day, and a previously innovative and vibrant industry becomes a creature of government rule-making.⁵⁸

What these scholars have identified are the costs of cronyism outlined by Mitchell, including rent-seeking, unproductive entrepreneurship, inattention to consumer desires, and, most importantly, loss of innovation and diminished long-run economic growth. These costs manifest themselves in various ways in the communications and media marketplaces.

Specifically, companies regularly seek government-granted advantages in the following forms:

- barriers to entry, most often through restrictive licensing requirements
- lighter-touch regulatory treatment for some relative to others
- contractual bargaining advantages
- subsidies or favorable tax treatment

Beyond the FCC, companies can pursue additional rent-seeking through other federal and state agencies, such as the Commerce Department's National Telecommunications and Information Administration, the Justice Department's Antitrust Division, state public utility commissions, and local governing bodies.⁵⁹ Rent-seeking and rent extraction are also at work in the legislative arena, where senators and representatives on the Senate and House commerce committees and judiciary committees regularly milk well-heeled communications, media, and now high-tech companies for campaign contributions in exchange for favorable treatment or

⁵⁸ David J. Farber & Gerald R. Faulhaber, *Net Neutrality: No One Will Be Satisfied, Everyone Will Complain*, THE ATLANTIC, Dec. 21, 2010, <http://www.theatlantic.com/technology/archive/2010/12/net-neutrality-no-one-will-be-satisfied-everyone-will-complain/68326>.

⁵⁹ Gordon L. Brady, *Applying Public Choice to Telecommunications*, in TULLOCK ET AL., *supra* note 4, at 106.

differential regulation.⁶⁰ Stanford University economist Bruce M. Owen argues that it is here in the legislative branch, not within the agencies themselves, where regulatory capture takes root. “It is rather legislative oversight and budget committees and their chairs that are (willingly) captured by special interests in the first instance. One could equally say that legislators capture the special interests, seeking campaign funding,” Owen argues. “The behavior of regulatory agencies simply reflects the preferences of their congressional masters. Regulators generally seek to please their committees, not to defy them,” he writes.⁶¹

B. Communications and Universal Service

Regardless of where it originates or is most routinely abused, what is undeniable is that capture and cronyism have been prevalent in the American communications and media marketplace for many decades. All too often in these sectors, government’s thumb is on the scales in someone’s favor, and this favor comes at the expense of competitors or consumers. The following case studies document this reality.

The cronyist origins of the Bell System monopoly. The early history of communications in the United States is a prime example of industry capture. The American Telegraph and Telephone Company (AT&T) secured a nationwide monopoly because of its cozy relationship with government officials. From the very beginning, economic historian Richard H. K. Vietor notes, “AT&T’s near monopoly in electronic voice communications was a function of regulation.”⁶²

⁶⁰ See generally Bruce Owen, Communication Policy Reform, Interest Groups, and Legislative Capture, Stanford Institute for Economic Policy Research (Jan. 19, 2012), SIEPR DISCUSSION PAPER no. 11-006, <http://publicpolicy.stanford.edu/publicationsprofile/2391>.

⁶¹ *Id.* at 2.

⁶² VIETOR, *supra* note 35, at 318.

After Alexander Graham Bell patented the telephone in 1876, AT&T secured hundreds of additional patents that gave the firm a temporary monopoly in the provision of voice service.⁶³ But as the 19th century came to a close and those patents expired, competition from smaller rivals blossomed. These competitors expanded rapidly in areas not served by the Bell System, but then quickly began invading AT&T's turf, especially areas where Bell service was poor. Just after the turn of the century, more than 3,000 competitors existed, and by 1907 non-Bell firms were operating 51 percent of the telephone businesses in local markets.⁶⁴ "After thirteen years of competition," observed industry historian Gerald W. Brock, "the United States had an extensive system of six million telephones, almost evenly divided between Bell and the independents, with service available practically anywhere in the country."⁶⁵ This heated competition increased consumer service options, drove down prices, and cut into AT&T's earlier profitability.⁶⁶

A decade later, however, this intensely competitive, pro-consumer free-for-all would be derailed by AT&T's brilliant strategy to use the government to accomplish what it could not in the free market: eliminate its rivals.

In 1907, Theodore Newton Vail became AT&T's president. He had a clear vision: achieving "universal service" (in the form of interconnected and fully integrated systems) by eliminating rivals and consolidating networks. Befriending lawmakers and regulators was a crucial component of this strategy. While many policymakers nominally supported the idea of

⁶³ Much of the history that follows originally appeared in Adam D. Thierer, *Unnatural Monopoly: Critical Moments in the Development of the Bell System Monopoly*, 14 CATO JOURNAL, 1994, <http://www.cato.org/sites/cato.org/files/serials/files/cato-journal/1994/11/cj14n2-6.pdf>.

⁶⁴ GERALD W. BROCK, *THE TELECOMMUNICATIONS INDUSTRY: THE DYNAMICS OF MARKET STRUCTURE* 111 (1981).

⁶⁵ *Id.* at 122.

⁶⁶ Whereas AT&T had earned an average return on investment of 46 percent in the late 1800s, by 1906 its return had dropped to 8 percent. LEONARD S. HYMAN, RICHARD C. TOOLE & ROSEMARY M. AVELLIS, *THE NEW TELECOMMUNICATIONS INDUSTRY: EVOLUTION AND ORGANIZATION* 78 (1987).

competition, they were more preoccupied with achieving widespread, interconnected network coverage. Vail capitalized on that impulse.

On December 19, 1913, the government and AT&T reached the “Kingsbury Commitment.” Named after AT&T vice president Nathan C. Kingsbury, who helped negotiate the terms, the agreement outlined a plan whereby AT&T agreed not to acquire any other independent companies while also allowing other competitors to interconnect with the Bell System. The Kingsbury Commitment was thought to be pro-competitive, yet it was hardly an altruistic agreement on AT&T’s part. Regulators did not interpret the agreement so as to restrict AT&T from acquiring any new telephone systems, but only to require that an equal number be sold to an independent buyer for each system AT&T purchased. Hence, the Kingsbury Commitment contained a built-in incentive for network swapping (trading systems and solidifying territorial monopolies) rather than continued competition.⁶⁷ “The government solution, in short, was not the steamy, unsettling cohabitation that marks competition but rather a sort of competitive apartheid, characterized by segregation and quarantine,” observe telecom legal experts Michael Kellogg, John Thorne, and Peter Huber.⁶⁸ Thus, the move toward interconnection, while appearing to assist independent operators, actually allowed AT&T to gain greater control over the industry.⁶⁹

“Vail chose at this time to put AT&T squarely behind government regulation, as the quid pro quo for avoiding competition,” explains Viator.⁷⁰ “This was the only politically acceptable

⁶⁷ “This provision allowed Bell and the independents to exchange telephones in order to give each other geographical monopolies. So long as only one company served a given geographical area there was little reason to expect price competition to take place.” BROCK, *supra* note 64, at 156.

⁶⁸ MICHAEL K. KELLOGG, JOHN THORNE & PETER W. HUBER, FEDERAL TELECOMMUNICATIONS LAW 16–17 (1992).

⁶⁹ WU, *supra* note 56, at 56. (“Superficially a victory for openness and competition, in time the Kingsbury Commitment would prove the insidious death knell of both.”)

⁷⁰ VIATOR, *supra* note 35, at 172.

way for AT&T to monopolize telephony,” he notes.⁷¹ AT&T’s 1917 annual report confirms this fact, stating, “[with a] combination of like activities under proper control and regulation, the service to the public would be better, more progressive, efficient, and economical than competitive systems.”

What sealed AT&T’s lock on the communications marketplace, however, was World War I.⁷² On August 1, 1918, in the midst of the war, the federal government nationalized the entire telecommunications industry for national security reasons. AT&T executives were initially quite nervous when it was announced that postmaster general Albert S. Burluson, a longtime advocate of nationalizing the telegraph and telephone industries, would assume control of the telephone system. But, once the benefits of nationalization were made evident to Theodore Vail, his anxieties disappeared. Industry historian George P. Oslin notes that when Vail expressed concern over the plan to Western Union president and close personal friend Newcom Carlton, Carlton reassured Vail that the plan was in his interest: “It’s your salvation. The government will be able to raise your rates and get you new money.”⁷³ As Oslin argues, “That was what happened. Burluson appointed Vail, rated by Carlton as a genius, to manage the telephone, and Carlton to operate the telegraph.”⁷⁴

⁷¹ *Id.* Also see ROBERT W. GARNET, *THE TELEPHONE ENTERPRISE: THE EVOLUTION OF THE BELL SYSTEM’S HORIZONTAL STRUCTURE, 1876–1909*, 130 (1985). (“Regulation played a crucial role in Vail’s plans. Astute enough to realize that the kind of system he proposed—universal integrated monopoly—would stand little chance of gaining public approval without some form of public control, he embraced state regulation. In doing so, he broke with the company’s long-standing opposition to what [AT&T] management had traditionally regarded as an unwarranted intrusion on its prerogatives. But after years of unfettered competition, during which the firm’s financial strengths had been sapped and its efforts to build an integrated system had been dangerously undermined, regulation became a much-preferred alternative. Thus, Vail obviously saw government regulation as the way to eliminate competitors: the one-way ticket, not only to universal service, but also to monopoly profits.”)

⁷² Michael Janson & Christopher S. Yoo, *The Government Takeover of the U.S. Telephone System During World War I*, Mar. 31, 2012, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2033124.

⁷³ Quoted in GEORGE P. OSLIN, *THE STORY OF TELECOMMUNICATIONS* 252 (1992).

⁷⁴ *Id.*

In his 1939 book *AT&T: The Story of Industrial Conquest*, Noobar R. Danielian concurred: “There is evidence that Vail appreciated the advantages of Federal control. . . . [H]e was not in much of a hurry in the early part of 1919 to have his System back from nominal government control.”⁷⁵ This attitude should not be at all surprising; shortly after the industry was nationalized, the postmaster general accepted AT&T’s proposed contract establishing the terms of government ownership and compensation. The terms were highly favorable to AT&T. Of the estimated \$50 million in rate increases approved by the postmaster general during nationalization, approximately \$42 million, or 84 percent, went to AT&T. Additionally, the government cut AT&T a \$13 million check at the end of the period to cover any losses the company might have incurred, although none were evident. Once the firm returned to private control following the war, regulators granted AT&T the sizable rate increases it requested.

That year of government nationalization was the final nail in the coffin of communications competition, and Congress basically blessed the entire scheme in 1921 with the passage of the Graham Act. This sad tale of corporatism only grew worse in subsequent years with the initiation of extensive rate regulation and direct barriers to entry and innovation. Rate regulation guaranteed AT&T stable returns and ensured that regulators suddenly had a vested interest in keeping the company healthy and protected from competition so that it could achieve the industrial policy vision of “One Policy, One System, Universal Service,” which had been the phrase AT&T adopted to encourage monopolization.⁷⁶ AT&T had so utterly captured legislators

⁷⁵ NOOBAR R. DANIELIAN, *AT&T: THE STORY OF INDUSTRIAL CONQUEST* 248 (1939).

⁷⁶ BROCK, *supra* note 64, at 159–61. (“The combination of state and federal regulation stabilized the industry and ended the rate wars that had occurred during the early period of competition. Regulation increased the difficulty of new entry. . . . By accepting regulation voluntarily, Bell reduced the risk that unfavorable regulation would be imposed. The system of competing federal and state regulation, together with the complex Bell structure, prevented real regulatory control while providing the protection and legitimacy of a regulated utility. . . . The acceptance of regulation was a risk-reducing decision. It substituted a limited but guaranteed return on capital and management freedom for the uncertainty of the marketplace. It gave the Bell system a powerful weapon to exclude competitors

and regulators that its corporate motto became the prime directive and modus operandi for all communications policy over the next half century. Telecommunications policy considered ubiquitous network coverage to be more important than competition and innovation, and AT&T's monopoly was locked in for the next half century.

Local cable franchising. Cable television franchising is another area where cronyism has been at work in the past. There are an estimated 30,000 franchise agreements for the provision of cable television service.⁷⁷ These agreements are technical contracts between a cable provider and a city or other local authority. Courts have allowed cable franchises—despite their inherently anticompetitive nature—under the assumption that cable television provision is a natural monopoly and no more than one provider is economically viable.⁷⁸ In return for providing an operator with a franchise, cities could impose obligations relating to geographical service (no cherry-picking of lucrative neighborhoods) and rates.⁷⁹ During the heyday of cable franchise agreements—the 1970s and 1980s—applying for a franchise presented ample opportunities for unseemly behavior by governments and by cable-franchise applicants. Scandals were common, and several cable operators and local politicians were caught in bribery schemes.⁸⁰

and justification for seeking a monopoly, as well as reducing the chances of outright nationalization or serious antitrust action.”)

⁷⁷ Kent Lassman, *Franchising in the Local Communications Market: A Primer and Discussion of Three Questions*, PROGRESS ON POINT: PERIODIC COMMENTARIES ON THE POLICY DEBATE, Release 12.9 (June 2005) at 1, <http://www.pff.org/issues-pubs/pops/pop12.9franchise.pdf>.

⁷⁸ See, e.g., *Central Telecomm., Inc. v. TCI Cablevision, Inc.*, 610 F. Supp. 891, 900–02 (1985) (“Since only one [cable] operator can survive in the market, it makes sense to allow the local government to choose the best applicant.”); *Omega Satellite Prod. Co. v. Indianapolis*, 694 F.2d 119, 126–27 (1982); *Community Comm. Co. v. Boulder*, 660 F.2d 1370, 1378–79 (1981). See also Oliver E. Williamson, *Franchise Bidding for Natural Monopolies—in General and with Respect to CATV*, 7 BELL J. ECON. 73, 1976. Aside from the natural monopoly justification, franchising can be justified since laying cable occupies public property and local rights-of-way. See, e.g., *Community Comm. Co. v. Boulder*, 660 F.2d 1370, 1379 (1981).

⁷⁹ Franchise agreements often functioned as granting a cable company a local monopoly, but not always.

⁸⁰ The most famous case might be the convictions of Irving Kahn, president of TelePrompster, and the mayor and a councilman of Johnstown, New Jersey. See *United States v. Kahn*, 340 F. Supp. 485 (1971). See also *United States*

City governments recognized decades ago that controlling cable franchises was lucrative. In 1973, the New York City mayor called cable licenses the “urban oil wells beneath our city streets.”⁸¹ A federal judge in a corruption case sentencing hearing commented in 1985, “I think it was a bribe, and [is] apparently what goes on in the cable industry all the time.”⁸²

In one case, the mayor of Johnstown, Pennsylvania, and a councilman pleaded guilty to requesting and receiving payments from the president of a cable company that had applied for a cable franchise.⁸³ The cable company president subsequently went to prison. In an Illinois case, a representative for a cable operator bribed the mayor of Fox Lake with a 5 percent interest in a subsidiary of the cable company, an illegal payment valued at \$250,000.⁸⁴ There, a village trustee and others involved in the kickback were found guilty. A Florida bribery case led to the indictment of 30 people and their employees.⁸⁵ In that case, a cable company gave money to several county commissioners in a failed attempt to receive a cable franchise. Many of these corruption cases involved middlemen, subsidiaries, and other ways of illegally seeking franchise approval.

Bribery, of course, is cronyism—but the more costly cronyism in franchise agreements was the more common and legal kind. Even more harmful to competition and consumers were the barely legal arrangements that occurred during this period. In practice, “cities exercise the franchising power to extract services such as access channels from cable companies in exchange

v. Italiano, 837 F.2d 1480 (1988) (a cable franchise applicant convicted for bribing a Florida county commissioner); United States v. Lovett, 811 F.2d 979 (1987) (a mayor, a cable representative, and others caught in a substantial Illinois bribery case).

⁸¹ Albin Krebs, *Cities Reassured on Cable TV Rights*, N.Y. TIMES, Feb. 6, 1973, at 73.

⁸² *Id.*

⁸³ United States v. Kahn, 340 F. Supp. 485, 488 (1971).

⁸⁴ United States v. Lovett, 811 F.2d 979, 981 (1987).

⁸⁵ United States v. Italiano, 837 F.2d 1480 (1988).

for permission to use public rights-of-way.”⁸⁶ A municipality would typically have a “needs assessment” by a commission or consultant. Then, the city would issue a request for proposals. City staff or consultants would evaluate these proposals for their public benefits. Public hearings would be held and determinations would be made about which cable provider offered the most public benefits.⁸⁷ The franchise-granting process took many forms, and one cable scholar writes that determinations resulted

in opportunities for influence in arranging various cross-subsidies, campaign contributions, lucrative private employment for staff members, family members, or themselves, illegal bribes, and legal bribes to friends or associates. These legal bribes were routinized in the cable franchising “gold rush” (from the late 1970s to the early 1980s). . . . [C]able operators bidding for franchises would create local subsidiaries and distribute a substantial minority equity interest to influential community members. These stock holders would then lobby municipal officials, receiving windfalls in the value of their shares should their company receive a de facto exclusive cable franchise.⁸⁸

In the preferred, legal way to persuade municipalities of the public benefits of their cable systems, operators would offer prominent local citizens discounted equity positions in their corporate stock with the understanding that the benefited citizen would communicate the benefits of the cable system to local leaders.⁸⁹ One extensive case study of Minneapolis in the 1980s found no illegality but a pernicious political climate:

Indeed, the crucial factor in the Minneapolis cable franchise decision was politics. The cable companies followed the pattern which has become commonplace in cable franchise contests. Each company went to considerable effort to align [itself] favorably within the local political dynamic. Lawyers, lobbyists, local investors, public relations firms and community groups were all involved. . . .

Local officials were only concerned marginally with [the] rational assessment of design configurations, service offerings and the enhancement of community life through the introduction of an advanced telecommunications technology. Once judged as

⁸⁶ William E. Lee, *Cable Franchising and the First Amendment*, 36 VAND. L. REV., 1983, at 867, 868.

⁸⁷ One study found that public interest commitments accounted for 11 percent of operating costs and 26 percent of capital costs for each franchised operator. Mark A. Zupan, *The Efficacy of Franchise Bidding Schemes in the Case of Cable Television: Some Systematic Evidence*, 32 J. L. & ECON., 1989, at 401, 405.

⁸⁸ Thomas W. Hazlett, *Cable TV Franchises as Barriers to Video Competition*, 12 VA. J.L. & TECH., 2007, at 2, 22.

⁸⁹ *Id.* at 34.

adequate, proposals were viewed as equal, and politics became a key element in the decision-making process.⁹⁰

These efforts to limit competition in local markets severely distorted the price and quality of video service. The blossoming competition today shows clearly that the local cable agreements harmed consumers. Today, video competition is driving down costs and expanding consumer options.⁹¹ Congress has prohibited exclusive licensing since 1992,⁹² and cities can deny franchises as long as denial is not “unreasonable.”⁹³ Satellite firms DirecTV and DISH Network provide competition, as do cable “overbuilders” (cable companies entering markets in the areas previously served only by cable franchisees) and telecommunications operators (telcos), which are increasingly a competitive threat to cable companies.⁹⁴ As recently as 2006, telcos offering video services were available to only 5 percent of households,⁹⁵ yet telcos’ effect on consumer prices was significant. In the early 2000s, the GAO found that the presence of a telco or other wire-based video competitor lowered cable rates by about 15 percent.⁹⁶ Beginning in earnest in 2005, telcos like AT&T and Verizon pressured state legislatures to ease barriers,⁹⁷

⁹⁰ Peter D. Edwards, *Cable Television Franchising: A Case Study of Minneapolis, Minnesota*, NEW YORK LAW SCHOOL, COMMUNICATIONS MEDIA CENTER 29 (1985).

⁹¹ As the GAO found when satellite competed with cable in the late 1990s, cable rates may increase, but that effect is accompanied by a significant increase in the number of channels offered. In that case, the quality-adjusted price is lower. GAO, TELECOMMUNICATIONS: THE EFFECT OF COMPETITION FROM SATELLITE PROVIDERS ON CABLE RATES, GAO/RCED-00-164 (2000), <http://www.gao.gov/assets/240/230487.pdf> (“[S]ome key findings suggest that in response to DBS [direct broadcast satellite], cable companies increased the quality of their services—in particular, the number of channels that they offered consumers.”).

⁹² Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385.

⁹³ See *id.*, § 621(4). In practice, however, one scholar noted the franchising process creates de facto exclusive licensing. Thomas W. Hazlett, *Duopolistic Competition in Cable Television: Implications for Public Policy*, 7 YALE J. ON REG., 1990, at 65.

⁹⁴ See FCC, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming 10-12, MB Docket No. 07-269, FCC 12-81 (2012), http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-12-81A1.pdf (describing the companies and competition in the cable marketplace).

⁹⁵ See *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 07-269, Fourteenth Report, 27 FCC Rcd 8610, 8624 (2012).

⁹⁶ GAO, TELECOMMUNICATIONS: ISSUES RELATED TO COMPETITION AND SUBSCRIBER RATES IN THE CABLE TELEVISION INDUSTRY 3, GAO-04-8 (2003), <http://www.gao.gov/new.items/d048.pdf>.

⁹⁷ James G. Parker, *Statewide Cable Franchising: Expand Nationwide or Cut the Cord?*, 64 FED. COMM. L.J., 2012, at 199, 206–11.

and today 25 states have adopted statewide cable franchising, overriding the ability of local governments to grant franchises.⁹⁸ Today, AT&T's U-Verse and Verizon's FiOS are available to close to 33 percent of households,⁹⁹ providing a substantial check on cable company market power in many areas.¹⁰⁰ These favorable developments should continue—resulting in lower quality-adjusted prices and more competitive options—and correct the consumer harms caused by exclusive franchising.

Universal service subsidies. As noted earlier, AT&T strategically used the social goal of “universal communications service” to coax policymakers into giving the company greater control and generous returns. It solidified the firm’s grasp of telecom markets for well over half a century. With the 1984 breakup of AT&T and the resulting competition, AT&T could no longer afford to subsidize its high-cost rural customers with its profitable urban customers. Lawmakers eventually responded by creating a system of “access charges” and eventually the current federal subsidy system, which is funded by the Universal Service Fund (USF). The USF was plagued by inefficiencies from the start and the subsidies distort the entire telephone market, but reform is restricted by firms that have built business models reliant on the subsidy system.

The USF is supposed to ensure low-priced and reasonable telephone bills for all Americans. Every month, consumers of phone service pay a fee to their service providers,

⁹⁸ Digital Policy Institute, *Telecommunication Deregulation: A Policy Progress Report 1* (2010), <http://cms.bsu.edu/-/media/WWW/DepartmentalContent/DPI/PDFs/TelecommDeregulation.pdf>.

⁹⁹ FCC, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming* 15-16, MB Docket No. 07-269, FCC 12-81 (2012), http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-12-81A1.pdf (“In 2006, facilities-based telephone MVPD service was available to approximately six million homes (4.7 percent). By 2010, telephone MVPD service had become available to 42.9 million homes (32.8 percent).”).

¹⁰⁰ Further liberalization may have been accelerated by a 2007 FCC order. *See* Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992, MB Docket No. 05-311, *Report and Order and Further Notice of Proposed Rulemaking*, 22 FCC Rcd 5101 (2007), *aff’d sub nom. Alliance for Community Media v. FCC*, 529 F.3d 763 (6th Cir. 2008).

usually called the “federal universal service charge.”¹⁰¹ In 2013, this fee accounted for more than 15 percent of service providers’ long-distance revenues.¹⁰² Telephone companies collect several billions of dollars each year from consumers in this way and remit the proceeds to the USF, which is distributed to various programs. The largest portion of the USF goes to high-cost areas—that is, to rural carriers, because rural service is much more costly to provide. In 2002, the GAO estimated that providing rural service cost nearly three times as much as providing service in metropolitan areas.¹⁰³

Because of the way the USF system is structured—with subsidies being delivered through carriers instead of directly to individuals—waste is common and the telecom market is severely distorted, particularly for rural carriers. While the USF’s political objectives are laudable, the federal programs suffer from a lack adequate oversight (from either Congress or the FCC) and from a payment system that invites abuse (the rate-of-return payment system, which will be explained below).¹⁰⁴

The federal USF includes four divisions: (1) high-cost carriers,¹⁰⁵ (2) low-income households,¹⁰⁶ (3) schools and libraries, and (4) rural health-care providers. Of these, the high-

¹⁰¹ This is not a tax found in the US tax code but rather a charge passed on to consumers since carriers are required by the FCC to commit a portion of their revenue to the USF. *See* 47 U.S.C. Section 254(b)(4).

¹⁰² FCC, Proposed Second Quarter 2013 Universal Service Contribution Factor 3 (Mar. 12, 2013), http://transition.fcc.gov/Daily_Releases/Daily_Business/2013/db0312/DA-13-422A1.pdf.

¹⁰³ GAO, TELECOMMUNICATIONS: FEDERAL AND STATE UNIVERSAL SERVICE PROGRAMS AND CHALLENGES TO FUNDING, GAO-02-187, (2002).

¹⁰⁴ The FCC diminished its reliance on rate of return carriers for USF purposes in its 2011 USF reform order, but this payment system still exists. *See* In the Matter of Connect America Fund; A National Broadband Plan for Our Future; Establishing Just and Reasonable Rates for Local Exchange Carriers; High-Cost Universal Service Support; Developing an Unified Intercarrier Compensation Regime; Federal-State Joint Board on Universal Service; Lifeline and Link-Up; Universal Service Reform—Mobility Fund, *Report and Order and Further Notice of Proposed Rulemaking*, FCC 11-161, 26 FCC Rcd 17663, 17674 (2011).

¹⁰⁵ The high-cost division directly and indirectly supports services including basic telephone service, broadband service, and wireless service.

¹⁰⁶ This includes the Link-Up and Lifeline programs.

cost carrier division is the most expensive,¹⁰⁷ and because of carriers' reliance on it, it is the most problematic division to reform. As economist Thomas Hazlett stated in his 2006 review of the USF and the high-cost beneficiaries, "Rural telephone companies have, in fact, gained a reputation among economists as the highly inefficient creatures of regulatory design."¹⁰⁸ Since 1986, more than \$48 billion has gone to high-cost support.¹⁰⁹

High-cost support includes "rate of return" regulation that guarantees incumbent rural carriers an 11.25 percent return on network investments. In 2009, rate-of-return carriers received \$2 billion in support.¹¹⁰ Because the high-cost fund subsidizes carriers based on their costs, firms face a perverse incentive to maximize expenditures.¹¹¹ Put differently, for a high-cost carrier, the higher its actual costs, the more USF funding it receives. In addition to some high-profile cases of outright fraud in the high-cost subsidy program,¹¹² there is empirical evidence that hundreds of carriers—those with costs approaching the level where subsidies kick in—systematically inflate or misreport costs.¹¹³ Economist Scott Wallsten estimated in 2011 that for every dollar of

¹⁰⁷ SCOTT WALLSTEN, *THE UNIVERSAL SERVICE FUND, WHAT DO HIGH-COST SUBSIDIES SUBSIDIZE?* 6, TECHNOLOGY POLICY INSTITUTE, Working Paper (2011).

¹⁰⁸ THOMAS W. HAZLETT, "UNIVERSAL SERVICE" TELEPHONE SUBSIDIES: WHAT DOES \$7 BILLION BUY? 33 (Arlington Economics 2006), <http://www.arlingtoneconomics.com/studies/whatdoes7billionbuy.pdf> (citation omitted).

¹⁰⁹ Figure not adjusted for inflation. *See id.*

¹¹⁰ Figure based on USAC preliminary 2009 disbursement data.

¹¹¹ GAO, *TELECOMMUNICATIONS: FCC NEEDS TO IMPROVE PERFORMANCE MANAGEMENT AND STRENGTHEN OVERSIGHT OF THE HIGH-COST PROGRAM* 17, GAO-08-633 (2008), available at <http://www.gao.gov/new.items/d08633.pdf>.

¹¹² Mike Brunker, *Alleged Mobsters Guilty in Vast Net, Phone Fraud*, NBCNEWS.COM, Feb. 15, 2005, http://www.msnbc.msn.com/id/6928696/ns/us_news-crime_and_courts/t/alleged-mobsters-guilty-vast-net-phone-fraud/#.UKAmpK7ZGSo. CassTel was a rural Missouri phone company used by Mafia affiliates to receive \$8.9 million in fraudulent overpayments, including \$3.5 million from universal service funds. *See United States v. Kenneth Matzdorff*, Case No. 05-00020-CR-W-SOW, Plea Agreement (W.D. Mo. 2005).

¹¹³ SANFORD BERG, LIANGLIANG JIANG & CHEN LIN, *UNIVERSAL SERVICE SUBSIDIES AND COST OVERSTATEMENT: EVIDENCE FROM THE U.S. TELECOMMUNICATIONS SECTOR*, working paper (2011), available at http://warrington.ufl.edu/centers/purc/purcdocs/papers/0818_Berg_Universal_Service_Subsidies.pdf.

subsidy to high-cost incumbent phone carriers, nearly 60 cents went to an increase in personnel, administrative, and general expenses.¹¹⁴

John Stanton, former CEO of a rural cellular provider, called the subsidies “an incentive for abuse,”¹¹⁵ and the National Broadband Plan reported that “current oversight of the specific uses of High-Cost support is limited.”¹¹⁶ Mean and median payments per phone line were \$649 and \$361 in 2008, but some firms receive as much as a \$20,000 subsidy per year per line.¹¹⁷ *USA Today* reported on a Texas firm that had 6,000 customers and an astonishing \$3.6 million in corporate overhead costs.¹¹⁸ Tales like these are common. An Oklahoma carrier was subsidized to the tune of \$1.6 million to provide service to 246 lines—even though all its customers had wireless coverage from AT&T, Verizon, and Sprint.¹¹⁹ Weavtel, a Washington State company that serviced 14 lines in the mountains, received around \$700,000 over three years.¹²⁰

The USF and especially the high-cost programs are rife with overpayment and abuse, which is why the FCC has attempted to reform the USF for years. Despite these abuses, from 2002 to 2008, the Universal Service Administrative Company (USAC), the administrator of the USF program, completed only 17 audits of more than 1,400 eligible carriers.¹²¹

The composition of USAC’s board of directors undermines the notion that it can provide competent oversight. USAC is a nonprofit subsidiary of the National Exchange Carrier Association (NECA), which was originally created by telecom companies in the 1980s to

¹¹⁴ WALLSTEN, *supra* note 107, at 3.

¹¹⁵ Paul Davidson, *Fees Paid by All Phone Customers Help Rural Phone Firms Prosper*, USA TODAY, Nov. 17, 2004, http://usatoday30.usatoday.com/money/industries/telecom/2004-11-15-rural-phone-fees_x.htm.

¹¹⁶ FEDERAL COMMUNICATIONS COMMISSION, THE NATIONAL BROADBAND PLAN, Chapter 8 141–42, *available at* <http://download.broadband.gov/plan/national-broadband-plan-chapter-8-availability.pdf>.

¹¹⁷ *Id.* at 12.

¹¹⁸ Davidson, *supra* note 115.

¹¹⁹ Nate Anderson, *Rural Telco Serves 17 People, Rakes in \$300K (of Your Money)*, ARS TECHNICA, July 12, 2010, <http://arstechnica.com/tech-policy/2010/07/rural-telco-serves-17-people-rakes-in-300k-of-your-money/>.

¹²⁰ *Id.*

¹²¹ GAO, *supra* note 111, at 6.

administer access charges. NECA's affiliation with the USF's administrator indicates how intimately industry is involved in the process.¹²² NECA's board is separate from USAC's board, but USAC's board composition does not inspire confidence in aggressive oversight of disbursement. Of USAC's 19 board members, only two are nominated by consumer groups.¹²³ Nine of the remaining directors are nominated by industry groups, and they are appointed after approval from the FCC chairman.¹²⁴

The idea that a board of directors nominated largely by the industry receiving disbursements will be an effective auditor strains credulity. The very rare audits and the documented waste indicate that the USF system is seriously flawed. Because of the lax state and federal oversight and a disproportionately rural national legislature, rural phone carriers have formed a powerful political force that resists reform of the universal service programs they are enriched by. In the quarterly newsletter for what was then called the Rural Cellular Association, Representative Don Young (R-AK) noted, "The more carriers engage with both their Representatives and Senators (on USF matters), the better. While the early bird may get the worm, the bird that doesn't even try definitely won't get any worms. The same applies to Congress."¹²⁵ When the FCC enacted a cap on high-cost subsidies in summer 2012, the industry instantly enlisted members of Congress to fight the cap.¹²⁶

The USF threatens to distort the wireless market in the same way that it distorts the wired market. Americans have grown more dependent on mobile phone service in the past few years, and recent growth in the high-cost program derives from wireless companies' increasing use of

¹²² *Id.*

¹²³ 47 CFR § 54.703. One director represents low-income consumers, another represents state consumer advocates.

¹²⁴ *Id.*

¹²⁵ *Congressional Spotlight: Rep. Don Young*, THE RCA VOICE, Spring/Summer 2012, <http://www.nxtbook.com/nxtbooks/naylor/RCAB0112/index.php#/50>.

¹²⁶ Grant Gross, *Rural Carriers Protest FCC Telephone Subsidy Reform*, PC WORLD (July 6, 2012), http://www.pcworld.com/article/258890/rural_carriers_protest_fcc_telephone_subsidy_reform.html.

USF funds.¹²⁷ Nationwide carriers Verizon and AT&T account for much of this growth, as they receive tens of millions of dollars every year from the USF and use much of that money for their wireless networks. Unfortunately, much of the subsidies to wireless companies merely duplicate service that already exists. As Hank Hultquist, a vice president of AT&T's federal regulatory affairs, put it, "It's almost as if the FCC put out a sign saying GET DOLLARS HERE."¹²⁸ Derek Turner at Free Press notes that some areas "have as many as 19 carriers serving [them] with USF funds."¹²⁹ Similarly, reporters found that an area in Mississippi has 15 competing carriers receiving USF funds, and an Alabama area has 12 subsidized carriers competing.¹³⁰

As the FCC shifts USF funds from voice service to broadband network penetration and creates a broadband program,¹³¹ it is imperative that policymakers avoid guaranteed profits through rate-of-return regulation and other policies that predictably enrich interest groups. Legislators, when considering a universal service law in the 1990s, believed the USF would increase competition, thereby decreasing or eliminating the need for universal service support.¹³² It is perverse that the program support has exploded, and some areas see more than a dozen phone companies competing. All the while, the GAO has said it is unclear that telephone and broadband subsidies funded through the USF significantly improve penetration, competition, or

¹²⁷ GAO, *supra* note 111, at 4–5.

¹²⁸ Joan Engebretson, *How AT&T Exec Defends Universal Service Funds*, CONNECTED PLANET ONLINE, Aug. 5, 2010, <http://connectedplanetonline.com/commentary/att-defends-usf-080510/>.

¹²⁹ Cecilia Kang, *AT&T, Verizon Get Most Federal Aid for Phone Service*, WASH. POST: POST TECH, July 8, 2010, http://voices.washingtonpost.com/posttech/2010/07/att_verizon_get_most_federal_a.html.

¹³⁰ Joan Engebretson, *The Real Story on the Latest USF Data*, CONNECTED PLANET ONLINE, July 15, 2010, <http://connectedplanetonline.com/commentary/real-story-usf-data-071510/>.

¹³¹ See In the Matter of Connect America Fund; A National Broadband Plan for Our Future; Establishing Just and Reasonable Rates for Local Exchange Carriers; High-Cost Universal Service Support; Developing an Unified Intercarrier Compensation Regime; Federal-State Joint Board on Universal Service; Lifeline and Link-Up; Universal Service Reform—Mobility Fund, *Report and Order and Further Notice of Proposed Rulemaking*, FCC 11-161, 26 FCC Rcd 17663 (2011).

¹³² S. Rep. No. 104-23 (1995).

economic development.¹³³ What is clear is that these subsidies have created a powerful group of subsidy-dependent carriers and have made it tough to sensibly reform the programs. The USF proceedings serve as a powerful example of Mancur Olson’s observation that when benefits are concentrated and costs are dispersed (across all telephone ratepayers in this case), powerful constituencies will develop to secure those benefits.¹³⁴

C. Spectrum Policy and Broadcast Industry Regulation

This section discusses the origins of spectrum regulation in the United States and outlines how government-granted privileges were present from the start. This history also shows how one sector in particular—FCC-licensed TV broadcasters—benefited from government-accorded privileges during the digital television transition and in ongoing “retransmission consent” negotiations.

Sadly, rent-seeking and rent extraction have proven to be regular fixtures in this field. “What distinguishes TV programs from other mass media content, including both traditional print and new online media,” observes Bruce Owen, “is the extreme eagerness of Washington to engage in efforts to prevent markets from working freely, often in response to interest group pressures and opportunities for political advantage and with almost complete indifference to the welfare of consumers.”¹³⁵

¹³³ GAO, *supra* note 111 at 4 (explaining that since larger carriers are typically exempt from USF funds, they may abandon a rural area for a subsidized competitor or fail to upgrade its network).

¹³⁴ Olson, *supra* note 44.

¹³⁵ Bruce M. Owen, Mercatus Center, *Consumer Welfare and TV Program Regulation*, 5 (May 24, 2012), <http://mercatus.org/publication/consumer-welfare-and-tv-program-regulation>.

The cronyist origins of spectrum licensing. In his important 1990 study on “The Rationality of U.S. Regulation of the Broadcast Spectrum,” Thomas Hazlett—expanding on Coase’s property rights work¹³⁶—pointed out that property rights in spectrum were beginning to develop naturally through common law cases in the 1920s. Such a regime could have solved interference claims without resorting to onerous administrative regulation.¹³⁷ “Private rights in the ether under common law were immediately recognized as a solution to the interference problem,” Hazlett revealed, and a “homesteading principle” could have taken hold to deal with interference claims in a bottom-up, organic fashion.¹³⁸

Unfortunately, federal officials and incumbent spectrum holders conspired to head off this market-oriented solution. Regulation was later justified as a way to alleviate spectrum “chaos,” or interference,¹³⁹ but, as Hazlett explained, “A careful examination of the early radio broadcasting market and the legislative history of the Federal Radio Act of 1927 reveals that the . . . licensing standard was a compromise designed to generate significant rents for each constituency in the process.”¹⁴⁰ Regulation was really a way to avoid the rigors of competition through strict rationing of spectrum via a licensing system.

Enactment of the Radio Act of 1927 “immediately grandfathered rights for major broadcasters, while eliminating marginal competitors and all new entry,” Hazlett notes.¹⁴¹ Kellogg, Thorne, and Huber have also pointed out the anticompetitive nature of the Radio Act, noting that “a gentlemanly agreement, reached under political pressure, had once again replaced

¹³⁶ Ronald H. Coase, *The Federal Communications Commission*, 2 J.L. & ECON. 1, 37 (Oct. 1959).

¹³⁷ Thomas W. Hazlett, *The Rationality of U.S. Regulation of the Broadcast Spectrum*, 33 J.L. & ECON. 133 (Apr. 1990), <http://mason.gmu.edu/~thazlett/pubs/Rationality%20of%20U.S.%20Regulation.pdf>.

¹³⁸ *Id.* at 151.

¹³⁹ *NBC v. U.S.*, 319 U.S. 190, 212–13 (1943). *See also* *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 375–76 (1969).

¹⁴⁰ Hazlett, *supra* note 137, at 133, 134.

¹⁴¹ Hazlett, *supra* note 137, at 154.

competition with complementary monopolies,” and that “Congress merely cemented and strengthened a division of markets and territories that the parties had already voluntarily embraced.”¹⁴²

In this advent of radio, it is nearly impossible to distinguish the industry’s desires from the government’s. In the fourth National Radio Conference in 1925, Secretary Hoover proclaimed his support for a “public interest” standard in allocating radio licenses.¹⁴³ At the same conference, the National Association of Broadcasters presented its resolution “that in any Congressional legislation . . . the test of the broadcasting privilege [will] be based upon the needs of the public. . . . The basis should be convenience and necessity.”¹⁴⁴ The broadcasters seemed enamored with their potential regulator:

The members of this conference express to the Secretary their appreciation of this opportunity for offering their suggestions and pledge their best efforts to help carry out the various provisions thereof . . . [and] the members assure him of their hearty approval and cooperation in any individual deviations from these provisions if, in his judgment, greater service may be rendered thereby.¹⁴⁵

They had little reason to fear. The senator who helped author the 1927 law explained that the public interest standard enshrined in law actually came from the industry itself in that 1925 conference.¹⁴⁶ In return, Congress had the ability to control this powerful new entertainment and news medium.¹⁴⁷ The new powers found in the act were eventually folded into the

¹⁴² KELLOGG, et al., *supra* note 68, at 19–20.

¹⁴³ Herbert C. Hoover, Opening Address, Fourth National Radio Conference Proceedings, reprinted in Radio Control, Hearings before the Committee on Interstate Commerce, United States Senate, Sixty-Ninth Congress, First Session 50-68 (1926).

¹⁴⁴ Radio Control, Hearings before the Committee on Interstate Commerce, United States Senate, Sixty-Ninth Congress, First Session 59 (1926).

¹⁴⁵ Radio Control, Hearings before the Committee on Interstate Commerce, United States Senate, Sixty-Ninth Congress, First Session 61 (1926).

¹⁴⁶ CLARENCE C. DILL, RADIO LAW, PRACTICE & PROCEDURE 89 (1938).

¹⁴⁷ Thomas W. Hazlett, *The Wireless Craze, the Unlimited Bandwidth Myth, the Spectrum Auction Faux Pas, and the Punchline to Ronald Coase’s “Big Joke”*: An Essay on Airwave Allocation Policy, 14 HARV. J. L. & TECH. 335, 352 (2001).

Communications Act of 1934, and the FCC was then fully entrenched as our nation's spectrum central planner.

The magnanimous relationship between regulator and industry was not a relic of simpler times; instead, Hazlett points out, this close relationship developed because the radio market was becoming dynamic and competitive and the major broadcasters sought to exclude rivals.¹⁴⁸ In the mid-1920s, radio technology expanded the available spectrum and the ability of the major broadcasters to extract rents was diminishing.¹⁴⁹ With no way to exclude rivals through competitive means, and after losing in the state courts, the industry's major players turned to Hoover.¹⁵⁰ Hoover, for years, had sought to bring broadcasts under federal control. With the industry's support—which was encouraged by Hoover's intentional negligence in policing the airwaves—he was finally able to get momentum for legislation.¹⁵¹ In the run-up to passage of the 1927 Radio Act, Morris Ernst, cofounder of the ACLU, wrote, “The proposed legislation contains phrases such as ‘public utility,’ ‘public necessity,’ and ‘public interest,’ but the operation of the bill is for private profit and for stabilization of investment.”¹⁵²

After passage of the 1927 law, the Federal Radio Commission (FRC) evidently agreed with the industry that there were “excess stations,”¹⁵³ declined to require broadcast-sharing agreements, and declined to widen the broadcast band.¹⁵⁴ The decision to make broadcast spectrum artificially scarce (hence, more valuable for existing broadcasters) was supported by the industry's specious claim that consumers were harmed by more radio stations since more

¹⁴⁸ Hazlett, *Rationality of U.S. Regulation*, *supra* note 137, at 153.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ Thomas W. Hazlett, *Physical Scarcity, Rent Seeking, and the First Amendment*, 97 COL. L. REV. 905, 922 (1997).

¹⁵² Morris Ernst, *Who Shall Control the Air?*, 122 NATION 443, 444 (1926).

¹⁵³ WELCOME TO THE RADIO COMMISSION, RADIO BROADCAST 555 (1927).

¹⁵⁴ Hazlett, *Rationality of U.S. Regulation*, *supra* note 137, at 155.

stations would require listeners to purchase new radio sets.¹⁵⁵ Further, the FRC defined “public interest” in ways that systematically excluded smaller competitors and entrants through capital requirements, advanced technology requirements, and requirements to broadcast continuously.¹⁵⁶ These regulations were devastating for nonprofit, educational, and small radio operators; many folded.¹⁵⁷ A few years later a popular business journal summarized the unholy alliance between the state and industry as follows: “While talking in terms of the public interest, convenience, and necessity the commission actually chose to further the ends of the commercial broadcasters. They form the substantive content of public interest as interpreted by the Commission.”¹⁵⁸ With the passage of the 1927 Radio Act, broadcast licenses were zero-priced and allocated to those firms that could show they were operating in the public interest. Commercial broadcasters had their prize—exclusion of rivals—and Congress and regulators had theirs: a pliant media and a hugely influential bargaining chip with which to increase political power.¹⁵⁹

The HDTV giveaway. As part of the Telecommunications Act of 1996, the broadcast industry effectively used its lobbying muscle to secure tens of billions of dollars’ worth of valuable spectrum in the name of assisting its transition to digital television. High-definition

¹⁵⁵ *Id.* Also see Owen, *supra* note 135. (“In making spectrum-allocation decisions, the FCC has been heavily influenced by industry interests, both directly and through congressional patrons of the broadcast and broader entertainment industries. For example, for decades the FCC made first radio and then TV licenses artificially scarce to protect the economic interests of broadcast networks and big-city stations. The evidence for this is found in the extremely high prices at which broadcast licenses were bought and sold, reflecting the capitalization of scarcity rents. This artificial scarcity of a crucial input to broadcasting resulted in massive losses of consumer welfare.”)

¹⁵⁶ PHILIP T. ROSEN, *THE MODERN STENTORS: RADIO BROADCASTING AND THE FEDERAL GOVERNMENT 1920–1934* 133 (1980).

¹⁵⁷ Hazlett, *Rationality of U.S. Regulation*, *supra* note 137, at 166, 169.

¹⁵⁸ ERIK BARNOUW, *A TOWER IN BABEL* 219 (1966).

¹⁵⁹ Hazlett, *The Wireless Craze*, *supra* note 147, at 357; Thomas W. Hazlett & Matthew L. Spitzer, *Digital Television and the Quid Pro Quo*, 2 *BUS. & POLITICS*, 2000, at 115, 118–19. Other scholars note, “The 1927 Act was a quantum leap in regulation. Congress did not content itself with curbing interference among users of spectrum, but instead included in the new Act provisions relating to programming, licensing and renewal, and many other aspects of broadcasting not related to electronic interference. These provisions were incorporated seven years later into the Communications Act of 1934.” Anne P. Jones & Harry W. Quillan, *Broadcasting Regulation: A Very Brief History*, 37 *FED. COMM. L.J.*, 1985, at 107 (footnotes omitted).

television (HDTV), digital television that requires substantial amounts of spectrum to display excellent picture quality on TV sets, was a catchphrase broadcasters began using in the late 1980s to convince regulators to reserve valuable parcels of spectrum for the future development of this new technology. Other companies were asking the FCC to give them the chance to use that spectrum for alternative wireless services, but broadcasters persuaded policymakers to set aside large swaths of spectrum for their future HDTV needs.¹⁶⁰

Each broadcaster already had a 6-megahertz (MHz) spectrum allocation that it used to provide consumers with old-fashioned analog TV signals. Huge portions of TV broadcast spectrum, however, were unused or underutilized because the higher frequencies had poor signal propagation characteristics.¹⁶¹ Other wireless service providers, like paging providers and two-way radio providers, saw this valuable resource lying relatively fallow. Not facing the technical propagation problems that plagued video broadcasting, they petitioned the FCC to reallocate some of the unused broadcast spectrum for their services.¹⁶²

In response, broadcasters made the case for transitioning their analog signal to high-quality HDTV. Because transitioning to HDTV was for public benefit, broadcasters argued,¹⁶³ they would need the government to “loan” them that vacant spectrum—6 MHz for every channel—to simulcast digital signals alongside their analog broadcasts until Americans made the complete transition to HDTV sets.¹⁶⁴ Once enough households had transitioned to the new digital spectrum, the broadcasters would hand back their old 6-MHz analog licenses, or so the theory

¹⁶⁰ See JOEL BRINKLEY, *DEFINING VISION: HOW BROADCASTERS LURED THE GOVERNMENT INTO INCITING A REVOLUTION IN TELEVISION* (1997).

¹⁶¹ Ultra-high frequency (UHF) was a poor transmitter of TV broadcast signals, and for that reason largely went unused. Thomas W. Hazlett & Matthew L. Spitzer, *Digital Television and the Quid Pro Quo*, 2 *BUS. & POLITICS*, 2000, at 115, 122–24.

¹⁶² *Id.* at 115, 124.

¹⁶³ *Id.* at 125–35.

¹⁶⁴ *Id.* at 124.

went. There was an additional catch associated with the broadcasters' scheme: They did not want to pay anything for the new spectrum. Broadcasters argued that it would be unfair to make them pay anything for the new spectrum since they were providing a new service to the public and the HDTV transition was going to be expensive for the industry.

Despite bipartisan opposition to the giveaway of such valuable spectrum, and the existence of many other spectrum users eager to bid billions to obtain that same spectrum for other uses, the broadcast industry's formidable lobbying proved too powerful to overcome and Congress signed off on the scheme as part of the Telecom Act. Additionally, in August 2002, the FCC mandated that television-set manufacturers include digital television tuners in all their new sets by 2006 to help speed the transition even though the DTV tuners were estimated to add more than \$200 to the cost of each new television.¹⁶⁵

Of course, as many critics pointed out in the early 1990s when this issue was debated, the opportunity costs of this scheme were quite high.¹⁶⁶ The spectrum that the broadcasters were asking for could have been auctioned off *immediately* for alternative uses instead of waiting years (perhaps even decades) for the old licenses to be returned for auction. If that spectrum had been auctioned immediately, it would have generated tens of billions of dollars for federal coffers *immediately*; there would have been no need to wait years for the broadcasters to vacate their analog channels.¹⁶⁷ Economist Coleman Bazelon estimated that the social value of the spectrum was substantially more—\$233 billion to \$473 billion.¹⁶⁸

¹⁶⁵ *In the Matter of Review of the Commission's Rules and Policies Affecting the Conversion to Digital Television*, Federal Communications Commission, MM Docket No. 00-39, Aug. 9, 2002, http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-02-230A1.pdf.

¹⁶⁶ See HAZLETT, *supra* note 108.

¹⁶⁷ Heather Forsgren Weaver, Intel study: 700 MHz spectrum worth \$233B in social benefits, RCR Wireless (June 3, 2005), <http://www.rcrwireless.com/article/20050603/sub/intel-study-700-mhz-spectrum-worth-233b-in-social-benefits/>.

¹⁶⁸ *Id.*

Why would lawmakers support such a blatant giveaway of a valuable resource? The broadcasters' aforementioned lobbying prowess is certainly one possible explanation. Television broadcasters are a powerful force in every congressional district, and even though Republicans have not traditionally had a good relationship with the media, they still must deal with them both at home and in Washington.¹⁶⁹ Further, spectrum incumbents know that the public interest standard by which the FCC judges spectrum allocations is highly elastic. Since incumbents enjoy rents thanks to licensing restrictions on entrants, incumbents like broadcasters can divert some profits toward politically popular programs and point to those efforts when the FCC or legislators threaten the status quo.¹⁷⁰

Another explanation is less cynical in nature. Many lawmakers stress the importance of continuing free, over-the-air local broadcasting as a vital public service regardless of the cost of doing so. Many lawmakers still view broadcast television as a birthright entitlement for Americans, even though just 9 percent of US households rely exclusively on over-the-air broadcast TV service today.¹⁷¹ Thus, schemes like the DTV transition are tolerated in the name of universal television service for the increasingly small percentage of homes that do not subscribe to cable or satellite TV.

Regardless of the rationale for it, the opportunity costs associated with this giveaway were staggering and continue today. Many other wireless companies were denied the opportunity to use that same spectrum for alternative services that the public might actually demand.

Wireless broadband providers, for example, could use this same spectrum to provide millions of

¹⁶⁹ See generally J.H. SNIDER, *SPEAK SOFTLY AND CARRY A BIG STICK: HOW LOCAL TV BROADCASTERS EXERT POLITICAL POWER* (2005).

¹⁷⁰ See THOMAS W. HAZLETT, *THE U.S. DIGITAL TV TRANSITION: TIME TO TOSS THE NEGROPONTE SWITCH* 23, AEI-Brookings Joint Center for Regulatory Studies, Working Paper 01-15 (2001).

¹⁷¹ Federal Communications Commission, *14th Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming* (July 20, 2012), Table 15, 92, http://transition.fcc.gov/Daily_Releases/Daily_Business/2012/db0723/FCC-12-81A1.pdf.

American households with a high-speed Internet connection. Nonetheless, policymakers, egged on by the broadcast lobby, sheltered broadcasters from those market pressures.

Modern video marketplace regulation. Other forms of government-granted privilege pervade the video marketplace and, once again, most of those privileges favor broadcast interests.

Even as viewing options from new sources have multiplied in recent decades, America's traditional video marketplace—broadcast television, cable TV, and satellite TV—has remained encumbered with many layers of federal regulation. This system prevents a truly free market in video programming from developing and simultaneously threatens to extend old regulations to new online platforms and services.¹⁷²

Among the rules that persist are a requirement that cable TV distributors carry broadcast signals even if they do not want to (“must carry” rules); rules that prohibit distributors from striking deals with broadcasters outside their local communities (“network nonduplication” and “syndicated exclusivity” rules); regulations specifying where broadcast channels appear on the cable channel lineup; and prohibitions against carrying sporting events on cable when the local stadium doesn't sell all its seats on game day (“sports blackout” rules). In addition, a hodgepodge of media ownership rules artificially limit marketplace transactions.

Most of these rules advantage broadcast-television license holders and content companies, and those interests fight vociferously for their retention.¹⁷³ In particular, those interests aggressively defend “retransmission consent” or “retrans” rules, which were put in

¹⁷² Adam Thierer, *Toward a True Free Market in Television Programming*, FORBES, Feb. 19, 2012, <http://www.forbes.com/sites/adamthierer/2012/02/19/toward-a-true-free-market-in-television-programming>.

¹⁷³ Jimmy Schaeffler, *Balancing Retransmission: And The Data Says . . . Advantage Broadcasters*, MULTICHANNEL NEWS (July 16, 2012), http://www.multichannel.com/blog/Mixed_Signals/33463-Balancing_Retransmission_And_The_Data_Says_Advantage_Broadcasters.php.

place as part of the Cable Act of 1992 and govern how video distributors carry signals from local TV broadcasters.¹⁷⁴ These rules let the FCC oversee the contractual negotiations, which are often highly contentious. Signal blackouts sometimes occur when parties cannot reach a deal, although that outcome is rare.

Broadcasters and most content companies oppose any effort to reform these rules since the current retransmission consent regulatory regime provides them with stable (and rapidly increasing) compensation for their programming. Broadcasters say the current system represents a decent proxy for actual free-market negotiations and that the current rule and other corresponding regulations are needed to preserve broadcasting's uniquely important role in local communities. However, it is precisely because of these rules that we have little idea what the actual market value of programming is.

Cable and satellite television distributors strongly oppose the retrans regime and the other rules listed previously, which they claim favor broadcasters and content companies. They are correct. Unfortunately, however, other rules exist that favor these video distributors. Video content transactions are governed by the compulsory licensing requirements of the Copyright Act of 1976, which essentially forced a "duty to deal" upon content owners to the benefit of video distributors. This requirement means content owners are not able to determine the actual market value of their programming through normal contractual negotiations.

As a result of all these overlapping rules, rent protection is alive and well in America's video marketplace since everyone has regulations they want preserved. Parties on all sides of this debate keep finding reasons to maintain or extend the status quo in an attempt to keep the

¹⁷⁴ Randolph J. May, Free State Foundation, *Broadcast Retransmission Negotiations and Free Markets*, Oct. 18, 2010, 5(24) PERSPECTIVES FROM FSF SCHOLARS, http://www.freestatefoundation.org/images/Broadcast_Retransmission_Consent_Negotiations_and_Free_Markets_101610.pdf.

government tilting the playing field in their preferred direction, even though no good economic or social reason exists to continue the rules.¹⁷⁵ In 2012, two congressional lawmakers introduced a proposal that would abolish these rules, but the law did not garner any additional support and was never seriously considered. Deregulation of these rules may prove difficult since few policymakers seem willing to embrace a truly free-market future for the video marketplace.¹⁷⁶

IV. Creeping Cronyism in the Digital Economy

This section investigates how cronyism could spread to new information sectors. It first considers the growing presence of high-tech firms inside Washington and the rapid expansion of their lobbying activities there. Then it examines examples of how favoritism has already been shown to specific firms or tech sectors.

A. Increases in Federal Tech Spending and Lobbying

Will rent-seeking become as big of a problem in the digital age as it was in the analog era? If the growing presence of technology companies in Washington is any indication, the signs are not encouraging. “Silicon Valley has long prided itself on avoiding the lumbering relationship

¹⁷⁵ “It is past time to stop extending interventions originally intended for old technology to a range of new competitive media,” Owen argues, since “no longer is there any rational public policy basis for a government agency to dictate how much or what content the viewing public can see, any more than there ever has been for printed media.” Moreover, he observes, “There is no market failure to which the current regulatory framework is responding.” *Id.* at 20.

¹⁷⁶ Sen. Jim DeMint (R-SC) and Rep. Steve Scalise (R-LA) introduced “The Next Generation Television Marketplace Act” in the 112th Congress. It proposed comprehensive deregulation of all these video marketplace rules. It received very little support, however. See Adam Thierer, *Continuing Confusion in the Debate over Retrans & Video Marketplace Deregulation*, TECHNOLOGY LIBERATION FRONT, Mar. 29, 2012, <http://techliberation.com/2012/03/29/continuing-confusion-in-the-debate-over-retrans-video-marketplace-deregulation>.

between big government and most industries, but somehow it has become one of the top lobbyists in Washington,” notes L. Gordon Crovitz, a *Wall Street Journal* columnist.¹⁷⁷

Information technology companies have gradually increased their presence not just in Washington but also in state capitals, while simultaneously increasing their overall campaign contributions at both levels.¹⁷⁸ Agency-level lobbying continues to grow as well. “Lobbying the FCC has become a major economic franchise,” reports the *Washington Post*. “Each day, hundreds of dark-suited lawyers crowd the antiseptic, midcentury-modern agency building.”¹⁷⁹

Certainly, lobbying is not always rent-seeking. Lobbying activity can provide useful information to legislators and regulators, as well as to journalists and the broader public. However, lobbying is frequently used as a sword against competitors or to gain regulatory advantages impossible to attain in the market. It is difficult to distinguish “good” lobbying from rent-seeking, but because lobbying creates an arms race among competitors, increased presence in DC is typically a bad sign for competition and consumers. That technology and information economy companies have become more participatory in politics and regulation in recent years is particularly concerning since it could sap the entrepreneurial spirit and competition in this innovative sector. Digital economy innovators have produced an impressive array of high-tech goods and services over the past 15 years, and it is doubtful that spending more time lobbying policymakers could improve that track record.

¹⁷⁷ L. Gordon Crovitz, *Silicon Valley's 'Suicide Impulse,'* WALL ST. J., Jan. 27, 2013, <http://online.wsj.com/article/SB10001424127887323539804578266290231304934.html>.

¹⁷⁸ Tam Harbert, *Internet Giants Adopt New Lobbying Tactics*, IEEE SPECTRUM (Oct. 2012), <http://spectrum.ieee.org/telecom/internet/internet-giants-adopt-new-lobbying-tactics>.

¹⁷⁹ Cecilia Kang, *FCC Chief's Painstaking Approach Earns Mixed Reviews in Turbulent Times for Telecom Industry*, WASH. POST, Dec. 2, 2012, http://www.washingtonpost.com/business/technology/2012/11/27/6fda5576-2f59-11e2-ac4a-33b8b41fb531_story.html.

Yet lobbying activity by these companies is unlikely to dissipate. Part of the reason for this growth is obvious since, as political scientist Lee Drutman points out, lobbying can generate a demand of its own and become reinforcing:

The modern growth of corporate lobbying reflects a path-dependent learning process. Companies may come to Washington for many different reasons, but the act of establishing an office sets in motion several reinforcing processes that make companies value lobbying more and more over time and that lead companies to become more proactive in their political strategies. The overall effect is that American businesses, once skeptical of government, cautious about getting involved in politics, and reactive in their strategies, have now become increasingly confident, proactive, and aggressive in their lobbying efforts, and businesses are increasingly seeing government policy as not just a threat, but also as a tool.¹⁸⁰

The rapid expansion in lobbying activity over the past two years has been led by tech innovators such as Google,¹⁸¹ Facebook,¹⁸² Netflix,¹⁸³ Pandora,¹⁸⁴ and others.¹⁸⁵ Figures 1 and 2 illustrate the growth of lobbying expenditures in this sector. Meanwhile, calls for more political activism are growing among notable technology industry figures.¹⁸⁶

¹⁸⁰ Lee Drutman, *The Business of America Is Lobbying: Explaining the Growth of Corporate Lobbying Activity in Washington, DC*, http://www.leedrutman.com/uploads/2/3/0/1/2301208/business_of_america_is_lobbying.pdf at 1.

¹⁸¹ Russ Choma, *Learning from Microsoft's Mistakes, Google Invests Heavily in Influence*, OPEN SECRETS BLOG, Jan. 7, 2013, <http://www.opensecrets.org/news/2013/01/learning-from-microsofts-mistakes-g.html>.

¹⁸² David Saleh Rauf, *Facebook Lobbying Sets Record in Q2*, POLITICO, July 7, 2012, <http://www.politico.com/news/stories/0712/78804.html>; Cecilia Kang, *Facebook Triples Lobbying Budget from Last Year, Eyes White House*, WASH. POST, July 23, 2012, http://www.washingtonpost.com/blogs/post-tech/post/facebook-triples-lobbying-budget-eyes-white-house/2012/07/23/gJQAodvo4W_blog.html.

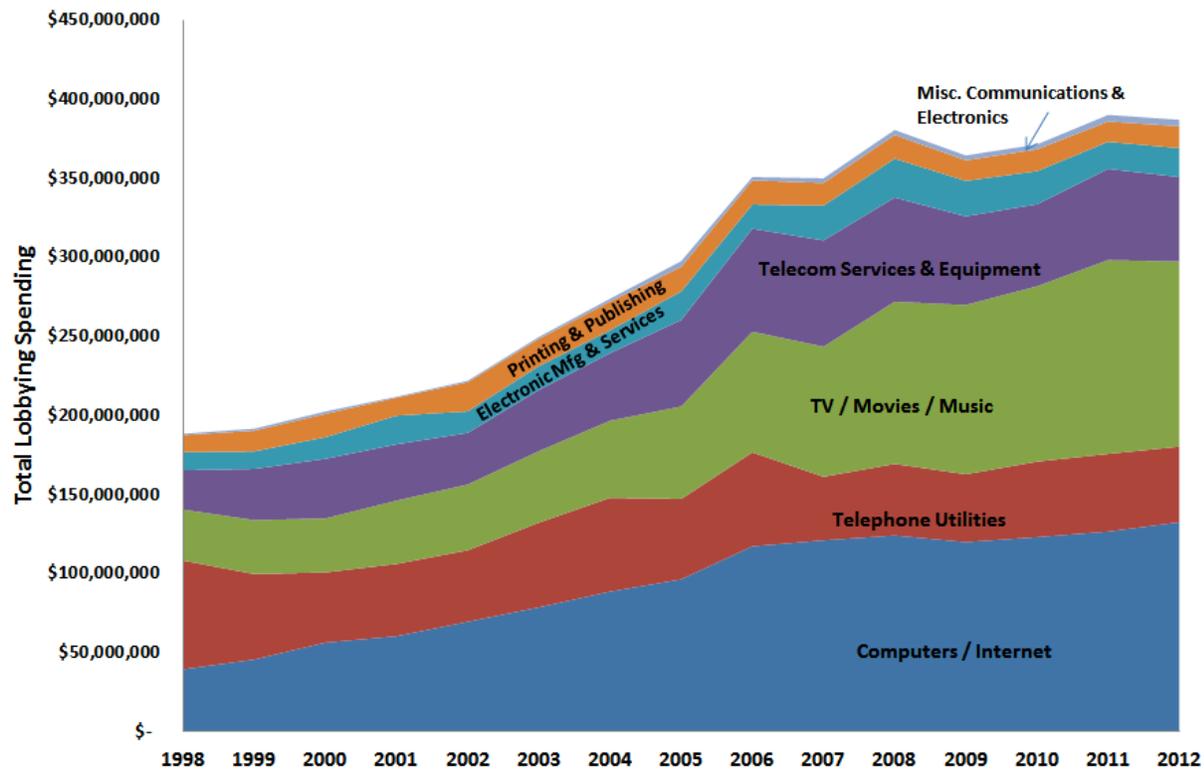
¹⁸³ Jess Kamen, *Big Week Ahead for Cybersecurity—Chamber Spars with SEC on Congo Minerals Rules—Q2 Lobby Disclosures Are In—Apple to Post Quarterly Earnings—FM Chip Battle: YouTube Edition*, POLITICO, July 23, 2012, <http://www.politico.com/morningtech/0712/morningtech516.html>.

¹⁸⁴ Elahe Izadi, *Pandora, Growing Up Washington Style*, NATIONAL JOURNAL, July 9, 2012, <http://influencealley.nationaljournal.com/2012/07/pandora-all-grown-up.php>.

¹⁸⁵ Somini Sengupta, *Tech Giants Brace for More Scrutiny from Regulators*, N.Y. TIMES, Jan. 1, 2013, http://www.nytimes.com/2013/01/02/technology/tech-giants-learning-the-ways-of-washington-brace-for-more-scrutiny.html?_r=0. (“At the end of 2012, tech companies were on track to have spent record amounts on lobbying for the year.”)

¹⁸⁶ Michelle Quinn, *Tech Lobbyists' New Mantra: Strength through Unity*, POLITICO, July 16, 2012, <http://www.politico.com/news/stories/0712/78567.html>; Tony Romm, *Obama's Tech Backers Woo with Potential Access*, POLITICO, Sept. 4, 2012, <http://www.politico.com/news/stories/0912/80640.html?hp=110>.

Figure 1. Lobbying Spending by Information Technology Sectors



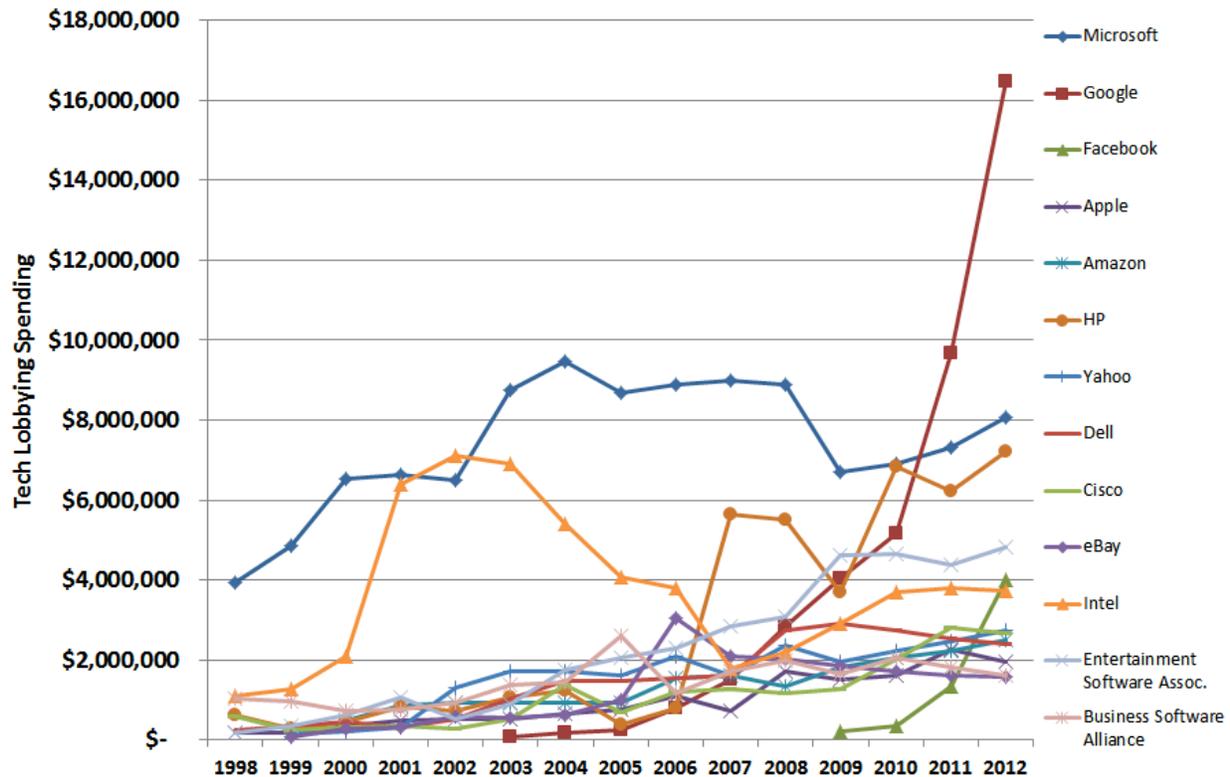
Source: Center for Responsive Politics (non-inflation-adjusted totals), <http://www.opensecrets.org/lobby/industries.php?id=B%20%20>.

In 2010, for example, Reid Hoffman, founder of LinkedIn, the popular social networking site for business professionals, worried that policymakers tend to ignore high-tech startups. “We don’t have an entrepreneurship lobby,” he said, “because entrepreneurs are off [being entrepreneurial].”¹⁸⁷ In particular, he fretted about startups not getting their share of recent stimulus funding. “It’s much easier when you’re embedded in the political infrastructure to respond to immediate things” like the stimulus package, he said.¹⁸⁸

¹⁸⁷ Sara Jerome, *Silicon Valley Needs a D.C. Lobby, Hoffman Says*, HILLICON VALLEY, Aug. 27, 2010, <http://thehill.com/blogs/hillicon-valley/technology/116121-silicon-valley-needs-a-dc-lobby-hoffman-says>.

¹⁸⁸ *Id.*

Figure 2. Lobbying Spending by Tech Companies



Source: Center for Responsive Politics (non-inflation-adjusted totals), <http://www.opensecrets.org/lobby/industry/client.php?id=B12>.

Lauren Weinstein, an Internet activist and the cofounder of People for Internet Responsibility, has called for the formation of an Internet policy Super PAC “to not only lobby in the name of protecting freedom and other rights on the Internet, but to also directly promote the election of politicians with sensible views regarding Internet freedoms, technology, and the intersection of these areas with individuals and society at large.”¹⁸⁹ He argues that “if we don’t learn to ‘play the game’ the way the big boys do in Washington and other seats of government around the world, we and our ideas will be steamrolled. If we refuse to utilize all legal tools at

¹⁸⁹ Lauren Weinstein, *Internet Rights, Internet Wrongs, and Internet War*, LAUREN WEINSTEIN’S BLOG, July 4, 2012, <http://lauren.vortex.com/archive/000972.html>.

our disposal to affect the political process in the name of our own goals, we and Internet freedoms will be crushed.”¹⁹⁰

In one sense, both Hoffman and Weinstein are correct; it certainly is easier to “play the game” when you have a small army of lobbyists inside the Beltway asking for special treatment or taxpayer handouts. But it is not clear whether they—and others in the Internet community—have fully considered the costs of such activities. High-tech America’s expanded embrace of Washington could take it down the familiar path followed by the agriculture and automotive sectors (among many others), with government becoming both protector and punisher of industry. The entrepreneurialism that Hoffman and others care most about will then be at serious risk. Today’s dynamic tech industries will increasingly stagnate as they come under the “Mother, may I?” permission-based regulatory regime that encumbered the older information technology sectors.

B. The State and Local Tax-Break Bonanza

State and local lawmakers who hope to encourage investment by high-tech companies are increasingly tapping tax credits and other tax-code-based inducements (such as tax rebates). Such efforts are sometimes described as “industrial recruitment” and in the older economy as “smokestack chasing.”¹⁹¹ While job creation is an oft-stated goal of such actions, when it comes to high-tech tax credits, it often seems that state and local policymakers are mostly offering such inducements to enhance the status or prestige of their communities. That is, they hope to create “the next Hollywood,” “the next Silicon Valley,” or “the next tech hub” in their region.¹⁹²

¹⁹⁰ *Id.*

¹⁹¹ Robert C. Turner, *The Political Economy of Gubernatorial Smokestack Chasing: Bad Policy and Bad Politics?*, 3 STATE POLITICS & POL’Y Q., 2003, at 270.

¹⁹² Alisha Hipwell, *Pittsburgh Reinvents Itself as the New Hollywood*, CNNMONEY, Aug. 7, 2012, http://money.cnn.com/2012/08/07/smallbusiness/pittsburgh-film/index.htm?iid=HP_River.

Political scientists and economists refer to such behavior as “credit claiming”¹⁹³—politicians looking to claim credit for their industrial recruitment efforts. Tax inducements are not as egregious a form of cronyism as the various types of government-granted privileges enjoyed by communications and media operators in the past. Nonetheless, when tax inducements target specific firms or sectors, they raise issues of both efficiency and fairness. First, in terms of efficiency, tax credits are, quite obviously, devised to incentivize certain investments. But incentives may have the consequence of redirecting societal resources to businesses or technologies that have very little market demand.

Second, the costs associated with awarding tax credits to one set of interests are ultimately borne by some other interests or individuals. If state and local lawmakers are looking to boost investments by tech companies by granting them favorable tax treatment, such favoritism will likely come at the expense of established businesses and individuals in those communities who will be forced to cover the tax shortfall.

Third, tax credits for digital technology companies are particularly misguided since (a) the most successful companies don’t need them and (b) the smaller companies or startups that might benefit from them present a very risky investment for taxpayers. Startups, famously, may be here today but gone tomorrow. Policymakers should leave such risky investments to venture capitalists and other private investors so taxpayers are not on the hook.

Finally, tax credits can actually become a time-consuming morass for innovators. Firms that ask for political privileges tend to be less innovative and less profitable.¹⁹⁴ A recent *Wall Street Journal* report noted that “many companies are saying ‘no, thanks’ and are likely paying

¹⁹³ Charlotte Twight, *From Claiming Credit to Avoiding Blame: The Evolution of Congressional Strategy for Asbestos Management*, 11 J. PUB. POL., 199, at 153–86 .

¹⁹⁴ Chung-Lei Yang, *Rent Seeking, Technology Commitment, and Economic Development*, 154 JOUR. INST. & THEOR. ECON., 1998, at 640–58.

more taxes than legally required,” because “the tax deductions are either too cumbersome or too confusing. In some cases, the cost of obtaining the tax benefit is greater than the benefit itself.”¹⁹⁵

These are just some of the issues to keep in mind while reviewing the growth of government-granted tax privileges in the high-tech sector. The following corporate cases studies list examples of how some tech firms have already sought and received special treatment from government officials.

Apple. In March 2012, Texas Governor Rick Perry announced that the Texas Enterprise Fund would provide Apple Inc. with \$21 million of state funds over 10 years.¹⁹⁶ In return, Apple agreed to create 3,635 new jobs by 2025 through a \$304 million investment to open an operations center outside Austin.¹⁹⁷ In addition, the city will provide Apple with \$8.6 million in tax rebates and Travis County will provide Apple with \$5.4 million to \$6.4 million over the course of the project.¹⁹⁸ Temporary contractors will account for 25 percent of anticipated new workers.¹⁹⁹

During negotiations, Apple explained that it considered other locations besides Austin.²⁰⁰ Yet there is some doubt that Apple was serious about any location besides Austin. In Phoenix, regarded as Austin’s main competitor to host the operations center, Arizona economic development officials were notified of the opportunity to host the center only about a month

¹⁹⁵ John D. McKinnon, *Firms Pass Up Tax Breaks, Citing Hassles, Complexity*, WALL ST. J., July 23, 2012, <http://online.wsj.com/article/SB10000872396390444025204577543060812237798.html>.

¹⁹⁶ Office of the Governor Rick Perry, Press Release, *Gov. Perry Announces Apple to Create 3,600 New Jobs in Austin*, Mar. 9, 2012, <http://www.governor.state.tx.us/news/press-release/17021>.

¹⁹⁷ *Id.*

¹⁹⁸ Farzad Mashhood, *Apple Gets Final Approval from County, Locks in at Least \$5.4 Million in Tax Rebates*, STATESMAN.COM, May 1, 2012, http://www.statesman.com/blogs/content/shared-gen/blogs/austin/cityhall/entries/2012/05/01/apple_gets_final_approval_from.html?cxntcid=breaking_news. One Travis County commissioner voted against the deal because of the absence of any provision that would ensure “economically disadvantaged” local residents would be hired.

¹⁹⁹ *Id.*

²⁰⁰ Betty Beard, *Was Apple Serious about Phoenix-Area Site?*, AZCENTRAL.COM, Mar. 23, 2012, <http://www.azcentral.com/news/articles/2012/03/21/20120321apple-serious-about-phoenix-site.html>.

before Apple formally announced its deal with the Texas Enterprise Fund. Furthermore, these officials were only given three days in February 2012 to prepare a pitch for why Phoenix was a suitable location for the center.²⁰¹ If Apple was bluffing, Austin gave it something for nothing.

Regardless, at least \$35 million in public funds will be credited to Apple from state and local governments as a result of the American operations center project. Yet these 2012 tax credits and subsidies are only a fraction of the taxpayer money that Apple received, directly and indirectly, from local, state, and federal governments in 2011. According to Apple's 10-K annual report filed with the Securities and Exchange Commission in 2011, the firm received \$167 million in research and development tax credits and a \$168 million domestic production activities deduction from the federal government.²⁰²

Twitter. In 2011, after two years at the same location in San Francisco, Twitter had already rented another floor in its office building but still had too many employees for its location.²⁰³ For its new headquarters, company managers looked to move to a nearby city that didn't require a payroll tax.²⁰⁴ To prevent Twitter from leaving the city, San Francisco city managers sought ways to make San Francisco more attractive for the company.²⁰⁵ To that end, city lawmakers approved in April 2011 the "Twitter tax break"—an exemption from payroll

²⁰¹ *Id.*

²⁰² Apple Inc., ANNUAL REPORT 2011, <http://sec.gov/Archives/edgar/data/320193/000119312511282113/d220209d10k.htm>. The domestic production activities deduction is a provision of the 2004 American Jobs Creation Act implemented in order to incentivize small businesses to generate manufacturing jobs in the United States.

²⁰³ Leslie Horn, *Is Twitter Leaving San Francisco?*, PCMAG.COM, Jan. 14, 2011, <http://www.pcmag.com/article2/0,2817,2375752,00.asp>.

²⁰⁴ Sara Yin, *Twitter Could Save \$22M in San Fran Tax Exemption*, PCMAG.COM, Apr. 6, 2011, <http://www.pcmag.com/article2/0,2817,2383167,00.asp>.

²⁰⁵ Horn, *supra* note 203.

taxes for six years with a \$22 million estimated benefit.²⁰⁶ Days later, the popular microblogging service announced it would keep its primary headquarters in downtown San Francisco “after a months-long campaign to secure a payroll tax break from the Board of Supervisors in return for staying in the city and agreeing to relocate to the troubled mid-Market Street area,” according to PCMag.com.²⁰⁷ According to the *San Francisco Examiner*, the “Twitter tax break” prompted other tech companies to request tax breaks from the city.²⁰⁸

Meanwhile, according to *BuzzFeed*, “Twitter and six other San Francisco tech companies are set to receive sizable tax breaks from the city in exchange for non-binding promises to make charitable contributions totaling, in many cases, just tens of thousands of dollars—along with promoted tweets for local groups.”²⁰⁹ Other companies that are receiving those tax breaks include Yammer (a Microsoft subsidiary), Zoosk, One Kings Lane, ZenDesk, and 21Tech.²¹⁰

Amazon. As online retailer Amazon expanded its physical presence in several US states and began building more warehouses and fulfillment centers, it opened itself up to new tax-collection liabilities. Amazon had traditionally opposed online sales taxes, correctly arguing that state and local governments did not have the constitutional authority to impose sales tax-collection obligations on “remote” (or out-of-state) sellers with no physical presence within the

²⁰⁶ Gerry Shih, *San Francisco Supervisors Pass ‘Twitter Tax Break’*, BAY CITIZEN, Apr. 19, 2011, <http://www.baycitizen.org/business/story/supervisors-twitter-tax-break>; Yin, *supra* note 204.

²⁰⁷ Stephanie Mlot, *Twitter Embraces New Nest, Remains in San Francisco*, PCMAG.COM, June 11, 2011, <http://www.pcmag.com/article2/0,2817,2405638,00.asp>.

²⁰⁸ Joshua Sabatini, *Twitter Tax Break Approved by San Francisco Supervisors*, SAN FRANCISCO EXAMINER, Apr. 5, 2011, <http://www.sfexaminer.com/local/2011/04/twitter-tax-break-approved-san-francisco-supervisors>.

²⁰⁹ Justine Sharrock, *Promises of Charity Won Tax Breaks for Tech Companies*, BUZZFEED, Jan. 27, 2013, <http://www.buzzfeed.com/justinesharrock/how-tech-companies-bought-big-tax-breaks-with-prom-8887>.

²¹⁰ *Id.*

given state or locality.²¹¹ But once it built physical facilities in those states or localities, Amazon would normally be required by law to collect sales taxes on purchases made by consumers in those areas, just as any other retailer would.

To counter or defer these new tax-collection obligations, Amazon sought to cut deals in some states to give the company special treatment compared to other businesses in exchange for promises of jobs and investment in those states or localities. Amazon made such deals with South Carolina and Texas, among other states.²¹² For example, the company was able to avoid a \$269 million tax bill in Texas despite the presence of a distribution center in Irving.²¹³ In 2012, Amazon struck a deal with the state to release the company from its tax bill in exchange for a promise to open new distribution facilities and hire 2,500 workers.²¹⁴ Similarly, Amazon secured a five-year exemption from sales-tax-collection obligations in South Carolina after promising to build a distribution center there.²¹⁵

LivingSocial. In July 2012, the DC Council approved the Social E-Commerce Job Creation Tax Incentive Act of 2012. The deal provided LivingSocial, a popular online coupon service, with corporate and property tax exemptions in Washington, DC, worth approximately

²¹¹ Veronique de Rugy & Adam Thierer, Mercatus Center, *The Internet, Sales Taxes, and Tax Competition*, Oct. 11, 2011, <http://mercatus.org/publication/internet-sales-taxes-and-tax-competition>.

²¹² Kenneth Corbin, *Amazon Reaches Agreement with Indiana on Sales Taxes*, ECOMMERCEBYTES, Jan. 11, 2012, <http://www.ecommercebytes.com/cab/abn/y12/m01/i11/s04>.

²¹³ Ross Ramsey, *Let's Make a Deal, Amazon Tells Texas*, N.Y. TIMES, July 23, 2011, <http://www.nytimes.com/2011/06/24/us/24ttramsey.html>.

²¹⁴ Louise Story, *Lines Blur as Texas Gives Industries a Bonanza*, N.Y. TIMES, Dec. 2, 2012, http://www.nytimes.com/2012/12/03/us/winners-and-losers-in-texas.html?_r=1&.

²¹⁵ David Slade, *Amazon to SC Residents: Pay Tax on the Stuff You Bought Last Year*, THE POST AND COURIER, Mar. 23, 2012, <http://www.postandcourier.com/article/20120127/PC05/301279979>.

\$32.5 million over five years beginning in 2015.²¹⁶ Legislators feared that LivingSocial would relocate to an area with a lower tax rate.²¹⁷

In exchange for the \$32.5 million, LivingSocial said it would attempt to add 1,000 employees to its payroll (roughly doubling its number of employees in the district). However, no contractual guarantee for job creation exists, and the firm had never been profitable.²¹⁸ There were some contractual obligations required for LivingSocial to receive these tax exemptions, such as a requirement that it must establish a program to mentor DC high school students, provide internships for DC students, remain in the district, and create a 200,000-square-foot headquarters there.²¹⁹ LivingSocial must also ensure that 50 percent of newly hired employees live in the district in order to receive the act's full \$32.5 million in exemptions.²²⁰

Just a few months after the deal was struck, it had already become apparent just how risky of a bet the DC government had made. In late November 2012, LivingSocial announced a net loss of \$566 million for the third quarter and that hundreds of employees would be laid off.²²¹ The company ended 2012 with just \$76 million in cash and current assets, but had \$338 million in short-term liabilities.²²² As a result, the firm's common stock was deemed "worthless" by

²¹⁶ Tim Craig, *D.C. Council Approves LivingSocial Tax Breaks*, WASH. POST, June 26, 2012, http://www.washingtonpost.com/blogs/dc-wire/post/dc-council-approves-livingsocial-tax-breaks/2012/06/26/gJQAQAvv4V_blog.html.

²¹⁷ *Id.*

²¹⁸ Steven Overly, *D.C. Council Approves LivingSocial Tax Break*, WASH. POST, July 10, 2012, http://www.washingtonpost.com/blogs/capital-business/post/dc-council-approves-livingsocial-tax-break/2012/07/10/gJQA7QL3aW_blog.html.

²¹⁹ Craig, *supra* note 216.

²²⁰ Tax Abatement Analysis of the Social E-Commerce Job Creation Tax Incentive Act of 2012, at 3, http://cfo.dc.gov/sites/default/files/dc/sites/ocfo/publication/attachments/ocfo_final_tafa_ecommerce_act_of_2012.pdf.

²²¹ Jonathan O'Connell, *LivingSocial Plans to Lay Off Hundreds in U.S., Company Sources Say*, WASH. POST, Nov. 28, 2012, http://www.washingtonpost.com/blogs/capital-business/post/livingsocial-plans-to-lay-off-hundreds-in-us-company-sources-say/2012/11/28/56ee5602-399f-11e2-b01f-5f55b193f58f_blog.html.

²²² *Living Social Receives Emergency \$110M Debt Infusion from Existing Investors with Oppressive Terms*, PRIVCO, Feb. 20, 2013, <http://www.privco.com/livingsocial-receives-emergency-110m-cash-infusion-from-existing-investors-to-avoid-bankruptcy>.

market watchers,²²³ despite a \$110 million cash infusion by investors in February 2013.²²⁴ The promise to roughly double the size of its DC-based workforce seems unlikely to be kept, and some analysts doubt the company will survive much longer.²²⁵

Groupon. Like Twitter, fast-growing Groupon expanded beyond its original headquarters in Chicago in 2010 and needed a new lease. The company had gone public in April and was recognized as a market innovator; consequently, other states lobbied Groupon to relocate.²²⁶ Illinois, however, was not willing to see Groupon leave. In October 2010, the company received a \$3.5 million incentive package from Illinois in return for a promise to create 250 jobs in Chicago.²²⁷ That same year, Illinois had the highest deficit of any US state and owed \$37.9 billion to creditors.²²⁸ Groupon has been struggling in recent quarters and is looking like an increasingly risky bet in terms of its long-term viability.²²⁹

Motorola. The deal between Motorola and the state of Illinois illustrates the dangers of permitting ad hoc, secretive agreements with favored firms. In May 2011, Motorola Mobility secured more than \$100 million in tax credits and incentives from Illinois in exchange for a

²²³ *Id.*

²²⁴ Thomas Heath, *LivingSocial Receives \$110 Million Cash Infusion*, WASH. POST, Feb. 20, 2013, http://www.washingtonpost.com/business/economy/livingsocial-receives-110-million-cash-infusion/2013/02/20/618163ea-7b79-11e2-9a75-dab0201670da_story.html.

²²⁵ Bill Flook, *For LivingSocial, the Snark Train Rolls In*, WASH. BUS. J., Oct. 31, 2012, <http://www.bizjournals.com/washington/blog/2012/10/for-livingsocial-the-snark-train.html>.

²²⁶ Melissa Harris, *Groupon Defends State Aid*, CHI. TRIB., Oct. 28, 2010, http://articles.chicagotribune.com/2010-10-28/business/ct-biz-1028-confidential-groupon-20101028_1_groupon-state-aid-life-fitness.

²²⁷ *Id.*

²²⁸ Andrew Thomason, *Illinois 50 out of 50 in 2010 for State Deficit*, ILLINOIS WATCHDOG, July 28, 2011, <http://watchdog.org/39913/ilshn-illinois-50-out-of-50-in-2010-for-state-deficit-2/>.

²²⁹ Evelyn M. Rusli & John Letzing, *Groupon's Growth Slows; Shares Plummet After-Hours*, WALL ST. J., Nov. 9, 2012, <http://online.wsj.com/article/SB10001424127887323894704578107304122978748.html>.

promise to keep its headquarters in Libertyville.²³⁰ At the deal-signing ceremony, Governor Pat Quinn surmised that President Abraham Lincoln “would be so proud that our state, Illinois, is home to Motorola.”²³¹

Although Motorola and Quinn made an “oral agreement” that Motorola Mobility would maintain a workforce of 3,000 in Libertyville, the actual agreement reads differently.²³² The true terms were not revealed until the *Chicago Tribune* filed a Freedom of Information Act (FOIA) request.²³³ Unlike any other deals formulated by the state-sponsored Economic Development for a Growing Economy (EDGE) program, this deal explicitly stated that Motorola need not hire any additional workers.²³⁴ According to the May 2011 agreement obtained through FOIA, Motorola Mobility will receive \$113.7 million in tax credits and incentives for simply retaining 2,500 employees and promising to invest \$600 million in the state.²³⁵

Only months after the agreement was announced, on August 15, 2011, Google announced an agreement to acquire Motorola Mobility.²³⁶ In October 2011, as this deal was pending regulatory approval, Motorola Mobility announced it would cut 185 jobs in Illinois, which did not threaten tax breaks from the state because of the carefully worded agreement.²³⁷ In

²³⁰ Kathy Bergen & Wailin Wong, *\$100 Million Keeps Motorola Mobility in Illinois*, CHI. TRIB., May 6, 2011, http://articles.chicagotribune.com/2011-05-06/business/ct-biz-0507-motorola-incentives-20110506_1_tax-credit-package-pat-quinn-quinn-sign.

²³¹ Korinna Grom, *Motorola Headquarters to Remain in Libertyville*, LIBERTYVILLE PATCH, May 6, 2011, <http://libertyville.patch.com/articles/motorola-headquarters-to-remain-in-libertyville>.

²³² Alejandra Cancino, *Wiggle Room in Motorola Mobility's State Tax Break*, CHI. TRIB., June 19, 2011, http://articles.chicagotribune.com/2011-06-19/business/chi-motorola-mobility-could-lay-off-790-and-keep-state-tax-break-20110619_1_motorola-mobility-incentive-state-tax.

²³³ *Id.*

²³⁴ *Id.*

²³⁵ Alejandra Cancino, *New Law to Shed More Light on State Tax Credit Program*, CHI. TRIB., July 6, 2012, http://articles.chicagotribune.com/2012-07-06/business/chi-new-law-to-shed-more-light-on-state-tax-credit-program-20120706_1_motorola-mobility-credits-tax-incentive-package.

²³⁶ *Facts about Google's Acquisition of Motorola*, Press Release, <http://www.google.com/press/motorola/>.

²³⁷ Wailin Wong, *Motorola Mobility to Cut 800 Jobs, 185 in Ill.*, CHI. TRIB., Oct. 31, 2011, http://articles.chicagotribune.com/2011-10-31/business/chi-motorola-mobility-to-cut-800-job-sec-filing-shows-20111028_1_motorola-mobility-severance-costs-jobs.

December, due to concerns about the Google deal, state Rep. Jack Franks sponsored a bill mandating that EDGE program deals be disclosed on the Illinois Department of Commerce and Economic Opportunity website. Shortly thereafter, on January 26, 2012, Motorola Mobility announced that it had lost \$80 million in the fourth fiscal quarter of 2011.²³⁸ Then, on May 1, the company announced it had lost \$86 million in the first fiscal quarter of 2012, almost one year to the day after Quinn announced the \$113.7 million deal.²³⁹

Four days later, *Crain's Chicago Business* reported that Google was planning to relocate Motorola Mobility away from Libertyville.²⁴⁰ Two months afterward, Rep. Jack Franks' transparency bill was signed into law by Governor Quinn. His spokesman remarked, "Governor Quinn has long advocated for openness in government."²⁴¹ In August 2012, Google announced major job cuts for Motorola as part of its restructuring.²⁴² Illinois taxpayers, who had their taxes increased during a recession to improve the state's fiscal condition, will be left on the hook for these corporate giveaways.

²³⁸ Donald Melanson, *Motorola Announces Q4 2011 Earnings: \$3.4 Billion Revenue, \$80 Million Net Loss*, ENGADGET, Jan. 26, 2012, <http://www.engadget.com/2012/01/26/motorola-announces-q4-2011-earnings-3-4-billion-revenue-80-m>.

²³⁹ Terrence O'Brien, *Motorola Mobility Loses \$86 Million in Q1, Device Shipments Way Down*, ENGADGET, May 1, 2012, <http://www.engadget.com/2012/05/01/motorola-mobility-loses-86-million-in-q1-device-shipments-way/>.

²⁴⁰ John Pletz, *Google Makes Plans to Move Motorola Mobility to Chicago*, CRAIN'S CHI. BUS., May 4, 2012, <http://www.chicagobusiness.com/article/20120504/NEWS08/120509853/google-makes-plans-to-move-motorola-mobility-to-chicago>.

²⁴¹ Alejandra Cancino, *New Law to Shed More Light on State Tax Credit Program*, CHI. TRIB., July 6, 2012, http://articles.chicagotribune.com/2012-07-06/business/chi-new-law-to-shed-more-light-on-state-tax-credit-program-2012-0706_1_motorola-mobility-credits-tax-incentive-package.

²⁴² Claire Cain Miller, *Motorola Set for Big Cuts as Google Reinvents It*, N.Y. TIMES, Aug. 13, 2012, http://www.nytimes.com/2012/08/13/technology/motorola-to-cut-20-of-work-force-part-of-sweeping-change.html?_r=1&page-wanted=all.

Film production. Motion picture studios benefit from a federal tax break that allows production companies to deduct the first \$15 million in filming costs from taxes,²⁴³ but it is state and local tax incentives for movie production that have expanded most rapidly over the past decade.²⁴⁴ These inducements include tax credits, sales tax exemptions, cash rebates, direct grants, and tax or fee reductions for lodging or locational shooting.²⁴⁵ In 2002, only five states offered such inducements for movie production.²⁴⁶ By the end of 2009, 45 states had incentives in place to lure film producers.²⁴⁷

In 2010, the film industry received an estimated \$1.5 billion in financial commitments from these programs.²⁴⁸ Unsurprisingly, these incentives have proven very popular with movie studios. Of the nine motion pictures that were nominated for Best Picture at the Academy Awards in 2012, five had received taxpayer-funded rebates, tax credits, and subsidies from state governments.²⁴⁹ *The Help* received a Mississippi spending rebate of \$3,547,780, and *The Tree of Life* received \$434,253 from Texas.²⁵⁰ In February 2012, Best Picture–nominee *Moneyball* received as much as \$5.8 million from California.²⁵¹ It had grossed over \$75 million at the box

²⁴³ Yaël Ossowski, *How Walt Disney Cashes In on Corporate Welfare*, REASON, Jan. 6, 2013, <http://reason.com/archives/2013/01/06/how-walt-disney-cashes-in-on-corporate-w>.

²⁴⁴ See SAG-AFTRA, *State Film Incentives*, <http://www.sagaftra.org/state-film-incentives> [accessed Nov. 22, 2012].

²⁴⁵ William Luther, *Movie Production Incentives: Blockbuster Support for Lackluster Policy*, Tax Foundation, SPECIAL REPORT, no. 173 (Jan. 2010), at 7, <http://taxfoundation.org/sites/taxfoundation.org/files/docs/sr173.pdf>.

²⁴⁶ *Id.*

²⁴⁷ See National Conference of State Legislatures, *State Film Production Incentives & Programs* (Jan. 2011), <http://www.ncsl.org/issues-research/budget/state-film-production-incentives-and-programs.aspx>.

²⁴⁸ Robert Tannenwald, *State Film Subsidies: Not Much Bang for Too Many Bucks*, Center on Budget & Policy Priorities (Dec. 9, 2010), <http://www.cbpp.org/cms/index.cfm?fa=view&id=3326>.

²⁴⁹ Will Wilson, *Oscar Night Secret: Tax Breaks for Films Go Undisclosed in Many States*, STATELINE, Feb. 22, 2012, <http://www.pewstates.org/projects/stateline/headlines/oscar-night-secret-tax-breaks-for-films-go-undisclosed-in-many-states-85899375403>.

²⁵⁰ *Id.*

²⁵¹ *Id.*

office.²⁵² More recently, the biopic *Lincoln* received roughly \$3.5 million in tax incentives from the Virginia Film Office.²⁵³

Many state and local governments offer these inducements in the hope of attracting new jobs and investment; others simply seek to bill themselves as “the new Hollywood.”²⁵⁴ It seems that the glamour and prestige associated with films and celebrities have trumped sound economics, however, since there is little evidence these tax incentives help state or local economies.

“Based on fanciful estimates of economic activity and tax revenue, states are investing in movie production projects with small returns and taking unnecessary risks with taxpayer dollars,” noted a 2010 Tax Foundation study.²⁵⁵ “In return, they attract mostly temporary jobs that are often transplanted from other states.”²⁵⁶ Studies of specific state-incentive programs confirm this statement, almost universally finding miniscule revenue gains for every dollar of film subsidies offered.²⁵⁷ The only two studies that have revealed positive results for such film-incentive programs were both conducted by Ernst & Young on behalf of the New York and New Mexico film offices. Other reports have shown consistent negative returns.²⁵⁸

Recently, some states have begun abandoning or limiting film-incentive programs or at least taking a hard look at their effectiveness.²⁵⁹ Iowa, for example, suspended its film program in

²⁵² *Moneyball*, YAHOO! MOVIES, <http://movies.yahoo.com/movie/moneyball>.

²⁵³ Carten Cordell & Kathryn Watson, *How Steven Spielberg’s Lincoln Benefited from Crony Capitalism*, REASON, Nov. 15, 2012, <http://reason.com/archives/2012/11/15/how-steven-spielbergs-lincoln-benefited>.

²⁵⁴ Luther, *supra* note 245, at 7. (“Some jobs are more glamorous than others. Hollywood epitomizes glamour. From politicians’ point of view, bringing Hollywood to town is the best of all possible photo opportunities—not just a ribbon-cutting to announce new job creation but a ribbon-cutting with a movie or TV star.”)

²⁵⁵ *Id.*, at 1.

²⁵⁶ *Id.*

²⁵⁷ Tannenwald, *supra* note 248, at 16.

²⁵⁸ *Id.*

²⁵⁹ Joseph Henchman, *More States Abandon Film Tax Incentives as Programs’ Ineffectiveness Becomes More Apparent*, TAX FOUNDATION FISCAL FACT no. 272 (June 2, 2011), <http://taxfoundation.org/article/more-states-abandon-film-tax-incentives-programs-ineffectiveness-becomes-more-apparent>.

2009 after an investigation revealed a scandal involving much waste and abuse.²⁶⁰ This scandal resulted in 10 criminal cases, through which seven people were eventually convicted.²⁶¹ Michigan governor Rick Snyder has also started reining in his state's film program as evidence has mounted that it has failed to create local jobs and has cost the state a great deal of tax revenue.²⁶²

Video-game makers. Following the example set by motion picture studios, many video-game companies have been pursuing state-based tax incentives in recent years. As with the motion picture industry, these tax incentives take the form of credits, rebates, grants, and exemptions. States offer such inducements “in hopes of attracting successful businesses and possibly becoming the ‘Hollywood’ of the video game industry.”²⁶³

As of mid-2011 20 states offered some form of tax inducement.²⁶⁴ According to the Entertainment Software Association, the video game industry's trade association, in 2011, “Twenty-five tax incentive proposals were introduced in 13 states and Puerto Rico. At the same time, in response to increased budget pressures, nine bills in three states were introduced to either reduce or eliminate incentives for game production. Four positive incentive bills for the industry passed in Florida, Puerto Rico, Texas and Utah in 2011. All of the bills proposing reduction or elimination of video game incentives were defeated.”²⁶⁵ In the previous year, 37 tax-

²⁶⁰ Joe Kristan, *Iowa Film Tax Credit Scandal: A Warning for Other States*, in Luther, *supra* note 245.

²⁶¹ David Pitt, *Film Financier Sues Iowa over Unpaid Film Credits*, BLOOMBERG BUSINESSWEEK, Dec. 4, 2012, <http://www.businessweek.com/ap/2012-12-04/film-financier-sues-iowa-over-unpaid-film-credits>.

²⁶² Louise Story, *Michigan Town Woos Hollywood, but Ends Up With a Bit Part*, N.Y. TIMES, Dec. 4, 2012, http://www.nytimes.com/2012/12/04/us/when-hollywood-comes-to-town.html?_r=0.

²⁶³ Sean Kane, Pillsbury Winthrop Shaw Pittman LLP, *A State-by-State Guide to Business Incentives for Your Interactive Entertainment Production* (Dec. 7, 2010), [http://www.slcatlanta.org/news/film_tax_credits/SET_White_Paper_USProductionIncentives_12710_final\(1\).pdf](http://www.slcatlanta.org/news/film_tax_credits/SET_White_Paper_USProductionIncentives_12710_final(1).pdf).

²⁶⁴ Stephen D. Riden, Beck Reed Riden LLP, *Tax Incentives for Video Game Companies* (Oct. 2010, updated June 2011), <http://www.beckreedriden.com/wp-content/uploads/2011/06/Video-Game-Tax-Incentives-June-2011.pdf>.

²⁶⁵ ENTERTAINMENT SOFTWARE ASSOCIATION, ANNUAL REPORT 2011, 3, (2012), http://www.theesa.com/about/ESA_2011_Annual_Report.pdf.

incentive bills were introduced in 16 states and two of them passed, while 13 measures were introduced to eliminate incentives but, again, none passed.²⁶⁶ The industry also benefits from a variety of federal tax breaks.²⁶⁷

Video game tax incentives were at the center of a recent controversy in Rhode Island involving former major-league baseball player Curt Schilling.²⁶⁸ The state sued a video game studio founded by Schilling, 38 Studios LLC, in an effort “to recover some of the \$75 million in loans it guaranteed to lure the firm from Massachusetts and alleging that the former Boston Red Sox pitcher and associates manipulated the state to secure the financing.”²⁶⁹ Evidence came to light after the state made that deal that it was riskier than its sponsors originally suggested.²⁷⁰

“The debacle involving Schilling’s company demonstrates why public entities should never be involved in picking winners and losers,” notes the tech blog *Engadget*. “One reason is that such entities typically do not have the necessary background to make informed judgments on the viability of companies in the private sector.”²⁷¹

²⁶⁶ Entertainment Software Association, ANNUAL REPORT 2010, 3, (2011), http://www.theesa.com/about/ESA_2010_Annual_Report.pdf.

²⁶⁷ David Kocieniewski, *Rich Tax Breaks Bolster Makers of Video Games*, N.Y. TIMES, Dec. 10, 2012, http://www.nytimes.com/2011/09/11/technology/rich-tax-breaks-bolster-video-game-makers.html?pagewanted=all&_r=0. (“Those tax incentives—a collection of deductions, write-offs and credits mostly devised for other industries in other eras—now make video game production one of the most highly subsidized businesses in the United States.”)

²⁶⁸ Todd Wallack, *38 Studios’ Troubles Could Cool Gaming Tax Breaks*, BOSTON GLOBE, June 3, 2012, <http://www.bostonglobe.com/business/2012/06/02/enthusiasm-for-gamingtax-breaks-may-chill-after-fall-studios/OFE3kpSI5JrF36pDVC7BeJ/story.html>.

²⁶⁹ Michael B. Farrell, *Rhode Island Sues Curt Schilling, 38 Studios to Recoup Losses*, BOSTON GLOBE, Nov. 1, 2012, <http://www.bostonglobe.com/business/2012/11/01/rhode-island-sues-studios-recoup-losses/qwcZFNtpfs1pAXupP2WCAM/story.html>.

²⁷⁰ Ted Nesi & Tim White, *Target 12: EDC Ignored 38 Studios Signs*, WPRI.COM, Nov. 20, 2012, http://www.wpri.com/dpp/news/local_news/nesi/target-12-edc-ignored-38-studios-signs.

²⁷¹ Jason Hidalgo, *Fallen Kingdom: 38 Studios’ Collapse and the Pitfalls of Using Public Money to Support Tech Companies*, ENGADGET, Sept. 7, 2012, <http://www.engadget.com/2012/09/07/38-studios-collapse-and-risk-of-public-private-partnerships>.

V. Strategies to Limit Cronyism

“There is only one way to end, or at least to reduce, the amount of cronyism, and that is to reduce government power,” argues economist David R. Henderson.²⁷² “To reduce cronyism, we must abolish regulations and cut or abolish special government subsidies,” he says. McChesney agrees, noting that “the one unambiguous solution for reducing rent extraction is reducing the size of the state itself and its power to threaten, expropriate, and transfer.”²⁷³

Henderson and McChesney are correct, but there are many strategies to limit the “power to threaten, expropriate, and transfer” in the short term. This section summarizes various strategies to limit cronyism and regulatory capture in the information technology sectors.

A. Deregulation and Regulatory Streamlining

In his history of the economic deregulation of several US sectors (telecommunications, airlines, natural gas, and banking), Vietor argues that “deregulation unleashed competition with new technology, new organizations, new suppliers and distribution.”²⁷⁴ He summarizes the major benefits of deregulation as follows:

- It expanded industry boundaries.²⁷⁵
- It lowered or eliminated barriers to entry (and exit).
- It reconfigured established market segmentation, and pricing mechanisms became more sophisticated.²⁷⁶
- It allowed distribution channels to develop as sophisticated competitive weapons.

²⁷² David R. Henderson, Mercatus Center, *The Economics and History of Cronyism* 19 (July 27, 2012).

²⁷³ McChesney, *supra* note 54, at 170.

²⁷⁴ VIETOR, *supra* note 35, at 319.

²⁷⁵ *Id.* (“Industries defined by regulation gave way to broader structures defined by technology, customer demand, and supplier economies.”)

²⁷⁶ This allowed creative pricing schemes to be developed to better serve different consumers.

- It caused industry structure to change and led to more competitors in every segment.
- Prices went down.

To the extent that there was any downside to America’s experience with economic deregulation, Vietor says it was that service quality for some consumers deteriorated slightly. But it is vital to recall that under regulation, many providers could only compete on quality since rates, quantity, and other variables were all controlled tightly by law. That meant some providers—most notably airline carriers—went overboard with service amenities (such as fancy meals or entertainment on flights) to differentiate themselves from others. Following deregulation, it became clear that consumers were more interested in competition on price, route options, and other variables—and that is exactly what they got.

Regardless, the important takeaway is that deregulation also limited or even ended cronyism and capture opportunities. After liberalization, there were simply fewer levers of control for industry to influence. Deregulation forced companies to spend more time satisfying consumers as opposed to lawmakers and regulators.

B. Auctions and Property Rights

Nobel Prize–winning economist Ronald Coase argued that “political pressures” on regulatory agencies would lead directly to “malallocations” of resources.²⁷⁷ He noted that, while many lawmakers bemoaned “the extent to which pressure is brought to bear on the Commission by politicians and businessmen . . . that this should be happening is hardly surprising.”²⁷⁸

When rights, worth millions of dollars, are awarded to one businessman and denied to others, it is no wonder if some applicants become overanxious and attempt to use

²⁷⁷ Ronald H. Coase, *The Federal Communications Commission*, 2 J.L. & ECON., 1959, at 1, 37.

²⁷⁸ *Id.* at 35–36.

whatever influence they have (political and otherwise), particularly as they can never be sure what pressure the other applicants may be exerting.²⁷⁹

Thus, Coase recognized the connection between the politicization of spectrum policy and the special-interest politics and lobbying that would inevitably accompany it. This problem, he explained, “largely arises because of a failure to charge for the rights granted. If these rights were disposed of to the highest bidder, the main reason for these improper activities would disappear.”²⁸⁰ By replacing regulation with market mechanisms, in other words, government could reduce the favoritism and corruption that naturally accompany the political allocation of wealth.

This is exactly what happened once lawmakers finally took Coase’s advice about radio-spectrum auctions. Congress granted the FCC the power to auction cellular licenses in 1993, ensuring that those resources could be largely privately managed and that markets, not regulatory mandates, would govern decision making. To be clear, auctions are only permitted over a small sliver of the available radio spectrum, and there are still some unnecessary restraints on who can bid and who can trade. With that caveat, where utilized, these auctions have raised billions of dollars for the federal government and rationalized the allocation of this valuable commercial input. Auctions helped get politics out of the spectrum-licensing field to some extent. “By eliminating excess demand, auctions end rent seeking,” argues Hazlett, and “competitive bidding is also a political cleanser, as arm’s length transactions reduce opportunities for corruption.”²⁸¹ The marketplace and consumer benefits of auctions have been clear, Hazlett notes, resulting in the following:

²⁷⁹ *Id.* at 36.

²⁸⁰ *Id.*

²⁸¹ Hazlett, *The Wireless Craze*, *supra* note 147, at 407.

- *Faster licensing.* “Auctions are relatively expedient, allowing services to be provided more quickly.”
- *Efficient distribution.* “License auctions result in superior initial assignments. Parties bidding the most tend to value licenses most.”
- *Efficient aggregation.* “Simultaneous auctions allowed markets to determine (advanced cellular) service area size. License aggregation instantly created regional and national coverage footprints.”
- *Efficient taxation.* “Lump sum payments to the Treasury resulting from auctions constitute a welfare improvement over income taxes because such transfers do not distort economic behavior.”
- *Momentum for liberalization.* “Perhaps the most important aspect of auctions is that they have given market mechanisms a test drive at the FCC. Despite warnings of public interest apocalypse, they have worked.”²⁸²

If this same logic were applied to *all* spectrum, rent-seeking pressures would diminish. Auctions and property rights would be particularly helpful if applied to the broadcast spectrum, which, as noted in section IIIC, is still governed by the same “public interest” regulatory regime that has existed since the industry’s earliest days.²⁸³

Cable franchising is an area that has improved but still presents many challenges to regulation. As described earlier, in 1992 Congress removed the ability of municipalities to grant

²⁸² *Id.* at 408–409.

²⁸³ *Also see* Owen, *supra* note 60 at 4, 11. (He argues that there is “no longer any reason for FCC bureaucrats to decide how much of the spectrum should be used for each of many existing and future commercial services,” and he recommends that policymakers “create efficient markets in spectrum rights . . . to permit licensees to use their assignments for purposes other than the use originally designated, subject to noninterference with adjacent users.” In other words, policymakers should institute strong property rights. “Providing adjacent spectrum users with a legal remedy for interference (trespass) would provide incentives to reallocate spectrum through market transactions.”)

exclusive franchises,²⁸⁴ which had led to so much corruption in the 1970s and 1980s. Further, many states have wisely adopted statewide franchising, which overrides municipal grants of franchises,²⁸⁵ and the rapid penetration of U-Verse and FiOS in recent years is evidence of increasing video competition. However, robust competition is still absent in many communities, partly as a result of the franchises granted decades ago and partly as a result of the economics of building more video-distribution systems. Most states still allow cities the much-abused power to grant cable licenses. While liberalization has occurred, progress has been inconsistent.

There is no simple solution, but steps can be taken to improve competition and limit political meddling. States that haven't revoked licensing abilities from localities should remove that particular temptation. Easing right-of-way restrictions on entrants would also aid competitive entry, but incumbent operators often ferociously (and successfully) fight these efforts. Early franchisees wired whole communities with the promise that competitors would not be allowed to enter the market and cherry-pick the high-margin neighborhoods with lower build-out costs. While exclusive licenses are not permitted any longer, incumbents exhibited detrimental reliance on the economics of exclusive licenses, and new entrants can upset their business models. This reliance is not a reason to slow down competitive reforms, but policymakers should recognize the source of resistance. The response should be that the economics of video competition have changed substantially in the past several decades. It is more important that consumers benefit from more competition and lower prices than that existing business models be preserved.

²⁸⁴ Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385.

²⁸⁵ Digital Policy Institute, Telecommunication Deregulation: A Policy Progress Report 1 (2010), <http://cms.bsu.edu/-/media/WWW/DepartmentalContent/DPI/PDFs/TelecommDeregulation.pdf>.

C. Vouchers

Cronyism sometimes develops around programs and policies that have the best of intentions. As noted earlier, this has been the case with various “universal service” efforts over the past century. Yet, when a communications welfare system is administered as a corporate welfare program, it creates perverse incentives. It creates waste and abuse because the higher the costs reported by the carrier providing service, the more funding the carrier receives from universal service programs. Moreover, delivering assistance through favored local providers limits the potential for new entry and undermines competition. A means-tested voucher could target assistance to those who need it without creating an inefficient, unsustainable hidden tax or undermining competition.

In essence, targeted assistance is how food assistance is provided today. Policymakers have wisely avoided providing assistance to needy Americans by subsidizing grocery stores to deliver that assistance. If they had, they would have created perverse incentives for private operators to game the system; they also likely would have limited competition among those providers. Unfortunately, those sorts of distortions are at work in communications markets today, meaning rural communities served by corporations that benefit from universal service programs could be discouraging competitive entry. Thus, vouchers could help limit cronyism in the provision of universal service.

D. Sunsets

Information technology companies must contend with the reality of “Moore’s Law,” the principle named after Intel cofounder Gordon E. Moore, who first observed that, generally

speaking, the processing power of computers doubles roughly every 18 months while prices remain fairly constant.²⁸⁶

Moore's Law has been a relentless regulator of markets and has helped keep the power of "tech titans" in check by keeping companies on their toes, constantly innovating to survive.²⁸⁷ Once policymakers recognize the power of Moore's Law to naturally regulate markets—and the corresponding danger of leaving Washington's laws on the books too long—it should be clear why it is essential to align America's legal and regulatory policies with the realities of modern tech markets. Phasing out archaic and unnecessary laws and regulations is also a useful way of minimizing the potential for cronyism. One way policymakers could do this is by applying Moore's Law to all current and future laws and regulations through two simple principles:²⁸⁸

- *Principle 1.* Include in every new technology proposal a provision sunseting the law or regulation 18 months after enactment. Policymakers can always reenact the rule if they believe it is still sensible.
- *Principle 2.* Reopen all existing technology laws and regulations and reassess their worth. If no compelling reason for their continued existence can be identified and substantiated, those laws or rules should be repealed within 18 months. If a rationale for continuing existing laws and regulations can be identified, the rule can be reimplemented and principle 1 applied to it.

²⁸⁶ Intel, *Moore's Law Inspires Intel Innovation*, <http://www.intel.com/content/www/us/en/silicon-innovations/moores-law-technology.html>. [Site accessed Aug. 2012.]

²⁸⁷ Adam Thierer, *Of 'Tech Titans' and Schumpeter's Vision*, FORBES, Aug. 22, 2011, <http://www.forbes.com/sites/adamthierer/2011/08/22/of-tech-titans-and-schumpeters-vision>.

²⁸⁸ Adam Thierer, *Sunsetting Technology Regulation: Applying Moore's Law to Washington*, FORBES, Mar. 25, 2012, <http://www.forbes.com/sites/adamthierer/2012/03/25/sunsetting-technology-regulation-applying-moores-law-to-washington>.

The test for determining when technology laws and regulations are retained should not be based on conjectural harms and boogeyman scenarios. Policymakers must conduct a robust benefit-cost analysis of all tech rules and then offer a clear showing of tangible harm or actual market failure before enactment or reenactment of any policy.²⁸⁹

E. Limits on Congressional Delegation of Power

Federal and state legislators often delegate broad, ambiguous authority to regulatory agencies to help address various policy objectives. Legislative delegation is particularly popular when the industries or technologies being regulated are viewed as being more complex in nature.

Unfortunately, as the histories documented in section III made clear, when agencies are given broad leeway to devise and administer regulatory regimes, this opens the door to potential capture and rent-seeking opportunities.²⁹⁰ As law professor David Schoenbrod notes in *Power Without Responsibility: How Congress Abuses the People through Delegation*,

Agency heads are usually not apolitical and, indeed, concentrated interests often prevail more easily in an agency than they can in Congress. Effective participation in agency lawmaking usually requires expensive legal representation as well as close connections to members of Congress who will pressure the agency on one's behalf. The agency itself is often closely linked with the industry it regulates. Not only large corporations, but also labor unions, cause-based groups, and other cohesive minority interests sometimes can use delegation to triumph over the interests of the larger part of the general public, which lacks the organization, finances, and know-how to participate as effectively in the administrative process.²⁹¹

To limit the potential for abuse, Congress should take steps to rein in agency power and limit delegation of open-ended powers to agencies in the future. At a minimum, legislators must

²⁸⁹ Richard Williams & Jerry Ellig, *Regulatory Oversight: The Basics of Regulatory Impact Analysis* (Mercatus Center at George Mason University, 2011), <http://mercatus.org/publication/regulatory-oversight>.

²⁹⁰ Lars Noah, *Administrative Arm-Twisting in the Shadow of Congressional Delegations of Authority*, 5 WISC. L. REV., 1997, at 873.

²⁹¹ DAVID SCHOENBROD, *POWER WITHOUT RESPONSIBILITY: HOW CONGRESS ABUSES THE PEOPLE THROUGH DELEGATION* 13 (1993).

make their regulatory intent and standards clearer *before* delegating authority to regulatory agencies, and if they fail to do so, courts should not be shy about declaring overly broad delegations of ambiguous authority to be presumptively invalid under the Constitution.²⁹²

F. Voluntary Corporate Disengagement

In 2000, T. J. Rodgers, the president and CEO of Cypress Semiconductor, penned a prescient manifesto for the Cato Institute with a provocative title: “Why Silicon Valley Should Not Normalize Relations with Washington, D.C.”²⁹³ It was a blistering critique of Washington rent-seeking culture and a clarion call warning high-tech companies not to succumb to it. “The political scene in Washington is antithetical to the core values that drive our success in the international marketplace and risks converting entrepreneurs into statist businessmen,” he warned.²⁹⁴ “The collectivist notion that drives policymaking in Washington is the irrevocable enemy of high-technology capitalism and the wealth creation process.”²⁹⁵

Sadly, it appears his worst fears have been realized as information technology markets and politics have become increasingly intertwined. Perhaps this state of affairs should not be surprising. In 1997, McChesney predicted that “Silicon Valley, with its sharp competition but rapidly increasing stock of capital, would seem like a natural target for (rent) extraction soon.”²⁹⁶

A handful of firms have shown that strategic disengagement is possible. Apple and Sony, for example, have so far bucked the trend to engage as aggressively in politics. While

²⁹² LOWI, *supra* note 42, at 300. (“The [Supreme] Court’s rule must once again become one of declaring invalid and unconstitutional any delegation of power to an administrative agency or to the president that is not accompanied by clear standards of implementation.”)

²⁹³ T. J. RODGERS, WHY SILICON VALLEY SHOULD NOT NORMALIZE RELATIONS WITH WASHINGTON, DC (2000), <http://www.cato.org/pubs/wtpapers/silvalley.pdf>.

²⁹⁴ *Id.* at 1.

²⁹⁵ *Id.*

²⁹⁶ McChesney, *supra* note 54, at 160.

those firms haven't shunned political engagement entirely, compared to most other information technology operators, which are rushing to expand their presence in Washington and in state capitals to curry political favor, Apple and Sony have largely focused on satisfying their customers instead of policymakers.

It would be naïve, however, to expect many firms to voluntarily reject cronyism opportunities when they are available to them. That is why the other institutional reforms itemized here must be pursued first to minimize the possibility that those opportunities will be available at all.

Such reforms and efforts by industries to voluntarily distance themselves from politics is important is because, at least thus far in the technology sector's brief history, information technology innovators have not been burdened by the same regulatory obstacles faced by analog-era producers. If they hope to keep it that way, the first step is to avoid the cronyist favor-seeking that earlier industries employed and that opened the door to the sort of incessant marketplace meddling that continues to haunt communications and media providers today.²⁹⁷

VI. Conclusion

This article has surveyed the major ingredients and byproducts of government favoritism in the fields of communications, media, and information technology. Cronyism and regulatory capture have been fixtures in these fields for many decades and now threaten to spread to newer high-tech sectors.

²⁹⁷ Crovitz, *supra* note 177. (“Rather than lobby government to go after one another, Silicon Valley lobbyists should unite to go after overreaching government. Instead of the “suicide impulse” of lobbying for more regulation, Silicon Valley should seek deregulation and a long-overdue freedom to return to its entrepreneurial roots.”)

Efforts to reform cronyist policies are challenging because “regulation is much easier to get than to get rid of,” as McChesney observes.²⁹⁸ Reform is challenging due to what Gordon Tullock has called the “transitional gains trap”: once a policy or program is put in place to favor a certain interest, most of its gains come early and are factored into future earnings.²⁹⁹ Those benefiting from the policies would face large transitional losses if reform were undertaken, even if these policies impose large deadweight costs on society as a whole. This “trap” can frustrate beneficial reform efforts.

The danger also exists that, as the side effects of cronyism begin to manifest themselves and efforts are made to remedy the problem through additional regulatory efforts, one intervention will simply beget another and another.³⁰⁰ Economist Anne Krueger summarizes how a “vicious circle” of rent-seeking results from those interventions:

If the market mechanism is suspect, the inevitable temptation is to resort to greater and greater intervention, thereby increasing the amount of economic activity devoted to rent seeking. As such, a political “vicious circle” may develop. People perceive that the market mechanism does not function in a way compatible with socially approved goals because of competitive rent seeking. A political consensus therefore emerges to intervene further in the market, rent seeking increases, and further intervention results.³⁰¹

Only comprehensive reform and deregulation can put a stop to such rent-seeking and vicious circles of intervention. But the best way to avoid the perils of cronyism is to avoid getting into Tullock’s “trap” to begin with. “Our predecessors have made bad mistakes and we are stuck with them,” he notes, “but we can at least make efforts to prevent our descendants from

²⁹⁸ Fred S. McChesney, *Of Stranded Costs and Stranded Hopes: The Difficulties of Deregulation*, 3 THE INDEPENDENT REVIEW, 1999, at 485, 506, http://www.independent.org/pdf/tir/tir_03_4_mcchesney.pdf.

²⁹⁹ Gordon Tullock, *The Transitional Gains Trap*, 6 BELL JOUR. L. ECON., 1975, at 671.

³⁰⁰ Ludwig von Mises, *Human Action*, 858 (3rd ed. 1963). (“All varieties of interference with the market phenomena not only fail to achieve the ends aimed at by their authors and supporters, but bring about a state of affairs which—from the point of view of their authors’ and advocates’ valuations—is less desirable than the previous state affairs which they were designed to alter. If one wants to correct their manifest unsuitableness and preposterousness by supplementing the first acts of intervention with more and more of such acts, one must go farther and farther until the market economy has been entirely destroyed and socialism has been substituted for it.”)

³⁰¹ Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM ECON. REV., 1974, at 302.

having even more such deadweight losses inflicted upon them.”³⁰² Information technology entrepreneurs and public policymakers should heed that lesson before cronyism takes hold in this innovative sector.

³⁰² Tullock, *supra* note 299, at 678.