Preemption by the FCC

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For a long time, the system of federal and state responsibility for communications regulation had been one of co-regulation. A high degree of commonality of federal and state goals existed in this system. The cooperative spirit was so great that the federal level permitted a system of revenue transfers to the states' regulated domain to support low local rates for which the federal government had no direct oversight responsibility. As the 1970s unfolded, however, the divergence in goals between the federal and state levels of government became pronounced, and the old system fell apart.

First, a bit of historical background. There was no federal regulation for the first 35 years of telephony. Federal regulation started in 1910 with the Mann-Elkins Act, which extended an undefined regulatory authority to the Interstate Commerce Commission. Although the ICC largely failed to exercise this authority, it did actively establish a position of dominance over state regulation of the railroads in the Shreveport rate cases. By analogy, the states' regulatory authority in the telephone area became also legally tenuous, even though the ICC did not in fact exercise its powers.

When the Communications Act of 1934 was drafted, the states urged a statutory limitation on the new Federal Communications Commission's powers over intrastate wire communications.

Congress responded positively by including in the Act Sections 2(b) and 221(b), which together prohibit FCC regulation "in connection with intrastate communication service by wire..." The congressional intent clearly was to limit the scope of federal telephone regulation. The House report on the bill, for example, stated that "some 97 1/2 or 98 percent of all telephone communications is intrastate, which this bill does not affect." How wrong they were!

During the era following the 1934 Act, public policy makers were under continuous pressure to reconcile the statutory fiction of separation of intrastate and interstate network components with the reality of integration. What emerged from these efforts was a system of co-regulation, in which both federal and state agencies regulated the same facilities at the same time, and in which the federal level cooperated in keeping local rates low.

The cooperative system, however, could not last when its constituents' fundamental goals diverged. This divergence of goals occurred when the FCC began to embrace the concepts of efficiency, competition, markets, and entry, while the state commissions continued to emphasize equity and redistribution. One should add parenthetically that many FCC policies are not truly deregulatory in the sense of non-interference. The FCC and Judge Greene have put up many structural regulations that establish who can do what, and in what market. For example, long-distance carriers cannot provide local service; local

exchange companies cannot provide cable TV service; cable TV operators can't own broadcasters in their locality; broadcast networks cannot own certain rights in TV series, and so on. So, to some extent, the FCC has regulation still firmly in place, but regulation more of a structural kind, rather than the behavioral kind which is being reduced, and which the states practice.

The split between the states and the FCC emerged first in a serious fashion in terminal equipment. In a series of decisions which culminated in Carterfone, the FCC opened the accessory equipment market to rivals of AT&T. Many states, on the other hand, advocated a restrictive approach during this period, largely for fear of having the phone companies lose revenue which supported residential rates.

But the Commission prevailed. North Carolina v. FCC was the landmark decision. The separation of interstate and intrastate communications by sections 2(b) and 221(b) of the 1934 Act, the legal linchpin of the cooperative system, did not survive this decision. Instead, the court found that the states' action had frustrated the Commission's efforts to discharge its responsibilities to create a national system of telecommunications, and was therefore invalid. The court read the protected part of telecommunications very narrowly and rendered it almost meaningless. If virtually all facilities of a nationwide network are part of the interstate network, FCC jurisdiction would extend to all aspects, and the federal preemption would relegate the states to a dependent role, at the

sufferance of the FCC.

That was ten years ago, and since then, preemption by the FCC of state regulation has been moving steadily and inexorably forward. Preemption, I should mention, is constitutionally based on interpretations of the Commerce and the Supremacy clauses of the federal constitution. For the Commerce Clause, there is a balancing test which weighs the local interest in the regulation, the burden on interstate commerce, and the regulatory method chosen. For the Supremacy Clause, the usually relevant test is whether the state policy may produce a result inconsistent with the objective of the federal statute.

Here are some of the FCC's preemptions just for the past three years or so:

New CPE.

De-tariffing of embedded CPE.

Flat rate end-user access charges.

Intrastate WATS.

Cellular radio CPE.

Much of the paging services.
Digital termination service.

Vertical blanking interval of TV signals.

Teletext.

FM subcarriers.

Depreciation rules. This is very important. It required states to switch from whole life to remaining life depreciation, and to equal life groups. Several states refused, and several

cases went up to the Supreme Court. In particular, the Fourth Circuit had found preemption even through federal and state depreciation rules could in principle coexist, since they were accounting methods. Arguments were made in the Supreme Court in January of 1986. If there is any preemption case in which the FCC might be reversed by the Supreme Court, this is it, because it is not a strong case on preemption, however one may feel about the merits. On the other hand, six federal courts had supported the FCC, and only one, in Arkansas, came out on the other side before it was reversed on appeal.

Another front involves cable TV services. The FCC preempted in 1983 rate regulation for access of non-mandatory channels. It preempted states from regulating cable systems that do not use public rights of way--so-called SMATV systems. And it excluded them recently, after the 1984 Cable Act, from regulating in most places even the basic rates for cable. It struck down the use of local zoning codes to limit backyard satellite antennas and amateur radio operations.

In the 1984 Crisp case involving Oklahoma, the Supreme Court held FCC regulations to override the state constitutional provisions regulating the advertising of alcohol, even though alcohol regulation has been traditionally left to the states.

In another significant decision, Cox Cable, the FCC preempted much of the states' ability to regulate the use of cable TV systems in bypass operations as a common carrier requiring state certification.

And there is more. This is a virtually unbroken string of state defeats in recent years. The last state victory of note in the courts was the NARUC II case in 1976. There have been a few instances of voluntary self-denial by the FCC, such as on pay phones--possibly temporary--and hotel surcharges. And the satellite dish preemption could have gone further. But these limitations were at the choice of the FCC, not due to local necessity. Recently, there was some rejoicing in the states because the FCC didn't go along with an IBM petition for a declaratory ruling that the FCC has preempted the state regulation of shared tenant services. But in the decision, which was released January 27, 1986, all that the Commission says is that it had not already preempted in the past by its earlier decision. And it issued simultaneously a notice of inquiry for comments on how it should proceed in the future.

As if this was not enough, Congress added the 1984 Cable Communications Act, which substantially reduced local and state regulatory power over cable operators, to the point of even superseding a few provisions of the franchise contracts which had been voluntarily entered by cable companies eager for the franchise.

Furthermore, courts have begun to find First Amendment rights for cable operators as sort of "video publishers," and local regulation has been held to be subject to the antitrust laws. Both developments raise further barriers to state and local regulation of telecommunications.

In the telephone area, there has also been an astonishing expansion of the role of the federal level through the metamorphosis of Judge Greene and the Antitrust Division into what seems to become a permanent Supreme Communications Commission over the telephone sector, a kind of FCC Number Two, which does not show any signs of fading away.

It is true, however, that the FCC has in recent months been a bit more conciliatory. In particular, it has used the Joint Board process to compromise, for example, on the actual rates in end-user access charges. But ultimately it always can ignore or reverse a Joint Board recommendation, and so the legal powers of the FCC remain left intact, even when it chooses to bring the states into the process.

Now, why is there a problem with federal predominance in regulation? Doesn't federal regulation avoid duplication, reduce spill-overs, lower the cost of compliance, and provide access to expertise? After all, virtually every other country in the world thinks so.

One major problem with the growing centralization is what it does to the distribution and balance of power in this country. A fundamental principle underlying federal and state constitutions has been the fragmentation of power among multiple institutions and levels of government. There is a cost to such fragmentation, of course, and every once in awhile one hears calls of frustration for an "energy czar," or a "housing czar"--a mythical figure who can make the trains run on time while

conducting himself like Mother Theresa. The Reagan administration has put a major emphasis on the role of the market in fragmenting power. In so doing, its deregulatory policies have pushed against the fragmentation of power among the different levels of government. Yes, it has relinquished governmental power to the private sector. But to accomplish this, it has shifted, at least in telecommunications, the balance of federalism between the central government and the states. Having to choose between deregulation and decentralization, it chose deregulation. Or, perhaps more accurately, the Administration perhaps did not notice that it was strengthening centralization, because much of it was in the context of eliminating regulatory restrictions. But once one establishes power to make states conform to one's regulatory policy, whether this regulatory policy is lenient or strict can always be reversed by a future administration. This centralization of regulatory power should give pause to conservatives, who should ask themselves whether this wholesale preemption is in their long term interest.

A decentralized structure also contributes to flexibility, proximity, and accountability in regulation. Different local circumstances require different solutions. Different environments prefer different arrangements. Also, non-uniformity states provide a mechanism for change. As Justice Brandeis wrote in a dissent, "It is one of the happy incidents of the federal sytem that a single courageous state may, if its citizens choose,

serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."

In the field of telecommunications, this country has gone through two decades of continued technological regulatory change. Other industrialized countries have had a much harder time in this transformation.

In America, in contrast to Europe, there was never a comprehensive blueprint for telecommunications reform, but there was steady and gradual change through the piecemeal and decentralized actions of many governmental units, courts, and private intitiatives.

The problem with these points in favor of federalism is that they do not fully explain what has been happening. The problem with analyzing federalism is that it is impossible to discuss the process and the distribution of power among different governments without reference to the policy outcomes. What is at stake is not which level of government makes decisions, but rather what kinds of decisions are being made. For example, when it comes to civil rights, liberals were all in favor of the federal government, and many conservatives in favor of states' rights, because they felt that their views were better served by these respective levels of government. Now that a conservative administration resides in Washington and appoints commissioners and judges, many liberals are discovering their devotion to the states, while many conservatives are frustrated with the states' obstruction of national deregulatory policy. People seem

to be fairly opportunistic about this. I once did a statistical study of eleven hundred building codes, looking at the factors that lead some locations to choose national standards, and others to establish purely local ones, and what one finds is that the primary explanation is not ideological, but outcome-oriented, and pragmatically dependent on interest group strength. Whichever interest group happened to control the local building department strongly preferred local standards, and did not want its influence diluted on the national level.

Now, what can one do about this trend towards federal predominence? One must be skeptical about the chances of using the federal courts to reduce much of the FCC's preemptive power. The general argument, to simplify, has been that much of telecommunications is tied into an interstate system, for which the FCC sets policy, and that the FCC's affirmative choice not to regulate constitutes a policy which the states may not frustrate.

The courts pretty much have gone along with this argument. In General Telephone Company of California v. FCC, Chief Judge Warren Burger, who was then a D.C. Circuit Judge, upheld an FCC preemption with the following words:

"Any other determination would tend to fragment the regulation of a communications activity which cannot be regulated on any realistic basis except by the central authority; fifty states and myriad local authorities cannot effectively deal with bits and pieces of what is really a unified system of communication."

Furthermore, it is likely that the federal appellate courts,

after the substantial number of court appointments by the Reagan Administration of influential and articulate judges with a Chicago economics bent--such as Bork, Posner, Easterbrook, Winter, Scalia, etc.--will be much more sympathetic to the substance of FCC deregulatory policies. This agreeement on the substantive level is likely to create some rationalizations for going along with procedural preemption.

The second approach to reverse the trend towards centralization is through the legislative process. By enlisting Congress and the governors, the states have on occasion put the FCC on the defensive and forced it to negotiate with the states and to compromise with them. This has in the last two years invigorated in several instances the Joint Board process. But it has been rare for legislation restricting the FCC to be passed. In fact, the major recent instance in which Congress took away some of the FCC's regulatory powers was the 1984 Cable Act, which took significantly more of the powers of the state and local governments. So one should not count too much on Congress. If anything, Congress will assign more regulatory power to itself rather than to the states.

On a a more general level, the problem of the states being expelled from so much of telecommunications policy decision may have to do with the fact that they do not usually come out on both the left and the right of the federal policy, but pretty consistently on the 'redistribution' side. In an ideal federal system, the national policy would be best placed roughly in the

center of the distribution of state policies. If that is the case, the national policy has a lot of acceptability. At the same time, it is then also more acceptable to leave policy to the states, because, on average, their policies are similar to the federal ones. In such a federal system one gets policy diversity, but not a fundamentally different policy. That, roughly, was the situation before the FCC embarked on its deregulation. But most state commissions did not follow. This is what makes the question of state vs. federal jurisdication not a question of process, but a question of policy outcome. Ironically, if the states were more evenly distributed on both sides of federal policy--that is, if they would be less uniform in their positions--they may well play a greater role.

This leads to the question of why the states and federal policies have been so different, and whether this is a permanent condition. There are the facts of electoral politics, of course, but some states have free-market oriented governors and still their regulatory policies in telecommunications are less free-market oriented than those of the FCC. It should be remembered that in many other fields of regulation, state rules tend to be more lenient than the federal ones. Take for example environmental or securities regulation. Maybe it is helpful to think of competition in regulation among the states in some areas. In corporate law, for example, the states, led by Delaware, have been involved for decades in a slide in their strictness which one former SEC Chairman has called the "race to

the bottom." On the other hand, when it comes to nuclear or chemical dumps, each state likes to regulate the activity out of its own territory right into its neighbor's back yard, and there is therefore some overregulation by the states.

Now, what is the situation in telecommunications? The state regulators are much closer to the people and policies than their federal cousins. They have to face the main losers of deregulation, the subsidized lower and middle class residential customers. In the past, the states were able to impose redistributory obligations on the telephone carriers and on some of their customers, beause the telephone company was not going to move to Delaware. In fact, the local telephone companies accepted these burdens, because they received a quid pro quo--namely protection from competition. And even for the larger users who paid some of the bills, these were too small a share of the costs of doing business to make them move away to another state with lower phone rates.

If the losers of deregulation are readily identified and require no invitation to make themselves heard, the benefits of deregulation are highly abstract -- things like productivity trends and efficiency -- and the beneficiaries are companies that reside far away in Silicon Valley, Westchester County or Taiwan. For each state then, there were many in-state -- and voting -- losers, and primarily out-of-state -- and corporate -- winners. It is therefore not surprising that states tended to over-regulate. Less than ten years ago, a good number of states

would not even permit competition in terminal equipment! If one can buy today a phone for less than $10 at the hardware store, it is not because of policy initiatives by the states. This must be said.

Now, to be fair, the federal level has been subject to another form of imbalance. It has been focused on eliminating the inefficiency of restrictions, and has not considered that telephone service is also a social service and that the public network has become part of the social fabric. The logical solution would have been to substitute open subsidies for the hidden ones of the regulated sytem. But for that, the FCC has no mandate, and Congress, which does, already has a $200 billion deficit on its hands, and redistribution is not a priority. Not having to consider the effects on subsidies, and indeed ideologically inclined to view all subsidies as wasteful if not sinful, the FCC underregulated in the sense of creating a lot of uncompensated losers. And where did these losers go to complain? To the state commissions, of course, since they were closer, more responsive, and more sympathetic. The state commissions found themselves having, in fact, to hold more than ever the redistributory bag in order to alleviate the impact of the federal policies. The various local service rate increases and life-line schemes are good examples. The state commissions also had to bear some of the administrative cost of the new federal policies.

Thus, whereas in the earlier days the federal policies in

the long distance field provided a source of revenue for the state policies of redistribution and subsidy, it has now become the reverse, with states helping to make the FCC policies politically acceptable by taking care of some of its fallout -- its negative externalities, as economists might say.

What makes the dispute between the states and the FCC so unfair as a fight is that the FCC has all the advantages. It is pretty free from direct presidential interferance. One major exception was in the mass media field, in something called the rule on financial interest and syndication. This is a dispute between New York based networks and California based movie producers. President Reagan had FCC Chairman Mark Fowler show up and report to him in the Oval Office on the issue, reportedly Fowler's only visit to the Oval Office. Given President Reagan's earlier professional and geographic ties, it is not hard to guess where his sympathies lie. The proposed deregulation favoring the networks was shelved. But that, and the Orion satellite application, were exceptions.

What makes the policy fight particularly unwinnable for the state is that the FCC is both a combatant and the umpire. Simply by defining an area as interstate in nature, the FCC wins virtually every argument. Government agencies often fight over turf and policy, but here we have a situation where the agency can expand its turf to suit its desired outcome. For example, just last year in the Hecht case, a private network that was physically entirely intrastate was held to be really interstate

in nature, and thus federal rather than Maryland rules applied. No wonder that the FCC's jurisdiction is steadily increasing! And this process is cumulative. It is pretty rare for an agency voluntarily to give up power once acquired. It is a bit like broadcasting in France, where an opposition party will relentlessly attack the government's control over television, until it comes to power itself. And each new Commission will add jurisdictional power in those areas of particular concern to itself. This cumulative process could go on for a good while. It has been made possible by the peculiar notion which the courts have accepted that the FCC is accorded much deference in determining the scope of its interstate regulatory jurisdiction, and not just on the substantive issues of regulation. Once you accept this, the role of the states is at the pleasure of the FCC. And this is not in the public interest in constitutional terms. It runs counter to the legislative history of the 1934 Act -- which was, after all, a piece of New Deal legislation -- and it is bad in terms of the division of power in a federal state.

The irony is that it is a conservative administration that has been adding so much to the power of central government regulation over the states, given the importance of home rule and states' rights int he conservative set of values.

To conclude: it is difficult to see how this situation can be changed. It would take, first, a much more skeptical attitude on the part of the courts to an expansion of jurisdiction by

preemption. Since 1983, there have been several cases outside of telecommunications, (Arkansas Electric, Pacific Gas and Electric, Silkwood, Hillsborough County, Hayfield Northern Railroad), which have come out on the states' side when the state action had a different rationale or method from the federal one, or where there was no clear congressional intent, or when the cost to pursue the congressional intent had become prohibitive. On the other hand, the court in the landmark Garcia decision last year undercut much of the Tenth Amendment defense against preemption. So in sum, I would not want to stake the future of state regulation on the courts. We will be soon enlightened when the Court views the depreciation case before it.

More fundamental would be to amend the underlying Act to reflect more specifically a jurisdictional boundary between the state and federal level, whatever it should be, rather than to leave this to the do-it-yourself jurisdictional discretion of an agency. But, any legislative change seems much more likely to happen if the states' policies are, as I discussed before, more widely distributed along the spectrum from strict regulation to substantial deregulation, and thus less different in policy outcome from the FCC than in the past. Is this likely? We are already seeing a widening of the spectrum of state policies. For example, on an issue such as shared tenant services, neighboring states like Texas and Oklahoma have arrived at radically differing policies. In the future, we should expect much more divergence. Similar divergence exists in intrastate

interexchange service. Why? Because states will begin to compete with each other in their telecommunications infrastructure, its price, and policy. As telecommunications becomes a major expense item for many service businesses, and as service variety becomes important, state telecommunications policy will try to attract firms to move, or to persuade them to stay, and it will be part of an industrial policy. For some states, the strategy will be to become low cost telecommunications havens. When, through such mechanisms, states will be more similar to the federal policy, they wil again play a more significant role in the regulatory system. This is a mechanism for regaining regulatory power for the states, but it is at the cost of state policies becoming more in line with the FCC's free-market philosophy.

Now, I do not know if this has been an optimistic or pessimistic message, but I do not see other forces restoring the states' powers. Thank you very much.