Five faulty premises, part 4: Innovation requires open access and an open Internet

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In this installment in a series of blogs based on my recentFree State Foundation Perspectives article, I look at the fourth of five faulty premises, that innovation requires open access, and in particular a (so-called) open Internet. While this isn't directly responsive to FCC Chairman Wheeler's announcement yesterday of his plans to initiate a new Open Internet rulemaking, given this faulty premise's relevance to the subject I offer some comments on such a rulemaking at the end.

This faulty premise is a doozy. It is the beautiful premise that launched a thousand ships on the sea of Network Neutrality. But its beauty is skin deep. While it is true that open access can facilitate some types of innovation, it both precludes other forms of innovation and imposes costs of its own. In the telecommunications context, open access is mostly about network neutrality – the idea that broadband providers should not be able to charge users or content providers for preferential access to specific services, let alone block specific content or services entirely (absent some compelling legal or technical justification).

It is unquestionably the case that open access can facilitate certain types of innovation. It reduces R&D and other transaction costs (especially search and negotiation costs to get permission or access to use existing infrastructure) and reduces opportunities for rent extraction by those who otherwise control an infrastructure. On the other hand, it makes some forms of innovation more expensive or difficult to implement. There are substantial literatures showing the benefits of vertical integration and the importance of defining proper modular boundaries. Nowadays, however, this point can be made more simply: Apple's hardware and software designs are part of a tightly-controlled, vertically integrated, closed product ecosystem. Apple would not exist if we had the equivalent of network neutrality for computer hardware or software. This does not mean that either an open or a closed model is necessarily better in any given case; it does mean that we want a more nuanced approach than one that mandates either approach in every situation.

The scale is tipped even further against mandated open access in the case of the Internet. This is because the Internet is a two-sided market – a market in which two or more distinct groups of consumers are brought together via some intermediary platform. That is, users and Internet content providers (e.g., firms like Google, Facebook, and Netflix) reach each other via the Internet. I looked at this issue in some depth in a prior FSF Perspectives piece; indeed, I first explored some of the early literature on multi-sided markets and the implications multi-sidedness has on the Network Neutrality debate in a 2006 article.

The crux of the two-sided markets analysis is that the platform that brings the different sides together – that is, broadband Internet access providers – ordinarily charge either or both sides of the market for access to the other. How much to charge each side, including whether to charge either side nothing or even to subsidize one side's access to the platform, involves a complex set of tradeoffs – and, most important, how much each side is charged can have substantial effects on the social value of the network. Critically, and I will say this in italics because it is so important, *the literature studying two-sided markets consistently shows that there is no reason to believe that a network neutrality rule benefits consumers, and consistently shows that such a rule can harm consumers*.

A network neutrality rule is really little more than a subsidy from the consumer side of the market to the content provider side of the market. Some, but not all, content providers benefit from this rule. Other content providers may be harmed by such a rule – especially those who offer, or would like to develop, services that would benefit from enhanced quality of service features or other features that may require some integration with Internet service providers.

Even more problematic, a network neutrality rule can harm consumers. It prevents ISPs and content providers from working together to offer innovative new products that consumers want. More tragic, it prevents these providers from developing lower-cost service packages – packages that could expand opportunities for access to currently underserved and disadvantaged communities. These rules likely increase cost of access and limit the development of potentially cheaper offerings that are more responsive to consumer demands – this is exactly the opposite of good telecom policy.

This point relates back to a concern in the first faulty premise considered in this series: the paramount importance of respecting consumer preferences, and not substituting the Washington-Silicon Valley-Ivory Tower views of what consumers should want for what they actually do want (and, more importantly, need).

By requiring that every consumer's Internet connection offers full-fare, first-class service, complete with movies, television, and free drink service, we price consumers who would be happy with discounted-fare economy Internet service out of the market.

I don't mean to give away the barn. The key takeaways from the literature in this field are all nuanced – different price structures "can" or "may" benefit or harm consumers. In some cases, "non-neutral" price structures may benefit consumers, in some it may harm them, and conversely. (Noted paraleptically, my own reading of the literature suggests that, given current market structures, non-neutral pricing is likely to be better for consumers than neutral pricing.) But this does not mean that we should prescribe *ex ante* prophylactic pricing rules – rather, it means that we should monitor conduct and pricing in the Internet ecosystem and be ready to bring *ex post* actions against pricing decisions that are demonstrably harmful to consumers.

Some additional comments bear mention in light of FCC Chairman Wheeler's announcement yesterday that a renewed Open Internet rulemaking process is in the offing. The goal of those rules must be to protect consumers, not to protect content companies. What's good for Google is not necessarily good for America.

Whatever rules the Commission may ultimately adopt, the Commission should be careful that they do not proscribe pro-consumer conduct. Given the difficulty of knowing ex ante whether any specific conduct is likely to benefit or harm consumers, whatever rules the Commission ultimately adopts likely should be limited to general principles – they should not define conduct that is to be prospectively permitted or prohibited, but rather (at most) indicate certain types of conduct that may bear scrutiny from the agency and the terms under which that conduct will be evaluated. Should the Commission take such an approach, it may yet craft an approach that passes judicial muster, provides useful guidance to agencies, and – most important – protects consumers from harmful conduct on the one hand while allowing them to benefit from pro-consumer innovation on the other.