Episode 351 - The Bad Economics of Net Neutrality
Guest: Peter Klein
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WOODS: Last time you were on we were smacking down Marxism. I can't even remember. There must have been some guy had written an article about how Marx was actually pretty cool contrary to what you rubes think, and we spent two episodes refuting that. I will link to those in the show notes for today's episode. Today is episode 351, if you can believe that, Peter, so the show notes page will be tomwoods.com/351, and I will link to your article that you did some time ago about the government and the Internet and the private sector making it glorious. We'll get to that before we're finished talking today, but right now I want to talk about the subject of net neutrality, which has come up a couple of times on the show in the past, but now there is a terrific urgency behind this topic because of this policy by the FCC that's been announced. So why don't we start off with you explaining to us in the most layman terms you can possibly do what net neutrality is all about.

KLEIN: Sure, well everybody is familiar with the basics of how the Internet works, right? Any sorts of devices that are connected, computers, phones, nowadays your garage door opener, and so forth. They are connected to this network where bits of information can be exchanged back and forth. The technology that Internet connections use is fundamentally different from the old-fashioned telephone technology that, Tom, those of your listeners who are our age or older will remember, where you pick up the phone and you call somebody, and when you speak to somebody on an old-fashioned telephone call you have one dedicated line, and when I speak, you hear me—when you speak, I hear you. But nobody else can use that line for the duration of our call. It's almost like you had a little roadway, and once I connect, we have a private roadway, and we can drive back and forth upon it unlike a modern interstate highway where lots of people get onto this big, thick multi-lane road, and some people get on here, and some people get off here. We share this large resource, and then people get off where they want to get off. So Internet communication works that way. We have these big, thick pipes, if you want to think of them as pipes with lots of people's data all jumbled together traveling down through the same pipe, and your little bit of information gets on here, and it goes one direction and then another. It gets off someplace else.

Meanwhile it's sharing the main road with lots of other people's little bits of information.

There are a lot of advantages to using that kind of model over the old-fashioned model, but the problem is obvious to anybody who's ever ridden on a multi-lane freeway in L.A. or New York, or Chicago, or any big city: namely, you get congestion. You get traffic jams. So the Internet also suffers from traffic jams. What the telecom companies and so-called Internet service providers and other have been trying to do is figure out a way to deal with the traffic jams. One way is to try to have toll roads or even sort of fast lanes just like on the highway. In some places if you have a carpool, you can go in a lane that's less congested and go faster. If you have a special kind of monthly pass when you get to a toll booth, you can zip right on through instead of having to stop and pay the toll. So net neutrality is a set of policies that are designed to prevent companies and organizations that manage these large, shared parts of the Internet from imposing any kind of distinctions among different users. It's to prevent anybody from letting certain streams of data go faster through a fast lane, where other streams of data go more slowly. It prevents charging prices to data streams that use these big trunk lines depending on how much the users are willing to pay. It essentially treats the Internet as a public utility that must be open to all, free to all—no prices can be charged to anybody, and naturally, that creates sort of the big mess, the tragedy of the commons that we'll all familiar with.

WOODS: All right, that is actually a very accessible explanation. I do think that there will be people who will respond to your description of a world in which prices can't be charged, in which there is a kind of forced equality going on in terms of information transmission, as a desirable thing—that they look at prices as being things that constrict our choices, that confine us, that are the opposite of freedom. Whereas, when you have government-imposed equality, this is vastly better for everybody because now we don't have to be reliant on large corporations that might discriminate on an arbitrary basis.

KLEIN: Right.

WOODS: I am trying to give you the classic, progressive response. So what's the libertarian answer?

KLEIN: I think there are a couple of different ways to think about it. One is more conceptual and theoretical, and you have already alluded to it in your comments, namely, that those who understand how markets work believe that scarce resources are most effectively allocated through some kind of competitive price system, that there just isn't enough stuff to go around so that everybody could have everything he or she could possibly want, like some kind of Marxist utopia. It's a fantasy land to think that everybody can consume as much as he wants or whatever he needs without any sort of

restriction and using prices, and money and so forth is just a way for greedy capitalists to rip off other people. That's just Econ 101.

But there is the more technical issue that I think is relevant here as well, Tom. There is some people who support network neutrality rules, i.e., support allowing the government to regulate the Internet like a public utility, who would understand the basics of how markets work, and they would say, yes, there is only so much bread, and it's fine to have markets and prices allocate bread as long as people aren't starving and so forth. People, I think, mistakenly think that the Internet is different—that there is something different about networks and technology and peer-to-peer sharing that make that a whole different ballgame, or to be more specific in this case, a lot of people think that Internet bandwidth is not a scarce resource, that it's essentially unlimited, that we can all dump as much data on the Internet that we want, and the only reason that Comcast or Century Link, or one of these ISPs that I am not defending, by the way, because they have a lot of other problems, but the only reason an ISP would ever charge a higher price to somebody who wants to stream Netflix, than the price is charged for somebody who just wants to send the occasional email. The only reason ISPs would do this is because they are greedy, rapacious SOBs, and they are trying to exploit their monopoly and power and take advantage of people and make them pay more and do something nefarious. But the problem with that is that Internet bandwidth is a scarce resource.

There is congestion on the Internet. Any of your listeners, Tom, who has ever had a video halt in the middle or had to wait for a video to buffer or couldn't get a page to load on their computer as fast as they wanted to, even when they are connected to their broadband Wi-Fi network or whatever, understands that there is congestion on the Internet. That's obvious. Why is there congestion on the Internet? Because it's a "free" resource that isn't priced. So lots of heavy users just sort of dump their stuff on the Internet.

The simple example is Netflix. I am a Netflix subscriber. I think Netflix is a great company. It's a great product. I absolutely love it. But a recent study—a study that came out in the fall—estimated that something like 35% of all Internet traffic in the U.S. is Netflix. Think about it for just a moment. One single app is using about a third of all the Internet bandwidth that is out there in the U.S. That's why everything else you try to do on the Internet is congested and why there is buffering and lags and so on, because Netflix is using a huge chunk of the available data. Now, there's nothing wrong with hat. As I say, Netflix is a great service, but why shouldn't Netflix users pay an appropriate price to compensate other users for the fact that Netflix users are using so much bandwidth. In other words, if Comcast or one of these ISPs wants to charge Netflix a premium to let its data go through—some of which Netflix, of course, would pass on to its customers—that's a reasonable way to allocate the scarce bandwidth across

competing uses. Otherwise, we get the problem that nobody is satisfied—nobody can get what they want.

WOODS: Peter, let me raise an example that you used when you were talking to Jeff Deist on the Mises Weekends program recently. You gave the example of grocery store neutrality as a way of helping people understand what's involved here. Suppose we said that—in other words, we would think of a grocery store a place where there is a finite amount of shelf space where products can be displayed, and you can have special display cases that companies can pay for, and companies can pay to have a display at the front of the store so that as you walk in, you see a particular kind of beer, or you get certain shelf placement of your product, and this is just a part of free contract between different companies and that there's no problem with that, and that if we were to say we need grocery store neutrality, that would be to say that nobody is allowed to do this. There is no way for you to negotiate a better spot on the shelf.

But I think with that example, which resonates very well with me and helps me understand the issue better, I bet the same kind of critics would say, well, that is a bad thing. We *should* have grocery store neutrality because it means that the long-standing firms that have all this money from their big profits can afford to continue to perpetuate their dominance by getting good shelf space, and that's not a good thing. We need to enforce equality here. How would you answer that?

KLEIN: Yeah, again, there are two ways to address that kind of complaint, theoretical and practical. On a theoretical level, the mindset that you just described: It represents a fundamental confusion about economics, about resources, and markets. There is no such thing as neutrality in that sense, nor would we ever want there to be neutrality in that sense. Tom, I am sure you've had other episodes where people talked about so-called perfect competition and why modern antitrust and regulatory policy goes wrong because it assumes that there is some ideal state where everything is free and open and nobody has any advantage over anybody else, and then evil capitalists swoop in and create monopolies and give people advantages and so forth. In reality, there is no neutrality or equality on markets or in the allocation of resources. There are so many resources available. Prices help to allocate those resources among competing uses, and prices are the profit mechanism to provide incentives for entrepreneurs to create or discover new and better resources—better uses of resources. It's this constant rough and tumble, hurly burly of free and open competition and innovation and creative destruction and so on that we want. That's what a market is.

So there is no neutrality in grocery store shelving or in communications or in anything. We don't want anything like that, even if it could exist. On a more practical level, if somebody doesn't like the grocery shelf example, we can try to come up with other examples and do a sort of *reductio ad absurdum*, you know, if you're waiting at home for a plumber to come by your house and fix a leaky faucet, you can't just snap your

fingers and have the genie, the plumber genie show up and fix it on the spot. Wherever you live, there are so many plumbers, and there are so many customers who want a plumber to come over to their house. Somebody is going to have to wait, and most of us are used to a system where the plumber says, well, I will be there between 8:00 and 1:00 and you sit there—wait, wait, wait—and maybe the plumber shows up and maybe the plumber doesn't.

What if there were an app on your phone where you could say, I need plumbing—a sort of Uber of plumbing, and you say this is what I want, this is how much I am willing to pay. I have a really bad problem. The basement is flooded. I've got to get somebody over now. It's doing hundreds of dollars of damage to my home. I would pay $300 to have a plumber here in 30 minutes. And there is some other guy who has a little, tiny drip in the sink. It's no big deal. It's just a minor annoyance. He wouldn't pay more than $50 to have that service done. If you required plumbing neutrality where no plumber can go to one customer before going to another customer based on what customers are willing to pay, well, then the guy will the little minor annoying drip might get his fix first, and the guy whose basement is flooded might not get his problem solved for a week. Is that desirable? Is that effective? Is that fair to people? No, I don't think it is. Again, plumbing neutrality would only be feasible if we lived in a fantasy land where you could snap your fingers and instantly get plumbing fixed. If somebody doesn't like that example, we can keep coming up with others just to hammer home the idea that neutrality is not feasible in any kind of set of relationships between customers, retailers, wholesalers, and so on. We have to let them duke it out. We have to let people work it out through negotiation and trial and error and come up with ways to allocate resources that make sense.

WOODS: Peter, assuming all this gets implemented, what do you fear will be the results?

KLEIN: Yeah, well, there at least two sets of concerns—just in terms of the technology of the Internet, essentially the SEC rule was to change the legal form under which the SEC regulates the Internet to change the classification of the Internet from one kind of activity to another with the statutes that apply now to give the government the ability to control pricing, to control access, essentially to regulate almost every aspect of Internet traffic the way they can regulate electric utilities and so forth. The problem for that is, of course, now all the congestion problems that I describe will simply become worse. Performance on the Internet will become worse. There will be more lags. It will be more difficult to get different apps to run. People will become increasingly dissatisfied with the performance of the network. Entrepreneurs will have reduced incentives to innovate not only for coming up with apps or websites, but for coming up with different technologies of sending out information on the Internet.

Just as an aside, Tom, I think the net neutrality crowd also misunderstands what innovation on the Internet is. They think that the backbone, the infrastructure, the technology for moving bits of information around, that's fixed for all time, that has to be neutral. But then we want entrepreneurs to compete in coming up with a new game or a new website or a new app or whatever.

But I say, why shouldn't they also compete in the delivery of the information? Why shouldn't they compete on the purely technological side of having this app from one home or business to another? Net neutrality stymies any incentives entrepreneurs might face for innovating in that way.

But the scariest thing—the thing that I worry about and lots of people are worrying about—is that government will now start to control content as well just as old-fashioned network television. Tom, you and I grew up in the era where there were three or four TV channels, and the government regulated, the Federal Communications Commission, regulated what could go on them. George Carlin's famous, I don't know, what is it? Seven dirty words or whatever? There were certain words that could not be said on network television. Why was network news so bland and so pro-government? Well, because the only way to get FCC approval was to have people like Walter Cronkite, who basically said whatever the government officials wanted him to say. If the government can regulate pricing and access on the Internet, then the government can regulate content on the Internet as well—so censorship, retaliation, and so forth—you can imagine a world in which people are afraid to express controversial opinions, and you would wouldn't see on the Internet for fear of government reprisal, and what will that do to fine websites like tomwoods.com?

WOODS: I shudder to think, Peter, what could happen to tomwoods.com. Let me ask you before I let you go—one final thing, and I will refer people—I wanted to get to your article, but we didn't. You have an article from some time ago about how the private sector really made the Internet glorious. It's very much worth reading. Check it out at tomwoods.com/351. But can you just say something briefly before you go about the idea of natural monopoly, any flaws with it, and its applicability in the case of the Internet?

KLEIN: Yes, natural monopoly is an economic theory that holds that there are certain markets in which the technical aspects of production are such that you can only have one firm in the industry. It makes sense only to have one firm in the industry. For example, you have very high initial, up-front investments, but then once somebody is up and running, it's very difficult for anyone else to come in and compete because the marginal cost once you are already up and running is very small. So like with electricity, you know, it's very expensive to build a power plant. Once you have the power plant built, it doesn't cost much for the producer to produce one more kilowatt hour of electricity. Therefore, once a power company is already up and running, no other power

companies can come in and compete, because they have to build the power plant. Whereas the first guy has already got his power plant built. It's a way of saying there are some markets where you can't have competition. You can only have one firm in the market. It's only efficient to have one firm in the market.

Therefore, according to proponents of this theory, we should have only one firm in the market, but the government should heavily regulate and constrain that firm to make sure it doesn't take advantage of consumers. There's a lot of good Austrian literature by people like Dominick Armentano, Tom DiLorenzo, Murray Rothbard on why the natural monopoly argument is flawed. It takes technology as fixed. It doesn't allow for entrepreneurship and innovation. It has an overly narrow view of what it means to compete and so forth. So basically, there are no natural monopolies in the sense that proponents use that term. There are always competitive alternatives.

And the application to the Internet is that it's not the case that we can't compete for the actual back-end functions of the Internet—that they have to be a monopoly controlled by the government. If you think about different—again, to see this as really easy to think about innovation. Tom, when people first started getting so-called, well, when we first had Internet to our homes and offices, most people had a dial-up connection. You remember AOL and CompuServe and these things?

WOODS: Oh, yeah.

KLEIN: You would dial up on your telephone line and get a slow connection. Then we got broadband through cable and DSL. People would say, oh, well, there's only one cable provider in my neighborhood. They have a monopoly. I have no choice. Yeah, but if you have a 4G cell phone, right? You can get almost broadband speed on your cell phone. If you have a satellite dish, you can get broadband for your satellite. If there is a Starbucks in your neighborhood, you can go to Starbucks and surf on their network for free. In other words, entrepreneurs are always coming up with new ways to do things, and the fact that there may be one particular moment where for one particular customer, the options for accessing the Internet are limited, but through competition, entrepreneurs, and innovation, there are always new alternatives coming on to the scene, and we don't want a regulatory system that makes it difficult for entrepreneurs to do what they do.

WOODS: Well, Peter, I am going to leave it there. I will link also to—I know about Tom's article, major article on natural monopoly, Tom DiLorenzo, so I will link to that at tomwoods.com/351 as well. I appreciate your time with us today, particularly on short notice, but we have to be informed on what's going on here, and having read what you've written and then heard your interview with Jeff Deist, I thought Peter Klein is our man. Thanks again, Peter.

KLEIN: Oh, thanks, Tom, it's always a pleasure to be with you.