FINANCIAL MARKETS AND
THE AT&T ANTITRUST SETTLEMENT

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INTRODUCTION

The 1982 Justice Department (DOJ) settlement with AT&T ended one of the major antitrust actions in U.S. history. The action involved the nation’s largest corporation. It encompassed services provided to practically every U.S. citizen, and marked a watershed in the history of U.S. telecommunications (Kovaleff, 1989).

The settlement spawned a family of “Little Bells,” and left AT&T to provide long distance services, to operate its Bell Laboratories division, and to run its Western Electric manufacturing subsidiary. AT&T was freed to enter previously closed markets including computers and satellite operations.

More to the point of this article, the settlement differed markedly from the DOJ’s announcements when the investigation was first opened, which is not atypical in antitrust negotiations. At the outset, the DOJ indicated AT&T might lose Western Electric. Uncertainty also surrounded the ultimate status of Bell Labs. When the dust settled, Western Electric and Bell Labs remained with AT&T.

The difference between the DOJ announcement and the settlement raises questions about how investors may have reacted to events along the way. For example, the Western Electric and Bell Labs outcomes seem to be a victory for AT&T, as did the opportunity AT&T received to enter the satellite and computer businesses. If AT&T investors gained from these outcomes, is there evidence that shareholders in the satellite and computer businesses lost wealth?

Following the research path of others (Burns, 1977; Eckbo and Wier, 1980), this article reports the first financial markets investigation of key events in the AT&T settlement. We present evidence that investors in financial markets made estimates of marginal portfolio effects in the AT&T case, evidence which lends some support to the special interest theory. In our research, we examined the movement of portfolios of stocks, AT&T and others, in association with three antitrust events: (1) the 20 November 1974, DOJ announcement that it was proceeding against AT&T; (2) the 8 January 1982 settlement decree announcement, which was mild relative to the initial charges; and (3) the 11 August 1982 settlement modification announced by Judge Harold H. Greene of the U.S. District Court (D.C.), described in detail later. The
research path we followed allowed daily portfolio movements to inform us about wealth effects associated with the three actions. The portfolios we analyze include AT&T, other firms in long-distance communications, firms that operate in the satellite industry, and computer manufacturers. The firms we included were selected from those with the same SIC code designation found in the Center for Research in Securities Pricing tapes. When identifying AT&T competitors, we selected firms we believed to be viable competitors in the long-distance telecommunications market.

At the margins of action, we find the owners of AT&T lost wealth with the DOJ announcement that it was investigating AT&T, but gained at the margin with the settlement. Looking elsewhere, we find AT&T's long-distance competitors gained wealth with the announced investigation, but lost with the settlement. The evidence of lost portfolio values for AT&T competitors is consistent with the theory that consumers gained lower priced long-distance service. Firms in the satellite industry, opened to AT&T by the settlement, lost wealth with the settlement. The satellite evidence suggests the development of a more competitive market and associated consumer gains. Computer firm shareholders were unaffected by the three events, and Judge Greene's modification had no discernible portfolio effects.

The article proceeds as follows: Part two gives a regulatory interpretation of AT&T's evolved position at the time the DOJ action was forming. Tracing the history of AT&T through the time of the settlement, the discussion develops around a special interest theme, but public interest arguments are also presented. The formal basis of the DOJ suit is described, along with the potential industry effects. An ideal settlement, from AT&T's perspective, is provided just before the testable implications of the settlement process are listed. The following section describes the statistical experiments used to isolate the financial markets effects and reports results for four portfolios of stocks. Finally, the last section reviews the findings and provides some brief final thoughts.

**AT&T'S CHANGING REGULATORY ENVIRONMENT**

**From Emerging Competition to Regulated Markets**

For many years, we believe, AT&T and its ancestor firms benefitted from regulation. Instead of being a straitjacket that constrained profitable movement, regulation, when it came, was more like a comfortable tweed jacket. Initially, the firm's market position was protected by patents, which became intertwined with Western Electric's production monopoly. Then, when patents expired and competition emerged, the firm strenuously sought federal regulation by promoting the notion of natural monopolies and rate of return regulation (Olasky, 1987).

Eventually, arguments about the elimination of wasteful competition, interconnected single networks, declining average costs, and universal service won popular support. In 1910, Congress gave the Interstate Commerce Commission regulatory powers over interstate telephone companies (AT&T); in 1921, telephone and tele-

graph mergers were immunized from antitrust scrutiny; and in 1934, Congress created the Federal Communications Commission (FCC) to regulate interstate telephone service. AT&T was in monopoly in long-distance service, virtual monopoly in local service, and monopoly in related research and manufacturing resulted. At the same time, AT&T was denied the right to enter certain businesses, like telegraph and satellite communications.

**The Emergence of Regulatory Constraints**

In time, what had become comfortable regulation gradually began to constrain AT&T's ability to compete in changing markets. Technological change made obsolete AT&T's regulatory clothing, which had allowed for profitable long-distance operations that subsidized local service and placated state regulators (Hamin and Galambos, 1987). When the regulatory dam cracked, microwave-based firms entered the profitable long-distance market and sought to skim the extra profits; no competitor wanted to enter and seize AT&T's local service where rates had been subsidized by long-distance users (McAvoy and Robinson, 1983). "Mr Bell" faltered.

**Antitrust Action Begins**

AT&T cut prices in the face of new competition and apparently reduced prices where new entry was expected. In the struggle to adjust to competitive entry by MCI, a microwave telecommunications firm, AT&T became the subject of a private antitrust suit. MCI sued and complained to the DOJ. MCI's complaint, which alleged anticompetitive pricing and "preemptive strikes" on the part of AT&T joined those of other independent telecommunications firms. MCI's suit was ultimately unsuccessful, but on 20 November 1974, the DOJ filed suit against AT&T, Western Electric, and Bell Telephone Laboratories.

Brought under the Sherman Act, Section Two, the DOJ alleged AT&T had illegally manipulated its dominant position in local telephone, long-distance telephone, and telecommunications equipment markets. AT&T was also accused of refusing to provide competitors with local interconnection service and of setting entry-inhibiting prices in potentially competitive parts of its business. As a remedy, the DOJ proposed divestiture of Western Electric and the local telephone providers. The matter of Bell Laboratories, which raised only mild antitrust questions regarding advantage from vertical integration, was left on the table.

**The Ideal Settlement**

The DOJ complaint smacks of orthodox public interest logic. Even though AT&T was regulated at every turn, the firm allegedly had abused its position. High profits made in some markets, it was alleged, provided a cross subsidy for other markets, which was seen as evidence of abusive monopoly power. Entry attempts were met with below cost prices. AT&T could always appeal for and expect to get a reasonable
return on its investment; and its investment was based on past regulatory decisions that barred entry and perpetuated a particular technology, so the argument went. All along, the deadweight loss of restricted output was borne by consumers. Following this public interest theme, the DOJ would have sought to obtain a court decision or settlement stripping AT&T of Western Electric and setting the local operating firms free to expand and compete without being hampered with equipment purchase and order AT&T mandates. We note here that the fact that AT&T's pricing had been subject to regulation raises a question about the efficiency of the FCC's regulatory procedures. Whatever AT&T had achieved was the result of FCC oversight.

With a public interest settlement, the new AT&T and other long-distance providers would be left to slug it out in the open market. What might be done with Bell Laboratories was a more complicated problem, since from the antitrust authority's position, the market for research and development was more difficult to analyze than that of telecommunications services and equipment. A special interest interpretation of the antitrust action asks us to reconsider what had happened to AT&T. Its regulatory environment had become obsolete and new competition had entered, but the firm had no way to escape the regulator's crippling grip. Somehow, the FCC had failed to maintain the regulatory walls. AT&T's market share was falling. By law, the firm had a duty to serve consumers in all its regulated markets. Its new competitors had no such duty. AT&T's Bell Labs held basic patents that had provided the technological basis for satellite communications and computer. But the firm was barred from entering these markets. Given this situation, a properly crafted antitrust settlement could be as beneficial to AT&T investors as the birth of federal regulation had been in 1910. But instead of spending resources to mount a public relations campaign as it did before, the firm had little choice but to invest in the work of lawyers who would fight the antitrust action and then handle a new regulatory environment.

From AT&T's standpoint, the ideal settlement or decision would allow AT&T to shed its subsidized local firms, hold to its core long-distance service business, keep its machinery and research and development divisions, and be allowed to enter any related business market it might choose to enter. Consumers would gain lower priced long-distance service; AT&T would be able to draw rents from its famous Bell Labs patent machine. In other words, if the antitrust train was headed in AT&T's direction, and it was, the ideal agreement seems to correspond more to the one that emerged in the settlement, not the one included in the initial DOJ complaint.

The Actual Settlement

The results of a negotiated settlement were announced on 8 January 1982. Two major bargains were struck. First, the DOJ agreed not to press for the divestiture of Western Electric and Bell Telephone Labs. AT&T agreed to divest 22 operating companies. Second, the DOJ agreed to lift its 1966 restrictions on the types of services and markets AT&T could provide and enter. The provisions of the agreement are as follows:

1. AT&T's 22 Associated Companies, termed "Bell Operating Companies" (BOCs) were to be divested, within eighteen months after court approval, as wholly separate business entities, forever independent of AT&T, without binding license and supply contracts, and fully capable technically, financially, and otherwise, of operating alone.

2. The BOCs were to be established as purely "natural monopolies," situated between the customer premise equipment and long-distance components, serving solely as interconnectors of subscribers with each other and with interexchange carriers providing long-distance service, only within the exchange component.

3. The BOCs were to be prohibited from operating in the long-distance component, providing information services not directly related to telecommunications, manufacturing products, and selling customer premise equipment (except under emergency conditions) [Bolling, 1985, 55-66].

The negotiated settlement required approval by the federal court, and Judge Greene surprised many observers by invoking the Tunney Act, which empowers the court to serve as an independent check on government antitrust actions to assure that settlement provisions are in the public interest. Judge Greene made some modifications, which affected primarily the timing of the disposal of the Baby Bells, and asserted his authority to oversee the implementation of the settlement.

How Investors at the Time Perceived the Effects

Based on this discussion, a timely examination of the movement of AT&T's stock, relative to the market, should provide the following evidence:

- Abnormal losses in wealth occur for AT&T when the DOJ announces its investigation and complaints. The DOJ proposal would strip AT&T of its losses (local Bells) and its winners (Western Electric and perhaps Bell Labs). The streamlined firm would be left to compete in a technologically fresh market.

- Abnormal gains in wealth occur when the DOJ settlement is presented. The settlement allows AT&T to keep Western Electric and Bell Labs and to rid itself of the subsidized local providers.

- Abnormal gains occur when Judge Greene asserts his authority over post-settlement activities. As a one-man FCC, he will abide predictably by the letter of the law.

Turning to the effects of the three events on a portfolio of AT&T's long-distance competitors, the story we have told predicts the following:
Abnormal gains will accrue to competitor shareholders when DOJ announces its investigation of AT&T. The complete disruption of AT&T will shear the firm of its management team, eliminate its research and manufacturing advantage, and reduce the firm to the status of wounded competitor.

Abnormal losses will be generated when the settlement is announced. Instead of facing a wounded competitor, the independent long-distance competitors face a slimmer long-distance provider with research, manufacturing, and patents intact.

No effects observed with Judge Greene's announcement. The settlement event was the determining factor.

For AT&T's potential competitors in the satellite and computer industries, we predict the following:

- No effects with the DOJ announced investigation. AT&T has no track record in the industries, and the antitrust investigation reveals no premise that AT&T will have any advantage in the new market. AT&T will enter without its machinery and R&D divisions.
- Negative effects with the settlement. Now, a new competitor emerges, one with brand-name recognition, deep research capabilities, especially in satellite technology, and manufacturing capabilities.
- No effect from Judge Greene's announcement. The settlement effects say it all.

THE FINANCIAL MARKET EFFECTS

The Financial Markets Model

Following the lines of Schwartz's [1981] analysis of regulatory actions and the related work of Burns [1977] and Eckbo and Wier [1985], we used the standard capital assets pricing model to estimate portfolio effects of the AT&T antitrust events. Our tests for abnormal returns address the predictions contained at the end of the previous section. In separate estimates, we isolated changes in systematic risk associated with each event. Our basic estimating equation, which was used for four portfolios, is written:

\[ R_i - \bar{R} = \beta_i + \beta_{D1} + \beta_{E} + \varepsilon_i \]

where \( R_i \) is the dividend adjusted return to the ith portfolio for time period \( t \); the intercept, \( \beta_i \), is the return on a riskless asset; \( \bar{R} \) is the return to the entire financial market. \( D1 \) is a dummy variable for the event in question, which tests for abnormal returns and is the standard technique used in event analysis. \( E \) is a normally distributed error term. We will report the details for our estimate of abnormal returns and discuss the results for systematic risk.

The Four Portfolio Three Events

Following the general procedures used by Eckbo and Wier [1985] in their investigation of antitrust practices, which used equally weighted portfolios of stocks from the same industries, we made estimates for four portfolios of NYSE and NASDAQ stocks, testing for returns relative to the overall markets in each case. The first, named AT&T, contains that one stock. The second portfolio, COMPETE, contains the following equally weighted telecommunications firms that participated in the long-distance telephone business at the time of the suit: Allied Telephone Co., Central Telephone and Utilities Corp.; Century Telephone Enterprises, Inc.; General Telephone & Electronics Corp.; Microwave Communications Inc.; and United Telecommunications. Seventeen firms in the computer industry, equally weighted, filled the third portfolio, COMPUTER, and five equally weighted firms from the satellite industry formed the fourth portfolio SATELLITE. All tests were run using the COMPUSTAT tapes for daily returns.

We estimated abnormal returns for three events, using 550 observations of data before and after each event. The first event is 21 November 1974, the day following the opening of the antitrust suit. That day is used because trading in AT&T stock was suspended on the day of the announcement. The second event is set for 11 January 1982, the Monday following the Friday, January 8, public announcement of the settlement. Again, trading was suspended on the day of the announcement. 11 August 1982, the date of Judge Greene's decision, is the third event. Our estimates proved robust in spite of the fact that investors were most likely forming opinions of the outcome as the events unfolded.

The results of our tests for abnormal returns are reported in Table 1. As indicated there, the AT&T portfolio experienced a 6.3 percent loss in association with the suit announcement. The coefficient is highly significant and negative. The COMPETE portfolio experienced a 2.9 percent gain, which is at the borderline of statistical significance. There are no significant gains or losses for the Satellite and Computer portfolios.

The announcement of the settlement is associated with a 4.0 percent gain in the AT&T portfolio, which is highly significant. Notice that the gain here is less than the loss experienced when the suit was opened. There is 5.0 percent loss experienced for the competitors' portfolio, COMPETE, which is also highly significant and more than twice the gain associated with the DOJ announcement of action. Apparently, investors in the stock of AT&T's competitors were discouraged by the settlement's outcome. With Bell Labs and Western Electric, AT&T would be a stronger long-distance competitor than if its research and manufacturing divisions had been shared away.

The COMPUTER portfolio registers no effect with the settlement. Even though AT&T is allowed to enter the computer industry, investors assigned no value to the settlement. We infer that AT&T was not viewed as a strong potential entrant. However, the owners of AT&T's new SATELLITE competitors experienced a 3.30 percent loss, which is statistically significant. Unlike investors in computers, the owners of satellite stocks were discouraged by the settlement. The results suggest that AT&T would be a viable satellite production and service firm.
Judge Greene's announcement that he would administer the decision caused no stock market ripples. None of the four portfolios are affected significantly by the event. We infer here that the added effects of judicial review were seen by daily investors as a non-event.

Other Tests and Summary

As mentioned earlier, we made event estimates that controlled for changes in systematic risk. The theoretical basis for these estimates, provided by Feltzman [1976], argues that regulation protects the sheltered firm from the full force of changes in economic activity. Of course, AT&T was the regulated firm. We made estimates of abnormal returns and changes in systematic risk for the AT&T portfolio.

The results of this experiment for abnormal returns were similar to those observed in the first estimate. However, the AT&T portfolio showed reductions in systematic risk and negative abnormal returns with the announcement. There was no evidence of changes in systematic risk found in the two remaining event tests. The evidence on abnormal returns was basically unchanged. We have no theoretical basis for interpreting the results other than to rely on the buffering theory. The theory suggests that AT&T's regulatory buffer would improve, even at the cost of abnormal losses.

In summary, our empirical work indicates that daily investors saw significant differences that developed in the AT&T case. The wealth of investors in AT&T was affected negatively when Western Electric and Bell Labs were potentially excluded, and then positively when the two divisions were maintained. The marginal losses were larger than the marginal gains. The wealth position of investors in AT&T's competitors is a mirror reflection of the results for AT&T's owners. They gained and lost, with the losses exceeding the gains. Owners of firms in the computer industry apparently viewed that AT&T would enter their crowded industry. There is no evidence of wealth effects. But the owners of firms in the satellite industry assigned significance to the action, at least to part of it. There were industry-specific effects of the episode. We can claim that instead of being stripped naked and thrown to competitive wolves, which the DOJ suit suggested could happen, AT&T was given a bit of armor as it left the old regulatory regime.

Investors in AT&T's long-distance competitors appear to have recognized armor when they saw it. Where they had gained with the prospect of a stripped AT&T, they lost when the armor was restored. The owners of firms in one industry AT&T could enter experienced negative effects. Our findings confirm what common sense suggests: potential competition matters. However, just what might be potential competition is sometimes hard to recognize.

<table>
<thead>
<tr>
<th>EVENT</th>
<th>AT&amp;T</th>
<th>COMPETE</th>
<th>COMPUTER</th>
<th>SATELLITE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nov. 21, 1974</td>
<td>CE</td>
<td>0.060</td>
<td>0.020</td>
<td>0.013</td>
</tr>
<tr>
<td></td>
<td>TR</td>
<td>-4.815A</td>
<td>1.601B</td>
<td>1.022</td>
</tr>
<tr>
<td></td>
<td>R2</td>
<td>0.462</td>
<td>0.397</td>
<td>0.636</td>
</tr>
<tr>
<td>Jan. 11, 1982</td>
<td>CE</td>
<td>0.040</td>
<td>-0.050</td>
<td>-0.002</td>
</tr>
<tr>
<td></td>
<td>TR</td>
<td>4.803A</td>
<td>-8.650A</td>
<td>-3.257</td>
</tr>
<tr>
<td></td>
<td>R2</td>
<td>0.161</td>
<td>0.521</td>
<td>0.666</td>
</tr>
<tr>
<td>Aug. 11, 1982</td>
<td>CE</td>
<td>0.032</td>
<td>0.008</td>
<td>0.005</td>
</tr>
<tr>
<td></td>
<td>TR</td>
<td>1.068</td>
<td>1.134</td>
<td>0.414</td>
</tr>
<tr>
<td></td>
<td>R2</td>
<td>0.375</td>
<td>0.560</td>
<td>0.688</td>
</tr>
</tbody>
</table>

The table presents the results for tests for abnormal returns on the key dates discussed in the text. The abbreviations are: CE = Coefficient Estimate for Abnormal return; TR = T ratio for the coefficient; R2 = R-squared for the equation. a: Indicates significance greater than the 5 percent level of confidence. b: Indicates significance at the 10.3 percent level. Results for the full equations are available upon request.

The antitrust episode, at least at the margin of daily investment activity. The gains, which came in the second stage of the episode, were smaller than the losses.

Given the limitations of our estimating procedures, we cannot determine the overall financial effects of the episode. We can claim that instead of being stripped naked and thrown to competitive wolves, which the DOJ suit suggested could happen, AT&T was given a bit of armor as it left the old regulatory regime.

Investors in AT&T's long-distance competitors appear to have recognized armor when they saw it. Where they had gained with the prospect of a stripped AT&T, they lost when the armor was restored. The owners of firms in one industry AT&T could enter experienced negative effects. Our findings confirm what common sense suggests: potential competition matters. However, just what might be potential competition is sometimes hard to recognize.
NOTES

We express appreciation to anonymous referees of this Journal and to Fred S. McChesney for helpful comments and criticisms.

1. Indeed, after the settlement of the AT&T and IBM cases, which were proceeding simultaneously for a period of time, the Antitrust Division of the DOJ allowed for a reorganization of 80 positions due to the closing of the cases. In March 1983, the Division had 101 attorneys assigned to the AT&T case; 39 were assigned to IBM ("What if they Had Broken Up IBM Like AT&T?" 1992).

2. In general, AT&T's reaction to common carrier communications, which arose in an earlier, 1956.

3. At this time, AT&T's reaction to the electronic publishing of antitrust consent decree was filed. However, the firm was denied entry to the electronic publishing scene until November 1983. According to the report, the market value of AT&T's common stock just before recently in Forlan. In 1988, the report, the market value of AT&T's common stock just before.

4. The amount of AT&T's common stock just before recently in Forlan. In 1988, the report, the market value of AT&T's common stock just before.

5. We call attention to the work of Burns (1987), one of the earliest efforts to apply financial markets analysis to antitrust actions. Burns provides detailed justification of the use of financial markets testing of such actions and explains how the earliest asset pricing model developed.

6. See note 1 for a complete listing of firms included in the portfolio.

7. The discount rate of AT&T's debt is the same rate as the discount rate on the Federal Reserve.

8. In the early 1980s, the discount rate for AT&T's debt was the same rate as the discount rate on the Federal Reserve.

9. The discount rate for AT&T's debt was the same rate as the discount rate on the Federal Reserve.

10. The discount rate for AT&T's debt was the same rate as the discount rate on the Federal Reserve.

11. Specifically, DOJ made the following allegations in its filing: "The antitrust combination and conspiracy to monopolize has consisted of a continuing agreement and concert of action among the defendant and the conspirators, the substantial terms of which have been and are: (a) That AT&T shall achieve and maintain control over the operations and policies of Western Electric, Bell Laboratories and the Bell Operating Companies; (b) That the defendant and co-conspirators shall attempt to prevent, restrain and eliminate competition from other telecommunications systems; (c) That Western Electric shall supply the telecommunications equipment requirements of the Bell System; (d) That defendants and co-conspirators shall attempt to prevent, restrain and eliminate competition from other manufacturers and suppliers of telecommunications equipment." AT&T was alleged to have obtained a U.S. monopoly for telecommunications services, submarkets thereof, and related equipment. Actual and potential competition had been restrained and eliminated, and consumers had been denied the benefits of free markets. (Bell, 1983, 49-50).

12. In a purely theoretical way, since we have no way of knowing how the DOJ might do so, it is curious that DOJ did not use the FCC for failing to serve the public interest. After all, the alleged AT&T abuses had occurred while the firm was regulated by the FCC.

13. AT&T should have been able to obtain the present value of rents generated by its patents through licensing arrangements. Theoretically, the royalties obtained would equal the additional profit the firm would make if it controlled the patents. Here we assume that AT&T's royalty arrangements were negotiated freely, without FCC interference. Brennan points out that the FCC in fact allowed market-determined royalties for Bell patents, so long as the payments were not excessive (Brennan, 1987, 775).


15. Petriko (1976) argues that a firm's regulatory environment can be a positive force. This might affect the protected firm's cost, a constraint of systematic risk. Petriko's argument is the basis for testing for changes in beta. We added a second variable to our basic equation in testing for systematic risk effects. The variable is formed by using an event dummy variable multiplied by the firm's return to the NYSE market. The dummy is set to zero for the event and is one otherwise. A significant change in the dummy coefficient is interpreted as a change in systematic risk. The firm's observed and expected returns are used in estimating the parameters of the equation. The regression coefficients are estimated using the ordinary least squares method.

16. The firms in the computer manufacturer, supplier and software industry are: Apple Computer, Inc.; IBM Corporation; Digital Equipment Corporation; Tandy Corporation; Hewlett-Packard Co.; Sun Microsystems, Inc.; Software Carat; NEC Corporation; NTT; and Fujitsu. The software companies are: Microsoft Corporation; Lotus Development Corporation; and Oracle Corporation. The computer suppliers and software industry firms are: Antec Corporation; Compaq Computer Corporation; NEC Corporation; and Yasuda Electronics Co., Ltd.

17. We note that the settlement between DOJ and AT&T was completed on January 6. The public announcement was delayed to allow time to inform AT&T top managers and a few key government officials.

18. We also note that estimates using five-year windows centered on the day of the event. In all cases that one, the results for abnormal returns were either similar or inferior. The estimate for Judge Greene's announcement was associated with positive abnormal returns for AT&T. We interpret the results to imply that Oliner's decision was known in advance and that AT&T investors were encouraged by the Judge's intervention.

19. We report levels of significance in the accompanying tables. Due to the Durbin-Watson statistic indicates no evidence of first-order autocorrelation.

20. A purely experimental analysis suggests that beta was just unstable at the rate of the estimate, which implies that investors were uncertain about the relative risk of AT&T.
REFERENCES


SPECIAL INTERESTS AND COMPARATIVE STATE POLICY:
AN ANALYSIS OF ENVIRONMENTAL QUALITY EXPENDITURES

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INTRODUCTION

The adoption of the National Environmental Policy Act and the establishment of the Environmental Protection Agency (EPA) in 1970 marked a shift in control of environmental regulation from the state and local governments to the federal government. Federal involvement in environmental matters reached its zenith during the 1970s with several important legislative actions, most notably the Clean Air Act and the Clean Water Act. The EPA, which is responsible for implementing federal air and water pollution legislation, saw its budget increased by over 50 percent during this period (in constant dollars). In contrast, the 1980s saw a return to relatively greater reliance on state and local government caused both by the Reagan administration's "New Federalism" policy and the need to implement the federal policies enacted during the 1970s and early 1980s. From 1980 to 1988, the EPA budget actually declined in real terms (Porteous, 1990).

Shifts from state to federal control of environmental policy can have at least two important effects. First, they create more or less homogeneity among states in environmental regulation. Second, they fundamentally change the political economy of policy formation. Much research has sought to explain the formation of regulation policy in general and environmental policy in particular. Stigler [1971] and Peltzman [1976] have suggested that economic regulation acts to protect and enhance the regulated parties. In applications of this hypothesis, Yandle [1983] and Quain and Yandle [1986] found that special interests, including regulated parties and citizen groups, influenced state air quality policy before and during the federal regulatory era of the 1970s; however, the relative influence of competing special interests changed over this period. Before increased federal involvement, groups that could organize more effectively at the state and local level had greater influence. With increased federal involvement, such groups had less influence.

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