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Regulation of Platform Markets in Transportation

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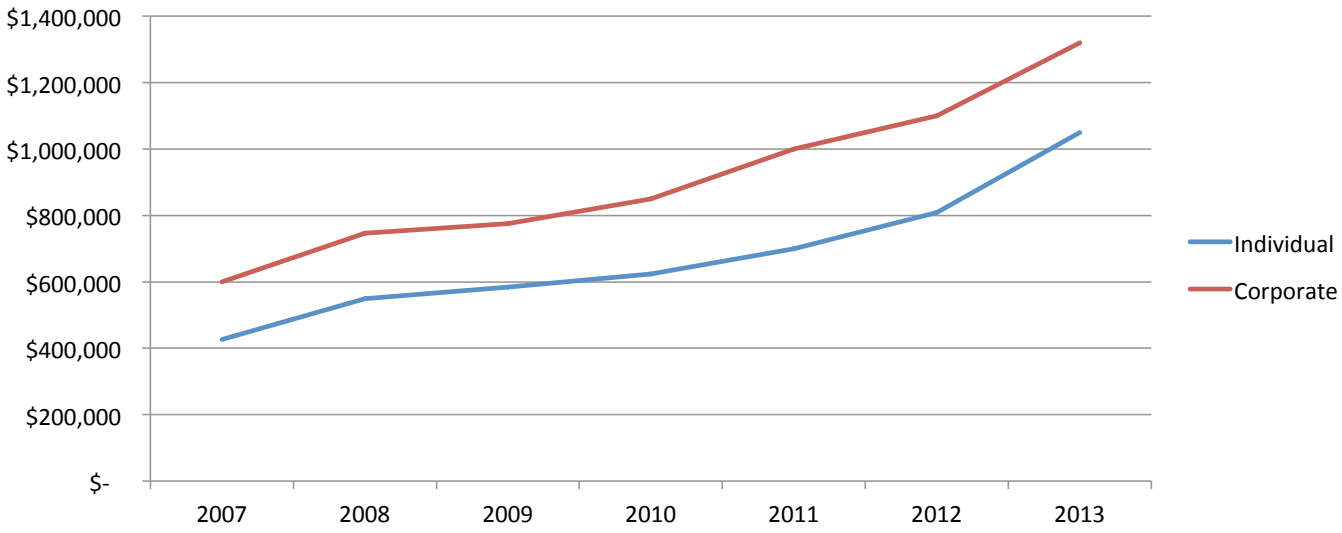
The development of communication networks along with the rapidly expanding use of smartphones has resulted in unexpected innovations, revolutionizing taxicab and transportation services. Two new firms, Uber and Lyft, offer a particularly novel transportation service by providing car-share and taxi services via cell phone applications and GPS. Users needing rides simply push buttons on their phones, and within minutes, vehicles arrive at their locations.

This platform market would seem to be a boon to both customers and providers. But, as novel services, Uber and Lyft are competing with established taxicab companies, who resist these newcomers. In cities such as Chicago, Houston, Seattle, and Boston, local taxi companies are suing and submitting regulatory complaints in attempts to shut down these would-be competitors.[1]

These threatened taxicab firms are spending scarce resources on contesting wealth instead of creating it, or rent-seeking.[2] The goal of rent-seeking is to create higher profits by lobbying politicians to impose costly regulatory burdens, such as licensure, safety prescriptions, and price controls, on their new competitors. This is how entrenched interest groups, citing something like public safety, use government to protect their privileges and stifle market innovations.

But even without regulation, firms must maintain good reputations to remain competitive. Government regulation at best duplicates and at worst hinders the role of reputation in encouraging firms to maximize the benefit of their services to their customers. As it currently stands, even a company with an excellent reputation is limited in how fast it can expand its services because of preexisting regulation of transportation services.

Figure 1. Average price of NYC medallions.



Source: NYC Taxi & Limousine Commission, http://www.nyc.gov/html/tlc/html/home/home.shtml.

Traditional taxi regulations restrict entry by requiring a license to legally operate a taxicab. This effectively limits the number of available taxis. The rationale for regulating taxicabs is to protect consumers, yet the regulation's main result is to keep prices high and actively discourage services to lower-income customers. Platform market transportation services, such as Uber and Lyft, can reverse this trend by maintaining a high quality of service while extending coverage to underserved communities.

WHO REALLY PROFITS FROM CAB SERVICES?

Taxicabs are an integral component of any urban transportation network. In 2013 more than 236 million passengers used taxicabs in New York City, and the average taxi traveled 70,000 miles a year.[3] Like many cities, New York heavily regulates taxi companies by restricting the number of potential drivers. The Haas Act of 1937 regulated taxis and limited the number of cab licenses in New York City to 16,900. Despite the population growth of the last 70 years, the number of licenses has actually decreased. In 2004 only 12,187 medallion cabs operated in the city.[4]

Limiting the supply of medallions allows the taxi cartel to maintain high fares by preventing entrepreneurs from entering the market.

Since then, the price of medallions has increased dramatically, as shown in figure 1, above. Indeed, over the last 80 years, taxi medallions have generated an annualized 15.5 percent rate of return.[5] Put another way, the value of a medallion doubled, on average, every four and a half years.

The returns for this particular type of rent-seeking are staggering, especially given the fact that these profits come not only from higher fares to consumers, but through worse coverage in poor and minority communities, as we explain below.[6] One would think this windfall for cartel operators would trickle down to cab drivers, but this is not the case. As reported by the *Washington Post*, cab drivers make approximately $30K a year.[7] The real winners of licensure are not customers or even cab drivers but the original owners of the medallions,[8] who have seen tremendous growth in this asset's value.[9] Put another way, the bulk of the revenue produced by the system is used to pay the up-front costs of procuring new licenses. Under such a system, current operators gain little from increasing total production; in fact, they gain by lowering it.

WON'T DEREGULATION HURT CONSUMERS, ESPECIALLY TOURISTS?

Consumer protection is one of the most cited justifications for taxi regulation and is usually framed in defense of tourists. Tourists have two distinct disadvantages compared to natives when it comes to information about taxicabs. First, they are unlikely to be familiar with the specific rates of competing cab companies, and, of course, every driver has a strong incentive to claim

they have the best rates in town. Second, it is assumed that tourists have no idea whether their driver is taking the optimal route.[10] This asymmetry in information between operators and customers is used to justify regulation as a consumer protection measure.

But these concerns are largely addressed by the self-regulating properties of these markets. One way that platform market systems counter the problem of information asymmetry is by letting customers rate their drivers. If drivers aren't courteous, drive unsafely, or do not maintain their vehicles, customers can leave negative ratings and comment on driver performance. Other users can view this information, and if a driver's rating drops below a certain threshold, they are no longer able to operate. The same technology that allows platform networks to operate provides the infrastructure for consumers to get the information they need.

When consumers are able to use technology to easily obtain information about quality, firms respond by offering higher-quality products and services.[11] Firms suffer when consumers associate them with a low quality of service, as this limits the prices they can charge and decreases their return on investment.

Uber and Lyft want to hire safe drivers because safe drivers will increase profitability. Poor safety is bad business. Hiring safe drivers will lower their expected cost of insurance, whereas hiring drivers with poor histories will only increase insurance costs and, in turn, lower profitability. There is a similar dynamic on the vehicle side. Utilizing unsafe vehicles or forgoing routine maintenance will result in higher insurance costs and decrease their profitability. In a sense, insurance is a form of third-party certification that allows firms to signal the quality of their service.

Both Uber and Lyft have taken advantage of this. For example, Lyft requires that all vehicles be at least model year 2000 or later and pass a 19-point inspection. Lyft's drivers must also carry an excess liability coverage of one million dollars and an excess uninsured/underinsured motorist policy of one million dollars.[12] Uber also mandates their drivers carry insurance and when the drivers are on a trip, Uber covers all damage up to a million dollars.[13]

Firms often invest in reputational capital as a way of signaling to customers their commitment to high quality. In a study on eBay and reputation, sellers with a high percentage of negative ratings were hampered in their ability to get high prices for their wares.[14] Similarly, if a customer gives a driver a bad rating, that driver will be excluded from accessing the system. And if the overarching firm gets a bad reputation, customers can use another one. If platform markets are allowed to flourish, then firms that excel at customer service will grow while those that allow their reputations to suffer will quickly be replaced.

The self-regulating properties of the market follow from two sources: a good reputation that keeps revenues high and low insurance rates that keep costs low. By extension, lower quality leads to lower prices, and negligence increases the costs of operation. These dynamics provide a strong incentive for firms to self-police and maintain a high level of consumer safety and satisfaction.

In contrast, under the current licensing system, firms do not have the same incentives to compete on quality. And since licensing limits the number of taxis in operations, there will always be an abundance of passengers.

FLEXIBLE PRICING IS PRO-CONSUMER AND PRO-CAB DRIVER

In addition to encouraging self-regulation, deregulation would also abolish the current system of uniform rates. Uniform rates are no more in the consumer's favor than having uniform health insurance premiums for smokers and nonsmokers would be, and for much the same reason: risk. Driving a cab is dangerous work. There were 1,126 occupational homicides of taxi and livery drivers between 1980 and 2009.[15] According to OSHA, taxi and livery drivers were 60 times more likely to be murdered on the job compared to other workers.[16] Operating in high-crime areas puts drivers at an increased risk of robbery and violence.

Normally, this increased risk would be offset by requiring a larger fare from customers. This option, however, is precluded when fares are fixed by local regulations. Drivers effectively lose money when servicing high-crime areas because they are not being compensated for bearing additional risk. The claimed public interest in rate fixing is to prevent drivers from surprising customers with high rates. But when drivers have no flexibility in raising rates, they simply refuse to accept fares. The unintended consequence of this regulation is that by protecting customers from high prices, some communities now have much less reliable transportation services.

By increasing the number of vehicles in operation, deregulation forces companies to expand service into new areas, and with little to no increase in rates. Under regulation, firms had more customers than capacity and could pick and choose their fares. Unscrupulous drivers could ignore certain individuals and neighborhoods and be certain they would find customers elsewhere. But deregulation increases the opportunity cost of turning down a fare. Now, a driver may not be able to afford to ignore a request. This is why, in practice, Uber and Lyft fares have remained fairly uniform.

Finally, keeping the transaction between the driver and the rider removes the rent-seeking cartel operator from the equation and therefore lowers operating costs across the board. Good drivers are rewarded for providing a high-quality service; it's why Uber drivers make an estimated $90K (or three times their cartelized counterparts) per year in New York City.[17]

LET MARKETS WORK

In a survey of academic literature, the majority of economists find taxi deregulation beneficial as it results in greater service and lower prices for customers.[18] Further, in a recent IGM poll, there was unanimous support from academic economists on the benefits of deregulation.[19] A recent case study of London taxicab services found that free movement of labor (entry and exit into the taxicab industry) was responsible for keeping down the real costs of production.[20] In addition, a study of the taxicab radio dispatch market in 103 US cities found that deregulation has been overwhelmingly beneficial to consumers, resulting in greater service, lower fares, and faster response times.[21]

Without the ability for entrepreneurs to legally enter the market, existing providers have little incentive to increase the quality of their service or cater to less lucrative communities. Increased competition, on the other hand, pressures existing providers to adapt. Platforms that use digital dispatch competing directly with radio dispatch are therefore likely to provide substantial consumer benefits.

In conclusion, increased competition in the taxicab market keeps fares low and affordable while expanding service to previously underserved communities. Increased competition also helps to maintain high standards of safety as new technology overcomes the traditional problems of information and reputation. Platform markets in transportation should be encouraged as they become an increasingly important part of urban transportation services.

NOTES

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9. Companies that wish to expand their operation must procure new medallions at higher prices. This is a very large investment and one source of their opposition.

10. Loukas Balafoutas et al., "What Drives Taxi Drivers? A Field Experiment on Fraud in a Market for Credence Goods," *Review of Economic Studies* 80, no. 3 (2013).

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13. Nairi, "Insurance for UberX with Ridesharing," Uber, last updated July 22, 2014, http://blog.uber.com/ridesharinginsurance.

14. Christian Grund and Oliver Guertler, "The Effect of Reputation on

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16. *Risk Factors and Protective Measures for Taxi and Livery Drivers* (Washington, DC: Occupational Safety and Health Administration, US Department of Labor, May 2000), https://www.osha.gov/OSHAFacts/taxi-livery-drivers.pdf.

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