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PRESENTATION

RETHINKING TNC REGULATIONS
ENSHRINING THE PAST FORESTALLS THE FUTURE

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INTRODUCTION

Good afternoon Chairman Villanueva, Chairman Carrico, and members of the Virginia Joint Transportation Committee. I am grateful for the invitation to discuss research[1] that I and my colleagues at the Mercatus Center at George Mason University have conducted regarding the sharing economy in general and transportation network company (TNC) regulations in particular.

TNCs like Uber and Lyft are barely five years old, yet they have already caused a transportation revolution by putting "dead capital"—or previously underutilized resources—to productive use.[2] They have achieved this by reducing transaction costs[3] between consumers and service providers, which previously inhibited trade from

1. Christopher Koopman, Matthew Mitchell, and Adam Thierer, "The Sharing Economy and Consumer Protection Regulation: The Case for Policy Change," *Journal of Business, Entrepreneurship & the Law* 8, no. 2 (2015); Adam Thierer et al., "How the Internet, the Sharing Economy, and Reputational Feedback Mechanisms Solve the 'Lemons Problem'" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA, May 2015); Michael Farren, Christopher Koopman, and Matthew Mitchell, "Rethinking Taxi Regulations: The Case for Fundamental Reform" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2016).
2. "Dead capital" is a concept developed by economist Hernando de Soto to describe an asset that—because it lacks full legal recognition—cannot easily be bought, sold, valued, or used as an investment. Dead capital in this sense refers to resources such as vehicles, homes, or human services that lack the means to be utilized or are inhibited from being used productively because the law will not permit it. Daniel M. Rothschild, "How Uber and Airbnb Resurrect 'Dead Capital,'" *The Ümlaut*, April 9, 2014; "Dead Capital," The Power of the Poor, accessed November 2, 2016; Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).
3. "Transaction costs" are the nonmonetary costs required to achieve an exchange between trading partners, including search and information costs, bargaining and decision costs, and policing and enforcement costs. John Naughton, "How a 1930s Theory Explains the Economics of the Internet," *Guardian*, September 7, 2013; Paul M. Johnson, "Transaction Costs," A Glossary of Political Economy

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taking place. This revolution has disrupted not only the established transportation service industry, but also the existing laws and regulations concerning for-hire transportation services.[4] Policymakers now need to critically reexamine statutes and regulations affecting the transportation service industry to determine which legal rules, if any, are still necessary.[5]

In this testimony, I will:

1. Provide an overview of state TNC statutes.
2. Discuss how provisions on entry and licensing costs, public safety concerns, and business model mandates act as barriers to entry and stifle competition.
3. Recommend starting from a blank slate in evaluating new legislation.

OVERVIEW OF TNC STATUTES

The 39 state TNC statutes enacted between 2014 and 2016 are a mix of boilerplate text and state-specific considerations. Insurance mandates for TNC operations are perhaps the most similar between states, due to the fact that most states have broadly adopted the "Compromise Model Bill" developed by Uber, Lyft, and a number of insurance companies.[6] However, other aspects of TNC laws are substantially different, such as licensing costs and business model mandates.

I categorize the provisions contained in TNC laws according to the following three broad dimensions:

1. Entry and Licensing Costs
2. Public Safety
3. Business Model Mandates

1. ENTRY AND LICENSING COSTS

Entry and licensing costs include both monetary fees and nonmonetary procedural costs that TNCs face in obtaining and maintaining legal authorization to connect customers with for-hire drivers. The most obvious examples of the monetary costs are application, registration, and renewal fees. Annual licensing fees for the TNC platform firms vary widely, ranging from a high of $300,000 in Georgia to a low of $250 in Kentucky. Many states' licensing fees are $5,000 or less.

Virginia has one of the highest licensing fees, with an initial application fee of $100,000 and subsequent renewal fees of $60,000. High licensing fees create what economists call a "barrier to entry" for entrepreneurs, thereby protecting established companies from new competition. The result is that established companies enjoy a degree of monopoly power. Protection from competition tends to raise prices, reduce service quality, or decrease the quantity of service offered. As my colleague Christopher Koopman has written:

> Consumers are often left with higher prices, fewer choices, and lower quality service. Barriers to entry mean that incumbent firms have little need to focus on satisfying consumer desires; instead, their success depends upon their ability to court regulators and retain regulatory protections. Over time,

Terms, accessed November 2, 2016; Carl J. Dahlman, "The Problem of Externality," *Journal of Law & Economics* 22, no. 1 (1979): 141–62; R. H. Coase, "The Nature of the Firm," *Economica* 4, no. 16 (1937): 386–405.
4. Koopman, Mitchell, and Thierer, "The Sharing Economy and Consumer Protection Regulation"; Thierer et al., "How the Internet, the Sharing Economy, and Reputational Feedback Mechanisms.'"
5. Farren, Koopman, and Mitchell, "Rethinking Taxi Regulations."
6. Alexander B. Traum, "Sharing Risk in the Sharing Economy: Insurance Regulation in the Age of Uber," *Cardozo Public Law, Policy & Ethics Journal* 14 (2016): 531.

> barriers to entry ensure that firms become sluggish, lazy, and less alert to the sorts of entrepreneurial innovations that drive consumers to purchase products or use their services.[7]

The nonmonetary procedural costs of acquiring legal authorization to offer service are also important. For example, taxi regulations in Washington, DC, require separate licenses for the taxi driver, the taxicab, and the taxi company. Research I conducted with Christopher Koopman and Matthew Mitchell found that this "triple-gate" style of licensing unnecessarily increases the burden associated with starting up a new taxi company, which decreases the competitive pressure facing established taxi companies.[8]

In a similar fashion, Virginia requires both that TNC companies be licensed and that each TNC vehicle be registered with the state in order to offer for-hire transportation service. The efficacy of requiring multiple special licenses or registrations is debatable, since research led by Adam Thierer and Christopher Koopman and published by the Mercatus Center illustrates how sharing economy firms actually have better information on their service providers—and a greater incentive to act on it—than government regulators. As a result, TNCs are better positioned to oversee their service providers than government regulators.[9]

2. PUBLIC SAFETY

TNC statutes putatively address concerns regarding public safety through several means, the primary method being mandates that require TNCs to screen their drivers through specific kinds of background checks (generally focusing on driving histories and criminal records). TNC statutes have also addressed public safety by requiring that vehicles providing TNC services display some form of trade dress, like a brand logo identifying the TNC. These provisions seem to be intended to mitigate problems associated with "asymmetric information," which occurs when service providers know more about the quality or safety of their product than the customer.[10] However, Thierer and Koopman's research shows that these kinds of legal rules are increasingly unnecessary in a world where communication and information costs are lower than ever before because of the Internet and smartphones. They write:

> We argue that a private market solution has presented itself in the form of the information revolution, online reputational and trust-building mechanisms, and the lower search costs of an interconnected world. Therefore, government interventions justified on the basis of information asymmetries must be reevaluated.[11]

In fact, many public safety aspects of the TNC statutes have simply enshrined into law the current practices of sharing economy platform firms. As safety-related information becomes more accessible, customers are increasingly able to protect themselves more successfully than government previously could.[12]

Similarly, it is important to recognize that competition between firms to attract customers provides an incentive to ensure public safety, and regulations mandating specific background check requirements create barriers to entry that limit competition. Allowing companies the freedom to innovate in how they screen service providers

7. Christopher Koopman, "Today's Solutions, Tomorrow's Problems," *Cato Unbound*, February 17, 2015.
8. Farren, Koopman, and Mitchell, "Rethinking Taxi Regulations."
9. Thierer et al., "How the Internet, the Sharing Economy, and Reputational Feedback Mechanisms Solve the 'Lemons Problem.'"
10. Asymmetric information occurs when one party to a transaction has relevant information regarding the product being traded that the other party does not. In many cases, laws and regulations focused on consumer protection are based on asymmetric information concerns.
11. Thierer et al., "How the Internet, the Sharing Economy, and Reputational Feedback Mechanisms," 11.
12. "Thus, "to the extent that consumer protection regulation is based on the claim that consumers lack adequate information," notes John C. Moorhouse, "the case for government intervention is weakened by the Internet's powerful and unprecedented ability to provide timely and pointed consumer information." Correspondingly, because the Internet and information technology alleviates the need for regulation in this fashion, and in light of the deficiencies associated with traditional regulatory mechanisms discussed above, consumer welfare may ultimately be better protected by loosening traditional regulations." Koopman, Mitchell, and Thierer, "The Sharing Economy and Consumer Protection Regulation," 17.

also allows for future improvements in filtering out the bad apples, rather than relying on the mandated best practices from the past that were never updated. When specific methods of compliance are set in regulatory stone, as I discuss next, it destroys entrepreneurs' motivation to explore more effective and efficient means of achieving the same end.

3. BUSINESS MODEL MANDATES

Lastly, TNC statutes impose business model mandates on for-hire transportation service providers, meaning that the laws prohibit (or require) certain business structures or practices. Regulatory constraints and mandates effectively prohibit innovation in the regulated area, meaning that any associated economic growth is unachievable. This can have substantial negative effects on long-run economic growth.[13] For example, although some business model mandates can clarify legal issues, such as mandating that a TNC service provider be considered an independent contractor, such a requirement simultaneously closes off future avenues of development for TNCs because there are legal limits to the training that can be offered to independent contractors.[14] Other business model mandates include specifying the type, breadth, and depth of background checks for service providers, requiring a certain kind of trade dress, and specifying vehicle or driver characteristics (limiting vehicle size, specifying vehicle and driver age limits, or prohibiting cash payments). Laws such as these inhibit entrepreneurs from even *trying* to come up with innovations in the regulated area.

Perhaps the clearest example of a business model mandate is the requirement contained in nearly all state TNC statutes that at least $1,000,000 worth of liability insurance coverage be provided when a driver has accepted a passenger's request for a ride.[15] This mandate is far in excess of the minimum level of insurance required for ordinary operation of personal vehicles on public roadways (and often even exceeds existing taxi and limousine insurance requirements).[16] Importantly, stipulating a certain high level of insurance removes an avenue of competition between companies which could use a high level of insurance as a distinguishing characteristic of their service. In addition, the size of the insurance mandate and its accompanying higher operation costs creates a barrier to entry for smaller firms wishing to enter the market and compete with Uber and Lyft. Alternately, companies sometimes lobby for regulations that mandate their own current business model in order to raise their rivals' costs.[17]

The insurance example illustrates the problem created by enshrining current company business practices into law. In addition, more than simply deterring other service providers from entering the market, such codifications suggest that no further future innovations are possible and remove the incentive for entrepreneurs to discover better solutions.

THE ROAD FORWARD

Over the last two years, state legislatures around the country hurried to ensure that they provided TNCs a legal basis for offering services. In their haste, policymakers may have missed the opportunity to more critically examine which regulations are actually needed for the sharing economy. In fact, a better question might be whether *any*

13. Dawson and Seater estimate that federal regulations decreased annual economic growth by 2.2 percent from 1949 through 2011. John W. Dawson and John J. Seater, "Federal Regulation and Aggregate Economic Growth," *Journal of Economic Growth* 18, no. 2 (June 1, 2013): 137–77.
14. A better system would provide entrepreneurs the maximum flexibility to develop new products and methods of doing business, such as allowing training for independent contractors. Molly McHugh, "Uber and Lyft Drivers Work Dangerous Jobs—But They're on Their Own," *Wired*, March 10, 2016.
15. Alternately, the law allows the TNC driver to provide the insurance. Va. Code Ann. § 46.2-2099.52.
16. Bruce Schaller, "Taxi, Sedan, and Limousine Industries and Regulations, Appendix B" (Special Report 319, Transportation Research Board: Committee for Study of Innovative Urban Mobility Services, January 20, 2015), 15.
17. Steven C. Salop and David T. Scheffman, "Raising Rivals' Costs," *American Economic Review* 73, no. 2 (1983): 267–71; David T. Scheffman and Richard S. Higgins, "Twenty Years of Raising Rivals' Costs: History, Assessment, and Future," *George Mason Law Review* 12 (2003): 371; Morten Hviid and Matthew Olczak, "Raising Rivals' Fixed Costs," *International Journal of the Economics of Business* 23, no. 1 (2016): 19–36.

regulations are needed. Research from scholars at the Mercatus Center demonstrates that the revolution in communication technology caused by the Internet and smartphones has ameliorated consumer protection and asymmetric information concerns underlying many previous rationales for regulation.[18]

Our research finds that the most appropriate road forward is to start from a blank slate, deliberately eschewing the status quo of past regulations.[19] This approach will help ensure that established companies do not enjoy a government-granted privilege[20]—even inadvertently—because laws and regulations have been written to accommodate and enshrine their current business models. Instead, any consideration of regulations must begin with an explicit definition of the nature of the problem and an explanation of why it represents a systematic market failure that cannot be addressed by entrepreneurs. This is important because many problems also represent a profit opportunity for those who can solve them.[21]

If there is a systematic problem that cannot be solved by normal market interactions, then there may be a rationale for government action. However, the alternative of "doing nothing" should also be explicitly considered because of the possibility of government failure.[22] Misdirected use of governmental authority can cause a larger problem than the market failure that motivated the intervention.

As economist Harold Demsetz advises, policymakers must avoid the "nirvana fallacy,"[23] which they may commit by simply imagining a better world and assuming that they can achieve it through policy. Instead, policymakers should follow a "comparative institutions" approach that analyzes which outcomes are most likely to occur given real-world institutional arrangements and constraints.

Because of the ease of falling into the nirvana fallacy, it is important to identify the expected costs and benefits of each potential solution and quantify each as rigorously as possible. Lastly, it is important to remember that social and market processes are dynamic and can evolve to accommodate changing circumstances, meaning that the solution to the problem may be discovered in the future, as long as a suboptimal solution is not mandated today.

CONCLUSION

In conclusion, it would seem wise to reexamine the flurry of TNC laws passed over the last two years and determine which regulations, if any, are incapable of being solved by ordinary voluntary interaction by private citizens. If there are problems that are beyond entrepreneurial resolution, it is worth questioning whether they are also beyond effective government solution. Regardless, any regulations that remain should ensure that barriers to entry are kept to an absolute minimum to avoid providing monopoly-type power to established companies. Similarly, statutes should strictly avoid business model mandates, especially those that curtail areas of innovation and competition. We can only achieve the best possible future in an environment where service providers are free to innovate, and in fact *must* innovate, to attract customers.

18. Koopman, Mitchell, and Thierer, "The Sharing Economy and Consumer Protection Regulation"; Thierer et al., "How the Internet, the Sharing Economy, and Reputational Feedback Mechanisms"; Farren, Koopman, and Mitchell, "Rethinking Taxi Regulations."
19. Koopman, Mitchell, and Thierer, "The Sharing Economy and Consumer Protection Regulation"; Thierer et al., "How the Internet, the Sharing Economy, and Reputational Feedback Mechanisms"; Farren, Koopman, and Mitchell, "Rethinking Taxi Regulations."
20. Matthew Mitchell, *The Pathology of Privilege: The Economic Consequences of Government Favoritism* (Arlington, VA: Mercatus Center at George Mason University, 2014).
21. "Markets are not static; they are a dynamic process. And every perceived information problem also creates an incentive for the entrepreneur to discover new ways to create profit opportunities." Thierer et al., "How the Internet, the Sharing Economy, and Reputational Feedback Mechanisms," 20.
22. "But as Harold Demsetz pointed out over 40 years ago, it is not enough to condemn market failure and call for some government intervention to correct the error. One also needs to analyze the government's actions and see whether or not it is prone to failure." Matt Mitchell, "Market Failure vs. Government Failure," Neighborhood Effects, October 8, 2010; Charles Wolf, Markets or Governments: Choosing between Imperfect Alternatives, 2nd ed.(Cambridge, MA: MIT Press, 1994); Julianle Grand, "The Theory of Government Failure," British Journal of Political Science 21, no. 4 (1991): 423–42.
23. Harold Demsetz, "Information and Efficiency: Another Viewpoint," *Journal of Law & Economics* 12, no. 1 (1969): 1–22.