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The Sharing Economy and Consumer Protection Regulation: The Case for Policy Change

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THE SHARING ECONOMY AND CONSUMER PROTECTION REGULATION

THE CASE FOR POLICY CHANGE

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I. INTRODUCTION

The rise of the sharing economy has been rapid and transformative. It has changed the way many Americans commute, shop, vacation, and borrow. It has also disrupted long-established industries, from taxis to hotels, and has confounded policymakers unsure of how or even whether to regulate these new markets. In this Paper, we discuss the central benefit of the sharing economy thus far: it has overcome market imperfections without recourse to regulatory bodies prone to capture by entrenched firms.

As an introduction to the various issues surrounding this ongoing debate, we begin with an explanation of the sharing economy.[1] Then we review the traditional “consumer protection” rationales for economic regulation and explain why many regulations persist even though their initial justifications are no longer valid.[2] We argue continued application of these outmoded regulatory regimes is likely to harm consumers.[3] In the last section, we explain how the Internet and information technology alleviate the need for much of this top-down regulation and are likely to do a better job of serving consumers.[4] We conclude with some proposals for further research in this area and call for a more informed regulatory approach that accounts for the innovations of the sharing economy.[5] When market circumstances change dramatically—or when new technology or competition alleviate the need for regulation—then public policy should evolve and adapt to accommodate these new realities.

II. RISE OF THE SHARING ECONOMY

While still in its infancy, the sharing economy has grown substantially in recent years. Young firms like Uber and Airbnb claim thousands of customers, operate in hundreds of cities worldwide, and are valued at tens of billions of

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[1] *See infra* Part II and accompanying notes 6–13.
[2] *See infra* Part III and accompanying notes 14–49.
[3] *See infra* Part IV and accompanying notes 50–71.
[4] *See infra* Part V and accompanying note 72.
[5] *See infra* Part VI and accompanying notes 73–74.

dollars.[6] Despite its rapid growth and enormous popularity with consumers, there is no universally accepted definition of the "sharing economy," which is also known as the "collaborative economy," the "peer-production economy," or the "peer-to-peer economy."[7] We suggest it is helpful to think of the sharing economy as any marketplace that brings together distributed networks of individuals to share or exchange otherwise underutilized assets.[8] It encompasses all manner of goods and services shared or exchanged for both monetary and nonmonetary benefit.

The sharing economy creates value in at least five ways:

> • By giving people an opportunity to use others' cars, kitchens, apartments, and other property, it allows underutilized assets or "dead capital" to be put to more productive use.[9]
>
> • By bringing together multiple buyers and sellers, it makes both the supply and demand sides of its markets more competitive and allows greater specialization.
>
> • By lowering the cost of finding willing traders, haggling over terms, and monitoring performance, it cuts transaction costs and expands the scope of trade.[10]
>
> • By aggregating the reviews of past consumers and producers and

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[6] Scott Austin, Chris Canipe & Sarah Slobin, *The Billion-Dollar Startup Club*, WALL ST. J., Feb. 18, 2015, http://graphics.wsj.com/billion-dollar-club.

[7] *See* RACHEL BOTSMAN & ROO ROGERS, WHAT'S MINE IS YOURS: THE RISE OF COLLABORATIVE CONSUMPTION (HarperCollins Publishers 2010); DON TAPSCOTT & ANTHONY D. WILLIAMS, WIKINOMICS: HOW MASS COLLABORATION CHANGES EVERYTHING (Portfolio 2008); JEFF HOWE, CROWDSOURCING: WHY THE POWER OF THE CROWD IS DRIVING THE FUTURE OF BUSINESS (Crown Business 2008); GLENN REYNOLDS, AN ARMY OF DAVIDS: HOW MARKETS AND TECHNOLOGY EMPOWER ORDINARY PEOPLE TO BEAT BIG MEDIA, BIG GOVERNMENT, AND OTHER GOLIATHS (Thomas Nelson 2006); YOCHAI BENKLER, THE WEALTH OF NETWORKS: HOW SOCIAL PRODUCTION TRANSFORMS MARKETS AND FREEDOM (Yale Univ. Press 2006).

[8] *See, e.g.*, Rachel Boston, *The Sharing Economy Lacks a Shared Definition*, FAST COMPANY (Nov. 21, 2013), http://www.fastcoexist.com/3022028/the-sharing-economy-lacks-a-shared-definition. It may be helpful to think of a sharing economy as a special case of a "two-sided" or "platform" market. It is special because it typically employs technology to bring together large numbers of buyers and large numbers of sellers. For more on platform markets, see Alex Tabarrok, *Jean Tirole and Platform Markets*, MARGINAL REVOLUTION (Oct. 13, 2014), http://marginal revolution.com/marginalrevolution/2014/10/tirole-and-platform-markets.html. *See also* Stewart Dompe & Adam Smith, *Regulation of Platform Markets in Transportation*, MERCATUS CENTER AT GEORGE MASON UNIV. (Oct. 27 2014), http://mercatus.org/publication/regulation-platform-markets-transportation.

[9] Daniel M. Rothschild, *How Uber and Airbnb Resurrect 'Dead Capital'*, UMLAUT (Apr. 9, 2014), http://theumlaut.com/2014/04/09/how-uber-and-airbnb-resurrect-dead-capital. On the broader concept of "dead capital," see HERNANDO DE SOTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM SUCCEEDS IN THE WEST AND FAILS EVERYWHERE ELSE, (1st ed., Basic Books 2000).

[10] Carl J. Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141 (1979).

putting them at the fingertips of new market participants, it can significantly diminish the problem of asymmetric information between producers and consumers.[11]

• By offering an "end-run" around regulators who are captured by existing producers, it allows suppliers to create value for customers long underserved by those incumbents that have become inefficient and unresponsive because of their regulatory protections.

These factors can improve consumer welfare by offering new innovations, more choices, more service differentiation, better prices, and higher-quality services. Despite this, the sharing economy and its regulation have become highly charged policy topics, especially at the local level.[12] Fueling this debate, many municipal governments are attempting to impose older regulatory regimes on these new services without much thought about whether they are still necessary to protect consumer welfare.[13] However, by expanding the range of options and information available to consumers, the sharing economy removes the need for regulation in many cases. In fact, continued application of outmoded regulatory regimes may actually harm consumers.

III. CONSUMER PROTECTION: FROM MARKET FAILURE TO GOVERNMENT FAILURE

Protecting consumer welfare has long been one of the principal rationales for economic regulation. Under the traditional "public interest theory" of regulation, regulation is sought to protect consumers from externalities, inadequate competition, price gouging, asymmetric information, unequal bargaining power, and a host of other perceived "market failures."[14]

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[11] George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84.3 Q. J. ECON 488–500 (1970).

[12] Katheleen Conti, *Municipalities Seek to Regulate Peer-to-Peer Services*, BOSTON GLOBE, Aug. 31, 2014, http://www.bostonglobe.com/metro/regionals/south/2014/08/30/quincy-fines-couple-for-running-illegal-enters-debate-over-regulation-service-sharing-economy/K43HOxC5N6zXy5dwVk4CTM/story.html; Shane Tews, *The Sharing Economy under Pressure: Uber, Lyft and Airbnb's Regulatory Roadblocks Continue*, TECH POL'Y DAILY (Sept. 29, 2014), http://www.techpolicydaily.com/technology/sharing-economy-pressure.

[13] Eli Lehrer & Andrew Moylan, *Embracing the Peer-Production Economy*, NAT'L AFFAIRS 51, 56 (2014), http://www.nationalaffairs.com/publications/detail/embracing-the-peer-production-economy ("Across the country, laws that were written long before the emergence of the peer-production economy to address issues quite different from those under consideration today are now being invoked as barriers to peer-production services. These antiquated regulatory structures have led to something of a 'ban first, ask questions later' mentality in many cities.").

[14] *See* 1 Alfred E. Kahn, The Economics of Regulation: Principles and Institutions (MIT Press 1971); David L. Kaserman & John W. Mayo, Government and Business: The Economics of Antitrust and Regulation 9–15 (Dryden Press 1995).

Unfortunately, as economists Mark Steckbeck and Peter J. Boettke observe, regulators often ignore "the dynamism of markets and the incentive mechanism driving entrepreneurs to discover ways to ameliorate problems associated with market exchange."[15] Markets are not static, and every information problem is also an information *opportunity*. "Market processes emerge from a series of trial and error experimentations, derived from a progression of finding a more efficient means of facilitating exchange," note Steckbeck and Boettke.[16] "The role of the entrepreneur is, by continually updating information, to discover more efficient means of promoting human interaction, thus facilitating exchange."[17]

Moreover, the historical analysis of regulation demonstrates, in practice, regulation does not always live up to the normative goals of those who seek it in the "public interest." The mere fact academics or policymakers claim that well-intentioned regulation will protect consumers does not mean it actually will do so.[18] This danger was well understood by one of the original exponents of the public interest theory of regulation. Writing in 1920, Arthur C. Pigou cautioned against contrasting "the imperfect adjustments of unfettered private enterprise with the best adjustment that economists in their studies can imagine."[19] Instead, he noted, in the real world, policymakers might not implement policy as scholars think they ought to: "[F]or we cannot expect that any public authority

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[15] Mark Steckbeck & Peter J. Boettke, *Turning Lemons into Lemonade: Entrepreneurial Solutions in Adverse Selection Problems in E-Commerce*, *in* Markets, Information and Communication: Austrian Perspectives on the Internet Economy 221, 221 (Jack Bimer ed., Routledge 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1538369. Steckbeck and Boettke's comments echo sentiments first raised by Ludwig von Mises and Israel Kirzner, who argue for a more dynamic view of the market process. *See, e.g.*, Israel M. Kirzner, Competition and Entrepreneurship (Liberty Fund rev. ed. 2010) (1963); Israel M. Kirzner, Market Theory and the Price System (Liberty Fund rev. ed. 2011) (1963); Ludgwig Von Mises, Human Action: A Treatise on Economics, (Liberty Fund rev. ed. 2010) (1949). Their works have demonstrated that market forces, instead of government regulations, can adjust behaviors and practices to correct imperfections, reduce frictions, and solve the problems of coordination that many others tend to identify as "failures." *See, e.g.*, Israel M. Kirzner, Competition and Entrepreneurship (Liberty Fund rev. ed. 2010) (1963); Israel M. Kirzner, Market Theory and the Price System (Liberty Fund rev. ed. 2011) (1963); Ludgwig Von Mises, Human Action: A Treatise on Economics, (Liberty Fund rev. ed. 2010) (1949).

[16] Steckbeck & Boettke, *supra* note 15, at 222.

[17] *Id.* at 227.

[18] As Milton Friedman once noted, "[o]ne of the great mistakes is to judge policies and programs by their intentions rather than their results." *The Open Mind: Living Within Our Means* (PBS television broadcast Dec. 7, 1975). In addition, a reliance on good intentions has precipitated the move away from regulating perceived market failures to regulating perceived individual failures. This is particularly true in the rise of behavioral-based regulations. *See* Christopher Koopman & Nita Ghei, *Behavioral Economics, Consumer Choice, and Regulatory Agencies*, Mercatus Center at George Mason Univ. (Aug. 27, 2013), http://mercatus.org/publication/behavioral-economics-consumer-choice-and-regulatory-agencies.

[19] A.C. Pigou, The Economics of Welfare 332 (Macmillan reprint ed. 1920).

will attain, or will even whole-heartedly seek, that ideal. Such authorities are liable alike to ignorance, to sectional pressure and to personal corruption by private interest. A loud-voiced part of their constituents, if organised for votes, may easily outweigh the whole."[20]

Indeed, public choice scholars have found Pigou's warning to be prescient.[21] Some of the deficiencies and unintended consequences of economic regulation are discussed below.

A. Regulatory Capture and Rent-Seeking

While many regulations are initially justified with the hope they will serve the public interest, the reality is many persist even when they no longer (or perhaps never did) correct any identifiable market failure. As generations of economists, historians, and other scholars have noted, powerful and politically well-connected incumbents have an incentive to "capture" the regulatory system that is supposed to constrain them.[22] This is because, by limiting entry or by raising rivals' costs, regulations can be *useful* to the regulated firms.[23] Though regulations often make consumers worse off, they are often sustained by political pressure from consumer advocates because they can be disguised as "consumer protection."[24] Scholars have identified a number of reasons why we might come to expect regulatory capture.

For one, if a firm succeeds in capturing its regulator, it and perhaps a handful of other incumbents will reap the benefits of enhanced profits, while a large and diffuse group of consumers will bear the costs. As the political economist Mancur Olson and others have shown, small, concentrated interests often find it easier to organize for their collective benefit than do large and

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[20] *Id.* at 332.

[21] For a primer on public choice, see Matthew Mitchell & Peter Boettke, *Bridging the Gap: The Mercatus Center at George Mason University and the Application of Academic Ideas to Real World Problems*, MERCATUS CENTER AT GEORGE MASON UNIV. (forthcoming). For a primer on regulation, see SUSAN DUDLEY & JERRY BRITO, REGULATION: A PRIMER 12–15 (2nd ed. 2012).

[22] Adam Thierer, *Regulatory Capture: What the Experts Have Found*, TECH. LIBERATION FRONT (Dec. 19, 2010), http://techliberation.com/2010/12/19/regulatory-capture-what-the-experts-have-found; Sam Peltzman, *Toward a More General Theory of Regulation*, 2 J.L. & ECON. 211–40 (1976); George Stigler, *The Theory of Economic Regulation*, 2 BELL J. OF ECON. & MGMT. SCI. 3 (1971).

[23] Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267, 267–71 (1983).

[24] Bruce Yandle, *Bootleggers and Baptists-The Education of a Regulatory Economist*, REGULATION, May–June 1983, at 12–16; ADAM SMITH & BRUCE YANDLE, BOOTLEGGERS AND BAPTISTS: HOW ECONOMIC FORCES AND MORAL PERSUASION INTERACT TO SHAPE REGULATORY POLITICS (Cato Inst. 2014).

diffuse interests.[25] Thus, producers, rather than consumers, are likely to prevail in the effort to influence regulators.

In addition to their organizational advantage, firms also have an informational advantage; they know more about their products than others. Though this information asymmetry is one rationale for regulation, it also explains why regulatory capture occurs. Because firms are in a better position than the government to know their true costs, regulators have some discretion over how much effort they put into discovering these costs. This, in turn, gives firms an incentive to bribe or otherwise convince regulators not to discover or reveal these costs.[26] Firms can entice regulators with cash bribes, lobbying, or campaign donations. But, those are not the only ways to buy influence. Information itself can be a currency. Especially in highly technical fields, regulators often come to rely on firms for their knowledge and expertise. Indeed, it may be rational for them to do so.[27] It is only natural, then, that regulators may come to see the world as the regulated firms see it.[28]

Capture is also enhanced by the phenomenon of the revolving door: the tendency for personnel to move back and forth between regulatory agencies and the firms they oversee. The revolving door spins because personal connections to government officials offer firms access to what those officials are thinking and may allow them to influence that thinking.[29] It also spins because regulators and those responsible for firms' regulatory compliance must develop highly

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[25] MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (Harvard Univ. Press rev. ed. 1965).

[26] Ernesto Dal Bó, *Regulatory Capture: A Review*, 22 OXFORD REV. OF ECON. POL'Y 203, 203–25 (2006); JEAN-JACQUES LAFFONT & JEAN TIROLE, A THEORY OF INCENTIVES IN PROCUREMENT AND REGULATION (MIT Press 1993).

[27] Randall L. Calvert, *The Value of Biased Information: A Rational Choice Model of Political Advice*, 47 J. POL. 530, 530–55 (1985).

[28] 2 ALFRED E. KAHN, THE ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS 36 (MIT Press 1971):

> When a commission is responsible for the performance of an industry, it is under never completely escapable pressure to protect the health of the companies it regulates, to assure a desirable performance by relying on those monopolistic chosen instruments and its own controls rather than on the unplanned and unplannable forces of competition.

Id. at 46. "Responsible for the continued provision and improvement of service, [the regulatory commission] comes increasingly and understandably to identify the interest of the public with that of the existing companies on whom it must rely to deliver goods." *Id.* at 12.

[29] Daron Acemoghu et al., *The Value of Connections in Turbulent Times: Evidence from the United States* (Nat'l Bureau of Econ. Research, Working Paper No. 19701, 2013), *available at* http://www.nber.org/papers/w19701; Benjamin M. Blau, Tyler J. Brough & Diana W. Thomas, *Corporate Lobbying, Political Connections, and the Bailout of Banks*, 37 J. OF BANKING & FIN. 3007, 3007–17 (2013); Jordi Blanes I Vidal et al., *Revolving Door Lobbyists*, 102 AM. ECON. REV. 3731, 3731–48 (2012).

specialized skillsets that are significantly less valuable anywhere else, a phenomenon known as "natural capture due to specialization."[30]

Lastly, regulators are prone to capture because the firms they oversee are often in a position to harm the reputation of the regulator or to make its life more difficult by, as the literature terms it, "squawking."[31] As a result, in an effort to avoid criticism or public complaints, regulators act not in the public interest but with the goal of keeping these interest groups quiet. This can help explain the DC Taxicab Commissioner's statement that it "does not fight with the people it regulates,"[32] but instead acts as referee between competing interest groups.[33]

Regulatory capture is not simply inequitable or unjust; it is also socially costly. The possibility of capture encourages firms to expend vast amounts of resources—time, money, and effort—to influence regulators and their political overseers.[34] This is what economists refer to as "rent-seeking." Because rent-seeking is used to contrive exclusive privileges, rather than to create value for customers, these efforts cost society forgone productive opportunities.[35] To compound the problem, rent-seeking changes the way people allocate their talents. Rather than keeping a focus on devising new and innovative ways to create value, entrepreneurs turn their efforts toward devising new ways to acquire these regulatory privileges. This not only wastes resources in a static sense, it also reduces the rate of economic growth over time by misdirecting entrepreneurial energy.[36]

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[30] LUIGI ZINGALES, A CAPITALISM FOR THE PEOPLE: RECAPTURING THE LOST GENIUS OF AMERICAN PROSPERITY, at xxvi (Basic Books 2014).

[31] *See* George W. Hilton, *The Basic Behavior of Regulatory Commissions*, 62 AM. ECON. REV. 47, 47–54 (1972); *see also* Clare Leaver, *Bureaucratic Minimal Squawk Behavior: Theory and Evidence from Regulatory Agencies*, 99 AM. ECON. REV. 572, 572–607 (2009); Ernesto Dal Bó, Pedro Dal Bó & Rafael Di Tella, *Plata o Plomo?: Bribe and Punishment in a Theory of Political Influence*, 100 AM. POL. SCI. REV. 41, 41–53 (2006).

[32] Martin Di Caro, *Regulations Prompt New Fight between D.C. Taxicab Commission and Uber*, AM. UNIV. RADIO, (Aug. 21, 2013), http://wamu.org/news/13/08/21/new_regulations_prompt_new_fight_between_dc_taxicab_commission_and_uber.

[33] Editorial Board, *The D.C. Taxicab Commission's Uber Problem*, WASH. POST, Aug. 26, 2013, http://www.washingtonpost.com/opinions/the-dc-taxicab-commissions-uber-problem/2013/08/26/a0538428-0b38-11e3-9941-6711ed662e71_story.html.

[34] *See* MATTHEW MITCHELL, THE PATHOLOGY OF PRIVILEGE: THE ECONOMIC CONSEQUENCES OF GOVERNMENT FAVORITISM 21–25 (George Mason Univ. Mercatus Ctr. ed., 2012), *available at* http://mercatus.org/publication/pathology-privilege-economic-consequences-government-favoritism.

[35] *Id.*; *see also* Gordon Tullock, *The Welfare Costs of Tarriffs, Monopolies and Theft*, 5 W. ECON. J. 224, 224–32 (1967); Anne Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291, 291–303 (1974); DENNIS C. MUELLER, PUBLIC CHOICE III 336–37 (3d. ed., Cambridge Univ. Press 2003).

[36] William J. Baumol, *Entrepreneurship: Productive, Unproductive, and Destructive*, 98 J. POL. ECON. 893, 893–921 (1990); Kevin M. Murphy, Andrei Shleifer & Robert W. Vishny, *The Allocation of Talent: Implications for Growth*, 106 Q. J. ECON. 503, 503–30 (1991); MANCUR OLSON, THE RISE AND DECLINE OF NATIONS: ECONOMIC GROWTH, STAGFLATION, AND SOCIAL

B. Restrictions on Entry and Innovation

Due to the capture problem discussed above, regulations often become formidable barriers to new innovation, entry, and entrepreneurship. For example, at the beginning of the 20th century many local governments began regulating the taxicab industry in an attempt to protect consumers from potential harms caused by market failures in the form of "information asymmetries." As a result, entry into the taxicab market and taxicab fares, services, and quality were restricted in a substantial way in most cities around the country.[37] In 2006, there were only 12,799 licensed taxicabs in New York City, compared with 21,000 in 1931, when the city had about 1 million fewer inhabitants.[38] While many of the initial justifications have since faded away, these regulations remain, with the practical effect of protecting established incumbents from increased competition in the form of Uber and Lyft. This is also true of many of the regulatory efforts prohibiting or limiting Airbnb and other innovative firms within and outside the sharing economy.[39]

Sometimes even seemingly innocuous regulations can have counterproductive effects. Some cities—such as Washington, DC, and New York—require all taxicabs to be painted the same color, ostensibly to make them more identifiable for potential passengers.[40] Unfortunately, however, this requirement makes it more difficult for competitors to differentiate by brand. This undermines the competitive rivalry within the industry and reduces the incentive for firms to distinguish themselves in the level of customer service they provide. With riders unable to differentiate those firms that provide additional levels of care from those that do not—especially when hailing taxicabs from the street—incumbent firms need not compete with one another on the quality of services they provide.

It is not just customer care that may decline—innovation may also suffer. In a competitive market characterized by open entry and exit, firms are constantly competing to earn increased profits in one of two ways.[41] First, they

RIGIDITIES 75–117 (Yale Univ. Press 1982).

37 Matthew Mitchell & Michael Farren, *If You Like Uber, You Would've Loved the Jitney*, L.A. TIMES, July 12, 2014, http://www.latimes.com/opinion/op-ed/la-oe-mitchell-jitneys-uber-ride-share-20140713-story.html.

38 SCHALLER CONSULTING, THE NEW YORK CITY TAXICAB FACT BOOK (2006), *available at* http://www.schallerconsult.com/taxi/taxifb.pdf.

39 Mark P. Mills, *Airbnb at the Tip of the Spear of the Regulatory State versus Innovators*, FORBES (June 18, 2014, 1:28 PM), http://www.forbes.com/sites/markpmills/2014/06/18/airbnb-at-the-tip-of-the-spear-of-the-regulatory-state-versus-innovators/.

40 *D.C. Taxis Getting New Color Scheme*, NBC WASHINGTON (Oct. 12, 2013, 7:41 AM), http://www.nbcwashington.com/news/local/DC-Taxis-Getting-New-Color-Scheme-227450421.html.

41 MITCHELL, *supra* note 34, at 17–18.

can find innovative ways to minimize their costs, passing on some of the savings to customers. As firms operate more efficiently, others will seek to innovate and economize as well, and those that fail to do so will eventually be driven out of the industry. Second, as mentioned above, firms can compete by differentiating their products from those of their competitors. This "dynamic competition" encourages firms to discover new ways of doing business and new ways of creating value for their customers.[42]

When regulations prohibit price competition, competition along the quality dimension often becomes more intense. This, in turn, encourages firms to seek further regulations that prohibit quality competition. As the regulator and regulatory expert Alfred Kahn once put it, this explains the "inexorable tendency for regulation in the competitive market to spread."[43] It tells why we have seen a proliferation of taxi regulations that govern not just the quantity of cabs and the prices that they may charge, but also the paint colors and exterior lighting schemes they use, the passenger notices they post, the car models they drive, the payment methods they employ, and much more. As one driver told the *Washington Post*, "Everywhere on this car has been regulated. Look at it!"[44]

The net effect of regulations that limit entry and homogenize price and quality is to insulate incumbent firms from dynamic competition that would otherwise benefit consumers.

C. Higher Prices and Fewer Choices

As a result of the above factors, regulation often undermines competition, resulting in higher prices, fewer choices, lower quality service, or some

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[42] Israel M. Kirzner, *Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach*, 35 J. ECON. LIT. 60, 62 (1997). Dynamic competition stands in stark contrast to the "perfectly competitive" model of neoclassical economics. *Id.* at 68. In the perfectly competitive model, "price taking" firms produce identical, homogenous products, and there is little role for the entrepreneur. *Id.* at 70. According to Israel Kirzner, dynamic competition is a better description of real-world competition and its benefits. *Id.* at 69–70.

[43] THOMAS K. MCCRAW, PROPHETS OF REGULATION 272 (Harvard Univ. Press 1984). In the context of airline regulations, Kahn asserts:

> Control price, and the result will be artificial stimulus to entry. Control entry as well, and the result will be an artificial stimulus to compete by offering larger commission to travel agents, advertising, scheduling, free meals, and bigger seats. The response of the complete regulator, then, is to limit advertising, control scheduling and travel agents' commissions, specify the size of the sandwiches and seats and the charge for inflight movies.

Id.

[44] Emily Badger, *Taxi Medallions Have Been the Best Investment in America for Years: Now Uber May Be Changing That*, WASH. POST, June 20, 2014, http://www.washingtonpost.com/blogs/wonkblog/wp/2014/06/20/taxi-medallions-have-been-the-best-investment-in-america-for-years-now-uber-may-be-changing-that/.

combination thereof.[45] In particular, if firms are insulated from competition from new entrants, they can obtain some measure of monopoly or pricing power. This diminishes consumer welfare while enhancing producer profit. But, because consumer welfare is diminished more than producer profit is enhanced, it yields a social loss, which economists refer to as "deadweight loss."[46]

To compound the problem, firms that benefit from regulatory barriers to entry are unlikely to minimize production costs. Free of the rigor of competition, these firms and their employees are allowed to "slack off." These higher-than-normal production costs are known as "x-inefficiencies" and are in addition to the deadweight losses and rent-seeking losses we have already discussed.[47]

For similar reasons, protected firms do not have the same need to satisfy consumer desires; instead, their success depends more on their ability to please regulators.[48] This tends to make firms less alert to the sorts of entrepreneurial product and service innovations that consumers desire.[49] This explains why regulated taxis have tended to only adopt credit card readers when their regulators have mandated them, while Uber and Lyft have done so without needing to be told.

IV. HOW THE INTERNET SOLVES INFORMATION PROBLEMS

The growth of the Internet and information technology markets opens up the possibility that consumer welfare can better be served by innovation and competition than by regulation. In this section, we note the Internet helps entrepreneurs accomplish several things that regulation has failed to achieve. Specifically, it allows innovators to offer an expanded range of goods and services, greatly expands the information available to consumers, and provides strong reputational incentives for firms to improve the level of service being provided.

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[45] ROBERT CRANDALL & JERRY ELLIG, ECONOMIC DEREGULATION AND CUSTOMER CHOICE: LESSONS FOR THE ELECTRIC INDUSTRY (George Mason Univ. Mercatus Ctr. ed., 1997), *available at* http://mercatus.org/publication/economic-deregulation-and-customer-choice-lessons-electric-industry.

[46] Deadweight loss can also be thought of as the forgone opportunity for mutually beneficial exchange.

[47] Harvey Leibenstein, *Allocative Efficiency vs. 'X-Efficiency'*, 56 AM. ECON. REV. 392, 392–415 (1966).

[48] MITCHELL, *supra* note 34, at 20.

[49] Kirzner, *supra* note 42, at 81.

A. Expanded Range of Goods and Services

First, and most obviously, the Internet and information technology give the public access to a broader range of goods and services.[50] The ease of entry and innovation in the online world mean new entrants can provide better options and address problems previously thought to be unsolvable in the absence of regulation.[51] Polls have revealed consumers currently take advantage of sharing economy services primarily because they offer greater convenience, better prices, and higher quality.[52]

This is also attested by comparisons of Yelp ratings in almost any major city where ride-sharing firms operate.[53]

B. Expanded Information

Second, the Internet and information technology offer consumers more information about products and services and empower consumers to come together and act on that information.[54] Traditionally, many economists have worried about the existence of information asymmetries between producers and consumers and argued that "the difficulty of distinguishing good quality from bad is inherent in the business world."[55] The best that could be hoped for in the pre-Internet era was that consumer watchdogs, competition between firms, and brand "goodwill" would be enough to safeguard consumer welfare.[56]

But, the Internet largely solves this problem by providing consumers with

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[50] *See* Bret Swanson, *The Exponential Internet*, BUS. HORIZON Q., Spring 2014, at 40–47, *available at* http://www.uschamberfoundation.org/sites/default/files/article/foundation/BHQ-Spring12-Issue3-SwansonTheExponentialInternet.pdf.

[51] ADAM THIERER, PERMISSIONLESS INNOVATION: THE CONTINUING CASE FOR COMPREHENSIVE TECHNOLOGICAL FREEDOM 1–7 (George Mason Univ. Mercatus Ctr. ed., 2014).

[52] Jeremiah Owyang, *People are Sharing in the Collaborative Economy for Convenience and Price*, WEB-STRATEGIST.COM (Mar. 24, 2014), http://www.web-strategist.com/blog/2014/03/24/people-are-sharing-in-the-collaborative-economy-for-convenience-and-price.

[53] *See, e.g.*, Matthew Mitchell, *An Uber Challenge to Tacky Taxis*, WASH. TIMES, Aug. 28, 2013, http://www.washingtontimes.com/news/2013/aug/28/an-uber-challenge-to-tacky-taxis/; *see also* Matthew Mitchell & Christopher Koopman, *Ride-Sharing Shows How Slow Governments Can Be*, PITTSBURGH POST-GAZETTE, July 6, 2014, http://www.post-gazette.com/opinion/Op-Ed/2014/07/07/Ride-sharing-shows-how-slow-governments-can-be/stories/201407070009.

[54] "By making it easier for groups to self-assemble and for individuals to contribute to group effort without requiring formal management (and its attendant overhead), these tools have radically altered the old limits on the size, sophistication, and scope of unsupervised effort." CLAY SHIRKY, HERE COMES EVERYBODY: THE POWER OF ORGANIZING WITHOUT ORGANIZATIONS 21 (Penguin Press 2008).

[55] Akerlof, *supra* note 11, at 500.

[56] *See* MILTON FRIEDMAN & ROSE FRIEDMAN, FREE TO CHOOSE: A PERSONAL STATEMENT 223–24 (Harcourt Brace Jovanovich 1980).

robust search and monitoring tools to find more and better choices. These tools lower both search costs and transaction costs associated with commercial interactions.[57] Moreover, unlike regulatory solutions, these market-developed tools cannot be captured. Online e-commerce and the sharing economy developed thanks to these new realities.

C. Consumer Empowerment via Reputational Feedback Mechanisms

Third, information technology has facilitated the creation of countless reputational feedback mechanisms across the online ecosystem—such as product rating and review systems—that give consumers a more powerful voice in economic transactions.[58] Before the Internet, "reputations travel[ed] haphazardly [through] word of mouth, . . . rumor[], or . . . the mass media," but first-generation e-commerce sites like eBay and Amazon helped blaze the way for far more robust reputational feedback systems.[59] Moreover, countless "expert" product review sites have been developed for almost every good and service available to consumers.[60] Today, almost all sharing economy firms depend on these reputational feedback mechanisms to establish trust between suppliers and consumers.[61] David D. Friedman notes "reputational enforcement works by spreading true information about bad behavior. People who receive that information modify their actions accordingly, which imposes costs on those who have behaved badly."[62]

Sharing economy entrepreneurs have developed a number of other

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[57] Clay Shirky speaks of a "ladder of activities . . . that are enabled by social tools" and that create greater opportunities for sharing, cooperation, collaboration, and collective action. SHIRKY, *supra* note 54, at 47–54. This enables what he refers to as "ridiculously easy group-forming," which "matters because the desire to be part of a group that shares, cooperates, or acts in concert is a basic human instinct that has always been constrained by transaction costs." *Id.*

[58] *See, e.g.*, RANDY FARMER & BRYCE GLASS, BUILDING WEB REPUTATION SYSTEMS (O'Reilly Media 2010).

[59] Paul Resnick et al., *Reputation Systems*, 43 COMM. OF THE ACM 45, 45–48 (2000), *available at* http://cacm.acm.org/magazines/2000/12/7494-reputation-systems/abstract.

[60] *See* Liangjun You & Riyaz Sikora, *Performance of Online Reputation Mechanisms under the Influence of Different Types of Biases*, 12 INFO. SYS. & E. BUS. MGMT. 418 (2014) ("Online opinion and consumer-review sites have dramatically changed the way consumers shop, enhancing or even supplanting traditional sources of consumer information such as advertising.").

[61] *See* Chrysanthos Dellarocas, *Designing Reputation Systems for the Social Web*, *in* THE REPUTATION SOCIETY: HOW ONLINE OPINIONS ARE RESHAPING THE OFFLINE WORLD 3, 3 (Hassan Masum & Mark Tovey eds., MIT Press 2011) ("Reputation systems are arguably the unsung heroes of the social web. In some form or another, they are an integral part of most of today's social web applications.").

[62] DAVID D. FRIEDMAN, *Contracts in Cyberspace*, *in* FUTURE IMPERFECT: TECHNOLOGY AND FREEDOM IN AN UNCERTAIN WORLD 97, 100 (Cambridge Univ. Press 2008); *see also* Daniel Klein, *Knowledge, Reputation, and Trust, by Voluntary Means*, *in* REPUTATION: STUDIES IN THE VOLUNTARY ELICITATION OF GOOD CONDUCT 1, 1–14 (Univ. of Mich. Press 1997).

monitoring mechanisms to ensure quality. Uber and Lyft, for example, allow consumers to see the GPS path of their rides so they can independently verify the driver took the shortest route. The firms also have the address and credit card information of every customer, which helps to ensure the drivers' safety. This also permits all transactions to be cashless, reducing the incentive for theft. The result is more fully informed and empowered consumers.[63] As economist Tyler Cowen observes, "[t]here has been a fundamental shift in the balance of power between consumers and salesmen over the last generation[,] and it points in the direction of consumers."[64]

D. Self-Regulating and Other-Regulating Markets

The combination of these factors results in a powerful check on market power or abusive behavior. The reputational incentives at work require firms to constantly seek ways to satisfy rapidly evolving consumer demands and to gain (and keep) consumers' trust.[65] As Adam Smith noted more than 250 years ago in *The Theory of Moral Sentiments*, "We desire both to be respectable and to be respected," and people's success in life "almost always depends upon the favour and good opinion of their neighbours and equals; and without a tolerably regular conduct these can very seldom be obtained. The good old proverb, therefore, that honesty is the best policy, holds, in such situations, almost always perfectly true."[66]

Modern online feedback mechanisms have made it easier for honesty to be enforced through strong reputational incentives.[67] And, because sharing

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63 *See* Randolph J. May & Michael J. Horney, *The Sharing Economy: A Positive Shared Vision for the Future*, 9 PERSPECTIVES FROM FSF SCHOLARS 1, 8 (Free State Foundation 2014), *available at* https://www.heartland.org/sites/default/files/the_sharing_economy_-_a_positive_shared_vision_for_the_future_072914.pdf ("[O]nline applications offer a new, additional means of enabling trust, thereby facilitating trading and sharing in a way that creates new consumer choices and positively impacts the economy.").

64 TYLER COWEN, CREATE YOUR OWN ECONOMY: THE PATH TO PROSPERITY IN A DISORDERED WORLD 117 (Dutton 2009).

65 *See* Gordon Tullock, *Adam Smith and the Prisoners' Dilemma*, 100 Q. J. OF ECON. 1078, 1081 (1985) ("A reputation for being 'sound' is a valuable asset, and we should expect people to make every effort to get it. . . . When the market is broad and there are many alternatives, you had better cooperate. If you choose the noncooperative solution, you may find you have no one to noncooperate with.").

66 ADAM SMITH, THE THEORY OF MORAL SENTIMENTS 72, 74 (Knud Haakonssen ed., 2002).

67 *See* Elodie Fourquet, Kate Larson & William Cowan, *A Reputation Mechanism for Layered Communities*, 6 ACM SIGECOM EXCH. 11, 11 (2006) ("Social science research has shown that feedback systems, or reputation mechanisms, increase trust and trustworthiness among strangers engaging in commercial transactions. They provide summarized histories of past behaviour, increasing the opportunities of well-behaved participants, and decreasing those of poorly-behaved ones. They thus improve trust by rewarding cooperation.") (internal citation omitted).

platforms have opened traditionally cartelized industries to new competition, they have also permitted firms to regulate one another's behavior. Competitive firms are often quicker than regulators to point out the substandard service of their rivals. The result is reasonably well-functioning, self-regulating markets with strong checks on improper behavior. Bad actors get weeded out fairly quickly through better information, reputational incentives, and aggressive community self-policing. Eric Goldman of Santa Clara School of Law refers to this as a "secondary invisible hand":

> When information about producers and vendors is costly, reputational information can improve the operation of the invisible hand by helping consumers make better decisions. In this case, reputational information acts like an invisible hand of the invisible hand (an effect I call the *secondary invisible hand*) because reputational information can guide consumers to make marketplace choices that in aggregate enable the invisible hand. Thus, in an information economy with transaction costs, reputational information can play an essential role in rewarding good producers and punishing poor ones.[68]

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."[69] 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.[70]

Economists generally agree that the presence of increased competition, innovation, and better information obviates the need for heavy-handed regulation. For example, in a recent poll, 93% of surveyed economists said they "agreed" or "strongly agreed" (and none disagreed) with the statement, "Letting car services such as Uber or Lyft compete with taxi firms on equal footing regarding genuine safety and insurance requirements, but without restrictions on prices or routes, raises consumer welfare."[71]

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[68] Eric Goldman, *Regulating Reputation*, *in* THE REPUTATION SOCIETY: HOW ONLINE OPINIONS ARE RESHAPING THE OFFLINE WORLD 53 (Hassan Masum & Mark Tovey eds., MIT Press 2011).

[69] John C. Moorhouse, *Consumer Protection Regulation and Information on the Internet*, *in* THE HALF-LIFE OF POLICY RATIONALES: HOW NEW TECHNOLOGY AFFECTS OLD POLICY ISSUES 139–40 (Fred E. Foldvary & Daniel B. Klein eds., Cato Inst. 2003).

[70] Arun Sundararajan, *Why the Government Doesn't Need to Regulate the Sharing Economy*, WIRED (Oct. 22, 2012, 1:45 PM), http://www.wired.com/2012/10/from-airbnb-to-coursera-why-the-government-shouldnt-regulate-the-sharing-economy.

[71] *Taxi Competition*, IGM FORUM (Sept. 29, 2014, 9:10 AM), http://www.igmchicago.org/igm-

V. THE PRO-CONSUMER, PRO-INNOVATION WAY TO "LEVEL THE PLAYING FIELD"

Accidents will always happen, of course, and remedies to monitor and deal with bad behavior will always be necessary. Importantly, private insurance, contracts, torts and product liability law, and other legal remedies exist when things go wrong. Such ex post remedies do not discourage innovation and competition the way ex ante regulation does. By trying to head off every hypothetical worst-case scenario, preemptive regulations actually discourage many *best-case* scenarios from ever coming about.[72]

Incumbents who oppose new entry by sharing economy innovators will argue that they still face various regulatory burdens that new entrants are evading. These include licensing requirements, price controls, service area requirements, marketing limitations, and technology standards. In theory, this could place incumbents at a disadvantage relative to new sharing economy start-ups that might not face the same regulations (even though those same regulations could simultaneously be used to keep smaller start-ups out of the market).

Nevertheless, such regulatory asymmetries represent a legitimate policy problem. But, the solution is not to punish new innovations by simply rolling old regulatory regimes onto new technologies and sectors. The better alternative is to level the playing field by "deregulating down" to put everyone on equal footing, not by "regulating up" to achieve parity. Policymakers should relax old rules on incumbents as new entrants and new technologies challenge the status quo. By extension, new entrants should only face minimal regulatory requirements as more onerous and unnecessary restrictions on incumbents are relaxed.

VI. CONCLUSION

As we have explained, the fact regulations were justified on the grounds of consumer protection does not mean they accomplished those goals or that they are still needed today.[73] Even well-intentioned policies must be judged against real-world evidence.[74] Unfortunately, the evidence shows that many traditional

economic-experts-panel/poll-results?SurveyID=SV_eyDrhnya7vAPrX7.

[72] THIERER, *supra* note 51, at viii.

[73] "Unfortunately, when it comes to public policy, good intentions are only slightly better than bad intentions, and not always even that." Joseph Epstein, *ObamaCare and the Good Intentions Paving Co.*, WALL ST. J., Dec. 31, 2013, http://on.wsj.com/18UEwfx.

[74] "Intentions are not results." Don Boudreaux, *Unintended Consequences*, LEARN LIBERTY (June 29, 2011), http://www.learnliberty.org/videos/unintended-consequences.

consumer protection regulations hurt consumer welfare. Markets, competition, reputational systems, and ongoing innovation often solve problems better than regulation when we give them a chance to do so.

While this Paper provides a brief introduction to the future of the sharing economy and a framework for understanding many of the issues surrounding its regulation, more research is needed in this area. In particular, scholars could explore the ways in which the sharing economy has dealt with the problem of asymmetric information and evaluate how these solutions compare with traditional regulatory approaches. What are the net benefits to society as a result of the growth in the sharing economy, and what are the overall consumer surpluses resulting from these new services and industries? What are the benefits to those individuals that utilize these services—Uber, Lyft, Airbnb—as sources of income? To what degree is the sharing economy creating new markets, rather than simply supplanting older forms of transactions? As the sharing economy continues to grow, these and other questions should be addressed, and we hope policymakers will be open to the reforms that may be needed to maximize the potential for increases in consumer welfare.