Change the Legislation, Not the Sharing Economy: The Czech Perspective

*
ALEŠ
ROD

The sharing economy is currently a very trendy term. Politicians, bureaucrats, journalists, traditional market players organized in guild associations – all of these agents have recently been faced with the question: What exactly does a sharing economy mean for my own well-being? And so, for politicians, a sharing economy is a new way of interacting with their voters, but also a playground for collaboration with business interest groups. Bureaucrats are faced with a new regulative challenge. For journalists, a sharing economy means a new area for future stories and criticism. Guild associations experience the risk of losing their positions. But for all of them, a sharing economy is something new, unknown and potentially dangerous. This, however, is an absolutely wrong interpretation of the term.

> SHARING ECONOMY IS SOMETHING NEW, UNKNOWN AND POTENTIALLY DANGEROUS

A sharing economy represents technological progress in all its purity. It is a new way of collaboration between various agents; an efficient way of transforming an existing network of assets into more economic activity. A sharing economy is not a *thing*, it means *thinking*! People find out they can transform their old behavior patterns into new ways of doing things on platforms which enable individuals to satisfy more needs, and therefore create more wealth. Paradoxically, the two most obvious groups of agents within the scope of a sharing economy have not been mentioned in the very first paragraph of this article – namely, suppliers and their customers. Nevertheless, these are the subjects who have no difficulty analyzing the meaning of the term itself. Actually, they do much more than just define it – they use it! And they increase their utility in various sharing economy markets.

If people understood the term 'sharing economy' correctly (as *thinking*, not as a *thing*), they should be open to the discussion that it needs a new legislative environment. No one can prevent people from consuming smart economic goods for lower prices. It would be simply wasteful and, moreover, banning such solutions would be a strong incentive for moving the *sharing* economy into the *shadow* economy That is just a fact.

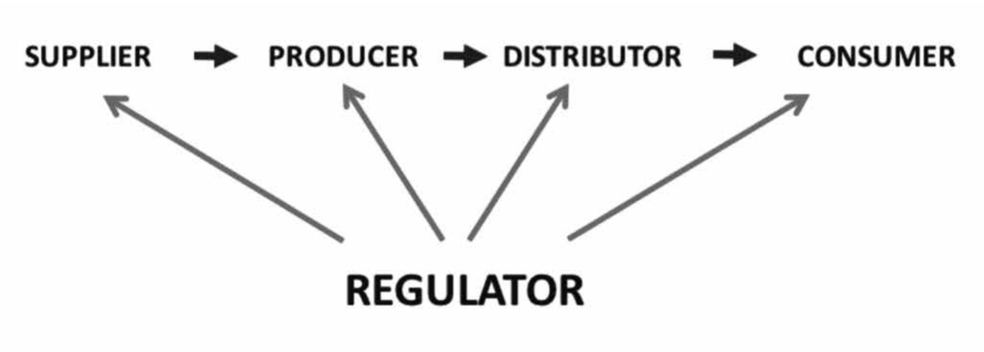
PROBLEMS WITH REGULATION

A standard regulation goes hand in hand with the *prohibitio ordinem*[1] approach, i.e. the approach in which a regulative body sets up rules of the game for all related subjects under the threat of punishment for those who do not respect it. The actual control is conducted by the means of a selective method – everyone knows they could be controlled any time, so they should always respect the existing rules.

Historically, this approach has been the only way of supervising behavior patterns within the society – costs for further (individual) controlling were so excessive that a temptation to cheat was being eliminated

[1] *Prohibition by force*: a government lays down the rules and penalties for violations.

Figure 1: Regulation Prohibitio Ordinem



by very high penalties[2]. Due to the fact that the motivations of cheating subjects to hide these activities are far greater than the motivations of state regulators to invest their effort in uncovering frauds but also because the regulators' capacity to watch and control all subjects and transactions is limited, a probability of the transgressions being revealed decreases regardless of the increasing of the potential punishments. [See Figure 1]

The abovementioned issue mirrors yet another regulative manner of fettering economic behavior. In the selected branches of economy, governments impose such common measures as excise duties, licensing and entry fees, defined ways of accounting and reporting, etc. These measures increase transactions costs for the interaction between supply and demand with significant impact on collective wealth. Let us use a few Econ101 graphs to illustrate the matter.

Consider a market with a good X. Consumers are represented by a descending demand curve[3] and suppliers are represented by an increasing supply curve[4]. The market finds the equilibrium at coordinates X_A (quantity) and P_A (price). As we see, some customers would be willing to pay more money than P_A to satisfy their needs, but they do not have to. The P_A is the market price. Therefore, the G triangle represents consumers' value from market interactions above the amount paid (consumer surplus).

On the other hand, some suppliers are willing to supply good X for lower amounts than P_A, but they do not have to. The P_A is the market price – so the B triangle represents manufacturers' benefits from market interactions (production surplus). Consequently, both B and G triangle illustrate the collective wealth arising from market transactions. [See Figure 2]

Figure 3 demonstrates a situation after regulatory measures have been imposed. The supply curve shifts upward, because manufacturers cannot produce and deliver a certain quantity X at the same costs level

[2] Economics and crime: According to Gary Becker, criminals rationally evaluate the benefits of their crime and the costs such as the probability of apprehension, conviction, and punishment, and their current set of opportunities. Read more in Becker, G. S. (1968), "Crime and punishment: An economic approach" [in]: *The Economic Dimensions of Crime* (pp. 13-68), Palgrave Macmillan UK.

[3] Consumers follow the rule of diminishing marginal utility, i.e. every additional item of good X brings a lower marginal utility to the individual because their needs are more and more satisfied. Therefore, the individual is willing to pay less for every additional item of the X good.

[4] Suppliers follow increasing marginal costs at the production process – for the production of every additional unit of good X, a manufacturer must invest more scarce economic sources, i.e. they require a higher price for every additional item delivered to the market.

Figure 2: Consumer Surplus and Producer Surplus

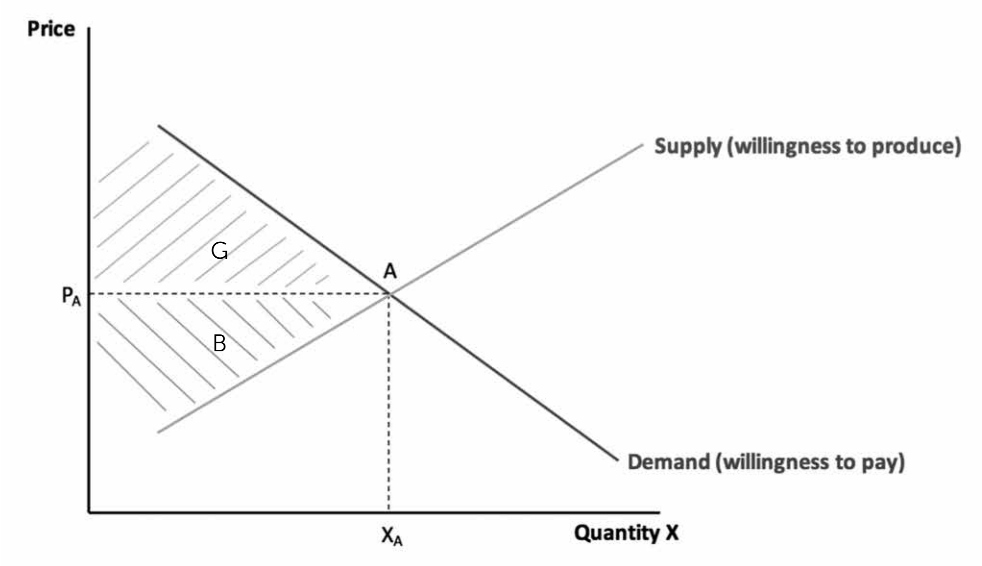
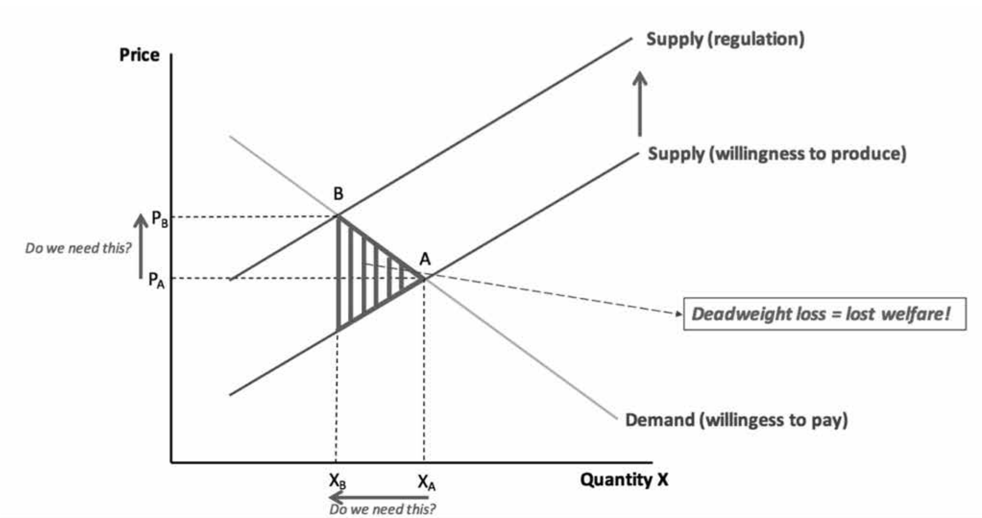


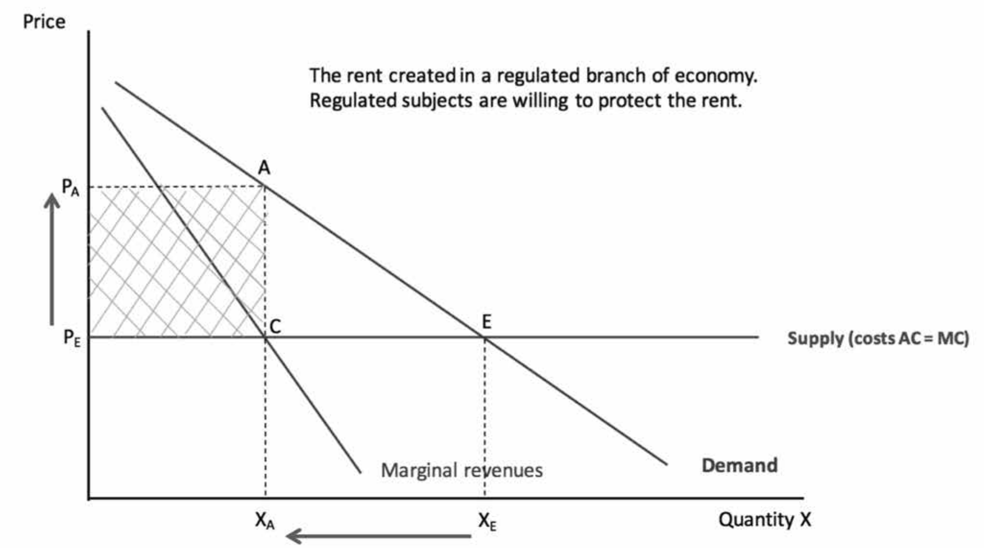
Figure 3: Impact of regulation



– the regulation has increased transaction costs and created barriers for economic interactions between consumers and suppliers. Therefore, a smaller quantity of good X is traded (X_A => X_B) for a higher market price (P_A => P_B). The collective wealth arising from market transactions is significantly lower than in the previous situation (see the triangle deadweight loss). The consumer surplus is lowered by the regulation[5]. [See Figure 3]

[5] The Manufacturer surplus also depends on the form of regulation.

Figure 4: Rent-seeking



As we see, the crucial economic impact is illustrated on both axes – the market distributes less of good X for a higher price, with a significant impact on the utilities of economic agents, regardless of whether good X is food service, transport service, accommodation service or the shared ownership of assets. After the regulation, less economic transactions are completed in the official economy – not only as a part of a sharing economy, but also in general. The point is: Do we consider this deadweight loss as an adequate trade-off for fulfilling regulatory goals? And moreover, for whom is this situation favorable?

RENT-SEEKING IN TRADITIONAL BRANCHES

An answer to the previous questions could be related to the term 'rent-seeking'[6]. It refers to an activity when a subject spends scarce economic resources on creating administrative barriers, which preclude competitors from a substantial part of the market. The *rent* is a rent-seeker's potential profit. Considering this, a rent-seeker does not mind spending costs up to the rent itself. When there are more competitors willing to seek for rent, total rent-seeking costs can even exceed the rent itself[7].

The matter is illustrated on figure 4. Firstly, it shows a market with one company producing good X with constant average costs and decreasing marginal revenues. Although the market equilibrium is at point E (quantity X_E; price P_E), the company maximizes its profit[8] when producing the quan-

[6] The concept was first explained by Gordon Tullock (1967), the term 'rent-seeking' was first used by Anne Krueger (1974).

[7] Example: A city council would like to choose an official provider of taxi services from the City Airport for a 5-year period. This would mean high and stable revenues for the chosen provider. Therefore, taxi providers start to invest their efforts into preparing for a public tender (lawyers, lobbyists, consultants, investments in new cars, etc.) or even to secure unfair conditions (clientelism, corruption). When all the direct and indirect costs spent by providers are added up, it turns out that the sum would be higher than the revenues from the monopoly airport operation.

[8] The golden rule of profit maximization states that a company will aim to produce under the condition that marginal revenues from the last produced good cover

tity X_A and selling it for the price P_A. This behavior leads to the profit illustrated by the rectangle P_E-P_A-C-A in the same figure. [See Figure 4]

The profit, however, also represents the rent. The company knows that the administrative barrier comfortably secures the collection of this rent, so it does not mind spending scarce resources (lobbying, political support, corruption, blackmailing, among others) to keep the supply side of the market (i.e. keep the rent) for itself. However, competitors willing to enter the market must expend adequate resources as a reaction to this rent-seeking activity by its own activities (litigations, studies and analyses, lobbying, PR activities, among others). This spending of scarce resources is very inefficient: the total resources spent by both sides could exceed the rent itself. Economic theory illustrates these inefficiencies by the deadweight loss (a lost part of both consumer and manufacturer surplus) illustrated by the C-E-A triangle.

”

SHARING ECONOMY PLATFORMS ARE BASED ON TECHNOLOGICAL INNOVATIONS AND BRING A NEW DIMENSION OF PROVIDING SERVICES INTO THE CLASSIC BRANCHES OF THE ECONOMY

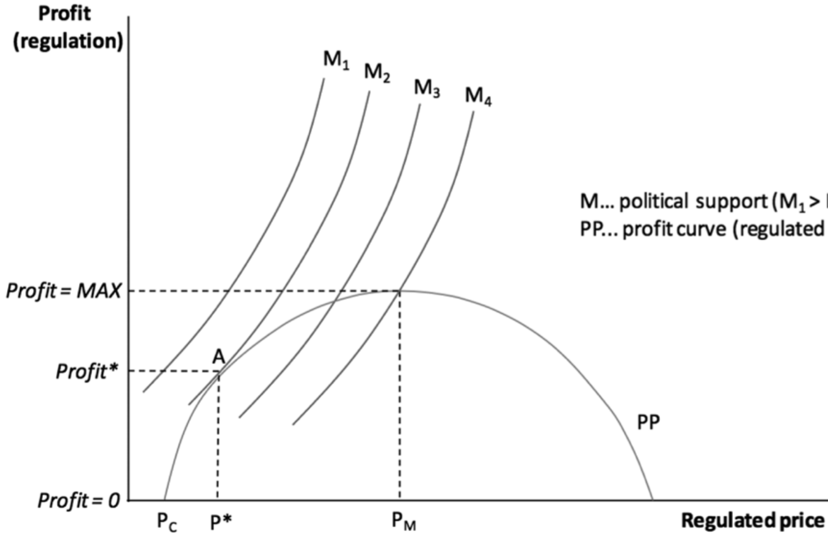
Sharing economy platforms are based on technological innovations and bring a new dimension of providing services into the classic branches of the economy. These branches have gone through decades of a gradual regulation, which – at the end of the day – has prevented competitors from free entry into the market. All these licenses, rules, terms and conditions have created remarkable rents for taxi companies, hotels, car rentals, banks, etc. At present, market agents consider any development as a threat to their stable positions. Changes activate the resistance which is manifested by using various arguments – market balance, iniquity or the necessity to protect consumers are among them. All sharing economy agents face these arguments in favor of keeping the “standard environment” on the market and instead introducing more regulations on platforms such as: UBER, Airbnb, Zonky, ZIPCAR, etc. Which approach is the best? Well, all eyes are pointed on the politicians.

POLITICIANS AND SHARING ECONOMY REGULATION

Needless to say, the role of politicians is crucial as far as the sharing economy is concerned. All interest groups target their arguments precisely at politicians. They determine whether rents would be created and among whom they would be redistributed. Politicians make decisions about regulatory issues and create the leg-

the marginal costs necessary for the production of this item.

Figure 5: Stigler-Peltzman Model



Source: Based on Peltzman (1976)

islation, which is the most important factor determining conditions on the market. Sam Peltzman (1976), a famous economist responsible for developing the theory of regulation, pointed out the phenomenon of a politician balancing between voters on the one side and interest groups on the other. Figure 5 illustrates the concept of the Stigler-Peltzman Model[9].

[See Figure 5] Politicians decide on the price level in a regulated industry. The price of a regulated economic good is depicted on the horizontal axis ('Regulated price'). The vertical axis, labelled as 'Profit (regulation)', describes profits (rents) in a regulated branch of the economy. Curves M_1 to M_4 represent political support for a politician, inversely proportional to the regulated price from the stand of voters and directly proportional to the regulated price from the stand of businessmen[10] – the M_1 support curve is more desirable than the M_2 support curve, *et cetera*. The PP curve represents profits of a regulated business – the curve is concave due to the fact that very high prices discourage customers from consumption.

Peltzman explains that a politician faces a trade-off challenge between the support from the electorate and support from rent-seekers. A rational politician does not seek either the maximum support from business (P_M *de facto* means a monopoly market structure), or the maximum support from voters (P_C *de facto* means a very competitive market structure). A rational politician,

[9] With respect to the work of another great economist George Stigler, the concept is usually referred to as the 'Stigler-Peltzman Model'. The terms 'Peltzman Model' or 'Chicago Model of Regulation' are also used. See more in Peltzman, S. (1976), *Toward a more general theory of regulation.*

[10] A lower price of the good means cheaper products, i.e. higher support for the politician from voters. A higher price of the good means higher profits, i.e. higher support for the politician from businessmen.

> RENT-SEEKERS SEEK PROFITS, WHEREAS USERS SEEK UNINHIBITED ACCESS TO THE SHARING ECONOMY SERVICES THEY LIKE MOST

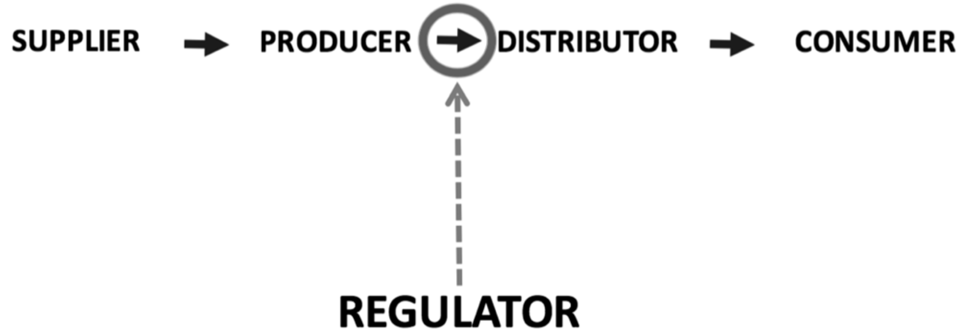
Peltzman says, should regulate the industry at point A, when the price level P* determines Profit* (business) and M_1 support (voters) – at this point, a politician gets the maximum possible support from voters with respect to maximum possible support from businessmen.

The recent debate about the sharing economy in most EU countries follows this concept from the point of the theory of regulation. The PP curve is understood as a profit curve of rent-seekers from "traditional branches" (e.g. taxi drivers, hoteliers, banks and credit institutions), M curves are embodying preferences of sharing economy users (on both the supply and the demand side). Naturally, rent-seekers seek profits, whereas users seek uninhibited access to the sharing economy services they like most. At the same time, politicians seek reelection.

According to the economic theory, the model of regulation determines the real motivations of politicians in sharing economy regulation – it would be naive to think that politicians would enable a 100% free environment for a sharing economy (subjects from traditional branches have some influence on politicians). On the other hand, politicians should not ignore preferences of sharing economy users, i.e. their voters. However, the model mentioned above implicitly determines the role of non-elected bureaucrats, on which the crucial responsibility could be delivered at the end of the day.

If a politician found out the dilemma between voters and businessmen is too complicated for easy political wins, he could show his "deep involvement" by moving the issue onto specialized bureaucratic institutions (bureau, ministry, commission,

Figure 6: Better regulation



etc.). However, shifting the responsibility onto a new regulative body with non-elected bureaucrats creates a basis for a growth of the state. Why? According to the public choice theorists, bureaucrats want to enlarge their administration because of more competencies, more respect and influence, work positions, money, opportunities for career elevators and higher stability of their position. Some regulation is, naturally, better than no regulation for bureaucrats and the issue of sharing economy could be another field where to follow subjective goals.

BETTER REGULATION

Sharing economy ideas need new and innovative regulation. This new regulation (or deregulation) shall systematically analyze an economic activity running on sharing platforms, highlight problematic aspects related to it and create positive incentives to prevent particular problems such as tax issues or reporting to state officials. [See Figure 6]

Let us consider the supply-demand chain and the tax issue arising between the manufacturer and the distributor, resulting in the negative fiscal impact. The *Prohibitio Ordinem* approach would try to control all transactions in the entire supply-demand chain, probably without satisfactory results (too many transactions to control equals too low a probability of being controlled). This could lead to an ascending regulation, prohibition or other regulatory steps (in favor of rent-seekers).

Inefficiency is pushed more by the argument of an unofficial economy – if the economic activity has a strong demand basis, it can move into the the shadow economy area where no control is easily carried out. The better regulation approach systematically identifies only particular issues and neutralizes them in two possible ways – the standard "see and punish" way (follow the rule or a penalty will come) or a better, positive way (do the transaction in a desirable way and affirmative action will happen). Of course, the form and scope of affirmative actions could vary – from the basic supporting cashless and trackable transactions on the one hand, to digital systems with online control of transactions and automatic tax obligation calculations run by government on the other.

Talking about the sharing economy, two areas are debated broadly these days in the Czech Republic – namely, taxi and accommodation services.

TAXI SERVICES IN THE CZECH REPUBLIC

A taxi service, defined by the Road Transport Act (111/1994), is an activity based on transport services provided to maximally nine customers, provided regularly and with the aim of creating profit. A driver must get under a special taxi concession to enter the business. In order to become a taxi driver in the Czech Republic, one has to go through four steps:

1. get a taxi driver ID;

2. pass a taxi driver exam (topography, legislation, taximeter operation);

3. register the car as a taxi driver's car;

4. acquire a trade license in the form of "taxi concession".

Apart from this, the driver must also possess a special insurance covering any potential customer-related issues during the transport (the so-called "seat insurance").

The controversy around the discussed sector is very often related to carpooling, which mirrors the legal dispute about regulative requirements targeting taxi drivers.

The current discussion focuses on three main topics:

- according to the Road Transport Act, the key component of the service is a question of "Whose need is satisfied?". Talking about transport, a customer decides on the destination and the driver simply satisfies the need for a contracted sum of money. On the other hand, when it comes to carpooling, it is the driver who decides on the destination and the passenger simply shares the cost. The factor of choosing the final destination is used as a key argument against carpooling companies in the Czech Republic;

- according to the Trade Act, each trade (economic) activity is defined as a permanent activity provided individually, under one's own name, on one's own responsibility and with the aim of generating a profit. The factor of "mercenary purpose" is a key argument used against carpooling companies in the Czech Republic;

- according to the Income Tax Act, the legislation defines an occasional income as a random activity which generates unsystematic revenue not higher than CZK 30,000 a year. Critics say that this definition does not apply to the carpool services since the drivers intentionally install the sharing platform application in their smartphones and profit is their only objective, and so they should have a trade license and follow both tax and social security obligations[11].

Although agents from classic industries tend to interpret these points as very serious problems, they are rather problematic areas than real obstacles. They could be easily dealt with by the means of a legislative procedure (e.g. defining sharing economy transport platforms as an official business channel with simple rules and conditions – taxation, insurance, etc.) which would be in line with the attitude of thousands customers and supporters, instead of tens or hundreds of rent-seekers, especially taxi drivers. The regulator must admit that there is a new market with new way of car transport, which needs a new, simple legislative which must be introduced. It is not surprising that technological revolution does not fit the old legislation.

ACCOMMODATION IN THE CZECH REPUBLIC

According to the Czech legislation, one can provide accommodation on their property in two situations: as an economic activity (under the Trade Act) or a rental activity (under the Income Tax Act).

The first regime requires a trade certificate (accommodation services), what means a regular business goal with a purpose of profit-seeking based on accommodation contracts with customers. The second regime is based on a short-term property rental contract – an individual does not need any trade certificate, but the income should be taxed under §9 of the Income Tax Act (income from rentals). One should also have an agreement with the property owner, should the property be not in their sole possession.

As far as the sharing accommodation services are concerned, the following three issues are discussed at length and emphasized by critics:

- registration of foreign guests at the Foreign Police database: According to the legislation, anyone who comes to the Czech Republic from a non-EU state for more than one day or from an EU state for more than 30 days, must register their stay at the Foreign

[11] With respect to tax duties, a debate about the Value Added Tax obligation is also on the table. When the platform as an economic subject is registered abroad and drivers (as economic entities) receive the service from abroad, they should pay VAT from platforms' commissions similarly as individuals advertising through Google AdWords, critics say.

Police or do so through an accommodation provider. The provider should administer a guestbook and provide the information to the Foreign Police within three business days;

• institutional problems: These services usually are a part of the shadow economy (tax evasion), do not follow hygiene regulations and accommodation standards;

• a price bubble on market with real estate: Sharing accommodation services are highly profitable, so the investments to realties push the market prices high and as well as the rentals for regular inhabitants.

The state should want to keep all agents in the official economy. Therefore, the points mentioned above should be dealt with particular measures, combining an e-agenda (e.g. online reporting) and smart regulations (e.g. fulfilling tax duties directly via sharing economy platforms).

CONCLUSIONS

Technologies are changing, so it should not be surprising that people are changing their economic behavior patterns. Therefore, it is both inefficient and useless to protect the rent of rent-seekers using traditional business models, or to try to fit the new businesses into the box with a deficient regulation. History knows many examples of giant companies whose sense of invincibility has led them to bankruptcy, or near to it: Blockbuster video, Pan-Am, USPS, Hummer, Kodak, Sears, Blackberry, A&F, to name just a few. Stop for a while and you will stagnate forever, it goes without saying.

Rent-seekers use three main arguments to convince regulators that regulation which will secure stable profits to rent-seekers is desirable:

1. The regulation is advantageous for the society, because “some” is always better than “none”.

2. The regulation has been imposed abroad also, so we should undoubtedly follow the practice of foreign countries.

3. The regulation will protect consumers, because it defines standards of products and services which is great.

When used at the right time and in front of the right audience, these arguments may look very serious. However, they are rather examples of a clever rhetoric. Bad regulations in favor of wellbeing of several rent-seekers is definitely not better than no regulations (1). It is not smart to copy any of the practices used abroad, but only the best practices from abroad (2). And, last but not least, the term ‘consumer protection’ does automatically signify that a consumer is probably better off, especially when this protection means printed contracts with officially verified signatures related to small transactions for several euros (3).

When talking about a massive development of markets and behavior patterns that a sharing economy provides, nobody can artificially decide what is really advantageous and what is just a whim. This decision can be made only by market actors. And they do not want to be “protected” from technological progress, better quality and low prices by the means of any regulation. A sharing economy is about to change the world, not the other way around. ●

*

ALEŠ
ROD

Founder and director of CETA – The Centre for Economic and Market Analyses. He teaches at the Faculty of Economics, University of Economics in Prague, where he finishes his Ph.D. studies in the field of Economic Theory. His research deals with principles and impacts of regulation and taxation (public finance in general), banking and economics of luxury