

Less  
Regulation,  
More  
Reputation!



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RÓBERT  
CHOVANCULIAK

**T**he emergence of a sharing economy has shaken things up in many sectors and within the regulatory frameworks. The greatest upheavals are currently being experienced by the taxi and accommodation services, since these are the services where the sharing economy has managed to compete with traditional service providers by (re-)employing idle capital.

Nevertheless, this is just one part of the influence of a sharing economy. The two aforementioned sectors are also characterized by rather extensive public regulation. This regulation is supposed to help mitigate the problem of asymmetrical information between service providers and their customers, i.e. to protect customers from inappropriate behavior on the part of providers.

This is the point where the sharing economy indirectly influences traditional sectors. The sharing economy demonstrates that existing public regulations are not the only alternative to alleviating the problem of asymmetrical information. Another alternative is private regulation provided by sharing economy platforms.

### COMMERCIAL BUSINESS REGULATION

Regulation of the commercial business sphere by the government is a relatively hot topic these days. According to a new study by Coffey, McLaughlin and Peretto (2016)<sup>1</sup>, the current GDP of the US would be 25% higher if federal regulation had not increased since the 1980s. So why does one need to regulate a voluntary contract between two fully responsible parties at all? If both sides voluntarily agree to a con-

tract, by definition both sides gain ex ante. Otherwise, such a contract would not be entered into.

Currently, supporters of regulation most often cite the argument of the economic concept of information asymmetry. This is a situation where one party to the contract has an information advantage over the other<sup>2</sup>. In general, the provider of the product or service is the more informed party, who actually knows more about what is being sold than the buyer. Subsequently, as a solution to this "market failure", the government began to recommend regulation by public authorities that would bring about a balanced relationship between the provider and buyer. Thus, the term "consumer protection" came to be connected with the support of regulation. This approach to regulation will be hereinafter referred to as "public regulation."

Examples of such information asymmetry also exist in the areas of personal transport and accommodation. For example, at the end of the 19th century, some taxi drivers in San Francisco were called "nighthawks". The term was coined because, instead of taking their customers to the location they had requested, they would drive them out to some faraway, abandoned place where they would then demand extra money for not leaving them there. These taxi drivers misused their information advantage with regard to the customer. Public institutions at the time reacted promptly and issued a generally valid public regulation which prohibited a person from working as a taxi driver without a special license. A condition for obtaining the license was that the driver had to prove to officials that he was "a law-abiding citizen of good moral character"<sup>3</sup>.

<sup>1</sup> Coffey, B., McLaughlin, P. and Peretto, P. (2016) The Cumulative Cost of Regulations, The Mercatus Center at George Mason University, Available [online]: <http://mercatus.org/publication/cumulative-cost-regulations>

<sup>2</sup> Akerlof, G. A. (1970) "The Market for "Lemons": Quality Uncertainty and the Market Mechanism", *The Quarterly Journal of Economics*, Vol. 84, No. 3 (Aug., 1970), pp. 488-500.

<sup>3</sup> Anderson, D. (2013) *The Short, Contentious History*

This approach to regulation – a monopolistic authority creates generally valid rules for the entire sector – was often the only solution in the last century. And if there was a potential space for opportunistic action by service providers, the public authorities would, as a rule, react by limiting access to the field through licensing requirements, and imposing standards and rules, which were subsequently forced upon the providers and monitored through various inspections. However, this approach to regulation – “public regulation” – had its costs and shortcomings as well. Analytically, one can divide them into three areas: badly set incentives, knowledge problems and high transaction costs.

### THREE SHORTCOMINGS OF PUBLIC REGULATION

In the second half of the 20<sup>th</sup> century, economists began to warn that if the market did not produce optimal results, it would not automatically mean that intervention by a monopolistic (State) authority would best solve the problem. They started pointing to what they called “the nirvana fallacy” (comparison of the perfect state to the imperfect function of the actual market) and, instead of simple recommendations for intervention, they guided research efforts towards comparisons of how various institutional arrangements worked<sup>4</sup>. Based on this approach, they discovered several shortcomings in the monopolistic approach.

#### I The Issue of Incentive Structure in Public Regulation

The first problem that public regulation faces is how to set the structure of incentives and the motivation of those who cre-

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of the Gurney Cab Company in San Francisco, Available [online]: [http://foundsf.org/index.php?title=The\\_Short\\_Contentious\\_History\\_of\\_the\\_Gurney\\_Cab\\_Company\\_in\\_San\\_Francisco](http://foundsf.org/index.php?title=The_Short_Contentious_History_of_the_Gurney_Cab_Company_in_San_Francisco)

<sup>4</sup> Demsetz, H. (1972) “Information and Efficiency: Another Viewpoint”, *Journal of Law and Economics*.



IT IS THE SMALLER ORGANIZED GROUPS OF SERVICE PROVIDERS WHICH WILL BE MORE CAPABLE OF COORDINATING AND LOBBYING THE CREATORS OF PUBLIC REGULATION THAN LARGE, DISSIPATED GROUPS OF CONSUMERS

ate them. If one wants to better understand the origins of public regulation, one must first let go of the assumption of the public sector as a benevolent creator of rules and regulations. Thus, the same (realistic) assumption must be applied to those who create policy as to other economic actors – they act in their own interests. In other words, it is naive to assume that public authorities automatically create regulation which is in the interest of the public as a whole, instead of regulation that benefits the narrow interests of certain groups<sup>5</sup>.

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<sup>5</sup> Buchanan, J. (1999) “Politics without Romance:

Economists have come up with several explanations of how regulation does not help “protect consumers”, but instead actually helps bring political rents to selected companies. They explain the “capture of the regulator”, who is actually captured by companies that she/he was supposed to regulate in the first place<sup>6</sup>.

The main problem is that the right to regulate entire branches of industry is in the hands of *temporary administrators* (with a monopoly on the creation of regulation). These actors can transfer the costs of their decisions on to the masses (e.g. consumers) and, on the contrary, direct benefits in the form of rents into the hands of narrowly defined interest groups (e.g. established service providers) that reward them for it. Expecting something else from those who create public regulation thus means expecting them to contribute (with their work, time or careers) to the public good in the form of laws created for the public benefit. Nevertheless, as economists explain, the public good has a tendency to be under-produced<sup>7</sup>. So the same tendency for “under-production” will exist with public benefit regulation.

Furthermore, Mancur Olson (1984)<sup>8</sup> showed that it is the smaller organized groups of service providers which will be more capable of coordinating and lobbying the creators of public regulation than large, dissipated groups of consumers. Moreover,

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A Sketch of Positive Public Choice Theory and Its Normative Implications”, [in]: *Collected Works of James M. Buchanan*, Indianapolis: Liberty Fund, 1999, pp. 45–59.

<sup>6</sup> Stigler, G. (1971) “The Theory of Economic Regulation”, [in]: *Bell Journal of Economics and Management Science* 2, pp. 3–21.

<sup>7</sup> Samuelson, P. (1954) “The Pure Theory of Public Expenditure”, [in]: *The Review of Economics and Statistics*, Vol. 36, No. 4. (Nov., 1954), pp. 387–389.

<sup>8</sup> Olson, M. (1984) *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, Yale University Press; new edition.



THERE WILL ALWAYS BE A SYSTEMATIC TENDENCY FOR THE CREATION OF REGULATION THAT WILL, RATHER THAN PROTECT CONSUMERS, PROTECT THE MONOPOLY POSITION OF SEVERAL SELECTED PROVIDERS

established service providers often have an information advantage, not only over customers, but also over regulators (i.e. they know their true costs better). They can thus influence regulators’ decisions, and in doing so, secure regulation that suits them better. There is also a frequent phenomenon known as the “revolving door”, where the same people move between employment as a regulator and employment with a regulated firm, thereby perpetuating the above-mentioned capture of the regulator.

In the example cited above, where public regulation was supposed to be a tool against “nighthawks”, it is also possible to find elements of the “capture of the regu-

lator". Public regulation in San Francisco stipulated that for one registered vehicle, there could only be one licensed taxi driver. This efficiently protected against the entry of new competitors from other states, who were more effective in providing transportation (they charged lower prices). The reason for their effectiveness was above all the fact that several drivers used the same vehicle during the day and night. Independent drivers in San Francisco, who were attached to one vehicle and represented by the Carriage Drivers' Protective Union, did not like this. This Union actively supported the abovementioned public regulation prohibiting multiple drivers from using the same vehicle.

With regard to public regulation, there will always be a systematic tendency for the creation of regulation that will, rather than protect consumers, protect the monopoly position of several selected providers. The results are several types of ineffectiveness which economists have described: **a deadweight loss** (a less mutually beneficial exchange will take place than would take place without regulation); **rent seeking** (entrepreneurs spend resources on gaining political advantage and not on satisfying the needs of consumers); and **X-inefficiency** (there is no pressure of competition driving the effective management and operation of companies and no pressure to innovate). In a broad study by Matthew Mitchell (2012)<sup>9</sup>, the author recorded numerous real-world examples where the regulator was captured by companies that were supposed to be regulated, leading to exactly this type of ineffectiveness.

## II A Knowledge Problem When Setting Public Regulation

<sup>9</sup> Mitchell, M. (2012) Beyond Bailouts: What Is Cronyism?, The Mercatus Center at George Mason University, Available [online] : <http://mercatus.org/publication/beyond-bailouts-what-cronyism>

If one was to assume that a regulator has the best intentions (i.e. one ignores the problem of a bad incentive structure), the issue of identifying and creating the correct regulation remains (i.e. the knowledge problem).

Regulation creates various costs and benefits for the individual parties to a contract. Even the same piece of regulation can mean more costs than benefits for one side and more benefits than costs for the other side. How is a public regulator to decide whether to approve such regulation? If a regulator accepts strict conditions governing licensing for entrance to a field (for example, every hotel room must have air conditioning), high costs are created for providers. However, at the same time benefits are provided to consumers, who thus receive higher quality service (the guest can be sure that the room will never be too hot) . Thus public authorities face a knowledge problem when the costs of strict regulation are justified for providers, because they are more than compensated for by the benefits provided to consumers.

The principal challenge of a central public regulatory authority is to create rules and regulations that are sufficiently strict or lenient to generate more benefits than costs on the whole for all the actors involved. In other words, they result in the maximum total net gains.

However, when creating public regulation, the regulator does not generally possess the necessary knowledge of the specific time and place that is needed to evaluate individual costs and benefits correctly for various parties to the contract. A public authority with a monopoly on a blanket regulation valid for the entire economy also has no feedback that could assist it in finding out *ex post* whether the regulation in question generates net benefits or losses. No competitive pressure which would help to



expose such unsuccessful regulation exists<sup>10</sup>. What is more, market conditions are continually and rapidly changing, which alters the relative costs and benefits of regulation, and also presents a plethora of new methods for resolving the problem of asymmetric information and opportunistic behavior. Nonetheless, a public authority is not flexible enough to react to these changes, since it cannot evaluate their relative advantages and does not have feedback available to it.

For example, within the realm of the taxi service in the Slovak Republic, registering an automobile which is more than eight years old as a taxi is prohibited. This regulation obviously represents costs for the service provider, who is forced to buy a newer car than he might have done if the regulation did not exist. On the other hand, it provides certain benefits to the customer who, thanks to the regulation, can travel in newer automobiles. Nevertheless, the question is whether this regulation produces net benefits in reality. Customers might be more willing to travel in older cars and pay lower prices. But the public regulator has no way of knowing whether the arbitrary decision was a good one and has no feedback available to assist in overcoming this knowledge gap. And its public regulation is generally valid throughout the entire territory of the country, so there is no pressure of competition.

### III The High Transaction Costs of Public Regulation

If one assumed that public regulation was created by actors according to the well-being of society as a whole and that somehow

they have managed to discover the correct types of regulation, it still does not guarantee the optimal functioning of public regulation. The reason for this is the high transaction cost which causes regulation, despite its correctness or quality, to function differently from the way it should. Regulation is far from self-enforcing and requires an active approach, whether from the side of those monitoring it, the subjects of the regulation themselves, or their customers.

An example of this could be the provision of taxi services as researched by us. For example, the public regulator in the Slovak Republic established rules for the correct provision of taxi services. If these rules are violated, customers can turn to an inspector. The latter will then issue a fine to the taxi driver or even confiscate his or her license. Under Law no. 56/2012 on road transportation, a taxi driver is obliged to let customers see the meter during the trip from beginning to end, and to take the shortest route possible, given the traffic situation. Another route can be taken only if the customer agrees to it or proposes it him- or herself.

Even if one assumes that these regulations are optimally set, the problem that, from the customer's point of view, it is often difficult to recognize a violation still remains. And if a customer can identify one, there are relatively high costs associated with pointing it out. The result is regulation that does not function optimally – it is not enforced. This is also the reason why taxi drivers in various cities often have a dubious reputation, despite the existence of regulation. In fact, taxi drivers know that the existing public regulation is often not enforced, and that they can abuse their position with regard to the consumer to their advantage, without real consequences.

Similarly, a central authority can issue the correct standards of quality and rules of service provision, but if it does not have suf-

<sup>10</sup> In other words, the creation of public regulation suffers from the same problems that central planners encountered when operating socialist economies without access to prices and the possibility of calculating profits and losses. See: Mises von, L. (1920) *Economic Calculation in the Socialist Commonwealth*, Auburn, Alabama: Ludwig von Mises Institute and Hayek von, F. (1935) *Collectivist Economic Planning*, Augustus M Kelley Pubs; New issue of 1935 edition.

efficient control or resources, the regulation remains without any real influence. For example, the Transportation Regulation Authority of the Slovak Republic (SR) has the right to levy a fine of EUR 100-15,000 on taxi drivers who charge prices that do not correspond with their normal tariffs. And despite the existence of this public regulation, there are relatively frequent examples of drivers overcharging tourists fares far above the official taxi tariff<sup>11</sup>.

Thus, the result can be a situation where despite the *de jure* existence of the correct public regulation, the relationship between the service provider and the consumer will *de facto* be unregulated. And in this case, there will continue to be room for opportunistic behavior.

## SHARING ECONOMY AND PRIVATE REGULATION

However, public regulation is not the only alternative. One does not face the choice between public regulation or no regulation at all. There is a third alternative – private regulation – which has, in recent times, been popularized above all by a sharing economy.

## SHARING ECONOMY IN BRIEF

An alternative to the centralized approach to regulation as described above has been introduced by an IT revolution in the form of the Internet. At the turn of the millennium, the Internet was generally used as an “electronic newspaper”. That is, an average user mostly took information from Internet pages in a passive way. With the appearance of Web 2.0 applications, however, it became possible and easy to actively participate in creating content and coordinating a large

quantity of people at a low cost. Thus the first platforms enabling communication and online collaboration, the first social networks with virtual communities and mobile applications enabling interaction from practically any place in the world, began to appear. In addition to a revolution in blogging, social networks and crowdfunding, there was a revolution in the sphere of sharing. This brought with it (in addition to many other things) some interesting solutions to the problems of the information asymmetry described above. Specifically, this was in the area of private regulation through competition among decentralized platforms in a sharing economy.

Before sharing economy platforms emerged, numerous potentially advantageous exchanges existed, which were never implemented because of high transaction costs. It could easily happen that someone had a long unused drill at home, while at the same time someone in the next street needed one. What prevented the drill from getting from the hands of the first person into the hands of the second was that they simply did not know about each other. And if they did know, it would have been difficult for them to agree on a price; and if they did agree, they would have had to sign a contract; and if they had signed one, there would still be the problem of its enforcement and control. In other words, what prevented advantageous exchange were the abovementioned high transaction costs. And it is here, in the lowering of these costs, that sharing economy platforms have begun to function – and to achieve a profit<sup>12</sup>.

<sup>11</sup> The problem is a slow and costly legal dispute resolution, which can also ultimately hinder the function of the regulation.

<sup>12</sup> Munger, M. (2015) The Third Entrepreneurial Revolution: A Middleman Economy, Duke University Department of Political Science.

Above all, the last part — that of transaction costs for “enforcement and control” — is highly relevant for this analysis. This is exactly the point where the platforms have managed to replace and even surmount existing public regulation. In other words, in many traditional fields, a sharing economy brought with it an alternative to public regulation. An alternative in the form of a decentralized approach to the creation of private regulation. Subsequently, with the aid of various mechanisms and systems, it creates trust between the two parties to a contract and mitigates the problem of asymmetric information, simultaneously solving all three of the problems of public regulation described above.

In addition to a more intensive use of resources (through sharing, renting and facilitating services), a sharing economy has also enabled the identification and pointing out of existing ineffective public regulation and then replacing it with higher quality private regulation. How this has been achieved is the subject of the following sections.

### THREE ADVANTAGES OF A DECENTRALIZED APPROACH TO PRIVATE REGULATION

#### I Aligned Incentives in Private Regulation

The owners of platforms are the creators of private regulation. In contrast to politicians — the *temporary* administrators — who are responsible for creating public regulation, the makers of private regulation are the owners of the platform’s equity. Thus, they have an incentive to approve rules and regulations that will maximize the value of their platforms in the long term.

For this reason, the owners of platforms in pursuing their own interests have to take the interests of all of the platform’s par-

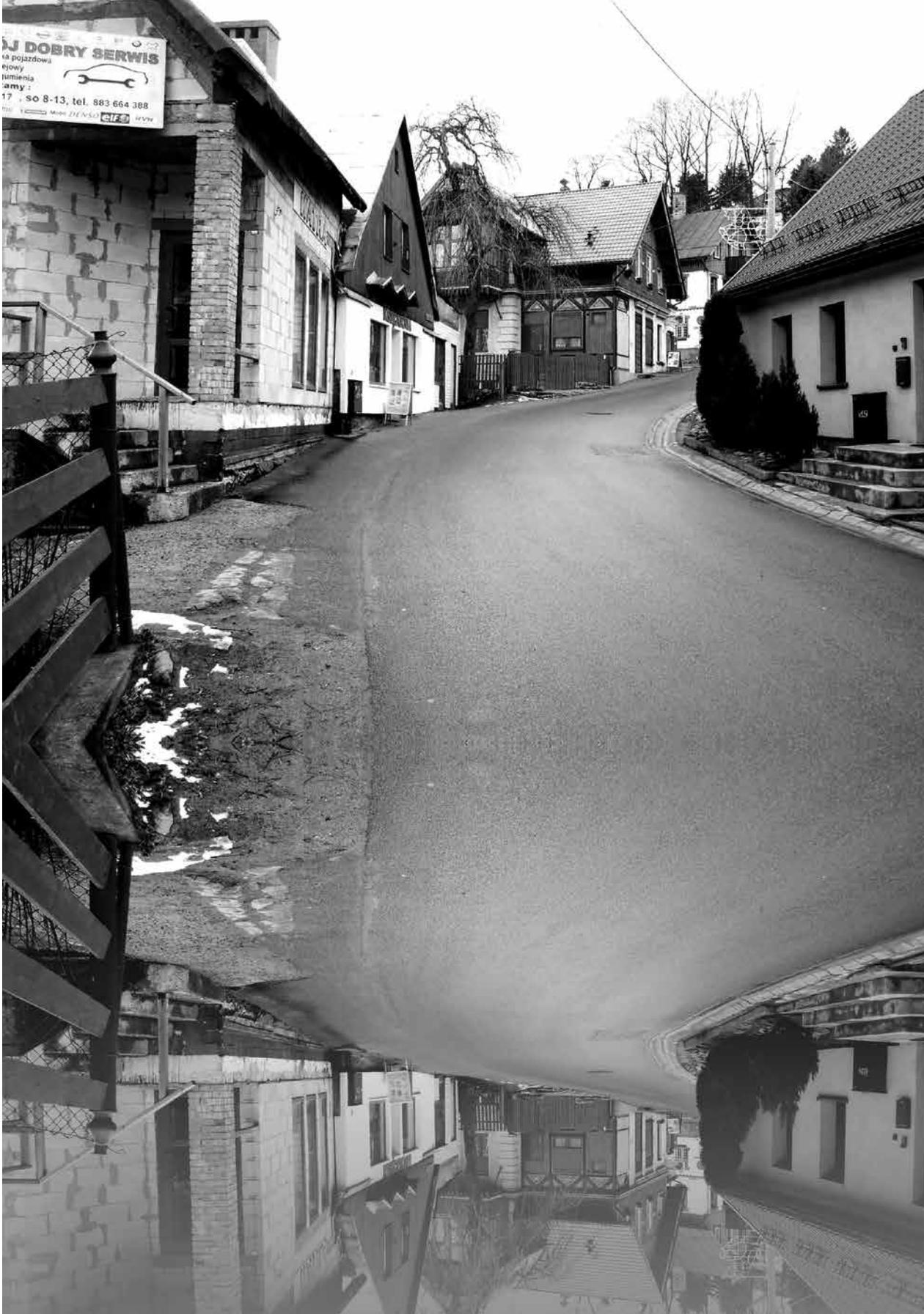
ticipants into account, i.e. the service providers as well as the customers. The only way platform owners can make a profit is to create an environment (rules and regulations) that secures the maximum number of commercial transactions. So it is in the personal interest of private regulators to ensure that the platform is safe and that individual actors will be willing to sell, share, rent and provide services to the greatest extent possible.

Platform owners know that if individual actors feel secure, they will be willing to pay an increasing amount for services and enter into a larger number of contracts. This is how platforms generate income. And this is the reason why platforms in a sharing economy cannot be captured, as is the case in public regulation.

So income and wealth for a platform owner are thus directly dependent on how well the own private regulation can be set up. The incentives are aligned with the interests of the customers, just as, for example, with regard to Adam Smith’s well-known baker:

“It is not from the benevolence of the butcher, the brewer or the baker, that we expect our dinner, but from their regard to their own self-interest. We address ourselves not to their humanity, but to their self-love, and never talk to them of our own necessities, but of their advantages.”

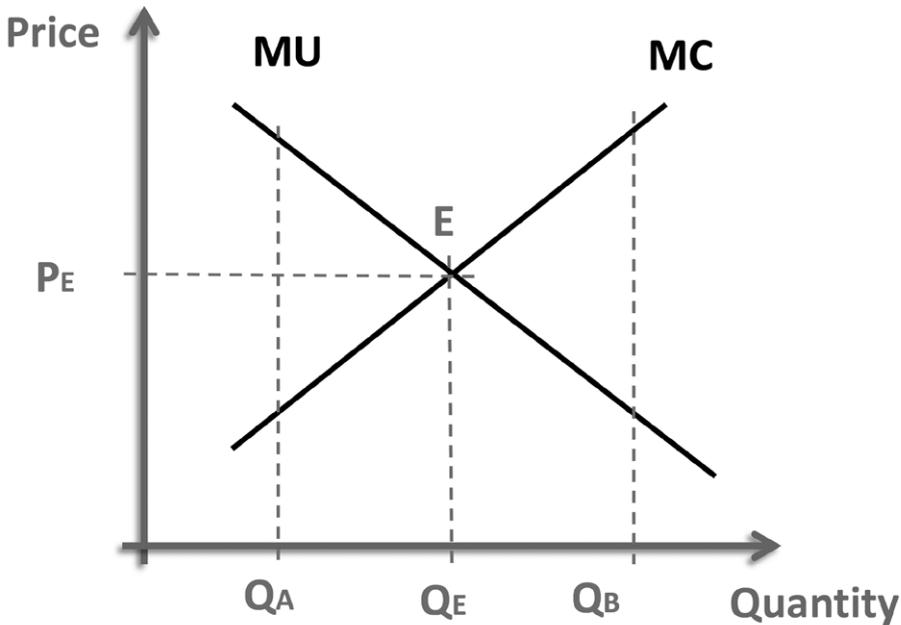
One does not necessarily expect anything different from the creators of private regulation, except that they will serve their own interests. In the case of public regulation, it is exactly the opposite. The establishment of regulations that uplift the well-being of society would require good intentions on the part of politicians and regulators.



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**Figure 1: Marginal Utility and Marginal Costs of regulations**

## II Competition among Private Regulation which Generates Knowledge

In contrast to the creator of public regulation, a platform owner who creates private regulation does not have the opportunity of imposing his/her ideas about the correct way to regulate (for example, in the area of personal transport) on all the other participants in the economy. Nevertheless, platform owners possess the opportunity of limiting access to their own platforms – for those who do not fulfill the rules and regulations required by it. The owners can therefore regulate the conditions on their own platforms. Thus, a space for competition among decentralized platforms in the creation of private regulation emerges.

This competition helps to resolve the knowledge problem present when creating public regulation, which was already

described above. Correct regulation must, after all, possess several attributes simultaneously. The same piece of regulation can bring both utility to the customer and unjustifiably high costs to providers. In the process of competition, entrepreneurs will discover that extent of regulation where the marginal costs will equal the marginal benefits (Figure 1, point E). That is regulation, which maximizes the net benefits resulting from it.

If, for example, one adopted regulation were too permissive (the left side of Figure 1, i.e. points  $Q_A$  to  $Q_E$ ), there would be an opportunity for advantage through tightening the platform's safety regulations. This is because customers would be willing to pay more for higher security than the actual costs linked with the regulation itself – in economic terms,  $MU > MC$  (marginal utility > marginal costs). In the oppo-

site case (the right side of Figure 1, points  $Q_E$  to  $Q_B$ ), there would be a profit opportunity in abolishing regulations that are too strict (this is the reason why the private sector has the tendency to avoid excessive and unnecessary bureaucracy, in contrast to the public sector). The optimal level of regulation is found at the point where the marginal costs equal the marginal benefits of the added strictness of regulation. [See Figure 1]

However, in principle, private regulators by themselves do not have any better access to knowledge (than that needed to create the correct regulation) than the public regulator. They do, however, have access to feedback, and at the same time, are part of the process of market competition. With the aid of trial and error, market competition enables them to generate the required knowledge important for avoiding bad business decisions, while imitating and developing successful ones.

This characteristic of market competition was best described by the economist, Friedrich von Hayek (1968), who expanded the static understanding of competition to include its dynamic nature in the form of entrepreneur discovery. Later, he also applied this approach (in addition to relationships within the market) to the creation and emergence of law as an alternative to legislation (Hayek, 1973). Furthermore, he showed how the same process of dynamic discovery can also function in the monetary sphere where, according to him, competition between currencies should help to discover the correct form of money<sup>13</sup>.

<sup>13</sup> Hayek von, F. (1968) "Competition as a Discovery Procedure", [in]: *Quarterly Journal of Austrian Economics*, 5 (2002), pp. 9-23; Hayek von, F. (1973) *Law, Legislation and Liberty* By F. A. Hayek, London: Routledge and Hayek von, F. (1976) *Denationalisation of Money: The Argument Refined*, Coronet Books Inc., 3rd edition (June 1990).



THE CREATORS  
OF PRIVATE  
REGULATION HAVE  
FEEDBACK  
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OF PROFITS  
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AT THEIR DISPOSAL,  
OR THE WAXING  
AND WANING  
OF CUSTOMERS  
AND SERVICE  
PROVIDERS

Today one can observe this process of dynamic discovery, thanks to a sharing economy and its platforms, as well as in the regulation<sup>14</sup>. Private regulation thus enables the parallel functioning of several regulatory frameworks, among which is competition. Moreover, the creators of pri-

<sup>14</sup> Similar competition in the field of rules, regulations and security creation exists, for example, among proprietary communities, condominiums, hotels, shopping malls, amusement parks, etc. (Beito, Gordon and Tabarrok, 2009). The first rules and private regulation of stock exchanges emerged in a similar way in 17<sup>th</sup>-century Holland and later in England (Stringham, 2002 and 2003). See: Beito, D. T., Gordon, P., Tabarrok, A. (2009) *The Voluntary City: Choice, Community, and Civil Society*, Independent Institute; Stringham, E. (2002) "The emergence of the London Stock Exchange as a self-policing club", [in]: *Journal of Private Enterprise* and Stringham, E. (2003) "The extralegal development of securities trading in seventeenth-century Amsterdam", [in]: *Quarterly Review of Economics and Finance*.

vate regulation have feedback in the form of profits and losses at their disposal, or the waxing and waning of customers and service providers. This process helps them to select the correct types of regulations – bringing in those that result in net gains and getting rid of those that do not work.

For example, Uber established many conditions that interested service providers must adhere to on its platform. In some areas, these requirements are looser than those imposed by public regulation (vehicle inspections, psychological testing, knowledge testing), while in others they are stricter (e.g. driver screening and insurance levels)<sup>15</sup>. For example, Uber also requires that cars be not more than 10 years old, that drivers have no criminal record, (unpaid alimony is an exception) and have a minimum of three years of driving experience. Moreover, Uber requires that one enters one's payment card information to join the platform, and also has completely eliminated cash transactions (in doing so, it has significantly increased the safety of both drivers and customers). It also regulates its rates and a pairing mechanism – customers may not choose a driver themselves, but can refuse one who is assigned to them; similarly, the drivers see the demand for their services, but cannot see the destination of a trip. Furthermore, Uber provides information on how demand for transport is evolving or will evolve. It also insures its drivers and third parties against risk of up to EUR one million<sup>16</sup>.

<sup>15</sup> Feeney, M. (2015) *Is Ridesharing Safe?* The Cato Institute. January 27, 2015 | Number 767.

<sup>16</sup> This insurance becomes active only from the moment the Uber application is opened and the customer gets into the car. The moment the application is closed, the vehicle is covered only by normal compulsory insurance. A problematic situation emerged when the application was turned on, but the customer

All these rules are merely attempts within the discovery process and other platforms can offer other solutions. For example, Lyft, the competing platform, enables customers to tip drivers – which Uber prohibits. Lyft also uses a different algorithm for matching and generating prices, surveys its drivers in more depth via interviews, requires drivers to mark their cars with a "fake pink moustache", offers a more personal approach with a greater representation of women and has an Emergency Call Center operating 24/7.

A similar discovery process for the correct regulations also exists on accommodation platforms. For example, Airbnb worked for a long time on designing the parameters in its disclosure system. Based on its own analyses, it came to the conclusion that, if on first contact people revealed too little or too much about themselves, their willingness to accept a guest decreased. The optimum was somewhere in the middle. For this reason, they designed a special acquaintance form for first contact where the guest has to answer three questions for the host: "tell us something about yourself; what brings you to the city and who is coming with you; and what did you like about our accommodation?" The space for the answers is set out precisely, so that answers are neither too short nor too long. The result is a higher level of trust between individuals on the platform.

### III Radical Decrease in Transaction Costs of Private Regulation

In the previous section, it was shown how even the correct public regulation approved by benevolent regulators can be

was not in the car. In this case, Uber provided only supplemental insurance known as "contingent liability coverage". In time, a type of insurance covering exactly this kind of situation came on to the market in the US. This insurance product is not as inexpensive as the classic non-commercial insurance, nor is it as expensive as the commercial insurance that taxi drivers use.

ineffective, if its enforcement is associated with high transaction costs, meaning this sort of public regulation works only *de jure* and not *de facto*. As platform owners, private regulators cannot afford this. Within the process of entrepreneurial discovery, they have brought various mechanisms to bear, which enable a radical decrease in transaction costs for the enforcement of private regulation. Examples of these are, above all, reputation systems and big data analysis.

Reputation systems allow for mutual evaluation by the individual parties to a contract. Customers say how satisfied they were with the service, and providers indicate how satisfied they were with the customer. Such reputation systems immediately create two-sided pressure on the parties to behave well and to refrain from abusing their information advantage.

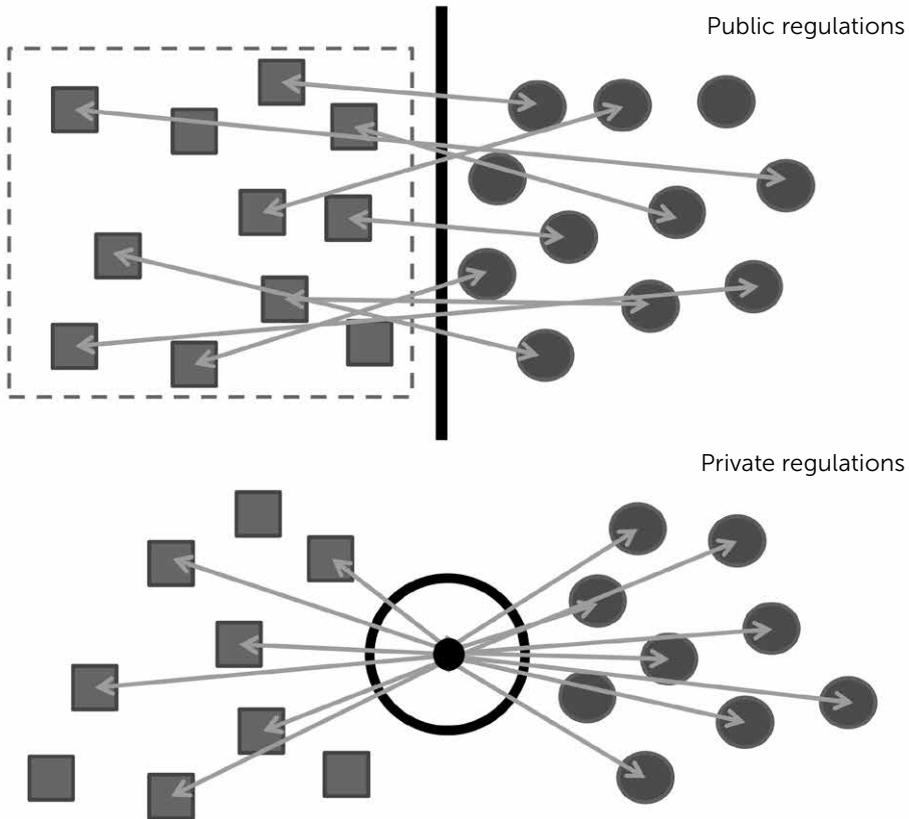
1. The parties to the contract are *ex ante* motivated only to look for and enter into contracts with another party that has a positive evaluation and, thus, has behaved according to expectations in the past.
2. Subsequently, during the contract, the parties are motivated to uphold the rules of the platform and to avoid opportunistic behavior, since they will then *ex post* receive a poor evaluation.

Reputation systems thus improve cooperation, act as enforcement mechanisms, help signal trustworthiness and quality, lower risks, and motivate good behavior while punishing bad. In other words, they assist in solving the problem of information asymmetry.

If a driver on the Lyft platform receives an evaluation of less than 4.6 stars out of 5, his/her account will be deactivated. Alternatively, if a customer gives a driver less



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**Figure 2: Public vs. private regulation in personal transport**

than three stars, he or she will never again be paired with that driver. These mechanisms are also used effectively by a platform called Feastly, which links home cooks who are willing to prepare dinner at home, with potential customers who are willing to eat at someone else's house and pay for it. In this way, reputation systems help resolve even those situations where there is a high level of information asymmetry.

These systems replace anonymous interactions between random actors with interactions that happen in a center (the platform). This platform records the history of

these interactions and thus helps to eliminate anonymity and to create trust. On the left side of Figure 2 are squares depicting drivers and, on the right, circles depicting customers. Arrows represent contracts between taxi drivers and their customers. Under classic public regulation, there is an effort to define correct service provision and then to enforce it (marked by the blue border lines). However, this method of enforcing regulation is very costly and often unreliable<sup>17</sup>.

<sup>17</sup> For example, for years, regulators in Las Vegas had a problem with taxi drivers who cheated tourists by driving them the long way from the airport in order to

The establishment of a contract between the provider and customer under public regulation is, however, formed on a random basis and remains anonymous to a large extent (random arrows). The customer does not know the taxi driver's history, and potential opportunistic behavior does not affect his/her future reputation in any way. The taxi driver is motivated to externalize the costs of his/her bad behavior on to other taxi drivers, thus damaging the reputation of all taxi drivers.

The exact opposite happens on the lower part of the figure, where there is a diagram showing how the transportation of persons through the platform works (all arrows aiming towards the big black circle). Here, the customer knows the driver's history and the latter cannot externalize costs to other drivers through bad behavior. Instead, the costs remain internalized with him/her. This, of course, creates the pressure to behave well. [See Figure 2]

Another method used by platform owners to decrease information asymmetry is "big data" analysis. This sort of analysis uses computer algorithms to monitor millions of transactions and, based on the certain keys, block or mark those that are suspicious. The latter are then sent to a team of investigators for a deeper analysis.

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make more money. The local regulator had tried everything: from the classic issuance of standards for taxi driver behavior and police monitoring of the drivers' routes to large information boards showing the right route or creating a system where travelers could submit complaints. They even had a plan for requiring the installation of new surveillance equipment that would monitor whether a taxi driver was cheating customers. None of these were effective (Ross, 2014). This problem in Las Vegas was finally resolved by Uber with its private regulation and reputation systems. And only until the moment it was banned (a year later it was allowed again). See: Ross, B. (2014) *Uber.gov It's Time to Let the Government Drive*, Available [online]: <https://medium.com/@blakeross/uber-gov-29db5fdff372>

In all three problematic areas (incentives, knowledge and transaction costs), private regulation in a sharing economy brings theoretical tendency with it as well as the empirical experience to outdo public regulation by public authorities. If one takes these tendencies and experience seriously, a sharing economy can represent not only a tool for implementing a mutually beneficial exchange that would not oth-

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erwise occur<sup>18</sup>, but can also be a means of the identification and overturn of an old, dysfunctional and ineffective public regulation.

### SHARING ECONOMY AS A LITMUS TEST

The mere existence of public regulation in the legislation does not automatically mean that it is economically or socially justified or even beneficial. The opposite is true in several cases. Despite the fact that public regulation of the business environment normally presents itself as assistance to consumers, many public regulations are more a result of pressure from interest groups or excessively active and naive politicians (regulators).

In this case, it would be better from the consumer's point of view if the particular regulation were abolished or not formally enforced. Yet, in practice, it is not easy to recognize when the costs of public regulation are higher than its benefits and when it rather benefits a concentrated interest group than dissipated and disorganized consumers.

When resolving this problem, on the one hand, one can try to rely on political processes and democratic mechanisms. Nonetheless, this takes a long time and in some cases one cannot even expect to see such changes. The problem is information asymmetry between voters and politicians on the one side and between consumers and interest groups on the other. Voters simply do not have the motivation to inform themselves on a daily basis or to monitor politi-

cians as to whether they are approving only regulations that increase public well-being. So politicians have wide room to manoeuvre when performing their legislative-regulatory roles. It is as difficult for people to evaluate whether, from the point of view of consumers, the regulated branch would function better or worse without public regulation. The consumer would have to undertake some complex thinking about how the world would appear without a specific piece of public regulation.

One is getting into a paradoxical situation here. As was illustrated at the beginning, information asymmetry is presented as one of the main arguments for bringing in regulation (the producer or service provider knows more than the customer) and, at the same time, one of the main reasons for the ineffectiveness of these public regulations (the voter and consumer cannot monitor politicians or identify ineffective regulation).



## SHARING ECONOMY WITH ITS PRIVATE REGULATION CAN HELP TO BREAK THE THICK POLITICAL ICE

It is, however, sharing economy with its private regulation that can help to break the thick political ice. A sharing economy disrupts old public regulation. And it does

<sup>18</sup> A new study by Krueger and Cramer (2016) finds that Uber drivers can use their time much more effectively when they are driving. They spend 30-50% less time and drive 30-50% fewer kilometers with an empty vehicle than normal taxi drivers. So Uber not only outdoes the old regulation, but also enables more effective use of time and space. See: Cramer J., Krueger, A. B. (2016) *Disruptive Change in the Taxi Business: The Case of Uber*, NBER Working Paper No. 22083.



so in such a way as to test the net benefit resulting from it and simultaneously to mobilize people to political action. In this way, it solves two of the problems described above.

3. In a sharing economy, consumers, through their buying decisions, compare classic services under public regulation with services based on new technology and private regulation. In this way, they test the relative effectiveness of public regulation vs new private regulation in a sharing economy. A sharing economy thus lets customers experience what a service which is not publicly regulated looks like – a service that solves the problem of information asymmetry through the private rules of a platform. If public regulation is truly justified, then its private alternative should collapse into a spiral of dysfunction due to customer dissatisfaction from information asymmetry (as the theory of usefulness of governmental regulation predicts).

4. A sharing economy therefore also enables the mobilization of people and the creation of pressure on politicians whose room for manoeuvre is thus decreased. The latter then give in to the people's will. For this reason, it is a highly democratic way of changing regulation. A recent example of such a series of events took place in New York City, where Mayor Bill de Blasio attempted to limit the number of drivers allowed to drive for Uber. There was a large wave of protest against this by ordinary citizens, and de Blasio, who had officially received campaign contributions of USD 500,000 from the taxi lobby, had to withdraw the proposal. Because of Uber's popularity and the pressure brought to bear by the public, New York has one fewer bad regulations (even if the old regulation is still in place). Mayor de Blasio had to give in to the voters.

An even more recent and definitely more interesting example comes from the city of Sarasota, Florida, where the city council was supposed to vote on the proposed regulation of Uber. The proposal was to impose all the existing regulation for classic taxi drivers on Uber as well. Uber reacted to this by threatening to leave the city. Once again, this made for an angry public, which had become used to Uber and considered it as something positive. Finally, not only was Councilwoman Susan Chapman's proposal not accepted and Uber not regulated, but the existing regulation on classic taxi drivers was unanimously abolished.

## EU INSTITUTIONS AND A SHARING ECONOMY

At the beginning of 2016, the European Parliament commissioned a study, the main conclusion of which was that a sharing economy could potentially bring Europe added value of as much as EUR 572 billion annually. This would occur mainly because of better utilization of valuable resources and capacities. The study's conclusions are positive about a sharing economy, but warn of the possible risks represented by, above all, extreme reactions by governments in the form of regulation and the limitation of functions of a sharing economy. Eventually, these reactions could shrink its added value.

Another EU institution addressing a sharing economy is the European Court of Justice. It is expected to decide whether Uber will be considered a transportation service or a technology company. Based on this decision, Uber will be subject to various regulations and limitations under EU law.

Quite recently, the European Commission (EC) published guidance and policy recommendations (02/06/2016). The relatively positive stance of the EC towards a sharing economy's benefits should be welcomed.

The EC literally points out that a sharing economy offers marked benefits and represents new opportunities for the future.

The EC's call on governments to release a sharing economy from highly restrictive and often unjustified limitations should also be welcomed. And this is predominantly the case in situations where the effects and results of a sharing economy have not been sufficiently researched, while at the same time much less limiting approaches than "prohibit it completely" exist.

The EC also points out to member states that they can use the sharing economy's arrival to re-evaluate the added value of existing public regulation. That is, above all, its frequent shortcomings, which were indicated above. At the same time, the EC underlines the function of "rating and reputational systems or other mechanisms" within a sharing economy, which can, according to the EC, "reduce risks for consumers stemming from information asymmetries". And thus, "this can contribute to higher quality services and potentially reduce the need for certain elements of regulation".

On the other hand, the EC refused to set a type of "maximum" regulation limits and often admits evaluating the appropriate level of regulation on a "case by case" basis. This approach raises concerns that too many countries or regions can claim their situation as unique and apply restrictive regulations. And the result will be exactly what this study and the EC fear and warn against.

Nevertheless, trying to create uniform regulation for a sharing economy on the EU level is not a solution either. The problem is that state public regulations which have to be changed as a result of a sharing econ-



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omy are very diverse in different countries: taxes, labor codes, social policy, licensing, establishment of a business, etc.

## CONCLUSIONS

Firstly, it is important to recognize that one has to compare real public regulations with real private regulations. Neither of them is perfect. However, as was shown above, creators of private regulations are owners and it is in their self-interest to create as effective regulations as possible. This does not hold for public regulations.

It is also important to recognize that although individual sharing economy platforms compete with companies from various traditional sectors, it does not follow that they should be regulated by existing



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public regulations. Rather than trying to force new technologies to submit to old existing regulations, existing public regulations should be adapted to current developments.

The approach to “shoot first and ask questions later” being used by various (local) governments is even worse. It not only cuts off current customers and suppliers from the mutually beneficial exchange, but it creates high costs and barriers to entry into the markets (not everyone can afford to pay lawyers and fines to get their representatives out of prison). Hence, governments by their incorrect approach to a sharing economy can create monopoly problems in the

future (which will then require other interventions and thus trigger a spiral of interventions).

Furthermore, this approach cuts off the whole of society from the future potential of new technologies and solutions to all kinds of problems, needs and requirements. Thus, society faces the risk of slowing or negatively affecting the development and enormous potential of this new branch of the economy.

There are six principles which should be followed when creating or re-evaluating public regulations of a sharing economy:

1. New regulations should not limit choices for customers and service providers within a sharing economy;
2. New regulations should support a sharing economy’s strong points – flexibility, decreased transaction costs, employment, employment of marginalized population groups, identification of bad public regulations;
3. The playing field should be levelled towards fewer regulations; it should lead to the liberalization of existing public regulations;
4. Public authorities should set clear and simple rules assigning responsibility for safety and apply them equally to all platforms and traditional service providers. This means that entrepreneurs should be held liable for potential harm to consumers, but legislation should not try to prescribe detailed solutions. There should be space for innovative answers to the problems;
5. The EU should develop a guideline for best practices on how to react to a sharing economy. It should also focus on

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making sure that states do not violate basic rules – open competition and the free movement of goods, services, people and capital;

6. The possibility of tax compensation for traditional sectors, which were forced to bear the cost of public regulations so as to mitigate their opposition, should be reconsidered. A sharing economy is an opportunity for everyone. Do not get it wrong. There will be losers. Like every innovation, a sharing economy threatens the traditional ways of doing things. So how can one be sure that there will be more winners? The main reason is that this change is taking place through a chain of voluntary exchanges. The voluntariness is the ultimate test of net benefits for society. Hence, a sharing economy is a threat to some, but an opportunity for everyone.

*The article is a part of the paper “Less regulation, more reputation! Case Study: Sharing economy in transportation and accommodation” published by 4liberty.eu in July 2016. The study was conducted by INESS (Slovakia), LFMI (Lithuania), IME (Bulgaria) and CETA (the Czech Republic). The publication can be accessed online: <http://4liberty.eu/less-regulation-more-reputation/> •*



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