



REGULATION

Spontaneous Deregulation

by Benjamin Edelman and Damien Geradin

FROM THE APRIL 2016 ISSUE

Many successful platform businesses—think Airbnb, Uber, and YouTube—ignore laws and regulations that appear to preclude their approach. Caught up, perhaps, by enthusiasm for their model and a belief in its utility for customers, the founders and managers of these companies seem to see many of the existing rules as unwanted holdovers from a bygone era not yet ready for their innovations. In this worldview, the laws and regulations need to be changed to reflect new tech-enabled realities. Perhaps the rule breakers also remember the maxim credited to Grace Murray Hopper, a pioneering naval officer and computer programmer: It’s easier to ask for forgiveness than to get permission.

This rule flouting is a phenomenon we call “spontaneous private deregulation,” and it is not new. Innovation has often rendered laws and regulations obsolete. As the sidebar “Spontaneous Deregulation in an Earlier Era” explains, the budding automobile and aviation industries faced similar challenges. Of course, laws are often necessary and appropriate, and spontaneous deregulation can sometimes be problematic. Many people with disabilities can’t use Uber or Lyft because those services do not have to guarantee wheelchair accessibility, unlike taxi fleet firms in



most U.S. jurisdictions. And as one of us (Edelman) found in a recent study with Michael Luca and Daniel Svirsky, some customers in the Airbnb world are more equal than others. (See the sidebar “More Downsides to Deregulation.”)

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transportation services with or without licenses, while Airbnb hosts skip the taxes, zoning, and safety protections that add complexity and expense to the hotel business. Other new platforms offer prepared foods without meeting the requirements that apply to restaurants regarding health inspections, food safety training, zoning, and taxation. As all these platforms reshape markets, the scope of activity subject to regulation tends to decrease, and various forms of protection disappear.

In this environment, managers in a range of industries need to assess the threat of spontaneous private deregulation. Forward-thinking leaders should plan their responses—an exercise bound to be challenging as they consider ignoring laws they have spent decades learning to follow.

You May Be More Vulnerable Than You Think

A striking variety of firms face potential threats from spontaneous private deregulation. For example, many lawyers perform services that don't really require the personal engagement of an expensive trained professional. Consider routine real estate transactions, uncontested divorces, and small-business contracts. (In fact, in most law firms these matters are already handled largely by paralegals, but at prices that include attorney overhead.) Similarly, investment bankers may become less important as web-based platforms enable entrepreneurs to sell equity directly to both individual and institutional investors.

In many situations the threat comes from innovators that find ways to leverage the underused capabilities or assets of private individuals, realizing both lower costs and greater flexibility. Previously, successful companies could satisfy customers by combining specialized equipment

Benign or otherwise, spontaneous deregulation is happening increasingly rapidly and in ever more industries. A decade ago, new software start-ups like Napster and YouTube ushered in a wave of piracy that rendered copyright laws effectively irrelevant and drove media companies closer to the brink of failure. Today platforms such as Uber launch new

with staff trained and supervised in the use of that equipment. But many private individuals also have assets—think cars and spare rooms—with excess capacity that can be profitably deployed through tech-enabled platforms like Uber and Airbnb. And such casual providers may not consider it a hardship to work nights and weekends, when established companies ordinarily need to pay premium wages. At the same time, many of the skills traditionally learned from employers can now be taught through software, supplemented when needed with training videos and other limited guidance. Finally, private individuals can more easily avoid regulations that constrain established commercial providers: For example, taxis have to wait in a queue at most airports, but Uber cars cut the line.



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To figure out whether your industry and company are vulnerable, ask yourself the following questions.

Are Consumers Being Unnecessarily Protected?

Many industries require that providers be licensed to operate. In most cases these requirements are intended to safeguard consumers by providing some degree of quality assurance, even if they also end up shielding incumbents from competition. But many successful new platforms simply

High-end incumbents often believe that they occupy a relatively safe niche, but they are threatened too. Black-car service may be superior to Uber because it allows customers to make advance reservations, but if you need a car on short notice, Uber probably has one in your area—perhaps even a luxury car. In the hotel industry, secure market positions are equally uncertain. Four Seasons might think it's in a different league from properties on Airbnb, but Airbnb now offers a remarkable array of deluxe options. In New York City alone, it has several hundred listings priced above \$500 per night, including penthouse suites that easily match

ignore the legal requirements. How do they get away with it? A common defense is to claim that consumers can dispense with traditional protections because the platform offers an alternative, possibly superior protection mechanism.

This mechanism is often an online reputation system. For example, passengers can rate Uber's drivers, and customers can check a driver's rating before accepting service. Meanwhile, drivers are operating their own vehicles and thus have a direct incentive to keep them in good condition. Furthermore, passengers might notice serious safety shortfalls and alert others through an unfavorable rating. Perhaps Uber's approach is imperfect, but licensing isn't necessarily more reassuring. After riding in a less-than-sparkling taxicab, a passenger can't help wondering what corners taxis might cut in vehicle maintenance as well as cleanliness. Combine the questionable effectiveness of government oversight with platforms' incentives for good performance, and it's arguable that compliance functions are best left to the likes of Uber, Airbnb, and their decentralized service providers, rather than to the government.

Formal regulation of many other service providers—from tax advisers to real estate agents to venture capitalists—may be equally unnecessary. The public's comfort in using unlicensed competitors depends on consumers' ability to detect substandard service and their willingness to bear the costs if the service disappoints. Few people would accept heart surgery from an unqualified practitioner, but the risk of an unsafe vehicle seems modest in most American cities. To be sure, serious problems have been reported with some Uber drivers and Airbnb hosts, including physical and sexual assaults, but dangers can also exist in taxis and hotels, and a thoughtful consumer would struggle to figure out where the risk is greatest.

As platforms reshape markets, fewer activities are subject to regulation.

With limited information, consumer beliefs and attitudes play an important role. An anxious first-time home buyer may be willing to pay for a lawyer to manage a title transfer in order to have peace of mind; an experienced property investor might prefer to save on the fees. Tired business travelers may want the comfort of knowing what to expect at check-in—a standard room and services, with someone ready to greet them no matter what time they arrive. However, a globe-trotting extrovert might relish the adventure of staying in a host's spare room.

If the need for protection is relatively low and customers can easily acquire any relevant knowledge, then the industry is vulnerable to a platform that pushes past regulation. The vulnerability is particularly acute if (as is often the case) the regulatory system has created an oligopoly, protecting license holders from price competition and the need to be responsive to certain customer concerns. Indeed, the success of Uber owes much to the fact that many cities restricted the number of taxi licenses, creating a shortage of vehicles and reducing the interest of license holders in investing to improve their service. That created an opening for Uber drivers, who have a personal stake in important aspects of quality because they drive their own cars, and who provide customers with easier access to rides at peak times because there are no controls on the supply of vehicles.

Can Your Business Practices Be Codified?

Incumbent firms typically have processes for assuring quality, most notably through the selection and training of employees. For example, hotel chains ensure that rooms are clean by training and supervising the housekeeping staff. In many cases, the law mandates that workers complete certain courses and demonstrate certain competencies. Most states, for instance, require real estate professionals to pass exams about the home-buying process and property regulations, and aspiring plumbers, electricians, cooks, and myriad other service providers must also satisfy state standards.

Of course, much of the knowledge involved in this training can be and is codified. As more people get access to this information, ordinary consumers are increasingly able to perform many of the routine practices that were previously reserved for regulated firms and specialists. This advance draws partly on a culture of self-help: Why call a registered plumber to fix your water purifier if you can watch a free online video and do it yourself—or have a handy friend take care of it for far less than the plumber would charge?

More Downsides to Deregulation

Spontaneous private deregulation tends to give consumers more choices. But it's difficult to celebrate some other effects.

Discrimination. Laws (at least in the United States) require equal treatment of all guests, regardless of race, who book at hotel websites or through travel agents. But it is unclear whether or how this requirement applies to less-regulated platforms like Airbnb. In a field experiment, one of us (Edelman, with Mike Luca and Dan Svirsky) found that Airbnb hosts were 16% less likely to accept a reservation request if the guest's name suggested black rather than

white ethnicity. (All requests were fictitious; the team created identical profiles for would-be guests but attached names that census records and survey data showed were disproportionately associated with particular races.)

Tax avoidance. Commercial vehicles usually pay higher fees for registration, tolls, and the like than do the owners of private cars participating in platforms such as Uber. Similarly, hotel rooms tend to be highly taxed, whereas rooms booked through Airbnb and other platforms usually go untaxed. Governments need revenue, and it's hard to see why some providers should contribute while others are exempt. That said, modern platforms create an electronic record of every transaction, facilitating tax collection in sectors like taxis, where cash payments previously invited tax evasion.

The threat of spontaneous deregulation is compounded when software platforms reduce the quality and reliability gap between casual providers and firms employing licensed professionals. London's famous black-cab taxi drivers previously boasted an unrivaled command of the city's geography; acquiring that in-depth knowledge required intensive training and examination. Now anyone with Google Maps can take you from Piccadilly to Putney. Similarly, some consumers and small businesses have found that tools like QuickBooks and TurboTax offer an attractive substitute for formal accounting training. Routine legal transactions are likewise becoming manageable without three years of law school, thanks to digital tools.

At the same time, online platforms make it easy to dispatch the growing number of semi-specialists who have a bit of experience albeit perhaps no official certification. Services that might formerly have seemed "marginal" increasingly seem "good enough." Thus to meet ordinary needs, specialized training may become difficult to justify, as software platforms deliver a phalanx of casual competitors with sufficient quality and a systematic cost advantage.

The more readily a business's methods can be codified, and the more readily its benefits can be provided by self-trained or tech-enabled enthusiasts, the more vulnerable that business is to low-cost competition from spontaneous private deregulation.

Do the Regulations Protect Third Parties?

Many regulations are imposed on businesses to ensure the welfare of other parties besides customers. Automobile safety requirements protect not just the people using the cars but also bystanders who might be injured by catastrophic failures. Power companies have to avoid excessive pollution not solely for the good of their customers but also because air quality affects everyone.

Platforms make it easy to dispatch semi-specialists who lack certification.

Typically, the cost of meeting regulations gets passed on to each firm's respective customers. But companies that are subject to those regulations are vulnerable to competition from platforms that facilitate less-accountable relationships. Often, when a platform coordinates hundreds or thousands of casual providers, it becomes unclear just who is harming the third parties or how existing rules apply to the web of relationships.

For example, a city may require special fire-safety equipment for commercial real estate and short-term rentals. Who is responsible for ensuring the installation of such equipment—Airbnb, its hosts, both, or neither? This ambiguity enables both parties to avoid investing in the fire-safety measures and to pass on their savings to customers via lower prices. Plenty of customers are happy to accept this trade-off, but third parties who might be affected by a fire aren't in a position to make the choice. And if some properties (such as those that brand themselves hotels) are rigorously inspected and others (Airbnb accommodations) are not, the former will find themselves at a cost disadvantage.

Crafting a Response

The businesses at greatest risk of spontaneous private deregulation are those that answer yes to all three questions: Are consumers being unnecessarily protected? Can business practices be codified? Are third parties being protected? Often regulators themselves worry that some rules may be excessive, or at least ineffective. When private individuals begin to provide services, they usually fly under the regulatory radar at first, making it especially easy for them to find footholds. As they gain popularity, they may seem virtually unstoppable and even praiseworthy—all the more so when harmed parties, such as noncustomer third parties, have little ability or incentive to speak up.

An incumbent might consider acquiring a threatening entrant. But if the entrant's value grows as rapidly as we have seen with Airbnb and Uber, this quickly becomes unrealistic. And incumbents could hardly claim the regulatory high ground if their response to allegedly illegal entry was to acquire the entrant and embrace the same methods.

So let's turn now to the strategic options that are open to businesses at risk of experiencing spontaneous private deregulation—or already facing the threat.

Option 1: Call Your Lawyer

When a competitor enters the market and ignores key regulations, it is natural to seek legal assistance—perhaps through private litigation or by urging a regulator to take action. When violations are clear-cut, this strategy can be effective, if the incumbents and those protected by the regulations unite behind it. For example, in 1999, copyright holders began to sue software companies that were facilitating copyright infringement, and their litigation successes compelled the shutdown of Napster’s file-sharing service (among others).



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most regions worldwide.

There is another key drawback to filing suit. Legal action assumes that laws will remain as they are. But if consumers embrace an entrant’s approach, laws may change—sometimes rapidly. Upstarts have discovered the power of mobilizing their users to influence regulators. For example, Uber has encouraged its passengers to contact regulators in cities where its service has been banned or is at risk of being banned. In contrast, an incumbent usually lacks popular support when seeking to maintain the status quo. Any lawsuit is vulnerable to ever-shifting political debates, which in turn influence legal requirements. An incumbent who sues may look like a sore loser in the public’s eye—and may be a loser in court as well, if legal rules shift or an unsympathetic legal system undermines the suit.

Yet this strategy has important limitations. Legal action can be slow, costly, and unpredictable. Moreover, courts often take a dim view of competitors seeking to enforce regulations, finding that only regulators have the authority to do so. More than a dozen taxi associations, fleet owners, and operators have sued Uber in the United States, but almost all the cases have been dismissed as invalid on procedural grounds. Uber’s critics have had more success outside the United States, especially in Western Europe, but some people have attributed the rulings against Uber to anti-American sentiment and to incumbents’ co-opting of the regulators. On the whole, Uber’s approach has prevailed in

Option 2: Embrace Aspects of the New Model

For an incumbent facing a creative entrant, a natural starting point is to adopt the best aspects of the competitor's approach. This is a promising way to neutralize new rivals and remain viable. For example, Napster came on the scene with music that was usually copyright-infringing, but the service's real value lay in its ability to provide songs nearly instantly to any device. In contrast, early online music sales platforms asked users to navigate a multistep purchase process and then delivered files encrypted with digital rights management (DRM) technology. This meant the files could be played only on a limited set of compatible devices, and the music was often difficult to transfer if a consumer changed devices.

Spontaneous Deregulation in an Earlier Era

Rapid technological change forces us to reevaluate which laws are still needed. That was as true decades ago as it is now.

Automobiles. At the dawn of mechanized transportation, the British Parliament's Locomotive Acts established onerous requirements for all mechanically propelled vehicles. In 1865, vehicles were limited to traveling two miles per hour in cities, towns, and villages, and four miles per hour elsewhere. Vehicle operators particularly disliked the requirement that three people attend the vehicle at all times, with one of them assigned to carry a red flag at least 60 yards ahead of it to warn approaching horseback riders and horse-drawn carriages.

A few drivers flouted the law, risking fines as large as £10 (equivalent to more than \$1,100 in 2015). Over time, as more people became aware of the benefits of automobiles and as fears proved overblown, support for the Locomotive Acts waned, and the rules were significantly loosened in 1896.

Airplanes. Regulatory questions also arose at the dawn of aviation a few decades later. The Romans had held that a landowner's property extended "from the bowels of the earth to the heavens above." British and American law copied that approach. But in the 1900s, anyone piloting a plane would necessarily pass over thousands of parcels with diverse ownership. Aviation would collapse under the administrative burden of negotiating flying rights with every landowner. Fortunately Congress recognized the problem, and in 1940 it declared "navigable airspace" to be free for everyone to use, with no permission required from landowners below. Here, at least, legal rules imposed little real barrier to transportation innovation.

Of course, music sellers had every reason to fear piracy. But locking their content behind DRM probably pushed consumers into piracy more than it increased sales. Facing competition from copyright infringement and pressure from e-retailers, music sellers ultimately embraced

unencrypted files that widened consumers' options. Legal music sales might have taken off faster, and piracy might have been correspondingly reduced, had rights holders recognized that Napster owed its success as much to its convenience as to the fact that it was free.

Similarly, Uber and Lyft attracted customers with user-friendly platforms providing quick and reliable service. Customers also relished the opportunity to rate drivers, yielding incentives for safe and polite service. To stay in the game, taxi operators in most cities launched their own applications and made efforts to improve service quality. Many passengers think arranging a cab ride means a phone call to a grumpy dispatcher, but taxi companies now widely offer web- and app-based ordering, through a customer interface not unlike Uber's (in fact, some taxi fleets offered web-based booking years before Uber). Even vehicle-en-route tracking has been around for years. If a taxi fleet operator complains about Uber but fails to offer these services, it's hard to feel much sympathy.

Nonetheless, copying the entrant's strategy can be tough to put into practice. For one thing, most incumbents build up capabilities that are not useful in the new entrants' models. Consider the skills required to run a national hotel chain—attracting and supervising franchisees, coordinating marketing efforts, booking conferences and events. It's unlikely that these skills translate to success in a world where short-term accommodations follow Airbnb's model. In fact, staff trained in the old way may resist the changes, or at least struggle to implement them.

Moreover, incomplete efforts to adopt a new model may be tragically ineffective. Consider a taxi fleet operator concerned about competition from app-based transportation services. Uber claims important cost advantages: It doesn't buy medallions (operating licenses), forgoes commercial vehicle registration and insurance, and sidesteps the driver verification that many cities require of taxis. Woe to the fleet operator who expects an online booking feature to overcome that cost gap. When Hailo tried to organize New York taxis via a modern app, its prices were always higher than Uber's—predictably disappointing the customers concerned about the cost of a ride.

Option 3: Play to Your Strengths

New platforms typically offer some benefits, but there are usually also downsides. Novice Uber drivers, for example, won't know shortcuts commonly used by experienced taxi drivers. And an Airbnb stay may give travelers an "authentic" taste of the local culture, but if a delayed flight

complicates meeting the host, the guest will surely miss the convenience of a front desk open around the clock. Incumbents should remind consumers of the advantages they offer; for the right customers in the right circumstances, the message may resonate.

For example, forward-thinking hotel operators are playing to their strengths as they adjust their offerings in the face of competition from Airbnb. New “pod”-style hotels forgo oversized guest rooms and deluxe furniture. Yet by gathering a group of travelers in a single building with comfortable common areas, they create social environments that scattered Airbnb properties can’t match. And with smaller rooms and basic fixtures, their costs may approach or even beat those of informal competitors. CitizenM, the Pod Hotel, and Yotel are testing this model in New York City and several cities in Europe, and it seems to be gaining traction.

A big challenge for many incumbents is that when customers assess available options, they often pay no attention to the potential for unanticipated problems. To be sure, the consequences of not having a fire escape in your Airbnb room or being driven by a bad Uber driver can be severe—indeed, deadly. But rare is the consumer who actually considers the probabilities, let alone the possibilities. Perhaps a safer room or a professional driver transforms a one-in-10-million risk into one in 20 million. At \$20 extra, is that a good deal? Most of us could run the analysis if the numbers were known, but these risks tend to be uncertain and difficult to measure.

Option 4: Bow to the Inevitable

Google’s widely used YouTube video service began as a classic example of spontaneous private deregulation. It hosted copyright-infringing videos uploaded by the service’s users (and sometimes by its founders). Fast-forward a few years, and record company executives found themselves up against a wall in their negotiations with YouTube. They ultimately accepted modest royalties because the only apparent alternative was piracy, which paid them nothing at all. No one faults them for choosing the former, but it was a painful outcome for record companies, as it left them with a small fraction of their prior revenue. Their experience illustrates the potential for losses when firms are too slow to respond to changing conditions, both in law and in practice.

Smart hotel operators are adjusting their offerings to compete with Airbnb.

Still, if spontaneous private deregulation is unavoidable and the prior options offer little promise, the best response may well be an early, voluntary dissolution, expensive as that can be. If you were holding taxi medallions, for example, you might prefer to sell them and cut your losses, accepting a price well below the recent peak, because the alternative could be still worse. Indeed, several taxi fleets attributed their recent bankruptcies to competition from Uber. Ceasing operation is obviously not an incumbent's preferred strategy; it's far better for threatened companies to address their vulnerabilities early on. But accepting and planning for the inevitable may be the best and least expensive response in an industry whose changing norms and sources of competitive advantage have made a company's assets and capabilities largely redundant.

Looking Forward

While incumbents often find it tempting to accuse platform-based companies of unfair play, there is little doubt that these platforms are here to stay—and grow. Technological innovation makes it possible for software applications to carry out increasingly complex tasks, and two-sided platforms that connect casual providers with customers are well-positioned to leapfrog traditional firms. To survive, incumbents in industries that are vulnerable to software platforms must themselves adopt modern tools but also play to their strengths. In many ways, Uber and Airbnb seduced consumers who were disenchanted with the services provided by taxicabs and hotel chains. With diligence and foresight, other established providers can avoid a similar loss of customers.

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