Federal Trade Commission

Regulation in High-Tech Markets:
Public Choice, Regulatory Capture, and the FTC

Remarks of Joshua D. Wright*
Commissioner, Federal Trade Commission

at the

Big Ideas about Information Lecture

Clemson University

Clemson, South Carolina

April 2, 2015

Good afternoon. Thank you for the kind introduction and warm welcome. I am excited to be here today at Clemson. I'd like to thank Professor Hazlett, the Information Economy Project, and the Department of Economics for the generous invitation to speak with you all today.

---

* The views stated here are my own and do not necessarily reflect the views of the Commission or other Commissioners. I am grateful to my advisor Derek Moore for his invaluable assistance in preparing this speech.

I. Introduction

I want to focus my remarks today on the question of how regulators should approach, analyze, and respond to the ever-increasing appeals from incumbent firms to impose costs on their rivals and potential entrants through law enforcement or regulation. But first, let me begin with a simple observation: the development of new technologies often is a harbinger of disruption. Smart TVs, smartphones, and even smart thermostats can disrupt markets and create a boon for consumers. Looking at just one relatively "low-tech" sector – the broad "retail" industry – we can see multiple types of disruptive competition through the use of technology. Wal-Mart revolutionized the market through innovative inventory management. Years later, Amazon used the Internet to transform retailing worldwide, a disruption that is still shaking out in the marketplace today. Just this week, Amazon announced that it would expand its business model from products to services like installing a garbage disposal or providing piano lessons.[1] These and other forms of disruptive competition spur economic growth and generate enormous benefits for consumers.

One immediate question that arises when thinking about disruptive competition is: what type of firm – an incumbent or a new entrant – typically develops the technology or business model that disrupts competition in an existing industry? This is

[1] Megan Geuss, *Amazon launches 'Home Services' business, wants to give you drum lessons*, ARS TECHNICA (Mar. 30, 2015), http://arstechnica.com/business/2015/03/amazon-launches-home-services-business-wants-to-give-you-drum-lessons/.

a question that has attracted significant attention from economists and antitrust lawyers. There is a well-developed literature in economics devoted to addressing the question of whether innovation is the result of "competition for the market," the product of an industry that is currently competitive, or some combination of the two.[2] One view, which holds that innovation predominantly results from "creative destruction," has its roots in the work of Joseph Schumpeter.[3] Another view, advanced by Kenneth Arrow, is that a competitive product market is a precondition for innovation.[4] So which view wins? The economics literature doesn't deliver a clean and simple verdict. Sometimes it is incumbent firms that develop technologies that disrupt competition in a marketplace, but disruption is often the work of emerging firms that use new technologies to challenge incumbents.

I do not plan to wade into the debate about the impact market structure has on future innovation. Instead, I will focus on one important type of disruption that undoubtedly occurs frequently and across many markets we are all familiar with: an innovation in technology or business practice that is developed by a new entrant. In

---

[2] *See* Douglas H. Ginsburg & Joshua D. Wright, *Dynamic Analysis and the Limits of Antitrust Institutions*, 78 ANTITRUST L.J. 1, 4 (2012) (describing existing models).

[3] *See* JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 81–90 (1942).

[4] *See* Kenneth J. Arrow, *Economic Welfare and the Allocation of Resources for Invention*, *in* THE RATE AND DIRECTION OF INVENTIVE ACTIVITY: ECONOMIC AND SOCIAL FACTORS 609 (Richard Nelson ed., 1962). For an excellent survey of this literature, see Richard Gilbert, *Looking for Mr. Schumpeter: Where Are We in the Competition-Innovation Debate?*, *in* 6 INNOVATION POLICY AND THE ECONOMY 159 (Adam B. Jaffe et al. eds., 2006).

particular, I am interested in how incumbent firms respond to disruption developed by a new market participant. For example, how do established hotels respond to new competition from Airbnb? How do existing taxicab companies respond to the rise of app-based services like Uber and Lyft? How an incumbent responds to the threat of "creative destruction" is key to its future success, and in extreme cases, its future existence.

We can usefully divide incumbent responses to disruptive competition into three broad categories. First, there is competition on the merits. The incumbent can respond to disruptive entry by competing on price, quality, seeking greater efficiency in distribution, further innovation, and many other types of competition. Consider the competitive response of supermarkets when a Wal-Mart super center comes to town. Jerry Hausman and Ephraim Leibtag find that in addition to the benefits of lower food prices at Wal-Mart stores, supermarkets reduce prices another 5 percent to remain competitive. This is a big deal, especially for low-income families. The authors show that for a family making less than $10,000 annually, the presence of the super center increases what the family can purchase by more than 30 percent.[5]

On the other end of the competitive spectrum, a second potential response to disruptive competition is exclusionary conduct. By this I mean the incumbent firm

[5] Jerry Hausman & Ephraim Leibtag, *Consumer Benefits from Increased Competition in Shopping Outlets: Measuring the Effect of Wal-Mart* (Nat'l Bureau of Econ. Research, Working Paper No. 11809, 2005), *available at* http://www.nber.org/papers/w11809.

engages in conduct that raises the entrant's cost of competing in the marketplace in order to stave off competition and maintain its monopoly power. Students of antitrust are familiar with the sorts of tactics an incumbent with market power might use to try and stave off creative destruction and whether and under what conditions those tactics are likely to be effective.[6] Conduct that "raises rivals' costs" occasionally gives rise to antitrust liability when a plaintiff can prove the conduct results in greater market power and harm to competition without offsetting competitive virtues.[7] An illustrative example comes from the *Lorain Journal* case from the Supreme Court in the 1950s in which a dominant local newspaper forbade advertisers that wished to advertise in the paper from also advertising with its rival, the local radio station.[8] Central questions for the productive application of antitrust analysis involving allegedly exclusionary conduct are the difficulties of identifying and distinguishing anticompetitive conduct from that with procompetitive virtues, and the role of the market in protecting consumers from attempts to harm competition.[9] This second category relies solely upon private competition among firms.

---

[6] *See* James C. Cooper, Luke M. Froeb, Dan O'Brien & Michael G. Vita, *Vertical Antitrust Policy as a Problem of Inference*, 23 INT'L J. INDUS. ORG. 639 (2005).

[7] *See* Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983); Thomas Krattenmaker & Steven C. Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 YALE L.J. 234 (1986).

[8] *See* Lorain Journal Co. v. United States, 342 U.S. 143 (1951).

[9] *See, e.g.*, Frank H. Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984).

A third category – and the focus of my remarks today – involves attempts to raise rivals' costs in the sphere of "public" competition. Public competition includes efforts to influence lawmakers and regulators to act in ways that may affect competition in the marketplace. The Supreme Court's recent decision affirming the FTC's case prohibiting the North Carolina Board of Dental Examiners from forbidding non-dentists from selling teeth-whitening services to customers is a victory for those who wish to limit incumbents' ability to use public competition to thwart new entry.[10]

The tactics employed in public competition are varied and numerous. And although this form of rent-seeking is not new it has, in my view, become increasingly common in the modern regulatory environment. One timely example is the net neutrality regulation recently adopted by the FCC. My view is that the FCC's approach is misguided for a host of reasons.[11] Relevant to today's topic, however, is the fact that the FCC's effort to reclassify broadband providers under Title II of the Communications Act of 1934 will no doubt have the effect of raising the cost of entry for wireless internet service providers, new entrants that provide a low-cost alternative to the big telcos,

---

[10] *See* North Carolina State Bd. of Dental Exam'rs v. FTC, 135 S. Ct. 1101 (2015).

[11] *See, e.g.*, *Wrecking the Internet to Save it? The FCC's Net Neutrality Rule: Hearing Before the H. Judiciary Comm.*, 114th Cong. (2015) (statement of Joshua D. Wright, Comm'r, Fed. Trade Comm'n); *Net Neutrality: Is Antitrust Law More Effective than Regulation in Protecting Consumers and Innovation: Hearing Before the Subcomm. on Reg. Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 11-16 (2014) (statement of Joshua D. Wright); Thomas W. Hazlett & Joshua D. Wright, *The Law and Economics of Network Neutrality*, 45 IND. L. REV. 767 (2012); Joshua D. Wright, Net Neutrality Meets Regulatory Economics 101, Remarks Before the Federalist Society's Media and Telecommunications Practice Group Event (Feb. 25, 2015).

particularly in rural areas.[12] In general, the threat to competition posed by attempts to use public restraints to raise rivals' costs and harm competition are more pernicious than their private counterparts because this form of rent-seeking does not have offsetting procompetitive virtues and regulations that destroy competition are more insulated from market forces that would otherwise protect consumers.[13] One example, as I will expand upon later, is efforts by incumbent taxicab operators to convince local taxi commissions to regulate companies that facilitate the provision of transportation services through smartphone applications.

Today I am going to argue that, in the context of potentially disruptive forms of competition through new technologies or new business models, we should generally be skeptical of regulatory efforts that have the effect of favoring incumbent industry participants. There is a vast literature in economics that has been developed over the last sixty-odd years – public choice and regulatory economics – that explains how government decision-makers purporting to act in the public interest are in fact influenced by economic forces.[14] The lessons from that literature – lessons from James Buchanan, George Stigler, Gordon Tullock, Fred McChesney, Bob Tollison, and Bruce

---

[12] *See Wrecking the Internet to Save it? The FCC's Net Neutrality Rule, supra* note 11 (statement of Ajit Pai, Comm'r, Fed. Commc'n Comm'n).

[13] Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967).

[14] Robert D. Tollison, *Rent Seeking: A Survey,* 35 KYKLOS 575 (1982); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974); George J. Stigler, *The Theory of Economic Regulation,* 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

Yandle, among others – are as or more important for the modern regulator to understand right now than ever before.[15] There are countless examples of a regulator or legislator cloaking an act of economic protectionism that benefits a set of industry participants as being "in the public interest." There are also many examples of government actors not even bothering to cloak their protectionist actions as being in the public interest; in these contexts, the protectionism is open and notorious. In any event, public choice economics provides a set of tools to understand how government actors often choose regulations that are contrary to the public interest in having competitive markets. These insights have particular application to regulations that create barriers for firms hoping to engage in destructive competition through the use of new technology. They also identify a positive and productive role for the FTC in using its full panoply of tools to fight public restraints on trade.[16]

II. The Economics of Regulation – Regulatory Capture and Public Choice

Before I discuss how and why lawmakers sometimes adopt certain rules that harm rather than benefit the public at large, it is worthwhile first to consider the theoretical bases for economic regulation. In other words, what can we say generally about why regulation may be necessary in certain industries? As a general matter,

---

[15] *See e.g.*, JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT (1962); FRED S. MCCHESNEY, MONEY FOR NOTHING: POLITICIANS, RENT EXTRACTION, AND POLITICAL EXTORTION (1997); Tollison, *supra* note 14; Stigler, *supra* note 14.

[16] *See generally* James C. Cooper & William E. Kovacic, *U.S. Convergence with International Competition Norms: Antitrust Law and Public Restraints on Competition*, 90 B.U. L. REV. 1555 (2010).

regulation may be necessary – and I stress *may* here as there are multiple ways to solve the problems I am about to describe, including private ordering – because an unfettered free market may result in the misallocation of resources; the free market results in under- or over-production of a good in question or the quality-level of the good is below a socially acceptable level. In other words, there is some definable market failure in the industry. General regulation focuses upon potential market failures involving monopoly power, externalities, or asymmetric information.

Of course, successful identification of a market failure is necessary but not sufficient to justify regulation on economic grounds. Markets do not always deliver the social optimum; but neither do governments. Once a market failure has been identified the case for regulation requires that the regulatory solution itself survives a rigorous economic cost-benefit test – one that factors in the potential for unintended consequences. The theoretical underpinnings of economic regulation are fairly well defined and have been for decades. However, economists beginning in the 1950s began to question whether the regulations observed in practice corresponded with the economic bases for regulating industries. The conclusions were stark. In 1974, Richard Posner observed that "[s]ome fifteen years of theoretical and empirical research, conducted mainly by economists, have demonstrated that regulation is not positively correlated with the presence of external economies or diseconomies with monopolistic market structure."[17]

The gap between theory and regulatory practice led to the obvious question: if regulation does not occur because regulated industries possess the characteristics that make government regulation necessary, then what explains the spread of regulation in the United States? And relatedly, if regulators were not motivated by the things that make regulation a necessary and effective tool to promote economic growth, then what was in fact motivating regulators? Economists developed robust evidence that regulation benefitted producers and harmed consumers.[18] In monopolistic industries, there was evidence that regulation failed to solve the conflict between allocative and productive efficiency and did *not* keep prices below monopoly levels. In more competitive industries, there was evidence that regulation supported prices above costs and prevented new firms from entering the market. The efficiency losses from rent-seeking efforts by market participants to influence regulation go beyond the deadweight loss associated with the creation of entry barriers to distort competition.

[17] Posner, *supra* note 14, at 336.

[18] William A. Jordan, *Producer Protection, Prior Market Structure, and the Effects of Government Regulation*, 15 J.L. & ECON. 151 (1972).

These activities also siphon resources from productive to redistributive uses as long as it's possible to use government to gain a monopoly.[19]

With regard to regulators' motivation, Nobel Laureate James Buchanan and Gordon Tullock developed "public choice" economics to help explain why legislators and regulators performed in ways that did not necessarily benefit a majority of consumer-voters. Indeed, this literature has made clear that regulators and legislators are not Platonic guardians of their constituents' best interests. Rather, legislators and regulators, like other economic principles, act in their own self-interest. Their goals are to maximize utility, however defined, just as private citizens do.

Public choice economists observed three important facts about regulation: (1) regulatory legislation redistributes wealth; (2) the behavior of legislators is driven by their desire to remain in office, which means that legislation is designed to maximize political support; (3) interest groups compete by offering political support in exchange for favorable legislation.[20] Considering these facts together, "[t]he general result that follows is that regulation is likely to be biased toward benefitting interest groups that are better organized (so that they are more effective at delivering political support) and gain more from favorable legislation (so that they are willing to invest more resources

---

[19] Public choice economists also highlighted the role of "rent extraction" in regulation. Rent extraction refers to the threat by regulatory bodies to take action that will impact a group of producers or other special interest group in order to induce rent-seeking. *See* MCCHESNEY, *supra* note 15.

[20] *See* Stigler, *supra* note 14; Peltzman, *supra* note 14.

in acquiring political support). More specifically, regulation is likely to benefit small interest groups with strongly felt preferences at the cost of large interest groups with weakly felt preferences."[21]

These insights help us understand the related and now familiar concept of regulatory capture. Under capture theory, regulation is either "supplied in response to the industry's demand for regulation (in other words, legislators are captured by the industry) or the regulatory agency comes to be controlled by the industry over time (in other words, regulators are captured by the industry)."[22] One can certainly imagine a scenario in which multiple firms operating in an industry with significant externalities – thus providing a plausible basis for regulating the industry – banding together to convince legislators to introduce regulatory legislation with the principal aim of the legislation to create barriers to new entry. Alternatively, and based upon our experience with regulation in this country during the 20th century, one can certainly imagine regulatory bodies designed to solve the conflict between productive and allocative efficiency that results from natural monopoly conditions becoming populated over time with industry insiders who are unable or unwilling to keep prices below monopoly levels.

---

[21] W. KIP VISCUSI ET AL., ECONOMICS OF REGULATION AND ANTITRUST 382 (4th ed. 2005).

[22] *Id.* at 379-80.

In any event, public choice and regulatory economics provide insights into the causes of the observed fact that regulation often favored producers rather than consumers. The obvious explanation for this outcome is that producer groups supporting anticompetitive regulation are typically smaller in number than the consumers that would oppose the regulation.[23] Opposing regulation, which would spread an enormous benefit across a very large group of people, simply does not in many cases have a high rate of political return, which is why we observe pernicious regulatory policies with staying power.

So far I have considered the evidence that regulation tends to be pro-producer, at least when comparing producers to consumers. Another question to ask is: why do some regulations favor one set of producers over another? In general, the reason we observe some producers getting more favorable treatment from legislators and regulators has to depend on political power. Some sets of producers are simply better organized and more politically connected than others. Further, there is no theoretical reason to think that regulation favoring one set of producers over another is better or worse than the alternative of regulation that favors the other set of producers. Without knowing specific characteristics about a the competing sets of producers and the

---

[23] MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (President and Fellows of Harvard College ed., 1971).

particulars of the industry, we have no reason to believe that one set of producers has interests that more closely align with consumers than another set of producers.

The conclusions change, however, when we begin to think of the typical scenarios in which disruptive competition is likely to arise. When a new technology or a new business model is likely to disrupt an entire industry, the entity that develops the disruption is likely to have interests that are more closely aligned with consumers. The disruptor wants to enter and compete. Incumbents, relying on soon-to-be outdated technologies or business models that once competed with one another for regulatory favoritism, are now aligned against a common cause: they want to forestall the disruptor's entry and hamstring its ability to compete. There is no reason to believe that incumbents are always better organized politically than disruptors, but in regulated industries, regulatory bodies are far more likely to be populated by industry insiders with favorable inclinations towards older and outdated modes of doing business. In my view, for these reasons, there ought to be a general skepticism of all regulation of technologies and business models that threaten to disrupt an industry. Indeed, hearing a regulator say something like "we need to watch closely because Company X may disrupt the industry" is in effect an admission by the regulator that whatever regulation he is about to adopt is one that will harm consumers.

III. Public Restraints and the FTC

Many before me have drawn similar conclusions about how and why legislators and regulators act contrary to the interests of their constituents and enact policies that thwart or slow the growth of disruptive competitors. For many years, the FTC has used its mantle to comment on legislation and regulation that may restrain competition in a way that harms consumers. This advocacy program has been a priority at the Commission since the early 1980s with broad support among commissioners of all political stripes. Though the program began in earnest in 1974, it was most active in the 1980s under the chairmanship of James Miller, himself a public choice economist influenced by James Buchanan and Gordon Tullock.[24] Though the program has been effective in some instances in convincing regulators to make more pro-consumer choices, the success of any given advocacy effort is highly dependent upon a host of factors, such as whether the regulatory body operates at the state or federal level, or whether the interest group supporting the anticompetitive regulation is well-organized and well-funded.[25]

The FTC's Office of Policy Planning helms the Commission's advocacy program. The comments provided by OPP typically take the form of written letters, comments, or testimony. The comments are provided both to state and local legislators and

---

[24] *See* James C. Cooper et al., *Competition Advocacy at the FTC*, 72 ANTITRUST L.J. 1091, 1094-95 (2005).

[25] *Id.* at 1105-1110.

regulators and also to legislators and regulators in the federal government. Often the legislators or regulators solicit the FTC specifically to comment upon the impact of the proposed regulation. Other times, the FTC finds potentially troublesome regulations on its own initiative or through complaints from market participants or consumer groups. Though OPP takes the helm, the Bureau of Competition, Bureau of Consumer Protection, Bureau of Economics, and the FTC commissioners review and comment on the agency's advocacy efforts. There are two bases that underlie the Commission's advocacy efforts, both reflected in relevant Supreme Court decisions. First, "competition will produce not only lower prices, but also better goods and services. . . . [A]ll elements of a bargain – quality, service, safety, and durability . . . are favorably affected by the free opportunity to select among alternative offers."[26] Second, competition should be restricted only when necessary to achieve some "countervailing procompetitive virtue" – such as protecting the public from significant harm – and such restrictions should be narrowly drawn.[27] These are two general points Commission staff typically highlight in advocacy efforts that relate to potentially anticompetitive legislation or regulation.

Commentators have calculated that between 1980 and 2004, the Commission issued a total of 708 comments to local and national legislators and regulators, or 28 per

---

[26] Nat'l Soc'y of Prof'l Eng'rs v. United States, 435 U.S. 679, 695 (1978).

[27] *See* FTC v. Indiana Fed'n of Dentists, 476 U.S. 447, 459 (1986).

year.[28] Between 2007 and 2013, the Commission undertook a total of 114 advocacy efforts in the competition area. This figure is not restricted only to advocacy efforts that relate to potentially anticompetitive regulation; it includes amicus briefs in competition cases and other efforts that do not necessarily touch on anticompetitive actions by governmental actors. Nevertheless, it is fair to say that the FTC's efforts to convince regulators and legislators not to undertake an action that protects producers and harms consumers or to undo or roll back a prior anticompetitive regulation number in the double digits year after year. Further, the Commission's advocacy efforts, as one ABA Report concluded, have a high rate of return: "Because ill advised governmental restraints can impose staggering costs on consumers, the potential benefits from an advocacy program exceed the Commission's entire budget."[29]

Over the years, the Commission has focused its advocacy program on numerous disparate industries. These include transportation regulatory reform, telecommunications regulatory reform, regulation of professions, health care, electricity regulation, and barriers to Internet commerce and competition. Since I have been at the Commission, staff has filed comments on laws and regulations in industries as

---

[28] Cooper et al., *supra* note 24, at 1093 (these figures include comments oriented toward issues of consumer protection in addition to comments focused upon issues of competition).

[29] Miles W. Kirkpatrick et al., *Report of the American Bar Association Section of Antitrust Law Special Committee to Study the Role of the Federal Trade Commission*, *reprinted in* 58 ANTITRUST L.J. 53, 94 (1989).

disparate as health care, electricity, and taxi cabs.[30] With regard to forms of competition that may be characterized as "high-tech," staff has focused on Internet-related industries. In particular, staff has encouraged legislators to allow Internet shipment of wine to consumers in their state, which threatens the Prohibition-era three-tiered alcohol distribution system that exists in many states.[31] Further, staff has commented on laws and regulations that forestall entry by smartphone applications that match consumers to taxi drivers in a ways that threaten to disrupt the existing taxicab market

[30] *See, e.g.*, Fed. Trade Comm'n, Staff Comment Before the Public Service Commission of the State of Delaware Concerning its Proposal to Revised Its Rules for Certification and Regulation of Electric Suppliers (Nov. 13, 2013), *available at* http://www.ftc.gov/policy/policy-actions/advocacy-filings/2013/11/ftc-staff-comment-public-service-commission-state; Fed. Trade Comm'n, Staff Comment Before The Arizona Corporation Commission Concerning Retail Electric Competition, Docket No. E00000W-13-0135 (July 11, 2013), *available at* http://www.ftc.gov/policy/policy-actions/advocacy-filings/2013/07/ftc-staff-comment-arizona-corporation-commission; Fed. Trade Comm'n, Staff Comment Before the Connecticut General Assembly Labor and Employees Committee Regarding Connecticut House Bill 6431 Concerning Joint Negotiations by Competing Physicians in Cooperative Health Care Arrangements (June 4, 2013), *available at* http://www.ftc.gov/policy/policy-actions/advocacy-filings/2013/06/ftc-staff-comment-connecticut-general-assembly-labor; Fed. Trade Comm'n, Staff Comments Before the District of Columbia Taxicab Commission Concerning Proposed Rulemakings on Passenger Motor Vehicle Transportation Services (June 7, 2013), *available at* http://www.ftc.gov/policy/policy-actions/advocacy-filings/2013/06/ftc-staff-comments-district-columbia-taxicab.

[31] *See, e.g.*, Fed. Trade Comm'n, Staff Comment to The Honorable Paula Dockery Concerning Florida Senate Bill 282, A Bill To Allow Direct Shipment of Wine to Florida Consumers From Manufacturers Inside or Outside Florida (Apr. 10, 2006), *available at* http://www.ftc.gov/policy/policy-actions/advocacy-filings/2006/04/ftc-staff-comment-honorable-paula-dockery-concerning; Fed. Trade Comm'n, Staff Comment to The Honorable Eric D. Fingerhut Concerning Ohio S.B. 179 to Allow Direct Shipment of Wine to Ohio Consumers (Mar. 22, 2006), *available at* http://www.ftc.gov/policy/policy-actions/advocacy-filings/2006/03/ftc-staff-comment-honorable-eric-d-fingerhut; Fed. Trade Comm'n, Staff Comment to the Honorable William Magee et al. Concerning New York A.B. 9560-A; S.B. 606-A; and S.B. 1192 to Allow Out-of State Vendors to Ship Wine Directly to New York Consumers (Mar. 29, 2004), *available at* http://www.ftc.gov/policy/policy-actions/advocacy-filings/2004/03/ftc-staff-comment-honorable-william-magee-et-al.

as it operates today. Finally, in 2004 staff issued a report on potential legislative and regulatory barriers to the sale of contact lenses over the Internet.[32]

IV. Another Tool: Antitrust Enforcement

Now I would like to turn to my final topic, which is a form of disruptive competition that has captured the Commission's recent attention and is something I have mentioned earlier today: smartphone applications and the taxicab industry.[33] The Commission has a long and interesting history with taxi regulation, which I will explain in a moment. But first I would like to discuss how the taxi industry came to be so heavily regulated in the first place.

The taxi industry was largely unregulated until the 1930s. Since then, the industry has been heavily regulated by local governments though there is significant variation in the type and extent of the regulation.[34] Some regulation is done at the state level, typically through public utility-type commissions, but most is done at the local level, by municipal governments and airports. In 1984 the FTC completed a thorough economic study of the industry in the United States and concluded that "[i]n general, the extent of regulation increases with city size. A substantial majority of large cities

---

[32] FED. TRADE COMM'N STAFF REPORT, POSSIBLE ANTICOMPETITIVE BARRIERS TO E-COMMERCE: CONTACT LENSES (March 2004), *available at* http://www.ftc.gov/sites/default/files/documents/advocacy_documents/possible-anticompetitive-barriers-e-commerce-contact-lenses-report-staff-ftc/040329clreportfinal.pdf.

[33] Joshua D. Wright, *D.C.'s Cab Rules Should Put Consumers First*, WASH. POST (Sept. 6, 2013).

[34] VISCUSI ET AL., *supra* note 21, at 583-85.

have strict controls on entry, fares, and service. By contrast, some small communities have virtually no taxicab regulations."[35]

There are many approaches to regulating the taxi industry. Existing regulations include restrictions on entry, such as limiting the number of licenses available to operate a taxi in a particular city; fare controls, such as maximum and minimum charges or specific fee schedules; requirements or prohibitions on certain types of service, such as requiring drivers to service all areas in a city or forbidding ride sharing; and quality regulations, such as requiring certain vehicle inspections or driver qualifications.[36]

Those who have taken taxis in major metropolitan areas are no doubt familiar with many of these types of regulations. But what are the supposed bases for regulating the industry in the first place? There are several commonly proffered reasons. First, some argue that regulation is necessary to curb traffic congestion. If a free market resulted in an increase in the number of taxis, then congestion would increase, which could have deleterious effects on society. Second, some argue that regulation is necessary because price competition would be imperfect in a free taxi market because of the transaction costs consumers would incur in finding the lowest

---

[35] MARK W. FRANKENA & PAUL A. PAUTLER, AN ECONOMIC ANALYSIS OF TAXICAB REGULATION 15 (1984) (FTC Bureau of Econ. Staff Report), *available at* http://www.ftc.gov/reports/economic-analysis-taxicab-regulation.

[36] *Id.* at 2.

fare. It is no doubt true that comparison shopping for the best taxi price is difficult to do while hailing a cab on the street. When one moves beyond street hails to consider dispatch service, however, it seems to me that price competition would be no more difficult than in many other highly competitive and well-functioning industries. Relatedly, some argue consumers are incapable of judging the "quality" of taxi service or that price controls are necessary to prevent taxi operators from engaging in price discrimination. Third, some argue that fare regulation is necessary because otherwise taxis might not service certain trips because they are unprofitable. In other words, a taxi commission sets fares above cost in exchange for requiring taxis to service all areas in a city or agree to operate at certain times when service might otherwise be sparse or nonexistent.

Judging the effect of taxi regulation as it existed 30 years ago, the Commission made the following conclusions: "taxi regulations are responsible for misallocation of resources. Some of the more obvious ways in which the allocation of resources under existing regulations is inefficient include: (a) the number of taxi rides taken is inefficiently low, because of regulations that raise fares, restrict the amount of service, and increase waiting times; (b) the cost of producing taxi trips is unnecessarily high, because of regulations that prevent ride sharing and increase deadheading[37] and waiting in taxi lines; and (c) there are shortages of certain types of service because of the incentives provided by the structure of fares."[38] The continued existence of these same regulations in many areas combined with new and existing regulations applied to smartphone applications suggests there is ample reason to believe the cost that consumers bear from the negative impact of taxi regulations has increased in certain jurisdictions since the FTC last visited the issue. Further, studies outside the U.S. demonstrate that harmful taxi regulation is not just an American phenomenon.[39]

Thus far I've focused primarily upon the FTC's advocacy efforts involving anticompetitive taxicab regulation. I also mentioned that the FTC has had a long and interesting history with the taxicab industry and its regulators. The FTC chose to go beyond its advocacy program and actually brought enforcement actions against the cities of New Orleans and Minneapolis in 1984. The Commission alleged that the cities unlawfully restrained trade by combining with taxicab operators to impose regulations

---

[37] Deadheading occurs when a taxi licensed to pick up a passenger in Jurisdiction A transports the passenger to Jurisdiction B, where the taxi is unlicensed and prohibited from picking up a passenger to return to Jurisdiction A. *See* FRANKENA & PAUTLER, *supra* note 35, at 91.

[38] *Id.* at 7.

[39] *See* OFFICE OF FAIR TRADING, EVALUATING THE IMPACT OF THE TAXIS MARKET STUDY (2007), at 1.19 (evaluating the effect of taxi regulations in the UK and estimating that efforts to deregulate in certain cities produce £2-£5 million annually and that further deregulatory efforts could result in annual consumer benefits as high as £13 million annually), *available at* http://www.rother.gov.uk/media/pdf/p/a/O.F.T._EVALUATING_THE_IMPACT_OF_THE_TAXI_MARKET_STUDY.pdf

that limited the number of taxicab licenses, increased fares, and eliminated other forms of competition among taxi operators. The complaint against Minneapolis was withdrawn after the city revised its ordinance to permit more competition. The complaint against New Orleans also was withdrawn after the state – which, unlike the city, was immune from suit under the federal antitrust laws – amended its laws specifically to authorize New Orleans to engage in the offending conduct.[40]

The taxi industry has been undergoing a revolution since 2007 when the smartphone first came to market. Application developers such as Uber, Hailo, Lyft, and others are using the GPS capabilities of smartphones to allow consumers to hail a ride with the tap of a button and watch on a map as the driver arrives to pick them up. The apps allow riders to pay for their rides electronically, and to rate their experience with particular drivers. Fares are determined by a variety of factors and in some cases the fare is adjusted by the amount of demand the ride service is facing at a particular time. Not surprisingly given the history of taxi regulations in this country, entrenched interests such as incumbent taxi operators have responded with "public" competition and, in some cases, regulators have responded by doubling down on competition-reducing regulations rather than by allowing new disruptive competition to flourish. In 2013 the FTC has issued comments to two sets of proposed regulations that, if adopted,

---

[40] *See generally* FED. TRADE COMM'N, 1985 ANNUAL REPORT 5 (1985), *available at* http://www.ftc.gov/os/annualreports/ar1985.pdf.

would have forestalled the disruptive competitive efforts of smartphone passenger service applications.[41]

Though the regulatory approach to new entry in the taxi business is the same as it has always been – obstruction – the entry by smartphone apps is different in significant ways from the entry the Commission was concerned about when it sued New Orleans and Minneapolis in the 1980s. Then, the Commission was concerned about cities creating an artificial limit to the number of available taxi licenses in order to drive up the value of existing licenses, and the cities' decisions regarding the level of taxi fares. Though new taxi entrants in the 1980s would have improved the taxi marketplace, the result would simply have been more taxis and lower fares, not necessarily a different type of taxi or a different way of matching drivers and riders. The smartphone apps seeking to enter the industry today are providing an entirely different type of service. Indeed, the apps themselves seek to solve many of the problems that proponents of regulation use to justify regulation in the taxi industry in the first place.

Smartphone apps can facilitate price transparency and price competition. In cities where multiple apps are operating, consumers can choose from a variety of ride

---

[41] Fed. Trade Comm'n, Staff Comments Before the District of Columbia Taxicab Commission, *supra* note 30; Fed. Trade Comm'n, Staff Comments Before the Colorado Public Utilities Commission In The Matter of The Proposed Rules Regulating Transportation By Motor Vehicle, 4 Code of Colorado Regulations 723-6 (Mar. 6, 2013), *available at* http://ftc.gov/os/2013/03/130703coloradopublicutilities.pdf.

providers based upon price, location, perceived quality, reputation, and a host of other factors. It is not a stretch to imagine an app that allows a would-be rider to auction off his ride to the lowest bidder. Because of the instantaneous connectivity of smartphones and their GPS capabilities, the pre-existing transaction costs associated with comparison shopping among taxi services are reduced enormously. Further, the ability of smartphone apps to adjust their pricing based upon demand and other relevant factors enables apps to provide taxi service that might otherwise be unprofitable under the regulated fare conditions. A consumer willing to pay more for a ride at an inconvenient time and from an inconvenient location would have the opportunity to pay for it through a smartphone app without any interference from the government.

Because the entry of smartphone apps in the taxi market is different in important ways, the cost to consumers of regulatory obfuscation is much higher than it has been in the past. For that reason, making sure this entry occurs without regulatory obstruction is of paramount importance. If the case was strong for the Commission's efforts to promote competition in the taxi industry in the 1980s – and I think it was – the case is even stronger today.

The specter of the FTC using its enforcement authority to police public restraints of trade in the taxi and other industries as a means to ensure consumers enjoy the benefits of competition enabled by technology raises some additional issues. First, the antitrust agencies do not have a clean record when it comes to being hospitable to competition that relies on new technology or new business models. The antitrust agencies were initially "inhospitable" to various patent licensing arrangements, announcing "Nine No-No's" – a list of prohibited licensing practices that ignored the potential procompetitive benefits of such arrangements.[42] The agencies reversed course over time, culminating in the 1995 Guidelines on IP licensing that explicitly recognize the benefits associated with certain licensing arrangements.[43] The antitrust agencies eventually became hospitable to new technologies and new business models, but it took a while.

Second, the insights of public choice economists are not limited to state and local legislators and regulators; these insights can apply to federal regulators as well. Indeed, in dissent in *North Carolina Dental*, Justice Alito argues that removing state regulators' immunity from federal antitrust suits if they have been captured by industry participants presents the difficult question of determining whether capture has actually occurred.[44] Justice Alito intimates that "all this will be worked out be the lower courts and the . . . FTC," but notes that "it has even been charged that the FTC . . . has been captured by entities over which it has jurisdiction."[45]

---

[42] *See* Joshua D. Wright & Douglas H. Ginsburg, *Whither Symmetry? Antitrust Analysis of Intellectual Property Rights at the FTC and DOJ*, 9 COMPETITION POL'Y INT'L 2 (2013).

[43] U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N, ANTITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY (1995).

[44] *North Carolina State Bd.*, 135 S. Ct. 1101, 1123 (Alito, J., dissenting).

[45] *Id.* at n. 6.

Justice Alito is no doubt correct that there is no reason to believe the FTC is immune from regulatory capture. However, there are a couple of reasons to think the FTC is less likely to be captured by special interests than state and local regulatory entities. First, the evidence Justice Alito cites for the proposition that the FTC has been "charged" with being captured is from a report and an article written in 1969.[46] Almost half a century has passed since the FTC endured those charges of capture, and an enormous amount has changed at the agency since then. Second, unlike the North Carolina Board of Dentistry or local taxi commissions that exist to regulate a specific industry, the FTC has economy-wide jurisdiction. The FTC is less likely to be captured by industry participants given that the subjects of its regulatory efforts are diverse and ever-changing, whereas a local taxi commission regulates the very same entities year after year. Third, the FTC's primary mandate is law enforcement, not regulation. FTC enforcement actions certainly impact the entities involved in the actions, and very likely deter similarly situated entities from engaging in the challenged conduct.

Nevertheless, there is good reason to believe that the dangers of capture are lower in the enforcement context than in the regulation context. It is certainly true that third-party firms spend resources to convince the FTC to sue a particular enforcement target. Indeed, it is increasingly common in high-tech markets for well-funded firms to

---

[46] *Id.* (citing E. Cox, "The Nader Report" on the Federal Trade Commission vii-xiv (1969); Posner, Federal Trade Commission, U. CHI. L. REV. 47, 82–84 (1969)).

attempt to persuade the FTC and other antitrust agencies to sue or at least investigate their rivals. Such third parties may be motivated by a desire to ensure a fully competitive economy, but they may also be motivated by a desire to benefit directly from an FTC lawsuit that hamstrings a competitor, or they may be motivated by a desire to have the FTC supply bargaining leverage to one party or another in an otherwise private dispute.[47]

Nonetheless, to the extent the FTC is convinced by third parties to pursue actions against firms for conduct that does not harm competition, such actions could have significant and lasting market impact. However, an enforcement action that is targeted at one firm in a market – usually a dominant firm – is materially different from a prospective regulation that is generally favorable to the firms being regulated. To the extent disruptive competition is supplied by new entrants, regulation that favors incumbents over new entrants will make it more difficult for firms to bring to market the disruptive business models that revolutionize industries and provide enormous benefits to consumers. Notwithstanding Justice Alito's conjecture, I think the FTC is in

[47] William J. Baumol & Janusz A. Ordover, *Use of Antitrust to Subvert Competition*, 28 J.L. & ECON. 247 (1985) ("There is a specter that haunts our antitrust institutions. Its threat is that, far from serving as the bulwark of competition, these institutions will become the most powerful instrument in the hands of those who wish to subvert it. More than that, it threatens to draw great quantities of resources into the struggle to prevent effective competition, thereby more than offsetting the contributions to economic efficiency promised by antitrust activities. This is a specter that may well dwarf any other source of concern about the antitrust process").

a good position to use its full arsenal of tools to ensure that state and local regulators do not thwart new entrants from using technology to disrupt existing marketplaces.

Public choice economics, regulatory economics, and the history of regulation in the United States offer many lessons to the modern regulator. Let me close my remarks today with three simple and practical rules for regulators – with a special emphasis on antitrust enforcers like myself – that I think are implied if not required by those lessons.

First, public restraints are especially pernicious for consumers and an especially worthy target for antitrust agencies. I am quite confident that a significant shift of agency resources away from enforcement efforts aimed at taming private restraints of trade and instead toward fighting public restraints would improve consumer welfare.

Second, regulators and enforcers should use all of their available tools to fight public restraints of trade. For the FTC, this means both advocacy and enforcement. The FTC's advocacy program to persuade state and local legislators and regulators not to adopt public restraints or to act in ways to reduce the anticompetitive impact of such restraints has been an unabashed success. The only criticism one could conceivably levy is that the program has not been active enough. When considering the activity of regulators – including federal regulators and regulators at the FTC – it is true that more is not always better. In fact, more is often worse. But in the case of the FTC's advocacy program, more is indeed better.

But, in my view, advocacy is not enough to curb the pernicious effect of public restraints. Advocacy needs to be convincing, but the captured regulator may not be in the market to be convinced. More is required. Enforcement actions aimed at public regulators do not require a captured regulator to be convinced. Rather, a successful enforcement action will coerce the captured regulator. Moreover, enforcement actions aimed at public restraints are relatively rare, at least in comparison with advocacy efforts. These enforcement actions have enormous deterrent potential. I have no doubt that dental boards in states other than North Carolina will be deterred from prohibiting non-dentists from offering teeth whitening services as a result of the FTC's enforcement action and ultimate victory in the Supreme Court. My strong belief is that the FTC should look long and hard for more potential enforcement actions involving public restraints.

Third, and finally, I believe and apply a strong but rebuttable presumption against regulation favoring incumbents over new entrants or accepting invitations from disgruntled firms to have the antitrust agencies sue their rivals. The first instinct of the antitrust enforcer when his or her phone rings and on the other line is a disgruntled competitor complaining about the competitive tactics on his successful rival should be to hang up. Economic history and public choice have proven the opportunity cost of taking that call is very high.

*   *   *   *   *

Thank you again for having me here today. I am happy to take your questions.