A disruptive innovation like Uber is not 'spontaneous deregulation'

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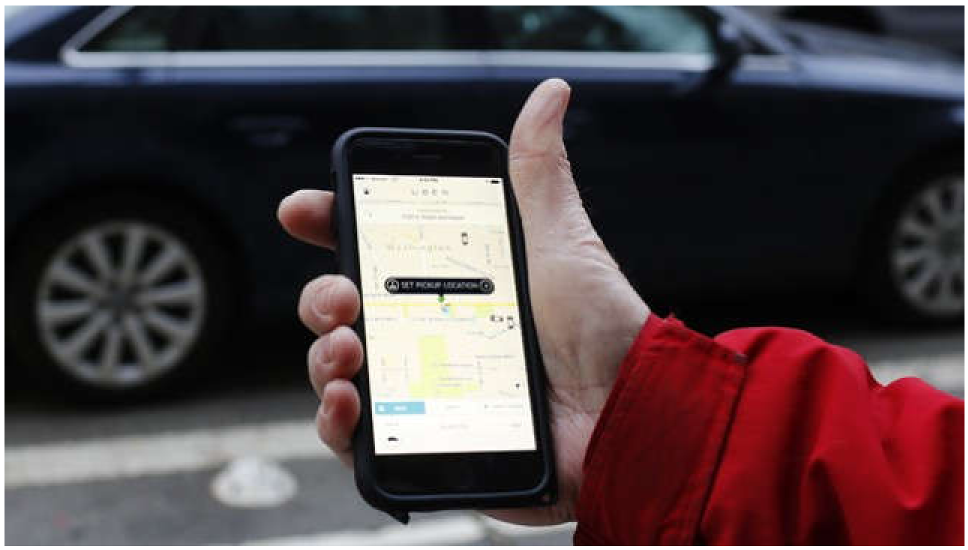

A recent article in the Harvard Business Review reviewed the vulnerabilities and response options for incumbents in traditional industries — such as taxi operators — when challenged by a platform-based system, such as Uber or Airbnb. Central to the article by Benjamin Edelman, professor at Harvard Business School, and Damien Geradin, of Tilburg University and George Mason University School of Law (where I also teach), is their term, "spontaneous private deregulation." It's a catchy phrase, and it partly conveys the importance of regulation as an explanation of the rise of disruptive innovators.

The term may work well to describe the perception of incumbents. Yet from a broader perspective that considers not only incumbents but also new businesses, entrepreneurs and consumers, a more appropriate term is "regulatory bricolage," because disruptive innovation often occurs where old regulations are in need of serious repairs.
As a description of how companies in the platform economy innovate, spontaneous deregulation is a misnomer. Innovation is almost never spontaneous. Instead, innovation typically arises as an entrepreneur's solution to a problem — hence the old saw, "Necessity is the mother of invention." It's true that platforms are often most noticeable in those industries where antiquated regulatory schemes have held back innovation, often for decades. But platforms' primary innovation is not dependent on regulation or "spontaneous deregulation." A platform facilitates transactions, and to be successful, it must reduce the cost of buying and selling a good or service. Smartphones have facilitated the entry of platforms into many areas of life, but market-making platforms predated both the internet and telephony itself: Stock markets, auction houses and poker tables are all platforms.

The innovation of platforms does not depend upon "spontaneous deregulation." One of the primary innovations delivered by platforms is the facilitation of transactions. In a broad sense, web-based platforms act like market makers: They connect sellers with buyers. In the cases of Uber or Airbnb, the buyers are customers who want to rent idle capital or hire the services of others on a short-term contract, and the sellers are those who own that idle capital. A platform company that facilitates transactions between buyers and sellers, such as Uber, can only be successful if there are sufficient buyers and sellers using the company's service, regardless of the preexisting regulatory environment. There's no doubt that the market-making function of companies that are successful in this space produces value to the economy by reducing search and transaction costs.

A second innovation delivered by modern platforms is the rating system. Rating systems like the ubiquitous five-star systems offer information on individuals' quality of service for the consideration of consumers, incentives for complete effort and an outlet for reporting problems and issues. If you give your Uber driver a poor rating, the effect is nearly instantaneous: Uber responds and asks for details about what happened. Do you have faith that lodging a complaint about a taxi driver would elicit similar responsiveness?

But perhaps the greatest innovation delivered by platforms involves forcing improvements to regulatory systems in certain cities and states. Terms like "spontaneous deregulation" may convey the incumbent's viewpoint, just as the better-known term, "regulatory arbitrage," can describe part of the innovative new platform's business strategy. Those perspectives don't capture the big picture.

Disruptive platforms can crystalize society's focus on policies that were holding back innovation, and produce entrepreneurial solutions to problems that aging regulatory schemes either created or failed to solve. As we've seen from Austin to Paris, incumbents often protest that a platform system creates an unfair situation by permitting competitors to "flout regulations." However, if those regulations only served the incumbents' interest, rather than the public interest, then the disruptive innovator is actually performing "regulatory bricolage" in the public interest — effectively repairing the broken pieces of regulatory code that have held back the industry.

For example, many regulations, like occupational licensing requirements or taxi medallion systems, directly deter business formation by making it more difficult to legally establish new enterprises. While the rationale behind these regulations is typically to guarantee a minimum quality of service, empirical studies of these regulations rarely find such an effect. On the other hand, occupational licensure certainly raises the cost of entry. To the would-be entrepreneur who wants to open a hair salon, the legal requirements of hundreds of hours of training, a minimum number of years of education, and the successful completion of a written and theory exam may be simply insurmountable. Similarly, acquiring a taxi medallion in New York City before the advent of Uber and Lyft would have cost you over $1 million, just for the right to legally transport others in your car. Less entry means less competition, which affects not only quality but also innovation and prices.

This logic does not only apply to hair salons or dentists. Every car owner, for example, is a potential competitor with taxi companies. But prior to Uber, Lyft and other transportation platforms, the car owner who tried to use that resource to operate a legal livery service often discovered that many other resources — especially, time — would be required to jump through prohibitively costly hoops before she could legally do so.

While the normal forces of supply and demand always apply, regulations and other public policies can affect the choice to leave useful buildings and equipment idle — another reason why the term "spontaneous" is a bit misleading. While the inventors of platforms like Uber and Airbnb deserve enormous credit for lowering the cost of entry and improving competition in the passenger transportation and short-term rental industries, to some degree those companies' success depended upon regulatory barriers to entry in the first place.

In fact, the common theme across all those industries where a market-making platform has been extremely successful is that regulations protecting incumbents helped create the opportunity for disruption in the first place. Instead of being characterized in a negative light, platforms that identify regulatory failures, and deliver innovative solutions, should be praised for performing the "regulatory bricolage" that regulators should have done long ago.

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