

# Regulating the Sharing Economy

Sinclair Davidson

## Introduction

In June 2017 the New South Wales government issued an Option paper (Roberts and Kean 2017) calling for community and stakeholder feedback into a proposed policy framework on Short-term Holiday Letting. The policy paper investigated how best the New South Wales government should respond to growth in that industry, including the activities of platform economy firms AirBnB and Stayz.

This paper discusses regulation of the platform economy in the context of the Short-term Holiday Letting market. Specifically it provides a definition of the platform economy and then discusses arguments relating to the regulation of the platform economy. While many arguments for uniquely regulating the platform economy are proposed this paper argues that they are either misplaced or fail to properly understand the role of the platform economy. In short, there are no good arguments for uniquely regulating the platform economy. The appendix provides answers to the detailed questions posed by the policy paper.

Roberts and Kean suggest that the Short-term Holiday Letting market may be subject to an unusually high level of negative externalities. This paper shows that the underlying conditions to support the notion of negative externalities are weak or lacking in the property market. As such it is highly unlikely that the Short-term Holiday Letting market suffers from unusually high negative externalities. Rather it is more likely that opposition to that market is due to NIMBYism (Not In My Back Yard) or vested interests in the hospitality industry trying to create barriers to entry for new competitors.

## Defining the Sharing Economy

Very often the sharing economy (sometimes also known as platform economy, or peer-to-peer economy) is simply defined by the companies that operate within it – for example, AirBnB and Uber. It is as if the industry is defined by the firm, and not the activities of the firm. Erikson and Sørensen (2015: 5) have a somewhat convoluted definition:

At its core, the sharing economy consists of an agreement between participants to contribute an owned resource (labour, goods, creative expression) to a common pool from which others may draw, with or without a commercial transaction.

That sounds very much like a definition of a firm in the Coasean tradition (firms are viewed as being a nexus of contracts) but tells us little if anything about what the sharing economy might be.

Certainly the term “sharing” seems somewhat misleading – while there may be some sharing in the sharing economy, it seems that most sharing is in fact exchange and trade as traditionally understood.

Munger (2015: 15) suggests that the sharing economy implies a far “more intensive use of existing goods and skills of service providers”. That, however, is a potential benefit of the sharing economy. It is hardly a definition.

Allen and Berg (2014: 4) provide a comprehensive definition of the sharing economy:

The sharing economy is a broad term for an emerging set of business models, platforms and exchanges. The sharing economy is about sharing the knowledge of goods and services to better exchange them. These exchanges are leveraged by ubiquitous and cheap knowledge made available through disruptive technology. The distinguishing characteristics include decentralised exchange, a focus on access over ownership of resources, firms becoming the facilitator of exchange (rather than acting as a producer), and mechanisms of self-governance.

This definition touches on several elements that make the sharing economy somewhat different to traditional conceptions of the economy. The profound point is that technology has operated to substantially reduce information costs (and subsequently transactions costs) in some industries. This has led to the development of business models that facilitate trade between third parties rather than firms being producers of goods and services. Now the notion of middlemen and information brokers is hardly new – yet the sharing economy has enabled the emergence of businesses that operate well-beyond such industries as logistics and warehousing or information trading. Rather the sharing economy has facilitated the mobilisation and monetisation of the substantial excess capacity that exists in the modern economy.

Katz (2015: 1072) writes that the sharing economy exists somewhere “between purely passive message boards and direct service providers”. The service being provided is a substantial reduction in the transactions costs of achieving a given economic outcome (see Munger 2015 for a full discussion of this point). In particular, to provide a viable economic model, the sharing economy must meet three criteria (Munger 2015: 201):

- Provide information about options and prices in a way that is searchable, sortable and immediate.
- Outsource trust to assure safety and quality in a way that requires no investigation or effort by the users.
- Consummate the transaction in a way that is reliable, immediate and does not require negotiation or enforcement on the part of the users.

It is in meeting these three valuable economic objectives thereby mobilising and monetising excess capacity that generates the value within the sharing economy. It is important to appreciate that while engaging in regulatory arbitrage does provide some value to the sharing economy, it is through reducing transactions costs and managing risks that the bulk of economic value in this economy is created. Alternatively the creation of value could be understood as value being realised (even liberated) from mobilising excess capacity or idle capital.

By contrast Koopman, Mitchell and Thierer (2015: 531 – 532) suggest five mechanisms where the sharing economy creates value:

- Mobilisation of idle capital.
- Expansion of market size leading to increased competition and specialisation.
- Lowering transaction costs and expanding the scope of trade.
- Reduction of asymmetric information facilitating trade.
- Regulatory arbitrage undermining incumbent regulatory capture.

However the sharing economy is defined or described it appears that that it is associated with substantial value creation (or liberation) that is driven by a reduction in transaction costs and information costs. It appears that regulatory arbitrage plays some role – but discussion of that role is best deferred to the next section.

## Regulating the Sharing Economy

The economic theory of regulation is broken up into three strands. The “public interest” theory, following the work of Arthur Cecil Pigou, suggests that governments intervene in order to correct for various market failures. The “special interest” or “capture theory” of regulation, following the work of George Stigler, suggests that industry seeks out regulation in order to create barriers to entry for new rivals, and to maintain profitability.

In a series of papers Andrei Shleifer (2012, with various co-authors) has developed an institutional theory that posits regulation as emerging from societal trade-offs between the *costs of private disorder* and the *costs of government dictatorship*. Disorder relates to the ability of private individuals to inflict harm on others, while dictatorship relates to the ability of government and its bureaucrats to inflict harm on citizens.

Depending on the relative costs of disorder and dictatorship different regulatory approaches are more or less appropriate. For example, in some instances private litigation is efficient, or public bodies to regulate and litigate may be efficient, and so on. In some, perhaps very few instances, state ownership and prohibition becomes efficient.

What is important to recognise is that government has a role to play in reducing private disorder when private solutions are unavailable, or too costly; subject, of course, to not imposing too high dictatorship costs itself. A group of scholars at RMIT University have applied this general model to several very specific instances. Davidson (2013) investigated the scope for regulatory reform leading to productivity improvements. Davidson (2014) examined environmental protection laws. Berg and Davidson (2015) investigate media regulation, while Berg and Davidson (2016) investigate the regulation of free speech. Davidson and Potts (2016a, 2016b) have applied the model to the institutions of innovation policy. Davidson (forthcoming) applies this theory to the issue of tobacco control.

In order to justify some or other regulation it need be demonstrated that an activity generates private disorder costs.

Katz (2015: 1078 – 1080) suggests two problems relating to the sharing economy (she specifies three, but two of her three are closely related). First she suggests a harm principle, “... certain transactions pose unique health, safety, and financial concerns for consumers”. Then related to that is her third concern, that the service provider is best able to mitigate those unique concerns. She also raises the issue of monopoly power – that service providers may have disproportionate bargaining power relative to consumers. It is not clear that these concerns can constitute social disorder. The sharing economy is known for its wide choice and increased competition relative to the established economy. As such it is not clear that there are any unique harms associated with it, or that the service providers can have market power.

Erikson and Sørensen (2015: 6 – 7) identify four regulatory challenges raised by the sharing economy.

- Labour and working conditions.
- Trust.
- Risk and liability.
- Agency.

Each of these is discussed in turn.

*Labour and working conditions.* In one sense this is the regulatory arbitrage argument – that the sharing economy creates value by reducing the mandated minimum working conditions that employees enjoy under industrial relations laws. It is possible to argue that the sharing economy creates no value but rather that value is expropriated from workers and redistributed to platform providers and consumers. There are, at least, two problems with this sort of analysis. First it must assume that platform providers (Uber, AirBnB, and the like) must enjoy market power in the labour market. That somehow these firms are able to enforce working conditions that are below those that employees could enjoy elsewhere in the economy.

Second it assumes that the only viable model for working is being an employee. In this view of the world an individual can only ever be a master or a servant. It is true that since the industrial revolution and the emergence of large scale industrial production in the factory system that this has been the dominate form of work, but this particular work practice is not, and never has been, the only model for work. The 2009 economics laureate Oliver Williamson (1985: 218) describes the now dominant employee model of work as being a capitalist-mode authority relationship. Here a capitalist owns the means of production and employs workers to operate those means of production in a hierarchical relationship. By contrast, workers in the sharing economy can be described as being in an entrepreneurial-mode putting out system (Williamson 1985: 215). This is how Williamson describes that work relationship:

A merchant-coordinator supplies the raw materials, owns the work-in-progress inventories, and makes contracts with the individual entrepreneurs, each of whom performs one of the basic operations at his own home using his own equipment.

Workers in the sharing economy are micro-businesses in much the same way as workers were prior to the industrial revolution. Now it is true that many such workers only ever work for a single organisation in what appears to be an employment relationship, yet there is an absence of hierarchy and joint ownership of capital. Workers in the sharing economy are independent contractors who supply both skills and capital to the contractual relationship between consumer, worker, and platform.

*Trust.* Here Erikson and Sørensen argue that within the sharing economy that “buyers and sellers typically have less information than they would in a traditional exchange”. This is an astonishing claim – within the sharing economy the identity of both buyer and sellers are known to the platform and very often both the buyer and seller provide ratings of their interaction with the other. So consumers rate the service provider *and* the service provider rates the consumer. Indeed the benefit of the sharing economy is that it lowers information costs and so facilitates greater exchange. It is important to emphasise that consumers voluntarily participate in the sharing economy and to the extent that they perceive there to be unresolved trust issues they can always default back into the traditional economy.

*Risk and liability.* Erikson and Sørensen suggest that the sharing economy transfers risk from the corporate sector to private responsibility. Unfortunately they provide no explanation as to why this is inappropriate. Private responsibility for risks is entirely consistent with service providers being self-employed independent contractors.

*Agency.* There are two arguments here. First Erikson and Sørensen suggest that service providers are limited in their choices as to conducting their business. Not only is this statement true, it is a feature of the sharing economy. The service providers provide the capital and skills and the platforms provide the business model. The division of labour and specialisation is at work – the platform attracts the consumers and sets prices and conditions of service, while the independent contractors provide the service. The second argument is worth quoting in full (Erikson and Sørensen 2015: 7):

... the ability of communities to impose national or local regulation on sharing economy platforms is reduced due to their novelty, their reliance on non-transparent algorithmic systems and their global reach.

This is not so much a regulatory issue but a complaint that governments are unable to control their citizens peacefully exchanging goods and services to their mutual benefit.

This survey of the academic literature suggests that there is little basis, in principle, to provide any unique regulation of the sharing economy beyond standard regulations against fraudulent behaviour and the like. To its credit the NSW Options paper (Roberts and Kean 2017) does not suggest any of these arguments – rather it raises the issue of negative externality.

Roberts and Kean (2017: 4) make the following claim:

[Short term holiday letting] has the potential to generate impacts on the community if not adequately managed. These impacts could include noise, waste, traffic and parking, safety and security, and the potential impact on housing and broader industry in general.

Skilfully hidden within that claim relating to negative externalities is also a point that is best described as industry capture. It is very likely that short term holiday letting will have an impact on “broader industry in general”. This impact – greater competition leading to reduced prices and greater choice for consumers – should be welcomed. It is clear, however, that the advent of platforms that can bring a large number of micro-service providers into the market will not be welcomed by the existing industry and any attempt to extend regulations to the industry will disproportionately impact these micro-providers.

The problem with invoking externality as a basis for policy intervention is best described by Barnett and Yandle (2009: 134):

... the concept of externality has been to microeconomics what Keynesian economics was to macroeconomics. Specifically, it provides a rationale for virtually unlimited government intervention into private transactions. When viewed through this lens, unintended (uncontracted) effects are pervasive. We find them in virtually every sphere of human activity. Each can be characterized as an externality, with a corresponding appeal for government action.

Economists analyse voluntary interactions between individuals – externalities occur when involuntary interactions actions occur. A transaction between a willing buyer and seller can have an impact on a third party. When that interaction occurs via the third parties utility function it is said to be a “technological” externality and can be a basis for public intervention. Third party interactions that occur via the price system are “pecuniary” externalities and do not provide an economic basis for public intervention. Externalities that cause nuisance are known as negative externalities and it is these externalities that could provide a basis for the further regulation of the Short term holiday letting market.

It is easy to claim nuisance – what must be demonstrated, however, is an actual externality. This involves a two-pronged test: that the externality exists at all *and* that the externality persists in equilibrium. Externalities can only exist under any one of three situations:

- Missing markets.
- Ill-defined property rights.

- Unpriced resources.

It is not clear that there are missing markets in the short term holiday letting market. Rather the problem here, if it exists at all, is one of ill-defined property rights. The question then becomes, “Do property owners have the right to earn an income from their property?” The answer to that question must be “Yes”. Government wishing to attenuate that right are engaging in a regulatory taking (Sandefur 2016: 14). There could also, however, be a problem of unpriced resources. This seems unlikely. To be sure individuals may quibble over the correct price and whether prices are too low (high), but it is unlikely that resources are unpriced in the property market.

The fact is that local authorities already make rules and regulations relating to “noise, waste, traffic and parking, [and] safety and security”. It may well be the case that these rules and regulations are poorly enforced or expensive to administer and implement. Those problems, however, are instances of government failure and not market failure. As such it is difficult to sustain the argument that the short term letting market is a unique source of negative externality that requires unique regulation.

The argument for regulation in the short term letting market is weak. Sandefur (2016: 14) has alternate explanations:

- Prohibitions on home-sharing are often nothing more than a turf war by existing businesses that use their local political power to block possible competition.
- Another motive behind anti-home-sharing campaigns is old fashioned NIMBYism although phrased in terms of preventing noise, limiting neighbourhood traffic, or protecting people against nuisances, these efforts are often little more than the desires of locals to keep visitors away.

The sharing economy has the capacity to substantially disrupt the traditional economy. Lobbying by incumbents to either prohibit entrants to markets is a well-known and transparent mechanism to restrain trade. A somewhat more subtle mechanism to restrain trade is to impose high levels of regulation on an industry in the knowledge that compliance is a fixed cost and small providers are unable to cover that fixed cost at a profit.

So we see that there are no good economic reasons to regulate the sharing economy in general and the short term letting market in particular. There are, however, bad reasons to do so.

## Conclusion

Allen and Berg (2014) provide an extensive analysis of the sharing economy and suggest five recommendations for regulating the sharing economy (2014: 28 – 34):

- Encouraging bottom up self-regulation is preferable to top-down government control.
- Reduce occupational licensing across the economy.
- Eliminate industry specific controls that tend to entrench existing business structures.
- Create a business environment where platforms can develop private solutions to potential market failure.
- Reduce regulation in order to encourage entrepreneurship.

There is no reason to deviate from those recommendations. The platform economy provides opportunity to millions of Australians be they service providers or consumers. Government should not

intervene in the process whereby individuals make better and effective use of their capital and skill to improve their lives by better serving the needs of their fellow Australians.

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## Appendix: Responses to Specific Questions

### Introduction

Do you use or have you ever used short-term holiday accommodation?

*Yes.*

Are you or have you ever been a short-term holiday accommodation host?

*No.*

Do you provide another form of short-term holiday accommodation?

*No.*

Do you live near a property that provides short-term holiday accommodation?

*I do not know. I respect the privacy of my neighbours.*

Are you from an STHL industry group, owners' corporations or community group?

*No.*

### Impacts Associated with STHL

Please indicate below which impact(s) are you most concerned about and how do you believe these could be managed.

- Noise
- Waste
- Party Houses
- Parking
- Hazards and Evacuation

*I am not convinced that any of these problems are unique to the Short-term Holiday Letting Market and as such they should managed within existing frameworks.*

### Self-Regulation

Considering the mechanisms below, how could self-regulation in NSW best address any negative impacts of STHL?

The Code of Conduct

Complaint Management Mechanism

Monitoring & Reporting

*In the first instance monitoring and reporting should be undertaken to establish whether or not there is an actual social disorder problem generated by the Short-term Holiday Letting Market as opposed to mere allegation of disorder driven by NIMBYism.*

Are there barriers that may reduce the effectiveness of self-regulation?

*No. In the first instance self-regulation is the preferable regulatory framework. It is only when self-regulation is shown to be ineffective that alternate regulatory frameworks should be adopted. As it is the Australian urban landscape is highly regulated already and the Short-term Holiday Letting market should not be subject to any unique regulation.*

### STHL in Strata Properties

Should owners' corporations be given the legal ability to prohibit or restrict STHL? If so, how and under what circumstances?

*No. This would constitute private expropriation of property rights.*

Should the Strata Schemes Management Act be amended to increase the ability of owners' corporations to manage the impact of STHL and obtain compensation for adverse impacts? If so, under what circumstances?

*No. Plaintiffs who can demonstrate loss through the ordinary courts already have a claim for compensation. Any attempt to modify the Strata Act would constitute a subsidy to NIMBYism.*

Is there scope for industry self-regulation in the short-term holiday letting industry? Would this effectively address issues that occur in short term letting in strata schemes?

*Again there is scope for monitoring and reporting to establish that existing regulation is deficient.*

### **Regulation through the Planning System**

How should STHL be subject to a planning regulatory framework? What would be the impacts of applying a planning framework to STHL?

Exempt

Complying

Development Consent

No planning regulation

*There should be no unique planning regulation for the Short-term Holiday Letting market. Existing planning laws should apply to all planning activities.*

If STHL is to be regulated via the planning framework, how should it apply?

*Not applicable – see previous answer.*

Should there be different planning frameworks in regional and metropolitan areas? If so, how and why?

*No.*

### **Registration or Licensing**

Could a licensing system for STHL work in NSW? If so, how might it operate?

*No. Existing laws and licence requirements should not be changed simply due to the Short-term Holiday Letting Market. If anything laws, regulations and licences should be reformed and relaxed.*

### **About the Author**

Sinclair Davidson is Professor of Institutional Economics in the School of Economics, Finance and Marketing at RMIT University, a Fellow with the RMIT Blockchain Innovation Hub, a Senior Research Fellow at the Institute of Public Affairs, and an Academic Fellow at the Australian Taxpayers' Alliance. He is a member of the Centre for Independent Studies Council of Academic Advisers. Sinclair has published in academic journals such as the *European Journal of Political Economy*, *Journal of Economic Behavior and Organization*, *Economic Affairs*, and *The Cato Journal*. He is a regular contributor to public debate. His opinion pieces have been published in *The Age*, *The Australian*, *Australian Financial Review*, *The Conversation*, *Daily Telegraph*, *Sydney Morning Herald*, and *Wall Street Journal Asia*. He blogs at Catallaxy Files and Tweets @SincDavidson.