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"Prospects for Growth: The App Economy versus Vested Interests"

Abstract

Creative Destruction denotes a significant change in technology which dislodges the old into the new, leading to higher economic growth. We propose that the new ("app") economy has potential for this radical economic transformation. Perfect competition assumes zero transaction costs. Smartphones and mobile apps introduce reductions in information costs and lead to more perfect competition. However creative destruction can make the status quo obsolete. We observe that vested interests are resisting this change. Several examples are given. Because the new economy is decentralized, it is difficult to tax and to unionize. Therefore we see that city and state governments pass laws making it difficult for room- and ride-sharing apps to do business. Central banks and national treasuries dislike competition in currency so we find that digital monies are facing constraints. We also find the new economy is changing labor markets, entrepreneurial talent is becoming an increasingly important factor of production.

Keywords: asset specificity, creative destruction, new economy, rent-seeking, economic growth

JEL Classifications: D2, D4, E5, I3, K2

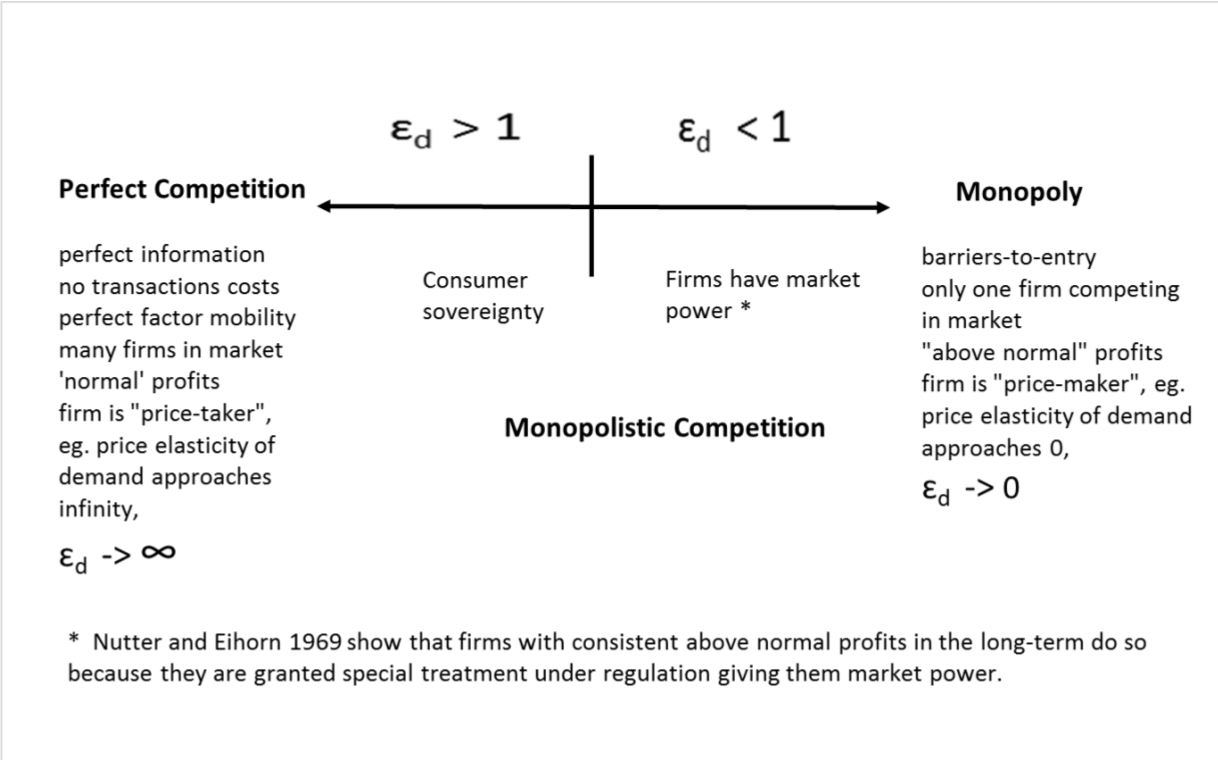
I. Introduction

This research has two main objectives. The first is to theorize the industrial relationship between the new economy (the "app" economy) and those vested interests who have economic rents to lose through the creative destruction inherent as the new economy gains traction over time. Following the economics of industrial organization, we posit that the new economy is in a position to improve market efficiency, and therefore improve economic growth and increase standards of living (from which the reduction in absolute poverty arises). The second purpose of this paper is to give several specific and contemporary examples of suppression of the new economy by vested interests, providing evidence for the theory that it is in the interests of the institutions of the status quo (the "vested interests") to use discretionary power to create barriers to entry for new economy firms as is predicted from our theory that vested interests need protect their rents.

Towards "Perfect Competition" through asset specificity

Most economists agree that the market, as opposed to politics, is the most efficient way to allocate society's scarce economic resources.[i] A common result in industrial economics is that the more consumer sovereignty there is (the less monopoly power a firm has) the more does a given market resemble "perfect competition" and therefore the efficiency afforded by market exchange. From the ground-breaking work of Anne Krueger's "The Political Economy of the Rent-Seeking Society" (1974) we know that special interests attempt to game the regulatory system (Krueger uses the example of trade-barriers) to get above-normal economic profits without having to create value through the market as do other firms who need seek profits in competitive markets. See Illustration 1 below which can help clarify the categories of perfect competition and monopolistic competition.

Illustration 1: Continuum between perfect competition and monopoly



We find as the industrial organization of a market moves towards the left in the continuum as found in Illustration 1, towards "perfect competition," that economic efficiency is increased (and therefore as well is there reductions in absolute poverty). The new, "app," economy has the power to radically change certain markets due to the reduction in information and transactions costs, as much if not most consumer information has become instantaneous on the internet. However we find that vested interests currently benefitting from state enjoined market power need resist the new economy for self-interest in maintaining historically-derived market power, examples are given below.

We know from the work of Oliver E. Williamson and others that real life in most instances does not resemble the textbook "perfect competition," transactions take place in specific times and places among specific economic actors. Over time and under repeated transactions, relationships form among economic actors which create the status quo patterns of trade and investment, or said another way, market decisions accumulate into "asset specificities". Some of these asset specificity regimes may be harmful to society in that these regimes prevent, rather than encourage, the factor mobilities which lead to the economic growth brought about by entrepreneurial creative destruction.[ii] It makes sense to assume that vested interests do not want to face "destruction" of their market powers through new economy competition.

Vested interest market distortions most commonly take form in barriers-to-entry or subsidies, and, as we have seen most predominantly recently in reaction to the 2008 Financial Crisis, overt bailouts of specific firms in specificity regimes with government decision-makers. As Krueger (1974) highlights more and more rent-seeking (by asset specificity regimes, author) will eventually prevent the market from efficiently allocating society's scarce resources. This explanation is a plausible one for the lower economic growth we have experienced since the financial crisis and bailouts of bankrupt assets, these interventions can be seen as unprecedented in American economic history and that's why the familiar refrain on the 'new normal' of 2% real growth instead of 3% growth or more prior to the reactions to 2007-8 is probably an accurate one, though this could change with supply-side reforms.

II. The New Economy and its opposition in vested interests: Monetary and tax authorities

In this paper we are identifying markets being transformed by the new economy, specifically industries where internet and smartphone technologies are rapidly and radically reducing transactions costs, most specifically in the form of reduced information costs (a reduction in information costs again leading from monopolistic competition towards more perfect market competition). In identifying these markets concurrently, we are able to deduce vested interests who are opposed to the creative destruction brought about by our current technological revolution.

The special treatment of new economy tech firms came to my attention most predominantly with the Apple tax case brought by the EU against both Ireland and Apple, ultimately resulting in Apple paying a past-due tax bill of €13bn (Farrell and McDonald 2016).[iii] It became clear that the EU is not interested in policy competition for the attraction of investment, rather the EU is interested in holding on to its power to regulate tax codes throughout the EU member states. Thus centralized tax authorities are one vested interest which can be seen as suppressing movements towards perfect competition, in that the regulatory burdens (increased transaction costs) are for firms are to comply with the EU rather than directly with the nations in which they invest.

This conclusion is reiterated with the EU tax case against Google and Italy, where Google is required to pay an EU-determined €306m in back taxes (Politi 2017). What distinguishes tech firms in relation to bricks and mortar industries is that much of what they do is invisible to tax authorities, internet transactions are decentralized and peer-to-peer, denying tax authorities easy solutions to complex tax issues. The expense of complying with opaque EU regulation is one way to suppress firms which are seen as too successful and therefore a threat to the status quo by EU regulators.

An example of tax (and monetary) authorities using their monopoly on power to tax and to print money is seen by the case of Bitcoin in the USA. In March 2014 the United States Internal Revenue Service (US IRS) declared Bitcoin and other digital money as "property" (e.g., not as legal tender), therefore taxing alternative currencies under the capital gains tax (US IRS 2014). The state simply does not want the competition of digital currencies, which are hard to trace as compared to the formal banking system regime specificities (which are based on oligopolistic central bank and treasury regulation and monopoly fiat currency issuance.)[iv]

The policies since the 2008 Financial Crises have been that of "easy money" in the form of monetary stimulus, which occurred in the USA for almost 8 years and which continues in Europe and Japan. Easy money means devalued money, so competition in currencies offered by digital money would provide unwanted competition for the monopoly currencies under current tax and monetary authorities. The IRS has gone so far as to request transactions records from alternative currency trading platforms (Porter 2016), again an attempt to save the power of the vested interests through non-market interventions, suppressing competition and the most efficient allocation of resources under the potentials offered by the new economy.[v]

III. The New Economy and its opposition in vested interests: The sharing economy

Rideshare

Much of what we gain through today's technological revolution is what we can call the 'sharing economy'. This phenomenon is most predominant with rideshares and homeshares where apps like Uber and Airbnb monetize assets which may otherwise go to waste. For example most cars are parked 95% of the time (Morris 2016) and many home-owners have extra rooms (empty nesters for example). Rideshare and homeshare digital applications make these otherwise unused assets available to the economy increasing well-being and standards of living. However these sharing platforms also face vested interests who do not like the competition that these apps bring.[vi]

Let’s start with ride-sharing apps. The most obvious vested interest against ride-sharing apps are city-sanctioned taxi services. Taxi permits by definition limit the supply of taxi-services and therefore by definition create greater profits than if there were not this regulation.[vii] Taxi cartels are also a source of political patronage for city politicians, who grant the taxis their special privileges and city treasuries receive steady and predictable taxes from these city licensed taxi-drivers.

Rideshare apps (platforms) provide competition against the taxi asset specificity regime and therefore these vested interests tend to suppress rideshare apps when possible. For example, where were the Paris police during the anti-Uber protests of June 25, 2015 when taxi-drivers blocked roads to and from airports and rail-stations (Thomson and Bennett 2015)?[viii]

Rideshare apps are decentralized and drivers are independent contractors, this has two implications. Rideshare platforms are not as easily visible as are for example the yellow cabs in New York City and the black cabs in London. This very invisibility itself is a threat to the vested interests in that the rideshares are less visibly taxable, this is annoying to city politicians and city treasuries. There are also labor market implications. Labor unions are important to city politicians as a well-known source of campaign contributions and votes. City, local and national governments and labor unions have formed a strong asset specificity regime over many decades.[ix]

Illustration 2.

Anti-rideshare taxi strike in downtown London, September 2015 (photo from Crossley 2015)[x]

It is very difficult to organize rideshare drivers into unions due to their decentralization and relative invisibility so unions in general (and not just taxi unions, for example public transportation unions[xi] and police and civil service unions are part of the anti-rideshare asset regime) are against the sharing-economy due to the creative destruction that independent contractors are bringing to the labor force in the new app economy.[xii]

Most importantly it is the consumer who gains (the consumer sovereignty of markets with more perfect competition than monopolistic characteristics) with lower cost and better service with the rideshare apps as opposed to state monopoly taxis. With monopoly power taxi-drivers do not have the incentive to innovate in service delivery. Rideshare innovation with almost instantaneous access in mass markets to rides at any time of the day move the transportation market away from cartelization and monopoly and towards perfect competition, and this transformation obviously must face resistance in vested interests.

Homeshare

Homeshare platforms are another means to unfetter assets in order to create value in market exchange which would otherwise be under-used. It is obvious that the most vested interest against homeshare innovation is the hotel specificity regime. Cities which are attractive to tourists can charge 15% hotel tax and the hotel industry lobby, and concurrent hotel worker unions, are well-organized, with most large cities in the USA being under Democrat (pro-union) mayors. City treasuries (and therefore by definition city politicians who favor spending programs) find homeshares a problem as the decentralized and anonymous nature of the internet poses a threat to the hotel regime and its steady source of taxation for city treasuries and the steady unionization of hotel workers.

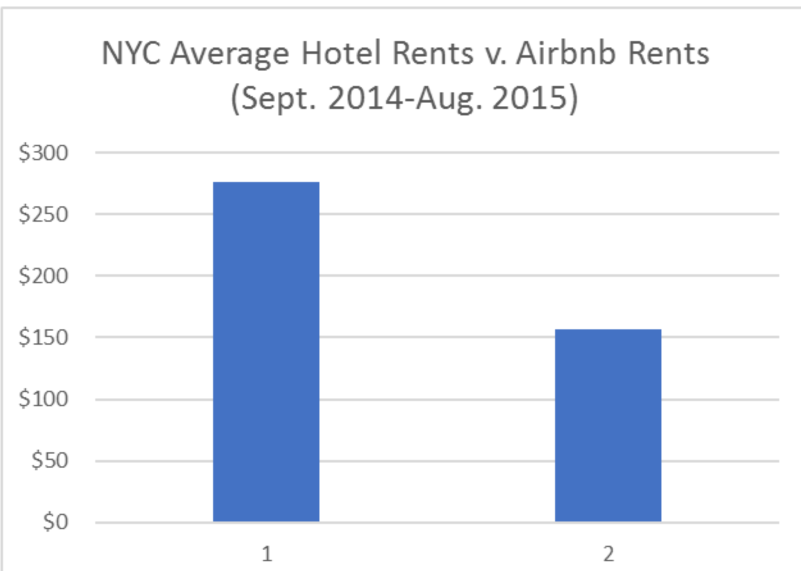
The American Hotel and Lodging Association (the association) is encouraging the US Federal Trade Commission investigation that Airbnb is a cause of increasing housing costs in American cities (see Illustration 3 which counters this claim by showing that Airbnb rentals have been less than hotel rentals in New York City).

> The association also met with legislators and attorneys general in dozens of other states [other than New York, author] to discuss how Airbnb hosts often do not comply with rules imposed on hotels, like anti-discrimination legislation, local tax collection laws, and safety and fire inspection standards. In some markets, the group says, Airbnb is dodging paying local lodging taxes. In other places, it encouraged officials not to collect taxes so as not to legitimatize short-term rentals (Benner 2017).

As we can see the regulatory state of play for the sharing economy is being negotiated contemporarily, with the new economy having to fight the vested interests in court and regulatory arbitrage rather than in value creation for consumers in the market.[xiii] For example Airbnb settled its lawsuit with the city of San Francisco by requiring that hosts using the Airbnb platform obtain city licenses through the Airbnb website (Dickey 2017).[xiv] The settlement of the New York City Airbnb case is that renters, not the Airbnb platform, are responsible for registering with the city and are responsible for the up to $7,500 fee for not doing so, rather than Airbnb being required to pay the regulatory fee (Benner 2016).

As found above the regulation of much of the new economy is in how the courts define platforms as direct service providers. The results of these locational legislative decisions might provide a good proxy in economic geography for how 'liberal' a regime is toward creative destruction or towards old-fashioned cronyism.

Illustration 3.



Data source: statista.com.

Hotel room costs 1. $276 per night; Airbnb costs 2. $157 per night

Youtube

Youtube is unique in the streaming world as for the most part it is free (if you ignore the adverts) as opposed to Spotify and Apple Music which pay royalties (as opposed to or in addition to advertising revenues) to the artists. In this case of course in opposition to Youtube is the asset specificity regime who gains profits from the copyrights on individual performances and songwriting. Therefore we find the Recording Association of America, which represents major labels, against the new economy Youtube (Sisario 2017).

Youtube is a platform which advises its content uploaders when copyright claims are lodged against them. Major recording artists (from personal experience, Bob Dylan) have their copyrighted content scrubbed from youtube in a timely manner. This Youtube monitoring of course may be resource intensive for copyright holders, although the music copyright asset specificity regime appears to be embracing in general the new economy rather than seeking rents against its competition, for example paid music streaming revenue is up 11% in 2016 from 2015 (Sisario 2017).

IV. Explanation and Conclusion

As theorized and shown empirically we are in a new, app, economy where entrepreneurship / independent contracting is changing labor relationships and transaction costs in certain industries, moving these sectors towards more perfect competition and therefore resulting in increasing standards of living.

However new higher standards of living through the creative destruction process in society through the app economy can only be realized through competition, competition which as we have seen has been thwarted by many (but not all, see streaming music above) vested interests (politicians, public and private unions and copyright holders and associations, cable companies, city and national treasuries and monetary policy-makers) given the specific circumstances in the cases as described.

Despite optimism over innovations in the market, only time will tell, perhaps a generation or more (as only recent generations have grown-up with smartphones), if indeed we are in a revolutionary “new” economy due to the technological advances of the smartphone and the satellite internet. The rate of change in the new economy will depend on how well vested interests protect their positions versus how free markets allow entrepreneurship without undue anti-trust litigation increasing transactions costs.

The internet revolution is occurring with or without the concurrence of the state. An intelligent state might seek ways to gain as well from the tech revolution, by allowing more competition and negotiation and less regime-specific lawsuits, regulatory burdens, and labor blockages and even riots in certain cases.

Notes:

1. For example see any first-year textbook of economic principles such as Gregory Mankiw's (the best-selling author of economics textbooks in the United States), where in his economic "Principle 1: People Face Trade-offs" he finds that people face trade-offs between the *efficiency* of the market and the inefficiencies caused by government intervention in the name of *equality*. "In other words, efficiency refers to the size of the economic pie, and equality refers to how the pie is divided into individual slices" (Mankiw 2015, p. 5, *emphasis added*).
2. See Weber 2017 for an example of asset specificity regimes based around the bailout and nationalization of General Motors by the US government in 2009, where we find that despite having accumulated debts of more than $30 billion over a 20-year period GM gets bailed-out to the detriment of the rule of law and creative destruction through bankruptcy and to the benefit of the United Auto Workers, who were big donors to the Obama (and of course other Democrats) campaign. The paper describes the historical emergence of the US government – UAW asset specificity regime during the 1970s through today, both Republican and Democrat administrations at national and local levels have given special treatment to domestic automobile manufacturing and distribution.
3. For context the successful "Brexit" vote in the UK was June 23, 2016, two months before the final ruling in the Apple-EU tax case.
4. It is not well-known that the shareholders of the Federal Reserve Bank are private banks, not the US government. This is another example of state policy and regulation giving which are now vested interests monopolistic power. This special interest asset specificity regime is at risk under the creative destruction inherent in the new economy, for example this year the blow back against crypto-currencies. The shareholders of the Fed get guaranteed year-in year-out returns of 6% - mostly from the interest on government bonds held by the Fed as part of seigniorage in money issuance. The Fed transfers all central bank profits beyond those given to shareholders to the US treasury, something we can refer to as "monetary cronyism" (Brown 2016).
5. F.A. Hayek after studying monetary economics for more than 50 years argued for the "denationalization" of money, in order to keep state money honest. Hayek was writing in context against the creation of the Euro (€) as a common fiat-monopoly for Europe, but the economic arguments hold in all nations with fiat-monopoly money (Hayek 1990).
6. The European Court of Justice is deliberating whether Uber is a "car service" or a "platform," which will determine its regulatory future in the EU (Orlowksi 2017). Gutteridge (2017) finds that if the EU court determines Uber a car service that it will be regulated out of existence in the EU.
7. Holodny 2016 reports that New York City taxi tokens decreased in value from around $1.3 million in 2014 to less than $500,000 in 2016. This is an example of the creative destruction about which vested interests are fearful. NYC taxi tokens are traded through nycitycab.com.

8. In 2016 the Los Angeles Police Department entrapped and arrested 240 rideshare drivers for accepting cash for rides (Hunter 2016). Uber's use of "Greyball" technology is of course a way to reduce entrapment transactions costs as a means of doing business. The classical liberal view is that competition creates innovation and moves markets towards perfect competition, albeit with disruptions in the short-term. It is these short-term disruptions which politicians and their coalitions are concerned about as it reduces state discretionary control.
9. In particular in the United States it was the National Labor Relations Act, or the Wagner Act, of 1935 which gave unions monopolistic bargaining power by bringing legal action for redress against union-caused damages to the administration rather than the civil court system. Unionization tripled under the FDR administration after the Wagner Act (Higgs 1987).
10. In September 2016 London Mayor Sadiq Khan announces a £65m program of support for London's black cabs to include subsidies for new vehicle purchases and a city-provided and paid-for cab app. In addition 20 new London bus lanes are added, which can be used by black cabs but not rideshare drivers (*The Telegraph* 2016).
11. The MTA, which is predominantly union labor, in the New York City area is more than $34 billion in debt (Evans 2015)
12. The concept of vested interests is nothing new, see Polanyi (2001) where the church (i.e., tithes via land ownership) and the manor and political system in England are organized against free trade in agriculture goods. The Corn Laws are finally over-turned in 1846 after more than 40 years of agitation for reform, and becomes law only after the potato famine causes relative starvation and out-migration for many Irish people.
13. It could be argued that city regulatory agencies for rental property are made obsolete with the app economy as on-line reputations through instantaneous consumer feedback are more relevant to potential consumers than is a government license.
14. Note that this resolution in San Francisco side-steps the issue of whether Airbnb is a service or a platform. The question still remains if Airbnb is legally responsible for its platform clients to register with the city. New Orleans, Chicago and Denver have the same "process" as does San Francisco (Dickey 2017). See https://www.airbnb.com/help/article/871/san-francisco--ca for Airbnb's guidance to its San Francisco hosts. Airbnb hosts are independent contractors as are Uber drivers, responsible for paying their own taxes on income, though it appears Airbnb might be a tax-collector for the city of Paris (*The Guardian* 2016).

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