READINGS

KICKING COMPETITION TO THE CURB

Curb Rights: A Foundation for Free Enterprise in Urban Transit
by Daniel B. Klein, Adrian T. Moore, and Binyam Reja.
(Brookings Institution, 1997) 148 pp.

Deregulating Freight Transportation: Delivering the Goods
by Paul Teske, Samuel Best, and Michael Mintrom
(AEI Press, 1995) 236 pp.

Reviewed by Michael C. Munger

> Scarcely anyone interests himself in social problems without being led to do so by the desire to see reforms enacted. . . . Only a few have the strength to accept the knowledge that these reforms are impracticable and to draw all the inferences from it. Most men endure the sacrifice of their intellect more easily than the sacrifice of their daydreams. . . . What they yearn for is another reality different from the one given in this world.
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> Ludwig von Mises, *Epistemological Problems of Economics* (1981; German edition first published 1933).

Von Mises probably wrote those words while on a bus. Transportation is difficult to regulate and manage because it is so tempting a target for utopian planners. Further, transport is a mobile service with significant externalities in both production and consumption. Regulatory schemes based on market failures always fail. Hence, regulators cannot leave transportation alone.

The two books considered, Klein, Moore, and Reja's, *Curb Rights* and Teske, Best, and Mintrom's *Deregulating Freight Transportation* are refreshing. Anyone interested in genuine transportation reform should refer to both books.

As is well known by any sophomore economics student, it is orthodox to claim that there are three kinds of market failure: information, externalities, and economies of scale. However, in some ways those are the least important. The list of market failures should read, from most to least important:

1. Government removes, or fails to create, what Hayek called the infrastructure of market processes. Infrastructure includes a system for defining and trading property rights, a legal system for the adjudication of disputes, and a monetary system to facilitate exchange.
2. Government creates, or fails to remove, impediments to market processes. Such impediments might include taxes, subsidies, regulations, or standards that distort prices and information.
3. Markets fail to perform efficiently because of informational asymmetries, externalities in consumption or production, or large economies of scale in production.

The first type of market failure (herein referred to as type 1) arises from inadequate infrastructure; the second (type 2) results from poorly designed policies; and flaws in market processes cause the third (type 3).

Blaming type 1 failure on markets is like thinking your car is a lemon because there is no road. Charging markets with type 2 failure is like blaming your car for breaking down after pouring water in the gas tank and sand in the crankcase. Only type 3 is really a market failure; type 1 and 2 failures are malfunctions of government management of markets.

Consider the importance of those distinctions for diagnosing problems. In all three cases, the car won't go. Should you conclude that the car is a lemon and trade it in? Unless one can think more fundamentally, the result will be an endless cycle of expensive trade-ins, none of which get anyone anywhere.

The point of departure of both books is that United States transportation policy has consistently tried to "trade in," or reform policies without considering whether the markets fail because government has failed. The real problems in transportation are not found in the policies designed to solve market failures. They lie in basic Hayekian infrastructure, e.g., poorly defined property rights, inadequate protection of investments, conflicting regulatory regimes, and inaccurate price signals (distortions resulting from regulations and subsidies).

Curb Rights may be the most important book on mass transit written in this decade. It makes the seemingly innocuous claim that the main arguments in mass transit can be boiled down to disputes over the size of public subsidies. For all practical purposes, the dispute has nothing to do with the quality of the mass transit market.

The real question is whether government will allow property rights to passengers or congregation areas to be defined and enforced. *Curb Rights* is both clear and persuasive. The problem is that most mass transit, public or private, operates on public streets. Congregation areas for passengers along those streets constitute a kind of commons. The city or county owns the streets, so buses, taxis, and other forms of transit-for-hire cannot define exclusive rights to use any part of those streets.

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Curb Rights draws a nice analogy between patents for ideas and property rights to passengers. The problem with intellectual investments or inventions is simple: unless inventors can expect profits from an invention, they will not invent. There are two extreme solutions to the problem: no patent protection at all, so that investment is either nonexistent or highly secretive and restrained; or patent protection forever, so that profits to any use of an invention must be paid, no matter when the invention was made. Of course, permanent patents would mean we still owe patent fees to the person who invented the wheel.

If those were the only alternatives, there would be either far too little invention or far too little dynamic flexibility in the use of inventions. But almost no one seriously advocates either of those two extremes (in the U.S. for example, patent protection is generally limited to seventeen years). However, as *Curb Rights* points out, in mass transit policy only the two extremes are offered. Inadequate definition of property rights and economic infrastructure has restricted policy choices to either completely private or completely public forever. The failures of the mass transit market are due, not to the market, but to the failure of policy supporting the market.

The missing, or ill-defined, property right is the transit provider's right to the customers that it has attracted to the curb. Those curb rights are either nonexistent, or defined and enforced as an exclusive monopoly held by a public mass transit firm. *Curb Rights* argues that the importance of well-defined curb rights varies depending on the concentration of transit service consumers. However, defining curb rights and making those rights enforceable and transferable will dramatically improve urban transportation services in both thick markets and thin markets.

In a thick market, consumer congregation is high enough to sustain one or more carriers even without curb rights. However, the quality, frequency, and cost of the service will still be suboptimal. The problem, from an economic perspective, is that the incentives to invest in publishing and meeting a schedule, advertising, training competent and courteous drivers, and maintaining clean and safe vehicles is attenuated by transit interlopers. Interlopers are jitneys or taxis that steal customers drawn to congregation areas by the investments of other firms. My immediate response to the claim that interloping is a problem was, "Why not just allow competition? Let any transit firm pick up anyone, anywhere."

I was wrong. Curb Rights argues persuasively that interloping is an example of market parasitism that prevents the proper functioning of price and brand-name as mechanisms for efficiently sorting and allocating resources. We are all familiar with market parasitism in standard examples: adverse selection in insurance markets, patent infringement in nations that do not enforce intellectual property rights, or nationalization of manufacturing plants in third world nations. In each of those cases, the rights to the profits from an investment are simply stolen or are poorly defined. Recognizing the problem, firms underinvest, and the market "fails." As noted above, however, that is a market failure of the first type: the failure is due to an ill-defined property right, or market infrastructure problem; it is not a problem of markets themselves.

Curb Rights argues that firms must somehow profit from the customers that they draw to the curb. Transit customers appear to take the first viable vehicle to appear at a stop; they don't wait for a brand-name carrier. Clearly, if people would wait for the brand-name carrier, interloping would be much less of a problem. But the authors say that does not happen. As evidence, they cite the example of the Super Shuttle service in Los Angeles. Super Shuttle bought quality vehicles, trained drivers in the geography of the Los Angeles area, and made it easy to call for shuttle service between city centers and other transit services (particularly airports).

Interlopers drove Super Shuttle out of business. Other firms, knowing where Super Shuttle customers congregated at airports, simply drove around the terminals until they saw a rider. Stopping, the interloper offered a lower fare to the same location, and the customer stepped in. However, those vehicles were often poorly maintained and driven by fly-by-night operators without training, safety awareness, or even proper insurance. Drivers had no idea how to find addresses, and were rude and abusive. Since Super Shuttle could not defend their curb rights to customers attracted by their investment, they lost that investment to the interlopers. Super Shuttle has pulled out of the competitive Los Angeles market, offering its name for a franchise fee. Clearly, the name is of little value, however, because brand name did not solve the interloping problem, even when Super Shuttle was a direct market participant.

In thin markets, interloping is even more pernicious. Even in a thin market, there are enough potential customers to make mass transit viable, if curb rights are well defined. However, as one company becomes successful in attracting customers to the curb at set times (necessary in a thin market, as there are too few people to solve coordination problems of congregation by chance), interlopers emerge. That is destructive market parasitism. The interlopers destroy the host. There is insufficient margin to sustain multiple transit services. Organized competitive transit service in such a market is impossible. The market devolves to one of two extremes: (1) no mass transit, taxis and informal jitneys serve ad hoc demands, or (2) scheduled "public" mass transit, often inefficiently run busses that receive heavy public subsidies to charge fares low enough to deter interloping.

The main weakness in the authors' argument is the claim that consumers would never use brand names as a way of allowing rewards to investment in quality. That is not obviously true as an axiom, but *Curb Rights* marshals considerable evidence to argue that many customers simply will take the first shuttle or taxi that comes along.

When all is said and done, *Curb Rights* comes out for competition in urban transit. That is hardly novel, and may seem like a knee-jerk libertarian reaction. In fact, the authors provide some surprising new policy recommendations that marry enhancement of property rights to profits from investments and competitive service providers. The proposals in *Curb Rights* start with suggestions about how to conceive, define, and enforce property rights for an effective transit provider's investment and brand name.

With the property rights infrastructure in place, the authors would deregulate all transit services, requiring only safety, licensing, and insurance regulations. All public transit agencies would be dissolved and their assets sold, "It makes no more sense for government to produce transit than it does for government to produce corn flakes." It would be possible to end all federal subsidies and transfers to transit programs, as well as implicit and explicit subsidies to automobiles. *Curb Rights* is not anti-automobile. But it points out that while autos should not be scorned, they should also not be favored. Peak-load pricing schemes on roads, through the use of electronic sensors or other low time-cost collection mechanisms, would actually make auto users pay closer to their share of the actual cost of road use. Pricing schemes would also make competitive mass transit viable even in thin markets.

Curb Rights argues that it may be necessary to institute subsidy programs to some customers. Ending subsidies will differentially affect those least able to pay: the urban poor for whom bus or other transit service is the only option. But the difference between subsidizing providers and subsidizing consumers is enormous. Similar to food stamps, "transit stamps" would be an efficient form of in-kind transfer, and might shore up an important market segment of heavy public transit users. The subsidized consumers would choose amongst competitive providers. On the other hand, the current approach of subsidizing administration and operation of a monopoly public carrier makes private competition impossible.

The interesting thing about the proposals in *Curb Rights* is that they address the usual (type 3) "market failure" claim that competition cannot work for transit markets. "An artless proposal of free competition for route-based transit unregulated operation of buses and jitneys with no particular system of bus stops or curb rights should raise serious objections and doubts of the success of such a system." *Curb Rights* points out that the present form of transit competition cannot solve the infrastructure problem of poorly designed curb rights. Markets in that setting are designed to fail. A genuinely competitive system, the authors argue persuasively, lies between the extremes of monopoly and pestilent competition.

FREIGHT TRANSPORT

Deregulating Freight Transportation reviews the academic and policy literature on freight transportation (de)regulation and decides who is right. The book is detailed, interesting, and well written. I can easily see it being used as a textbook for policy classes or as a reference for the professional who wants a comprehensive volume on deregulation and transportation. *Deregulating Freight Transportation* may be the only book on transportation regulation that offers a detailed review of both state and federal policies and follows changes in those policies over time.

Freight identifies three stages in the "life cycle" of industry regulation: promotion, regulation, and deregulation.

(1) *Promotion:* The federal government and many states subsidize the development, or even operating expenses, of infant industries. In transportation regulation, those subsidies can be either explicit (cheap land for rights-of-way), or implicit (price floors or monopoly route agreements to prevent "destructive" competition). The rationale for promotion through subsidy is that transportation infrastructure is a precondition for many other kinds of economic development, so that transport industries have significant positive externalities in developing countries or regions.

(2) *Regulation:* The usual rationale for market intervention, either direct or indirect regulation, is the third type of "market failure" listed above. Transportation industries have seen regulations based on all three motives, the earliest being large economies of scale in the highly capital intensive railroad industry. However, health and occupational safety regulations for workers (information asymmetries) and operational safety restrictions on weights, size, and inspection requirements (externalities) have also played an important role. There is an ongoing debate about the goals of those regulations. Regulation may serve either consumers (by preventing monopoly pricing, ensuring safety, and deterring fraud) or producers (by assisting the coordination of prices, deterring entry, or redistributing wealth). *Freight* is agnostic in that debate. Whatever the motive for the origin of regulation, the authors note that ". . . by the start of the 1970s, virtually every significant issue in the transportation industry was resolved by government intervention, not market forces."

(3) *Deregulation:* Here the authors are not just agnostic, but downright disingenuous: ". . . recognizing that those industries had changed and that the regulation was no longer productive, the federal government, and some states, deregulated." Well, yes, but no longer productive to whom? The elaborated Stigler-Peltzman "capture" theory would hold that industries are deregulated only if corresponding key producers no longer favor regulation. There is no question that the publicly stated rationale for deregulation is also important, but what was the real cause for the deregulatory fervor of the 1970s and 1980s?

The problem is that of confusion between types of market failure. Arguably, transportation industries were at first regulated because of type 3 market failures due to economies of scale and the need to guarantee quality and safety. But they were deregulated because distortions introduced by subsidies, cross-subsidies, price floors, and entry barriers made regulation too expensive. Technological and economic change in regulated industries was slowed or blocked completely. The cumulative macroeconomic effects of those policies became noticeable, and the American economy suffered.

Freight follows academic fashion in calling those problems "government failure," and there is some logic in attributing type 1 or type 2 market failures to government, as I have argued above. However, the impacts of government actions

(or failures to act) are registered in markets. The advantage of conceiving of the integrated hierarchy of market failure I have proposed is that one can restate the *Freight* thesis about evolution more succinctly. That evolution occurs as follows:

(a) Governments promote transportation to solve type 1 market failures (nonexistence of infrastructure).
(b) Governments regulate transportation to solve (alleged) type 3 market failures (economies of scale, externalities, information asymmetries).
(c) Governments deregulate transportation to solve type 2 market failures (distortions introduced by regulatory policy).

Of course, all that leads to the big question: is regulation a logically necessary stage in evolution of an industry, or is the temptation to regulate just so irresistible that we always observe it as an empirical matter? As I have noted, the authors are agnostic on that question, but I wonder why they did not take it on more directly.

To be fair, one answer may be that the bulk of analysis in *Freight* addresses the trucking industry, unique among the freight transport industries in that it has a very large intrastate component. Because of loading and other fixed costs, aircraft, barge, and rail transport are largely interstate (San Francisco-Los Angeles traffic; is an exception, especially by air). The comparison of the history of federal policy on trucking, which has seen dramatic deregulation since the Motor Carrier Act (1980), and the history of state policy is instructive. The authors note that, if states are "the laboratories of democracy," then the federal government and the states must be working on completely different experiments.

State regulation of trucking has hardly responded at all to the forces that caused deregulation at the national level. In fact, contrary to the "policy diffusion" literature, fathered by Jack Walker, even evidence that deregulation in other states (e.g., Florida, Arizona, Maine all deregulated in some measure by 1982) had positive effects did not cause a widespread deregulatory movement to take hold among state governments. In fact, the authors claim: "The differences could not be more stark between federal deregulation of most sectors of the freight transportation industry after 1980 and the heavy state regulation of intrastate trucking that continued right into 1994." In 1994, the whole question was taken out of state hands by a federal preemption that forced immediate and consistent deregulation for all states, even on intrastate routes.

The authors exhaustively survey strictness of state regulation of trucking (as of mid-1994); and offer detailed case studies of regulatory histories in Texas, Michigan, California, and Indiana. They offer a catalog of special restrictions and their forms as of 1994, and give explanations of differences in state policies. Those explanations are about what one would expect, historical idiosyncrasies, institutional explanations based on how commissions are chosen and financed, and interest group pressures and levels of organization. But the documentation offered is most impressive. *Deregulating Freight Transportation* will be an important book for decades to come, because it gives an authoritative snapshot of state trucking regulation in 1994, the last year such regulation was possible under federal law.

As noted above, the two books have broadly different goals, but both are very successful. *Curb Rights* is a provocative, forward-looking volume that should have an immediate impact on government policy toward fostering competition in mass transit. *Deregulating Freight Transportation* is a deeply reflective, historically important study of the processes and pitfalls of regulation in a federal system. Both books belong in the required reading section.

BEDTIME READING FOR MARKET DOUBTERS

Regulation and Economic Analysis
by Richard L. Gordon
(Kluwer Academic Publishers, 1994) 273 pp.

Reviewed by Peter VanDoren

In the February 1997 *Atlantic Monthly*, George Soros argued that free markets are a threat to an open society because they are unstable and inequitable. He contends that general equilibrium theory, the theory that defends free markets as stable, is not supported by empirical evidence; it requires perfect information and a large number of anonymous market participants who are price takers. Since those conditions are not met, the empirical support for laissez faire does not exist. According to Soros, in the absence of empirical support, economic theory is a nonscientific axiomatic religion like Marxism, and just as dangerous to an open society.

Obviously, Soros did not consult the recent book by Richard Gordon before he wrote his article. Gordon, Professor Emeritus of Mineral Economics at Penn State University, has written an encyclopedic review of the regulation of markets covering the last two hundred years. After a short introductory chapter, the second chapter introduces Soros' bogeyman, the general equilibrium theory. Gordon agrees with Soros that the maximizing firm and consumer are stylized facts that abstract from reality. But he points out that does not mean we should throw the baby out with the bath water. Gordon instead focuses on the interaction of people responding to scarcity through a division of labor and exchange as the best view of the actual economy.

Gordon concludes the second chapter with two useful lessons that Soros should have incorporated in his article. First, market processes eliminate differences in wages and prices. Those differences persist only because of strong forces, often political, that limit trade and prevent arbitrage from operating. Second, individuals often do not like market prices

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and develop elaborate rationales why prices are undesirable. But as Gordon says, nonmarket valuations, at best, would be based on tradition and at worst on assertions by interest groups. Such subjectively determined prices thwart shifting resources out of inefficient existing uses (as in farm price supports) or encourage moving resources into less productive new uses (such as motor fuels from grain in the United States). Thus, no one has defined a workable alternative to market prices.

Chapter 3 introduces market failure. Soros argues that because actual markets do not possess all the characteristics of markets that an undergraduate might study in Economics 101, they are a dangerous threat to an open society. Gordon, by contrast, argues that while market failures reduce the advantages of markets, if the idealized markets of general equilibrium theory are the reference points, the advantages are not eliminated. In fact the market failure concept is often abused to provide a rationale for unwise regulation.

Gordon describes in some detail how each generation of economists uncritically accepts assertions of market failure, only to have subsequent research cast doubt on such claims. The most famous may be Paul Samuelson's claim that lighthouses were an example of a public good that could not be supplied optimally by private transactions. In subsequent research, Nobel Prize winner Ronald Coase demonstrated that lighthouses were provided by private associations in England's past. The petroleum market often has been characterized as a market prone to market failure, especially monopoly, but the work of Morris Adelman banished that view from respectable economic discussion. The current example of market failure that is undergoing revision is the belief that natural gas and electricity transmission are natural monopolies. The work of Wayne Cruz and Paul Ballanoff, published by the Cato Institute, is casting great doubt on those two examples of market failure still taught to undergraduates.

The remaining chapters of the book examine international trade, the role that transaction costs play in the economy, the development of firms, macroeconomics, equity and fairness, the environment, the regulation of land, and the extraction of natural resources. The chapters provide comprehensive reviews of the literature on those respective topics; the exception being the chapter on land use and mineral extraction. That chapter is based on Professor Gordon's own research as well as his involvement as an evaluator of the Department of the Interior's Coal Leasing program. The book ends with a forty-two page annotated bibliography. The bibliography alone is a valuable reference tool for anyone interested in political economy literature.

Regulation and Economic Analysis is an extended commentary on two hundred years of economic thinking about the regulation of markets. Too bad George Soros didn't consult it before writing his article.