Global Forum on Competition

COMPETITION POLICY AND THE INFORMAL ECONOMY

Contribution from the United States

-- Session II --

This contribution is submitted by the United States under session II of the Global Forum on Competition to be held on 19 and 20 February 2009.

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JT03258629

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--United States--

1. The influence of the informal economy is not as prevalent in the United States as it is in some economies. While there are many reasons for this, one of the most significant is that the regulatory cost of doing business in most markets in the United States is sufficiently low that entrepreneurs do not feel a need to retreat to the informal economy in order to avoid those costs\(^1\). The informal economy thus has a minimal impact on the antitrust agencies’ direct enforcement responsibilities. The need to ensure that the regulatory cost of doing business remains at a level that encourages firms to remain within the formal economy suggests a critical role for competition advocacy to oppose overly burdensome regulations.

1. The Informal Economy and Enforcement

2. The United States antitrust agencies, the Department of Justice and the Federal Trade Commission, do not directly attempt to address the causes and effects of the informal economy. For example, the failure to pay taxes is addressed by the Internal Revenue Service and state and local taxing authorities, laws requiring the registration of businesses are enforced by the business registration authorities in the various states, counterfeiting of trademarks and patent infringement is subject to the imposition of legal remedies under the intellectual property regime, and relevant health and safety regulations are enforced by specialised regulators. To be sure, the failure of firms in the informal economy to abide by these rules can affect their role in the market, to the extent that firms that do not comply with these regulations likely incur fewer costs than firms that comply with regulatory requirements. Nonetheless, these problems are more effectively addressed by specialised regulators who have particular expertise and appropriate enforcement tools.

3. To some extent, the market can play a role in correcting competitive distortions created by the informal sector. In some sectors, consumers may perceive goods and services provided through the informal economy as being of uncertain quality and purchase them from informal sources only at a substantial discount. The FTC’s consumer protection function includes a consumer education component which, among other things, provides information to consumers about doing business through the informal economy\(^2\).

4. In cases in which informal market participants play a role in an antitrust market under investigation, the role of those market participants is taken into account just as formal participants are. Their market shares would be estimated according to the best available data and their ability to constrain an anticompetitive rise in prices or decrease in output would be considered. Consideration of their ability to constrain prices would, of course, need to take into account any limitations on their competitive significance that is caused by the informal nature of their market participation, the likelihood of market exit that might be caused by law enforcement efforts, and the extent to which price discrimination is feasible against an infra-marginal group of purchasers who insist on lawful products and who qualify as a distinct market.

\(^1\) According to the World Bank, it takes six days to form a business in the United States, as opposed to 64.5 days in the Latin America and the Caribbean region; 40 days to deal with construction permits as opposed to 271.1 days in sub-Saharan Africa; and 12 days to register real property, as opposed to 106 days in South Asia. World Bank, Doing Business Project, available at [http://www.doingbusiness.org/](http://www.doingbusiness.org/).

5. For instance, the Department of Justice investigated the formation by the major record companies’ of two joint ventures, pressplay and MusicNet, for the sale and distribution of digital music to consumers. Among the issues considered in the investigation was whether competing distributors of digital music over the Internet, including the informal unauthorised sharing of digital music among consumers, would limit the ability of the joint ventures and the parent record companies to exercise market power in recorded music in their Internet subscription services and in their positions in the distribution of music on physical media. Based in part on the well-publicised size of the informal sector in the music industry, the Department closed its investigation of the joint ventures without taking any action.

2. Removal of Incentives to Participate in the Informal Economy

6. Identifying the most appropriate role for a competition agency in addressing market distortions caused by the informal economy requires asking why firms operate in the shadows rather than as part of the formal economy. While there are many reasons, one documented cause is that burdensome regulation can make it difficult for entrepreneurs to enter the formal market and thus drive them underground. As Hernando De Soto notes:

“in Peru, for example, it takes a new entrepreneur thirteen years to overcome the legal and administrative hurdles required to build a retail market for food that would help take vendors off the street; twenty-one years to obtain authorisation to construct a legally titled building on wasteland; twenty-six months to get authorisation to operate a new bus route; and nearly a year, working six hours a day, to gain the legal license to operate a sewing machine for commercial purposes.

In the face of such obstacles, new entrepreneurs hold their assets outside the law and therefore do not have access to the facilitative devices that a formal legal system should provide to help them organise and leverage resources. Because they have no secure property rights and cannot issue shares, they cannot capture investment. Because they have no patents or royalties, they cannot encourage or protect innovations. Because they do not have access to contracts and justice organised on a wide scale, they cannot develop long-term projects. Because they cannot legally burden their assets, they are unable to use their homes and businesses to guarantee credit.”

7. Submissions made by participants in this Global Forum echo this theme. According to Ukraine, "emergence and development of the informal (underground) economy is a reaction to excessive tax and regulatory pressure on the part of the state," and it takes 33 days and 115 Euro to start a business, a process that 70% of Ukrainian survey respondents described as difficult or very difficult. Mongolia tells us that among the reasons why herdsmen prefer to sell their livestock to the informal sector instead of to established processing plants is the many kinds of documents they are asked to provide by the latter.

8. Even though the presence of the informal economy is not as significant in the United States today as it is in some other countries, its experience during the “Prohibition era” in the 1920s amply illustrates the potential for regulation to fuel the rise of a vigorous informal sector. In 1920, the 18th Amendment to the United States Constitution effectively prohibited the production, sale, importation, and export of

alcoholic beverages. As a result, an entire industry was effectively replaced by an informal sector, much of which was dominated by organised crime. Tax revenue previously generated by the sector was lost to the government altogether. When Prohibition was repealed in 1933, most of the industry returned to the formal sector.

9. While regulation clearly has an important role in protecting consumers’ health, safety, and well being, a valuable role that a competition agency can play is to encourage regulators and lawmakers to balance the costs and benefits of regulation. In the United States, through their competition advocacy functions, the DOJ and FTC assist in such balancing when the regulation in question appears to unduly harm competition. This function has a long history at both agencies and was in “full swing” at the FTC since at least June 1980, which was around the time that the move to deregulate air and surface transportation was beginning to take hold. More broadly, the Office of Information and Regulatory Affairs in the Office of Management and Budget has responsibility for balancing costs and benefits of federal regulation generally. Without an informed balance of costs and benefits, it can be difficult to understand the hidden effects of regulation and to recognise when those costs outweigh the desired benefits. Indeed, there are many cases where proponents of regulation assert some public benefit when the real purpose and effect of the proposed regulation is to restrict or eliminate competition.

10. Through its competition advocacy functions, a competition agency can bring great value by helping to illuminate the difference between the legitimate purposes of regulation and attempts to use regulation to hinder competition. Restrictive business regulation is typically promoted by those who have an economic stake in restricting entry into markets, normally vested incumbents.

11. More broadly, competition agencies may be among those within government who institutionally appreciate the importance of applying a cost-benefit analysis to regulation. They may thus be well-positioned to assist legislators and regulators to develop an approach to regulation informed by an understanding of how their actions can create or destroy incentives for entrepreneurs to participate in the formal economy. In some cases, the competition agency may be the only government institution with the expertise, interest, and resources to balance the costs and benefits of regulation and to advocate publicly for the removal of regulations that prevent entrepreneurs from entering the market.

12. As other participants in this Forum have pointed out, the informal sector is most prominent in sectors that require little capital, use primitive production and marketing methods and employ unskilled workers. We examine sectors meeting these criteria in which we have engaged in competition advocacy aimed at explaining to regulators and legislators how burdensome regulation impedes entrepreneurs from entering markets.

13. While these interventions were aimed at increasing competition and were not specifically aimed at moving entrepreneurs from the informal sector to the formal one, the effect may have been the same.

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7 James C. Cooper, Paul A. Pautler, Todd J. Zywicki, Theory and Practice of Competition Advocacy At The FTC, 72 Antitrust L.J. 1091, 1094-95 (2005).

8 See http://www.whitehouse.gov/omb/inforeg/regpol.html.

9 Submission of Jordan, ¶24.
2.1. Taxis

14. In the United States, taxi services are regulated at the state or local level. Although the details of regulation vary from place to place, most major cities continue to regulate entry and fares in some manner, most also regulate the types of service that can be provided (e.g., minimum number of cabs per company or association, 24/7 coverage of telephone requests, shared riding, conditions for service refusals, definitions of service areas, required dispatch capability, required taximeters), vehicle and driver characteristics (e.g., cab age and design, signs, no criminal background, knowledge of the city streets and landmarks, record keeping, neatness, facility with the English language, and sensitivity training), and service quality (e.g., cab cleanliness, maximum response times). In addition, jurisdictions often regulate the maximum hours of service per driver per day, license transferability, safety inspection frequency, and insurance and bond requirements. In some cities, particularly around airports, a significant unlicensed sector operates outside of the formal economy.

15. From the time that most cities in the United States adopted entry restrictions in the 1930s, a time when many U.S. industries sought governmental protection from competition, a handful of experiments with taxicab deregulation have provided important evidence on the relationship between regulation and market entry. The involvement of the Federal Trade Commission in this sector has focused primarily on efforts to assist deregulation in the industry, through reports and advocacy efforts, including 19 filings with various local authorities from 1984 through the present. The FTC’s advocacy efforts were largely based on a staff report on taxicab regulation.

16. Among other things, reviews of the effects of deregulation experiences in the United States indicate that the number of cabs and cab companies rises and, therefore, employment opportunities and the number of cab hours of service rise and that the bulk of the new entrants are individual drivers who serve taxi-stand markets that do not require radio-dispatch capability. Entry restraints were not shown to have any appreciable benefit to consumers. While the reviews did not address the extent to which deregulation reduced the number of unlicensed cabs on the street, it is fair to infer that many of the newly licensed taxis may have come from the ranks of unlicensed drivers.

2.2. Trucking

17. Trucking is an industry that is highly susceptible to participation by the informal economy. Entry into the trucking business requires only a truck and a telephone, and may be paid for in cash. Thirty years ago, interstate trucking was heavily regulated at the federal level, with new entry restricted and specific routes subject to approval. Deregulation of the industry began in 1980. Today little economic regulation of interstate trucking remains, although regulation of intrastate trucking at the state level persisted for years afterwards. Entry is no longer restricted and barriers to entry are low.

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13 The need for targeted regulatory intervention may continue to exist at airports and taxi stands, based on the particular characteristics of that part of the market.
18. The FTC and DOJ were active proponents of trucking deregulation, and sought to advocate competition in the sector by explaining the costs that trucking regulation imposed on consumers and the benefits of competition. The Federal Trade Commission (FTC) alone made at least 17 such submissions, principally directed to state governments that retained the power to regulate intrastate trucking even after interstate regulation ended at the Federal level\textsuperscript{14}. In a submission to the Railroad Commission of Texas, for example, the FTC presented evidence that shipping of a common consumer product that cost $2.52 per mile between two key cities in Texas’ regulated market cost only $1.46 per mile for a similar distance in the unregulated interstate market. It also cited the positive effects of deregulation in states that had deregulated: lower prices, continued service to small communities, and undiminished service\textsuperscript{15}.

19. A 1988 FTC study is especially instructive because it closely examined and addressed the arguments advanced by proponents of trucking regulation. Opponents of trucking deregulation have made four main predictions about the effects of partial deregulation: that service to small communities will be reduced, that “destructive competition” will ultimately harm consumers, that confusion and inefficiency will be created, and that highway safety will deteriorate. None of these predictions was supported by the evidence.

20. According to the 1988 FTC study, federal and state regulation of trucking drove prices up and encouraged inefficient practices. Among other things, it found that employment in the trucking industry has risen sharply since deregulation. In 1980, 1.48 million people were employed in trucking services. By 1987 that number had risen 29.2% to 1.8 million\textsuperscript{16}. Regardless of whether these new entrants came from expansion or by bringing truckers from the informal to the formal sectors, deregulation reduced incentives for truckers to operate in the shadows\textsuperscript{17}.

3. Conclusion

21. The United States’ experience has shown that removal of burdensome regulation can open the way to new entry into a variety of sectors of the economy and help to eliminate disincentives from participating in the formal economy\textsuperscript{18}.

22. The United States’ experience also highlights how a competition agency can help legislators and regulators to understand the importance of balancing the costs – including the possible expansion of the informal sector -- against the benefits of regulation. The fact that some regulations serve only to advance

\textsuperscript{14} E.g., Comment of the Staff of the Bureau of Economics to the South Carolina Legislative Audit Commission (1994), available at \texttt{http://www.ftc.gov/be/healthcare/docs/V940003%20SC%20Trucking%20Regulation.PDF}.

\textsuperscript{15} Letter from Thomas Carter, Regional Director, Federal Trade Commission, to Raymond Bennett, Director, Transportation/Gas Utilities Division, Railroad Commission of Texas, October 2, 1989


\textsuperscript{17} When trucking was deregulated in the 1980s, it was expected that private carriage – trucking service that was performed in-house by firms that were not regulated by the Interstate Commerce Commission but was inefficient because firms could carry only their own goods and thus had many empty return trips – would be replaced by for-hire service as prices declined. In fact private trucking has not lost a significant market share, and some transportation experts attribute this to private carriers entering the formal for-hire market.

\textsuperscript{18} It would go too far to suggest that the underground economy does not exist in the United States. Even after the repeal of prohibition, a significant traffic in illegal alcohol persisted, especially in mountainous southern regions, in response to the pervasive state regulation that replaced prohibition. Passengers arriving in American airports are familiar with promoters of unlicensed taxis that frequent the arrivals areas.
the economic interests of their proponents does not mean that others do not serve a legitimate purpose. The state does have a legitimate interest in ensuring the safe operation of trucks, and ensuring that taxis are safe and readily available. Due consideration must be given to the legitimate ends of regulation, while putting them into context and balancing them against how they impact entry.