

## *Keeping the Competition Out*

Most competitors hate competition. And who can blame them? After all, if a firm can keep the competition out, profits are sure to rise. How high they will rise obviously varies by industry, but the lowly taxicab market gives some indication of what is at stake.

In New York City, the number of taxicabs is limited by law—limited, in fact, to one cab for every 600 people, in a town where many people don't own cars. To legally operate a taxi in New York, one must own a taxi medallion, a city-issued metal shield affixed to a cab's hood. After capping the number of medallions since 1937, the city offered 133 new ones for sale in 1996. Winning bidders paid about \$175,000 for each medallion—that is, for the right to work 70-hour weeks, subject to robbery, rude customers, and the erratic driving habits of other cabbies. And lest you think New York taxi drivers are crazy to pay such sums, keep this in mind: because the city keeps the competition out, the taxi business is so lucrative that the medallions can be used as collateral to borrow money at favorable interest rates, and any cabby who wants to leave the business can immediately find a buyer for his medallion, usually at a price that will bring even more profit. And those new medallions that went for \$175,000 in 1996? Well, by 1998 they had risen in value to over \$250,000, but five years later their prices had dropped back to “only” \$225,000.

In 2004 the city implemented two changes affecting the taxi market. First, it began to phase in a fare hike of about 25 percent, one that will bring fares to their highest inflation-adjusted level since the 1970s. Second, the city decided to start selling 900 new taxi medallions, to bring the total on the street to 13,087. Both of

these measures will make it easier to get a cab in New York City. But here's another fact you can count on: Because the city gets to keep the revenues from the sale of the new medallions, it will be sure to time their sales so that the price of medallions is not adversely affected.

Keeping the competition out works this way: Reducing the number of firms in an industry decreases the supply of the good, thus driving up its price. Firms that remain thereby enjoy both a higher price for their product and a larger market share. Consumers lose, however, suffering not only from higher prices but also from fewer alternative sources of supply from which to choose. Another group of losers is comprised of the firms who are excluded. They are forced to go into lower-paying pursuits for which they are not as well suited. The higher profits enjoyed by the firms that are protected from competition thus come at the expense of consumers and excluded competitors; the net result is also an overall loss to society as a whole, because the limit on competition reduces the total extent of mutually beneficial exchange.

Note we said that the number of taxi medallions in New York is limited by the government. This is typical. Even though many government agencies (for example, the Federal Trade Commission and the Department of Justice at the federal level) are supposed to promote competition, the most effective way to *prevent* competition is usually to get the government involved. Consider telephones. It used to be that both long-distance and local telephone markets were regulated by the federal government. In 1984 the long-distance market was deregulated, and AT&T had to begin competing with MCI and Sprint for customers. The result was a 40 percent drop in inflation-adjusted long-distance rates. Local telephone service continued to be regulated by the Federal Communications Commission (FCC), however, and over the same period of time, local phone rates *rose* 40 percent in real terms—chiefly because the FCC has kept competition out of the local phone service market.

The government of Mexico has been even more successful in protecting phone giant Telmex from competition. Formerly a state-owned company, Telmex was privatized in 1990, with the understanding that the government would gradually but steadily end the firm's monopoly. The thought was nice, but the monopoly remains.

Telmex has effectively been permitted to prevent potential entrants to the Mexican phone market from connecting through its dominant switching equipment. The result has been sky-high connection charges and virtually no new connections. Hence, there are now only 10 telephones per 100 inhabitants of Mexico. In Poland, the fellow member of the Organization of Economic Cooperation and Development with the next fewest number of lines, there are 20 telephones per 100 inhabitants. In addition to poor service, the lack of competition also shows up in prices, which sharply hamper Mexican businesses. For example, a U.S. firm trying to drum up business in London would pay \$5.40 to make five phone calls to Britain of four minutes each. Those same calls would cost its Mexican rival \$25.40.

Many of the decision makers who work for the government agencies that limit competition are lawyers, so it is not surprising that competition among lawyers is limited. For example, in every state but one (California), the number of law schools is capped by state law, thereby restricting entry into the profession and driving up earnings. The high fees lawyers earn have in turn generated competition from lawyers' assistants, called paralegals. This competition—or rather, attempted competition—can be seen in the market for personal bankruptcies. Rising consumer debt, combined with less restrictive federal bankruptcy law, caused the number of people declaring bankruptcy to triple during the 1990s. A typical personal bankruptcy case costs about \$750 when done by a lawyer, but the procedure is a simple one, requiring only that some standard paperwork be filled out and filed with the relevant authorities. Thus, in come the paralegals (who, if working for a lawyer, would be doing the paperwork anyway), offering to perform the same services for, say, \$269. Faced with competition like this, the legal profession struck back, gaining passage of Section 110 of the Bankruptcy Reform Act. This statute gives judges the power to cap the fees paralegals can charge. Thus far, imposed caps have run from \$50 to \$100 per case, which is low enough to force most paralegals out. Paralegals who charge more than the legal limit are subject to fines of up to \$500 for each violation of the law. Lawyers are free to charge what they like, sometimes as much as \$1500, now that they don't have paralegals to worry about.

Sometimes the government gets involved in some unlikely markets in its efforts to prevent the ravages of competition from taking their toll. Consider hair braiding. Some African Americans like to have their hair straightened in beauty shops, a procedure that requires a touch-up every four weeks, for an average monthly cost (excluding cutting and styling) of about \$100. An alternative is to get one's hair braided at a braiding salon. There are now about 10,000 of these salons across the country. Braids need maintenance only once every ten weeks, cutting the cost to \$50 per month. The same low cost and convenience that make braiding salons attractive to consumers also make them threatening to the conventional beauty shops that straighten hair, especially in fashion-conscious California. Claiming that they are seeking to protect consumers, agents of the California Barbering & Cosmetology Board have begun raiding the salons of unlicensed hair braiders. Not surprisingly, the hair braiders think the state is actually trying to protect state-licensed cosmetologists at beauty shops, who must spend \$6000 for 1600 hours of training to get their licenses. Indeed, one of the braiders, Ali Rasheed, argues that the marketplace is better than state licensing boards at protecting consumers. "It's simple," he says. "If I mess up your hair, you don't come back. You spread the word. And very quickly I'd be out of business." Perhaps so, but it looks like the state of California doesn't want to give consumers that option.

Back in New York, there is an example of the fact that the government likes to protect itself from competition, too. New York City is well known for its massive public transit system, comprising both subways and bus lines. What is not so well known is that mass transit in New York City started off as private enterprise. The first horsecars and elevated trains in the city were developed by private companies. Moreover, even though New York's first subway was partly financed by a loan from the city, it was otherwise a private operation, operated profitably at a fare of a nickel (the equivalent of less than a dollar today).

New York's politicians refused to allow fares to rise during the inflation of World War I, yielding financial losses for the private transit companies. Promising to show the private sector how to run a transit system efficiently, while simultaneously offering to protect the public from the "dictatorship" of the transit firms, the city

took over the subway, merged it with the bus line, and promptly started raising fares. Despite fare increases double the inflation rate, however, costs have risen even faster, so that today, even though the basic fare is \$1.50, the city *loses* \$2 a passenger.

Enter the jitneys, privately owned vans that operate along regular routes, like buses, but charge only \$1 a passenger and make detours for pick-ups and drop-offs on request. Actually, we should have said “attempted entry” by the jitneys, because the New York City Council—at the insistence of the public transit system—has denied operating permits to almost all jitney operators who have applied. The council says it is only seeking to prevent the vans from causing accidents and traffic problems, but even fully insured drivers who have met federal requirements for operating interstate van services are routinely denied permits. Thus most of the hundreds of jitneys operating in New York City do so illegally. Even the few jitneys that have managed to get licensed are forbidden from operating along public bus routes—all in the name of public safety, of course.

Transportation economists such as Daniel Klein of Santa Clara University have argued that public transit systems could once more be profitable—instead of losing sixty cents on the dollar—if the jitneys were given a chance. “Government has demonstrated that it has no more business producing transit than producing cornflakes. It should concentrate instead on establishing new rules to foster competition,” says Klein. Unfortunately for the jitneys and their customers, however, that competition would come at the expense of New York’s public transit system. Thus, for the foreseeable future, it seems the jitneys will have to compete only by breaking the laws, because, like most competitors, the New York City mass transit system just hates competition.

### DISCUSSION QUESTIONS

1. Consider two different ways of beating your competition. One way is to offer your customers lower prices and better service. The other is to get a law passed that raises your competitors’ costs—for example, by imposing special operating requirements

- on them. Can you see any difference between these two methods, assuming that both succeed in keeping your competition out?
2. Although governments at all levels sometimes act to prevent some individuals from competing with others, the federal government is probably the most active in this role, state governments are less active, and local governments are the least active. Can you explain this pattern?
  3. Is there any difference between prohibiting entry by a group of firms and levying a special tax on those firms?