Uber: A Market Solution or Call for Government Intervention?

Before the emergence of Uber, a taxi service that uses a mobile app to pair passengers with drivers, whom drive their own cars, the taxi market experienced three market failures: asymmetric information, transaction costs, and imperfect competition. In this paper, I will examine whether Uber’s entrance into the taxi market demonstrates the market’s ability to correct inefficiencies or calls for government intervention in the market. I address both the benefits and failures of the taxi market before and after Uber as well as the benefits and failures of governments to determine if the market or the government can best address the three taxi market failures. After analyzing both sides of the debate, I conclude that the government should prohibit Uber and develop an app or rating service that would solve the asymmetric information problem.

Markets are commonly praised for their capacity not only to stimulate worldwide economic growth but also produce efficient outcomes by realizing any potential gains from trade without any central control. According to the philosopher Adam Smith, markets achieve this Pareto efficiency because as people pursue their own self-interests when engaging in economic activity, they make others better off as well. Smith claims that our selfish acts are guided by an invisible hand that produces efficient outcomes for society as a whole. The idea of the invisible hand working in the background to create an optimal market state is only possible if it is assumed people are rational, have complete information, there are no transaction costs or barriers to entering the market, and there are no externalities, which are costs or benefits imposed on a third party not involved in a particular economic exchange.

Milton and Rose Friedman suggest that markets convey the information necessary to achieve efficiency through prices. They claim that every good’s market price provides key information about its supply and demand, encourages suppliers to maximize the use of factors of its production, and distributes income based on involvement in the economy. So the transparency of market prices offers consumers and producers enough information about the state of a particular market and whether further Pareto improvements can be made to achieve efficiency.

While markets seem fully capable of correcting any inefficiencies that arise, there are instances, like the pre-Uber market for taxis in New York City, where they fail to do so. There were three main instances of inefficiency, called market failure, in the taxi market before Uber: asymmetric information, transaction costs, and imperfect competition. First, passengers faced the issue of asymmetric information as they did not know anything about their driver, like if he speeds or is safe, or the state of the driver’s vehicle prior to riding with him. Next, there were transaction costs that imposed a costly barrier to entry to becoming a taxicab driver. Drivers must obtain a special license called a medallion to operate a taxi, and since the number of medallions issued is limited, they are extremely difficult to acquire. Before Uber became popular, the cost of a medallion in large US cities like New York City was between $350,000 and $1,000,000 (Petropoulos).

Third, the market for taxis was plagued by imperfect competition. Due to the restriction on the number of medallions available, there was a shortage in supply of taxis as the taxi market is not able to provide the amount of rides demanded at a given time. Also, a price ceiling on the maximum amount of a fare set by the government prevented drivers from charging the true value of their service. Since the price ceiling was set below the efficient market price, the drivers lost a great amount of profit, a deadweight loss, which they could have earned if they were able to charge the true value of their service.

Now, with the help of the invisible hand, the market resolved these inefficiencies through Uber. Uber fixed the asymmetric information issue as its app allows passengers to rate drivers and drivers to rate passengers. Currently, each group has full information about the other. Furthermore, the transaction costs are significantly lower to become an Uber driver than a taxi driver. All one needs to become an Uber driver is a phone, the Uber app, a car, a driver’s license, car registration, car insurance, and a passed background check (Uber). Additionally, with Uber, there is more competition in the taxi market, so the taxi fare price is at a more efficient equilibrium price. With Uber’s ability to have surge pricing at peak times of demand, Uber eliminates the deadweight loss created by the price ceiling on fares as drivers can charge the true market price. These higher prices encourage more people to drive, so everyone who wants a ride can find one.

While Uber seems to illustrate the power of markets, it is important to consider whether its emergence in the market has indeed made the market more efficient or government involvement could have produced a more efficient outcome. Advocates of government intervention would insist that Uber has created a new set of market failures in the taxi market. Due to Uber’s popularity, one could argue that Uber is becoming the biggest provider of taxi service and is close to having a monopoly over the taxi market. Uber is able to set a lower market price (when not surge pricing) and regular taxis can’t compete (Petropoulos). While the previous taxi system can be seen as a monopoly, it is really a necessary natural monopoly because having more than one type of taxi service creates a great deal of safety, monetary, and logistical problems for drivers and passengers. Some of these issues include low levels of driver quality and experience, leading to an increase in accidents, confusing and unpredictable prices (which has occurred with Uber), and too many drivers, lowering the fare prices so that drivers have difficulty making a good living (Who’s). Regular taxi service simplifies the process and gives passengers peace of mind. Additionally, Uber is causing negative environmental externalities by putting more cars on the road.

These resultant market failures suggest that perhaps government intervention is required to achieve efficiency in the taxi market. Proponents of government intervention would say, the government was right to impose a price ceiling on fares as prices would get out of hand and consumers would be exploited, like with Uber’s surge pricing. Furthermore, limiting the amount of taxi drivers enables drivers to make a living wage. So, to make the taxi market more efficient, the government should have implemented a solution to resolve the asymmetric information problem for passengers. The taxi industry could develop its own app that could have ratings for drivers, increasing quality of service, experiences for passengers, and tips for drivers. If a driver receives low ratings, he could attend a training on safety and customer service to help improve his ratings.

However, since Uber is a reality, we need to determine whether the market or the government is most capable to fix new current market failures. If the market is left to its own devices to solve the inefficiencies, it does not seem that other companies will be able to enter the market and make an impact. It has been argued that other similar companies, like Lyft, have not been able to take much of a competitive role in the market (Petropoulos). Yet, it might be possible that a better company will come along and correct the imperfect competition market inefficiency.

The government can address the issues in the taxi market by prohibiting companies like Uber, regulating Uber, or lessening its control over the taxi system. While markets fail, it is important to keep in mind that governments are also not infallible. Prohibiting Uber brings back the problem of asymmetric information, a common government failure. Regulating Uber could disincentivize the taxi market and make taxis less efficient. No other firms would desire to enter the market, and Uber might not work as hard to improve its service if it does not have complete control over its operations. Removing some governmental control over the taxi market might allow taxi drivers to better compete with Uber drivers and create a more efficient market.

Even though Uber has eliminated transaction costs and eliminated the deadweight loss caused by the taxi shortage and fare price ceiling, it has created a whole new set of issues. It turns out that the taxi market’s medallion system and the price ceiling protect passengers from exploitation and provide drivers with a good wage. Also, competition does more to harm drivers and passengers than good. Therefore, rather than regulating Uber or removing restrictions on regular taxis so they can compete with Uber, the government should prohibit Uber and create an app or some other kind of rating service to solve the asymmetric information problem and achieve a higher level of efficiency in the taxi market.

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