Regulatory Barriers to Online Commerce

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It is difficult to overstate how radically the Internet has redefined the exchange of goods and services globally, and specifically within the United States, where users enjoy largely uninhibited access to the Internet. Shoppers from all across the globe can buy items and services to which they previously had no practical access—or indeed, even knew existed. The Internet makes this possible in a way that reduces transaction costs and makes markets transparent. The effect is a creative disruption of existing business models, to the benefit of consumers.

The changes in commerce created by the online revolution have frequently been met with opposition by entrenched interests that profited from the old system, and laws that long protected the status quo. While such barriers to online commerce have fallen in some areas, they still limit Web entrepreneurs and consumers in many others.

Removing existing barriers to e-commerce is especially important as online retail has become a consumer staple in the United States and has continued to experience rapid growth. Total annual online sales have increased tenfold since 2000 and grew at about 15 percent in 2014 alone.[48] While online retail still constitutes a relatively small share of overall retail activity, that share is growing. E-commerce accounted for only 0.6 percent of total retail in 1999, but today e-commerce sales have grown to almost 7 percent of total retail sales.[49]

Online commerce has flourished in the United States in large part because the government has taken a light touch regulatory approach toward the Internet. However, state-level regulations continue to place hurdles in the path of e-commerce.

These laws have various origins. Some are no doubt well intentioned. Others were specifically intended to limit new competition that would challenge incumbent players in the marketplace. Such limits include many laws adopted before the Internet was even imagined, as well as some adopted to ward off perceived threats from Internet-based competitors. Whatever the origins, these laws impose real costs on consumers, depriving them of the full benefits that Internet technology can provide.

The following illustrates how such rules have harmed consumers in three different markets:

Online Wine Shopping and Delivery

Internet-based sales of wine were severely limited due to a long-standing labyrinth of state and local laws limiting the interstate shipment of wine. These laws varied in their coverage, but effectively curtailed challenges to in-state distributors by Internet-based sellers, as well as mail-order sellers. The rules were so restrictive that, as during the Prohibition era, many modern-day vintners turned to bootlegging to sell their product.[50]

According to a 2003 Federal Trade Commission (FTC) study, these bans hurt consumers. In particular, the variety of wines available online was 15 percent greater than the local selection, and was available at up to a 20 percent discount compared to local prices.[51] The FTC noted that statewide bans on direct shipping of wine to consumers were the largest barrier facing the industry, but also observed myriad other regulations, including:

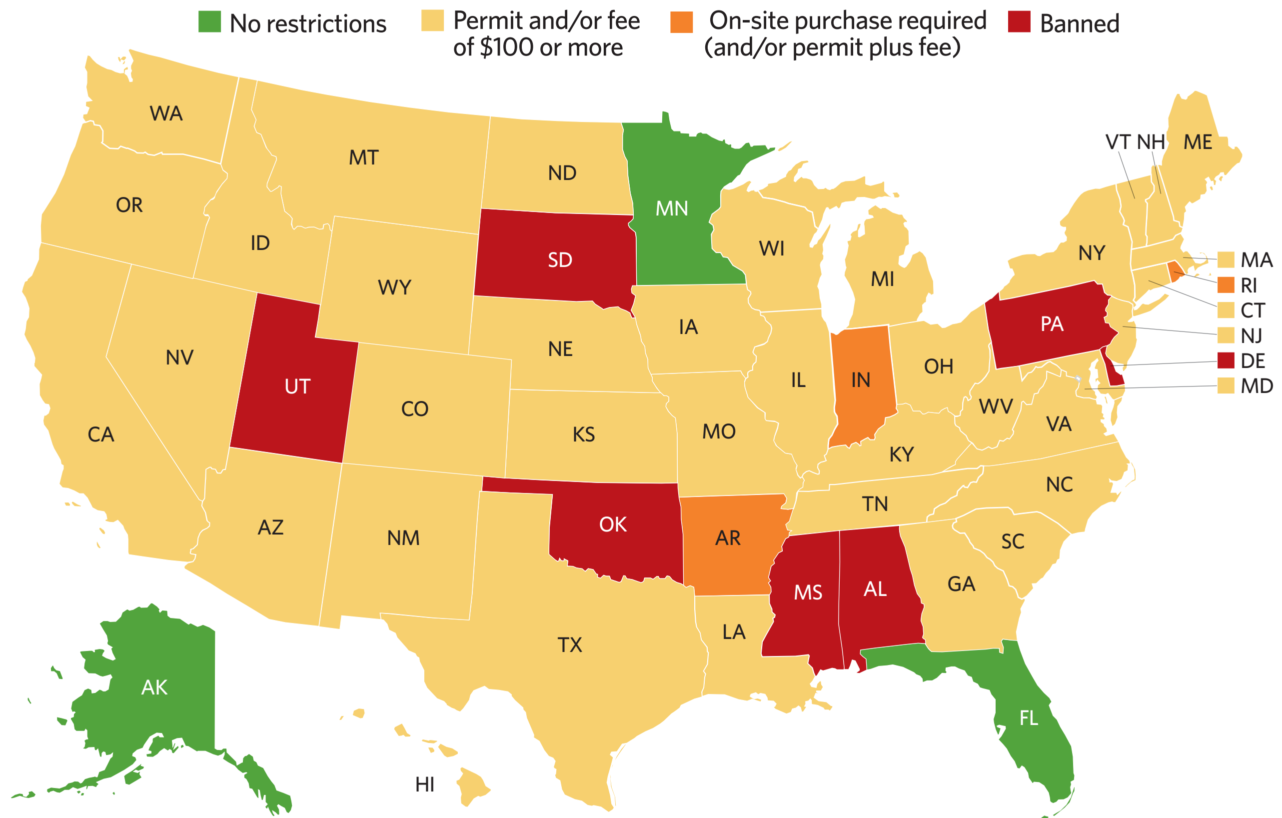
> [P]rohibitions on online orders, very low ceilings on annual purchases, bans on advertising from out-of-state suppliers, requirements that individual consumers purchase "connoisseurs' permits," and requirements that delivery companies obtain a special individual license for every vehicle that might be used to deliver wine.[52]

A great deal of progress has been made since 2003 as states have overhauled their shipping rules to allow online purchase and shipping of wine. This trend was spurred by a 2005 Supreme Court ruling prohibiting states from discriminating against wine shipped from another state.[53] To some extent, this relaxation of rules has upended Prohibition-era laws in many states that banned producers from selling their product directly to consumers. However, many problems remain. The direct shipment of wine[54] is still prohibited (with some exceptions) in seven states: Alabama, Delaware, Mississippi, Oklahoma, Pennsylvania, South Dakota, and Utah. These states would do well for their residents to remove laws that artificially limit selection and increase prices for consumers.

MAP 2

State Restrictions Obstruct Internet Wine Sales

State laws that ban out-of-state wine shipments continue to inhibit the growth of online wine sales. Seven states prohibit the direct shipment of wine entirely. Thirty-nine states impose permitting requirements or fees of $100 or more, while several require the consumer to place a shipping order on-site at a winery. Only three states do not have significant requirements for direct shipments.



Source: Wine Institute, "Who Ships Where Table: State-by-State Carrier Status," February 1, 2015, http://www.wineinstitute.org/files/shipping_statutes.pdf (accessed May 5, 2015).

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Various problems also continue even in states that allow direct shipments by online wine distributors. Many states require out-of-state wineries to obtain permits or licenses in order to ship to customers in their states.[55] Massachusetts, which just authorized direct wine shipments in January 2015, requires that both the producing vintner and each vehicle transporting the wine obtain a permit from the state.[56] Furthermore, some states, such as Rhode Island, require the consumer to conduct the purchase onsite at the vintner's, thus eliminating the convenience of ordering wine online. When this burden is multiplied across multiple states, permitting requirements and other restrictions create significant barriers to commerce.

Other regulations plague even the largest online distributors. Wine.com, the leading online retailer, spent $2 million for regulatory compliance in 2012, compared to total revenues of $80 million.[57] The retailer has faced fines from the State of New York for seemingly innocuous violations of state laws such as shipping bottles of wine with food in gift baskets. (New York law requires that alcohol be shipped separately from food.) In addition, the retailer had to build seven separate warehouses to comply with various state laws and regulations.[58]

While state and local governments often have good intentions and justification for passing

frivolous-sounding laws to protect consumers, the overall effect of these laws is to harm consumers' choice and purchasing power.

Direct Automobile Sales

The Internet has given users unprecedented access to customizable goods and services. Users order exactly what they want, from new clothing to a new home. Yet there is one major life purchase that cannot be made online: a new car.

Given the customizability of today's autos, it should be easy to pick a make and model online and then buy it directly from the manufacturer. But such direct sales are now banned in 47 states. These bans, specifically intended to protect local dealers from competition from out-of-state carmakers, date back to the early 20th century. It is only one of many rules imposed on behalf of dealers, who have long exercised outsized influence with local lawmakers.[59]

But whatever their ostensible justification at the time, today, in a time of globalization and intense competition in the auto market, these regulations simply ensure that dealers remain the middlemen between manufacturers and consumers. Instead of being able to design a built-to-order car online and order it straight from a manufacturer, new car customers have to physically visit a dealership and haggle with a salesman. This arrangement ignores the increasing trend of consumer preference for online shopping—even for cars. In 2014, consulting firm Capgemini found that 34 percent of American car buyers would be likely or very likely to purchase a car online (opposed to researching online and buying at a dealer[60])—up from 25 percent just a year before.[61] Even worse, the regulation comes at the expense of the consumer: One study estimates that the dealer requirement adds $2,000 to the sticker price of a new automobile.[62]

Allowing consumers to buy cars directly from manufacturers who sell online—rather than through a dealer who merely resells cars as a middleman—would give them greater access to customizability, efficiency, and choice. Manufacturers would be able to distribute and ship cars from one or few locations to anywhere in the country, as opposed to shipping first to hundreds or thousands of dealerships.[63]

Recognizing the potential of direct online car sales to benefit consumers, the automaker Tesla—a newcomer to the auto manufacturing market—is trying to overcome these state restrictions and sell online directly to consumers. Tesla has had some victories: The company recently won legislative battles in Nevada, Georgia, and New Jersey that will allow it to engage in direct sales. A court decision in Massachusetts has paved the way for direct sales in that state as well.[64]

But aside from these recent successes for Tesla and consumers, regulations and protectionism have prevailed. Most states still have legislative bans on direct sales, and Michigan, under pressure from the dealers' lobby, even enacted a specific bill that strengthened the ban of direct-to-consumer sales just as Tesla was about to expand in the state.[65] Even in Georgia, where Tesla recently scored a relative victory when the State House of Representatives voted to lift the 150-vehicle limit for direct sales, the state still imposes a limit on the number of Tesla dealerships the maker is allowed to establish, currently capped at five.[66] Similarly, New Jersey's law limits Tesla to four dealerships statewide.[67]

This protectionism is indefensible from an economic and consumer-welfare standpoint. As John Kerr, a communications fellow at the Institute for Justice, pointed out in *The Wall Street Journal*:

> There is no rational reason Tesla—or any other automobile manufacturer—should be restricted from selling new cars directly to those who seek to buy them. Arguments that franchise arrangements benefit consumers ignore not only the higher costs inherent in regulations that limit choice, but the benefits of a vibrant and responsive market in which new-car buyers are free to avail themselves of multiple purchasing options.[68]

Indeed, even General Motors, America's largest automaker, has realized the benefits of this superior business model. Recently, the entrenched firm invested in 8,000 software programmers to develop its "shop-click-drive" website, which enables users to choose and purchase a car online.[69] But there's a catch: The transaction must still be completed through a GM dealer and the dealer's own website. In addition to the inherent difficulties of developing an online experience as complex as GM's, routing it through various dealership websites made the whole process "difficult" according to a GM spokeswoman. Indeed, GM's shop-click-drive manager Jim Bement acknowledged that "[t]here is no way a

dealer could do something like this on his own," begging the question of why dealers should be involved in a transaction that could otherwise be completed directly between the consumer and the automaker.

The "Sharing Economy"

The rise of cheap mobile phones and data programs has allowed a variety of platforms to connect people in direct peer-to-peer networks, enabling a more efficient exchange of goods and services. Dubbed the "sharing economy," online applications, such as ridesharing services (Lyft, Sidecar, or Uber) or apartment sharing (Airbnb) have revolutionized industries by linking users directly to individuals who provide the requested service, such as a car ride, via the Internet.

These new "sharing" businesses, made possible by the Internet, do not fit neatly into any existing regulatory categories. Should they be treated as commercial hotels and taxicabs, or more like an individual who sublets his apartment or gives occasional rides to others? The business categories blur the existing lines, and that is precisely what makes them so difficult to pigeonhole. "We've lived in a world where there was this clear line between picking your friend up at the airport—you clearly don't need a permit for that—or lending your apartment to a cousin when he or she or visits, and running a hotel," says New York University's Arun Sundararajan. "It's important to recognize that these lines are blurring."[70]

Incumbent players have fought these new enterprises at every turn. Taxi cab monopolies in major cities attempted to ban ridesharing services outright or subject them to the same artificial restrictions and price regulation imposed on taxis.[71] The hotel industry has fought Airbnb, pushing to subject it to the full panoply of hotel rules.[72]

Again, these rules are often imposed under the guise of consumer protection, but the regulations benefit entrenched firms, raise consumer prices, and squash innovation. As Heritage Foundation legal scholars Jason Snead and Paul J. Larkin, Jr., note, the practice of using regulatory clout to bankrupt competitors is not only wrong, but will hurt American ingenuity in the long run:

> The only sure way to keep markets open to the next Uber-like innovator is to get the government out of the business of picking winners and criminalizing competition. Not only does government generally do a poor job of it, but entrepreneurial success in America should not be dependent on political connection and favoritism. Nor should new competitors be threatened with costly court battles in every market they try to enter.[73]

Rather than blindly applying existing rules to these new forms of commerce, policymakers should carefully reconsider whether those rules still make sense, and whether they make sense for new business forms. Thanks to the new challengers, for instance, there are now more choices and more competition among taxi services than ever before. Why are government price controls necessary in this new competitive environment? Other rules, such as permits, may also not make sense for the "sharing" business. The effect without rules will be a disruption of the existing marketplace, and that is a plus, not a minus for consumers and entrepreneurs. The Internet has made these new forms of economic and consumer freedom possible; these benefits should not be dismissed due to fear of change.

Conclusion

The Internet has radically redefined commerce by decreasing transaction costs of selling almost anything that can be imagined, all to the great benefit of both vendors and buyers. Yet impediments remain due to outdated regulation and laws designed to benefit politically connected middlemen. In this case, the states—not the federal government—are the leading offenders. Freeing online enterprises from these rules will not only benefit entrepreneurs, it will also allow innovation to flourish, advance consumer welfare, and bolster economic freedom.

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