Principles for the governance and regulation of digital platforms

- Politicians praise the contribution of digital platforms whilst calling for some to be regulated

- Should regulation of platforms require them comply with principles or rules?

- How can regulators decide which platform markets should be subject to regulation?

Politicians and policy makers often start speeches about digital platforms by highlighting the extraordinary contribution platforms have made to the global economy: but follow such praise with a suggestion that some platforms and too big and too powerful and so need to be regulated. The regulation of the telecoms sector is often seen as a source of inspiration for platform regulation, but the dynamic, innovative and fast paced nature of platform markets poses unique challenges.

This edition of Hexagon, which is based on a White Paper by Launchworks & Co.[i] co-authored by Benoit Reillier, Richard Cadman and Justin Coutts, addresses two questions:

- Is principles-based regulation better suited to digital platform markets than rules-based regulation?
- How can regulators avoid the risk of over-regulation?

Regulatory principles or specific rules?

Whilst economic platforms are not new, dating back to physical marketplaces from the dawn of civilisation, digital platforms differ as they operate in on-line multi-sided markets and attract complements to their ecosystem. These complex systems mean that platforms need to design operating principles that create trust amongst ecosystem participants to facilitate successful transactions. Even such principles are not new: The Grand Bazar in Istanbul was set up in 1471 and still has unique governance principles to ensure its effective operation.

A further complication for digital platforms, however, is the fact that they may compete with some of their participants, such as when an app store platform also offers its own apps. This may create incentives to favour their own services in ways that may appear anticompetitive, but may also by justified to protect consumers from, for example, low quality apps.

Regulations may take many forms. They could be prescriptive rules that specify precisely how industry participants should behave. By contrast, regulations may be a set of principles setting high level standards with which firms must comply but leaving companies to translate those principles into concrete actions.

Technology may make rules-based regulation redundant and rules-based regulation may hold back technical developments.

As an example, a rules-based regulation of taxis may require that only people who have passed a specified knowledge exam can provide a taxi service, whilst a principles-based approach may focus on the passenger being confident that the driver will get them to their destination. Before the invention of satnavs, the prescriptive rule may have made sense but makes less sense now that technology can guide the driver along the best route.

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In the context of digital platforms market, principle-based regulation offers three key advantages:

1. Digital platforms are subject to rapid technology change that might be held back by prescriptive rules.
2. Specific rules assume technology choices and business model design whereas principles allow managers to make those choices in the best interests of platform participants.
3. Digital platforms already have extensive experience of principles-based codes, for example Airbnb's stakeholder principles[ii].

There are also some disadvantages to principles-based regulation. Vague or poorly drafted principles may be easy for firms to circumvent and hard for regulators to enforce. There may also be a lack of legal certainty and/or a weak sanctions regime that lowers the cost of non-compliance. Finally, overly subjective principles may be interpreted differently by different stakeholders.

On balance, however, principles-based regulation provides platform participants with greater flexibility to reach desirable outcomes than prescriptive rules that risk being made obsolete by technology or holding back the development of welfare-enhancing business models.

How can the risk of over-regulation be avoided?

One of the greats of economics, Ronald Coase, once wrote that when economists do not understand something, they look for a monopoly explanation and that the extent of economists' ignorance is such that they do so frequently[iii].

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This is particularly true in markets characterised by high levels of innovation because the welfare enhancing effects of innovation may not be passed through to consumers through the medium of price. The problem may go further in digital platform markets where one side of the market faces a cash price of zero but may pay for the service by revealing data about their behaviour and practices that the platform can monetise.

There is a need, therefore, not to introduce Type I or Type II errors: where markets are subject to regulation when they should not be, or are not regulated when they should be, respectively.

The European Commission has sought to avoid this problem in telecoms markets by using the "three criteria test" to establish whether a defined relevant market is "susceptible to *ex ante* regulation". The test asks whether:

i) The market is subject to high and non-transitory barriers to entry.
ii) The market is not trending towards effective competition.
iii) Competition law alone cannot adequately address the market failures concerned.

The criteria must be addressed in order and all three must be fulfilled. This is important because *ex ante* regulation is only considered when barriers to entry and persistent dominance cannot be adequately addressed by competition law, which remains the default approach to addressing market failures.

The specifics of the economic analysis of the first two criteria may be different in platform markets rather than telecoms. For example, some platform activities may be protected from entry by network effects and "single-homing" by participants may prevent the development of effective competition. However, using a variation of the well-established and understood three criteria test should help avoid using *ex ante* regulation when competition law is sufficient and so avoid costly Type I errors.

[i] Launchworks White Paper Available at https://www.launchworks.co/insights/platforms-regulation-a-matter-of-principles/

[ii] See https://news.airbnb.com/serving-all-stakeholders/

[iii] Coase, R.H. (1972), *Industrial Policy: a proposal for research Economic Research: Retrospect and Prospect Vol. 3* Policy Issues and Research Opportunities in Industrial Organisation, NBER 1972, 59 - 73

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