

## Frictions in a Competitive, Regulated Market: Evidence from Taxis<sup>†</sup>

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*This paper presents a dynamic equilibrium model of a taxi market. The model is estimated using data from New York City yellow cabs. Two salient features by which most taxi markets deviate from the efficient market ideal are, first, matching frictions created by the need for both market sides to physically search for trading partners, and second, regulatory limitations to entry. To assess the importance of these features, we use the model to simulate the effect of changes in entry, alternative matching technologies, and different market density. We use the geographical features of the matching process to back out unobserved demand through a matching simulation. The matching function exhibits increasing returns to scale, which is important to understand the impact of changes in this market and has welfare implications. For instance, although alternative dispatch platforms can be more efficient than street-hailing, platform competition is harmful because it reduces effective density. (JEL C78, L51, L84, L92, L98, R48)*

This paper estimates a dynamic equilibrium model of the New York City (NYC) taxicab market. The estimated model is used to assess the importance of regulatory entry restrictions and of matching frictions. The ability to overcome these barriers to trade has been a key element for the success of new technology entrants such as Uber, which have expanded supply in many local markets and introduced a novel dispatch technology to reduce matching frictions. Our counterfactual results isolate the relative importance of these two effects and highlight the importance of density for matching frictions. We also show that segmenting the market between traditional taxis and a dispatch platform such as Uber could lead to a reduction in market thickness that can worsen matching frictions in the aggregate.

Taxi services offer limited room for product differentiation. Moreover, a firm in this market is of relatively low organizational complexity. In its simplest form,

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it consists of a unit of capital (a car) plus the labor (a driver) needed to operate it. The labor-skill requirements are relatively modest and the capital is in vast supply. Finally, in a city like New York, taxi drivers make many decisions independently, with little real-time information about aggregate conditions. Thus, absent regulatory interventions, this market has several of the features of textbook examples of a “perfectly competitive” industry with many firms making decisions independently, jointly affecting aggregate market conditions. It therefore presents an interesting case study of an important benchmark. However, even absent regulatory restrictions, inherent matching frictions are present that create barriers to trade. Furthermore, most taxi markets are subject to licensing restrictions that limit entry and to regulations of fares.<sup>1</sup>

We first document some important patterns in this market that will then motivate some of the key ingredients of our model. We provide evidence that entry restrictions are strongly binding in NYC. If no other frictions were present, one might therefore expect all taxis to be utilized at least during the daytime. However, activity is often well below capacity, highlighting the importance of understanding the labor-supply decisions of taxi drivers. Labor supply cannot instantaneously adjust to market conditions, because drivers operate on a two-shift system, leading to shift-indivisibilities in labor supply.

Because of regulations, this market does not feature any price flexibility. This inflexibility, together with capacity limits, implies that regular (and predictable) patterns of variation in demand for rides during the day (e.g., rush hours) lead to large fluctuations in costly delays for matches between passengers and taxis. Drivers’ earnings and the number of active taxis vary during the day depending on how long drivers need to spend searching for their passengers. The average search time for an active taxi between dropping off a passenger and picking up the next one ranges between 5 and 16 minutes depending on the time of day. To appreciate the magnitude of these numbers, note the average duration of a trip is 12 minutes. We report that the fraction of time taxis are “unemployed” ranges between 30 percent and 70 percent depending on the hour of day. Passengers also wait to obtain a taxi, and this wait time varies during the day. Absent price adjustments, passenger wait times and taxi search times serve as (wasteful) market-clearing variables.<sup>2</sup>

In our model, drivers make daily entry and hourly stopping decisions. Licenses to operate a taxi (medallions) are scarce, so entry is only possible for inactive medallions. Hourly profits are determined by the number of matches between searching taxis and waiting passengers. *Ceteris paribus*, increasing the number of taxis increases the search time for a driver to encounter the next passenger and reduces expected hourly earnings. The number of taxis is determined endogenously as part of the competitive equilibrium in this market. Stopping (exit) decisions are determined by comparing a random, terminal outside option with continuation values determined by expected hourly earnings net of a marginal cost of driving. Starting (entry) decisions result from comparing an outside option and the expected value of a shift (given expected optimal stopping behavior).

<sup>1</sup>As an important component of the urban transport infrastructure, the functioning of the taxi market also has potential consequences for congestion and pollution.

<sup>2</sup>This form of rationing is common in other markets.

To estimate the model, we make use of rich data on the NYC taxi market from 2011 and 2012. These data include every trip of the yellow cab fleet in this time span. The data entry of a trip includes the fare, tip, distance, and duration, as well as the geo-spatial start and end points of the trip. We have a panel identifier for the medallion as well as the driver which allows us to account for an important source of heterogeneity in drivers' characteristics (i.e., owner-operators versus fleet drivers) that affects the intensity of utilization.<sup>3</sup>

Prior papers have used the taxi market as a useful environment to study labor-supply decisions because drivers have more flexibility in deciding when to stop than workers employed in firms. However, we show that important rigidities are tied to the two-shift structure of operation. Our model delivers responses to earnings shocks that strongly depend on their timing during the day. Specifically, we contrast the response to a uniform shock throughout the day to an hour-specific shock for each hour. The former results in an elasticity estimate of 1.8, which, interestingly, is not too far from the number (1.2) reported by Angrist, Caldwell, and Hall (2017) from an experiment on Uber data. The latter results in estimates that vary from 0.9 to 2.6 depending on the hour, with beginning- and end-of-shift elasticities that are lower than those for the middle of the shift.

On the demand side, we face a challenge. Although we observe the number of matches, neither the passengers' wait time nor the number of hailing passengers is directly observable in the data. However, we are able to recover these variables by using information about other observables as well as the nature of the matching process. Our first step is to obtain the matching function that maps the number of taxis and passengers (in addition to other observables such as traffic speed) into the number of matches, as well as values for search time for taxis and wait time for passengers. We develop an explicit description of the geographical nature of the matching process, and we then recover, via simulation, a numerical representation of the matching function. We can then invert the function to recover how many people must have been waiting for a cab given the number of passenger pickups we observe (successful matches), how long taxis search for passengers, the number of cabs on the street, and the speed at which traffic flows; we observe all of these variables in our data. The empirical literature on search and matching typically uses known inputs such as the number of job vacancies and unemployed workers, as well as the observed number of matches, to estimate parameters of an assumed functional form (e.g., Cobb-Douglas) for the matching function.<sup>4</sup> We proceed in the other direction by using a specific matching process that defines a matching function, and we then use the observed matches and the number of active taxis to infer the other key inputs to the matching function, that is, the number of waiting passengers and their wait time. Interestingly, the matching process displays varying degrees of returns to scale depending on the level of activity. At low levels of activity, such as during the nighttime, returns to scale are substantial. However, for daytime levels of activity, returns to scale become essentially constant. This feature of the matching process has important welfare consequences.

<sup>3</sup>These identifiers are no longer available for more recent data from NYC.

<sup>4</sup>See, for instance, Petrongolo and Pissarides (2001).

With the recovered demand data in hand, we proceed to estimate a demand function in terms of the expected wait time for a cab (recall that fares are fixed). We find that the demand elasticity with respect to wait time is not large, but demand is sufficiently responsive that this plays a significant role in the counterfactuals.

Our first counterfactual evaluates the effects of additional entry. A 10 percent increase in the number of medallions leads to 8.9 percent increase in the number of active taxis.<sup>5</sup> The reason for the less than proportionate increase relative to the additional entry is that drivers respond to reduced earnings by choosing shorter shifts, highlighting the importance of modeling the intensive margin on the supply side. However, the increase in activity would be a lot smaller if we did not incorporate in the model the dependence of passenger demand on expected wait times. The increase in the number of taxis leads to a reduction in wait time, which leads to an increase in the number of passengers, which in turn moderates the reduction in earnings caused by the increase in the number of medallions.

Our next set of counterfactuals concerns the magnitude of matching frictions and possible ways to reduce them. Specifically, we consider an improved matching technology in line with the dispatch system of the Uber platform and other ride-hailing services. We first consider a polar opposite of the NYC decentralized decision-making model by introducing a centralized dispatcher for the entire fleet. We show relatively large gains for both sides of the market due to reductions in wait times for both passengers and taxis. Interestingly, the number of active taxis increases by almost the same amount as in the counterfactual with 10 percent more medallions, despite the fact that the number of medallions is left unchanged. The number of matches increases by 12 percent, a larger amount than the increase in the number of taxis. The difference is due to the fact that the dispatch system reduces matching frictions.

We then consider what happens in the more realistic case in which the dispatch platform only achieves partial market penetration, with the remainder of the market functioning according to the traditional street-hailing system.<sup>6</sup> We show that market segmentation on different platforms creates an inefficiency that is due to a reduction in market thickness for both platforms.<sup>7</sup> Partial coverage by a dispatcher has two effects compared with a market with no dispatcher: on the one hand, at the market sizes we consider, the partial dispatcher is a more effective platform for taxis and passengers that are served by it; on the other hand, segmentation of the market makes both segments thinner, with the consequence of longer average distances between a random taxi and a random passenger. When we consider the case in which there is an equal number of potential taxis divided between dispatch and decentralized platforms, we find the second effect dominates, and therefore aggregate outcomes become worse than in the baseline case. Interestingly, the effects are quite different during the daytime relative to nighttime hours, reflecting the importance of the initial thickness of the baseline market environment.

<sup>5</sup>This number is an average across the day for a typical weekday. The extent of the increase in activity depends on the hour of the day.

<sup>6</sup>In order to isolate this effect we keep the total number of cabs the same and only change the dispatch process.

<sup>7</sup>Uber seems to be well aware of this effect and therefore subsidizes drivers, especially when they first enter a city. See, for instance, Sam Knight, "How Uber Conquered London," *Guardian*, April 27, 2016, <https://www.theguardian.com/technology/2016/apr/27/how-uber-conquered-london>.

Finally, we consider the effects of density: we simulate a city that is otherwise identical to Manhattan, but is one-third as dense; that is, the same number of potential passengers is spread over a larger territory covered by the same number of potential taxis. We find our model predicts dramatic losses in efficiency due to lower density. However, these inefficiencies are substantially alleviated by a dispatch platform whose performance is (comparatively) much better in a less dense environment.

The insights that we gain from our counterfactuals are of broader relevance than the taxi market. Entry restrictions are related to the issue of occupational licensing, which affects a large number of workers in the United States. For instance, Kleiner and Krueger (2013) report that 29 percent of workers are subject to licensing regulations. Our results also speak to the effects of shift indivisibility and are therefore relevant to the literature studying the flexibility of work arrangements.<sup>8</sup> Our results are directly relevant for thinking about search and matching frictions, which have been greatly emphasized in labor markets and housing markets. In this respect, our paper is the first to offer an explicit simulation of the matching process as deriving from spatial matching frictions. This spatial simulation could be a useful metaphor for other markets in which matching frictions are important.<sup>9</sup> Finally, our results on competing dispatch platforms speak to the literature on network externalities and trading platforms.<sup>10</sup>

## I. Related Literature

This project combines elements from the entry/exit literature, neoclassical labor-supply models, and search. Structural estimation of entry and exit models goes back to Bresnahan and Reiss (1991). This entry/exit perspective on the problem is motivated by the fact that drivers in the New York taxi industry, like in many other cities, are private independent contractors and decide freely when to work subject to the regulatory constraints. The labor-supply decisions of private contractors have, for example, been studied in Oettinger (1999), who uses data from stadium vendors. In the spirit of the entry/exit literature, we recover a sunk cost, which in our case is the opportunity cost of alternative time use from observed entry and exit decisions and their timing. One distinguishing feature of our work relative to the prior work in Industrial Organization is that our market contains tens of thousands of entrants. Entry is therefore competitive and entrants only keep track of the aggregate state of the market, which is summarized in the hourly wage that is determined in equilibrium as a function of aggregate entry and exit decisions. Another distinguishing feature is that previous papers on the topic, for instance, Bresnahan and Ross (1991), Berry (1992), Jia (2008), Holmes (2011), Ryan (2012), Collard-Wexler (2013), and Kalouptsidei (2014), feature relatively *long-term* entry decisions (building a ship, building a plant, building a store, etc.), making both entry and exit somewhat infrequent. In our setting, entry and exit decisions are made daily, creating a closer

<sup>8</sup>See, for instance, Chen et al. (2017), who discuss the value of flexibility for Uber drivers. See also Mas and Pallais (2017).

<sup>9</sup>See Eckstein and van den Berg (2007) for a survey on empirical work on labor search, and Petrongolo and Pissarides (2001) for a survey on the matching function. On the housing market, see Wheaton (1990).

<sup>10</sup>Cantillon and Yin (2008) competition discuss competing trading platforms in financial markets; Hendel, Nevo, and Ortalo-Magné (2009) discuss the role of competing platforms in the housing market.

link between realized payoffs and expected payoffs. Brancaccio, Kalouptsi, and Papageorgiou (2017) consider the related application of exporters matching to ships. They develop and estimate a model that features geography, search frictions, and forward-looking optimizing ships and exporters.

A direct application of spatial search to the taxi market is provided in Lagos (2003), who calibrates an equilibrium model (with frictions) of the taxicab market, and includes some heterogeneity among locations. However, he assumes all medallions are active throughout the day and thus does not model the labor-supply decision, nor does he allow demand to be elastic to wait time.<sup>11</sup> Using the model, he quantifies the impact of policies increasing fares and the number of medallions.

Buchholz (2018) also estimates a structural model of the NYC yellow cab market but focuses on the spatial dimension of the drivers' choice, while taking the intertemporal supply of taxis as exogenous. Buchholz (2018) relies on spatial variation in fares due to the two components of fares, namely, a fixed fare and a fare that is variable in the travel distance, to estimate demand as a function of price. By contrast, absent aggregate intertemporal variation in fares, we allow demand to depend on the expected passenger wait time. Although we do not study the spatial dimension of drivers' choices, taxi activity is endogenous in our model and we attempt to match the patterns of daily activity allowing for different behavior for fleet versus owner-operators. Hence, although Buchholz (2018) can explore counterfactuals with respect to fare structure, our paper can investigate the relaxation of entry restrictions and the extensive margin of supply more broadly.

Some earlier papers have used NYC trip-sheet taxi data to investigate individual labor-supply decisions. Camerer et al. (1997) find a sizable negative elasticity of daily labor supply and argue that this finding is inconsistent with neoclassical labor-supply analysis. This interpretation has been challenged by Farber (2008). Crawford and Meng (2011) estimate a structural model of a taxi driver's stopping decision, allowing for a more sophisticated version of reference-dependent preferences. They do not consider a cab driver's entry decision, and do not analyze the industry equilibrium. We opted to stay within the neoclassical framework to study the overall equilibrium of the taxi market, in contrast to these papers that all focus on the intensive margin of daily individual labor supply decisions. We note that although some drivers might not fit this assumption, the aggregate patterns are consistent with a standard model. Hence, a standard model of labor supply seems to be a reasonable starting place.<sup>12</sup> This perspective is also supported by the new evidence in Farber (2014), who uses the Taxicab Passenger Enhancements Project data and shows that only a small fraction of drivers exhibit negative supply elasticities.<sup>13</sup>

<sup>11</sup> Lagos (2003) does not have data on hourly or daily decisions by taxi drivers.

<sup>12</sup> Note also that our models fits aggregate patterns relatively well; hence, any gains from allowing for a richer labor-supply decision would be small in aggregate.

<sup>13</sup> Other papers that use these data are less directly related. For instance, Haggag and Paci (2014) study the impact of suggested tips on the NYC taxi-driver payment screen for clients on the realized tip. Haggag, McManus, and Paci (2014) study how taxi drivers learn driving strategies based on their experiences. Buchholz, Xu, and Shum (2016) argue that both "behavioral" and "neoclassical" wage responses are present in the data, with the behavioral income-targeting story explaining shorter shifts, and the standard neoclassical model explaining longer shifts. Methodologically, their paper uses a different estimation procedure than we do: they develop a new closed-form estimator for the stopping problem. Thakral and Tô (2017) find reductions in cab driver labor supply in response to higher accumulated daily earnings and stronger effects for more recent earnings. They argue that the income effect is inconsistent with the neoclassical model and the non-fungibility of daily income rejects models invoking

## II. Industry Details and Data

### A. Industry Details

Operating a yellow cab in NYC requires ownership of a medallion. In the time period covered by the data, only yellow cabs are allowed to pick up street-hailing passengers.<sup>14</sup> This regulation differentiates cabs from other transportation services such as black limousines, for which rides have to be pre-arranged via a phone call or the Internet.<sup>15</sup> The cab market is regulated by New York's Taxi and Limousine Commission (TLC), which sets rules such as the fare drivers can charge, the qualifications for a taxi-driver license, the insurance and maintenance requirements, and restrictions on the leasing rates (daily or weekly) medallion owners can charge drivers.

Approximately 40 percent of the medallions are owner-operated and require that the owner of the medallion drive the taxi for at least 210 shifts in a year. The remaining 60 percent of medallions are called minifleets, and are operated by approximately 70 fleet companies that manage an average of 115 taxis each.<sup>16</sup> Fleet companies therefore manage many medallions and rent taxis out to drivers on a daily or weekly basis.<sup>17</sup> The presence of owner-operated medallions prevents concentration of ownership and therefore guarantees a fraction of "small businesses" in the industry. We later show that the requirement of owner-operated medallions leads to less flexible rental arrangements and lower utilization, implying that allowing for heterogeneity among ownership types in our estimation is important.

The TLC imposes several restrictions on the terms of the leases between medallion owners and drivers. Leases can either be for a shift or an entire week. A rental for a shift has to last 12 consecutive hours, and a weekly lease must last seven consecutive days. Minifleets must operate their cabs for a minimum of two nine-hour shifts per day every day of the week.<sup>18</sup> The TLC also specifies a cap on the price that medallion owners can charge which varies with the time of the lease and the type of vehicle.<sup>19</sup>

### B. Data

Our main data source is the TLC's Taxicab Passenger Enhancements Project (TPEP), which creates an electronic record of every yellow cab trip. For each trip, it records a unique identifier for the driver as well as the medallion. It also records

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daily income targets. Hall, Horton, and Knoepfle (2017) use fare changes on Uber to explore short-run and long-run labor supply responses. Finally, Jackson and Schneider (2011) find evidence of moral hazard in the behavior of taxi drivers and document that this problem is moderated if drivers lease from fleets owned by someone in their social network.

<sup>14</sup>In the time period that we consider, Uber was not yet a significant presence.

<sup>15</sup>The TLC recently established an ability to hail cabs via a mobile app, but this option was not available during our observation period.

<sup>16</sup>Some fleet owners operate more than 1,000 taxis. Source: <http://www.nycitycab.com/Services/AgentsandFleets.aspx>.

<sup>17</sup>Fleet companies not only operate medallions that they own for themselves, but might also operate medallions for medallion agents who lease them to the fleet companies.

<sup>18</sup>See TLC Rules and Regulations, paragraph 58–20 (a) (1): <http://www.nyc.gov/html/tlc/html/rules/rules.shtml>.

<sup>19</sup>The leasing-rate caps are between \$115 and \$141 depending on the weekday, the vehicle type, as well as whether it is a night shift or day shift. Rate caps for weekly rentals vary between \$690 and \$812.

the length, distance, and duration of the trip, the fare and any surcharges, and the geo-spatial start and endpoint of the trip. The TPEP data can be obtained from the TLC. In this project we only use a subset of the data which includes roughly four months: October 1, 2011, to November 22, 2011, and August 1, 2012, to September 30, 2012. During the time spanned by our data we see the universe of 13,520 medallions. We also observe all 37,406 licensed drivers who have been active in that period. We complement these data with information about the medallion type (minifleet or owner-operated), and the vehicle type.

We focus our analysis on Monday through Thursday. The average activity of these days looks almost identical whereas Friday, Saturday, and Sunday each have some peculiarity. The reason we do not further differentiate between weekdays is that doing so would make obtaining counterfactuals computationally prohibitive, and, as we will see, these days display very similar patterns. Furthermore, in the estimation, we focus on trips that originate in Manhattan, which account for most of the activity in the data (approximately 90 percent of trips).<sup>20</sup>

### III. Descriptive Evidence

We now provide some background information and descriptive evidence about the functioning of the market. We also offer evidence for each of the following features of the market that are later incorporated in the model and will be addressed in the counterfactual calculations: (i) entry restrictions, (ii) daily patterns of activity, and (iii) search frictions.

#### A. Entry Restrictions

As we mentioned in the introduction, most taxi markets are subject to tight entry restrictions. In NYC, the number of medallions during the time period of our data is 13,520. This number is an absolute limit on the number of possible taxis on the street at any moment in time. Prices of medallions are an indicator of the quantitative importance of the entry restriction.<sup>21</sup> During the period we consider, these prices exceeded half a million dollars. Of course, such medallions would not be valuable in a market with no entry restriction. We have also verified that the percentage of medallions that are driven at least once a day is close to 97 percent during weekdays, and 92 percent even on Sunday. Given that some natural failure rate of vehicles and other idiosyncratic reasons explain why taxis may fail to be utilized, this seems to be a very intense rate of utilization. As we will see next, the daily utilization rate is quite different from the utilization rate for a typical hour, which is much lower and also depends on drivers' hourly stopping behavior.

<sup>20</sup>Most of the remaining trips originate at one of the two NYC airports.

<sup>21</sup>Medallions are often traded in auctions and prices are public data.



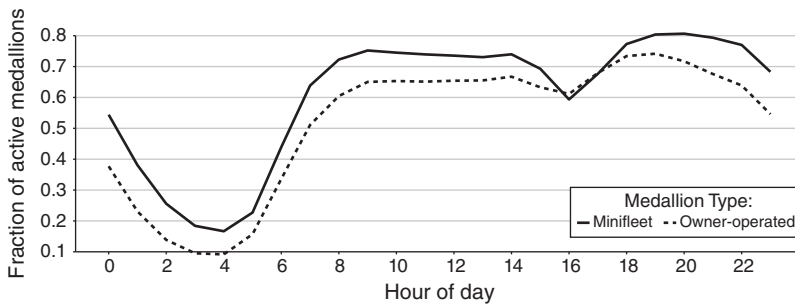


FIGURE 1. COMPARING ACTIVITY OF OWNER-OPERATED AND FLEET MEDALLIONS

### B. Daily Patterns of Activity

Figure 1 displays the fraction of taxis that are active at each hour of the day for a typical weekday, distinguishing whether it is a minifleet or an owner-operated medallion.<sup>22</sup>

We wish to draw attention to several features of this figure. First, fleet medallions are more intensely utilized for every hour of the day.<sup>23</sup> To place the magnitude of the difference in utilization in perspective, this difference is larger than the difference between Uber and taxis reported by Cramer and Krueger (2016). Second, substantial intra-day variation in activity exists, but this variation does not seem to fully reflect expected patterns of intra-day variation of demand, despite the fact that activity is well below capacity for the entire day.<sup>24</sup> Third, a large reduction in activity occurs precisely during the evening rush hour. This time is known as the witching hour. The drop in activity is more pronounced for fleet medallions.

Our model of the supply side of the market incorporates features that allow it to match all of these data patterns of daily activity. In particular, these patterns imply the need to take into account the intensive margin of supply and its variation during the day, as well as the importance of allowing for differences between fleet and owner-operated medallions. We have also explored these in differences in counterfactual computations where we allow all medallions to be operated by minifleets. Such a change would lead to similar improvements in consumer welfare as a 10 percent increase (the same as in our entry counterfactual) in the number of medallions (see online Appendix Table K1).

### C. Search Frictions

An important friction in this market relative to the ideal of a Walrasian market arises from the fact that drivers and passengers have to physically search for trading

<sup>22</sup> At most one owner-operated medallion can be owned at any time. However, owners can lease the taxi to other drivers as long as the owner operates the taxi for a minimal number of shifts.

<sup>23</sup> In online Appendix G we discuss additional facts on the difference in utilization between fleet medallions and owner-operated medallions.

<sup>24</sup> Below we provide evidence that activity is indeed less variable than demand.

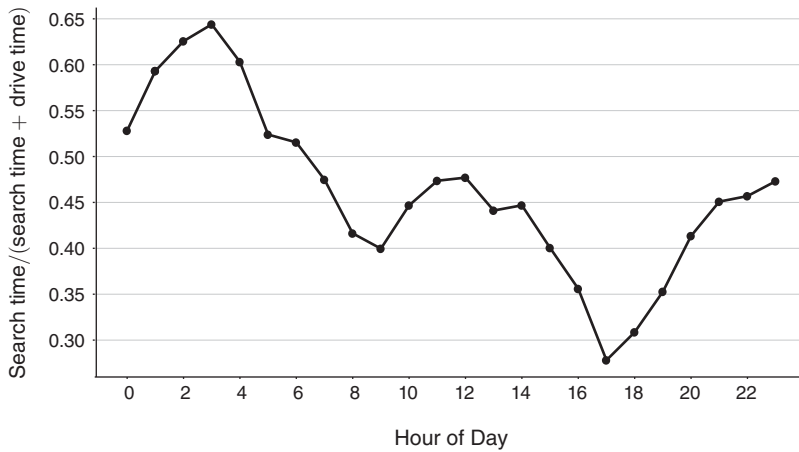


FIGURE 2. SEARCH TIME RELATIVE TO DELIVERY TIME DURING THE DAY

*Notes:* This plot shows the ratio of the average time a taxi spends searching for a passenger as a percentage of total time spent driving. The plot shows that search time is highest in the nighttime hours and lowest during the “witching” hour when demand picks up for the evening rush hour and many medallions are transitioned between shifts.

partners. We now provide some indirect evidence that matching frictions are important in this market.

Figure 2 describes the fraction of time an average taxi spends searching for passengers relative to the total time it is active, that is, the unemployment rate for taxis.

Two notable features are the following. First, the fraction of time taxis spend searching is almost never lower than 30 percent and displays substantial variation during the day, going as high as 65 percent at its peak. Note that, under the current system of fixed fares, most intertemporal variation in driver profits and customer welfare are created by variation in delays in finding a partner. Indeed, a simple linear model reveals that variation in taxi search time explains about 60 percent of the variation in drivers’ hourly wages.<sup>25</sup> The low point of search time is reached at 5 PM, shortly after the shift change, when many medallions are still inactive (see Figure 3). The high point of search time is during the late night hours. For passengers, the wait time increases at night relative to the late evening hours but is still lower than during the peak of daytime values (see Figure 3, the wait time for passengers is inferred from our simulation, which is described in detail later). We will see that the negative relationship between search time and wait time during much of the day is mostly due to changes in the ratio of passengers and cabs. However, the fact that both search time and wait time increase during the night relative to the evening hours, illustrates an “economy of density” that implies that both market sides benefit from the fact that density facilitates the matching process.

Additional evidence for the presence of search frictions can be obtained by comparing the actual travel time between the observed drop-off location and the

<sup>25</sup> Most of the remaining variation is explained by trip-length and the rate that is charged per minute of driving. This rate varies with the speed of traffic due to the mixture of time-based and distance-based metering.

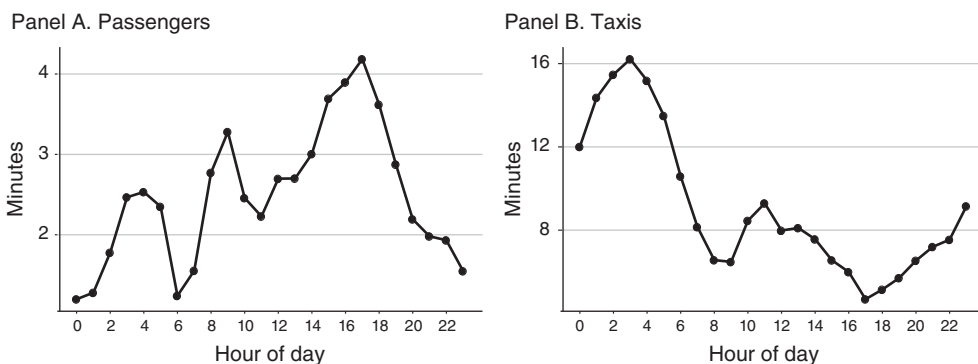


FIGURE 3. SEARCH TIME FOR TAXIS (FROM DATA) AND WAIT TIME FOR PASSENGERS (FROM SIMULATION), IN MINUTES

Notes: Panel A shows waiting time, in minutes, for passengers as recovered by our simulation, averaged for each hour of the day. Panel B shows search time for taxis in minutes, again averaged for each hour of the day.

subsequent pick-up location of a cab (the start and endpoint of the search process) with the travel time of the fastest route between these points. To obtain the latter, we query Google's distance *API* for the travel time between 1,500 randomly selected drop-off and pick-up locations from our data. For each of these observations, we computed the ratio of the actual time taxis spent traveling between the two points over the suggested fastest time and find that taxis spend on average 220 percent more time traveling between these points. The final piece of evidence for search frictions emerges from examining the degree of predictability of the order in which empty taxis find passengers in a given area: absent search frictions, one would expect the pick-up order of taxis in a specific area to be highly correlated with their drop-off order. In other words, focusing on a narrow enough area with uniform demand conditions, the  $i$ th cab to drop off a passenger in this area should also be the  $i$ th one to subsequently pick up the next passenger. Figure 4 displays the result of this exercise, along with the 45-degree line (steeper line) and the linear fit (flatter line). Although we find that the drop-off sequence and the pick-up sequence are positively correlated (correlation coefficient is 0.51), a large amount of dispersion is still present. We interpret this dispersion as evidence of search frictions.<sup>26</sup>

#### IV. Model and Estimation

Because the NYC taxi market operates under a fixed-fare system, the endogenous variables that adjust to clear the market are the wait time  $w_t$  for passengers to find a taxi and the search time  $s_t$  for taxis to find a passenger. There are three key ingredients in our equilibrium model of the taxi market. First, hourly taxi supply will be obtained as a result of an optimal dynamic entry and stopping process for drivers and

<sup>26</sup> As a placebo we also conduct the same analysis at JFK airport, where cabs are queuing for passengers. Under such a system, one would expect drop-offs and pick-ups to be much more correlated. Here we find a correlation coefficient of 0.73, which is statistically significantly different from the one above. The reason that the correlation at JFK is not even higher is that we must pool drop-offs at different terminals and that there are exemptions from queuing for drivers that were previously servicing short trips from the airport.

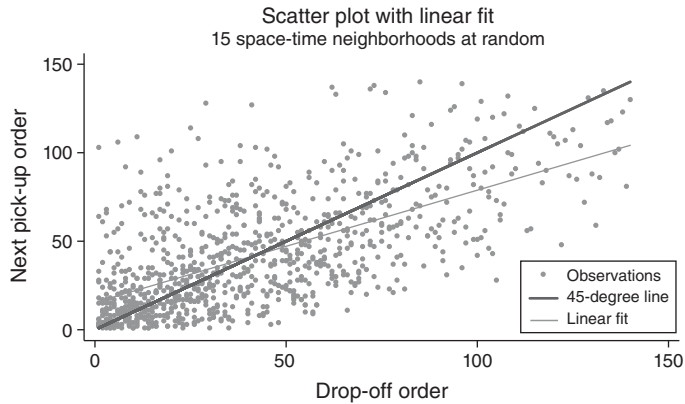


FIGURE 4. DROP-OFF ORDER AGAINST PICK-UP ORDER

determined by outside options and hourly earnings, which themselves are largely determined by  $s_t$ . Second, hourly taxi demand is assumed to take a log-linear form as a function of hourly wait time  $w_t$ . Furthermore, we do not observe the number of passengers  $d_t$  or wait time  $w_t$  directly. We infer these variables from our observations of the number of matches, the number of searching cabs, and the search time, given the third key ingredient: the matching process. This process is captured by a function  $g(\cdot)$  that relates the number of taxis and passengers, as well as other observable market conditions to wait time and search time. We provide a simulation-based approximation for this matching function that replicates the geographic nature of the matching process and features of the taxi market in NYC.

#### A. Demand-Side Model

The estimation of the demand function presents two distinct challenges. The first problem is that, although we observe the number of matches between passengers and taxis, we do not directly observe either the number of waiting passengers  $d_t$  (demand) or their wait time  $w_t$  (price). A fraction of this demand may not be fulfilled because some passengers may go unmatched. The second problem is the issue of simultaneity, which is the typical challenge in the estimation of demand. In this subsection, we explain how we deal with the first problem to recover the demand data we need to estimate a demand function. In Section IVA, we then describe the instrumental variable approach to deal with endogeneity concerns.

Given a number of searching taxis (which we observe), the average time a taxi spends searching (which we also observe) reveals information about the number of passengers that must have been waiting on the street. To be more concrete, imagine two scenarios in which the same number of searching cabs,  $c_1 = c_2$ , have different search times,  $s_1 > s_2$ . If all other relevant factors (e.g., the speed of traffic) are the same in the two scenarios, then, more passengers must have been waiting on the street in scenario two. Our approach uses this basic intuition.

Let  $i \in \{1, \dots, I\}$  be the index of an area in the city. We denote the total number of waiting passengers in the entire city by  $d_t$ . These passengers are distributed across

the areas of the city according to proportion  $\{p_i^d | i = 1, \dots, I\}$ .<sup>27</sup> We denote the vector of waiting passengers  $\mathbf{d}_t = (d_t \cdot p_1^d, \dots, d_t \cdot p_I^d)$ .

The matching process is captured by a function  $g$  that maps a vector of waiting passengers  $\mathbf{d}_t$  and searching taxis  $\mathbf{c}_t = (c_{1t}, \dots, c_{It})$ , as well as other exogenous time-varying variables  $\phi_t$ , into an aggregate search time  $s_t$  and wait time  $w_t$ :

$$(1) \quad \begin{pmatrix} s_t \\ w_t \end{pmatrix} = g(\mathbf{d}_t, \mathbf{c}_t, \phi_t).$$

If we knew  $g(\cdot)$ , then, for given values of  $\mathbf{c}_t$  and  $\phi_t$ , inverting this function would allow us to infer  $d_t$ , assuming, of course, the function is invertible. We use our knowledge about the *geographical nature* of the matching process to infer the form of  $g(\cdot)$ . In particular, we obtain an approximation of  $g$  by simulating the matching process of waiting passengers and searching taxis on a grid that represents an idealized version of the Manhattan street grid.<sup>28</sup>

*Implementing the Simulation.*—We assume passengers wait at fixed locations on a two-dimensional grid. The map consists of nodes whose spacing is proportional to 1/20 miles. Each of these nodes is a spot at which passengers potentially wait. Street blocks are assumed to be 4/20 miles wide (east-west) by 1/20 miles long (north-south), which corresponds to the approximate block size in Manhattan. Figure 5 shows the structure of the resulting grid. Gray nodes represent intersections between streets and avenues, at which cabs can change their direction of travel. Turns at (gray) nodes are random with equal probability for each feasible travel direction.

We assume the effect of time-varying factors can be summarized by the speed, *mph*<sub>*t*</sub>, at which the traffic flows and the average distance, *miles*<sub>*t*</sub>, to deliver a passenger from his fixed position on the grid to the destination.<sup>29</sup> Both factors are included in  $\phi_t$ , and both are directly observed in our data by using the average hourly speed of the entire taxi fleet as well as the average distance of all trips on an hourly basis. For each combination of variables we feed into  $g$ , we simulate the resulting average wait time for passengers and search time for taxis over an hour-long time interval. Every ten minutes  $d/6$  potential passengers are born and placed on the map for a total of  $d$  passengers during the hour. We assume that the maximal waiting time is 20 minutes. After 20 minutes, a passenger stops waiting and counts as unmatched.<sup>30</sup>

To account for the fact that the number of trips originating from different parts of the city varies, we divide Manhattan into eight equally spaced areas (see online

<sup>27</sup>These proportions are inferred from the data; see Section IVA for more details.

<sup>28</sup>Our matching function is effectively deterministic. While we could have allowed for randomness in the matching process, this feature does not seem important in the aggregate given the large number of matches at the hourly level. This, of course, does not mean that the components of the matching function, such as demand and supply, are deterministic. In fact, we will allow for error terms in the demand function, and it is important to do so.

<sup>29</sup>Note the trip distance is an important ingredient because it determines the effective supply. Longer trips mean fewer taxis are available for the delivery of passengers.

<sup>30</sup>Our results are robust to changing the maximal value of the waiting time. See online Appendix Section D.D2 for more details.

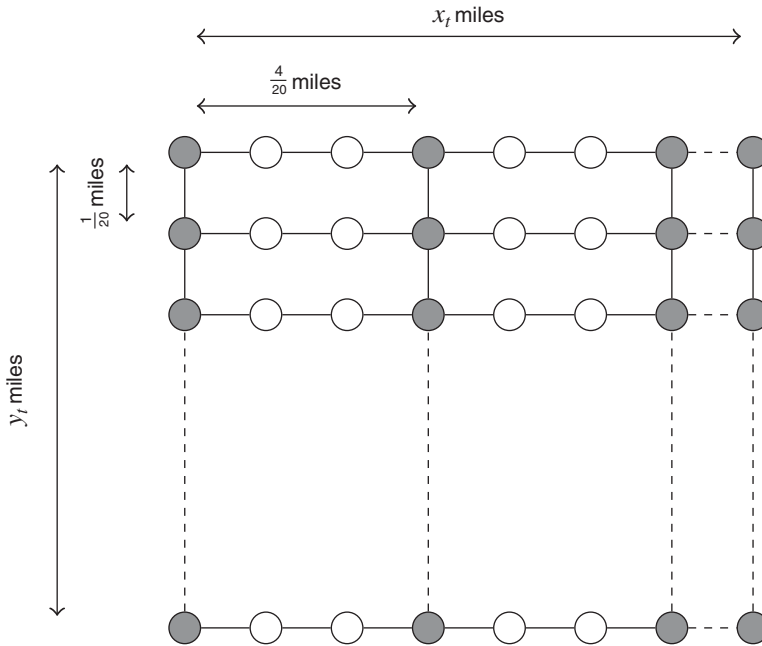


FIGURE 5. SCHEMATIC OF THE SIMULATION GRID

Notes: Gray nodes represent street corners, but all nodes (gray and white) are potential passenger locations.

Appendix Figure 20 for details).<sup>31</sup> Passengers appear on the corresponding parts of the grid in proportion to the observed pick-up probabilities of those areas and cabs reappear according to the observed drop-off probabilities. In other words, for each of the passengers placed on the map, we first randomly determine an area according to a multinomial distribution with probabilities  $\{\hat{p}_i^d | i = 1, \dots, 8\}$  and then a node within an area, where each node has equal probability. The probabilities  $\{\hat{p}_i^d | i = 1, \dots, 8\}$  are estimated as the fractions of trips originating in these areas. Similarly, cabs reappear on the map in area  $i$  according to multinomial probabilities  $\{\hat{p}_i^c | i = 1, \dots, 8\}$  and with equal probability on each node within an area. The probabilities  $\{\hat{p}_i^c | i = 1, \dots, 8\}$  are measured as the frequencies of drop-offs in those areas.<sup>32</sup> In online Appendix Section D.D1, we discuss the robustness of our inversion results to alternative (finer) divisions of the map. Although our approach allows us to account for some of the heterogeneity in locations, we do not consider endogenous location choices as in Buchholz (2018).

Note that, with the exception of the division into areas according to multinomial probabilities, none of the steps so far required the use of observed data. Our

<sup>31</sup>To explore the robustness of the results with respect to the fineness of the division into areas, we have also performed the simulation for 16 areas and results are almost identical. We report these in online Appendix B.

<sup>32</sup>We therefore do not consider conditional drop-off and pick-up probabilities. These probabilities would only be of interest if we wished to follow individual drivers. For the purpose of this simulation, however, driver identities are irrelevant and only aggregates matter.

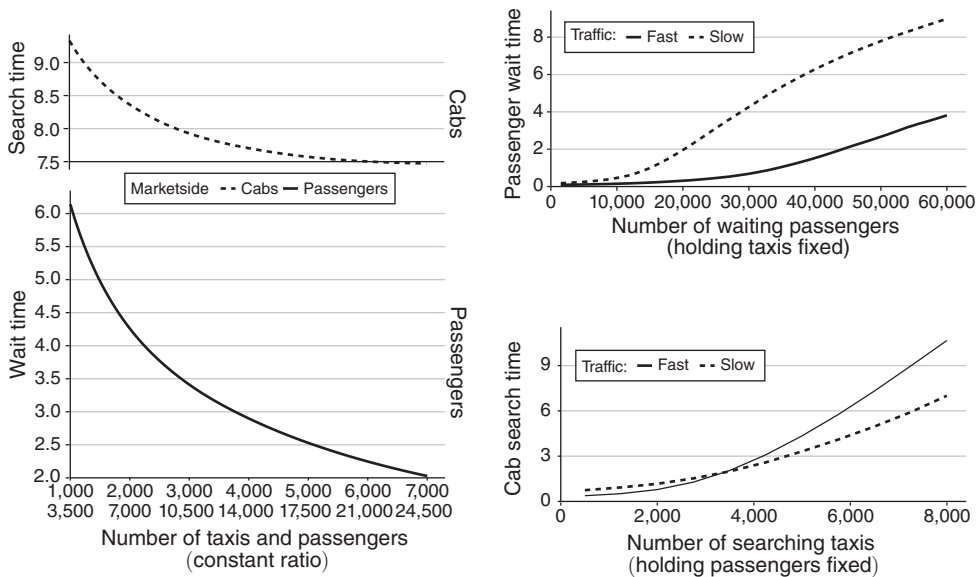


FIGURE 6. GRAPHICAL ILLUSTRATION OF MATCHING FUNCTION

simulation simply generates an approximation of  $g(\cdot)$  for any point in its domain.<sup>33</sup> As long as the simulation approximates the true matching process closely enough, we can use  $\hat{g}$  to back out  $d_t$  for each combination of hourly averages of search time  $s_t$ , number of taxis  $c_t$ , traffic speed, and trip distance observed in the data. Once the number of passengers is known we can insert it into  $\hat{g}$  to determine wait time  $w_t$  as well. Additional details on the simulation, including the algorithm, are provided in online Appendix D.

*Properties of the Matching Function.*—Figure 6 graphically illustrates properties of the matching function. The figure on the left shows what happens to wait time and search time as the market becomes thicker. On the horizontal axis, the number of taxis and passengers vary while keeping constant the ratio between the two. Both passenger wait time and search time decrease as the market becomes thicker, but the improvements decrease relatively quickly. For the numbers observed during the late hours of the night, the returns to additional thickness are substantial. By contrast, at the scale corresponding to the average number of daily taxis in the data (approximately 7,800 when averaging over the entire 24 hours), additional returns to market

<sup>33</sup> Due to computational limitations, performing this simulation for each point in the domain of  $g$  is not feasible. For example, if we assume that in an hour there are at most 70,000 passengers waiting, and multiply this number by the maximal number of medallions, we would already obtain 945 million different points in the domain. Furthermore, there is variation in  $\phi$ . We therefore simulate  $g$  for a lower number of grid points, and we interpolate linearly between those points to obtain the image for points in between. For each of the four independent variables of  $g(\cdot)$ , we pick eight different evenly spaced grid points. Because the outcome of the matching process is random, we have to repeat the simulation multiple times for each of those points. In practice, we have found that the average of these simulations does not change much after ten iterations, which is therefore what we use to produce this average.

thickness are fairly small, especially regarding search time. For a city with low density, however, increasing returns would be significant at all hours of the day.<sup>34</sup>

All of this richness, which arises naturally from the physical structure of the matching process, would be missed by assuming the standard matching function. In particular, the variation in returns to scale across different times of the day might have easily been missed under a parametric specification. Because density is a crucial feature of this market, and an important ingredient in evaluating the impact of various changes in the market as discussed in our counterfactuals, we view our departure from standard parametric assumptions as a strength of our approach.

The figures on the right give a sense of how market *tightness* affects outcomes for taxis and passengers. In the top-right panel, the number of passengers is increased while holding fixed the number of taxis at the median observed in the data. In the bottom-right panel, the number of taxis varies, holding fixed the number of passengers at the median. Both figures also display level changes due to differences in traffic speed, one of the exogenous inputs to the matching function. The dotted line is obtained under a traffic speed that is one standard deviation below the median, and the solid line is for a traffic speed that is one standard deviation above the median. Although a faster traffic speed is unequivocally good for passengers, two contrasting effects exist for cabs. On the one hand, faster traffic speed allows an individual cab to more quickly reach a waiting passenger, thereby reducing search time. On the other hand, faster traffic speed speeds up aggregate deliveries of passengers, and therefore leads to an increase in competition, effectively increasing the number of available cabs. At the median number of observed passengers, the latter effect outweighs the former at less than 3,000 cabs.

Figure 7 displays the wait time and the number of passengers for an average weekday as well as the number of passengers for an entire average week that is inferred from our demand recovery. The passenger figures confirm an expected pattern of strong rush-hour demand in the morning and evening hours on all weekdays. We find that demand is lower on Sundays than during weekdays, and no clear division exists between morning and evening rush hours. This, again, appears to be reasonable. One can see that the wait time in the morning rush hour spikes exactly when demand peaks between the hours of 7 AM and 10 AM. This finding stands in contrast to the peak in wait time in the evening that occurs at 5 PM, before the spike in demand occurring at 7 PM. We believe that the reason for this pattern is the coordinated shift change (witching hour) that spills over beyond 5 PM and leads to the more unfavorable ratio of active cabs to searching passengers.

To provide additional validation for the results of our demand recovery, we consider the effect of weather shocks, one of the important demand shifters in this market. Table 10 in the online Appendix shows that our inferred wait times and demand are both highly correlated with rainfall shocks, an external source of data that was not used in the initial demand recovery.

<sup>34</sup> Regarding the number of matches, we consider a 10 percent increase for both taxis and passengers. If this increase is applied to the numbers we observe late at night (2,000 cabs, 5,000 passengers), the resulting number of matches increases by 11 percent, so that the matching function displays modest increasing returns. When instead we scale it to something closer to the daytime numbers (10,000 cabs, 25,000 passengers), then we obtain a 9.8 percent increase in the number of matches, implying, if anything, a slight level of decreasing returns for matches at these higher values.



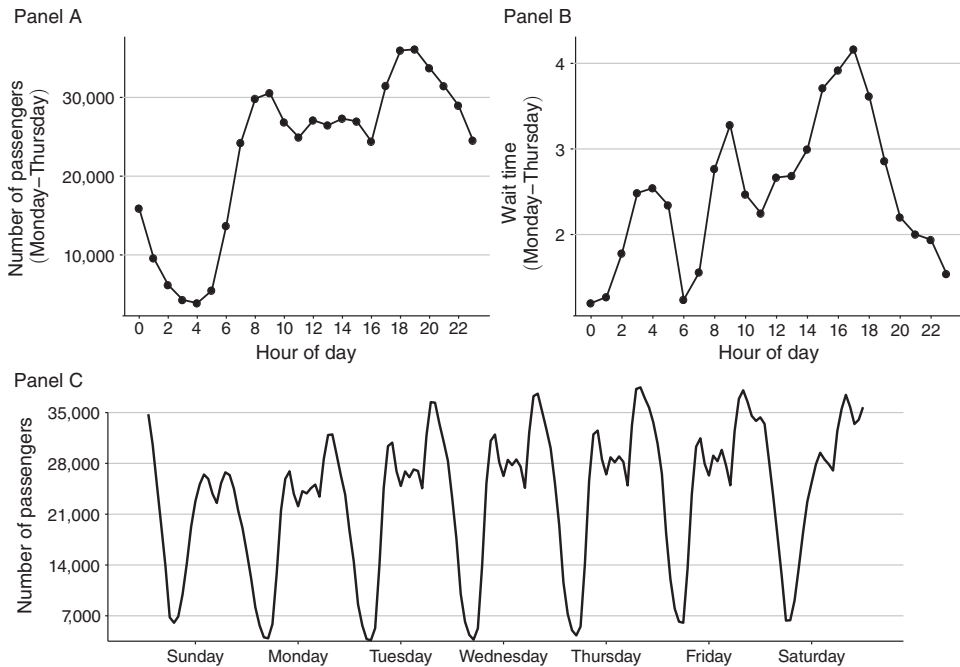


FIGURE 7. GRAPHICAL RESULTS OF DEMAND AND WAIT TIME

*Estimating the Demand Function.*—We now proceed to estimate a demand function that relates the number of passengers to wait time. We do not explicitly model the passenger choice problem among modes of transportation or whether to travel at all.<sup>35</sup> Our demand function has a similar interpretation to the standard case: some consumers will not travel by taxi because the realized price (wait time) is too high, whereas others do choose to travel. We assume a constant elasticity demand function of the following form:<sup>36</sup>

$$(2) \quad d_t = \exp\left(\beta_0 + \sum_{h_t} \beta_{h_t} \cdot \mathbf{1}\{h_t\} + \mathbf{x}_t \cdot \beta_x\right) \cdot w_t^\eta \cdot \exp(\xi_t).$$

The multiplicative component  $\exp(\beta_0 + \sum_{h_t} \beta_{h_t} \cdot \mathbf{1}\{h_t\} + \mathbf{x}_t \cdot \beta_x)$  captures observed exogenous factors that may shift demand, as well as persistent unobserved components through dummy variables, and  $\xi_t$  captures *unobserved* time-varying conditions that shift demand. The main parameter of interest is  $\eta$ , the elasticity of demand with respect to wait time. Taking logs, demand can be estimated as a linear model,

$$(3) \quad \log(d_t) = \beta_0 + \sum_{h_t} \beta_{h_t} \cdot \mathbf{1}\{h_t\} + \mathbf{x}_t \cdot \beta_x + \eta \cdot \log(w_t) + \xi_t.$$

<sup>35</sup>This absence of choice model is not an issue for the counterfactuals that we consider. We do discuss how demand is related to determinants of outside options such as subway functioning and weather.

<sup>36</sup>Because we break up the data at the hourly levels and only use a subset of weekdays, we are left with slightly more than 1,500 observations. The assumption of log-linearity is not unusual for this type of problem; see, for example, Kalouptsi (2014).

TABLE 1—DEMAND ESTIMATION

	$\log(w_t)$	$\log(d_t)$
Shift instrument	0.179 (0.00762)	
$\log(w_t)$		-1.225 (0.0601)
Observations	1,531	1,531
2-hour fixed effects	Yes	Yes
$R^2$	0.572	0.637

*Notes:* All regressions are based on our subset of 2011–2012 TPEP data, excluding Fridays, Saturdays, and Sundays. An observation consists of an hourly average over all trips in that hour. Standard errors clustered at the date level.

A potential problem is that the wait time itself is a function of the number of passengers as well as the number of cab drivers. In particular, unobserved factors that shift demand will directly affect  $w_t$ . Furthermore, drivers may condition their decisions on factors included in the error term  $\xi_t$ , which would lead to a decrease in wait time. For both of these reasons, the error term  $\xi_t$  and the wait time  $w_t$  may be correlated. This correlation would, of course, introduce a bias in the estimation of  $\eta$ . To address this concern, we instrument for wait time. We need a variable that is correlated with wait time and that affects demand only through wait time. A supply shifter satisfies this requirement.

We make use of the shift change (or witching hour) as a supply shifter. In online Appendix I, we argue that the shift change is timed so that the day shift and the night shift have similar returns on average. This equalization ensures both shifts are attractive to potential drivers.<sup>37</sup> Thus, the timing of the shift change is not chosen to accommodate hourly demand shocks.<sup>38</sup>

Although we do not consider an explicit model of consumer choice, we have made an effort to validate our demand estimates with data on subway rides, which is the other major form of transportation in Manhattan.<sup>39</sup> Because the data on subway rides are only measured at four-hour intervals, we aggregate data at a daily level. For the validation, we compute the expected number of subway rides conditional on weekday, month, and year fixed effects and we consider the residuals of these regressions as measure departures from routine subway travel conditions. We

<sup>37</sup> Because fleets face caps on the lease rates they can charge to drivers, an excess supply of drivers in one shift does not lead to a higher ability to charge more for leasing a taxi during that shift. Additional explanation is provided in online Appendix I.

<sup>38</sup> The shift changes occur from 5 AM to 7 AM and 3 PM to 5 PM. We have also experimented with another instrument: the lagged number of active taxis (every hour up to six hours before). As we argue in detail in our supply-side model, hourly supply is determined by drivers' longer-term decisions involving starting and ending a shift. Early starting and stopping decisions therefore respond to unobserved shocks that are different from later ones. Supply decisions that respond to these shocks will nevertheless shift supply in later hours. For example, drivers who have made decisions to start because early hours are profitable have sunk the entry cost and will tend to remain on the shift later even if subsequent hours are not particularly profitable. From this instrument we get an elasticity of  $-0.7$  ( $p < 0.001$ ). Although our main instrument is coarser, we opted not to focus on this one as the shift change instrument seems more clearly exogenous.

<sup>39</sup> In related work in progress Buchholz et al. (2019) report hourly demand elasticities with respect to wait time. Their data allow them to observe trip-level waiting times and therefore allow them to obtain clean estimates of hourly elasticities. For the daytime, the values range between  $-1.01$  and  $-0.83$  which is not a lot of intra-day variation and are relatively close to the estimates we find with our shift-change instrument.

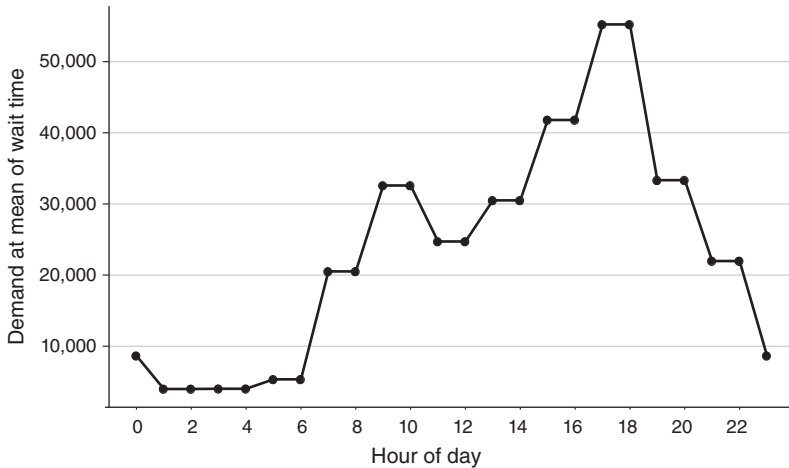


FIGURE 8. DEMAND FUNCTION EVALUATED AT THE MEAN OF WAIT TIME

take two approaches to verify the robustness of our results. First, we include these residuals as controls in our specifications. This inclusion has no discernible effect on our results. Our second approach uses the idea that the left tail of the residual distribution from this regression can be interpreted as a shortfall in subway rides, possibly due to delays or breakdowns. Conditioning our demand estimation on the data corresponding to the lowest 20 percent of residuals, we find that, as expected, at these times, demand is slightly less elastic, but that the average elasticities (computing these regressions on both subsets and then taking the weighted average of the two elasticities) is very similar to the one we obtain without conditioning.<sup>40</sup>

Figure 8 shows what demand would be if the wait time were held fixed at the daily mean throughout the day. This finding highlights how the inelastic portion of demand is varying throughout the day. In other words, it is a representation of predictable hourly variation in demand. All else being equal, demand would be highest in the evening hours between 5 PM and 7 PM and lowest in the morning hours from 12 AM to 6 AM.

### B. Supply-Side Model

Agents make their decisions in discrete hourly intervals; for each time point  $t$  in our data,  $h_t$  denotes the hour of the day from the set  $H = \{0, \dots, 23\}$ . We interpret  $h_t$  as representative hours of a weekday. At each time point  $t$ ,  $N_t$  medallions are active and  $M_t$  are inactive summing up to the total number (13,520) of medallions issued by the city. Each hour an empty medallion is probabilistically filled with a driver, depending on the outside option of drivers and their entry decisions. At each hour, active drivers choose whether to stop or continue driving. As mentioned above, we focus on Monday through Thursday.

<sup>40</sup>Estimating the specification of Table 1 on the subset of days with the lowest 20 percent of residuals from the subway regression reduces elasticities from  $-1.225$  to  $-1.19$ . For the purpose of our counterfactuals, we are interested in the average elasticity in a stationary market environment, which is almost unaffected ( $-1.224$ ) by the omission of other transportation options. We have also considered other values for the cutoff of the residuals and results are not very sensitive to this definition.

*Accounting for Observed Medallion Heterogeneity.*—The model incorporates the main regulatory and organizational constraints imposed by the medallion system that we discussed in Section II. In Section II and Section III, we highlighted the fact that minifleet medallions are more heavily utilized than owner-operated medallions, and are also slightly more likely to transition between shifts at 5 PM. For a driver  $i$ , the index  $z_i \in \{Fleet, Own\}$  denotes the ownership type of the medallion. The model parameters are allowed to differ by ownership type.<sup>41</sup>

In addition to ownership-type heterogeneity, the model incorporates the observed heterogeneity in the shift transitions. We capture this heterogeneity in the model by first classifying medallions according to a coarser set of transition patterns than what is observed in the data. We allow each medallion to have one of four morning transition times (3 AM–6 AM) and one of four evening transition times (2 PM–5 PM). Thus, there are in total 16 possible shift-transition times. Each medallion is then assigned to the transition time that most closely resembles its transition pattern. We index medallions according to their group ( $k_i \in K$ ). The relevance of these transition times is the following. We know that drivers have to pay fines if they return the car after the designated end of their shift. These fines exist to ensure drivers do not operate the cab longer than contractually specified. Because fines are not directly observable to us, we estimate them as parameters. The transition types determine at what hours a driver of a particular medallion has to pay the fines, should it drive during the hours in which fines are active.

If, for example, the most common transition time in the morning from night to day-shift (as measured by the modal transition hour) is 5 AM, we assume a driver has to pay a fine for handing in the medallion later than this.<sup>42</sup>

*Optimal Stopping for Active Drivers.*—We first discuss the optimal stopping decision for a driver who is already on a shift, and then we discuss the decision to start a shift. At the beginning of each hour, the driver decides whether he wants to collect the flow payoff from driving plus the continuation value of an active shift, or the random value of an outside option.<sup>43</sup> The state vector is given by  $\mathbf{x}_{it} = (h_t, l_{it}, z_i, k_i)$ , which includes the hour of the day,  $h_t$ , the number of hours the driver has been on a shift,  $l_{it}$ , as well as an idiosyncratic unobservable vector,  $\epsilon_{it} = (\epsilon_{it0}, \epsilon_{it1})$ , assumed to be distributed according to i.i.d. *TIEV* distributions with scale parameter  $\sigma_\epsilon$ .<sup>44</sup> Note  $h_t$  as well as  $l_{it}$  evolve deterministically and that  $z_i$  and  $k_i$  do not change over time. Therefore, the only random component is  $\epsilon_{it}$ .

<sup>41</sup>We could alternatively impose that cost parameters are the same for minifleets and owner-operated medallions, but minifleets have a deeper pool of drivers to draw from. This is essentially an equivalent problem and we expect that our results would be robust to this alternative approach.

<sup>42</sup>Transition times are in principle endogenous, and one could imagine these times take into consideration daily variation in the value of day shifts and night shifts to time the transition in a negotiation process. Such a fully endogenous model is currently outside the scope of this paper. However, as we argue in online Appendix I, the current regulatory arrangements limit the flexibility of transitions. Furthermore, as we show in online Appendix Figure 16, the transition types we specify account for a large fraction of observed transition patterns.

<sup>43</sup>We assume no discounting because decisions occur hourly. In the estimation, the maximal shift length that we allow is 13 hours, which is longer than the regulatory maximum of 12 hours and is surpassed in the data only in very few cases.

<sup>44</sup>Thus, we do not include any persistence in these hourly shocks. The model could be modified to incorporate persistence but, as we will see below, this additional generality does not seem required in order to match the daily aggregate patterns of activity.

We specify a cost of driving,  $C_{z_i, h_t}(l_{it})$ , which is a function of  $l_{it}$  and therefore allows for a rising disamenity value as the shift progresses.<sup>45</sup> The parameters of this function are indexed both by the medallion type  $z_i$  and by the hour of the day  $h_t$ . We interpret this cost function as a combination of the hourly opportunity cost of driving, which may vary throughout the day, as well as the disutility of driving. We assume the cost function takes the following form:

$$C_{z_i, h_t}(l_{it}) = \lambda_{0, z_i, h_t} + \lambda_{1, z_i} \cdot l_{it} + \lambda_{2, z_i} \cdot l_{it}^2.$$
<sup>46</sup>

The fixed components,  $\lambda_{0, z_i, h_t}$ , take one of four possible values for each type  $z_i$ , depending on the time of day. The term  $f(h_t, k_i)$  is a fine that has to be paid in the event that the driver returns the taxi after the transition time; this time is obtained from the classification into types that we describe above.<sup>47</sup> A morning driver has to pay a fine  $f_{z_i}$  whenever he goes past the common night shift starting time and analogously for a night driver.<sup>48</sup> The fine is indexed by  $z_i$  to account for the fact that owner-operated medallions seem to have less stringent transition times. We denote by  $h_{k_i}$  the set of hours for which a driver of medallion  $k_i$  is subject to the fine when driving. We therefore have:  $f_{z_i}(h_t, k_i) = f_{z_i} \cdot \mathbf{1}\{h_t \in h_{k_i}\}$ . Putting all these ingredients together, the value function for a driver conditional on state  $x_{it} = (h_t, l_{it}, z_i, k_i)$  is given by

$$V(\mathbf{x}_{it}, \epsilon_{it}) = \max \left\{ \epsilon_{it0}, \pi_{h_t} - C_{z_i, h_t}(l_{it}) - f(h_t, k_i) + \epsilon_{it1} + E_{\epsilon_{i(t+1)}} \left[ V(\mathbf{x}_{i(t+1)}, \epsilon_{i(t+1)}) \right] \right\}.$$

As is well known, *TIEV* distributions for the error terms lead to closed-form expressions for the choice probabilities. We obtain the conditional stopping probabilities as

$$p(\mathbf{x}_{it}) = \frac{\exp\left(\frac{1}{\sigma_v}\right)}{\exp\left(\frac{1}{\sigma_v}\right) + \exp\left(\frac{\pi_{h_t} - C_{z_i, h_t}(l_{it}) - f(h_t, k_i) + E_{\epsilon_{i(t+1)}} \left[ V(\mathbf{x}_{i(t+1)}, \epsilon_{i(t+1)}) \right]}{\sigma_v}\right)}.$$

*Starting Decision for Idle Medallions.*—We now discuss the decision of whether to start a shift. For each hour  $t$  during which a medallion is inactive, a driver  $i$  has an opportunity to be matched with this medallion. He decides to enter if the value of driving, given optimal stopping behavior, is higher than his outside option. If he decides not to enter, the medallion will be available to another potential driver the following hour. We assume the utility from the outside option consists of a fixed

<sup>45</sup> Also note the cost function absorbs the fuel costs, but does not include time-varying components. We do not incorporate data on fuel expenses because there is little variation in fuel costs in our sample. We have verified that in our sample there is no significant relation between taxi activity and fuel costs.

<sup>46</sup> We have also explored a specification with higher-order polynomials, but it does not affect the results.

<sup>47</sup> Because shift transitions are approximately two hours long on average, the fine is imposed for those two hours.

<sup>48</sup> We view the fines as a reduced form of a potentially more complicated set of sanctions without explicitly modeling the many possible arrangements between drivers and owners. Unfortunately, we are not able to observe whether there are private arrangements to deviate from the regular transition patterns. We elaborate on the role of these fines when we discuss identification.

value  $\mu_z$  that depends on the medallion type and on whether it is a day or night shift, as well as an idiosyncratic random component  $v_{it0}$ . The utility of driving depends on the entire expected value of a shift (described below) as well as an idiosyncratic component  $v_{it1}$ . We assume  $v_{it0}$  and  $v_{it1}$  are i.i.d. random variables distributed according to a type 1 extreme value (TEV) with scale parameter  $\sigma_v$ .<sup>49</sup> Drivers also have to pay a daily rental fee  $r$  that depends on whether they drive during the day shift or the night shift. If they own the medallion, they have an opportunity cost of driving equal to  $r$ . We set  $r_{h_t}$  equal to the rate caps, which, according to anecdotal evidence, were always binding during the data period.<sup>50</sup> To summarize, the utility of the outside option is given by

$$u_{it0} = \mu_{h_t, z_i} + v_{it0},$$

and the utility of starting a shift is given by

$$u_{it1} = E_{\epsilon_{i(t+1)}} [V(\mathbf{x}_{i(t+1)}, \epsilon_{i(t+1)})] - r_{h_t} + v_{it1}.$$

Denoting by  $q(\mathbf{x}_{it})$  the probability that an inactive driver starts a shift at time  $t$ , conditional on state  $\mathbf{x}_{it}$ , we obtain

$$q(\mathbf{x}_{it}) = \frac{\exp\left(\left(E_{\epsilon_{i(t+1)}} [V(\mathbf{x}_{t+1}, \epsilon_{i(t+1)})] - r_{h_t}\right) / \sigma_v\right)}{\exp\left(\left(E_{\epsilon_{i(t+1)}} [V(\mathbf{x}_{t+1}, \epsilon_{i(t+1)})] - r_{h_t}\right) / \sigma_v\right) + \exp(\mu_{h_t} / \sigma_v)}.$$

*Equilibrium Definition.*—Hourly earnings,  $\pi_{h_t}$ , are determined by the equilibrium distributions of active medallions,  $c_{h_t}$ , and searching passengers,  $d_{h_t}$ .<sup>51</sup> The number of actively searching cabs and passengers ( $c_{h_t}$  and  $d_{h_t}$ ) determine wait times,  $w_{h_t}$ , and search time,  $s_{h_t}$  through  $g(\cdot)$ .

**DEFINITION 1:** A competitive equilibrium in the taxi market is a set:  $\{s_{h_t}, w_{h_t}, c_{h_t}, d_{h_t}, \pi_{h_t} : h_t \in H_t\}$ , such that

- (i)  $d_{h_t}$  results from the demand function  $d(\cdot)$  under the wait time  $w_{h_t}$ ,
- (ii)  $s_{h_t}$  and  $w_{h_t}$  result from  $d_{h_t}$  and  $c_{h_t}$  under the matching function  $g(\cdot)$ .
- (iii)  $c_{h_t}$  results from optimal starting and stopping under  $\pi_{h_t}$ .

<sup>49</sup>The scale parameter  $\sigma_v$  is identified because  $E_{\epsilon_t}[V(\mathbf{x}_{t+1})]$  is a given value from the stopping problem and not pre-multiplied by any parameter.

<sup>50</sup>Recall that the sample period precedes the time when Uber entry became substantial in NYC. By 2015, rental rate caps were likely no longer binding. In our discussion of counterfactuals, we discuss how the endogenous determination of lease rates may change our results.

<sup>51</sup>Hourly earnings are determined as  $\frac{e(\text{miles, mph})}{e(\text{miles, mph}) + s(d, c, \text{miles, mph})} \cdot 60 \cdot \pi^0$ , where  $e$  is the expected trip length, and  $\pi^0$  is the rate that drivers earn per minute of driving. Search time,  $s$ , is determined under the matching function  $g(d, c, \text{miles, mph})$ .

(iv)  $\pi_{h_t}$  results from  $s_{h_t}$ .

The idiosyncratic uncertainty on the supply side, such as the random outside options, averages out across the large number of taxis.<sup>52</sup> We do not allow for autocorrelation in the shocks or earnings. In fact, it turns out that most of the variation in demand and wait time is explained by hourly fixed effects. The same is true for search time.

### C. Identification of Supply-Side Parameters

In this section, we briefly discuss how the primitives of the model are identified.

We need to identify six main objects: (i) cost-function terms that vary with the duration of the shift, (ii) an hourly fixed component of the cost function, (iii) the fines, (iv) the standard deviation of the hourly outside option, (v) the mean of the daily outside option, and (vi) the standard deviation of the daily outside option.

The identification of (i) can be best understood by using backward induction for the driver's decision problem. At the maximum allowed shift length of 13 hours, the continuation value is zero; thus, the driver only compares expected income in that last hour against the cost of driving. The value of the cost function for  $l_{\max}$  is therefore determined to match the expected earning in the last shift hour, which is a data object. Once the value of the cost function in the last hour is identified, it determines the continuation value from the perspective of the preceding hour. Hence, the second to last value of the cost function is identified: earnings in that hour and the continuation value are composed of data and identified objects. We can repeat the argument until we reach the first hour of the shift. However, (ii) is also dependent on the hour of the day. This part of the cost function is identified by systematic intertemporal variation in the stopping probabilities throughout the day after conditioning on shift-length and earnings. For example, the stopping probability increases sharply after 12 PM, even though no contemporaneous sharp decline in earnings occurs. This kind of variation in the data identifies the differences in the values of  $\lambda_0$ .

Object (iii) is identified by the increase in the stopping probabilities at shift-transition times independently of the length of time a driver has been on a shift. While drivers' shift lengths vary, the arrangements with other drivers are very consistent, and transitions occur mostly at the same hours. This is the data feature that we would have difficulty explaining without the fines. For instance, we frequently observe that some drivers start their day shift late, around 12 PM, let's say, and then hand over the car to the next driver at four before the night shift starts. If stopping times were purely rationalized by shift length, this pervasive data pattern would not be replicated by our model. In aggregate, our model would predict that too few people stop at the hours 1 PM, 2 PM, etc. To illustrate this point further, online Appendix J shows that stopping probabilities rise during 3 AM–6 AM and 2 PM–5 PM even for short shifts.

<sup>52</sup>Since we are interested in aggregate market condition, over the entire city, we use the simple concept of a competitive equilibrium. This distinguishes our work from settings with many firms where firms still have some market power, in which case an equilibrium concept such as Weintraub, Benkard, and Van Roy (2008) would be more appropriate.

Object (iv) is identified by the variation in earnings. This concludes the identification of the value function, which can be treated as a known object for the discussion of the primitives of the entry decision. The varying values throughout the day of  $E_{\epsilon_{i(t+1)}} \left[ V(\mathbf{x}_{i(t+1)}, \epsilon_{i(t+1)}) \right] - r_{h_t}$ , which is composed of data and identified objects, identify the different values of  $\mu_{h_t}(v)$  and their dispersion, that is, the value of  $\sigma_v(v)$ . In online Appendix J we show the conditional choice probabilities.

#### D. Estimation

*Constructing the Data for Supply-Side Estimation.*—To estimate the model, the trip-based TPEP data have to be transformed into a shift dataset in which the unit of observation is a medallion-hour combination.

Shifts are defined following Farber (2008) as a consecutive sequence of trips, where breaks between two trips cannot be longer than five hours. This definition might sometimes lead to long breaks within a shift if the interval between two trips is long but shorter than five hours. We do not model breaks: instead, we call a break a gap between a drop-off and a pick-up that is longer than 45 minutes. We assume breaks to be an exogenous process, we estimate the likelihood of a break for each hour conditional on the state, and compute hourly earnings as the expected wage that is earned while searching for passengers, multiplied by the probability that the driver is not on a break.<sup>53</sup> Formatting the data this way leads to 9,562,892 medallion-hour observations during which medallions have been active in a shift as well as 5,747,837 medallion-hour observations during which medallions have been inactive. From these data we drop shifts that are only one hour long, which make up less than 0.3 percent of the active shift data.<sup>54</sup>

The search time relates the aggregate market conditions to the hourly earnings potential of drivers. Recall from the discussion above that earnings are a result of a combination of time-based and mile-based metering. We first calculate the *actual hourly based rate*  $\pi_t^0$  for each trip by dividing the total fare of each trip by the duration of a trip. These rates also include the tip that drivers earn. Because tips are only recorded for credit card transactions, we impute tips for trips that have been paid in cash.<sup>55</sup> For each hour, we also compute the average trip length as well as the average search time for a taxi to find a passenger. Before we compute these averages, all variables are winsorized at the 1 percent level to avoid them being driven by large outliers. The length of the ride  $e_t$  determines together with search time the effective number of taxis searching on the street as the ratio of search versus delivery time. If the average ride length in an hour is  $e_t$ , the average search time  $s_t$ , and there are  $c_t$  active cabs on a shift then the number of searching taxis is determined as  $c_t \cdot (s_t / (e_t + s_t))$ . Based on these hourly averages we can then compute a realization of the hourly wage rate as  $\pi_t = \pi_t^0 \cdot (e_t / (e_t + s_t))$ , that is, the actual hourly rate

<sup>53</sup>In online Appendix Section D.D3, we report that our results are robust to alternative definition of breaks.

<sup>54</sup>These disparate hours might be part of an interrupted longer shift and may not be captured by the shift definition used here.

<sup>55</sup>We first run a regression with hourly dummy variables predicting the tip rate for each hour of the day. We then use predicted rates to impute the tips for trips for which the tip is not observed. About 47 percent of all transactions are paid by credit card.



times the fraction of the time the driver is delivering a passenger as opposed to searching. Note that  $s_i$  is the search time and an endogenous variable, which will adjust in our counterfactual computations according to demand, supply, and the matching process.

*Estimation Procedure.*—For the estimation of supply-side parameters, which we denote by  $\theta$ , we make use of the fact that we can compute the supply-side problem as if it were a single-agent decision problem against given hourly equilibrium earnings  $\pi_t$ . In other words, because we observe equilibrium earnings directly in the data, we do not need to compute equilibria in the estimation. We also make use of the fact that the dynamic decision problem can be formulated as a constraint on the likelihood for starting and stopping probabilities of drivers. This approach is known as mathematical programming with equilibrium constraints (MPEC).<sup>56</sup>

In our case, constraints are derived from the assumption that the data are generated by a model of decentralized optimal starting and stopping decisions. MPEC allows the constraint imposed by the value function to be slack during the search but requires that it be satisfied for the final set of recovered parameters.<sup>57</sup>

We specify a likelihood objective function. For a driver  $j$ , we allow two different daily outside options  $\mu_{z_j}$ , one for the daytime shift, 5 AM to 5 PM, and one for the evening/night shift. We also allow the fine,  $f_{h_t, z_j}$ , to depend on whether the driver is on a night-shift,  $f_{0, z_j}$ , or a day-shift,  $f_{1, z_j}$ . The constant part of the cost function is allowed to take different values in four time intervals: from 12 AM to 5 AM, from 5 AM to 12 PM, and from 5 PM to 12 AM. The other two parameters of the cost function,  $\lambda_{1, z_j}$  and  $\lambda_{2, z_j}$ , are assumed to be time invariant. The remaining parameters are the standard deviation of the idiosyncratic shocks to the starting decision,  $\sigma_v$ , and to the stopping decision,  $\sigma_e$ . We require those to be the same across the two medallion types.

### E. Parameter Estimates

Table 2 gives an overview of the estimated parameters. Results are shown separately for minifleet and owner-operated medallions. Standard error calculations are bootstrapped: we drew 50 samples with replacement at the medallion level.

The mean values of the outside option for the night shift ( $\mu_{z_j, 0}$ ) and day shift ( $\mu_{z_j, 1}$ ) are estimated to be \$167.56 and \$174.98 for minifleet drivers, and \$179.27 and \$175.44 for owner-operators. As we discussed in the identification section, these values are pinned down by the values of starting a shift. The values for minifleets

<sup>56</sup>Su and Judd (2012) demonstrates the computational advantage of MPEC over nested fixed point computations (NFXP) in the classical example of Rust (1987) bus-engine-replacement problem. Applications of MPEC to demand models and dynamic oligopoly models can be found in, for example, Conlon (2010) and Dubé, Fox, and Su (2012). An intuitive explanation for the computational advantage of MPEC is that the constraints imposed by the economic model are not required to be satisfied at each evaluation of the objective function.

<sup>57</sup>Because the latter is a dynamic decision problem, one would normally iterate on the contraction mapping to solve for the value function for each parameter guess  $\theta$ . Note the literature provides suggestions that would avoid the NFXP, such as Bajari, Benkard, and Levin (2007), where value functions are forward simulated. A second advantage of MPEC is that it provides a convenient way of specifying an optimization problem in closed form, which allows the use of a state of the art nonlinear solver. In this paper, we use the JuMP solver interface (Lubin and Dunning 2013), which automatically computes the exact gradient of the objective function as well as the exact second-order derivatives.

TABLE 2—PARAMETER ESTIMATES

Parameter	Description	Minifleet ( $z_j = F$ )	Owner-operated ( $z_j = NF$ )
$\mu_{z_j,0}$	outside-option, 6 PM–4 AM	167.56 (16.31)	179.27 (16.61)
$\mu_{z_j,1}$	outside-option, 5 AM–5 PM	174.98 (16.889)	175.44 (16.918)
$f_{0,z_j}$	fine (night shift)	59.14 (3.613)	56.79 (3.911)
$f_{1,z_j}$	fine (day shift)	63.8 (3.507)	50.3 (2.863)
$\lambda_{0,z_j,0}$	fixed cost (1 AM–5 AM)	66.6 (2.383)	59.79 (2.253)
$\lambda_{0,z_j,1}$	fixed cost (6 AM–12 PM)	54.56 (1.355)	39.6 (0.934)
$\lambda_{0,z_j,2}$	fixed cost (1 PM–5 PM)	44.03 (1.083)	34.44 (0.947)
$\lambda_{0,z_j,3}$	fixed cost (6 PM–12 AM)	53.89 (1.084)	38.34 (0.784)
$\lambda_{1,z_j}$	linear cost coefficient	−9.68 (0.649)	−3.92 (0.434)
$\lambda_{2,z_j}$	quadratic cost coefficient	1.0 (0.064)	0.56 (0.046)
$\sigma_\epsilon$	SD i.i.d. hourly outside option	40.33 (2.448)	40.33 (2.448)
$\sigma_v$	SD i.i.d. daily outside option	37.3 (2.166)	37.3 (2.166)

Note: Standard errors in parentheses

are slightly lower, consistent with the descriptive evidence that fleet medallions are utilized more intensely. The estimated fines,  $f_{0,z_j}$  and  $f_{1,z_j}$ , are \$59.14 (night shifts) and \$63.8 (day shift) for minifleet medallions. For owner-operated medallions, the night-shift fine is \$56.79 and the day-shift fine is \$50.3. The fixed part of the cost function parameters for minifleets are estimated as \$66.6 from 1 AM to 5 AM, \$54.56 from 6 AM to 12 PM, \$44.03 from 1 PM to 5 PM, and \$53.89 from 6 PM to 12 AM. For owner-operated medallions, the corresponding values are \$59.79, \$39.6, \$34.44, and \$38.34. The linear parameter of the hourly increase in cost is estimated to be −\$9.68 for minifleet and −\$3.92 for owner-operated cabs; the quadratic parameters are 1.0 for minifleets and 0.56 for owner-operated medallions. Because the cost parameter values by themselves are not very informative about the shape of the cost function, we provide a graphical representation in Figure 9. The standard deviation of the hourly outside option is 40.33. The standard deviation of the daily outside option is 37.3.

*Discussion of Parameter Estimates.*—A few observations about the estimates are worth highlighting. As shown in online Appendix A, minifleet medallions follow the 5 AM to 5 PM shift pattern more stringently than owner-operated taxis. This pattern is reflected in the estimates. Figure 9 displays the cost functions for both fleets and owner-operated taxis at different times of the day.<sup>58</sup> The graph shows the cost functions for a typical day and night shift (starting at 5 AM and 5 PM respectively). Owner-operated medallions have higher costs but less convex cost functions, which leads to stopping behavior that is “smoother” than for minifleet medallions. It also means owner-operators have a higher percentage of short shifts.

To evaluate the value of the outside option, comparing it to average daily earnings is useful. The hourly wage distribution is centered around \$38.7 and a shift is on average 9.4 hours. Thus, expected earnings during a shift are approximately \$364. If

<sup>58</sup> A potential anomaly is the slightly decreasing costs at the beginning of a shift. This reflects higher stopping probability after one hour of driving than after two or three hours. We interpret these extremely short shifts as due to drivers discovering problems with the car or being assigned the wrong vehicle. After this, costs are increasing, except for the small blip for Fleet drivers, which occurs at the time where the intercept of the cost functions changes (which varies by time of day) on the typical day shift.

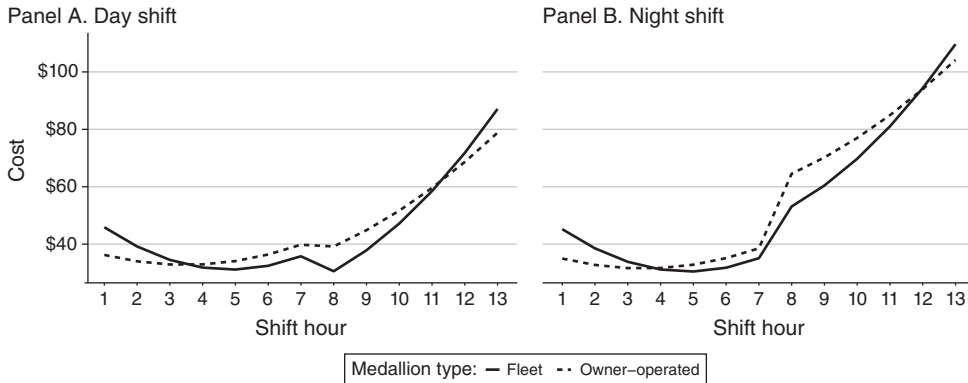


FIGURE 9. NIGHT AND DAY SHIFT COST FUNCTION

*Notes:* The graph shows the cost functions for a typical day and night shift (starting at 5 AM and 5 PM respectively). Note that the model allows the intercept to take on two values depending on time of day. Since the intercept varies not by hours on a shift but by time of day, this discontinuity might happen at a different shift duration value for a drivers who starts at a different point in time than those displayed.

we subtract the rental rate of \$112, we find that the outside option is not out of line relative the expected monetary value of the shift.

*Model Fit.*—To evaluate the model fit it is useful to transform aggregate drivers’ decisions into a law of motion for medallions. Medallions that are “available” for starting drivers are those that are un-utilized or in the last hour of their shift. The probability that an active medallion becomes inactive is given by the probability that the driver using it stops and that no other driver decides to use it in the same hour:  $\hat{p}^M(t) = \hat{p}(h_t) \cdot (1 - \hat{q}(h_t))$ . The probability that an inactive medallion becomes active is the probability that a driver starts utilizing an inactive medallion  $\hat{q}^M = \hat{q}(h_t)$ . The stopping probabilities unconditional on the hours on a shift are obtained from the conditional stopping probabilities. Let  $N_t$  be the number of inactive medallions and let  $M_t$  be the number of active medallions. The law of motion for medallions discretized into hourly intervals is:  $N_{t+1} = (1 - p_t^M) \cdot N_t + q_t^M \cdot M_t$  and  $M_{t+1} = (1 - q_t^M) \cdot M_t + p_t^M \cdot N_t$ .

The model fit for the aggregate law of motion is presented in Figure 10, which shows we are able to replicate the daily pattern of supply activity quite well.

### F. Labor-Supply Elasticity

We now discuss the supply elasticities implied by our model. Given the shift indivisibilities and the dynamic nature of the labor-supply problem, the supply responsiveness to earnings depends on the type of change (shock) to the earnings process we consider. We contrast a uniform (anticipated) increase in earnings throughout the day to an hour-specific (anticipated) increase that has the same normalized value, and we describe the response of total daily supply to each of these hourly shocks. Figure 11 displays the results. The uniform increase results in an elasticity estimate of 1.8, which, interestingly, is not too far from the number (1.2) reported in Angrist, Caldwell, and Hall (2017) in an experiment on Uber data.

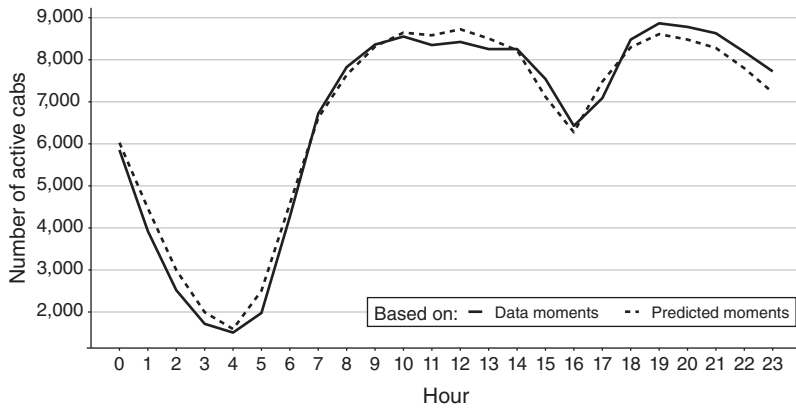


FIGURE 10. MODEL FIT

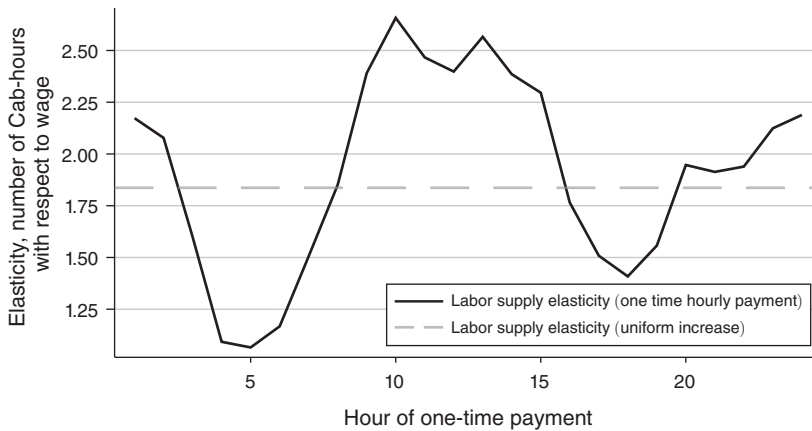


FIGURE 11. LABOR-SUPPLY ELASTICITY

The effect of the homogeneous daily increase is due to a combination of additional entry and longer continuation decisions, as continuation becomes more profitable at all hours relative to the (unchanged) outside options.

The response to hourly increases varies from 0.9 to 2.6 depending on the hour, with beginning- and end-of-shift elasticities lower than those for the middle of the shift. The reason for this heterogeneity in the responsiveness of total labor supply is complex, but we can highlight some of the forces at play. As we consider hourly increase later in the shift, two of the contrasting effects on labor supply are the following. The effect on daily entry decisions is highest for earnings increases in the first few hours of the shift. This is because the probability of actually receiving these earnings decreases as the shift becomes longer since the probability of stopping increases (due to both increasing costs as well as repeated exposure to hourly outside options). This effect works against later hours, which drivers are unlikely to reach. However, an earnings increase in hour  $t$  has an effect on all continuation decisions in hours prior to  $t$ , because of the expected future “bonus” at hour  $t$ . This effect penalizes earlier hours, although this is made more complicated by the fact

that the effects depends on the likelihood of reaching those hours. In addition to those, there is a “mechanical” effect from a “bonus” at time  $t$  that comes from the fact that now that a driver is active at hours they would not have been active otherwise, they may receive an increase in those hours that induces them to continue working. Finally, an additional effect at play and working against hours that are very close to the end of the shift is that the fines are a strong deterrent to ending a shift late, so we find little responsiveness of supply in those hours. All of these counter-vailing forces come together to create the non-monotonic relation between hours in a shift and elasticities.

Comparing the pattern of hourly supply elasticities in Figure 11 and of total taxi activity in Figure 10, it is apparent that there are some important differences. In particular, while supply in the early evening hours is high, the supply elasticity is relatively low. This is explained by the fact that earnings are especially high in the early evening hours.

## V. Counterfactual Experiments

As we argued earlier, two important sources of inefficiency in the taxi market are regulatory entry barriers and matching frictions. Part of the success of startup ride hailing services can be attributed to the fact that they address both of these inefficiencies.<sup>59</sup> Our counterfactuals attempt to distinguish the effects of additional entry from those of more efficient matching. We also investigate whether market segmentation between different operators may lead to inefficiencies: the introduction of a dispatch system à la Uber that only covers part of the market may reduce overall market thickness and lead to overall inferior outcomes in spite of an inherently superior dispatch platform. We then evaluate how matching frictions are affected by density: we discuss how outcomes change if we consider a city that is identical to Manhattan except that its passengers are spread over an area that is three times as large.<sup>60</sup>

For all counterfactuals, we highlight changes in the average number of active cabs, the number of passengers, hourly driver revenues, discounted medallion revenues, as well as consumer surplus (measured in minutes).<sup>61</sup>

Medallion revenue streams are obtained via simulation: we compute the number of times a medallion is rented out in a year in equilibrium and then use this number to compute the present discounted revenue under an annual interest rate of 5 percent. Revenues are averaged over the different types of medallions according to their observed fractions in the data.

All counterfactuals are computed in two steps. We first compute an equilibrium in which we fix demand. This scenario is then compared to the full counterfactual

<sup>59</sup> An additional effect is that surge pricing makes supply more responsive to demand shocks. We do not address this issue here.

<sup>60</sup> We expect the main qualitative insights that we obtain in this section to be robust, but some caution should be used in evaluating the magnitude that we report in our counterfactuals, as our model is fairly elaborate and does rely on a number of simplifying assumptions.

<sup>61</sup> Please note that the medallion revenues should not be confused with medallion price since we have no direct measure regulatory uncertainty, and cost variables associated with owning medallions. If we had been able to compute the full medallion prices from our model one could use observed medallion prices as additional identifying restrictions, such as in Heckman and Navarro (2007) and Kalouptsi, Scott, and Souza-Rodrigues (2015).

in which demand is allowed to adjust to changes in wait time. This computation highlights the impact of demand responsiveness to wait time.

The estimation did not require us to compute market equilibria because the supply-side parameters were estimated using the observed process of hourly earnings. For the counterfactuals, we have to address the challenge of equilibrium computation. We iteratively solve for the supply- and demand-side parameters, holding the variables of the respective other side of the market fixed until updates on both sides of the market fall below some specified tolerance. The exact algorithm is described in detail in online Appendix H.

Recall that in the estimation we set the daily lease rate a driver pays to rent a taxi equal to the binding rate cap. In the counterfactuals, we do not allow lease rates to adjust endogenously to changes in market conditions. This assumption is innocuous when we consider changes that improve drivers' earning, such as the universal dispatch counterfactual. In such cases, the lease cap would be even more binding. For the other counterfactuals, assuming the lease cap is still binding amounts to an assumption that the change is not large enough to move out of the region in which the rate cap is binding. Unfortunately, we do not have variation in the data that allows us to pin down where the lease cap would stop being binding. However, we acknowledge that for large changes, once the cap is no longer binding, lease rates would have to adjust to maintain drivers' entry unchanged. Thus, if we consider a change in market conditions that is large enough to affect lease rates, our model would potentially overstate the supply response because the adjustment in lease rates would moderate the negative effects on taxi aggregate supply. Stopping decisions would still be affected because for these decisions, the rental rate is sunk. (Lower lease rates would have an indirect offsetting effect through larger entry of reducing continuation earnings.)<sup>62</sup>

Our model does not account for the traffic externality and potential adverse environmental effects due to additional taxis on the street. Note, however, that when we view search times and wait times as measures of frictions, these times indirectly incorporate concerns such as congestion: if moving to a dispatch model reduces search time and wait time, this move also improves congestion because empty taxis that do not deliver any passengers contribute to congestion without any social value. Analogously, a policy that results in increases in wait time and search time can be viewed as having a negative contribution to congestion. Although environmental damage is hard to assess, the city recently investigated this issue and found that ride-hailing services are only a minor contributing factor to the recent decline in NYC traffic speed.<sup>63</sup> These findings stand in contrast to Mangrum and Molnar (2017), who document that the introduction of outer borough green cabs has led to a local decrease in traffic speed of about 9 percent.

<sup>62</sup>The natural model of lease determination would be one in which the market is competitive on both sides (fleets and drivers), with rental rates equating the supply (daily entry) of drivers with the demand for drivers. The demand for drivers should be completely inelastic because the number of medallions is fixed and investment in taxis is sunk.

<sup>63</sup>See <https://www1.nyc.gov/assets/operations/downloads/pdf/For-Hire-Vehicle-Transportation-Study.pdf>.

TABLE 3—COUNTERFACTUAL RESULTS

	Hourly active cabs	Hourly demand	Passenger wait time	Matches per day	Taxi search time	Hourly taxi revenues	Consumer surplus (minutes)	Medallion revenue
Baseline	6,785.0	23,592.0	2.58	20,898.63	7.62	40.37	1.66	1.53
Entry	7,386.0	25,530.0	2.43	22,633.47	7.69	40.21	1.74	1.52
Entry (% change)	8.86	8.22	-6.01	8.3	0.95	-0.39	4.99	-0.61
Entry (PE)	7,049.0	23,592.0	2.35	22,960.99	8.14	39.3	1.96	1.46
Entry (PE) (% change)	3.89	0.0	-8.87	9.87	6.84	-2.66	18.21	-4.59
Dispatch	7,434.0	24,739.0	2.53	23,457.65	6.96	42.22	1.77	1.65
Dispatch (%change)	9.57	4.87	-1.94	12.24	-8.65	4.57	6.89	7.64
Dispatch (PE)	7,121.0	23,592.0	2.6	23,525.06	7.45	41.41	1.84	1.59
Dispatch (PE) (% change)	4.95	0.0	0.58	12.57	-2.21	2.57	10.71	3.46
Segmented (50)	5,591.0	17,740.0	3.25	16,350.99	8.82	38.2	1.43	1.29
Segmented (50) (% change)	-17.6	-24.8	25.97	-21.76	15.74	-5.37	-14.17	-16.23
SegmentedEnd	5,377.0	21,725.0	2.78	20,319.2	9.5	37.8	1.66	1.26
SegmentedEnd (% change)	-20.75	-7.91	7.74	-2.77	24.59	-6.38	0.25	-17.93
Density	3,662.0	10,621.0	4.93	9,228.03	12.45	31.88	0.91	0.86
Density (% change)	-46.03	-54.98	90.96	-55.84	63.3	-21.03	-44.98	-43.67
DensityDispatch	6,534.0	20,675.0	2.89	19,613.32	8.04	39.7	1.61	1.5
DensityDispatch (% change)	-3.7	-12.36	12.1	-6.15	5.46	-1.67	-3.02	-2.29

*Notes:* The changes are a mean over all 24 hours of the day. The wait time and search time averages over hours are weighted by the number of trips, and the hourly driver profits are weighted by the number of active drivers across hours. *PE* means partial equilibrium and holds demand fixed to give a sense of how much the demand expansion changes counterfactual results. The percentage changes  $\Delta\%$  are the changes in the means over all hours compared to the baseline. Consumer surplus is computed under the assumption that the demand function is truncated above the maximal wait time observed in the data. The reason is that, for our parameter specifications, consumer surplus would be infinite if we integrated over all wait times. This issue results from the assumption of constant elasticity, log-linear demand. A similar issues arises, for example, in Wolak (1994), who also truncates the demand distribution. Note, however, that except for the limit case, the absolute difference in consumer surplus will be well defined and the same, no matter how high we choose the truncation point to be.

### A. Relaxing Entry Restrictions

To explore how additional entry affects the market, we consider a 10 percent increase in the number of medallions, from 13,500 to 14,850. To place this magnitude in context, note that Uber served 4 percent of the total number of trips in 2014 and 13 percent at the beginning of 2015.<sup>64</sup>

Table 3 describes counterfactual outcomes aggregated at the daily level. Changes for this counterfactual are of uniform sign at the hourly level, although the magnitudes for daytime versus nighttime responses are somewhat different. For instance, taxi activity changes less during the night. On average, taxi activity expands by 8.86 percent, which is proportionally less than the medallion increase, because earnings drop, causing drivers to work less. This increase in available taxis reduces wait time for passengers, and demand expands. On average, the expansion of demand is 8.22 percent, whereas the average reduction in wait time for passengers over all hours is 6.01 percent.<sup>65</sup> The demand expansion moderates the drop in taxi earnings caused by increased supply. This effect is sizable: if demand were held fixed, supply would only expand by 3.89 percent. The demand expansion almost completely compensates drivers for the additional competition: taking the mean over all changes in

<sup>64</sup> See <https://fivethirtyeight.com/features/uber-is-taking-millions-of-manhattan-rides-away-from-taxis/>. This report is based on data the city obtained from Uber for a traffic study.

<sup>65</sup> All averages across hours are weighted in proportion to the number of trips taken in each hour.

hourly income, the hourly wage of drivers decreases by only 0.39 percent. Earnings would instead fall by 2.66 percent if demand were held constant. The increase in the number of matches (or total number of trips) is 8.3 percent, which is very close to the increase in demand. The present discounted revenue stream for a medallion decreases only by 0.61 percent, which is a lot lower than if demand did not increase (in which case it would drop by 4.59 percent). Consumer surplus increases by roughly 5 percent and, perhaps surprisingly, would be higher without demand response. To understand this last result, note first that wait time drops a lot more when demand does not adjust than when it does. Second, the additional gain in the number of serviced trips when demand adjusts is relatively small. Thus, the gain in the infra-marginal trips that are already served in the scenario with no demand adjustment is larger.<sup>66</sup>

On a more speculative note, we have also explored what the socially optimal number of medallions would be. A social planner would ideally also adjust fares along with the number of medallions. However, this unconstrained planner's problem would require knowledge of the sensitivity of demand to price; and we do not have enough fare variation to gain information on this. However, we can conclude that if fares were fully flexible, then the optimal structure (absent considerations such as congestion) is to allow free entry. We can still compute the optimal number of medallions taking as given the current fare structure. Because we have measured consumer surplus in minutes and producer (driver) surplus in dollar terms, we first need to find a translation in order to make these consistent. We convert consumer wait time according to the median hourly wage in Manhattan. We also assume equal welfare weights on consumer and producer surplus. Under these assumptions, we find that the optimal number of medallions is approximately 21,000, i.e., about 55 percent higher than under the cap in 2012.<sup>67</sup>

### B. Improved Matching

*Universal Dispatcher.*—We now describe a counterfactual that considers an alternative matching technology: a dispatch platform that matches each empty (searching) cab with a waiting passenger. The dispatcher matches a passenger with the closest empty cab, if one is available within a one-mile radius.<sup>68</sup> This matching process is a natural alternative to the street-hailing system and approximates the one used, for instance, by Uber in its first years of operation. Ideally, a matching algorithm would not only search across empty taxis, but would also take into account the possibility that a soon-to-be-empty taxi may be closest to a passenger. Such an algorithm would be difficult to compute and is potentially difficult to implement, so we focus on a simpler case. But, because our dispatcher does not optimize in a forward-looking

<sup>66</sup>The same logic applies to the other counterfactuals.

<sup>67</sup>Allowing for flexible fares is likely to increase this number substantially. In our view, the two biggest caveats for interpreting this number are the following. (i) A sizable increase in the number of medallions may lead to significant externalities, such as traffic congestion and pollution, that we do not consider. (ii) The lease cap for rental rates for medallions may not be binding any longer for such a large increase in medallions. (iii) Passengers have higher than median wages, which would also mean a higher optimal number of medallions.

<sup>68</sup>Passengers who do not find an immediate match wait for taxis to become available. Taxis that are unmatched drive randomly until matched. For the dispatcher we also count the time it takes the taxi to get to the passenger as wait time and search time respectively.



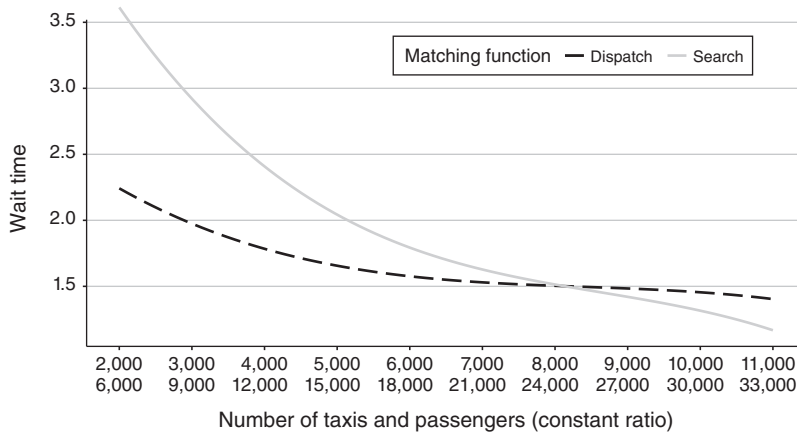


FIGURE 12. MATCHING FUNCTION COMPARISON

way, allowing for matches of passengers and cabs that are too far apart can be very costly. The restriction to a one-mile radius alleviates this problem.<sup>69</sup>

Before presenting the results, we discuss how the dispatch matching function differs from the matching function that results from the street-hail process that we have assumed so far and modeled in Section IVA. We describe some key features of a simulation of the dispatch matching function over a range of outcomes. Results are displayed in Figure 12. This figure considers what happens to passenger wait time as the market becomes thicker, that is, when we increase the market size (or density) while keeping constant the ratio of taxis to passengers. (Recall that a taxi serves multiple passengers within an hour.) Several features of this figure are worth noting. First, both matching functions display increasing returns, implying that as the market becomes thicker, wait time falls. Second, the dispatch matching function has a lower slope, implying that it is less sensitive to density. Third, for high values of density, the search matching function is superior so that wait times can become longer under dispatch when density is high. Point (iii) may be surprising, but it is closely related to the non-forward-looking nature of the dispatch platform: passengers may be better off waiting for a random cab that is currently delivering a passenger and therefore not available for dispatch. The street-hailing system implicitly incorporates this option value and therefore can be superior to the dispatch matching function.

We now describe results under the different dispatch scenarios, starting with the extreme case of the entire market operating under the dispatcher. Figure 13 gives

<sup>69</sup>The following extreme case illustrates why a pure spatial global search may not be optimal. Consider a scenario in which only one passenger is left waiting, only one empty cab is searching, and they are on opposite ends of the grid. The remaining cabs are delivering passengers. If the dispatcher were to commit them to a match, the chance is high that a better outcome could be obtained by waiting. The passenger is likely to obtain a faster match by waiting for one of the busy cabs to finish its trip and become available. Analogously, for the empty cab, a new passenger may appear on the map closer to its position. A dynamic algorithm that searches spatially as well as across time could account for these better match opportunities.

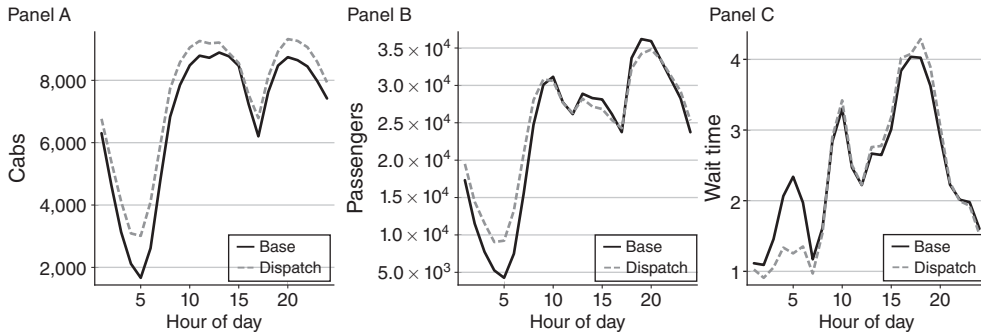


FIGURE 13. DISPATCH COUNTERFACTUAL

an overview of the changes across different hours. The panel for each respective variable shows the difference between what happens in the baseline case minus what happens in the counterfactual. In this counterfactual, the number of active taxis increases 9.57 percent, and the search time for taxis decreases substantially ( $-8.65$  percent). (If we did not allow for an expansion of demand in response to reduced wait times, the supply increase would, by contrast, only be 4.95 percent.) There is 4.87 percent more demand and the wait time for all passengers drops by 1.94 percent, consumer surplus increases by 6.89 percent, and the number of trips increases by 12.24 percent, more than proportionally to demand. The reason for the disproportionate change in consumer surplus and number of trips (successful matches) relative to demand is that fewer unmatched passengers are present. These passengers were previously unmatched because their wait time would have exceeded 20 minutes.<sup>70</sup> The value of medallions increases by 7.64 percent. To summarize, averaging across hours, all stakeholders benefit from the introduction of the dispatch technology, under the assumption that it is universally adopted.

### C. Partial Dispatching and Market Thickness

In reality, a new dispatch system is likely to only cover part of the market, at least initially. Thus, the introduction of a new matching technology may result in a segmentation of the market into multiple platforms. If consumers are divided between competing platforms, both segments of the market become thinner, which could potentially lead to losses in matching and wait time that could offset the improvements due to better matching within the dispatch platform.<sup>71</sup> To explore whether this outcome is plausible, we consider a scenario in which we divide the medallions equally across platforms: half operate on the search platform (baseline),

<sup>70</sup>We record the wait time of unmatched passengers as 20 minutes.

<sup>71</sup>In addition to segmenting the market between different platforms, Uber entry also added capacity to the market. We also considered a counterfactual that combines entry and market segmentation: 10 percent additional capacity is offered with a dispatch technology, whereas the remaining stock of taxis remains on the street-hailing system. The results of this counterfactual are a hybrid of the two separate counterfactuals. Consumer surplus and wait times improved relative to the baseline but less than if entry had all occurred on the street-hailing system as in our first counterfactual.

TABLE 4—DIFFERENT TYPES OF SEGMENTATION

	Baseline	Search/ Dispatch	$\Delta\%$	Search/ Search	$\Delta\%$	Dispatch/ Dispatch	$\Delta\%$
Consumer surplus (million minutes/day)	1.66	1.43	-14.17	1.2	-27.83	1.65	-0.86
Driver revenue (hourly income)	\$40.37	\$38.2	-5.37	\$33.85	-16.14	39.8	-1.41
Medallion revenue (PV in millions)	\$1.53	\$1.29	-16.23	\$1.09	-29.25	1.48	-3.22
Wait time (average in minutes)	2.58	3.25	25.97	3.92	52.03	2.84	10.02

half on the dispatch platform.<sup>72</sup> We assume both drivers and passengers are committed to a match: neither can cancel should another match option become available sooner.<sup>73</sup> We also first assume that passengers are exogenously assigned ex ante to one of the two platforms. We remove this assumption in what follows.

Online Appendix Figure A shows that the dispatch platform always serves more than 50 percent of the rides and that this share is highest during the night, where it can account for more than 60 percent of all rides. The advantage of the dispatch platform is due to the fact that it has lower wait times, and therefore, higher demand.<sup>74</sup> However, in the aggregate, compared to the baseline, the reduction in market thickness has negative consequences that more than offset the improved matching in the segment of market served by the dispatcher. Regardless of the hour, in the aggregate we see substantially fewer active cabs (-17.6 percent) and lower demand (-24.8 percent). Wait time and search time are much larger than baseline (+25.97 percent and +15.74 percent respectively).

To separate the respective roles of the market-thickness externality and of the dispatch platform, we perform the same exercise with two competing segmented dispatch platforms as well as with two competing street-hailing systems.<sup>75</sup> Table 4 presents the results of these scenarios.

The table shows that the two competing dispatch platforms perform substantially better, whereas the two competing search platforms deliver the worst outcomes. However, even the case with two competing dispatch platforms performs worse than the baseline, highlighting the importance of market thickness.<sup>76</sup>

Finally, we allow passengers to sort themselves endogenously into either the dispatch or the search platforms. Because we do not consider additional dimensions of heterogeneity across the two platforms, passenger choice must induce equal wait time across the two platforms. As more passengers move to the dispatch platform,

<sup>72</sup>For this step, we also divide up potential demand exogenously across platforms, by simply pre-multiplying the constant elasticity demand function  $d(w_i)$  by the shares of 0.5. This procedure ensures that if the wait time in the two platforms were the same, total demand would add up the baseline total demand. Realized demand, of course, depends on the wait time in the relevant platform. For the results we weigh wait times, driver earnings, and all the other variables by the respective hourly number of trips taken on both market sides and report those averages. The exception is medallion values, where we directly multiply the results by the respective share of issued medallions, in this case 50 percent of each type.

<sup>73</sup>For example, we do not allow a waiting passenger who is matched to a dispatch cab to accept a ride from a searching cab.

<sup>74</sup>The higher advantage of the dispatch platform in hours with lower demand density is related to the findings in Cramer and Krueger (2016) who show Uber's advantage in capacity utilization (defined as the fraction of time delivering passengers) is relatively minor in NYC but large in other cities that are less dense.

<sup>75</sup>This case is entirely hypothetical: what segmentation would mean for two street hailing platforms is not clear.

<sup>76</sup>One caveat of our analysis is that it does not take into account the potential difference in variance in wait times across platforms. It is likely that dispatch platforms deliver reduced uncertainty in wait times.

TABLE 5—DENSITY

	Baseline	Density	$\Delta\%$	Density dispatch	$\Delta\%$
Consumer surplus (million minutes/day)	1.65	0.91	-44.54	1.61	-3.02
Driver revenue (hourly income)	40.37	\$31.88	-21.59	\$39.68	-1.71
Medallion revenue (PV in millions)	1.53	\$0.86	-43.28	\$1.5	-2.33
Wait time (average in minutes)	2.6	4.93	90.1	2.89	12.07

it becomes more congested, while fewer passengers compete for the search taxis resulting in increased wait time for the dispatch platform and lower wait time for the search platform.<sup>77</sup> Line *SegmentedEnd* in Table 3 presents the results for this scenario. Compared to the case in which demand is segmented exogenously, substantially more market share is captured by the dispatch platform (especially during the nighttime). This increased penetration of the dispatch platform moderates some of the negative effects of the market-thickness externality for passengers but makes drivers worse off on average. On balance, however, the number of matches per day only drops by 2.77 percent compared to the baseline, much better than with exogenous demand division across platforms. Allowing passengers to choose also increases drivers earnings disparity, roughly doubling the earnings advantage that drivers on the dispatch platform enjoy.

#### D. Density Counterfactual

The last counterfactual explicitly addresses the spatial dimension of matching in this market. We now assume matching takes place in an area that is three times the area of our baseline simulation of Manhattan but is otherwise identical. This counterfactual emphasizes the role of geography. It shows how the market may function in less dense areas, such as more sparsely populated cities, or suburban areas. Of course, the counterfactual retains some of the basic functioning of the market which are in fact specific to NYC, but we believe that it is in fact informative. We first assume decentralized search (a street-hailing system) and compare outcomes in this less dense market to the baseline outcomes. We then introduce a universal dispatcher in order to evaluate how density affects the importance of the different matching technology. Table 5 reports the average welfare, driver income, medallion revenue and wait time in these two scenarios. This demonstrates the magnitude of the effects of density in our environment. For instance, wait time increases by 90 percent and driver revenue decreases by about 21 percent. However, the dispatcher has a much more sizable, positive effect in this low-density scenario, leading to a large improvement in all dimensions. Figure 14 displays the hourly number of active taxis, passengers, and wait time in these two scenarios compared to the baseline.

<sup>77</sup>For given numbers of taxis in the two platforms, this logic guarantees existence of such an indifference condition. In our setting, a complication arises because taxi supply is endogenous and therefore responds to this process. However, in the simulation, this endogeneity is not sufficient to lead to a corner solution.

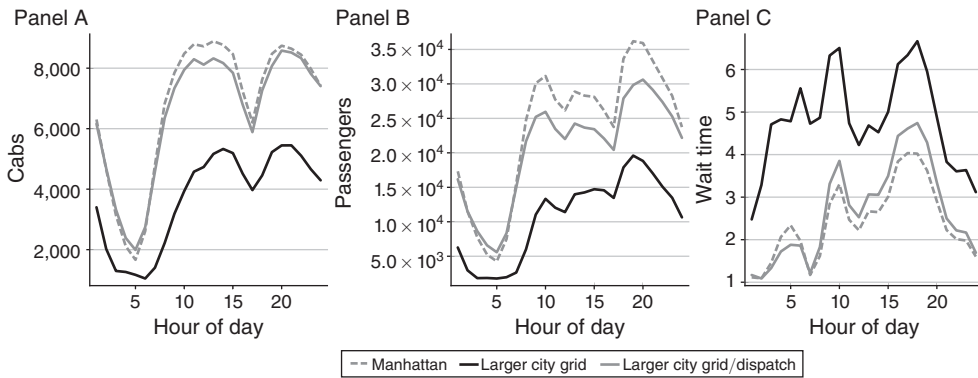


FIGURE 14. DENSITY INTRADAILY

## VI. Conclusion

This paper develops and estimates a dynamic equilibrium model of the NYC taxi market, which we use to understand the magnitude of the effects of entry restrictions and matching frictions. Drivers' hourly revenue is determined by the equilibrium number of searching cabs and waiting passengers, mediated by the time it takes to find the next passenger. Passengers' demand is affected by the wait time for a cab. To estimate the model, we first obtain a numerical representation of the matching function by explicitly modeling the geographic nature of the matching process. We then back out unobserved demand by inverting this matching function. The number of active taxis is determined by daily starting decisions and hourly stopping decisions given the anticipated level of earnings from the equilibrium level of cabs and passengers.

Counterfactual results from the model show that an improvement in the matching technology leads to substantial increases in consumers' welfare as well as drivers' earnings. However, our results also point to the fact that competition among dispatch platforms can lead to decreases in welfare because it leads to market segmentation and lower market thickness. Our analysis of segmented platforms is only suggestive, because the model does not incorporate any additional heterogeneity among the platforms and assumes exogenous assignments of drivers. Including such richness is not within the scope of the current paper but extending the analysis to study this issue in more depth would be interesting.

We have not considered the issue of surge pricing. To study this question, one would need to estimate a richer demand system that allows for dependence on both prices and wait time, allowing for correlation between consumers' responsiveness to wait time and to prices. Uber data may be helpful for studying such a question.

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