State Regulations and E-Commerce: The Case for Internet Casket Sales in Oklahoma*

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Death and taxes are the only two things which are inevitable in life. Although taxes fall naturally in the domain of economics, economists have paid scant attention to the death care industry, despite extensive regulation of the industry by the states. The potential exploitation of grieving family members provides the rationale for regulation of the industry, yet substantial anecdotal evidence of consumers= overpaying for funeral services under regulation abounds. Such allegations motivated the Federal Trade Commission to issue the Funeral Rule in 1984 to encourage price competition in the industry.

Caskets represent the largest single component of funeral costs. Funeral homes have traditionally sold caskets bundled with funeral services, but independent casket retailers have proliferated in the past decade. And with the emergence of e-commerce in the past decade, retailers now sell caskets via the Internet. As of 2002, ten states allowed only licensed funeral directors to sell caskets, preventing the entry of independent casket retailers in these states.

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Although the majority of policy attention regarding e-commerce has focused on taxation and the Internet (Goolsbee, 2001), e-commerce offers the prospect of undermining many anti-competitive state regulations (Mallinger, 2001).

I examine the effect of casket retailing on consumer welfare. I consider the extension of the rationale of protecting grieving consumers for funeral industry regulation to casket retailers. I contend that this offers an empty argument for consumer protection, and conclude that the entry of independent casket retailers is likely to yield substantial consumer benefits. I then examine evidence from the casket market in Oklahoma, a state which currently does not allow independent casket retailers. The Oklahoma market features high markups for caskets as well as considerable price dispersion. State regulation currently affords consumers little protection, so consumers, and even grieving consumers, would likely benefit from competition.

Protecting grieving consumers

I will first consider the protection of the grief-stricken consumer as a rationale for regulation of the funeral industry generally. I then consider the applicability of this argument to licensing casket sellers specifically.

Economics assumes that consumers in the bulk of their market activities are rational and self-interested. Consumers normally look out for their best interest as well as they can given the cost of acquiring information. Specifically economics assumes that consumers will purchase a homogeneous product from the seller offering the lowest price and will engage in rational search activity to find a good deal. Many people purchase funeral products and services immediately following the death of a loved one and due to emotional distress do not behave according to standard consumer theory. Such at-need consumers may emotionally be unable to engage in market search activity at this time. A grief-stricken consumer with little market information is likely to purchase all funeral products and services at one funeral home, often a home used previously by the family. Consequently the grief-stricken consumer is vulnerable to manipulation or exploitation by an unscrupulous supplier. A grief-stricken consumer might over pay for a funeral, since she is unaware of lower priced funeral homes in the market or due to misrepresentation of the legal requirements regarding funerals or the protective capability of expensive caskets. I take as given in this paper that protecting such vulnerable consumers is a worthy goal even though overpayment strictly speaking is a wealth transfer.

The case for regulation of the funeral industry turns on the effectiveness of market and regulatory mechanisms in protecting grief-stricken consumers. The supply of funeral services is similar to the supply of expert services; consumers in each case possess particularly limited information and tend to rely on the advice of sellers in making purchases. Repeat sales, a standard market mechanism of quality assurance, provide relative weak control of opportunistic behavior by sellers in this case because funeral purchases are infrequent. And although reputation plays an important role in the industry (McChesney, 1990), grief-stricken consumers may fail to search out funeral homes with good reputations. The licensing of funeral directors consequently could conceivably protect grief-stricken consumers. The cost of obtaining a funeral director=s license comprises a sunk investment which the director loses if he exits the business. The quasi-rents earned on the license provide a mechanism to discipline funeral directors; directors may refrain from overcharging or otherwise exploiting customers if they realize their director=s license will be revoked upon evidence of such opportunistic behavior.[1] The specific training required to become a funeral director does not in this case protect funeral consumers, but rather the sunk investment made by funeral directors. Requiring funeral directors to post a bond that would be forfeited upon evidence of opportunistic behavior provides a similar incentive.

Simply because licensing funeral directors could protect vulnerable consumers does not demonstrate that licensing actually serves this purpose. Occupational licensing often serves the interests of the regulated professions. The effort required to obtain the license creates a barrier to entry and reduces the number of suppliers (Friedman, 1962; Young, 1987). Revocation of a license can serve as

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[1]On the role of sunk investments in assuring contractual performance, see Klein and Leffler, 1981.

a punishment mechanism for enforcement of a regulatory cartel. Licensed professions also restrict forms of commercial behavior like advertising prices, which limits the potential gain for cartel breakers. And control of product and market information is an important element in successful demand inducement by professionals (Benham and Benham, 1975). Allowing only licensed funeral directors to sell caskets could facilitate a casket cartel through both a barrier to entry in the market and information control.

The benefits of funeral industry regulation depend on the proportion of customers who fit the grieving consumer model. A low proportion of grieving consumers limits the potential exploitation by funeral service providers and weakens the case for regulation. McChesney (1990) concludes based on surveys by the FTC and industry analysts that relatively few industry customers fit the grief-stricken consumer prototype. Many people purchase caskets and funeral services on a pre-need basis or pre-plan funeral arrangements, and relatives or friends can help make at-need arrangements. The surveys reveal that a high percentage of consumers felt they had sufficient information to make an informed purchase. Although McChesney argues that the FTC Funeral Rule was unnecessary, his argument actually applies to state licensing of funeral directors generally.[2]

[2]This also indicates that this consumer protection regulation actually benefits one group of consumers (the grief-stricken) at the expense of other consumers.

However one weighs the costs and benefits of funeral industry regulation, the grieving consumer rationale provides a highly dubious basis for only allowing licensed funeral directors to sell caskets. The formal training required to obtain a funeral director=s license amounts only to a sunk investment, and so is irrelevant; would-be casket retailers should willingly acquire any required training which actually facilitates selling caskets. Although the quasi-rents from the funeral directors= license provide an incentive to not take advantage of grief-stricken customers, this benefit is illusory when applied to casket retailers. Asymmetric information creates the potential for a funeral service provider to take advantage of a grief-stricken customer. The seller possesses the greatest information advantage when a grief-stricken customer visits only one funeral service provider. Casket retailers do not provide all funeral services, so customers purchasing a casket retail will necessarily still deal with a funeral director and funeral homes continue to sell caskets in states with independent casket retailers. Consequently casket retailers will not typically be the exclusive source of information concerning caskets to their customers. Funeral homes will undersell a casket retailer who prices caskets too high.[3] Alternatively, truly grief-stricken consumers will purchase all funeral goods and services at one funeral home. Grief-stricken consumers by definition do not comparison shop and thus few are likely to patronize casket retailers. A licensing mechanism applied to casket retailers will protect very few grief-stricken customers. On the other hand, the availability of additional casket retailers can only make price searching consumers better off.

Allowing entry by independent retailers will provide the greatest benefit to consumers when state funeral industry regulation supports an effective casket cartel. The ability to punish cheaters through license revocation is an important device in sustaining a cartel. State funeral directors lose the capability to punish all

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[3]Indeed the National Casket Retailers Association notes how casket retailers lose many sales to funeral homes who offer lower prices to price searching consumers (Brown 2002).

potential cartel breakers with independent cartel retailers.[4] Even grief-stricken consumers who never shop around will benefit from lower casket prices due to competition. In addition to lower prices, competition from casket retailers and particularly Internet retailers is likely to increase customer awareness of price dispersion. As Benham and Benham (1975) stress, a major effect of regulation of professions is to foster an environment in which consumers rely on professionals= advice and do not seek out other, possibly better deals. Advertising and price competition and advertising will lead more consumers to comparison shop for funeral services, reducing price differentials on other funeral services and merchandise besides caskets. The existence of more price searchers could reduce the overall price level and thus benefit grief-stricken consumers. E-commerce often produces such spillover benefits to customers who never venture on-line (Bakos, 2001). Since the casket is typically the largest component of funeral costs, the gains to consumers from deregulation of this segment of the market will also be correspondingly large.

[4] Elements of regulatory collusion could include disproportionately large markups on less expensive caskets or limits on the number of low priced caskets displayed.

How likely is a regulatory casket cartel in the absence of independent retailers? McChesney (1990) cites the importance of repeat business in the industry in arguing that funeral homes cannot readily overcharge customers for funeral services. Repeat sales are clearly a critical market force in assuring product quality (Klein and Leffler, 1981), but repeat sales may not work well as a discipline device in the highly regulated funeral industry. Darby and Karni (1973) emphasize that customers must recognize when a product or service fails to meet its expected quality for repeat sales to serve as a discipline device. Customers may be unable to observe when a funeral home exploits a grieving consumer. Consider the ways in which funeral homes might take advantage of customers. Misstatements of casket durability will not generally be verified because bodies are rarely exhumed. If people generally do not discuss casket and funeral costs, grief-stricken consumers may not realize they overpaid for a casket or that lower priced caskets were even available. Customers may not realize when they need to stop patronizing an establishment and continue to use the same funeral home over the years despite being overcharged. And a viable exit option is critical for the repeat sales mechanism (Horner 2002), so if all funeral homes participate in the regulatory cartel under threat of license revocation, consumers may be unable to find a funeral home that would not similarly overcharge them.

Restricting casket retailing might create a second cost to consumers. Funeral homes typically handle a relatively small number of funerals per year, yet each funeral home must display caskets. Sales restrictions could preclude realization of economies of scale in casket retailing. Specialized retailers with a large volume and wide variety of caskets might provide customers with better service at lower prices. Internet retailers often exploit economies in retailing (Borenstein and Saloner 2001); this would be especially true for casket retailers, because while few people might drive twenty miles to a casket superstore, many might view caskets and comparison shop online.[5]

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[5] Casket retail restrictions may conceivably serve as a vertical restraint to avoid independent retailers from free riding on the costly displays of caskets offered by

funeral homes. Clearly manufacturers sometimes impose such restraints on their retailers (Rubin 1990). But casket retailers could still impose such restraints on retailers who are not licensed funeral directors, and presumably do if needed in the majority of states which do not restrict casket retailing.

Whether Internet and independent casket retailers will benefit consumers depends in large part on the performance of the regulated funeral market without competition. I turn now to evidence on this point in the next section.

Regulation and the Oklahoma casket market

One way to examine the effect of casket licensing is through the cost of funerals. I have examined receipts of funeral homes from the 1997 Economic Census per state resident death. As of 1997, 13 states allowed only licensed funeral directors to sell caskets (Institute for Justice, 2001), but the prohibition was actually enforced in only eight states (National Association of Funeral Directors, 2002).[6] Receipts per death for the Funeral Homes SIC (#8122101) were $4506 in states with casket sales restrictions versus $4034 in states without this restriction, a difference of almost 12%, but the difference is not statistically significant. A more detailed regression analysis reveals that a casket sales restriction when combined with other state funeral industry regulations does significantly increase receipts per death (Sutter, 2004). In particular, casket sales restrictions combined with more years of training required obtain a funeral director=s license increase expenditures. Casket sales restrictions can lower consumer welfare even if funerals overall are no more expensive. Consumers may purchase lower quality caskets or spend less on other funeral expenses (flowers, grave markers, etc.) in response to high prices charged by a casket cartel to keep overall funeral costs unchanged. Regulation would still leave consumers with a less preferred bundle of funeral services.

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[6] The states were Alabama, Georgia, Louisiana, Mississippi, Oklahoma, South Carolina, Tennessee and Virginia.

Whether occupational licensing serves consumer or producer interest depends on the behavior of regulatory boards overseeing the industry. If boards never discipline practitioners, consumers receive little protection. The quasi-rents earned on the training required to obtain a funeral director=s license provides a performance bond against exploitation of grieving consumers only if the state board actually suspends or revokes the licenses of funeral directors upon receipt of complaints from grieving consumers who realize they were overcharged. Bentson (2003, p.20) notes, for instance, that the American Institute of Certified Public Accountants took disciplinary action against less than 20 percent of accountants sanctioned by the Securities and Exchange Commission.

Examination of complaints before the Oklahoma State Funeral Board thus provides evidence on the actual effect of licensing funeral directors. Records of the consumer complaints to the State Funeral Board were obtained for fiscal years 1998 to 2002. Licensed funeral directors have little to fear from customer complaints. A total of 186 complaints brought before the board, and 176 of these had been resolved by the end of fiscal year 2002. Very few funeral directors suffered severe penalties. Over these five years, 25 complaints resulted in fines, two funeral directors had their licenses suspended, and six had their licenses revoked. All of the license suspensions and revocations were the result of complaints regarding pre-need contracts or a funeral home not having a licensed director. Also most of the complaints which resulted in a fine or license revocation were brought by a state agency. The Oklahoma Insurance Commission, for instance, brought 19 complaints during the period examined, and 13 of their 18 resolved complaints resulted in fines and four in license revocation. Insurance Commission complaints were by far the most likely to result in a serious penalty. By comparison, two of six complaints by other state agencies, two of sixteen brought by funeral homes against other homes, and only 8 of 136 complaints brought by individuals resulted in a fine or license suspension or revocation. I additionally examined the complaints by type. The contract dispute and level of service seemed to correspond most closely to those likely to be filed by grief-stricken consumers who felt taken advantage of by funeral homes. A total of 55 complaints of these types were filed (all but three by individuals), but only three of the 49 resolved resulted in a fine against the funeral home, and no funeral director licenses were suspended or revoked as a result of these complaints. Other common types of disputes involved pre-need contracts (41), advertising (30), failure to have a licensed funeral director or embalmer (14) and solicitation of business (7). The behavior of the discipline board seems more consistent with a regulatory apparatus in place to protect funeral directors= interests.

Funeral homes in Oklahoma charge high prices for caskets. Price lists were obtained in April 2002 from fourteen funeral homes in the Oklahoma City and Tulsa metro areas as well as an Oklahoma based on-line casket retailer, Memorial Concepts Online. I identified 129 instances of caskets listed on one or more of the funeral home price lists which were also listed on Memorial Concepts Online=s website. The funeral homes= caskets were priced an average of 68% higher than the Internet retailer, indicating the potentially large savings available to consumers from competition in the casket market. Clearly many Oklahoma funeral homes sell caskets at prices well above cost under state regulation. In general, prices of goods offered for sale over the Internet are lower than the same products offered by bricks and mortar retailers (Koch and Cebula, 2002; Bakos, 2001), but the price difference here under regulation exceeds those reported for many unregulated products.

Price dispersion is another feature of the Oklahoma casket market. I identified thirty casket models listed on two or more funeral homes= price lists. For each casket I computed the price spread as a percentage of the lowest price for the model. The average price spread across the thirty different models of caskets was 52%; clearly the law of one price does not hold in this regulated market. Price dispersion indicates that the current regulatory regime is not effectively protecting grief-stricken consumers. If the law of one price held, grief-stricken consumers would not pay more due to their lack of search effort; with price dispersion, those who happen to choose a high priced funeral home will pay more. In addition, funeral homes appear to list caskets on their price lists in a highly idiosyncratic manner. Some funeral homes describe caskets by color and type of materials, while other homes describe caskets by their own names. Given the concentration of the U.S. casket market by a handful of manufacturers, the funeral homes must be selling many of the same caskets. Idiosyncratic identification of caskets, as opposed to identification by manufacturer and model, raises search costs for consumers who do comparison shop. The FTC Funeral Rule requires funeral homes to provide customers with price lists on request, but the price lists provided (at least in Oklahoma) do not comply with the spirit of the Rule.

A final noteworthy feature was a lack of low priced caskets offered by several funeral homes. Five of the fourteen funeral homes surveyed did not list a single casket on their price list for less than $1000; three funeral homes did not list a single casket for less than $1500. Grief-stricken consumers who do not comparison shop may end up patronizing a funeral home without any low priced options and may never learn that a low priced casket was even an option.

Critics allege that funeral homes engage in a number of tactics to induce customers to spend more on a funeral (induce consumer demand), such as not displaying low priced caskets, or displaying low price caskets only in unattractive colors, or overstating the protective capabilities of caskets (Roberts, 1997). I find no evidence that regulation in Oklahoma prevents this. The FTC sought to counter alleged abuses by the regulated funeral industry with the Funeral Rule. And recently Harrington and Krynski (2002) found evidence of demand inducement by funeral directors in their examination of cremation rates; traditional burial is more lucrative than cremation and cremation rates were lower in states with more highly regulated funeral markets. State regulation seems to have the effect of benefit sellers at consumers= expense.

Conclusion

Protection of consumers has long been offered as a rationale for regulation of the funeral industry. The prospect of businesses taking advantage of grief-stricken consumers offends many people. But occupational licensing can and does often in practice promote producer interests. One component of funeral industry regulation is a provision in ten states allowing only licensed funeral directors to sell caskets. Such a restriction creates a barrier to entry in the casket market and facilitates a regulatory cartel.

An examination of the casket market in Oklahoma, one of the states which does not allow independent casket retailers, indicates that regulation has created an environment which does not actually protect grief-stricken consumers. Internet retailers can offer caskets for sale at prices well below the current prices of Oklahoma funeral homes. In addition, considerable price dispersion exists in the market, so grief-stricken consumers who do not comparison shop could easily end up paying 50% or more for the same casket. The failure of regulation to accomplish its stated purpose and the inapplicability of the consumer protection rational for funeral homes to independent casket retailers suggests that competition in the Internet age might protect casket consumers better than regulation.

The constitutionality of applying funeral director licensing requirements to independent casket retailers has been challenged by the Institute for Justice in a series of recent cases. Economic regulation is generally subject to only slight judicial review under the rational basis test that regulation bear some relation to a legitimate state purpose. As Bernard Siegan (1980, p.4) notes in the context of the 1976 Supreme Court decision in *New Orleans v. Dukes*, AThe federal High Court was concerned only that some reason existed for the city council=s passing of the ordinance - a standard that even the most derelict of lawmakers can meet.@ At issue is whether the extensive educational requirements of funeral directing - including in some states training in embalming bodies - are reasonably related to sales of caskets by individuals who do not conduct funerals. To date federal courts have been divided on the issue. State laws in Tennessee and Mississippi were struck down by U.S. District Courts in *Craigmiles v. Giles* and *Casket Royale v. Mississippi*, but Oklahoma=s law was upheld by the District Court in *Powers v. Harris*. The *Craigmiles* decision was upheld by the 6th Circuit Court of Appeals, while the *Powers* case has been heard by the 10th Circuit Court. This litigation may well end up providing the Supreme Court an opportunity to establish just how much economic rationality the rational basis standard requires.

Internet sellers of caskets face formidable challenges. Since at-need purchasers will require delivery of their casket within a couple of days. Consequently Internet casket retailers will need to carry larger inventories and face higher costs for prompt delivery. Indeed, for many e-commerce goods, the price differential relative to bricks and mortar retailers disappears when overnight delivery is required (Koch and Cebula, 2002). Internet casket retailers offer a relatively low cost way for at-need purchasers (or their friends and relatives) to search out lower prices for caskets, and this might further reduce the percentage if purchasers who fit the grief-stricken consumer mold, weakening the very basis for industry regulation. But if independent casket retailers fail in the market, consumers will be no worse off than they are now in the ten states that maintain regulatory casket cartels.

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