Are state regulations impeding innovation and harming consumers in this very meaningful sector of the economy?

Breathing Life into the Funeral Market

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Many of the articles that appear in this magazine describe how government regulation in various "high-profile" sectors of the economy can act as a barrier to innovation and an impediment to consumer choice. But regulatory protection of rents and the status quo can happen in almost any market, including ones that are not often discussed but are very important to us as human beings. One such example is the market for funeral-related goods and services.

Important changes are occurring in funeral markets, including the emergence of online sales of caskets and the growing popularity of cremation. However, one feature of funeral markets that has changed very little over the last half-century is the stringent regulation of those markets by many states. That raises several questions: What effects do state funeral regulations have on the changes that are occurring within funeral markets? In particular, are state funeral regulations impeding innovations such as buying caskets over the Internet? If so, what would be the benefit to consumers of allowing those innovations to occur?

STATE FUNERAL REGULATIONS

If you were to ask someone familiar with state funeral regulations whether those regulations are burying funeral market innovation, you would likely receive a chuckle and then a serious "Of course they are." That is because state funeral regulations impede the entry of new firms — especially those specializing in low-cost alternatives to the funerals sold by conventional funeral homes — by raising the cost of entry via facility requirements, training requirements, and prohibitions against anyone other than funeral directors licensed in the state from selling funeral goods and services. In short, they increase the market power of existing funeral homes by excluding rivals.

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State funeral regulations may also increase the market power of existing funeral homes by reducing the cost to funeral directors of making disparaging comments about funeral market innovations such as cremation or online caskets. Consider the experiences of Steve Costomiris, who wanted to buy an online casket for his mother's funeral in Connecticut, as reported in the Oct. 8, 1999 edition of *USA Today*. When he asked about online caskets, the funeral director tried to discourage him, saying, "Those things are made by prisoners." At another funeral home he was told, "I'm sorry we don't have any tin cans for you to look at." While Steve persisted and bought an online casket, many other consumers would probably conclude that it was hopeless and return to the most convenient funeral home. Hence, funeral directors who make disparaging comments about funeral market innovations are less likely to lose customers if they are in markets where other funeral directors make similar comments.

Funeral directors are likely to make similar comments where they have the same level of training as each other and work in funeral homes with similar facilities, leading them to have the same attitudes about and incentives for resisting funeral market innovations. Because many states force funeral homes to have a common set of facilities and funeral directors to have a high level of training, the regulations lead to less diversity in those inputs than occurs in unregulated states. As a result, it is not just state prohibitions against online casket sales that hinder their growth; it is the entire set of state funeral regulations that contribute to an environment that is hostile to the sale of online caskets.

OPENING THE CASKET MARKET

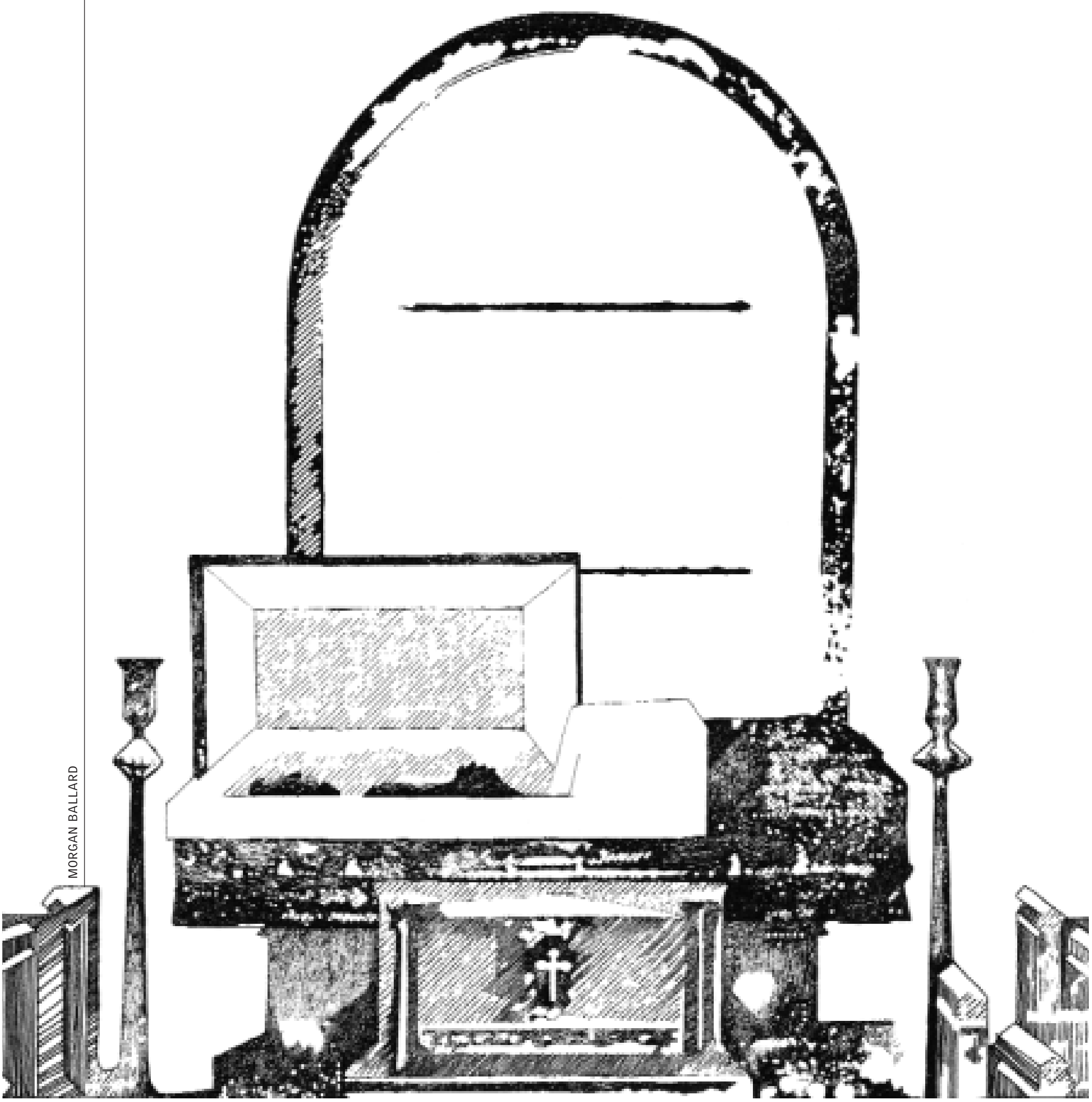
But could government remove those impediments by simply legalizing online casket sales nationwide? Consider the situation of Emma who just lost Joseph, her husband of 40 years.

Because she wants the Lewis Funeral Home to handle Joseph's funeral, she probably feels compelled to buy his coffin there; she is not likely to buy it at the nearby McBride's Mortuary, despite the fact that federal law prohibits the Lewis Funeral Home from charging her a casket handling fee. She might have been willing to buy online, but she lives in Georgia where only licensed funeral directors working in licensed funeral homes are legally allowed to sell coffins. In Emma's case, the purchase of Joseph's coffin is effectively tied to the purchase of the other goods and services of the Lewis Funeral Home.

Fixed proportions But what would happen if you were to cut the tie — or at least loosen the knot — by ensuring that people like Emma could buy coffins over the Internet? Suppose the increased competition from Internet coffin sales reduced the price of coffins relative to the prices of other goods and services sold by funeral homes. The profits of funeral homes would be hurt if consumers like Emma responded to the lower price of coffins by buying fancier ones, while cutting back on other funeral goods such as the number of limousines rented. However, there are obvious limits on how easily coffins can be substituted for other funeral goods and services. In the jargon of economics, one coffin per funeral implies that coffins and other goods and services are combined in roughly fixed proportions — a situation in which cutting the tie of casket sales would have little effect on the profits of funeral homes. Why? Because funeral homes would be able to raise the prices of the other goods and services they sell, thus compensating for the reduction in revenue from casket sales.

That situation reminds me of what Thomas Lynch, the funeral director and poet in *The Undertaking,* said about the impact of the "Funeral Rule":

> I used to use the "unit pricing" method — the old package deal. It meant that you had only one number to look at. It was a large number. Now everything is itemized. It's the law. So now there is a long list of items and numbers and italicized disclaimers, something like a menu or the Sears Roebuck Wish Book, and sometimes the federally mandated options begin to look like cruise control or rear-window defrost. I wear black most of the time, to keep folks in mind of the fact we're not talking Buicks here. At the bottom of the list there is still a large number.



MORGAN BALLARD

If the government legalized online caskets sales and funeral homes recouped their lost revenues by raising their other prices, a second edition of *The Undertaking* might have Lynch say:

> I used to sell everything you needed for a funeral. You bought everything from me. At the bottom of a long list of items and numbers and italicized disclaimers, there was a single number that customers focused on. It was a large number. Now, many of my customers choose to buy their coffins over the Internet, an option that I have to accommodate. It's the law. Now they get two lists with numbers at the bottom. When they add them together, it is still a large number.

For it to be the same number, it must also be true that the market power of funeral homes does not depend on their exclusive right to sell caskets. Suppose the homes' market power emanates primarily from their exclusive right to perform funerals. In that case, caskets are only an input into a process that funeral directors control. If caskets and other funeral goods are combined in fixed proportions, they may be able to raise their other prices enough to completely offset the lower price of coffins—a price that was driven down by the entry of firms selling coffins online. Indeed, Internet casket companies claim that funeral homes are already reacting that way, increasing their embalming, cosmetology, and professional fees to compensate for lower profits from coffin sales.

A more competitive market The fundamental point is that increasing competition in casket markets is not the same thing as increasing competition in funeral markets. For the Internet to yield large savings for funeral consumers, it must increase the amount of competition in funeral markets and not just in casket markets. One of the ways that the Internet could reach beyond casket markets is through the growth of Internet referral systems such as *FuneralDepot.com*. *FuneralDepot.com* recruits funeral homes into its nationwide network of service affiliates by offering them referrals in return for their willingness to accept caskets that are purchased online. The affiliates are also required to set low, haggle-free prices for funeral services. Using that system, *FuneralDepot.com* has become a leading retailer of caskets.

Similar Internet referral systems are being used in other markets by hundreds of thousands of consumers. Florian Zettelmeyer, Fiona Scott Morton, and Jorge Silva-Risso, in their 2001 paper "Cowboys or Cowards: Why Are Internet Car Prices Lower?" estimate that buying a new car through the Internet referral service *Autobytel.com* saves consumers approximately 2.2 percent on the price of their cars. The authors think that those consumers would do relatively poorly purchasing their cars offline, "perhaps because they have a high personal cost of collecting information and bargaining." Internet referral services like *FuneralDepot.com* could potentially yield even larger savings if people find collecting information and bargaining over funeral prices to be more costly than doing so for new cars.

Internet referral systems that sell caskets and funerals online can increase the amount of competition in funeral markets by inducing funeral homes to compete for Internet referrals. In that way, they do what consumers are reluctant to do: comparison shop for low-cost funeral homes. *FuneralDepot.com* currently guarantees that its affiliated funeral homes will charge no more than $2,995 for performing a funeral, including the use of a chapel and other customary funeral goods. If Internet referral systems "catch on," they will probably compete with one another by offering even lower prices for funerals. One of the reasons that they may "catch on" is that people dislike visiting funeral homes; indeed, *FuneralDepot.com* stresses that the "only time" its clients "need to go to the funeral home or cremation society is to finalize what was discussed over the telephone and to inspect the facilities."

Better information A funeral home owner recently told me that more and more people are coming to his funeral home with pictures (and prices) of caskets they found on the Internet, leading him to sell an increasing number of caskets using catalogues rather than the small number of caskets displayed at his funeral home. Armed with better information, some consumers may react to higher prices for things like professional services by searching for better deals, making it difficult for funeral homes to completely offset the lower price of caskets. A greater willingness to search on the part of consumers would also make it easier for new firms to attract customers from established firms, reducing one of the barriers to the entry of new firms into funeral markets.

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REGULATORY BARRIERS

If the Internet is going to reach beyond casket markets to funeral markets, it is important to eliminate any barriers created by state funeral regulations. Regulations that require funeral homes to have extensive facilities and funeral directors to have lengthy training make it more difficult for new firms to enter the market, potentially reducing the benefits to consumers of using the low-cost information available on the Internet to search for lower prices. Internet referral systems offer the promise of introducing more competition into funeral markets (and not just casket markets), thus it is especially important to investigate whether state funeral regulations impede the ability to form networks of affiliated funeral homes.

State funeral regulations are often defended as protecting consumers. Proponents of the regulations argue that banning online casket sales protects consumers against fraud, a crime that they claim is more likely to be committed by unregulated Internet casket companies. Similarly, state regulations requiring extensive facilities protect consumers against unscrupulous firms that would sell low-quality funeral services to uninformed consumers at very low prices. While it is easy to come up with stories of how state regulations protect consumers, the evidence suggests that funeral regulations primarily benefit the industry.

Escaping costly funerals The best evidence that we have on the anticompetitive effect of state funeral regulations is their effect on the proportion of people choosing cremation. Funeral directors have good reason to fear the growing popularity of cremation: People choosing cremations are less likely to purchase caskets and other funeral services such as embalming, chapels, hearses, and limousines. Quite simply, the increasing popularity of cremation reduces the demand for the goods and services provided by funeral directors, a reduction that should lower the revenues of funeral homes. If state funeral regulations are designed to protect funeral directors, we should see their anticompetitive effect in the market for cremations. More specifically, we should see a smaller proportion of people choosing cremation in states with more stringent funeral regulations.

States have adopted two distinct approaches to regulating funeral markets. While many states heavily regulate their funeral markets (requiring funeral homes to have extensive facilities and funeral directors to be embalmers), others leave them relatively unregulated. The mean cremation rates in counties from unregulated and regulated states are presented in Table 1. In 1990, the mean cremation rate was 14.7 percentage points higher in unregulated states (27.09 versus 12.43), implying that people were much more likely to choose cremation there. However, that comparison does not control for differences between unregulated and regulated states in the socioeconomic and religious characteristics of their populations. When those factors are held constant, the difference in cremation rates between unregulated and regulated states becomes smaller — 2.9 percentage points — but is still statistically significant. Because cremations are usually less expensive than burials, that difference in cremation rates implies that Americans spend roughly $250 million more per year on funerals than they otherwise would, according to a projection by Kathy Krynski and me. Because those regulations may affect other funeral choices, such as whether to purchase caskets online, the regulations' cost to consumers is likely to be much higher than $250 million per year.

We have just finished collecting county cremation rates for 2000, the means of which are also presented in Table 1. The cremation rate in the entire sample grew from 16.4 percent to 26.0 percent over the decade, reflecting the growth in the popularity of cremation. The gap in the cremation rate between unregulated and regulated states also grew slightly, increasing to 16.2 percentage points by 2000, because of a larger increase in the cremation rate in unregulated states over the 1990s. That suggests that the anticompetitive effects of state funeral regulations are still present and, if anything, are growing slightly larger over time.

One way that state funeral regulations may harm consumers is by increasing the amount of demand inducement. Funeral directors may induce demand, for example, by steering consumers away from cremations. Krynski and I found that cremation rates are lower in counties where the number of deaths has been falling, suggesting that funeral directors react to income losses from contracting markets by persuading more consumers to choose traditional funerals over less-profitable cremations. The fact that this pattern is more pronounced in strictly regulated states suggests to us that demand inducement is more prevalent there. The perception that funeral directors induce demand is so widespread that *FuneralDepot.com* advertises itself as a way to avoid it, saying that its clients "will receive exactly what each package describes without the pressure of upgrading to an unnecessary and costly alternative."

Free riding? What is the best story for why prohibitions against online casket sales might be in consumers' long-run interest? The one that I find most persuasive begins with the Batesville Casket Company, which claims that it sells "only to licensed funeral directors operating licensed funeral firms." To test that claim, I called an Internet casket company to see whether it would sell me a Batesville casket. The salesman said, "Sure, which one do you want?" I replied, "I don't know. I'm just interested in a regular one — one that's sort of middle of the road." "You can't really sell caskets that way," he said, explaining, "There are too many different models to choose among." When I asked whether I could look at pictures of Batesville caskets on his website, he said, "No. We're not allowed to put them on our website." At that point, I suggested that I would visit a funeral home, look over the different Batesville caskets, and call him back. "That would work," he said, ending the conversation with the pledge, "Be sure to call back, I'll save you a bundle."

That raises the potential problem that local funeral directors will help consumers choose their caskets, only to have consumers buy them online. In that case, the Internet casket companies are free riding on the service provided by funeral directors. If consumers then use funeral homes offering the lowest price for handling funerals — ones that do not help consumers choose caskets — the original funeral homes will not be rewarded for their service in helping consumers choose their caskets. Competitive pressures might eventually eliminate funeral homes that offer help in choosing caskets, leaving consumers in the dark. Because the manufacturers of high quality caskets do not want consumers to choose caskets by flipping coins (or worse yet, by lowest price), they have an incentive to reward funeral homes (and Internet casket companies) that inform con-

TABLE 1

Escaping Costly Funerals

Mean cremation rates in unregulated and regulated states.

	All States	Unregulated States	Regulated States	Difference
2000	26.04 (16.11)	37.91 (20.18)	21.67 (11.59)	16.24
1990	16.37 (13.42)	27.09 (17.30)	12.43 (8.86)	14.66
Δ 1990 - 2000	9.67 (4.74)	10.82 (5.25)	9.25 (4.46)	1.57
Sample Size	2147	557	1590	

NOTE: All statistics are weighted by the mean number of 1990 and 2000 resident deaths in the county. Standard deviations are in parentheses. The sample includes 35 states in the continental United States that provided county cremation rates for resident deaths. Thirteen states are missing because they did not enter disposition data into their mortality databases for 1990 and information for 2000 is unavailable for New Jersey.

sumers about quality. Dennis Carlton and Judith Chevalier, in their 2001 paper "Free Riding and Sales Strategies for the Internet," discuss a variety of ways that manufacturers can mitigate free riding by online retailers, including refusing to deal with price-cutters or eliminating online retailing altogether.

It would be a mistake to rationalize prohibitions against online casket sales on the basis of their effect on quality, especially because the quality issue cuts both ways. When consumers come into funeral homes with pictures of caskets they found on the Internet, funeral directors are free riding on the services of the Internet casket companies when they reach for their casket catalogues rather than guiding consumers to their casket display rooms. For example, it is hard to imagine that many funeral homes would display humorous caskets like WhiteLight's "Return to Sender" model, but most would be willing to sell them from catalogues. It is unlikely that those humorous caskets would have found their niche without Internet casket companies that could reach the small number of people interested in them.

States must do more than just allow online casket sales; they must reform regulations that restrict entry and impede competition in the funeral market.

CONCLUSION

State funeral regulations are burying online casket sales in some states, smothering competition that would reduce the price of caskets and offer greater variety to consumers. The changes arising from greater competition would encourage consumers to substitute fancier coffins for other funeral goods and services, reducing the economic rents of funeral homes. However, ensuring that consumers can buy caskets over the Internet would not benefit consumers as much as some people might imagine because funeral homes are likely to raise their prices for other goods and services as the market for caskets becomes more competitive.

The benefits to funeral consumers will be greater if the Internet can reach beyond casket markets to stimulate competition in funeral markets. One of the most promising ways that this might occur is through the growth of Internet referral systems like *FuneralDepot.com*. By getting funeral homes to compete for their referrals, those systems can shop for lower funeral prices —a task that many of their clients are unwilling to do for themselves. Greater competition in casket markets might also spill over to funeral markets if the price of caskets had been the best place to conceal the economic rents of funeral homes. For example, if funeral directors raised the price of their professional services to completely offset lower casket prices, consumers might view them as excessive, coaxing them to search for better deals.

There are a large number of state funeral regulations that impede competition in funeral markets, including facility requirements, training requirements, and statutes that designate the sale of caskets as being within the province of funeral directors only. Many of those regulations impede the sale of caskets online as well as the entry of new firms, especially those specializing in low-cost alternatives to the traditional funeral.

State statutes in Georgia, Oklahoma, and Tennessee that prohibit anyone other than licensed funeral directors from selling caskets have been challenged in court recently. A federal district court upheld the Oklahoma statute last December in the case of *Powers v. Harris*, ruling that federal courts should defer to the judgment of state legislatures concerning the regulation of caskets. In the same month, a federal appeals court found the Tennessee statute unconstitutional in the case of *Craigmiles v. Giles*, concluding that it was a "naked attempt to raise a fortress protecting the monopoly rents that funeral directors extract from consumers."

Overturning those statutes should increase the amount of competition in funeral markets. However, if those are the only types of state funeral regulations that are repealed or reformed, do not be surprised if there are still excessively large numbers at the bottom of consumers' funeral bills. R

READINGS

- "Cowboys or Cowards: Why Are Internet Car Prices Lower?" by Florian Zettelmeyer, Fiona Scott Morton, and Jorge Silva-Risso, NBER Working Paper No. 8667, December, 2001.
- "The Effects of State Funeral Regulations on Cremation Rates," by David E. Harrington and Kathy J. Krynski. *Journal of Law and Economics*, Vol. 45 (2002).
- "Free Riding and Sales Strategies for the Internet," by Dennis W. Carlton and Judith A. Chevalier. *Journal of Industrial Economics*, Vol. 49 (2001).