



White Paper

September 13, 1999

Regulatory Obstacles to Innovation: Is Self-Regulation The Answer? by Solveig Singleton

This paper was prepared for The White House Workshop on Priorities for Federal Innovation Reform

Self-regulation might be styled a "Third Way" for regulating the high-tech sector from the Internet to genetics. Under "Third Way" reforms, regulatory goals (education standards, for example) would be set at the federal levels, with responsibility for deciding how goals are to be reached falls on local government or even the private sector.

So when an innovative industry becomes too fast-paced and complex for government regulation, is self-regulation the answer? Self-regulation driven by market forces is a good solution--but self-regulation made-to-order to satisfy government demands is not.

Existing Systems of Self-Regulation

Historically, self-regulation of a number of different types has grown up.

- Regulation of electrical appliances and equipment through the Underwriters Laboratories.
- Green Seal, which develops standards for environmentally sound products.
- Certifications for kosher and halal food.
- Financial rating services, such as Dun & Bradstreet and Moody's.
- The MPAA motions picture ratings, the Comics Code, and the Recreational Software Advisory Council.

Some of these systems arrived in response to varying degrees of government pressure, including the MPAA ratings and proposals for self-regulation on privacy. Others are good examples of purely private, market driven conduct.

Why Self-Regulation?

From the standpoint of legislators or regulators, self-regulation is less costly than traditional command and control regulation. First, it is less costly to the economy. Command and control rules are for obvious reasons unsuited to the rapid changes of technology in the innovation age. Second, self-regulation is less costly to the government, because authorities need not drastically expand their enforcement mechanisms.

From the standpoint of participants in markets, either industry or consumers, self-regulation might arise as a natural outgrowth of consumer demand. *This "bottom-up" process is truly voluntary and likely to be highly decentralized.* Kosher food labels are a good example, offering consumers a choice of many different standards. In response to the incredible diversity in consumer demand, the market offers many competing forms of self-regulation, not just a single standard. In the health and safety context, self-regulation might be more likely to look to a single standard, as with the Underwriters Laboratories--but even UL has a number of smaller competitors.

But in most cases no third party standards or oversight at all are necessary for "self-regulation." That is, *true market-based self-regulation blurs into no regulation at all, with each company "regulating" itself according to internal standards of customer or client service, with no third party oversight.* Bad service is checked by competition. The failure of a market to develop a formal system of self-regulation does not, therefore, mean there has been a market failure.

Drawbacks of "Self-Regulation" I: Fixed Goals

In some high-tech regulatory contexts, such as privacy, "self-regulation" in response to government pressure is viewed as an alternative to top-down regulation. But such a system of self-regulation could easily share the drawbacks of top-down regulation.

One characteristic of demands made on e-commerce merchants respecting privacy "self-regulation" has been that the goals of the regulation are assumed to be *known*. Regulators have insisted that a system of self-regulation must ensure that customers have notice of how their data is being used, that they have a choice about whether it is not be collected or not, and so on.

In the real world, no one knows what state of affairs "ought" to obtain with respect to privacy. *The question of when human beings will need to reveal information to gain trust, will be willing to offer trust without information, and will need to respect confidentiality to gain trust is a bafflingly complex question.* It depends largely on individual preferences and needs. It may be resolved differently in different contexts from year to year--or even from minute to minute. The default rules for how human beings exchange information about one another favor the freedom of information--with privacy being by special arrangement. Finally, massive economic benefits accrue to all of us from the free flow on information through the economy--the widespread availability of credit is just one example.

When regulators insist that a system of "self-regulation" must conform to certain fixed, top-down goals, they are not talking about self-regulation that arises from market forces. In an innovative market, goals are evolving, varied, and diverse. If advocates of self-regulation expect the system to produce an outcome that guarantees certain fixed goals, they are doomed to disappointment--and thence to top-down regulation. True self-regulation means choice, variety, and experimentation.

Drawbacks of "Self-Regulation" II: Accountability

Self-regulation with a heavy element of government involvement in goal-setting and/or enforcement may have many of the same drawbacks as command-and-control--without the safeguards provided by the Administrative Procedures Act, formal rulemaking processes, or public accountability more generally.

For example, self-regulation in the privacy context threatens to evolve into a system where government makes vague rhetorical demands with no clear content or deadlines. Official involvement looms at every stage, and may be wildly unpredictable. We lose the benefits of a bottom-up learning process that occurs through the market, but also lose the benefits of certainty and accountability that (should) come with formal lawmaking procedures.

One element missing from the equation when government prematurely forces markets towards

"self-regulation" is cost-benefit analysis. Even in formal rulemaking proceedings, agencies are notoriously oblivious to the general idea that they should do more good than harm. The problem is exacerbated a thousand-fold when agencies pressure the market to regulate itself.

The result is the undertaking of massive, expensive regulatory programs that are little more than tokens of political concern. The V-chip is a prime example; now that it is out there, who is actually using it? These systems, like the Comics Code, will tend to collapse and be forgotten in any sector where there is little consumer demand for the standard self-regulation supplies.

Conclusions

- Self-regulation can arise as a result of market forces; however, the failure of such a system to arise does not mean there has been a "market failure."
- Government-driven self-regulation for innovative industries is not desirable, for it mimics many of the costs of command and control regulation without constitutional or other safeguards.

Simple deregulation is the best policy to support innovation.