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FACILITATED MARKET SOLUTIONS FOR SOCIAL PROBLEMS

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Facilitated Market Solutions for Social Problems

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Prior to the wave of regulations that began sweeping the country in the 20th century, virtually all solutions to social problems were solved by private markets. One solution for ensuring the quality and integrity of products was the creation of third party certifications, such as the "Seal of Good Housekeeping," which is still in use today. Word of mouth served for many to spread information about good and bad products. Direct word of mouth has now been amplified by internet RSS feeds, blogs, and other information on the Web. Normal market processes still solve most of the social problems confronting society today, matching society's productive resources to the particular demands of consumers. If, for example, there is the possibility of increasing the quality of a product, a market leader will generally improve their product to capture an additional share of the market, which forces others to follow.[i] Even where an industry's products have "negative" attributes, markets work through a process called "unfolding."[2] In this process, the product with the least "bad" attributes advertises that it is better than the next-best product, which forces that product to innovate. That product then advertises that it is better than the third-best product and this process continues until the last product innovates or is forced off the market by lack of demand.

But there are some types of improvements that must be made through intentional management of markets and this is usually assumed to be a case where government intervention is necessary. In these cases, the normal interaction of firms and consumers described above do not work. These may be cases where, for example, it is difficult to credibly signal safety or quality improvements to firms such that it is difficult for them to capture rents by increasing market share. It may also be the case, as we will see below, where some standardization is necessary and the transactions costs for doing so are too high in the absence of a coordinating body. If such improvements do not take place, it is possible that the demand for the products of the entire industry may decline. In these

[1] Thanks to Brad Stone and Peter Adler of the Keystone Center for their helpful comments.

[2] Grossman, S.J. 1981 "On the Impossibility of Informationally Efficient Markets," American Economic Review, vol. 70(3), pages 393-408, June.

cases, demand for regulation by larger firms may be observed, which often will have the added benefit (to them) of driving out some firms.[3]

Although it might actually make sense for firms in an industry to engage with one another to agree on these investments, this might run afoul of antitrust prohibitions against collusion. Many firms have tried to steer clear of antitrust violations by employing non-profit mediation firms like the Keystone Center. The Keystone Center describes itself as, "a non-profit 501(c)(3) organization whose mission is to develop solutions to societal issues through the innovative use of deliberative frameworks, inclusive processes, and analytical scientific information. Through its education and public policy programs, The Keystone Center improves decisions about long-term issues by helping thought-leaders, teachers, students, and decision-makers effectively address technically complex and politically uncertain situations."[4]

Regulatory Negotiations

Some see creation of this kind of a system as a natural function for the federal government utilizing the Administrative Procedures Act (APA), otherwise known as notice-and-comment rulemaking. In fact, the government does occasionally perform a similar function in "negotiated rulemakings," but these are not common and suffer from some constraints that do not affect private firms.

The facilitated market solutions described in this paper are, in one sense, quite similar to regulatory negotiation, a tool used by executive agencies since the early 1980s and officially codified in the Negotiated Rulemaking Act of 1990.[5] Regulatory negotiations were devised as a means of improving the regulatory process by bringing together stakeholders to discuss pending rulemakings. An agency can summon the corporate and social stakeholders that it believes have valuable points of view or information about a topic and ask them to reach a consensus decision about a given problem. Under a normal

[3] This would be, for example, small firms who cannot pass along large fixed costs and "fly-by-night" firms who find it less expensive to get into and out of a market than to make the quality investment.
[4] http://www.keystone.org
[5] 5 U.S.C. §§ 561-570.

scenario, once consensus has been reached, the agency then publishes the agreed-upon text as it would any other proposed rule, thus opening it for public notice and comment.

Proponents hoped that regulatory negotiation would be more successful than traditional agency-originated rules for several reasons. In most cases, stakeholders have more information about a given topic than regulators do (this is particularly true in very technical situations). By consulting with them, regulators would be able to put forward "smarter" rules that created less unnecessary burden on businesses and the economy as a whole. Further, because interested parties were given a chance to voice their concerns, the regulatory negotiation process was supposed to be faster than a traditional rulemaking and less prone to challenges in the courts.

Regulatory negotiation continues to be used today and some agencies have more fully embraced it than others (the EPA in particular was, at least for a time, enamored of this procedure), but on the whole negotiation has not lived up to its promise. Some anecdotal accounts indicate that stakeholders found very little benefit in the process.[6] At base, the problem seems to be that regulatory negotiation can be very time consuming and burdensome for stakeholders, with the costs to participants outweighing benefits to them. Empirical studies have been mixed. Cary Coglianese examined regulatory negotiations over thirteen years and concluded that they had saved little or no time over traditional processes and that the final rules emerging from such negotiations were just as likely to be challenged in court.[7] Other studies have found just the opposite: Regulatory negotiation participants were more satisfied and less likely to challenge the results, and that the process was significantly speedier.[8] Still others question regulatory negotiation at a more fundamental level. Whether or not regulatory negotiations result in faster action,

[6] *See* Lynn Sylvester and Ira Lobel, The Perfect Storm: Anatomy of a Failed Regulatory Negotiation, Dispute Resolution Journal, May-July 2004; *See also* Ellen Siegler, Regulatory Negotiations and Other Rulemaking Processes: Strengths and Weaknesses From an Industry Viewpoint. Duke Law Journal, Vol. 46, No.6, pp. 1429-1443 (April 1997).

[7] Cited in Shi-Ling Hsu, A Game-Theoretic Approach to Regulatory Negotiation and a Framework for Empirical Analysis. 26 Harv. Envtl. L. Rev. 33 (2002) p. 40.

[8] *See* Laura Langbein and Cornelius Kerwin. Regulatory Negotiation versus Conventional Rule Making: Claims, Counterclaims, and Empirical Evidence. 10 J-PART 2 pp. 599-632 (2000); *See also* Jody Freeman and Laura Langbein. Regulatory Negotiation and the Legitimacy Benefit. 9 NYU Environmental Law Journal 60 (2000).

for some observers they leave open troubling questions about undue corporate influence which, unmonitored, have the potential to undermine important democratic safeguards.[9]

While the evidence might remain in doubt, it seems clear that regulatory negotiation has not entirely lived up to its initial promise and has become more of an oddity than a commonly used mechanism Although similar in nature, privately negotiated solutions offer advantages over the government-run system of regulatory negotiation. Some of the advantages include avoidance of the political bias that may drive regulatory decisions as well as problems associated with "capture" by regulatory agencies.

Many observers have noted that there is a marked shift in the types and stringency of regulations produced depending upon which party currently holds the executive branch. In addition, permanent members of regulatory agencies will also bring their biases to rulemaking. These biases may come from philosophical beliefs or a sector of the economy that they have previously worked in, e.g., industry or advocacy, that can continue to drive their preferences. Finally, there is the long length of time it takes any agency to produce a regulation using the APA. Over the years, the analytical and review requirements that have been added to the process, while useful, have added many months to the overall promulgation of regulations. All of these problems have been explored at length in the legal and economic literature. Each of these problems may exist, to some degree, for regulatory negotiation as well.

Conditions for Facilitated Market Solutions

A facilitated market solution is a deliberate assembly of stakeholders led by a private professional organization to solve a specific social problem. Because stakeholders must pay for these solutions, over and above what they pay in taxes to fund regulatory agencies, there are unique conditions that must exist to make participation and consensus worthwhile. First, for any negotiated settlement to take place, there must be a policy driver such as an impending law or regulation that is on the horizon with a definitive time

[9] *See* Susan Rose-Ackerman, Consensus versus Incentives: A Skeptical Look at Regulatory Negotiation. 43 Duke L.J. 6 (1994); *See also* William Funk. Bargaining Toward the New Millennium: Regulatory Negotiation and the Subversion of the Public Interest. 46 Duke L.J. 6 (April 1997) pp. 1351-1388.

table and that stakeholders believe will not, left to the normal political process, serve their best interests, either procedurally or substantively. Stakeholders may also seek private negotiation if they believe that their views will not be given appropriate consideration or if they believe the traditional ways of handling these problems—legislation, regulation, and litigation—are unlikely to solve the problem. It is likely that this is the case for many stakeholders who engage in notice-and-comment rulemaking. In general, this kind of rulemaking results in a one-way conversation: Each stakeholder comments to an agency and receives no communication back unless they are able to find some mention of their comment in a final rule. If these two conditions hold, there is a strong incentive for stakeholders to come together to find solutions quickly.

What independent mediation and facilitation organizations offer are discrete, candid, and creative discussions where all views are aired and there is a multi-party dialog that takes place around every idea. One of the perennial challenges posed by formal regulatory negotiation is the exposure of industry secrets. Negotiations directly facilitated by an agency and culminating in a legally binding regulation necessarily must be made a matter of public record, creating an incentive for private actors to hold back important information that could lead to better outcomes.[ii] This problem does not exist in privately facilitated negotiation. The conversations can be kept secret so that only the results are reported out of the meetings which reduces the incentive to restrict important information. Further, private facilitators are not bound by (sometimes outdated) authorizing statutes or legal and cultural precedents unless they choose to be. They are free to come up with creative, progressive, and sometimes innovative solutions.

In some cases, it is actually the government who turns to private mediators for solutions. This may be the case because they feel the need for a faster solution, perhaps driven by a statutory mandate or because they understand that it is difficult to get candid views from stakeholders on certain issues who must direct their views directly to the government. For example, the Department of Health and Human Services employed this kind of a system to come up with new patient package inserts for prescription drugs because they were under a statutory deadline that they did not believe could be meet by conventional

methods. Stakeholders from industry, academia, and consumer groups were brought together and were able to come up with a solution relatively quickly. While this solution was not the end (there still needed to be informal rulemaking), this process moved the solution forward at a much faster rate than would have happened otherwise.

Private mediation firms are relatively new, having emerged about thirty years ago, primarily to handle site-specific environmental issues. They have been used internationally in dispute resolution between countries, such as the SALT talks and discussions regarding where to construct oil pipelines. More recently, these firms have engaged on environmental and energy issues such as the sustainable development initiative under President Clinton. There is a tremendous untapped potential to solve many, many more problems by this mechanism.

How it Works

Initiating a facilitated dialogue on complex marketplace solutions can happen in any of a variety of ways. Any prospective client—an NGO, a corporation, or a government entity—may approach an intermediary group or mediation company. Sometimes, the intermediary group might see a matter that seems ripe and opportune and approach multiple clients in various sectors with an idea for a facilitated discussion. Funding for the mediation company must come from the stakeholders or some acceptable subset of them. Great care must be taken to identify the right mix of participants with the goal of ensuring that all relevant views (and people) are included. One issue is how best to represent consumers at these meetings, whether it is through consumer organizations or some other type of representation. Another issue is small businesses; there are often thousand of small businesses in an industry who may have divergent interests. The job for the facilitator is to somehow identify these interests and try to ensure that they are all represented. Note, however, that even though regulatory dockets are open to all, it is not always the case that the affected small businesses are even aware of rulemaking as agencies generally do not actively seek out all relevant viewpoints. Finally, there is a concern about new entrants to the industry who did not participate or had their views

represented in the negotiation. However, they would have the same problems with regulation.

One goal for the mediation companies is ensure that they take an absolutely neutral position on the outcome. One concern that might be raised is the issue of whether or not paying for the mediators pays for an outcome. In a "repeated game" problem, a private facilitator would clearly not be able to attract any stakeholders who are not financial supporters if the history showed that their concerns and votes were likely to be discounted. The first area for consensus is exactly what the goals or problems are to be solved and what are the principles that will be used to solve those problems. Rules for participating are established such as whether or not the discussions will be confidential and how they will come to agreement, e.g., voting. One mediator noted that there is an extremely high rate of successful resolution of issues.[10]

A word of caution: Facilitated market solutions of this kind are *not* a regulatory activity. Unlike regulatory negotiations, even when consensus is reached by the stakeholders in a mediation situation, that outcome is not legally binding on them or other not-included parties. This issue was resolved in *A.L.A. Schechter Poultry Corp. v. United States*, which held that Congress could not delegate its regulatory powers to private organizations: "Such a delegation of legislative power is unknown to our law and is utterly inconsistent with the constitutional prerogatives and duties of Congress."[11] Yet private mediation has the potential to be a powerful tool for solving social problems. Government may encourage more of these solutions prior to stakeholders petitioning the government for new regulation and can acknowledge success by simply doing nothing.

While this the non-binding nature of the agreements sounds like a weakness, it is actually a source of strength. Because this is fundamentally a non-governmental solution, mediators are not bound by the same rules, procedures, and institutional culture of regulatory bodies. With fewer constraints, they are freer to find optimal solutions. If that

[10] Conversation with Brad Sperber of the Keystone Center, June 2008.
[11] 295 U.S. 495 (1935) at 537. Cited in Susan Rose-Ackerman, Consensus versus Incentives: A Skeptical Look at Regulatory Negotiation. 43 Duke L.J. 6 (1994) at 1216.

process fails, however, the government remains the ultimate safety net and can compel compliance if it believes that mediation has not resolved the underlying problem.

While agreement can be reached more rapidly by these groups, compliance may be a different manner. If it is a situation where the evidence for compliance is years off, and there is an urgent public health issue, this may not be a good situation for these types of agreements if there is some uncertainty as to whether or not a significant percentage of the market will comply. By significant, we mean enough compliance to significantly move forward in addressing the problem. In those instances, government may feel compelled to act given their unique powers to enforce rules. It is not clear whether it is an advantage of government rules that are seen to be able to provide some sort of legal umbrella that allows firms to avoid liability if they are in compliance with federal rules. Finally, U.S. rules often are carried into international agreements and, where there is an absence of a standard, international bodies may fill the void and U.S. firms must obey these rules if they wish to export. It is not clear whether these types of privately mediated agreements might also serve as substitutes for international agreements as happened in some of the agreements mentioned above.

An Existing Issue

One of the issues currently before the Keystone Center is the idea of placing nutrition health symbols on the front of packaged food products. These labels are symbols that attempt to signal to consumers that the labeled product is a healthier choice than alternatives. Many of these symbols are already on the market, but there is a proliferation of so many different types from so many different types of organizations that it has generated some confusion for consumers. The overall purpose of such symbols is to meet consumer demand for a faster, more comprehensive signal of the healthiness of the product without having to decipher the Nutrition Facts Panel on the back of packaged products. Currently, some symbols signal the presence of types of nutrients such as whole grains, some address a particular health condition (e.g., the American Heart Association logo), some are particular to supermarket chains (the Hannaford Supermarket chain's "Guiding Stars"), some are only on individual manufacturers' products (Kraft's "Sensible

Solutions"), and finally some are found only in restaurants (the "Weight Watchers" symbol in Applebee's restaurants). All have different nutrition criteria—some are all encompassing, and some point to specific macronutrients or calories. Competition does not seem to be driving the market toward a single, superior solution, probably because the sheer number of food producers creates a coordination problem. For consumers, this presents a somewhat bewildering jumble of signals. In addition, manufacturers are rapidly being placed in the position where they will need to have multiple labels and multiple formulations to compete in different marketplaces. Moreover, companies may soon start challenging each other's claims since those lead to market competitiveness between products.

The social benefits of replacing this jumbled patchwork with a single standard are potentially enormous. The costs of cardiovascular diseases and stroke alone in the U.S. are estimated by the Centers for Disease Control (CDC) at over $448 billion in 2008.[12] There are additional costs from poor diets including the costs of overweight and obesity (some of which lead to cardiovascular incidents), osteoarthritis, Type 2 diabetes, and some cancers. The overall benefits, which will depend on how much influence these icons have on food choices, are likely to vastly exceed the costs of the program.

The Keystone group is now working with manufacturers, retailers, academics and consumer organizations to produce a universal symbol that will help consumers to select healthier products.

Antitrust

One of the reasons that private mediation addressing market failures has not emerged as a significant force to date may be the barrier placed between companies by the government to prevent anti-trust violations. "Competitor collaboration" comprises a set of one or more agreements, other than merger agreements, between or among competitors to

[12] Centers for Disease Control, Division for heart Disease and Stroke Prevention: Addressing the Nation's Leading Killers 2008, February 2008. (http://www.cdc.gov/nccdphp/publications/AAG/pdf/dhdsp.pdf)

engage in economic activity, and the economic activity resulting therefrom.[13] In order to avoid anti-trust concerns, an agreement between firms must not either raise prices or reduce output; these are "per se" violations of the act. Other problems that would fall within the "rule of reason" would include agreements that reduce quality, service or innovation below what would be likely occur if they did not make such an agreement. Alternatively, it is recognized that some collaborations can benefit consumers if they provide consumers goods that are more valuable or cheaper to them. It is this kind of mediation between different parties, including industry, that this kind of activity appears to fall.

An amendment to the current economic executive order (currently E.O. 12866) could require that before agencies determine that they will regulate, they could (and perhaps should) examine the possibility of encouraging private mediation. In a single document, perhaps produced by the Department of Commerce in concert with the Federal Trade Commission and the Office of Management and Budget, the U.S. government could do much by producing a document that describes how to avoid any anti-trust problems and that simulatenously discusses past successes of these kinds of agreements. It can encourage petitioners to various agencies to appropriately consider private negotiation first. This can start a new way of thinking about resolving complex social problems that have at least part of their solution in the marketplace.

How These Solutions Will Help

The advantages of privately negotiated settlements are several. First, because all of the relevant parties are present and agree to a set of rules beforehand, solutions to social problems can come much more quickly than through the cumbersome notice-and-comment rulemaking. Next, because the involved stakeholders are not bound by antiquated laws or precedents that must be stretched, they are free to come up with novel solutions. Third, the stakeholders at hand often have all of the possible relevant data that needs to go into decision making and, as questions arise, can quickly pool that data in a form that preserves company privacy. For many economists and risk assessors, the

[13] http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf, p.2

paucity of data in their analyses used to inform decision making is thought to be a key fact that results in poor decisions. Fourth, the stakeholders are those people most affected by the decisions; it does not involve bureaucrats or oversight bodies making decisions that may advance their own utility at the expense of society. Particularly, agreements reached by these bodies can be made independently of whoever is in political power. Finally, many regulations result from intense pressure on bureaucracies, usually to respond to a problem even when they do not have a good solution. They will produce something just to appear to be doing something about a problem without really solving it. If all sides are well represented in a privately mediated agreement, that problem is unlikely to arise.

Additional Longer-run Research

There is much additional research that can be done to help:

1) Optimal structure of these groups. How should stakeholder representation be organized so that fair and representative solutions are found (it should be noted that, in fact, there is a fairly substantial literature in this area)?
2) What can government do to encourage, or at least not discourage, private negotiation? What, if any, role can government play if a major party is not included or feels compelled to abandon the settlement?

[i] Akerlof, George, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," Quarterly Journal of Economics, 84(3) 1970, pp. 488-500.

[ii] As noted by a reviewer, agencies can hold information submitted privately to them if the meetings are "preparatory" for decision meetings governed by FACA (Federal Advisory Committee Act). However, that information would not be shared with a larger group, only with regulators.