Promise and Pitfalls of Targeted Transparency: A Light-handed Approach to Social Policy

David Weil*, Archon Fung, Mary Graham

Transparency Policy Project
Harvard Kennedy School of Government

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*Contact author information:

David Weil, Professor of Markets, Public Policy & Law and Everett W. Lord Distinguished Faculty Scholar & Co-Director and Senior Scholar, Transparency Policy Project, Harvard Kennedy School of Government.

Address: Boston University School of Management, 595 Commonwealth Avenue, Room 520A.
email: davweil@bu.edu
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Introduction

In recent years, transparency has become a mainstream instrument of social policy. When rules, taxes or subsidies prove impractical as ways to reduce critical risks or improve public services, governments now employ the structured disclosure of standardized factual information as an alternative means of achieving specific policy objectives. Policy makers have used such targeted transparency to improve the health and safety of processed foods, the safety of new car designs, the quality of health care, pollution control, airline service, teaching in public schools, and the efficiency of financial markets.

In a familiar example, Congress required nutritional labels on processed foods in 1990 as a public health strategy to reduce deaths from heart disease, diabetes and other chronic ailments. Earlier, the federal government mandated safety and fuel economy ratings for new car models to induce companies to design safer, more fuel-efficient vehicles.

In the last four years, targeted transparency has become more widely recognized as a mature policy tool. The Obama administration became the first to explicitly encourage agencies to employ targeted transparency as an alternative to conventional regulation to “reduce burdens and maintain flexibility and freedom of choice for the public.”\(^1\) The latest edition of a leading administrative law treatise states that such mandated disclosure represents “one of the most striking developments in modern regulatory law.”\(^2\)

At the same time, Congress has created new transparency policies as core elements of major legislation. The Affordable Care Act of 2010 requires fast food chains to post calories with menu choices and requires all health plans to provide a standardized summary of coverage for enrollees and applicants.\(^3\) The Dodd-Frank Act requires greater transparency for complex
financial instruments such as credit default swaps, one of the derivatives at the center of the 2007 crisis.4

These targeted transparency policies differ in their architecture and goals from broader “right to know” and “open government” efforts. Beginning with the 1966 Freedom of Information Act, Congress has repeatedly affirmed the right of the public to examine most government documents. In 2009, the Obama administration introduced a broader “open government” initiative to encourage officials to make structured data sets available in order to create new private and public value.5

Targeted transparency represents a more focused approach to public information in which government compels companies or public service agencies to disclose information in standardized formats in order to reduce specific risks or improve services. Such policies are more light-handed than conventional regulation because they rely on the power of information rather than on enforcement of rules and standards or financial inducements to alter choices. Targeted transparency is frequently used to introduce new scientific evidence of public risks into market choices.

As targeted transparency takes a prominent place beside standard-setting and financial incentives as a tool of social policy, it becomes more important to understand when and how it works. Ineffective disclosure requirements can be costly. Forcing companies to collect and disclose information can require substantial resources. Mandated disclosure of incomplete or out-of-date information can mislead consumers and create new risks.

**How targeted transparency works**

Congress has employed transparency as a policy tool on occasion at least since the early 1900s. It was in 1913 that Louis Brandeis famously wrote in Harper’s Weekly that “sunlight
is…the best of disinfectants.” The 1906 Pure Food and Drug Act and the 1933 and 1934 Security and Exchange Acts employed transparency to improve food safety and to reduce corruption. However, the modern study of targeted transparency as a distinct form of social policy is relatively new.6 7

In Full Disclosure, we examined a large number of targeted transparency efforts and found that effective policies follow a demanding “action cycle” of information provision, use and response. Consumers must see and comprehend new information and integrate it into their choices of products and services; target companies must perceive and act on consumers responses in ways that reduce risks, improve services, minimize corruption or otherwise further a specific policy goal. 8

Many policies fail to satisfy these demanding conditions. Consumers may not be interested in new information, may not understand the information offered, may not have real choices or may not act in accord with policy makers’ aims. Likewise, target companies such as food manufacturers, car companies, hospitals or airlines may not take note of consumers’ changed choices, may not understand them or, if they do, many not act in accord with policy makers’ aims. In addition, the disclosure mandate itself may be flawed. Politics always plays a role in framing targeted transparency requirements, as it does in framing other regulatory regimes, so that information completeness, format, or timeliness may be compromised. Finally, disclosure systems erode over time due to policy drift if they are not designed to evolve as markets and scientific findings change.9

Three emerging questions

As targeted transparency policies have proliferated and matured, research about their use and effectiveness has begun to take shape among economists, political scientists, legal scholars,
and cognitive psychologists. Three questions that are central to the performance of targeted transparency policies arise from this emerging research: When should government step in to require disclosure? When and how do consumers respond to new information? And what factors influence whether target companies respond to disclosure by reducing risks or improving their practices?

Some have argued that government has only a small role to play in mandating transparency because market pressures create sufficient incentives for businesses to provide accurate information to consumers. If there is variation in product or service quality valued by consumers, top performers have an incentive to identify themselves through information. In principle, revelations about quality should “unravel” downward, with firms revealing quality measures in response to those producing higher quality products or services, since failure to do so would in itself signal low quality.\textsuperscript{10}

But researchers have also shown that incentives for voluntary disclosure break down for a variety of reasons. Multiple consumer priorities – for example, new car prices, design features, performance, reliability, fuel economy, and safety --can make revelation of any single dimension skew consumer choices in ways that do not advance public goals. Firms may under-disclose because disclosure is costly relative to its private benefits. Unraveling also assumes that consumers have enough baseline information about quality characteristics and their variation to compare products and practices. Any of these factors can undermine the voluntary disclosure of positive or negative information concerning risks, benefits or service quality.\textsuperscript{11, 12}

The case for public intervention arises when such barriers to voluntary disclosure deprive the public of critical information about product risks or service flaws. The resulting information asymmetry pushes markets away from socially optimal outcomes.\textsuperscript{13}
Even then, government action to mandate transparency may not be appropriate or feasible, however. When no consensus metrics exist, when risks cannot be clearly communicated, or when executive agencies lack the capacity to frame or oversee a targeted transparency system, policy makers must search for other approaches. Moreover, banning substances may be a more appropriate approach when transparency would produce variable responses that perpetuate unacceptable hazards to the public, such as allowing lead in some gasoline or mercury in some food.

A second set of questions concerns when and how individuals understand and use information provided to them. Research in the cognitive sciences, economics, political science, and law suggests that the process of decision-making is far different from that reflected in traditional models of individual rationality and optimization. Instead, people use cognitive shortcuts — streamlined paths of decision-making that can be useful but at times misleading. The foundational work in this area by Daniel Kahneman and Amos Tversky holds that individual failures to use or incorporate new information reflect cognitive errors because they lead to suboptimal decisions.\textsuperscript{14} For example, people may over-react to risks where they feel little control (e.g. flying on an airplane; being injured by tornadoes) but underestimate risks where they perceive control (e.g. riding a bicycle). Such reactions can influence how people respond to government-mandated information about risks.

The extent of such cognitive problems, their effects, and the influence of transparency formats in overcoming such problems remains contentious, however. Some cognitive scientists hold that behaviors that have been classified as errors in fact represent adaptive cognitive shortcuts that allow “fast and frugal” decision-making.\textsuperscript{15} In particular, decisions that are made repeatedly and reflect an individual’s enduring preferences may be usefully guided by simple
rules like “I always buy this product”; “my friends suggested this hotel”; and “you are providing this information for a reason.” In his most recent work, Kahneman himself suggests that most people make appropriate choices most of the time. However, Kahneman and others acknowledge that some choices will be more affected by new information than others. In particular, decisions that are infrequent, involve unfamiliar alternatives and multiple priorities may be particularly problematic. Examples include purchasing a home, investing money for retirement, selecting a school, or deciding on a major medical procedure.

At the same time, research suggests that transparency systems can be designed to mitigate such problems. In some instances, non-profit or for-profit firms take on the task of translating complex and potentially misleading information into easily understood rating systems or graphics. Such activities have proliferated with the rise of consumer-oriented web sites and social networking. Private organizations rank schools; environmental groups rank polluters; consumer groups rank airline performance.

Sometimes policy makers themselves take cognitive errors into account in requiring user-friendly formats to make complex information comprehensible by, for example, creating simplified hospital ratings, five star ratings for auto safety, or restaurant hygiene grades. Some of these rating systems have proven highly effective.

A third set of questions concerns the responses by companies and agencies that are required to provide information. Transparency, like all forms of regulation, ultimately seeks to change the behavior of organizations so it is more in line with public priorities. Recent research has investigated cases in which targeted transparency creates inappropriate incentives for businesses by focusing on one set of quality or risk dimensions versus others. When hospitals are compelled to disclose some but not all aspects of patient safety, for example, their actions
may have unintended consequences that increase risks that are not reported or discourage admission of high-risk patients.\textsuperscript{19}

Also, like other forms of regulation, targeted transparency is vulnerable to “gaming” in response to disclosure. Companies or agencies may try to avoid detection, appear as if they have complied or improved their performance, or raise some measures without altering underlying outcomes (e.g. “green washing” practices that appear to promote better environment practice but change little in practice). In extreme cases, the high stakes nature of transparency may lead those disclosing to try to undermine the system politically or to bribe those providing the ratings.\textsuperscript{20}

Recent research also suggests the importance of preemptive responses by managers in some situations. When Congress required major chemical companies to disclose toxic pollution, several took drastic steps to reduce such pollution before the public and press responded.\textsuperscript{21} Similarly, recent studies of the required disclosure of drinking water contaminants reveal significant preemptive responses by water quality agencies.\textsuperscript{22}

**The future of transparency research and policy**

As research continues on the central questions of when government should mandate transparency, and how consumers and businesses respond, scholars and policy makers need to focus more attention on issues that have been neglected: when to employ transparency versus other policy tools; how to design policies that improve over time; and how to harness information and communications technology to create a new generation of networked transparency.
Comparative research could contribute to understanding when transparency is likely to reduce risks and improve public services and when tools such as traditional standard setting, taxes, or “nudges” may prove more effective. For example, in recent policies aimed at discouraging consumption of food and drinks that contribute to obesity, some policy makers have introduced transparency measures while others have favored taxes and even product bans but little is known about the relative effectiveness of these actions. In their recent work, Cass Sunstein and Richard Thaler have suggested that “nudges” – socially beneficial defaults – may be useful when individuals invest little time in understanding significant risks associated with their choices but researchers understand little about when those circumstances occur and the marginal efficacy of additional information in those instances.23 24

Our research has suggested that some transparency policies become more robust and effective over time while others are reduced to costly and irrelevant disclosure exercises.25 Policies lose value when dynamics like gaming and capture undermine their purposes. They gain value when constituencies develop to fortify them or when companies gain competitive advantages from disclosures. Policies also must evolve to account for advances in scientific knowledge and for economic innovation. Recent transparency provisions designed to stabilize the financial system, for example, will become obsolete unless they are updated to address innovations in securitization, insurance, and derivative financial products. What are the design features of sustainable policies? How can analysis and feedback of policy effectiveness in changing circumstances be institutionalized?

Finally, it is now commonplace that the Internet, mobile technology, sensors, advanced barcoding and other leaps in information and communication technology have revolutionized the ways in which people generate and share knowledge. However, transparency policies have
lagged behind commercial applications in harnessing such advances to save lives and reduce injuries. Traditional transparency policies have relied on the limited and often outdated store of information that the government holds or can require. Data about life-threatening auto safety defects, drug side effects or food contaminants make their way to government offices only slowly and many incidents escape current reporting channels. How can technology enrich and speed knowledge of emerging risks in order to save lives? How can sensors, expert knowledge, shared experiences of ordinary citizens and new analytic tools create networks of transparency that quickly alert the public to new threats to public health or safety?

Entrepreneurial efforts have begun to emerge. The SARS pandemic in 2003 spurred the creation of a technology-enabled global network to monitor the emergence of serious infectious diseases. More recently, cheap sensors enabled citizens to quickly create accurate maps of radiation levels in residential areas near the Fukushima nuclear accident site in Japan to counter less nuanced government models. Web sites where patients share their experiences with medications have begun to provide clues about drug safety and effectiveness as a supplement to clinical trials. Future research should examine the ways in which such technologically enabled networks can complement or replace traditional transparency policies.

Targeted transparency policies seek to mobilize private decisions and market forces to reduce critical risks, improve public services and minimize corruption. This light-handed approach aims to advance public purposes by improving the quality of individual choices and business decisions. However, effective transparency requires a better understanding of how people use new information to make choices, how managers respond, when transparency is more effective than other interventions, how to create policies that improve over time, and how to harness technology to create a new generation of transparency. Continuing research from a
variety of disciplines as well as informed experimentation by federal and state agencies remains essential to achieve the promise while avoiding the pitfalls of targeted transparency.

References

1 Executive Order 13563, January 18, 2011.
3 See the Patient Protection and Affordable Care Act, Section 4205 regarding nutritional labeling requirements for restaurants and vending machines. A Kaiser Family Foundation tracking poll in November 2011 found the simplified disclosure requirement regarding insurance to be the single most popular provision of the Act. See Kaiser Family Foundation Health Tracking Poll, November 2011, http://www.kff.org/kaiserpolls/8259.cfm (accessed October 30, 2012).
4 See the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub.L. 111-203, Title VII.
6 For example, in the 1990s, Richard Zeckhauser and Cass Sunstein separately developed the idea that government-mandated disclosure of standardized information could influence corporate decisions concerning public health and safety while Tom Tietenberg and Mary Graham focused on disclosure strategies for pollution control. In 1999 William T. Gormley and David Leo Weimer examined the design and effectiveness of organizational report cards. [The suggested reading at the end of the article will list these and could also include the other citations in endnote 7.]
9 For a discussion of the broader phenomenon of policy drift, in which policies become ineffective over time as conditions change and actors learn to take advantage of ambiguities, see Hacker, Jacob S., and Paul Pierson. 2011. Winner-Take-All Politics: How Washington Made the Rich Richer--and Turned Its Back on the Middle Class. (New York: Simon & Schuster).
11 Dranove and Jin (2010).
13 The 2001 Nobel prize in Economic Sciences was awarded to George A. Akerlof, Michael Spence, and Joseph E. Stiglitz for their pioneering work on imperfect information. For a comprehensive review, see Stiglitz,


The last example relates to a famous experiment conducted by Kahneman and Tversky involving “Linda the bank teller” in which people systematically select an outcome, described by two characteristics with independent probabilities as more likely than one described by only one of those characteristics. Such logic defies basic statistical reasoning (the probability of a joint, independent probability must be less than either of the two probabilities alone), and is cited as an example of a persistent cognitive error. However, proponents of the “fast and frugal” school argue that the social context of information—here, that the party is giving information about two dimensions—is in itself additional information that provides a useful cue.


Daniel Ho makes this argument about the failure of restaurant hygiene ratings in New York City. It should be noted, however, that any regulatory system with “teeth” will elicit efforts on the part of the regulated to subvert it. Ho, Daniel. 2012. “Fudging the Nudge: Information Disclosure and Restaurant Grading.” *Yale Law Journal*, vol. 122 (Forthcoming)


