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PRIVATE REGULATION

A Real Alternative for Regulatory Reform

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Executive Summary

The federal regulatory system in the United States needs reform. Today, federal regulations take too much time, money, and resources to deliver results. Each year, Americans spend $710 billion to finance federal regulatory agencies and to comply with the federal regulations.

The original meaning of "regulate"--as in the constitutional authorization to "regulate . . . interstate commerce"--was to "make regular." In this sense, regulations provide customers information and help people make informed decisions so that they can protect themselves from dubious products.

But it is a mistake to assume that "regulation" necessarily involves the government. Much regulation in the American economy is private, produced and enforced by independent parties or trade associations. These private organizations can oversee market participants' actions by different processes, such as standard setting, certification, monitoring, brand approval, warranties, product evaluations, and arbitration. Private regulation works, and it deserves closer attention.

The federal government should consider transferring regulatory functions such as certification, inspection, monitoring, and product testing to independent parties; it should also consider allowing independent parties to compete with federal agencies in setting standards.

Incorporating independent third parties into the regulatory process will eliminate the existing command-and-control system and replace it with a flexible, responsive, and evolutionary process. It will drastically reduce the compliance costs of regulations by decreasing the time and other resources spent by businesses and private individuals.

Introduction

The federal regulatory system in the United States needs reform. Today, federal regulations take too much time, money, and resources to deliver results. Both Congress and the president have recognized the urgent need for regulatory reform. Since 1993, a number of major policy initiatives have been introduced to make the regulatory system work, but those attempts have yet to deliver effective results. In the meantime, the regulatory burden on the American people continues to increase.

Regulation is a powerful and appealing alternative for policymakers. It does not require direct taxing or spending by the federal government. In fact, the annual cost of running regulatory agencies within the federal government is around $17 billion, only 1.5 percent of the total federal budget.[1] As a consequence, the federal government is in the habit of creating new regulations to remedy various social problems.[2]

On-budget costs of federal regulation are only the tip of the iceberg. The total burden of regulation on the American people includes the value of all resources devoted to complying with those regulations. Today, there is no comprehensive accounting system to assess the costs and benefits of regulatory actions; however, estimates show that traceable costs of regulations including agency maintenance, compliance, and paperwork add up to around $710 billion per year.[3] This figure cannot account for hidden costs--or deadweight losses such as forgone benefits that people could have achieved--had resources not been spent on regulation.

Real regulatory reform should reduce the burden of regulation while keeping America safe and prosperous. Writing down more rules, or "micromanagement by the government,"[4] cannot achieve this goal. The regulatory system should be able to deliver positive incentives so that people will "voluntarily modify their behavior."[5] To accomplish that goal, other alternatives need to be examined.

In a discussion of regulatory alternatives, the first question that should be considered is why we want regulation at all. What is the goal of regulation? After all, the best guarantee of quality and price is a competitive marketplace--knowing that there are other suppliers forcing each producer to supply adequate quality at a competitive price. And whenever disputes arise in commerce we can turn to the courts.[6] So why not let the competitive marketplace and tort law protect us?

In the absence of regulations, damages resulting from the use of a particular good or service will be addressed by the courts. While regulation is preventive and anticipatory, tort cases take place only after a complaint arises and is brought to the court. In this sense tort law is responsive, not preventive.[7] However, the use of tort law is not a superior alternative to regulation. Tort cases in the United States are based on "strict liability" rather than "negligence."[8] That is to say, tort law does not offer well-defined standards of performance. The lack of such standards creates uncertainty for both buyers and sellers

and deters innovation.[9] In addition, the increasing ease with which compensation is collected through the court system has had many adverse consequences.[10] As exercised in the United States, tort law has lost its resilient nature. Preventive regulation might be a less costly alternative that could make up for the failures of our liability system.

Consumers often find the marketplace chaotic, with a dizzying array of prices and levels of quality. They lack knowledge about how to judge particular products and services, and they may seek more certainty about prices, quality, and safety than the market produces. Rules that provide regularity in the marketplace may in fact reduce search costs for consumers and help them make informed decisions.

The original meaning of "regulate," as in the constitutional authorization to "regulate . . . interstate commerce," was "to make regular." Producers may get together to regularize price schedules, making it easier for consumers to understand an array of prices (providing that antitrust laws do not prevent such regularizing). Regulations can disclose information on the safety and quality of a product or service and reduce information costs borne by consumers. By revealing various characteristics of goods and services, regulations reduce uncertainty. Regulations can also involve scientifically valid assessments of risks and help consumers avoid mistakes.[11]

Regulations are often desirable because they inform, educate, reduce uncertainty, and help people protect themselves from dubious products. However, it is a mistake to assume that "regulation" necessarily involves government. Much of the regulation in the American economy is entirely private, produced and enforced by trade associations or independent third parties. Private organizations can oversee market participants' actions by processes such as certification, brand approval, and standard setting; impose enforceable sanctions; and ensure that businesses deliver what they promise. This process takes much less time, consumes fewer resources, and costs less than its coercive counterpart. In addition, independent parties are responsive and flexible, evolutionary, and can avoid "one-size-fits-all" regulation.

The U.S. economy exhibits many examples of third parties that privately regulate market participants' behavior. Those examples can serve as a model for a true regulatory reform that would shift regulatory functions from the government to markets.

The Costs of Government Regulation

Federal regulations are intended to reduce uncertainty and search costs and to increase safety and quality. Even if they deliver those benefits, we need to compare the benefits with the costs. Today, there is no comprehensive accounting system that keeps track of the full cost of federal regulation on the American people. A realistic estimate, however, should account for all of the following:

• On-budget costs, or the costs of running and maintaining federal regulatory agencies.

• Compliance costs, or the costs that individuals, businesses, and the government have to bear in order to comply with the regulations. Compliance costs include the necessary expenditures for meeting regulatory requirements and the resources spent on filing the paperwork required by a specific regulation.

• Hidden costs, or the indirect costs of regulation, which include benefits that could have been attained if available government and private resources had not been devoted to excessive regulatory activity. The hidden costs of federal regulatory activity would include lost benefits (like increased security) of forgone public services (like more law enforcement), and benefits from alternative uses of private individuals' wealth (like better education, hence more human capital; higher income, hence higher living standards; or new businesses, hence more growth).

On-Budget Costs

Today, the budgeted cost of running federal regulatory agencies is around $17 billion.[12] Real government spending on 56 regulatory agencies increased by 800 percent between 1960 and 1995. Regulatory spending decreased during the Reagan period and started increasing during the Bush administration. Except for a slight dip in 1995, the costs have continued to rise (Figure 1).

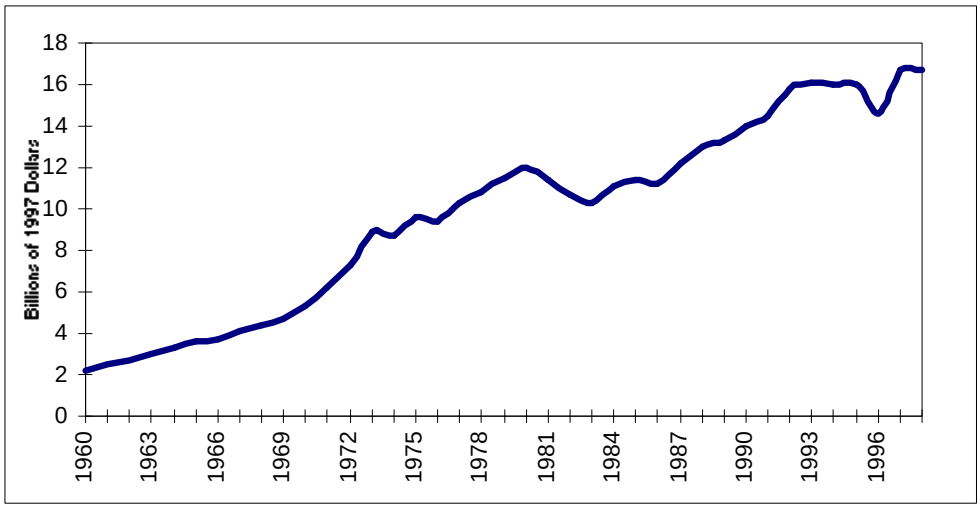
Even after adjusting for inflation, 1997 federal regulatory spending is almost three times the 1970 level.[13] Regulatory spending as a percentage of gross domestic product increased sharply until the 1980s. A significant decline took place during the Reagan administration, followed by an increase during the Bush and Clinton administrations. (Figure 2).[14] The number of full-time staff on regulatory agencies is estimated to be 125,773 for 1997, an 80.5 percent increase since 1970, when federal regulatory agencies employed 69,773 people.[15] Like regulatory spending, the number of total full-time, permanent employees fell from 121,791 to 104,412 during the Reagan period and started increasing during the Bush administration.[16] Since 1990, the number of full-time employees has increased by 9.8 percent.

Other measures of regulatory expansion are the numbers of pages of the Federal Register and the Code of Federal Regulations. The Federal Register is a government daily record book that keeps track of all regulatory proposals. Although the Federal Register includes regulatory proposals that are later dropped or modified, as well as notices removing regulations, it is still a useful measure of the time and resources devoted to regulatory purposes within the federal government. The Federal Register had 20,036 pages in 1970.[17] Even between 1995 and 1996, during the "reinventing government" project, the number of pages increased by almost 2,000, reaching 69,366 in 1996. The Code of Federal Regulations (CFR) is a record of all annual executive agency regulations,

including previously issued regulations that are still in effect. In 1970, the CFR occupied 54,834 pages.[18] By 1985, that number had increased to 105,935. In 1996, the CFR occupied 50 volumes totaling 124,156 pages.

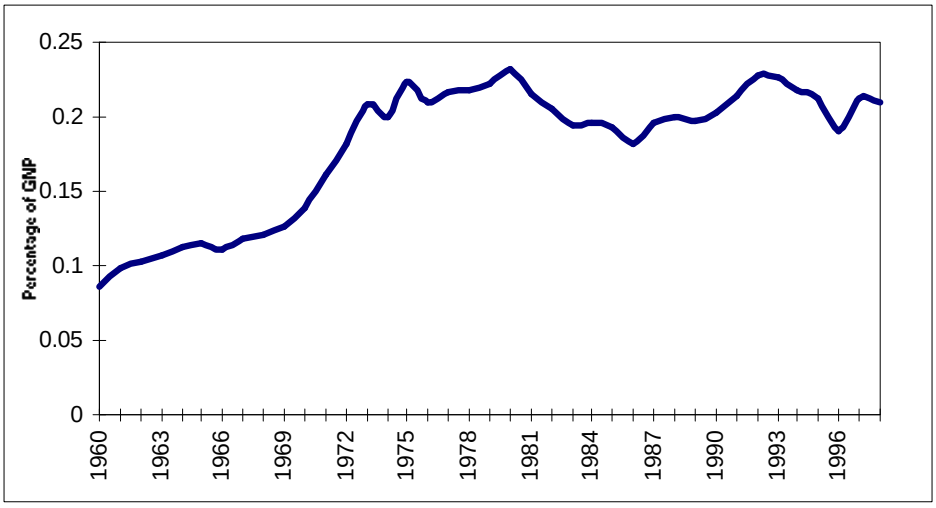
Under the auspices of the Clinton administration's "reinventing government" program, Executive Order 12866 issued in September 1993 mandated "reinventing" the pages of the CFR. As of September 1996, various agencies had eliminated 11,569 pages from the CFR. Elimination of pages, however, did not result in significant reductions in regulatory costs.[19] The eliminated pages consisted mostly of duplicative rules and regulations that are no longer appli cable. Despite elimination of pages, the CFR has continued to increase by thousands of pages each year. For example, in July 1995 the Environmental Protection Agency (EPA) had 14,384 pages of regulation in the CFR. As of July 1, 1996, EPA had eliminated 1,292 pages of the CFR, but by August 1996, EPA regulations had expanded to 14,690 pages, an increase of more than 300 pages in one year.[20]

Figure 1
Real Spending for Federal Regulatory Programs



Source: Christopher Douglas, Michael Orlando, and Melinda Warren, "Regulatory Changes and Trends: An Analysis of the 1998 Budget of the U.S. Government," Center for the Study of American Business, Policy Brief 182, August 1997, Table A-4, p. 31; Historical Tables from the Budget of the United States Government: Fiscal Year 1998; and author's calculations (1997 and 1998 are estimates).

Figure 2
Spending on Federal Regulatory Activity as a Percentage of GNP



Source: Christopher Douglas, Michael Orlando, and Melinda Warren, "Regulatory Changes and Trends: An Analysis of the 1998 Budget of the U.S. Government," Center for the Study of American Business, Policy Brief 182, August 1997, Table A-4, p. 31; Historical Tables from the Budget of the United States Government: Fiscal Year 1998; and author's calculations (1997 and 1998 are estimates).

Compliance Costs

Regulatory spending is only a tiny fraction of the federal budget. In fact, budgeted appropriations for regulation account for only 2 percent of the total regulatory burden. Far larger are the compliance costs, which include the costs--borne by businesses and consumers--of meeting regulatory obligations, as well as the costs to state and federal agencies of complying with other agencies' regulations. Economist Thomas D. Hopkins of the Rochester Institute of Technology divides compliance costs into three parts:[21]

- Compliance costs of environmental regulation and risk reduction,

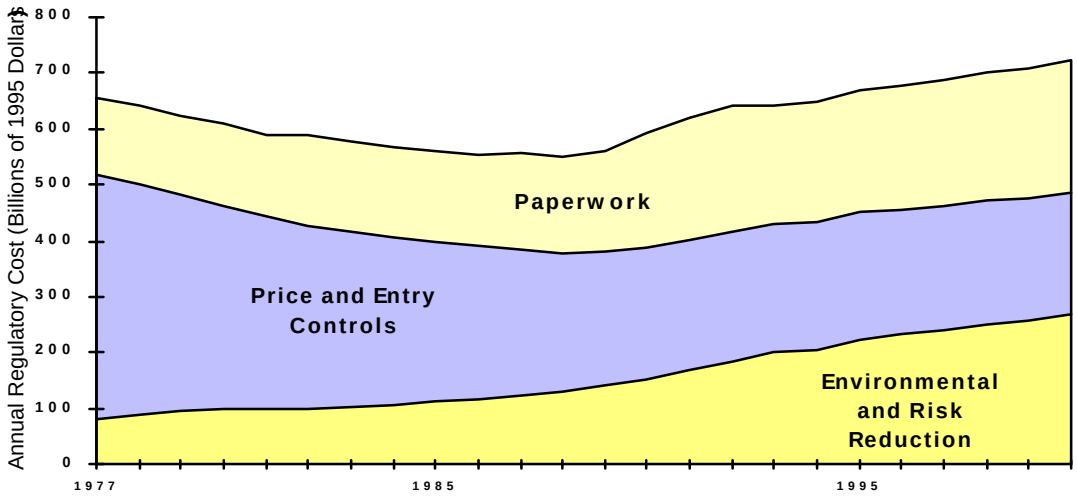
- Compliance costs of price and entry control regulations, and

- Compliance costs of paperwork, which include the cost of paperwork requirements not having a direct social or economic function. This category is largely the value of the time that businesses and people have to devote to paperwork.

Hopkins finds that in 1995 the American people had to spend $668 billion just to comply with the regulatory burden, and he projects that the figure could rise as high as $750 billion by the end of the century (Figure 3). The compliance costs fall disproportionately on small businesses,[22] which pay more in relative terms than do larger

entities. Businesses with fewer than 20 employees had to spend $5,500 per employee in 1992 just to comply with the regulations. In the same year, the per-employee cost of regulations for businesses with 500 or more employees was $3,000.[23]

Figure 3
Patterns in Total Regulatory Costs



Source: Thomas D. Hopkins, Regulatory Costs in Profile, pp. 9-10, Figure 2 and Table 2 (1995-2000 are estimates).

During the late 1970s and early 1980s, price and entry controls declined.[24] However, social regulations for environmental protection and risk reduction accelerated. In 1977, the cost of environmental and other social regulations was around $79 billion in 1995 dollars, only 12 percent of the total costs of regulation. In 1995, this number reached $223 billion, 33 percent of total regulatory costs.[25] For example, the Occupational Safety and Health Administration (OSHA) 1987 final ruling on the use of formaldehyde could save one person's life in every hundred years by spending $72 billion (in 1984 dollars).[26] The annual cost of complying with environmental regulations is $188 billion, 22 percent of total regulatory costs.[27]

The costs of regulation declined between 1977 and 1988, largely because of the reductions in economic regulations. Since 1992, with accelerated social regulation, the costs have been rising continuously.[28] According to Hopkins, "If all regulatory costs were shared equally and collected directly from individuals, every U.S. household in 1995 would have been billed nearly $7,000 in addition to taxes."[29]

Hidden Costs

Hidden costs consist of forgone benefits the American people could have collected if they did not face an excessive regulatory burden. Those costs are deadweight losses, which reduce the nation's wealth without any contribution to health, safety, or the quality of living.

One of the most important consequences of government regulations is the reduction of output. Regulations increase the costs for firms and, inevitably, the costs for consumers. As a result, productivity losses and decreased investment reduce total output and hamper growth. For example, economists Dale Jorgenson and Peter J. Wilcoxen of Harvard University estimate that when the Clean Air Act goes fully into effect in 2005, compliance with environmental regulations will reduce the nation's capital by 4 percent, increase the cost of capital by more than 5 percent, and reduce the rate of economic growth by more than 3 percent per year.[30] According to Richard Vedder, if the regulatory buildup since the Johnson period had not occurred, the U.S. economy could have been producing 20 percent more than its current total output.[31] That would represent a substantial increase in the standard of living, especially for low-income Americans.

Reduced wealth due to excessive regulations might in fact reduce living standards and increase mortality. Studies on health and longevity show that life-expectancy and health standards depend on economic progress.[32] Regulatory expenditures make the society poorer and divert resources from other uses like housing, food, medical care, and health services, all of which are crucial to high living standards.[33]

Regulations may also cost lives directly. The slowness in drug approval by the Food and Drug Administration (FDA) prevents Americans from accessing drugs that might save their lives. Even by a conservative estimate, FDA delays in allowing drugs used safely and effectively abroad to be marketed in the United States have cost the lives of at least 200,000 Americans over the past 30 years.[34] Today, it takes an average of 15 years to get a drug reviewed by the FDA.[35] For example, the FDA final review process takes around 28 months as opposed to the 180 days mandated by U.S. law.[36] Many drugs that are common in Europe become available to the American people only years later. This delay causes unnecessary pain, suffering, and deaths.[37]

At the same time, regulation destroys jobs. reducing the number of U.S. jobs by at least three million.[38] That happens in three ways. First, regulatory burdens increase the costs of employees to the firm. Mandated burdens like health insurance and paid family leave force firms to reduce their workforces. Second, regulatory burdens increase the overall costs to firms. This might force some firms out of business, or discourage people from starting up new businesses. Finally, some federal regulations even force people to close their businesses or carry them overseas. For example, federal efforts to protect the white-spotted owl closed millions of acres of land in Washington, Oregon, and Northern California and forced tens of thousands of loggers out of work.[39] FDA's slow and costly

drug approval process has forced medical manufacturers to move their businesses abroad, especially to Europe, where the regulatory environment is much more friendly.[40]

Congress and the president have been well aware of the problems with the current regulatory system. But such regulatory reform attempts as retroactive corrections, revisions, goal statements, cost-benefit analysis, and congressional review have occurred within the framework of the existing regulatory system and only produced marginal gains. Reforms can substantially reduce the burden of regulation on the American people only if they employ alternative models that would remedy the structural problems of the existing system.

Market-Based Solutions: Regulation by Independent Third Parties

Fortunately, the private sector offers a number of alternative models for regulation. Today, independent parties that certify, rate, or approve certain products and services confirm that markets deliver safe and high-quality products without federal regulation. Private regulation by independent third parties works and deserves closer attention as a possible alternative to the existing regulatory system for several reasons.

First, private regulation is effective. Even though compliance with private regulation is voluntary, market participants frequently choose to comply without any statutory mandates or government orders. In fact, firms perceive the compliance costs of private regulation as a necessity for survival in the marketplace rather than as a burden.[41] Take the example of product safety. Today, it is almost impossible for a producer of electric appliances and equipment to claim that its products are safe without the approval of Underwriters Laboratories (UL), an independent third party. Retailers, customers, and even insurance agencies look for UL approval. UL enforces high standards for product safety without government regulation, benefiting both producers and consumers.

Private regulation also has effective enforcement mechanisms. Independent third parties use legally enforceable contracts; sanctions including revoking of approvals, fines, and pulling products off the market; and public announcements. Companies that seek third-party approval also put their reputation--one of their most valuable assets--on the line.

Independent third parties are flexible and responsive. They are open to suggestions by industry members, consumers and consumer groups, academic institutions like universities or other scientific organizations, and even government agencies. As a result of that dynamic relationship, independent third parties closely follow changes and technological advancements to preserve their expert status. They continuously revise their standards or certification procedures.

Private regulation by independent parties also costs less. As opposed to federal regulatory agencies, which are run on tax dollars, independent third parties finance their

organizations by collecting from the businesses they regulate. Since the price of privately regulated goods reflects the full cost of regulation, independent third parties are very sensitive to the burdens they impose on businesses and consumers. They minimize the costs of running their organizations, and they decrease the costs of their regulatory activities by outsourcing various phases of the regulatory process, like product testing and evaluation. For example, the Green Seal, an independent organization that certifies "environmentally sound" products, uses the Underwriters Laboratories for product testing.

While increasing their own cost-effectiveness, independent third parties also lower compliance costs for businesses. In many instances, third parties provide firms with well-formulated guidelines and firm-specific recommendations, which help firms reduce compliance costs while meeting the necessary standards. Independent third parties also eliminate heavy paperwork, which significantly reduces the time-cost of regulation.

Indirect costs of private regulation are also minimal. Businesses know the fees and the compliance costs of private regulation in advance, and they can fully assess the expected costs and benefits. Firms choose to be regulated since such regulation will help them attract customers.

Patterns of Private Regulation by Independent Third Parties

In the United States, independent third parties play a variety of regulatory roles and oversee different phases of production and marketing activities (Figure 4). Major areas in which third parties assume a regulatory role are standardization, certification, brand approval, and warranties.

Independent third parties perform standardization duties when they have considerably greater knowledge and expertise in a given field. For example, Underwriters Laboratories has been setting standards for electric appliances for more than a hundred years.[42] Reputation and a large market share in a related product also provide third parties with standard-setting capabilities. Microsoft Corporation's dominant position in computer operating systems gives it the advantage of setting standards for complementary products like software.

Typically, in areas that require extensive specialization, standard-setting agencies are unique and do not face extensive competition. However, they face potential competitors in case they do not do a good job. Market authorities also face competition in the certification process.

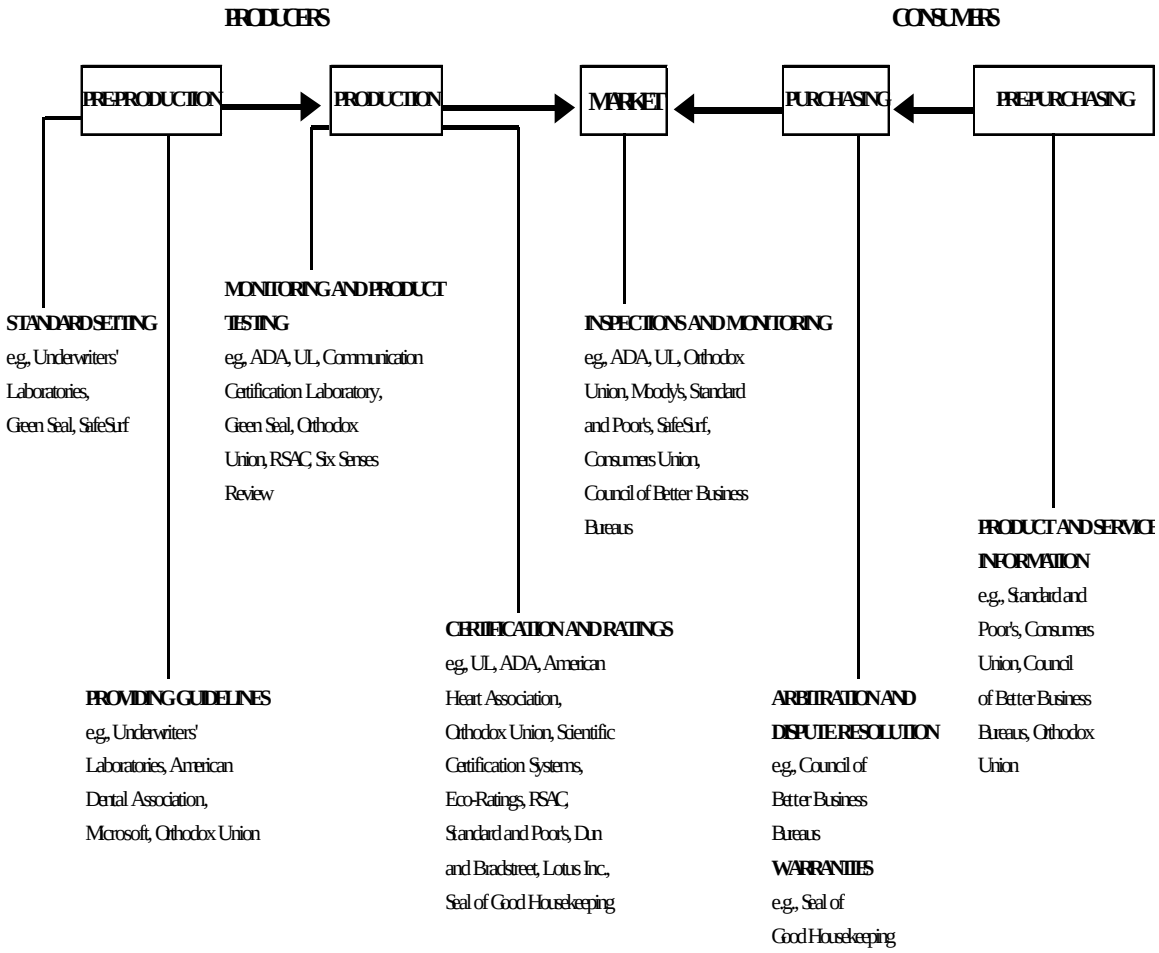
In cases where well-defined, widely accepted, and easy to understand standards exist, a different process of private regulation emerges. In such settings, institutions usually assume a certification role and face competition. Examples include the kosher food industry, financial ratings, and Internet ratings. Independent third parties also provide warranties and brand approvals. Microsoft approves software that is compatible

with its operating systems. The Good Housekeeping Institute provides warranties to consumers by promising refunds in case a product proves to be defective.

The roles of independent parties are not limited to standard setting and11 certification. Consumers Union directly aims at consumer protection but also delivers product evaluations that act as certifications without an official seal. The Council of Better Business Bureaus sets ethical standards for business conduct and provides arbitration for solving consumer problems.

In these ways, private regulators perform functions quite similar to those of government regulators.

Figure 4
Patterns of Private Regulation by Independent Third Parties



Examples of Private Regulation in the United States

Standard Setting and Certification

Underwriters Laboratories and Its Competitors. Underwriters Laboratories (UL) is an independent, not-for-profit organization that establishes safety criteria for a wide variety of manufactured products, systems and components, including electric appliances and equipment, automotive and mechanical products, fire-resistant building materials, medical appliances, bullet-resistant glass, and OSHA-designated "hazardous location" products like alarm systems and chemicals.[43] UL provides a full range of conformity and quality assessment services to manufacturers and other organizations, assists jurisdictional and provincial authorities, and provides educational materials to consumers. Besides testing, certification, and quality assessment services, UL also develops national and international standards that are widely used by manufacturers, other certification and testing laboratories, and many governmental agencies.[44]

Today UL has developed more than 717 standards, 70 percent of which have been approved as American National Standards by the American National Standards Institute.[45] UL certifies more than 17,000 products in its laboratories, and each year issues around 10 billion UL marks, the trademark symbol of approval for UL-certified products.[46] In 1996, UL employed more than 4,000 professionals for testing and inspection, conducted 420,000 on-site follow-up visits, and completed approximately 80,000 product investigations.[47]

The UL trademark is widely accepted as a sign of reliability by vendors and customers. Virtually all retailers are reluctant to carry products lacking the UL mark of approval, and insurance companies occasionally deny liability coverage for products that lack the UL certification.[48]

Underwriters Laboratories is completely private and independent. Its certification is voluntary, and no legal mandate requires a product to display the UL symbol. Though it is older and larger than its competitors and holds a dominant position in the market, UL is not the only institution that sets standards or performs product testing and evaluation.

UL tests products solely for safety concerns and does not evaluate the effectiveness of a specific product. It does not provide any advertising, testimonials, or marketing support for products.[49] It strictly maintains its independence as a third party.

UL standards are detailed specifications for a given product category. The company provides a free catalog of standards together with a product index to interested parties.

New standards are written as needed by manufacturers, jurisdictional authorities, code developers, insurers, and others.[50] UL asks for criticisms and comments from all affected parties and develops a standard proposal. The proposed standard undergoes a

strict review process, and UL amends the proposal as comments come in. The finalized proposal becomes a "published standard" that UL distributes to manufacturers. The open process enables UL to revise and change its standards in accordance with technological changes and advancements in related industries. In fact, while new UL standards are being published on a regular basis, existing standards are also being evaluated as part of an on-going cycle of revision and updating.[51]

The manufacturer initiates the certification process by delivering to UL samples of its product and relevant information about the product. UL informs the manufacturer of applicable standards and an estimated fee for testing. If the manufacturer agrees to continue, UL prepares a safety report on the product. It also prepares a "Follow-Up Services Procedure" that describes in detail the construction of the product. That procedure is a part of UL approval and provides a guide for UL field representatives who periodically examine certified products in the factory. The manufacturer must comply with this procedure to retain UL approval.[52] UL conducts annual and unannounced on-site monitoring and product inspection. If a company fails the inspection, UL can revoke its certification of the product.

The certification charge depends on the nature of the products and the tests UL finds are necessary for approval. UL also charges a flat fee for annual monitoring and an hourly rate for its inspectors.

Although it is the dominant standard-setting body in the United States, UL has many competitors in testing and certification. UL and its direct competitors are certified by OSHA as "nationally recognized testing laboratories" in accordance with specific statutory guidelines. OSHA certifies any laboratory that can meet its standards. Many of UL's competitors that offer testing and certification services use UL standards as their guidelines or criteria. By September 1997, 12 other testing laboratories were competing directly with UL in testing and certification for a variety of products including electrical devices, commercial and household electric and gas appliances, and communication devices. These organizations include the American Gas Association; Canadian Standards Association; Communication Certification Laboratory; Electro-Test, Inc.; Entela, Inc.; Factory Mutual Research Corporation; Intertek Testing Services NA, Inc.; MET Laboratories, Inc.; Southwest Research Institute; TUV Rheinland of North America, Inc.; Wyle Laboratories; and United States Testing Company, Inc./California Division.[53]

UL, as an independent third party, has succeeded in enforcing high standards for product safety. It has not lowered its standards or testing criteria at any time in its century-long history. It has managed to keep up with advancements and innovations in the marketplace by keeping its doors open to recommendations and comments by those who are affected by its actions. Although it has some competitors in standard setting, UL has become an industry expert with standards that serve not only the United States but many other countries as well.

The unique success of Underwriters Laboratories has attracted a lot of attention. The UL model has been proposed as a possible alternative to regulatory reform of FDA's drug approval process.[54] However, the UL model is also applicable to other problematic regulatory issues, like food safety and occupational safety.

The UL model includes all the components of a complete regulatory system. It monitors and inspects both the production process and the final product. Its approval is well-known among market participants; revocation of that approval destroys the marketability of the product in question. What UL does for product safety is the equivalent of what various government agencies attempt to do for food and occupational safety. The main difference is that UL keeps up with the market needs in its areas of expertise and delivers results in a more effective and less costly manner.

The American Dental Association. The American Dental Association (ADA) is a membership organization for dentists and dental students. It also establishes standards for dental products and equipment, reviews products for dental safety, and sets guidelines for advertisement of dental products. The ADA has been involved in standard setting for almost 125 years.[55] It established guidelines for testing and advertising of dental products as early as 1872. The ADA Seal of Acceptance was first awarded in 1931[56] and is widely recognized today, especially among professionals.

The ADA is strictly voluntary. Its seal of acceptance is carried by 350 different companies and by 1,300 dental products. Thirty percent of the approved products are end-user products like toothpaste, dental floss, electric toothbrushes, and mouth rinses. The rest are products prescribed or used by dentists, such as antibiotics and dental restorative materials.

The ADA uses more than 100 consultants for product evaluation and standard setting, including the members of the ADA's Council on Scientific Affairs and ADA scientific staff. Companies that seek the ADA seal must meet a variety of criteria, in areas from the manufacturing process to advertising. Typically, a company must provide objective data from clinical and laboratory studies that support the product's safety, effectiveness, and promotional claims. The company must also conduct clinical trials as needed in strict compliance with ADA guidelines and procedures. It must submit for review and approval ingredient lists and other pertinent product information, as well as all advertising, promotional claims, and patient education materials.

The ADA charges submission fees and maintenance fees for its Acceptance Program. The one-time submission fee is $9,000 for over-the-counter products and $500 for non-over-the-counter products. If a product is accepted, that fee covers the first year. The yearly maintenance fee is $1,500 for over-the-counter products and $100 for non-over-the-counter products.[57] The ADA's Council of Scientific Affairs can remove the Seal of Acceptance from a product at any time if the manufacturer fails to abide by a standard after the seal has been awarded. The seal can also be removed from a product if a

company violates the rules for use of the seal at any time.[58]

The ADA not only reviews the ingredients of a given product or the quality of a dental device; it also approves the advertising and packaging of the product, ensuring truthful and reliable information. As an independent agency, it delivered truthful product labels long before the Food and Drug Administration enforced labeling requirements.

The ADA assures safe products and truthful information, what FDA has been striving to achieve as a government agency. Like the FDA, the ADA regulates such things as drugs, medical devices, and end-user products, assuring safety, quality, and reliability. It responds to the needs of professionals and values the comments of manufacturers. With the help of industry experts, it frequently revises its Standards and Acceptance Program. Unlike the FDA, the ADA makes all of its standards and guidelines available to companies before approval, reducing the companies' compliance costs. The ADA also reduces the time and money costs of certification by employing other clinical laboratories while enforcing its own standards. The ADA and its Acceptance Program can serve as an alternative model for badly needed FDA reform.

Microsoft and Its Competitors. Today, Microsoft Corporation is an industry giant, providing computer operating systems to more businesses and households than the rest of its competitors combined. Microsoft's worldwide acceptance as a reliable and high-quality producer has enabled the company to be a widely recognized standard-setting organization for many complementary products like hardware and software.[59]

Through its partners program, Microsoft extends approvals to software and hardware that are compatible with various Microsoft products. The partners program is extremely specialized, covering many categories of products. For example, the Microsoft Independent Courseware Vendor Program covers only companies that design, develop, and market self-paced courseware, books, and other products that support Microsoft's technical education programs.[60]

Enrollment in the partners program is free. Vendors must pay a one-time fee of $2,600 per product for the review process.[61] If a company fails to pass the review process in its first attempt, Microsoft provides guidelines and suggestions for improving the product. It also charges an additional $1,500 for the subsequent review process. Once the product passes that review, it is awarded the Microsoft logo that is applicable to the relevant program. For example, independent courseware vendors receive the Microsoft "Certified Professional--Approved Study Guide" logo, whereas other independent vendors that develop recreational software for Windows 95 qualify for a "Designed for Microsoft Windows 95" logo.

Microsoft uses independent third parties for the software review process. The review takes from 5 to 10 business days. An independent third party reviews the products

following the guidelines issued by Microsoft. Those guidelines outline the desired characteristics in a complementary product. Products must also meet other quality standards set by the independent third party.

Hardware certification is done solely by Microsoft's Windows Hardware Quality Compatibility Labs (WHQL). WHQL's activities ensure quality computer hardware, including systems and peripherals available to users of Windows 95. Only hardware that passes WHQL certification tests qualifies to display the "Designed for Microsoft Windows 95" logo—the customer's assurance that a piece of hardware and associated device drivers will work with the Windows 95 family of products.

Microsoft's reputation enables the corporation to use its brand name as a sign of quality on other companies' products. Whereas nonprofit organizations like Underwriters Laboratories and the American Dental Association establish their credentials by "performing a public duty," Microsoft derives its credibility from its enormous success as a for-profit corporation.

Is standard setting part of an aggressive marketing strategy employed by Microsoft? One can argue that Microsoft could use its dominant position to put its competitors at a disadvantage in the operating systems industry. The fact is that Microsoft is able to set standards because of its leadership position in technology development and innovation. Microsoft can privately regulate because of the high quality and trust attached to its name, and it can use that power as long as it maintains its own reputation as a reliable producer.

Microsoft is not alone in brand approval. For example, Lotus Development Inc. initiated a similar program in 1995, and currently certifies and approves products by independent vendors that are Lotus compatible.[62] The Lotus partners program currently includes more than 4,200 companies that offer products and services based on Lotus technologies. Lotus provides certification as a free service to independent vendors who join the Lotus Business Partners Connection, a program designed for enhancing the marketability of Lotus compatible software. The annual fee for joining the Business Partners Connection is $495.

Brand approval by Microsoft or Lotus is solely a marketing activity. Microsoft and Lotus try to extend their market shares by expanding the list of complementary products available for end users. Companies that seek certification do the same thing by linking their names to well-known industry giants. In addition to making companies more profitable, that process also widely benefits the computer users who now deal with substantially fewer problems of compatibility. Market-based incentives provide an additional monitoring system for dependable, safe, and high-quality products without federal oversight.

Green Seal and Its Competitors. Green Seal develops and enforces standards for

environmentally sound products. The Green Seal of Approval is a certification program that labels products like napkins, bath and facial tissues, paints, efficient water fixtures, household cleaners, major household appliances, and re-refined engine oil. Green Seal defines itself as a national nonprofit labeling organization that helps consumers, both individual and institutional, choose environmentally preferable products.[63] An environmentally preferable product is one that causes significantly less harm to the environment when it is manufactured, used, and disposed of or recycled.

Green Seal develops environmental standards by a process of public review. First, it accepts category proposals from industry, consumer groups, environmental groups, and the public. Then it studies various characteristics that identify the environmental impact of manufacturing, consumption, and disposal of products in that category. It turns the results of the study into a proposed standard and circulates that proposal for public review. After manufacturers, trade associations, environmental and consumer groups, government agencies, and the public comment on the proposal, Green Seal releases a final standard.

The Green Seal of Certification is awarded to products that comply with the Green Seal standards. Certified products carry labels that tell consumers about significant environmental attributes, like the amount of certain toxins used in manufacturing and recycling characteristic of a product.[64] Companies that seek a Green Seal of Approval must apply for certification testing. The cost of certification is $5,000,[65] not including administrative costs, such as travel expenses, or the cost of the tests necessary for certification. Before certification testing takes place, Green Seal provides companies with estimated costs of product evaluation and testing fees.

Green Seal uses Underwriters Laboratories for all product evaluation tests. After a product passes the tests and becomes certified, Green Seal works with the company on designing the label that will appear on the product. Once the seal is awarded, the company signs a legal contract with Green Seal. Inspections are done by annual monitoring. Green Seal certifies more than 50 different categories, and has awarded its seal of approval to more than 230 products.

Green Seal's primary goal is to serve the public by promoting higher environmental standards. Green Seal views the voluntary participation of many industry leaders in the Green Seal of Approval program as an important indicator of the organization's success in reducing environmental pollution.[66]

Green Seal is not alone in private environmental regulation. Scientific Certification Systems is an internationally recognized independent third party that certifies particular attributes of participating products and prepares a "report card."[67] The report card, attached to the seal of certification, reports the superior characteristics of a given product by measures of reductions in energy consumption, carbon dioxide emission, acid rain, toxic water pollution, and solid waste.

Eco-Rating International, Inc., is a for-profit organization that also rates a wide variety of products and services for environmental soundness.[68] Ratings are performed on the basis of criteria such as the ingredients or raw materials, the manufacturing process, and waste generated during manufacturing or disposal of a product. Eco-Rating International rates consumer products, factories, corporations, and even vineyards and hotels. It promotes its ratings as a performance scale, similar to financial indices such as Moody's or Standard & Poor's.[69] According to the organization, an Eco-Rating benefits the bearer by attracting capital, reducing insurance premiums, and enhancing company image.

Green Seal, Scientific Certification Systems, and Eco-Rating International contribute to environmental protection by reducing environmental pollution, cutting waste of energy and natural resources, slowing ozone depletion, protecting wildlife, and reducing the use of toxic materials--all without federal regulation.

Even with organizations like Green Seal, of course, environmental problems will continue to exist, because the environment is an unowned resource. In other words, there are no well-defined property rights in environmental amenities, like air or wildlife.[70] Lack of property rights reduces people's willingness to protect the environment, in the same sense as they would protect their homes from hazards or their bodies from food poisoning. The opportunity to benefit from others' actions, in this case in the form of a clean environment, without having to pay might induce people to choose cheaper, low-quality products that generate more pollution. Independent third parties may increase the "environmental quality" of available goods and services by increasing the willingness of consumers to pay for environmentally safe products, but in the absence of property rights they would not suffice to develop enforceable standards. In that case, mandated regulations (but not necessarily mandated by the government) might be desirable.

Certifications and Ratings

Kosher Food and Halal Food. "Kosher" means fit or proper in Hebrew. Kosher food must meet all the various requirements of the dietary laws (Kashrut). The laws of Kashrut, created more than 5,000 years ago,[71] have evolved over time through extensive rabbinical interpretations and refinements.[72]

The laws of Kashrut extensively regulate eating habits, including the process of preparation. For example, meat can be kosher only if it comes from mammals that chew their cud and are cloven-hoofed. All birds of prey are forbidden. Fish must have fins and scales. Animals must be slaughtered in a special way. All ingredients must be kosher, including flavorings and emulsifiers. Meat and dairy products may not be mixed, but must be prepared separately, using separate utensils. Food must be produced by kashered equipment-- equipment that has been cleaned in accordance with the rules of Kashrut.

These extremely complex rules require rabbinical supervision of food production,

Page 19

including preparing processes and ingredients. Today, more than 130 independent and nonprofit organizations inspect and certify kosher food. Four of those organizations operate at the national level; the Orthodox Union, based in New York City is the largest certifying agency. The remaining organizations are regional and typically certify local producers. Certifying agencies send rabbis to production plants to check for compliance with the rules of the Kashrut. After certification, producers can use the approval symbol of the certifying organization on their products.

During the 1970s, companies used a generic letter, k, to indicate that a certain product had passed the kosher certification test. At that time, some 2,850 companies produced around 11,000 different kosher certified products.[73] Within less than 30 years, the single letter
evolved into a comprehensive labeling system. Today, not only does each independent agency have its own symbol, denoting the source of certification, but there are also industry-wide codes that classify kosher products. For example, the word "Pareve" means a product does not have any dairy products in it. Products that have dairy ingredients carry the letter D. "Passover" or P indicates that the product does not include corn or corn syrup.

Today, not only observant Jews but also people with certain allergies--Muslims, Seventh Day Adventists, and people who are lactose intolerant--benefit from the kosher labeling system. Other people have turned to kosher products because they feel kosher food is safer as a result of extra inspection.[74] In 1996, 8,100 companies produced 38,000 types of kosher certified products. Around seven million consumers strictly looked for kosher approval, and the total market share of kosher certified products reached $3 billion.[75]

The certification process requires many visits from inspecting rabbis to the facilities of firms that seek approval. An agency may even designate one of its rabbis as a full-time inspector at a certain site. Producers have to submit a detailed report on their products before certification and when they change the ingredients of an already certified the product.

A product earns kosher certification after it passes the necessary requirements. The producer signs a contract that turns the certification into a legally binding contract. Besides contract enforcement, inspection organizations usually announce products that pass or fail the certification process through their newsletters, magazines, or Internet Web sites. Competition between different agencies has created different charging schemes and lower fees for certification. Today the cost of kosher certification usually amounts to fractions of a cent per item.[76]

Kosher rules are not health or safety rules.[77] But detailed inspections have turned the kosher symbol into a sign of reliability and cleanliness for consumers. Private kosher

regulation has been highly successful. Today, any firm that claims to deliver kosher food must seek rabbinical certification to legitimize that claim. Companies in the kosher food business have accepted third-party certification as a requirement for survival.

"Halal" food is prepared in accordance with Islamic rules, which mainly oversee meat preparation, but also apply to other products that have animal by-products, like food and cosmetics. The halal regulations are applicable mainly in slaughtering, preparation, and ingredients.

Halal food must be prepared, processed, and stored separately from non-halal food. The producer must prevent any contact between halal and non-halal products. Animals must be slaughtered by a Muslim who is mentally sound and knowledgeable of Islamic slaughtering processes.[78] Pork, pork by-products, and alcohol are strictly forbidden: halal food cannot contain any pork or lard.

Halal inspection and certification are quite recent in the United States. Until the 1990s, being "halal" was mainly a self-declared claim by producers. However, within the past five years, many agencies have begun to inspect and certify halal food and other products such as cosmetics. Among those agencies are the Institute of Halal Food Control (IHFC) and the Islamic Food Authority of America. IHFC is a membership organization, but it also offers certification to nonmembers. The Islamic Food Authority is an independent agency that offers both certification and other services like Islamic slaughtering.

Internet Ratings. The Internet has been a consumer product for only four years. In that short time it has managed to become a daily part of our lives. Today, government agencies, companies, organizations, and individuals have Web pages. The Internet has become a way to communicate, conduct business, learn, pay the bills, and have fun. On the other hand, horror stories about the Internet have become all-too-common fare for newspapers. We have been warned repeatedly about the adult-oriented materials, bomb recipes, and child abductors brought into our homes through computers.

Today 750,000 on-line users are under the age of 18.[79] That inevitably raises concern among parents, educators, and industry. The concern among market participants has already created a private regulatory system on the Internet: Web page ratings. It should be noted that, unlike the other ratings systems discussed in this paper, many of the software and Web site ratings systems were developed under pressure from Congress. Industry participants concluded that "voluntary" self-regulation was less threatening to online information and commerce than legislative action.[80]

The first attempts to develop content standards for Web pages and Web sites started in early 1995. Industry players including Microsoft Corporation, Netscape Communications, and Progressive Networks created the Information Highway Parental Empowerment Group (IHPEG), which is aimed at helping parents control their children’s

access to material on the Internet. Many different organizations announced standard development proposals that would accurately describe the contents of a Web page. A number of services and products--like Cyber Patrol, NetNanny, or Internet Filter--also emerged to block inappropriate content.[81]

IHPEG joined with World Wide Web Consortium (W3C) and 20 other organizations in the same year to create the Platform for Internet Content Selection (PICS). PICS is not a content rating system, and it does not specify any rules about Web page contents. It is a standardized tool, like a common language, that provides a single technical method for the Internet rating organizations. PICS has provided a common platform for the encoding method for the rating systems.[82] It has enabled users to identify the contents of a rated page regardless of the rating agency and selectively block information based on an assigned rating. Today many independent Internet rating agencies develop their rating systems using PICS as an encoding standard.

Although Internet rating is new, many independent organizations already compete with one another in developing and implementing comprehensive rating systems. SafeSurf, with its Internet Rating Standard, is one of the oldest. SafeSurf operates as an independent third party, assuring customers of a child-safe Web environment. Its services include filtering software, content ratings, site classification, and parental education.[83] SafeSurf's Organization Review Committee rates Web pages based on various categories, including suitable age range, profanity, gambling, violent themes, and adult material. SafeSurf ratings can be placed on Web sites by any individual. But the ratings are subject to SafeSurf's approval and confirmation, and if SafeSurf discovers that a web page does not meet the standards of the ratings it carries, it changes or removes the ratings.

The Recreational Software Advisory Council (RSAC) is a Washington-based nonprofit organization that rates and certifies Web sites and computer software. RSAC, unfortunately, was formed under government pressure and bears some similarity to earlier efforts such as the Motion Picture Association of America ratings and the V-chip, also "private" ratings developed under government pressure.[84] RSAC defines its mission as empowering the public, especially parents, to make informed decisions about electronic media by means of an open, objective content advisory system.[85] RSAC uses its own rating system to rate computer game software. The RSAC system requires participating companies to fill in a questionnaire that asks detailed questions about their products. RSAC then reviews the questionnaire and assigns a "thermometer" label for the product.

RSAC merely describes the contents of a given product based on its standards; it does not recommend a suitable age group and leaves the choice to parents. RSAC requires the companies to sign a legally binding contract that outlines the terms of the rating agreement. If the actual qualifications of a product fail to match the reported qualifications in firm questionnaires, the contractual agreement authorizes RSAC to levy fines up to $10,000 and can require companies to pull their products off the shelf. RSAC

has rated more than 350 game titles from 94 different companies. So far it has faced only two appeals, and no suits have been filed for misrepresentation.[86] In April 1996, RSAC developed a very similar system, called RSACi, for Internet content ratings. It is using the PICS standard for rating encoding. The paper copy questionnaire is replaced with a Web-based questionnaire. The rating system is voluntary and currently free.

Content rating is not limited to child-safety concerns. For example, The Six Senses Review is a healthcare and medical Web site review organization that rates the Web pages of healthcare companies.[87] The review has six different categories, and the Web pages that collect a certain number of points over those categories are awarded with the Six Senses Seal of Approval. The rating system acts like a prescreening process for Internet users, drastically reducing the time it takes to retrieve relevant information.

Despite the Internet's brief history, major users have managed to set technical standards required for a common regulatory language. Today, numerous independent third parties develop content standards and rate Web pages. It is true that organizations like SafeSurf cannot keep indecent material away from children by themselves--only parents can do that by choosing to use ratings like SafeSurf's. Independent third parties have provided parents with the tools they need. Web page ratings enable parents to selectively block material from their children without limiting others' free speech or right to choose. Private regulation will be essential in persuading most parents to give their children Internet access, but First Amendment concerns mean that such regulation shall remain entirely private, neither imposed nor encouraged by government.

Financial Rating Services. Financial rating institutions evaluate a company's economic solvency. Financial rating companies rate the future ability of a bond issuer to make full and timely payments on principal and interest due to investors. Today many independent, for-profit companies assign ratings on long-term and short-term debt issued by privately held firms, corporations, and governments. Rating institutions also rate the ability of a borrower to honor other financial obligations like commercial papers, swaps, options, forwards, or letters of credit. They rate stocks, municipal bonds, mutual funds, and insurance companies' financial strength.

In the United States, financial rating organizations have served as a quality control mechanism for more than a century. Financial ratings privately regulate the financial sector by assigning standardized quality tags on various investment opportunities. Borrowers and investors voluntarily adopt these ratings. Ratings help investors manage risks on various investment decisions, and render a reality check on performance for borrowers. Financial rating companies view themselves as service providers both for the buyers and the sellers and identify their mission as promotion and protection of trade.[88]

The first independent organization that extended impartial credit evaluations was established in 1841 in New York as the Mercantile Agency. The Mercantile Agency is the father of Dun & Bradstreet, one of today's biggest rating companies.[89] Within a century,

letters of recommendation widely used by 18th- and 19th-century traders evolved into a comprehensive rating system run by global rating companies that provide information on all aspects of trade.

Financial ratings are subjective risk assessments. Ratings provide information on the possible future performance of a debtor based on historic evidence as well as forecasts of general economic performance. Financial rating companies compete on the accuracy and predictive power of these ratings. Examples include Moody's, Standard & Poor's, Dun & Bradstreet, and Duff & Phelps.

Most borrowers approach financial rating agencies prior to the sale or registration of debt issues.[90] Rating agencies meet with the management of the issuing company and assign experts on the issuer's specific industry to collect the necessary information and render a rating.[91] Depending on the company and the issue date, ratings are usually delivered within four to six weeks. Ratings only measure the risk of credit loss on a given debt. Rating agencies reveal their ratings prior to the sale or registration of the debt issues, and they continuously monitor and review their ratings. For example, Standard & Poor's generally conducts a formal written review every year and changes ratings as necessary. However, rating agencies do not provide guidelines or advise issuers on improving their ratings. They strictly view themselves as independent agencies and perceive an advisory role as a potential threat to their credibility.

These independent, for-profit institutions promote and protect trade. They serve investors and debt issuers by differentiating valuable investment opportunities from lemons. For-profit agencies that independently regulate the financial markets minimize fraud, increase market participants' trust in one other, and help direct investments to financially strong and promising alternatives.

Consumer Protection: Monitoring, Reviews, and Warranties

The Council of Better Business Bureaus. The Council of Better Business Bureaus (CBBB) is the central organization of more than 150 local nonprofit bureaus in the United States and Canada.[92] The CBBB sets ethical conduct standards for member businesses and provides free business reports for consumers. The council describes its mission as "promoting and fostering the highest ethical relationship between the businesses and the public."[93]

Companies that have been in business for more than six months can apply for a membership in a local bureau. Membership criteria include compliance with guidelines set by the CBBB governing advertising and selling, promotion of goodwill in addressing consumer complaints, and compliance with local and federal regulations.[94]

The CBBB's business reports aim at providing prepurchase information for

consumers. A typical business report includes the company's name, establishment date, and company record. The council also includes complaint patterns and legal sanctions for unsatisfactory company records.[95]

The CBBB also acts as an arbitration agency, resolving disputes between its members and consumers. Dispute resolution services are free for consumers. In 1996, the CBBB handled more than 1.5 million consumer complaints. The council also has a National Advertising Division that handles disputes about national advertising claims.[96] In 1996, the Council's Children's Advertising Review Unit initiated self-regulatory guidelines for children's advertising. In April 1997, the CBBB launched BBBOnline, which aims at expanding the services provided by the council to businesses operating online. The CBBB offers its seal on the Web page of an online company as an indicator of reliability.

Consumers Union. The Consumers Union of the United States (CU) was established in 1936 as an offshoot of Consumers' Research, founded by Stuart Chase and F. J. Schlink in 1929. Chase and Schlink believed that manufacturers used consumers as "guinea pigs." To protect consumers, they published a monthly newsletter that within five years had gained 50,000 subscribers.[97]

CU seeks to protect consumers from "shoddy and unsafe products" and "deceptive business practices" by evaluating and testing products and services and publicizing the results. CU evaluates around 1,500 products every year and publicizes the results in its monthly publication Consumer Reports, its annual Buying Guide, and other media. More than five million Americans subscribe to Consumer Reports, making its circulation bigger than that of Newsweek or Time. Consumer Reports evaluates products in a variety of categories, including cars, exercise machines, running shoes, blood-pressure monitors, lawn mowers, air conditioners, pasta and spaghetti sauce, and nationwide restaurants. CU also publishes Zillions, a consumer magazine for children, and other newsletters on health and travel.

CU issues reports on "dubious business practices, unsafe product design, inadequate labeling, health quackery, and environmental considerations related to consumer products."[98] In addition to its magazines and newsletters, CU broadcasts its product reports on television and radio stations across the country, and its biweekly column is carried in more than 450 newspapers. CU also publishes approximately 30 books a year. Subscribers to Consumer Reports play an important role in evaluating products by filling out surveys and questionnaires. Subscribers receive an annual survey with questions about what they think of the products and services they bought during the year.

To maintain its independence, CU buys all the products it tests on the open market and does not accept advertising for its publications. CU also prohibits companies from using its reports to promote their products--for example, by advertising a product as receiving a high rating in Consumer Reports. CU also engages in advocacy work with

government bodies on consumer protection issues.

In 1996, CU had an annual budget of $100 million and a staff of more than 300. Its revenue comes only from sales of its publications and other information products, noncommercial grants, and individual contributions. In addition to its headquarters north of New York City, CU has offices in Washington, D.C.; Austin, Texas; and San Francisco.

Good Housekeeping. The Good Housekeeping Institute is the consumer product evaluation laboratory of Good Housekeeping magazine.[99] The institute was founded in 1901 for the purpose of consumer protection, education, and product evaluation. It includes departments specializing in engineering, home care, food, appliances, chemistry, environmental studies, nutrition, beauty products, and textiles. The institute oversees all advertising appearing in Good Housekeeping, and evaluates the acceptability of products for advertisement.

The Good Housekeeping Institute mainly tests for the durability and the quality of products. Products that pass the evaluation tests can place an advertisement in the magazine. Approval for advertisement is an advertisement itself, ensuring the quality and reliability of the product.

Since 1909, the institute has been awarding the Seal of Good Housekeeping. The seal is a warranty statement that promises that Good Housekeeping will replace a product or refund the purchase price if the product bearing the seal proves to be defective at any time within one year of purchase. This "insurance policy" covers all the products advertised in the magazine. In addition, products accepted for advertisement can carry the Seal of Good Housekeeping on their products and advertisements for one year. The seal expires with the termination of a one-year seal license agreement.

The institute charges only for the advertisement, which also covers the costs of approval and the seal. Producers who participate in the program see the cost of approval and achieving the seal as a part of their advertising budget, a valuable investment that enhances their reputation, not a burdensome obligation.

Besides legally binding agreements, the Good Housekeeping Institute uses public announcements as a part of its enforcement mechanism. Since May 1995, the magazine has included "GH Institute Reports" that highlight research and product evaluations performed by the Good Housekeeping staff.

Benefits of Private, Voluntary, Consumer Protection Programs

The Council of Better Business Bureaus, the Consumers Union, and the Good Housekeeping Institute are all voluntary programs. Through such tools as memberships, advertisements, company records, and product reports, they promote consumer protection.

They monitor and evaluate a wide variety of products and services and provide an additional quality check.

These examples, all from the United States, show that private regulation by independent third parties provides benefits often sought through state or federal regulations. Through mechanisms like standard setting, testing, certification, monitoring, brand approval, and warranties, they provide truthful information about goods and services they regulate and help people make informed choices. They help consumers to evaluate risks correctly and increase people's willingness to pay for safety, quality, purity, and effectiveness. Independent third parties also urge firms to disclose information about their products and increase the firms' willingness to produce products that are safe, pure, and effective. Third parties are flexible and responsive and can keep up with technological innovations and advancements. More important, because independent third parties are financed through voluntary participation by businesses, they can justify the costs accruing from their actions. Private regulation by independent third parties is a real alternative to federal regulation and must be recognized in the context of a regulatory reform.

Conclusions and Policy Recommendations

The Congress and the Clinton administration have been seriously considering different regulatory reforms for more than five years now. Proposals and attempts at regulatory reform (including the proposals under the Reinventing Government plan) have tended in one predictable direction: allocating even more time and resources to correct the existing system. None of the reforms has reduced the overall burden of regulation on the American people.

In assessing different alternatives like congressional review, cost-benefit analysis, or page elimination, Congress and the executive branch have failed to see other alternatives that extend beyond the existing system. Any regulatory reform that would reduce the burden of regulation while keeping America safe and prosperous must heavily depend on market incentives. Private regulation by independent third parties is a real alternative that could serve as a model for such reform. Regulatory reformers should consider the following proposals.

First, recognize the costs of coercive regulation and the benefits of the alternative model of private regulation. Many attempts to reform the regulatory system consist of comparisons of the current regulatory agencies with some ideal model. In fact, there is a huge world of private regulation that regulators, members of Congress, the president, and journalists are oblivious to. The existence of those independent third parties proves that the federal government is not the only source of standards and rules that increase the safety and quality in our lives. Therefore, the first step in a regulatory reform should be simply to recognize and come to understand all the important activity that is taking place without government direction. Further research and investigation could allow for comparison of coercive regulation with an actual model, putting the costs and benefits of

the current federal regulatory system in perspective.

Second, transfer certification and inspection processes to independent agencies. Independent third parties perform certification and inspection duties in a shorter time and for a lower cost. They typically provide guidelines, standards, and other relevant criteria to the producers in advance, and render firm-specific recommendations, drastically reducing the time and money costs of regulation. They also perform frequent and effective inspections on the products that they certify. Delegating certification and inspection can drastically increase the effectiveness of existing regulations while reducing the costs borne by taxpayers.

The federal government should consider transferring testing, certification, monitoring, and inspection duties from all federal regulatory agencies to independent third parties. In this scheme, the regulatory agencies would still mandate the rules, regulations, and standards that they develop. However, the rules would be enforced through independent third parties, and all firms currently regulated would have to obtain certification from those organizations. The federal government should be able to grant any organization that demonstrates the necessary capacity the right to perform testing, certification, monitoring, and inspection. In that case, independent organizations should be able to seek authority in any combination of those duties. Some organizations might want to perform only inspections on products; other organizations might want to perform only product evaluation or testing. Such flexibility would create specialization, increase effectiveness, and reduce the costs of certification.

Independent organizations could charge user fees to the producers that seek inspection and certification. Federal regulatory agencies already charge such user fees in limited cases. Although user fees might increase the final cost of a product, they would also eliminate the tax dollars spent on certifications and inspections. At the same time, competing independent third parties, which are more sensitive to the burdens they impose on producers, would help to reduce the compliance costs.

Transferring certification and inspection would reduce the costs of regulation while making regulations more effective--a substantial improvement over the existing system. Empowering independent third parties to do certifications and inspections is a necessary step in reforming federal regulatory agencies.

Third, allow independent third parties to compete with federal regulatory agencies and with one another in standard setting. As of June 1997, many regulatory agencies identified significant barriers that prevented them from focusing on results.[100] Those barriers included major problems in identifying and collecting data that would demonstrate the effectiveness of the agencies' actions. Federal regulatory agencies also cited diverse and complex factors like business cycles and technological innovations that limit their capability to implement long-term policies. Regulatory agencies emphasized their lack of

control or influence over many of these actions. They identified a long and unpredictable time lag between policy implementation and achievement of results as a major barrier to performance evaluation. Using independent third parties merely to enforce the regulations set by federal agencies would not eliminate any of these problems.

Many independent organizations already set performance standards, prepare procedures, or do extensive scientific research on product safety, food safety, aviation safety, environmental safety, and health and occupational safety. Competing organizations update their standards more frequently. They avoid impractical and costly procedures without lowering the quality of existing standards. Competing independent parties also provide effective monitoring and inspections that largely prevent problematic products from reaching the market. Independent consumer agencies and business groups aid private regulation by performing additional checks on goods and services that reach the market. The federal government should make full use of this market-based system.

To make full use of the existing private regulation, the federal government should give the producers of regulated products the opportunity to choose between federal regulatory agencies and independent organizations as their regulatory authority.[101] In this scheme, any independent organization that demonstrates the capability to scientifically investigate a socially important topic should be able to develop and enforce standards. That would enable independent third parties to compete with federal regulatory agencies and with one another in the standard-setting process. It could create incentives for the organizations that already have extensive knowledge in a field to become involved in private regulation. It would also allow for more performance-based and results-oriented standards as opposed to detailed specifications or procedures.

In areas without well-defined property rights, like environmental regulation, degeneration of standards might be a problem. Competition between federal and independent organizations could elevate this problem by inducing independent third parties to match the goals set by federal regulatory agencies. In addition, competition among independent third parties would motivate them to present credible proof of their independence from the firms they regulate. To ensure the integrity of the system, the federal government should develop and enforce strict laws against misrepresentation. It could assume an educational role to increase public consciousness about problems like product safety, food safety, and environmental protection.

Fourth, allow businesses and consumers to opt out of private or coercive regulation. Although allowing a choice between federal and private regulation is an improvement over the existing system, mandating private regulation could destroy many desirable characteristics of independent third parties, such as their need to survive through reputation and efficient management. A crucial characteristic of private regulation is its voluntary nature. Independent third parties help consumers make informed decisions by providing truthful information about the goods and services they regulate, and they do it without government coercion. Experience in the United States shows that voluntary

certifications and inspections obtained by businesses increase people's willingness to pay more for quality and safety.

The federal government should let regulated businesses and consumers opt out of both private and federal regulation.[102] In such a scheme, all certifications and inspections by independent third parties would be voluntary, not mandatory. Consumers would be free to choose between different levels of quality and safety in various aspects of their lives, their workplaces, their homes, their food. Regulation would become an option, a way that businesses might choose to assure customers of various qualities, including health and safety.

Such a system might prove problematic for environmental regulation, especially where private property rights are hard to define and implement. In such cases, mandated regulation might be the only solution. However, where possible, the federal government should create and enforce private property rights for the environment, like tradable pollution rights for air or water. In cases where private property rights are enforceable, businesses should be allowed to opt out of mandatory private regulation.

In nonenvironmental areas like health, safety, and risk reduction, voluntary regulation could totally replace mandatory inspections, certifications, or testing. Consumers value safety, health, purity, and effectiveness in the products that they consume. With mandated regulation, consumers do not have the freedom to choose the level of quality and safety they desire in a given product. Where people can make informed decisions about their lives and their property, mandated regulations are not necessary. Even without mandated regulations, independent third parties would continue to serve the public by enabling consumers to correctly identify health and safety levels in goods and services.

Conclusion

Regulation is usually identified with state or federal government, but that is a misconception. Today there are many independent third parties that privately regulate a sizeable portion of market activity without government involvement. Examples investigated in this study show that these parties could match the benefits usually attributed to federal regulation, and at lower costs.

True regulatory reform should rely extensively on market incentives. A structural change in the regulatory system must start by recognizing the market-based examples of independent third-party regulation in the United States. Incorporating independent third parties into the regulatory process will eliminate the existing command-and-control system and replace it with a flexible, responsive, and evolutionary process. It will drastically reduce the compliance costs of regulations by decreasing the time and other resources spent by businesses and private individuals. It will also increase the choices available to

the American people and reestablish the freedom to choose. Such a reform promises a net improvement over the existing system

Notes

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1. Christopher Douglas, Michael Orlando, and Melinda Warren, "Regulatory Changes and Trends: An Analysis of the 1998 Budget of the U.S. Government," Center for the Study of American Business, Policy Brief 182, August 1997, Table A-4, p. 31.

2. For example, the number of regulations with an economic impact of $100 million or more has been increasing since 1980. For details, see General Accounting Office, Regulatory Reform: Information on Costs, Cost-Effectiveness, and Mandated Deadlines for Regulation (Washington: Government Printing Office, March 1995), p. 25.

3. This number is adjusted for 1997 dollars. It includes on-budget costs, compliance costs, and paperwork costs estimated in 1995. For further details see Thomas D. Hopkins, "Regulatory Costs in Profile," Center for the Study of American Business, Policy Paper no. 132, August 1996; Thomas D. Hopkins, "Cost of Regulation: A Report to the Regulatory Information Service Center," August 1991; and General Accounting Office, Regulatory Reform: Information on Costs.

4. This phrase is taken from President Clinton's remarks at the REGO event, in Arlington, Va., on March 16, 1995, where he talked about reinventing government and reinventing the regulatory system. "First we recognize that market mechanisms generally make more sense than micromanagement by the government." White House, Office of the Press Secretary. (http://www.pub.whitehouse.gov/white-house-publications/1995/03/1995-03-16-remarks-of-president-at-rego-event.text, September 1997)

5. Murray Weidenbaum, "An Ambitious Agenda for Economic Growth," Center for the Study of American Business, Policy Brief no. 172, September 1996.

6. Unless there are contracts, disputes in commerce are handled by the tort law, which is concerned with wrongs that do not arise from contracts. For details, see G. Edward White, Tort Law In America: An Intellectual History (New

York and Oxford: Oxford University Press, 1980), p. xi.

7. Aaron Wildavsky, Searching for Safety (New Brunswick and London: Transaction Books, 1988), p. 170.

8. For a brief history of the American Tort Law, see ibid., pp. 171-76.

9. For example, see various essays in Peter W. Huber and Robert E. Litan, eds., The Liability Maze: The Impact of Liability Law on Safety and Innovation (Washington: Brookings Institution, 1991).

10. These consequences include increased negligence by consumers, abuse of the liability system, and "deep pocket" effects, where injured parties are more likely to sue wealthier agents. For details, see Wildavsky, pp. 178-92. In addition, each year Americans spend on tort suits the equivalent of Sweden's entire output. The total expenditure on tort cases adds up to 2.3% of the gross domestic product. This number is only 0.6% in the United Kingdom, 0.7% in Japan, 0.9% in Canada, and 1.2% in Germany. Pietro Nivola, "Inside Outsourcing: More Bad News from Business Regulation?" Brookings Policy Brief no. 8, November 1996. (http://www.brook.edu/ES/POLICY/POLBRF8.HTM, September 1997)

11. If people do not evaluate risks correctly, market outcomes can be equally flawed. Studies show that people tend to overestimate risks associated with lower probabilities and underestimate risks with higher probabilities. Risk evaluation might also depend on external effects such as how publicized an event is. W. Kip Viscusi, John M. Vernon, and Joseph E. Harrington Jr., Economics of Regulation and Antitrust, 2d ed. (Cambridge, Mass.: MIT Press, 1995), pp. 662-63.

12. Douglas, Orlando, and Warren, Table A-4, p. 31.

13. Ibid., p. 1.

14. Richard K. Vedder, "Federal Regulation's Impact on the Productivity Slowdown: A Trillion-Dollar Drag," Center for the Study of American Business, Policy Study no. 131, July 1996, p. 11.

15. Ed Rubenstein, "Right Data," National Review, July 14, 1997, p. 18.

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19. For further details, see Regulatory Reform: Implementation of the Regulatory Review Executive Order (Washington: Government Printing Office, September 1996).

20. Ibid., p. 17.

21. Hopkins, "Regulatory Costs in Profile."

22. For further details on the burden of regulation on small businesses, see Thomas D. Hopkins, "Profiles of Regulatory Costs," Report to the U.S. Small Business Administration, November 1995.

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26. The annual risk of death in populations exposed to formaldehyde is 6.8 in 10 million. W. Kip Viscusi, "Economic Foundations of the Current Regulatory Reform Efforts," Journal of Economic Perspectives 10, no. 3 (Summer 1996): 119-34.

27. Hopkins, "Profiles of Regulatory Costs," Table A-1.

28. Hopkins, "Regulatory Costs in Profile," p. 17.

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30. For details, see Dale Jorgenson and Peter J. Wilcoxen, "The Economic Impact of the Clean Air Act Amendments of 1990," Energy Journal 14, no. 1 (1993): 159-82.

31. Vedder looks at the relationship between regulatory activity and change in productivity while controlling for taxes, budget deficit, population change, fuel prices, and services. His model can explain 90% of the variation over time in productivity growth, and attributes nearly half of the productivity slowdown since the last year of the Kennedy

administration to regulatory expansion. For details, see Vedder, "Federal Regulation's Impact on the Productivity Slowdown: A Trillion-Dollar Drag," Center for the Study of American Business, Policy Study", no. 131, July 1996, p. 20.

32. These studies show economic progress to be far more important than medical technology in explaining longevity. For a detailed survey of studies on life expectancy, health progress, wealth, and economic progress, see Wildavsky, pp. 59-69.

33. Viscusi, p. 130.

34. Robert M. Goldberg, "Food and Drug Administration," in Cato Handbook for Congress, D. Boaz and E. Crane, eds. (Washington: Cato Institute, 1997), Chapter 32. (http://www.cato.org/pubs/handbook/hb105-32.html, September 1997)

35. Ibid.

36. Noel Campbell, "Making Drugs Safe and Available without the FDA," National Center for Policy Analysis, Policy Report no. 208, January 1997, p. 3.

37. According to Campbell, FDA's slowness in approving Misoprostol, a drug 94% effective in preventing bleeding ulcers, might have caused 8,000 to 15,000 deaths. FDA took two years to approve thrombolytic therapy, a treatment estimated to prevent fatalities by up to 18% by dissolving the blood clots in heart attack victims. Two years of approval time equals 22,000 heart attack fatalities that might have been prevented by faster action. Beta-blockers, effective in preventing heart attacks and coronary failures, could have saved 10,000 to 20,000 lives per year during the three years when they were not available in the United States. Ibid., pp. 3-4.

38. William G. Laffer III, "How Regulation Is Destroying American Jobs," Heritage Foundation, Backgrounder no. 926, February 13, 1993, p. 1.

39. Antonelli, p. 91.

40. According to Nivola, a recent survey of 500 U.S. medical equipment manufacturers found that more than 60% of them plan to commercialize advanced devices overseas before introducing them, if at all, in the United States. More than 90% of the surveyed companies cited the long FDA prod-

uct review requirements. Nivola.

41. For example, Mark Petrusi of Green Seal said many firms that seek certification for their products perceive the seal as one of their marketing tools. Phone conversation with Mr. Petrusi, June 23, 1997. Also, according to Joe Regenstein of Cornell University, companies that obtain kosher certification usually pay less for the approval of a certain product than they would pay for a medium-sized ad in the New York Times. Many food producers see kosher food certification fees as a part of their advertising costs. Phone conversation with Prof. Regenstein, June 3, 1997.

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43. Underwriters Laboratories Inc., "1996 Annual Report, Notes to the Consolidated Budget Sheet." (http://www.ul.com-/about/anrep/anrep8.html, August 1997)

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48. Robert Tollison, "Institutional Alternatives for the Regulation of Drugs and Medical Devices," in Advancing Medical Innovation: Health, Safety and the Role of Government in the 21st Century, Ralph Epstein et al., eds. (Washington: Progress and Freedom Foundation, 1996), pp. 17-40.

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