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From Food to Finance: What Makes Disclosure Policies Effective?

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Public transparency systems—requirements that government or private-sector entities inform the public about their products or performance—have become a mainstream form of governance in the information age: nutritional labels to reduce risks of heart disease and cancer; auto fuel-economy and rollover ratings to conserve energy and save lives; factory-by-factory reports to reduce toxic pollution; bank disclosures of mortgage lending practices to reduce discrimination; public school performance ratings to improve the quality of education; employers' reports to employees about hazardous chemicals in the workplace to reduce health risks; candidates' campaign finance disclosures to reduce corruption.

At the core of these laws is an elegantly simple idea: government intervention to require the disclosure of information can create economic and political incentives that advance important policy objectives. This idea is not new. Harnessing the power of information to serve public purposes has long been a familiar feature of United States' financial policy. Since 1933 Congress has required publicly traded companies to report their profits and losses in order to reduce risks to investors. The new generation of laws requires a broader range of public and private entities to disclose information in order to reduce risks to health and safety, improve public services, or minimize corruption. Whatever their goal, public transparency systems all require organizations to publicly disclose factual information about products and practices structured for comparability to serve a public purpose.

It is not surprising that public transparency systems have emerged in recent years as an important third wave of modern regulatory innovation. In the 1960s and 1970s, a time of optimism about the capacity of government to solve public problems, innovation in social regulation emphasized rules and penalties. In the 1980s, a time of unusual optimism about the capacity of market mechanisms to solve public problems, regulatory innovation embraced taxes, subsidies, and trading systems. Now, in a time of optimism about advances in communication and information technology, regulatory innovation emphasizes transparency.

At best, transparency policies advance public priorities by combining ordinary citizens' interests in making more informed choices with

The Transparency Policy Project

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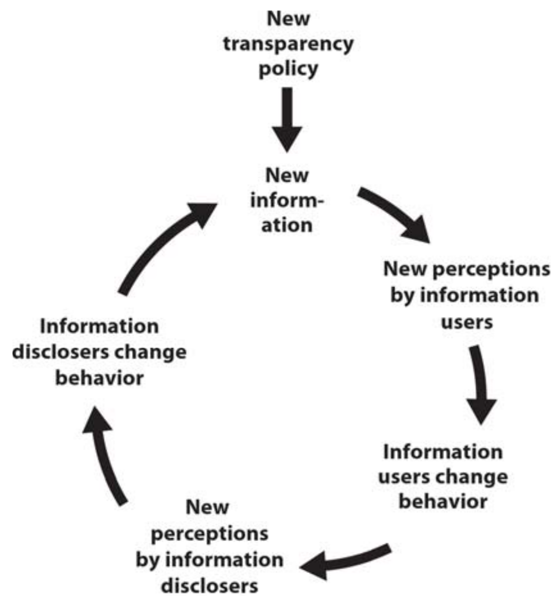
Table 1: The Transparency Policy Action Cycle



organizations' interests in improving their competitive position.

"At best, transparency policies advance public priorities by combining ordinary citizens' interests in making more informed choices with organizations interests in improving their competitive position."

However, more information is not always better. Inevitably products of political compromise, public transparency systems can be constructed in ways that do not advance policy goals. If poorly designed or executed, they can cause organizations to over-emphasize some public goals at the expense of others. They can confuse ordinary citizens so that their choices are counter-productive. They can be captured by narrow interests or grow outdated as markets and priorities change. Or they can simply waste resources because information is ignored. Our analysis of 15 public transparency systems in the United States reveals that some are highly effective in advancing important policy goals, some prove only moderately effective, and others are ineffective.

How Do Transparency Policies Work?

Effective public transparency systems trigger a virtuous chain of action and reaction. First, consumers, voters, or other information *users* react to new facts by changing their perceptions and behavior. Second, manufacturers, political candidates, or other information *disclosers* change their perceptions and behavior in response to users' actions in order to improve their competitive advantage. Thus the transparency action cycle is powered by the invisible hand of self-interested choices – influenced, however, by the very visible hand of government disclosure mandates.

The Transparency Policy Action Cycle

Transparency systems are likely to be effective only when they produce new information that becomes embedded in the everyday decision-making routines of both those who

use information and those who must disclose it. For that reason, the starting point for designing public transparency systems is an understanding of the ways in which new information meshes or clashes with everyday routines.

Los Angeles County's restaurant grading system, adopted in 1997, provides a simple example of how a public transparency system can improve public health by embedding new information in individual decision-making. Restaurants must display government grades of A, B, or C in their front windows. The grades reflect restaurants' scores on an inspector's 100-point checklist that takes off points for rodent droppings, unsafe food storage, lapses in employee hand-washing, and so on. Potential customers get information they care about and could not otherwise obtain in a form that makes comparison shopping easy and at the time and place they most need it. Restaurant managers have a powerful incentive to improve their hygiene. Research suggests that overall restaurant hygiene has measurably increased, and the number of hospitalizations due to food-related illnesses has significantly dropped.

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The familiar U.S. system of corporate financial reporting, recently tightened up as a result of accounting scandals in 2001 and 2002, reduces risks to investors by embedding new information in market participants' decision routines. Publicly traded companies must disclose their profits, losses, and financial risks in standardized formats at regular intervals. Brokers, analysts, fund managers, and other intermediaries use publicly-mandated information to advise clients and make investment choices. Companies, in turn, are extremely attentive to investors' responses to such information, since they are reflected quickly in stock prices. The system, initially adopted in the 1933 and 1934 Securities and Exchange Acts after millions of investors lost their savings in the stock market crash of 1929, has improved over time – often in response to crises that revealed design flaws or new attempts to game the system.

Sometimes public transparency systems work synergistically with conventional regulatory strategies. The Home Mortgage Disclosure Act, enacted in 1975 and significantly strengthened in 1989, requires banks to disclose information on mortgage lending by race, gender, census tract, and income level. When early data from this system suggested discriminatory practices, Congress approved a Community Reinvestment Act, which allows regulators to use disclosed mortgage-lending information as one factor in deciding whether to approve banks' requests for mergers and acquisitions.

Obstacles to Effective Transparency

Even policies that manage to embed information in decision-making routines may fail to become effective either because information users' goals are not the same as those of policy makers or because information users or disclosers misinterpret information.

Users and Policy Makers' Goals May Differ

Consumers, investors, employees, and other information users employ newly disclosed information to advance their own priorities. When those priorities do not mesh with those of policy makers, public transparency systems can produce perverse effects. For example, the public goal of nutritional labeling was to reduce the risks of heart disease and cancer by encouraging both production and consumption of healthier foods. The goal of many shoppers,

as it turned out, was to lose weight. When dieters focused simply on cutting calories, they often did not reduce the most serious disease risks, which were linked to over-consumption of saturated fats. Similarly, the public goal of so-called Megan's laws, which require disclosure of the place of residence of convicted sex offenders, was to enable residents to avoid offenders and increase their watchfulness. However, some neighbors employed the information to conduct vigilante attacks on offenders.

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Misinterpreting New Information

Even if information users' goals do mesh with those of policy makers, there are many ways information can be misinterpreted. The effectiveness of nutritional labeling, for example, depends on hurried shoppers checking nutritional labels and understanding how the information translates into health benefits. Likewise, the effectiveness of disclosure of toxic pollution or auto rollover risks depends partly on how well complex data concerning risk is comprehended.

Cognitive shortcuts that help make sense of new information may also lead to misinterpretation. Researchers have shown that people tend to overestimate the risk of more dramatic or gruesome events like shark attacks and earthquakes while discounting more mundane but probable threats like heart disease and auto accidents.

The Future of Transparency Systems

Public transparency systems represent a particularly promising form of information-age governance. When systems are designed to embed new information in decision routines and when obstacles can be minimized, transparency can advance public priorities in new ways. At best, such systems promote market processes, democratic participation, and individual choice. However, the benefits of transparency are not automatic. Such systems present daunting challenges for policy makers, businesses, and citizens. Continual advances in information technology expand the promise of these systems but also increase the danger of perverse consequences. Effective transparency systems require careful design, attentive enforcement, and periodic maintenance and repair. Transparency is likely to work best when it is used as part of a disciplined process that sets priorities, assesses probable impacts of alternative or complementary government measures, and provides architecture to minimize unintended consequences and provide for feedback and analysis about how the system is working. Nevertheless, there are likely to be many public priorities for which well-designed transparency systems may offer the most appropriate means of moving ahead.

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