Summary: Business Innovation Creates Policy Disruption

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Disruptive innovation has a technical meaning to business scholars. It signifies when a new firm picks off customers from an existing business, by coming up with a new product or service that is actually slightly inferior to the product or service offered by the existing firm. For instance, Airbnb offers up rooms in people’s homes in place of a traditional hotel room. Some (but not all!) disruptive innovations lead to what might be called policy disruption, in that they in some way challenge the current regulatory regime.¹

FOUR TYPES OF POLICY DISRUPTION

- **End-run** whereby the innovator is able to argue—notwithstanding similarities to the incumbent industry—that it is not subject to regulations that govern the incumbent. Think of Uber’s argument that it is not a taxi service and thus should not be regulated as such.

- **Exemption** in which the innovating firm fits into an express exemption in the law, but when the innovator scales up, it produces the same problems that the existing law was designed to address, raising the question of whether the exemption needs to be closed. For example: Let’s suppose a woman wants to rent a room in her private home. For privacy and personal comfort, she may legally choose to only rent the room to another woman, despite laws that protect against sex discrimination. But what if large numbers of female Airbnb hosts elected to do that same thing, and rent only to other women? That could create a social problem that anti-discrimination laws were designed to prevent.

- **Gap** where there is no existing regulatory regime that clearly applies to the innovator. Consider automobiles when they were first invented; there were no regulations governing their use.

- **Solution** where an innovation actually solves a regulatory problem, but which may be blocked by existing regulations from entering the market. A current example is distributed solar generation, which would solve aspects of climate change. But over-inclusive legal rules, which might require every individual desiring solar panels to apply for permission to the state utility commission to connect to the grid, would impede adoption of the technology.

HOW SHOULD REGULATORS RESPOND?

Just as there are four types of policy disruptions, there are four kinds of policy responses (although there is not a one-to-one correspondence between disruptions and responses):

- **Block** – Interpret legal rules so as to prevent the innovator from entering the market.

- **Free Pass** – Regulators allow the innovator into the market and do not apply the existing rules that govern incumbents. This is the most innovation-friendly option, but it can endanger if not doom the old business model, as has happened to taxis wherever Uber and Lyft operate.

- **Old Reg** – Apply existing rules to the innovating business.

- **New Reg** – Old rules do not fit, so regulators realize they need to write new rules to deal with issues raised by innovators.

¹ This policy brief is based on research published as Eric Biber, Sarah E. Light, J.B. Ruhl & James Salzman, Regulating Business Innovation as Policy Disruption: From the Model T to Airbnb, 70 Vanderbilt Law Review 1561 (2017), and Sarah E Light, Advisory Nonpreemption, 95 Washington University Law Review 325 (2017). The Three-Step Process chart appears at page 1610 of Regulating Business Innovation.
THREE-STEP PROCESS

STEP ONE

Does the existing legal regime treat the innovator differently from the incumbent based on its form of business organization?

Does it Block entry of the innovator and protect incumbents? Does it give the innovator a Free Pass to the detriment of the incumbent? Default principle should be organizationally neutral law.

STEP TWO

Should the neutral default be outweighed by public policy factors?

If yes: Block or Free Pass (non-neutral), depending upon whether the policy concerns outweigh neutrality principle.

If no: OldReg or NewReg (both can approach neutrality), depending upon whether existing rules can be applied to both the incumbent and the innovator, and whether the innovator raises any new policy concerns.

STEP THREE

Does the policy strategy upset an incumbent’s reliance interests, dilute revenue streams, or strains assets for the incumbent in ways that we should care about? If so, consider adding a Buy Out to the chosen strategy:

Free Pass: strongest case for a Buy Out
NewReg: weaker case for a Buy Out
OldReg: intermediate case for a Buy Out

CONCLUSION

Innovation in business is not only important for a strong economy, it is a natural response to changing technologies and consumer demands. Yet, it is the role of government to protect consumers from fraud, unsafe products, and general malfeasance. The three-step process outlined in this summary can serve as a general road-map for deciding how much regulatory oversight is needed to protect public interest while not tampering innovation.

Case Example: Autonomous Vehicles

AVs are an excellent subject for a study of policy disruption, to illustrate how we should regulate, as well as who should regulate. Current law puts the regulation of vehicles in to the hands of the federal government, as defined by the Motor Vehicle Safety Act of 1966, which makes the US Department of Transportation responsible for issuing vehicle safety standards. Regulation of drivers, however, is left to the states, which are responsible for licensing and setting insurance rules, traffic safety laws, and tort laws. The development of AVs, however, poses a policy disruption: Is the AV a "motor vehicle" or is it a "driver" . . . or is it both . . . or neither? And thus should regulation be left to the states, or to the federal government . . . or some combination . . . or none of the above?

WHO SHOULD REGULATE

Disruptive innovation (in the business sense) does not always lead to policy disruption. When it does, policymakers benefit from having a roadmap to make regulatory oversight decisions. If additional regulation is needed, “who should regulate” (state or federal government) may be part of the decision making process. Policymakers need to consider whether local or national concerns will predominate. There are four possible responses to the “who should regulate” dilemma:

• No regulation –private standards, self-regulation;
• Federal regulations preempt state laws;
• States regulate in absence of Federal law;
• Concurrent (dynamic) jurisdiction.