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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.

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NOTES

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.*

With all of the options, aside from the Block, a secondary policy question also arises: What, if anything, should be done for the incumbent firms? Should incumbents be compensated in some way for the market changes produced by the entry of the innovating business? The question of a buyout should be separate because we don't want regulatory system to be picking winners and losers, or to inhibit access to innovations that people find useful.

Aspects of Uber pertain to all of the possible policy responses. When Uber and Lyft first launched, Philadelphia, for instance, initially instituted the Block, declared them illegal and prohibited their drivers from operating within the city. Other locations instituted the Free Pass, allowing Uber and Lyft to operate without requiring that they comply with regulations applied to taxis, while others took an Old Reg approach, bringing Uber and Lyft into the local market while applying at least some of the current regulatory regime—for example, background checks for drivers. And then there were places such as California that implemented a New Reg response, creating an entirely new type of entity called a transportation network company, with its own rules and requirements. (At the same time, some localities also may have adjusted rules for taxis.) And then came the question of buyouts—for instance, taxi medallion owners in New York City who have brought suit against the city over the decline in the value of their medallions when the city failed to block the entry of Uber and Lyft.

From a business perspective, what should regulators be concerned about, with respect to balancing innovation with the public interest? Focus on substance over form. Unless there is some public interest that dictates otherwise, treat incumbents and innovators equally under the law if they provide the same product or service, even if they deliver it in different forms.

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?

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*

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.

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.