oppose retrospective legislation in general terms, it was the only way that the government could move at a time when tax evasion and avoidance were not being distinguished by some practitioners and the government could not cope with the significant proliferation of tax schemes. They seemed to be part and parcel of the behaviour of the business community, the professional groups and others – if not of the whole community, a very significant part of them. No amount of self regulation and chest beating by bodies such as the Institute of Chartered Accountants, the various law societies, etc was able to stop the proliferation of these schemes. Decisive action was needed by the regulator or by Parliament in these circumstances.

So whilst I continue to favour the use of self regulation, especially in those areas where regulation itself does not work or work as well (eg in the regulation of the professions) there must always be a willingness to regulate in other areas (eg environmental law).

Conclusion

Such remarks are probably of little value to most readers. I can provide you with no "magic pudding" or deep philosophical thoughts about how a regulator should act. Many said that during my term at the Commission we did good things; others felt we did not do enough. We certainly did as much as I think we could with inadequate laws, inadequate resources and a rather lukewarm Ministry and Department to support it. A momentum, however, was created. Pressure has been put on the government; and we will see what transpires in due course.

Responsive Business Regulatory Institutions

John Braithwaite

Debate about business regulatory institutions tends to proceed as a glorious battle between those who believe that business actors (individuals and firms) are fundamentally untrustworthy, and therefore must be coercively controlled, and those who plead that business people are responsible, capable of ethical self-regulation. Plausible evidence of the capacity of business for rapacious self-interest can be trotted out on one side of the debate. Credible case studies of the capacity for responsible reflection and ethical reform in business can be produced on the other side of the debate. It does not get us far to observe that which side of the debate gives a more compelling account of reality depends on the context. In this context business actors are self-interested scoundrels; in that context they are open to ethical suasion.

While such contextual understanding is clearly a valuable thing to acquire, it leaves unsolved the most fundamental question about the design of institutions. This is whether our institutions should be designed for knaves as counselled by Hume[1] and Hobbes,[2] or whether they should assume that citizens will be virtuous. For example, it can be argued that even if business is virtuous in a majority of contexts, one

In this chapter, I draw upon and extend work in Ayres, I and Braithwaite, J, "Designing Responsive Regulatory Institutions", in *The Responsive Community*, (in press) and Ayres, I and Braithwaite, J *Responsive Regulation: Transcending the Deregulation Debate*, New York, Oxford University Press, 1992. I express my appreciation to Ian Ayres for the large contribution he has made to developing the ideas expounded in this chapter.

1 Hume, D, "Of the Independency of Parliament", *Essays, Moral, Political and Literary*, Vol 1, London, Oxford University Press, 1963.

2 Hobbes, T, *De Cive*, New York, Appleton-Centry-Crofts, 1949.

case of knavery can have such disastrous consequences (a Three Mile Island, a Chernobyl, a Bhopal, a thalidomide) that regulatory institutions must be designed more with an eye to these worst cases than to the modal case.

This in fact is the line that Geoffrey Brennan and James Buchanan[3] take in *The Reason of Rules*. They argue for institutions that economise on virtue on grounds that the harm inflicted by those who behave worst will not be compensated for by the "good" done by those who behave better than average. Brennan and Buchanan assume that these worst case actors will be rationally non-virtuous. Hence, the solution lies with market institutions that are constituted so as to aggregate the self-interested rationality of the non-virtuous to nevertheless achieve virtuous ends.

Can we then build into the micro-foundations of our theories of institutional design the assumption that citizens will be virtuous? Do we design institutions on the assumption that actors will be rational economic actors? My thesis in this article is that we should decidedly not do any of these things. We should not design institutions based on motivational assumptions that are static. Dynamic institutional design that is responsive to multiple and changing human motivations will serve us best.

It is through focusing on the distinction between dynamic and static institutional thinking that I seek to rise to the challenge articulated in Sampford and Wood's chapter of integrating law, ethics and institutional design. It is through thinking dynamically about regulatory institutions that we can take seriously the need to nurture business virtue as emphasised in Bob Solomon's chapter, without being so naive as to believe that we will accomplish something by waving ethics texts in front of the glazed eyes of our most gruesome corporate criminals. It is through thinking dynamically about the fashioning of order that we can allow a thousand corporate ethical subcultures to bloom, as commended in Amanda Sinclair's chapter, while sustaining corporate and community-wide commitments to mobilise the power of the state against corporate subcultures that are unconscionably exploitative of other citizens, especially powerless ones. Finally, dynamic institutional design is needed to solve the crisis of chronic

3 Brennan, G and Buchanan, JM, *The Reason of Rules: Constitutional Political Economy*, Cambridge, Cambridge University Press, 1985, at 59.

under-resourcing of regulatory enforcement which is a theme of Bob Baxt's chapter.

The trouble with institutions which assume that people or firms or corporate subcultures will not be virtuous is that they destroy virtue. Some agencies that regulate business, particularly American agencies, tend to do just this. I have observed the tragic little drama of virtue being destroyed many times during my empirical research on business regulation. The government inspector marches into a workplace and starts making threats; citations are written; most critically, both the demeanour of the inspector and the policy that stands behind that demeanour communicate the expectation that the manager on the receiving end of the encounter is untrustworthy. The regulator communicates the assumption that it is only compulsion, or only the bottom line, that will move the manager to submit to the policy of the law. But this assumption is often wrong. The safety manager may deeply care about the safety of her workers, and she resents, bitterly resents, being treated as if she does not care. This resentment can destroy her good faith, her willingness to go an extra mile beyond what the inspector asks her to do. Common sense and a wealth of experimental psychological research[4] instructs us that when human beings are compelled to do something their commitment to doing it erodes. More precisely, commitment erodes in comparison with a situation where they voluntarily choose to do that thing because they are persuaded that it is the right thing to do.

Instead of institutions that economise on virtue, we need institutions that give actors space to be virtuous. Regulatory institutions can be designed to nurture rather than destroy civic virtue in the business community. At the same time, we need tough-minded regulatory institutions that can shift to a hard-headed approach when virtue fails, as it often will.

4 McCord, J, "Facts, Frameworks and Forecasts", (1992) 3, *Advances in Criminological Theory*, pp 115-135; Bandura, A, *The Social Foundations of Thought and Action*, Prentice-Hall, Englewood Cliffs, 1986, at p 478; Boggiano, AK, Barett, M, Weiher, AW, McLelland, GH and Lusk, CM, "Use of the Maximal-Operant Principle to Motivate Children's Intrinsic Interest", (1987) 53 *Journal of Personality and Social Psychology*, pp 866-879; Lepper, MR "Social Control Processes, Attributions of Motivation and the Internalisation of Social Values", in Higgins, ET, Ruble, DN and Hartup, DW (eds) *Social Cognition and Social Development: A Sociocultural Perspective*, New York, Cambridge University Press, 1983.

Hence, I favour regulatory institutions that first attempt to solve problems by persuasion and dialogue, that open regulatory interactions with an assumption of good faith commitment to implement the spirit of the law, even if this involves going beyond the letter of the law. When this fails, regulatory response should escalate to deterrent threats of increasing severity that progressively shift the motivational assumption from the desire to be law-abiding to the desire to protect the bottom line.

Sometimes, however, this shift to the rational actor assumption will also fail. A flaw with the Brennan and Buchanan analysis for economising on virtue is that it assumes that the worst cases will be rational non-virtuous actors. Yet some of the very worst cases will be "irrational" resisters to government authority. There are actors in the Australian and American business communities who have a "live free or die" attitude to resisting government regulation. The Mine Safety and Health Administration inspector confronts an extreme case of this type when an Appalachian mine owner chases him off the property brandishing a gun. But not all cases of business being impervious to rational deterrent threats are this extreme.

Nor is this irrational resistance to regulatory threats the only way in which the rational actor model of regulation fails. John C Coffee Jr has explained that regulators will often confront what he calls a deterrence trap because so many kinds of business crime have very high rewards and low probabilities of detection.[5] Let us imagine that a certain type of illegal stock market manipulation has only a one in a hundred chance of being detected and proven beyond reasonable doubt. The average returns from this kind of crime are $10 million. It follows that the fine required to deter the rational offender who gets an average return is over a billion dollars. If we want to deter those who get higher than average returns, the fine must be indeterminately higher. The state can then confront a deterrence trap: if it imposes the fine required by the rational actor model, it may bankrupt the firm or it will at least so deplete the liquid assets of the firm that workers will lose jobs, plants will not be built. Governments always hold back from punishments that hurt innocent workers, communities and creditors in this way, and with good political and economic reasons.

5 Coffee, JC Jr, "No Soul to Damn, No Body to Kick: An Unscandalized Inquiry into the Problem of Corporate Punishment", (1981) 79 *Michigan Law Review*, p 386.

Yet another way in which the rational actor model will fail is when non-compliance is caused neither by rational pursuit of self-interest nor by irrational resistance to the state, but simply because management of the firm is technically incompetent to comply with the spirit of the law. Most Third World pharmaceutical manufacturers are in this category, as were most pre-FDA US manufacturers. They are, or were, in the jargon, "bathtub" manufacturers. Similarly, many nursing home operators in the United States and Australia are not competent to care for large numbers of frail aged with multiple health problems.

When the state is in a deterrence trap, when it confronts an irrational resister, or a firm which lacks the technical capacity to comply, it should abandon the rational actor model. Ultimately, it should threaten instead corporate capital punishment. In the discourse of criminology, this means an incapacitative response instead of a deterrent response. What we advocate is that the state display an enforcement pyramid where, at the peak of that pyramid, the response of the state will be to withdraw the licence or charter of the corporation, to put the firm in liquidation, remove management, and sell the firm as a going concern to new owners who put in new management.

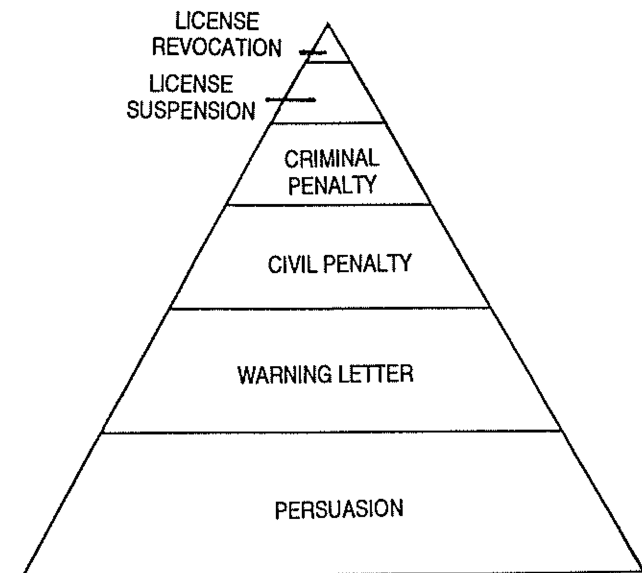

Figure 1: Example of an enforcement pyramid. The proportion of space at each layer represents the proportion of enforcement activity at that level.

Figure 1 gives an example of a regulatory pyramid. In my book with Ian Ayres, *Responsive Regulation: Transcending the Deregulation Debate*, we provide a detailed defence of this and other kinds of enforcement pyramids. Let us not worry about the detailed content of each layer of this particular example of an enforcement pyramid. It is the form of the pyramid and the abstractions that underpin its dynamic design that are of interest to us here.

At the base of the pyramid, regulators assume and nurture virtue – corporate responsibility (or ethical commitments within a corporate subculture as Amanda Sinclair might prefer to conceive it). When virtue fails, regulatory strategy shifts through escalating deterrent responses. When deterrence fails, strategy shifts again to an incapacitative response. Static assumptions about the motives of regulated actors are jettisoned in favour of a dynamic design with the feature of nurturing virtue as a first recourse and the most drastic interventionist remedies as the last resort. Instead of economising on virtue, Philip Pettit has pointed out that our model economises on motivation. A dynamic design is adopted that can be responsive to multiple motivational configurations.

A paradox of the pyramid is that the signalled capacity to escalate regulatory response to the most drastic of measures channels most of the regulatory action to the co-operative base of the pyramid. The bigger the sticks at the disposal of the regulator, the more it is able to achieve results by speaking softly. When the consequence of firms being non-virtuous is escalation ultimately to corporate capital punishment, firms are given reason to cultivate virtue.

Lop the top off the enforcement pyramid, put in place nothing other than a system of rational incentives – civil penalties or taxes on harm – and the firm is given little reason to cultivate business responsibility. Instead, it will act like a rational taxpayer which will evade taxes whenever this pays, challenge regulatory decisions in the courts when this pays, and generally do the minimum that the law can be practically enforced to require. This means adversarial, legalistic regulation which will settle for lose-lose solutions in circumstances where co-operative regulation could deliver win-win solutions. In the cases of the irrational resister to law and the technically incompetent firm, they will be chronically non-compliant and be either taxed to the hilt or constantly before the courts. In these cases, the lose-lose losses will be even higher than in the rational actor case.

I am suggesting that pyramidal forms of responsive regulation hold out the possibility of nurturing the virtuous citizen, deterring the venal actor and incapacitating the "irrational" or dangerously incompetent actor. What I am arguing for is a much more radical change of attitude than one that simply calls for a mix of regulatory strategies. My belief is that there is no prospect of a consistent law enforcement approach to any type of business regulation. To operate consistently near the peak of the enforcement pyramid would be far too costly for the taxpayer in any area of business regulation of which I know.

My response to that problem is more radical than simply harbouring scarce resources by saving tough enforcement action for the "really bad" business people. The attitude I advocate is a preference for starting at the bottom of the pyramid even with the "really bad" actor. The thesis here is that "really bad" people in fact have multiple selves: there is a virtuous side to even the very worst of us. Regulation should be designed to encourage generally irresponsible actors to put their best self forward. We should be ambitious about the quest for virtue in the worst of us. Christians are required to adopt this view. But non-Christians as well can discover that actors we stereotype as evil can surprise us with the way they put their ethical self forward when we treat them with a respect that communicates an expectation that they will do so. Hence, I am against a mixed enforcement strategy that picks ethically bad and good actors and responds appropriately. My favoured attitude is to look for the virtuous side of all actors, try working with that first, and then escalate to more coercive approaches only when appeals to the better nature of people fail.

Now many people have expressed the concern that this is naive, or dangerous, or both. I do not deny that bad people will often exploit being treated as if they are good. That is why it is necessary to stand ready to escalate up the pyramid in such cases. I point out, however, that "good people" often exploit being treated as if they are good. The fact is we are not very astute at picking which are the good and bad actors, especially when the actors are business firms, because good and bad character is so context-specific in the way it is manifested. Hence, a regulatory strategy that picks IBM as a firm of good character (because in most contexts it is), and consistently responds to IBM as such, will have some terrible consequences in selling out the public interest to the interests of IBM. This is why selective static matching of tough strategies for bad actors and self-regulatory strategies for good

actors fails as a way of dealing with the fiscal impossibility of a consistent law enforcement approach to business regulation.

The concession I make to the understandable concern mentioned above is this. There will be cases where rather early during a regulatory investigation, it will become clear that there is no chance of appealing to the better nature of a business wrongdoer in relation to the particular matter at hand. Indeed, perhaps escalating straight to nothing short of corporate capital punishment and seizing all the assets of the offender will solve the problem. As a matter of fact, it can be a good thing for the credibility of a regulatory program that from time to time this will be the case. A regulatory system that moves early, decisively and ferociously to bring a Bond Corporation or a Quintex to heel strengthens its arm with the whole business community. Cases of quick escalation to catastrophic enforcement gives all business actors reason to put their responsible selves forward at the first whiff of regulatory grapeshot.

Putting this another way, regulators should go into *all* regulatory encounters with an attitude that they prefer to solve the problem in the least coercive, most co-operative, way possible. They should also go into *all* regulatory encounters with a preparedness to abandon this attitude, regardless of their preconceptions of the virtue or otherwise of the business actors they are dealing with. If they do this, they will often enough need to abandon the starting preference for co-operative regulation. This policy, in other words, will generate a regulatory program with a credible deterrent record. And in Australia, we surely do need regulatory programs with more credible enforcement records.

Of course, it will be a deterrent record that will be deficient on the criterion of enforcement consistency, as Tony Coady and some of the other essayists in this volume have pointed out. Retributive principles are compromised by a system that allows evil actors who do evil deeds to negotiate packages of remedial reforms to compensate victims and prevent further wrongdoing. Elsewhere, Philip Pettit and I[6] have addressed this concern about the parsimonious approach to punitive escalation that we favour.

Our contention is that certain sociological facts about industrial societies make it inevitable that most crime will go unpunished and that the crimes of the rich will be more unpunished than the crimes of the

6 Braithwaite, J and Pettit, P, *Not Just Deserts: A Republican Theory of Criminal Justice*, Oxford, Oxford University Press, 1990.

poor. No philosophy of punishment can deliver consistent punishment of wrongdoers in proportion to their wrongdoing. Retributivism can deliver this in an ideal world, but in no sociologically possible world. The practical question then becomes which of all the philosophies of punishment will deliver the most equitable punishment practices in a possible world.

Pettit and I argue that policies of systematically preferring non-punitive problem solving whenever this works, policies we derive from a republican moral and political theory, will deliver more equitable punishment in contemporary Western societies than either the status quo or retributivism. This is because they are policies that require the release of most of the offenders currently serving time in our prisons, while requiring and enabling rather more frequent escalation to punitive responses to white-collar crime than we currently manage. Retributivism, in contrast, systematically exacerbates a situation where "just deserts" are successfully imposed as a first or second resort for the poor, while almost never being imposed even as a last resort by business regulatory agencies overwhelmed by their caseload of complex investigations. So Pettit and I argue for the irony that a theory based on parsimonious punishment that does not set justice as one of its goals will achieve a better measure of justice than retributivist theories that set their sights on justice.

Conclusion

The responsive regulatory institutions I favour assume that even the worst of us has some sense of care and responsibility to which appeal can be made, that all of us have moments when we can be persuaded by rational economic incentives, and that all of us contain the dark potential for intransigent resistance to appeals to our reason, responsibility and rationality. Responsive institutions reject static reifications of rationality or responsibility because they are designed to respond flexibly to the fact that each of us has unique conceptions of what it is to be responsible or rational. Instead, responsive institutions seek to nurture virtue and dialogue about different conceptions of right action at the base of a regulatory pyramid.

Early recourse to coercive threats is less likely to elicit a response that is worthy of our respect than a dialogue that treats the business actor with respect. Responsive institutions take seriously private

Beyond Command and Control:

Towards Flexible and Cost-Effective Business Regulation

Neil Gunningham

Introduction

Traditionally, the central policy mechanism invoked by government to achieve its goals in areas of social policy has been the law. More specifically, the favoured mechanism has been "command and control" government regulation, whereby legislatures proscribe certain behaviour and set up a regulatory agency to monitor and police compliance with the legal standards. Although this mechanism never completely displaced other forms of social control, it was nevertheless the "reigning conception" that guided policy making for many years. It still has many adherents today.[1]

Yet the use of regulatory agencies to control the behaviour of business and corporations is fraught with difficulty. By the late 1970s it was evident that much "command and control" regulation had not turned out the way policy-makers had planned. It was alleged that many regulatory agencies were characterised by unnecessary adversariness and delay, that regulations were often inflexible, unduly

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An earlier version of this chapter was delivered at the Conference "The Future of Regulatory Enforcement in Australia", Australian Institute of Criminology, Sydney, February 1992. I am indebted to John Braithwaite for his insightful comments on this paper.

1 See for example, Latin, H, "Ideal v. Real Regulatory Efficiency: Implementation of Uniform Standards and 'Fine Tuning' Regulatory Reforms", (1985) 37 *Stanford Law Review*, pp 1267-1332.