

The iteration deficit in responsive regulation: Are regulatory ambassadors an answer?

John Braithwaite and Seung-Hun Hong

Regulatory Institutions Network, Australian National University, Canberra, ACT, Australia

Abstract

One reason that regulation is difficult is that repeated encounters between regulator and regulatee are rare. We suggest diplomacy as a model for reconfiguring regulatory institutions in response. Ambassadors for Regulatory Affairs who would be agents for all state regulatory agencies could be based in most large firms and small and medium enterprises that pose unusual regulatory risks. In rural towns, police would be trained as regulatory ambassadors. Just as a US Secretary of State can launch a “diplomatic surge” in Myanmar from 2009, so regulatory surges are possible in market sectors of high risk or high opportunity. We propose strategies of indirect reciprocity as a way in which reciprocity that is only episodic in these strategic ways can promote more general responsiveness. Indirect reciprocity is reciprocity that we do not personally experience, but learn from the experience of a culture. This means that so long as we sustain regulation as a relational as opposed to a purely technocratic process, indirect reciprocity might civilize regulatory compliance in an historical process informed by the theories of Elias and Putnam.

Keywords: diplomacy, indirect reciprocity, responsive regulation.

1. Introduction: reciprocity as a scarce resource in regulation

Regulators face many difficulties: information challenges (discovering where bodies are buried); political challenges (working to political masters who like to be popular with business backers); and many more. The analysis in this essay is limited to just one of these other large challenges: repeat encounters between regulator and regulatee as the exception, rather than the norm. It has often been advanced as a criticism of responsive regulation (Ayres & Braithwaite 1992) that it depends on repeated encounters (Gunningham & Grabosky 1998, p. 404; Gunningham & Johnstone 1999; Scott 2004; Nielsen & Parker 2009; Ford 2011). This is because one important way that responsive regulation works is by escalating up a hierarchy of strategies, as regulated actors fail to respond to strategies at a lower level of the hierarchy. How can a regulator escalate up an enforcement pyramid in response to failure to respond to an earlier signal without repeated encounters? It is an approach that gives forbearance a chance to be reciprocated by reform or compliance, and redemption a chance at reciprocation by de-escalation down the pyramid. This reciprocity seems impossible without iterated encounters. Nor does tit-for-tat seem possible, as in a game-theoretic model of the evolution of cooperation (Axelrod 1984; Scholz 1984). Ayres and Braithwaite (1992) advanced such an iterated evolution of cooperation as one possible explanation for why a regulatory pyramid might work.

Correspondence: John Braithwaite, Regulatory Institutions Network, ANU College of Asia and the Pacific, Australian National University, Canberra, ACT 0200, Australia. Email: john.braithwaite@anu.edu.au

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While critics are justifiably concerned over reciprocity deficits making responsive regulation difficult in practice, the concern applies to some degree to all forms of regulation. One cannot replace command and control regulation of carbon emissions with a price on carbon without repeat encounters between regulated industries and new tax inspectors who ensure that recorded emissions are accurate. A pure education and persuasion model, like any kind of education, is hard to deliver in a single encounter between teacher and student. A police enforcement model based on prosecution at first evidence of breach of the law requires repeated encounters between the investigating officer and the suspect (and others who might testify). Usually it also involves more encounters than meet the eye. The suspect might hope that by granting the police officer access to a space without a search warrant or by voluntarily accompanying the officer to the police station without an arrest warrant, they might be less likely to be targeted by escalated investigation, compared to other suspects who are more combative.

One hypothesis derived from responsive regulatory theory is that when pyramidal approaches work well, they drive such a high proportion of regulation down to the cooperative base of the regulatory pyramid that regulatory inspection can secure compliance on the basis of *fewer* iterated encounters than a police investigation model. This is implicit in the claims of responsive regulation that it can achieve more regulatory coverage than a criminal enforcement model that ties law enforcers down in lengthy criminal investigations of a few cases. This aspect of responsive regulation has not been empirically tested.

The important point is that it is certainly hard to make responsive regulation work, and possibly any regulatory strategy work, without iterated encounters. The standard response of responsive regulators is to say that an implication of the theory is that we need to make the most crucial encounters more iterated to secure an evolution toward cooperative reform. The responsive regulator wants to see prudential regulators spending less time in their offices poring over quantitative risk models and more time visiting banks “kicking the tyres” (Braithwaite 2009, p. 440). The responsive regulator wants to see tax officials spending a higher proportion of their scarce resources visiting strategically chosen taxpayers, compared with time re-examining tax returns (Braithwaite 2005; Braithwaite *V. et al.* 2007). Responsive regulators pointed to evidence from the United States that when a full-time resident inspector is located at a coal mine with a corner-cutting safety culture, the best of these resident inspectors worked with management, unions, and local communities to challenge that safety culture. Mines selected for having an unusually high risk profile in the US were put into the resident inspector program; these mines finished with accident and fatality rates that were well below the national average (Braithwaite 1985, pp. 82–83).

The purpose of this article is to develop a prescription that puts more flesh on these bones and to suggest a research strategy to explore its merits by starting with a focus on the study of Key Client Manager innovations in South Korean and Australian regulation. The idea is transforming regulatory practice and institutions to render them structurally more focused on iterated encounters with human beings out in the field, less focused on processing pieces of paper. Since the 1990s, the way responsive regulatory implementation has been rolled out in tax administration, and, to a lesser extent, in other domains, such as securities regulation (Kingsford-Smith 2011), gives a clue to our final destination. Some tax offices and securities regulators have permanently located Key Client Managers in the offices of many firms for many years now (Braithwaite 2005, pp. 74–80). On the other hand, they “blitz” iterated short visits upon market segments or individual firms feared to be low in compliance. Responsive regulatory advocates then pointed to programs like the Transfer Pricing Record Review Project that targeted iterated encounters up and down a regulatory pyramid on companies with high levels of international

profit shifting to raise an extra billion dollars in tax revenue for each million dollars spent on the program (Braithwaite 2005, pp. 89–97). These are only incipient late twentieth century manifestations of the policy solution we seek to consider. Studying them is the start we propose toward advancing our empirical understanding of prospects for more richly relational regulation. First, however, we seek a more sophisticated relational vision by learning from a long-entrenched policy exemplar, diplomacy.

Our plan is first to discuss how diplomatic surges work, and then we compare this with regulatory surges in contexts where reciprocity is a scarce resource. The next section considers how Ambassadors for Regulatory Affairs would work, followed by a consideration of our proposed reconfiguration of rural policing in accordance with the diplomacy model. Finally, we reflect on the experience of diplomacy as a resiliently useful institution because it relies more on indirect reciprocity than direct reciprocity. Likewise, a diplomacy model of regulatory transformation might work through indirect reciprocity. The reasons it might not work, we argue, could be more about resistance from entrenched regulatory bureaucracies who repel surrender of their regulatory prerogatives to collaborations.

2. Blitzes where reciprocity is a scarce resource

2.1. Diplomatic surges

The President or Secretary of State of even the best-funded diplomatic endeavor, the US government, does not have the capacity to interact with all of the world's foreign ministers. Yet they can and do put on diplomatic surges with focused groups of nations when there is a priority diplomatic opportunity or risk. The other principal remedy is for states, even the poorest among them, to post permanent Ambassadors to the capitals of states that are diplomatically critical to them. Top-down diplomatic surges supply episodic focused reciprocity; Ambassadors provide continuous middle-out reciprocity, though only in key capitals. While an instructive model, in an era where so many civil wars start in rural areas (Autesserre 2010), diplomacy repeatedly runs up against the limits of diplomats cloistered in the embassies of national capitals. As with regulatory inspectors, diplomats need to get out where they “get their boots wet” (an expression from Hawkins's [1984] environmental inspectors). This is just to say that while diplomats cannot be everywhere, diplomatic surges need to go right down to rural hot spots in central Africa, as opposed to cocktail parties in Geneva, when those are the rural spaces that are igniting wars.

2.2. Regulatory surges

The diplomacy model for managing reciprocity has some (admittedly faint) resonances in regulatory practice. We have mentioned the Key Client Managers scheme, which has existed at the Australian Taxation Office (ATO) since the 1990s. This program is oriented to the largest or highest-risk companies that over periods of many years have an ATO auditor with a desk inside the corporate headquarters, but also visiting internal auditors on their travels around key operating sites. As with diplomatic deployment, one rationale for the policy is improving relationships and communication, and a second is improving intelligence by being close to the spaces, people, and transactions where bodies are buried.

At the individual level, the High Wealth Individuals Task Force was established in 1996, an Australian innovation that at least a dozen other national tax administrations have emulated since 2000 (OECD 2009, p. 56; for cases to 2009) after Australian success in increasing revenue from the wealthy individuals targeted. The targeting here was of 142 individuals and the set of companies they control (expanded to 700 by 2004). The initial intent was to target individuals

who had \$30 million in assets, but paid less than \$20,000 in tax. Most had much greater wealth than this, and in at least one case had paid no tax at all since 1987! Iterated relationships were established, not so much with them personally, as they were busy running the country, but with their accountants. Another responsive program of this sort by the ATO was the Promoters Task Force that worked with promoters of tax shelters to negotiate and monitor compliance plans. Because a number of these promoters were enforcement targets for non-tax regulatory agencies, whole-of-government plans were developed to curtail their aggressive gaming of the law across a number of arenas. This also seemed to achieve some success in shutting down the 1990s tax shelter boom in Australia (Braithwaite 2005).

An example from a different domain is the On-site Supervisor Program of the Financial Supervisory Service (FSS) of South Korea. The FSS led intensive restructuring of a financial sector recovering from the Asian financial crisis of 1997–8. It is responsible for micro-prudential supervision of financial firms. Since 2001, the On-site Supervisor Program has been oriented to banks, insurance, and securities companies showing negative signs in their management. On-site supervisors are dispatched to a firm with a broad brief to monitor corruption and illegality, inspect regulatory systems, improve relationships with other auditors, investigate the firm's risk level, and prevent escalation of potential financial crises. Eighty-one cases of on-site supervisors have been posted from the FSS mutual savings bank department alone, which has most actively run this program.¹

In prudential regulation, as with tax, there is more mundanely cyclical targeting of a wide range of types of financial actors. The idea is to communicate the possibility that the tax office may eventually get around to focused targeting on any and all vocations. In practice, targeting a vocation like academia may happen when there is some policy change that needs to be consolidated into compliance, say a change in the way academics' professional libraries are depreciated. The year when such a change comes in may be the time when academics are chosen for their summer of iterated encounters with tax auditors.

In summary, we might say that targeted surges to complement permanent missions (Key Client Managers) in tax administration have tended to take the form of blitzes. This philosophy has been influenced by Malcolm Sparrow's *The Regulatory Craft* (2000). Sparrow's advice is against regulators spreading themselves thinly across a wide terrain of problems, collecting reams of information that are rarely used. Rather, his advice is to "pick important problems and fix them," in the fashion of a busy US Secretary of State (2000, p. 133). This essay is not about suggesting which kinds of problems should be picked for iterated encounters of one kind or another. That answer will be very different for different kinds of regulators in different countries. Seung-Hun Hong's comparative empirical research program on the weaknesses and strengths of Key Client Managers will cast some light on this question for the first time.

Tax administration is, of course, an unusual case for drawing any lessons, both because of the large number of actors it must regulate – all the companies, partnerships, trusts, individuals in a country – and because tax administrations usually have very large numbers of regulatory personnel. It is harder for small agencies to locate permanent missions or to mount any surges. Nevertheless, there is a long history of innovative approaches to doing so.

From the nineteenth century, a tiny regulator, the Coal Mines Inspectorate in the state of Queensland, Australia, supervised many mines that were taking large numbers of miners' lives, as in China today, but with few staff to supervise them. They legislated for elected worker "check inspectors" to undertake tests for methane gas levels before every shift entered a mine and for various other powers that the state delegated to them. Later the state took over paying the salaries of these mine site workers (Braithwaite & Grabosky 1985, p. 43).

With nursing home inspection in the US, state government aged care inspectorates were so overwhelmed with getting the basics of nursing home inspection done that “picking important problems and fixing them” was something they rarely managed to do. In 1987, one of the interesting elements of a legislative reform package accomplished by the National Citizens’ Coalition for Nursing Home Reform required staff of all nursing homes to meet with their resident representatives to reach agreement on one quality of care problem that they would target as a priority of their choice (Braithwaite J. *et al.* 2007). That law did not specify anything about what the problem they pick to fix should be. It just required that it be chosen and a plan of action to fix it recorded, along with a methodology for measuring its accomplishment. Similar approaches were adopted in subsequent continuous improvement and continuous learning enforced self-regulation approaches to Australian nursing home regulation (Braithwaite J. *et al.* 2007, pp. 198–214). Another response in both the US and Australia has been government funding for Community Visitor and Ombudsman programs staffed mainly by volunteers who are concerned about aged care standards (often based on experiences with their own family members), with limited numbers of state-funded professionals to back up volunteers in the worst circumstances.

While such innovations show that responses are available to the problem of non-repeated encounters, the difficulties remain so endemic, especially for small agencies, that more radical reconfiguration of regulatory institutions might be considered as a remedy. It is to this we turn in the next section.

3. Reconfiguring regulatory institutions

3.1. Ambassadors for Regulatory Affairs

One feature of Ambassadors in foreign capitals is that they represent every agency of their home state. Wealthier states have specialists from some of their most powerful agencies – the trade ministry, defense, the intelligence service – but the state agencies of most states are represented by generalist diplomats in most foreign capitals. This introduces one of the challenges of diplomacy that would be bound to be replicated in regulatory diplomacy. Some state agencies are more powerful than others and different agencies frequently impose contradictory demands upon diplomats. So let us consider adapting this move to the reciprocity dilemmas of the regulatory state. All of the most important firms might have permanent state Ambassadors for Regulatory Affairs located within their offices. In the US context, this would go beyond the entire Fortune 500. It would include all significant firms in highly sensitive industries, such as defense contracting, mining, pharmaceuticals, nuclear power, and banks. These ambassadors would operate in the fashion of On-site Supervisors of the South Korean FSS or Key Client Managers of the ATO, but across all regulatory functions. Regulatory Ambassadors may have a staff that is a mixture of specialists and generalists, as in any diplomatic embassy.

They would be a liaison not only to the tax authority or to the securities regulator, but to both, and also to environmental, occupational health and safety (OHS), prudential regulators if they were a bank or insurance company – indeed to all state regulators. Their key interlocutors would be board audit committees and ethics committees, controllers, chief financial officers, corporate compliance groups, and specialist compliance groups, such as safety committees. Just as the latter private actors are bridge-builders who assist with enabling private power to be more “permeable” to public power (Parker 2002, pp. 38–43), so would Ambassadors for Regulatory Affairs supply public bridging capital.

One hope for Ambassadors for Regulatory Affairs is that they might leverage systemic improvement in compliance systems, audit, complaint handle, and learn from critical incidents at their firm that would be of benefit across all domains of regulatory compliance. Specialist regulators find it hard to justify systemic improvement diagnostics with one firm when there are manifest risks at a long list of other firms. They also fall down on sifting single firm intelligence for the same reason. They fail to pick up learning from critical incidents at a single firm that might drive what Parker (2002, p. 277) calls “triple loop learning” across a whole regulatory system in how to treat risks or seize opportunities for improvement.

While Ambassadors would be less expert in all substantive areas of regulation, they would become more expert at business diplomacy and at triple loop learning. So the Ambassador idea involves a trade-off between solving the problem of thin relationships and the technical competence problem. As with international diplomats, part of the craft of the diplomat is being good at knowing what expertise one lacks, knowing what part of one’s state or civil society has the expertise, and knowing how to build a bridge that expertise can travel across when it is most desperately needed. Sometimes the ambassador-generalist solution will be radically suboptimal. This happens when bridges are no substitute for having the expertise of a specialist regulator in place. Diplomacy has accumulated wisdom in how to make particularistic judgments about contexts where a generalist diplomat should call in a specialist. For example, many great trading cities of the world that are not national capitals are dotted with consulates staffed by a trade specialist from the home state, with no generalist diplomat to be found in the consulate. A military attaché may be found unaccompanied by generalist diplomats in rural war zones far from capitals.

Likewise, regulatory diplomats and their specialist staff need to spend much of their time “getting their boots wet” at the site level where so many problems arise. Many sites are significant enough to need their own ambassador supported by specialist staff, such as a nuclear power plant, a large environmentally and safety-sensitive mine, or an abattoir where there are constant tensions among consumer health, animal welfare, environmental, and occupational safety concerns. There are contradictory demands, for example, over the frequency and methods for washing blood from wet floors and managing large animals that are not killed cleanly. An advantage of the resident Ambassador is that they cannot pretend that these contradictory demands do not exist, pushing the contradiction onto the abattoir that decides, for example, to meet the demands of the food inspectors to wash down floors more frequently because they are more feared than OHS inspectors who demand dry floors for workers. Better regulation might come from sensible brokering of the contradictory demands by a diplomat whose job is to facilitate dialogue, discover optimal compromises, or innovate into third ways that are best discovered through on-site dialogue grounded in familiarity with local context.

A secondary function of a Ministry of Regulatory Affairs that deployed generalist regulatory Ambassadors would be nurturing coordination among state regulatory agencies. Strategic coordination among different state regulators has tended to be weak, so this might be a significant benefit. A cadre of regulatory generalist diplomats built up through ambassadorial experiences might help lay bare some of the gaps between regulators, contradictions, and missed opportunities in the rule of regulatory law and policy. A well-designed Ministry of Regulatory Affairs could also enhance accountability as a new node of oversight for captured, corrupt, or unreasonable regulators. The Ministry of Regulatory Affairs could have its own parliamentary oversight committee and a structure of consultative committees with civil society and business to enhance accountability up to the parliament and down to the people.

Ambassadors would need to make their intelligence function work to direct specialists from specialist regulators to targets from a large number of possible sites at which blitzes might be directed. This includes small and medium enterprise (SME) sites upstream and downstream from large firms that can be revealed as non-compliant from large firm intelligence sources. Conversely, SME blitzes by specialist regulators would need to be harnessed to provide intelligence to regulatory ambassadors at large firms upstream and downstream from SMEs. As with international diplomats, regulatory diplomats would be at risk of “going native,” becoming “captured,” and so would require the same remedy of optimized rotation. This is a different kind of trade-off. Rotations that are too long risk excessive capture by the powerful political actors of the local site; overly short rotations cut off reciprocity and the acquisition of specialized local knowledge before these are sufficiently matured.

The Australian Prudential Regulation Authority (APRA) sees its targeted specific issue audits as a check on the auditing of frontline Responsible Supervisors designated to one bank, and vice versa.² That is, there are times when a special purpose audit calls a bank’s Responsible Supervisor to account for failing to pick up a problem at their bank detected in the blitz across all firms. Conversely, the Responsible Supervisor sometimes calls the specialized auditor to account for failing to pick up something that they subsequently detect at their firm as a result of their superior intelligence. More mundanely, these two branches of regulatory management collaborate to each improve their work with the rather different kind of intelligence the other function generates. APRA sees this as an important management virtue where the biggest problems at the biggest players are doubly checked.

3.2. Returning police to their roots

Implementing Key Client Managers or On-site Supervisors is a strategy that is only likely to be effective and affordable at the sophisticated center, at or near the commanding heights of capitalism. To uncover a strategy that has worked at the periphery of capitalism, we now turn to the history of “police” as regulation. 1829 was a watershed year for the regulatory state. It saw the creation of the London Metropolitan Police. Much was decisive about this watershed; we will argue that a distinctive path dependency of the regulatory state flowed from it globally (see also Bayley & Shearing 1996; Ericson & Haggerty 1997; Johnston 2000). One shift was the rapid globalization in the course of the nineteenth century of police as paramilitary organizations specializing in one principal form of regulation – criminal law enforcement. This globalization was of a different conception of police from the dominant conception in Europe and North America in previous centuries.

From late medieval times, “police” had meant village and town constables who were regulatory generalists. Police had the same Greek etymology as politics and policy. In addition to regulating theft and violence, constables would regulate alcohol licensing, vagrancy, pollution into streams, weights and measures and other consumer protection, usury, the monopolies of guilds, forestry and hunting, community safety from sources that ranged across unsafe food, unsafe roads, unsafe machinery, unsafe mines, unsafe animals: the whole gamut of regulatory functions.³

After police became crime control specialists, from the mid-nineteenth century, new specialist regulatory agencies, such as the Alkali Inspectorate, factory inspectorates, mine inspectorates, weights and measures and health inspectorates, and workhouses to regulate the poor began to spring up to pick up functions the new Peelian police had sloughed off. This new late modern specialization in regulation worked well in many ways, but only in cities. Inspectors almost never got out to factories, shops, or sources of pollution or unsafe food located in rural

areas at long distances from their city offices. Regulatory scholarship, like regulatory practice, is myopically urban in orientation, neglecting the dysfunctionality of the regulatory state for rural people in all societies, and particularly its dysfunction in societies where most people are rural. Rural disadvantage is an important injustice in many countries. It is greatly increased by monopoly prices and unregulated exploitation that afflicts rural people.

Police continued to have a presence in rural towns and villages, but no longer saw themselves as responsible for non-criminal regulation. Rural people, especially in countries like Australia where rural spaces are vast, missed out on the benefits of the regulatory state (Braithwaite 2008). The worst rural pathologies of regulatory states are in the least developed economies. Illegal logging of the tropical forests of the Solomon Islands by foreign firms has contributed to war, top-down corruption of a kleptocratic state, trafficking of arms on logging ships under the protection of that corruption, and the trafficking of children for sexual exploitation (Braithwaite *et al.* 2010). Braithwaite and Dinnen's fieldwork revealed that when chiefs complained to local police that multinational loggers were destroying their village livelihoods and environments, they were told that it was not a police matter. They should complain to the Forestry Inspectorate far away in the capital city. Because there were few forestry inspectors in the capital, and the cost of travel to the remote forests targeted for destruction is prohibitive, no one comes; no one is even called.

Braithwaite (2008, p. 30) proposed that rural police officers could be agents for all regulatory agencies, responsible for the triage of regulatory breaches large and small. If a consumer has a complaint about a butcher's scales selling them short, the rural police officer could investigate this on behalf of the consumer protection agency. If another complains of the only two gas stations in the town moving their prices in liaison as a duopoly, the police officer, on behalf of the competition regulator, drops around to remind them of their legal obligations. If allegations of pollution into a river are made, the local police officer would get down to the river promptly in search of obvious pollution sources and dispatch samples to the laboratory of the environmental regulator. Rural police in contemporary conditions are in repeated contact with most local businesses in their town on all manner of service call-outs. In a world where they became not only the local ambassador of the criminal law, but also an ambassador for all regulatory law, reciprocity would become even more iterated. Obviously, each rural police officer would need to cover a smaller patch than they do today in order to cope with these extra responsibilities and so would need to be paid more than contemporary rural police.

Rural police, under our model for reconfiguring the regulatory state, would attend some of the same training courses at the Ministry for Regulatory Affairs that would equip regulatory Ambassadors to large corporations. They would be provided with some of the same intranet resources of the Ministry for Regulatory Affairs on how to conduct a preliminary investigation, how to report to the competition authority on their findings in a price fixing allegation, how to capture and seal that pollution sample from the river.

So our proposal for reconfiguring regulatory institutions is now fleshed out, not only as scattering Ambassadors for Regulatory Affairs across the big firms listed on the world's major stock exchanges, across many high-risk sites of those firms, and across high-risk SMEs, but also across the smallest of towns, where prospects for iterated regulatory encounters with city-based inspectorates are most remote. In between, in city firms that are not large or priority targets of regulatory scrutiny, repeated encounters with regulators only happen when regulatory surges target specific issues for their industry sector, or when specific allegations are laid against their firm of a serious nature. This means that there is still a huge deficit in relational regulation, yet a greatly reduced one in comparison to current configurations of regulatory states.

3.3. Reconfiguring regulatory capitalism

An agency like a tax authority that regulates tens of millions of entities, of course, does very little of its iterated regulatory work with taxpayers themselves. It does it with tax preparers, many of whom have hundreds or thousands of taxpayer clients. Mostly, when someone taps a taxpayer on the shoulder and warns them that their conduct may be a breach of the law, it is their tax preparer, rather than a tax inspector, who does it. When a company is alerted that an aspect of a prospectus they intend to issue is illegal, it is more likely that warning will come from a law firm retained to assist with the prospectus, than from the securities regulator. This is an observation from the regulatory capitalism tradition (Levi-Faur 2005) that while state regulators are important, in contemporary conditions most regulation is undertaken in a private market for regulatory services. In that world, smart regulators harness those private providers of regulatory services to their compliance projects. They write to all the registered tax advisors to request that they please warn all their clients of an intention to implement certain enforcement surges in the coming year. They urge accountants to please use the year to ensure all their clients are maintaining the records necessary to document their compliance with these provisions. It is not then the state enforcement on these things during the next year that drives most of the compliance benefit; it is private enforcement in the market for regulatory services. It is a meta regulatory, rather than a direct regulatory, accomplishment.

It follows that while the reforms we propose are for the reconfiguration of the regulatory state, under conditions of regulatory capitalism most of the leverage of state regulators and state Ambassadors for Regulatory Affairs would be indirect. This is relevant to considering the important limitation of our proposal that it trades off specialized technical competence for enhanced reciprocity. We would worry about that more in a world where most state regulation was directly supplied by state actors, rather than by leveraging the technical competence of private providers of regulation. So we envisage the monthly meeting of the local police constable wearing her hat as the Ambassador for Regulatory Affairs, running through a checklist of regulatory surges likely to arrive in the coming months at a local chamber of commerce meeting:

I advise that the tax office will be conducting a blitz on employment related expenses, so please talk to your accountant about assuring your compliance in that area. There will be some spot checks that gas pumps are delivering accurate volumes, including in rural areas, so you would be wise to get your pumps checked by a certified service agent. The environment inspectorate is blitzing noise pollution around pubs and clubs. If your business is in that category, I have noise detection equipment that I can lend you to check your own compliance before you get into trouble. I recommend you do that collaboratively with your nearest residential neighbors so they get to see that you are in compliance and that you are checking compliance. Then you will get fewer illegitimate complaints from your neighbors. The occupational health and safety inspectorate has made available at this website a self-auditing tool for threshing machines and other farm machinery. Please pass word among your farm customers that if they correctly, carefully self-certify as compliant and a farm worker does happen to be injured, I will be spared the unpleasant task of arresting them for a work safety breach. Any questions that I can answer myself or pass on to get you an answer from the experts?

Such a return to a regime more like nineteenth century European rural *Polizei* would need to be evaluated empirically in terms of whether it would enhance or erode the legitimacy of the police in performing contemporary criminal enforcement functions. And we can imagine a comparable town hall meeting of the Ambassador for Regulatory Affairs to a large corporation

where various constituencies within the firm, and perhaps from without as well, are put on notice about the advisability of getting a compliance audit done on this or that. Likewise, empirical research would be needed on whether this local relational regulation would enhance or erode the legitimacy of specialist regulatory offices.

4. The strategy of indirect reciprocity

We turn now to theoretical developments in the concept of reciprocity to consider what we call the strategy of indirect reciprocity. Our argument here will be that even though Regulatory Ambassadors to corporations and small towns combined with regulatory surges elsewhere spread reciprocity thinly (albeit more widely and strategically than current practice), if surges are discharged with sufficient frequency and publicity, they may imbue indirect reciprocity in the compliance behavior of those not targeted by surges or Ambassadors.

4.1. Cultivating habits of civility

The message of invincibility that an enforcement pyramid is intended to give is not learned mainly through the personal experience of being pushed up a pyramid by a regulator. It is also learned through efforts by regulators to educate a community that a regulatory pyramid exists. It is learned by observing misfortune befall others who escalate up pyramids during surges. Most of all, good responsive regulators use outside-in regulatory design (Braithwaite 2005, p. 156), that is, the regulated industry participates in designing regulatory pyramids. Participation in the design and periodic redesign of regulatory pyramids is another path whereby leaders from the regulated community learn to play the game at the base of the pyramid, reducing the frequency and costs of iterated encounters at higher levels of the pyramid.

One idea here is that even when a social practice like diplomacy is transacted in one-shot interactions, those who have been socialized as diplomats learn habits of cooperation. That is, the diplomatic norm, even with enemies, is that cooperation is the normal response, with betrayal reserved as a response for exceptional circumstances where interests are seen as exceptionally profound. Diplomats generally do not learn that cooperation is normally the right response from iterated encounters in which they experience bad consequences of non-cooperation. Rather, they learn to be cooperative in their training. Secondly, because so many of the moves and countermoves of diplomacy are publicly known, especially to insiders of the craft, diplomats learn from observing escalated iterated encounters experienced by other diplomats. They observe escalations to war even if in their personal experience they never encounter an escalation that leads to such a serious outcome. Socialization for civility is the first line of defense against people being uncivil back to us. Observation of consequences from uncivil escalations by others is a second less important defense. Personal experience of how one's own uncivil behavior has had consequences is the least important path to learning civility.

Elias (2000) sees a long historical trajectory of "civilizing" processes in the west. The theory of indirect reciprocity is a useful lens for seeing the brilliance of Elias and his relevance to understanding all forms of regulation. Diplomacy is central to the history Elias recounts. "Courtly" good manners arise first in the courts of kings and nobles in the Middle Ages. Before the rise of "courtesy," knights achieved their objectives through largely unregulated violence. Unarmed citizens deferred to knights out of fear. As state structures consolidated, however, even powerful knights learned to live in worlds surrounded by others capable of killing them. In the court, knights learned to avoid upsetting others by following courtesies of diverse kinds. These averted aggravation of others: from refraining from spitting on the floor to blowing one's nose

on a tablecloth. These forms of bad manners became shameful, though only if perpetrated in the gaze of other members of the aristocracy. All such things could be done in the presence of servants or the middle class. But from that point, according to Elias's documentary history of manners, shame democratized as an emotion. Shame evolved into a Victorian emotion that could be experienced by aristocrats for doing something shameful in the presence of the lower classes.

This was one of the ways that shame became a more powerful regulatory tool during the past 700 years of human history. At the end of this civilizing process, aristocrats ceased regulating lower classes by wearing a sword in public (Braithwaite 1993, p. 3; Shoemaker 2001, p. 205). Instead, the gentry learned that life was safer when both duels with other sword-wearing gentlemen were avoided and when abrasive encounters even with the poor were averted by habits of civility that became more universalized. At the end of this historical civilizing process, polite, cooperative encounters with others were favored over uncooperative, abusive ones, first through habits of socialization for civility, only secondly through observation of how escalation could befall others, and only thirdly through personal experiences of escalation to violence arising from one's own rudeness. This is the social structure of civility that contemporary regulators inherit and harness when they have the wit to do so. Elias likened the court to a stock exchange where the repute of each "courtier" was continuously being formed and assessed. Later, when the division of labor became more complex, those of high rank found themselves more dependent on the lowly, and so all of social life became an exchange where repute for civility was being formed and assessed. Technological change was also significant in Elias. In a seventeenth-century world with little traffic, the aristocracy did not fear shameless rudeness to the lower orders as something that might trigger road rage. While we agree that Elias taps something sociologically fundamental about the long-run democratization of shame and civility and its connection to today's low homicide rates compared to the Middle Ages, genocides remind us that there is no unidirectional inexorability or irreversibility about this. Genocide happens because all regulatory strategies fail at times, from civility induced by indirect reciprocity up to armed intervention to resist genocidaires. The next section describes indirect reciprocity more abstractly as a civilizing and trust-building process.

4.2. Learning from others' experience: Indirect reciprocity

It is obvious that people learn habits of cooperation not only from their own experience, but also from the experience of others. The examples presented above suggest that learning from others' experience is a cheaper way to internalize the value of cooperation, even for society as a whole. This lesson and its underlying logic are well captured and presented in reciprocity literature. Reciprocity is usually defined as a pattern of mutually contingent exchange between two or more players (Malinowski 1926; Gouldner 1960). Gouldner (1960) presented a systematic account whereby a norm of reciprocity, once established, develops a beneficent cycle of mutual reinforcement because people involved in this cycle have internalized some general moral norm. This concept of reciprocity based on previous encounters became more articulated as economists and biologists sought to use formal modeling to explain the evolution of cooperation (Taylor 1976; Axelrod 1984; Boyd & Richerson 1988; Nowak & Sigmund 1992; Bowles & Gintis 2004).

While Gouldner did not give a sufficient answer as to why altruistic behavior comes out of egoistic motivations, these scholars sought to resolve that dilemma through what Gouldner called "an altruism in egoism, made possible through reciprocity" (Gouldner 1960, p. 173). For example, Axelrod argued that reciprocity does not require us to assume conversation, trust, or

altruism between players, the presence of central authority, or even their rationality, if there is an indefinite number of interactions between them (Axelrod 1984, pp. 173–174). In a Prisoner's Dilemma, people have incentives not to cooperate with each other in a single encounter because of the possibility that the other will take advantage of this and defect. If the game is repeated indefinitely, however, then tit-for-tat, as revealed in Axelrod's famous computer tournaments, tends to foster an evolution of cooperation.

While this reciprocity assumes that individuals repeatedly encounter a partner, theories of non-direct reciprocity have now been proposed to accomplish the evolution of cooperation even without assuming indefinite bilateral encounters. According to the current literature on indirect reciprocity, cooperation can evolve without direct interactions because people learn that socially cooperative actions can increase their future benefits, though not reciprocated by the recipient, in a social web in which individual and collective activities are continuously observed and assessed by numerous others (Alexander 1987; Nowak & Sigmund 1998a,b; Wedekind & Milinski 2000; Leimar & Hammerstein 2001; Ohtsuki & Iwasa 2004, 2006; Tullberg 2004; Berger 2011; Sigmund 2012). Indirect reciprocity is a newer theoretical framework based on acquaintanceship in which cooperation does not require the same two individuals ever to meet again. What matters is an individual's reputation in the community as a civilized member of it. Note the resonance here with Elias on civility in courtly diplomacy. People are more inclined to cooperate with individuals who have helped others in the past, who present in encounters with habits of civility, even if they have not met them before. Nowak and Sigmund claim that indirect reciprocity works because cooperation "confers the image of a valuable community member to the cooperating individual" (1998b, p. 573).

Two conditions may apply: first, iterated encounters must be common in a community, though not necessarily between the same individuals; and second, it must be possible for a player to estimate the reputation of the opponent (Nowak & Sigmund 1998b, p. 576). It seems that iterated encounters are not necessary when indirect reciprocity exists in a situation where an individual is assigned to a partner for a single round and their decisions are observed by other community members (Fehr & Gächter 2002; Diekmann 2004; Ahn *et al.* 2009). Nevertheless, it is essential that iterated encounters occur somewhere in the regulatory landscape so that they are available to be observed, and, thus, individuals get opportunities to increase their reputation and, therefore, "increase the chance of obtaining benefit in a future encounter as a recipient" (Nowak & Sigmund 1998b, p. 576). Individuals and firms may not rely mainly on reputation that has been built in the course of a specific regulatory encounter in the present, but in past encounters with that regulator on very different matters and with unrelated officials who may not even be regulators.

A Regulatory Ambassador would strategically choose her target. By making the most crucial encounters more iterated, she can give a lesson to other potential regulatees that they are lucky to avoid regulatory investigation at this moment, but still subject to future escalation risks. The strategy of indirect reciprocity should give a sense to others that they always need to build a civil reputation that will help them cope with the next uncertain encounter with a regulator. This is cooperation without future encounter, but with *risk of future encounter*.

The first element of indirect reciprocity (iterated encounters between others that can be observed) is closely related to a second element: to make the regulator's reputation so conspicuous that regulatees are persuaded to indirect reciprocation. This instructs Regulatory Ambassadors to promote an image and a practice of active relational engagement with regulatees. By building this kind of reputation in the community, a prudent regulator also utilizes the relationships and communication with regulatees to strengthen networks of reciprocity and social

capital. This delivers the social capital benefits theorized by Putnam as effects of generalized reciprocity (Putnam *et al.* 1993; Putnam 2000).

Putnam recognizes the importance of this indirect reciprocity if it becomes a norm when he explains social capital, even though he employs a slightly different term. Instead, he uses generalized reciprocity, when he says “even more valuable, however, is a norm of *generalized* reciprocity: I’ll do this for you without expecting anything specific back from you, in the confident expectation that someone else will do something for me down the road” (Putnam 2000, pp. 20–21).⁴ He adapts the norm of generalized reciprocity as a means for networks of civic engagement to engender trust and social capital: “A society that relies on generalized reciprocity is more efficient than a distrustful society, for the same reason that money is more efficient than barter. Honesty and trust lubricate the inevitable frictions of social life” (Putnam 2000, p. 135).

In the era of regulatory capitalism, whether regulators build trust relationally or distrust through betrayal of responsiveness is a rather critical variable in the constitution of Putnam’s generalized reciprocity. Regulatory Ambassadors should prefer to get into the field and communicate with people as Venetian resident ambassadors in fifteenth-century Renaissance Italy first did at the Holy See or at the court of the Holy Roman Empire (Beverley 1999; Fubini 2000). Because by doing so, they can enhance the communication and intelligence, and at the same time, create the networks of relational regulation, which will eventually become social capital assets. By employing this strategy, Regulatory Ambassadors can build up “a cultural template for future collaboration” in a world where reciprocity is a scarce resource (Putnam 1995, p. 67). The great accomplishment of diplomacy from which regulatory scholarship can learn is that it does constitute a template for future collaboration. As in the move from direct reciprocity in Axelrod’s tournaments, to indirect reciprocity, as in the Elias civilizing process in medieval courts, a key insight in Putnam’s theory of social capital is that socialization to a reputation for collaborative, iterated problem solving helps diplomacy to succeed. This means that the well-socialized novice in their first diplomatic encounter on an issue that has seen no previous encounters can succeed by leaning on the reputation of their diplomatic service for reciprocity, on its reputational social capital, by enacting its norms of civility. So can business regulators.

5. Conclusion

Ford’s (2013) critique of responsive regulation is that it can work with regulatory challenges of modest scale and complexity, such as factory inspection, partly because iterated encounters between inspectors and factory managers are possible. However, responsive regulation struggles to secure scalability to problems where direct reciprocity is difficult because of large scale. Ford wonders whether more technological, less relational strategies may be in order to manage these scalability challenges. Braithwaite (2013) sought to respond to that critique by arguing that technological fixes can be a poor substitute for the relational regulation needed to confront big problems, like global financial crises. We do not rejoin all those arguments here. We must add to them, however, the observation that diplomacy is a game of vast scale, conducted at the commanding heights of states and the United Nations and encompassing the whole globe. Even at the level of the diplomats with the most sweeping power (the US president, the UN Secretary-General), the game is overwhelmingly played as a relational one. Players of the game enact a culture of civility with strangers because of the power of indirect reciprocity in diplomacy, at least until there is a strong interest in being uncivil.

World leaders who are above assiduous relationship building with friends and enemies alike come to be viewed as failed statesmen. When leaders come to believe that the scale of a particular

problem, such as global terrorism, is such that relational diplomacy is best substituted by a new regulatory technology, this is when their diplomacy is most likely to explode in their face. Drones for assassinating foreigners are likely to become an example when those foreigners start killing your leaders with strikes by reverse-engineered drones. John and Robert Kennedy spurned relational diplomacy with their neighbor, Fidel Castro. They banned any contact of their citizens with his people and mounted assassination attempts against him and his brother Raul. Who knows the truth, but at least one possibility is Johnson's view that this may have backfired: "Kennedy was trying to get Castro, but Castro got to him first" (Weiner 2007, p. 235). Relational regulation of Castro might have been a better path for Kennedy than the distanced coercion that also led to the Cuban Missile Crisis. The "principled engagement" model President Obama has deployed with Myanmar and Iran is the more productively relational model (Pedersen 2008; MacAskill 2009). Technocratic fixes can be useful regulatory tools, but are likely to prove thin reeds unless bound to relational supports and social capital.

Our interest, then, is in developing models of regulation that promote general social science theory, not theory narrowed to business regulation. It is not about applying diplomacy per se to business regulation. Rather, the objective is to diagnose relational strengths of diplomacy as a regulatory practice when it works well. Diplomacy is regulation in the sense that it steers the flow of events (Parker & Braithwaite 2003). We hypothesize that indirect reciprocity in non-iterated encounters, relational diplomatic surges, socialization for civility, and trust building are the essence of diplomacy when at its best. Yet success is also underwritten by the power to escalate to coercion in international affairs.

Reciprocity deficits, like information deficits, political commitment deficits, and other large challenges of regulatory capitalism cannot be fixed by any simple reconfiguration of the regulatory state. Nor is nihilism in order. The strength of the institutional redesign proposed here is that it might enhance the quality of regulatory conversations (Black 1998) at the center and at the periphery of capitalist societies. Regulatory ambassadors might not do much for the huge urban middle of SMEs and people who work for them. That is the realm where regulatory blitzes, indirect reciprocity, and social capital would have to do the work. Regulators can learn something from diplomats about the value of being seen, even at a distance at cocktail parties, in building indirect reciprocity. Yet we know that the capacity to deliver many blitzes is limited, even if we can economize on their use by deploying Ambassadors at both the commanding heights and the periphery of capitalism. And there are limits to the reach of indirect reciprocity without backup by enforcement surges. This backup is, of course, at the heart of the theory of responsive regulation. More than a sword is needed to achieve the objectives of the ruling classes of regulatory capitalism. Both the regulators and the regulatees who command the economy need civility that is not dependent on iterated encounters, yet that is secured by smoke curling from a benign big gun.

Some of us have had the experience of meeting diplomats at a cocktail party in which we are staggered by their ignorance about some aspect of the country in which they ply their craft. That is an inevitable hazard of relying on generalists. At the same time, the Global Financial Crisis was a warning that regulation has not worked well in the trust of disconnected specialists. Whether Ambassadors for Regulatory Affairs located in every one of those Wall Street, Irish, Icelandic, British, and Spanish banks that caused so much grief could have reduced the damage is something we could only learn from future empirical experience with such an innovation. Seung-Hun Hong's current research on resident banking supervisors in Korea and beyond is a modest beginning to that empirical work. Further conceptual work on the intricacies of diplomacy models is also needed.

While our proposal is for a radical reconfiguration of regulatory institutions, it is one that lends itself to randomly assigning rural towns, large corporations, and SMEs to receiving and not receiving an Ambassador for Regulatory Affairs. It would be then possible to evaluate experimentally whether outcomes improved – from greenhouse gases released, workers injured, taxes collected, to streamlined regulatory compliance costs. Responsive regulatory theory, relational regulatory theory, the theory of indirect reciprocity and social capital, and the theory of civility that underpins the socialization of diplomats all supply arguments for why such experiments might succeed. Yet they might fail for more mundane reasons than the invalidity of these theories.

These include resistance from police and regulatory bureaucracies who are comfortable in their existing silos and fear lost legitimacy should they break out. They include rivalry between entrenched regulators who might collaborate ineffectively in the training of Regulatory Ambassadors. The most mundane reason for failure may be one we can already see with some of the least effective Key Client Managers we have interviewed in our preliminary research. They allow themselves to become little more than a post box for messages from head office, eschewing the relational challenge at the heart of the idea of on-site supervision. Hence, testing the outcomes of policy experiments with Ambassadors for Regulatory Affairs may be more useful than testing the theories that justify the policy idea. Like all policy ideas, it is bound to be wrong in many regulatory contexts because it is wrong as an implementable theory more than because it is wrong as an abstract theory. Discovering contexts for success and failure is also best addressed through iterated policy experiments.

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Notes

- 1 This is based on author interviews at the FSS in August 2013.
- 2 This is based on author interviews at the APRA in November 2013.
- 3 One place we get a contemporary glimpse of a sophisticated financial center that retains pre-Peelian generalist police regulation that is radically relational, is the channel island of Jersey. Miles and Raynor (2014) show that pre-Peelian police regulation that is not relegated to specializing in crime works well in securing compliance with its laws, a separate question from whether all its laws are ones we might endorse. Jersey is an extremely wealthy, diversified little economy that has innovated with many rich hybrids, most famously the Jersey cow. Miles and Raynor show how Jersey was a liminal state at the intersection of the great French and British maritime empires. It was able to assert its geography to establish a high degree of independence from both empires to preserve its restorative/relational medieval Norman customary law and regulation.
- 4 It should be stressed that Putnam's usage of the term "generalized reciprocity" has evolved. He defined generalized reciprocity, in his 1993 book, as opposed to balanced reciprocity, in that it refers to bilateral relations where "a continuing relationship of exchange . . . involves mutual expectations that a benefit granted now should be repaid in the future" (Putnam *et al.* 1993, p. 172). Some biologists have also adapted generalized reciprocity when they explain the evolution of cooperation based on prior experiences, irrespective of the identity of their partners (Pfeiffer *et al.* 2005). Later Putnam uses this term in a similar way to our usage of indirect reciprocity.

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